The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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April 15, 2011

ICI Draft Comment Letter on SEC's Proposal to Remove NRSRO References from Rules 2a-7 and 5b-3; Comments Due April 21

[25112]

April 15, 2011

TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 24-11
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 21-11
SEC RULES COMMITTEE No. 35-11 RE: ICI DRAFT COMMENT LETTER ON SEC'S PROPOSAL TO REMOVE NRSRO REFERENCES FROM RULES 2a-7 AND 5b-3; COMMENTS DUE APRIL 21

As you know, the Securities and Exchange Commission recently proposed to remove references to credit ratings of nationally recognized statistical rating organizations (NRSROs) from certain rules and forms under the Investment Company Act of 1940. [1]The proposed amendments give effect to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that call for the amendment of SEC regulations that contain any references to or requirements regarding credit ratings that require the use of an assessment of the credit-worthiness of a security or money market instrument.

ICI has prepared a draft comment to the proposal, which is briefly summarized below. Please provide your written comments to the draft letter on or before Thursday, April 21 to the undersigned at jheinrichs@ici.org.

Rule 2a-7

The SEC is proposing to remove references to credit ratings in Rule 2a-7, which would affect various elements of the rule, including: determination of whether a security is an eligible security; determination of whether a security is a first tier security; credit quality standards for securities with a conditional demand feature; requirements for monitoring securities for ratings downgrades and other credit events; and stress testing.

Eligible Securities

The SEC's proposal would eliminate the objective requirement that an eligible security be rated by an NRSRO or be of comparable quality while maintaining the division between first and second tier securities. We instead offer the following alternatives to the SEC's proposal. [Members: We are offering two alternatives for your consideration. The final letter can have both, one, or some other standard you suggest. Please let us know your preference.]

Under our first alternative, an eligible security would mean "a security with a remaining maturity of 397 days or less that the fund's board of directors determines presents minimal credit risks and to be of prime credit quality." "Prime" is a word commonly used to describe non-government taxable money market funds and the instruments they hold, and generally is understood to correspond to securities that would receive credit ratings in the highest short-term rating categories.

Alternatively, the draft letter recommends defining the credit standard as a "strong capacity to meet short-term obligations." Given that both Standard & Poor's and Fitch use variants of the word "strong" to define their highest short-term rating category, this should convey the appropriate standard.

Either of the proposed alternatives would eliminate the first and second tier categories and effectively limit money market fund purchases to those securities that meet one uniform, but very high standard (e.g., securities generally comparable to securities rated in the highest rating category (i.e., first tier securities under the current rule)). Without an objective, external ratings floor, the draft letter states ICI concerns that it would be difficult, if not impossible, to retain the current distinctions between first and second tier securities without exceeding the risk parameters currently dictated by the rule's rating requirements. The draft letter further recommends that a fund be allowed to hold a security until it matures even if the security no longer would qualify as an eligible security (i.e., fails to comply with the uniform high credit standard), provided it continues to present minimal credit risks.

Securities with a Conditional Demand Feature

Currently, a security subject to a conditional demand feature may be determined to be an eligible security or a first tier security if, among other things, (1) the conditional demand feature is an eligible security or a first tier security, and (2) the underlying security (or its guarantee) has received either a short-term rating or a long-term rating, as the case may be, within the highest two categories from the requisite NRSROs or is a comparable unrated security. Under the proposal, the SEC would remove the credit rating requirement and amend the provision to require that the fund's board (or its delegate) determine that the underlying security or any guarantee of such a security be of high quality and subject to very low credit risk.

The draft letter expresses concern that removing references to ratings from the requirements for conditional demand features could substantially increase the risk that money market funds would not be able to exercise these demand features following a downgrade. The draft letter recommends instead that Rule 2a-7 provide that, if a demand feature provides for its termination upon a downgrade of the underlying security by a credit rating agency, a money market fund cannot acquire the security unless the security (or its issuer or guarantor, as the case may be) has received ratings from such rating agency at least two full ratings categories higher (without regard to gradations or subcategories) than the highest rating that would terminate the demand feature.

Monitoring Minimal Credit Risks

The draft letter expresses concerns that by removing the objective trigger for reassessing minimal credit risk (i.e., credit rating downgrades), the SEC's proposal would establish a more burdensome standard for reassessing minimal credit risk that would require the fund's board or its delegate to reassess if the adviser "becomes aware of any credible information about a portfolio security or an issuer of a portfolio security that suggests that the security is no longer a first tier security or a second tier security, as the case may be." Without an objective trigger, the draft letter states that the proposed reassessment requirement is simply too vague and impossible to administer from a compliance perspective.

The draft letter recommends instead that Rule 2a-7's reassessment paragraph (c)(7)(i) be eliminated and paragraph (c)(10)(i) be redrafted to include a general ongoing obligation to monitor the credit risks of all portfolio securities (it currently only applies to securities by which maturity is determined by a demand feature). By acknowledging that funds must review their credit assessments under Rule 2a-7 on an on-going basis, there does not appear to be a need for a separate requirement to identify specific triggers for reassessment.

Stress Testing

Rule 2a-7 currently requires a money market fund to stress test for, among other things, ratings downgrades of portfolio securities. The SEC's proposal would replace this reference to ratings downgrades and require a money market fund to stress test for an adverse change in the ability of a portfolio security issuer to meet its short-term financial obligations.

Unlike the other provisions of Rule 2a-7 that reference credit ratings, the reference to ratings downgrades in the stress testing paragraph does not require an assessment of a security's creditworthiness. Rather, this paragraph of the rule simply refers to whether a downgrade of a portfolio security by an NRSRO would impact a fund. The draft letter expresses ICI's belief that Section 939A of the Dodd-Frank Act does not preclude the SEC from promulgating regulations that simply refer to existing credit ratings.

Form N-MFP

Currently, money market funds must provide to the SEC a monthly filing of portfolio holding information on Form N-MFP through EDGAR in an XML tagged and standardized data format. The proposal would eliminate items in the form that require disclosure of the ratings of the securities in the portfolio. Similar to the stress testing requirement discussed above, the references to credit ratings in Form N-MFP refer to existing credit ratings and are merely a collection of data points so regulators and investors will better understand funds' portfolios. Nevertheless, the draft letter states that ICI would not object to the removal of this information from Form N-MFP (which could be quite voluminous and not standardized if no longer limited to designated NRSROs), provided that it is clear that funds may choose to include ratings from one or more NRSROs in the monthly website portfolio disclosure required by Rule 2a-7.

Rule 5b-3

Rule 5b-3 under the Investment Company Act allows a fund, for purposes of meeting the diversification requirements in Section 5(b), to treat the acquisition of a repurchase agreement as an acquisition of the securities collateralizing that agreement if the obligation of the seller to repurchase the securities is "collateralized fully." For funds other than money market funds, for a repurchase agreement to be "collateralized fully," the collateral must consist entirely of cash items, government securities, securities that are rated in the highest rating category by the requisite NRSROs, or unrated securities of a comparable quality as determined by the fund's board of directors or its delegate. The SEC is proposing to replace the reference to NRSRO ratings with a requirement that the fund board (or delegate) must determine that non-government securities at the time the repurchase agreement is entered into are both issued by an issuer that has the highest capacity to meet its financial obligations and sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days. The draft letter recommends instead using an "exceptionally strong capacity" to repay financial obligations as the standard, which would be consistent with the definitions used by many rating agencies to define their highest long-term rating category.

Shareholder Reports

Mutual funds and closed-end funds currently are required to provide one or more tables, charts, or graphs depicting portfolio holdings by reasonably identifiable categories in shareholder reports (e.g., credit quality). If a fund chooses to use credit quality to present portfolio holdings, it must be depicted using the credit ratings assigned by a single NRSRO. Under the proposal, a fund that chooses to use credit ratings assigned by a NRSRO to categorize the credit quality of the portfolio holdings would be required to use the credit ratings of a single NRSRO except in the case of portfolio holdings that are not rated by that NRSRO. If credit ratings of that NRSRO are not available for certain holdings, the fund would be required to briefly discuss the methodology for determining credit quality for such holdings, including, if applicable, the use of credit ratings assigned by another NRSRO.

Given the range of ways that funds can and do portray credit risk associated with certain bonds, the draft letter recommends instead that the SEC permit funds to choose which NRSRO rating to use in shareholder reports, provided that the choice is made consistently pursuant to a disclosed policy.

Use of Credit Ratings by Directors and in Procedures

The draft letter notes that we appreciate the repeated statements in the Release to the effect that the proposals will not require funds to remove references to credit ratings from their existing policies and procedures. The draft letter notes ICI's agreement that nothing in Section 939A of the Dodd-Frank Act should be construed to limit the voluntary use of credit ratings, even in procedures for compliance with Federal regulations.

This point is sufficiently important that the draft letter recommends that the SEC include a statement to this effect in the adopting release and that it be made as broadly as possible, so that there is no doubt that funds may continue to refer to credit ratings not only in their policies and procedures, but also in their investment strategies, reports to their directors and shareholders, and in their marketing literature.

Jane G. Heinrichs
Senior Associate Counsel

Attachment

endnotes

[1]See SEC Release No. IA-29592 (March 3, 2011) (Release), available on the SEC's website at http://sec.gov/rules/proposed/2011/33-9193.pdf.