The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 27845

January 15, 2014

SEC Eliminates References to NRSRO Ratings from Rule 5b-3 and Fund Registration Forms

[27845]

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 1-14
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 2-14
SEC RULES COMMITTEE No. 3-14 RE: SEC ELIMINATES REFERENCES TO NRSRO RATINGS FROM RULE 5b-3 AND FUND REGISTRATION FORMS

The SEC recently adopted amendments to certain rules and forms under the Investment Company Act of 1940 and the Securities Act of 1933 that eliminate credit ratings by nationally recognized statistical rating organizations ("NRSROs") from SEC Rules. [1] The changes were required by the Dodd-Frank Wall Street Reform and Consumer Protection Act and remove references to NRSRO credit ratings from Rule 5b-3 under the Investment Company Act and Forms N-1A, N-2, and N-3. The amendments will become effective on February 7, 2014 and the compliance date is July 7, 2014.

Amendment to Rule 5b-3

Rule 5b-3 permits funds, for purposes of meeting the diversification requirements in Section 5 (b)(1) and the limitation on investments in broker-dealers in Section 12(d)(3) of the Investment Company Act, 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 "collateralized fully." Under current Rule 5b-3, a repurchase agreement is "collateralized fully" for funds other than money market funds [2] if, among other things, the collateral consists only of (i) cash items, (ii) U.S. government securities, (iii) securities that at the time the repurchase agreement is entered into are rated in the highest ratings category by the "requisite NRSROs," or (iv) unrated securities that are of comparable quality to securities rated in the highest rating categories by the requisite NRSROs (as determined by the fund's board or its delegate).

Amended Rule 5b-3 eliminates the requirement that collateral other than cash or government securities be rated in the highest category by the requisite NRSROs or be of comparable quality. In place of that requirement, the amended Rule requires that collateral other than cash or government securities consist of securities that the fund's board of

directors (or delegate) determines at the time the repurchase agreement is entered into (i) are issued by an issuer that has an "exceptionally strong capacity" to meet its financial obligations on the collateral, and (ii) are sufficiently liquid that they can be sold by the fund at approximately their carrying value in the ordinary course of business within seven calendar days.

In response to comments by ICI [3] and others, the SEC revised the credit quality determination standard from its 2011 proposal. Under that proposed standard, issuers other than the U.S. government would have been required to have the "highest capacity" to meet financial obligations on collateral securities. ICI had argued that the proposed "highest capacity" standard may not necessarily be viewed as consistent with the current standards for receiving a rating in the highest rating category because the standard does not seem to contemplate any variation on credit-worthiness among such issuers. Instead, we recommended using an "exceptionally strong capacity" to repay financial obligations as the standard because it would be consistent with the definitions used by many rating agencies to define their highest long-term rating category. In response to these comments, the SEC replaced the proposed "highest capacity" standard with the "exceptionally strong capacity" standard, as noted above.

Although the amended rule does not provide specific factors or tests that the fund's board (or its delegate) must apply in performing the required credit analysis, the adopting release notes that under the amended rule, the credit analysis may incorporate ratings, reports, opinions and other assessments issued by third parties, including NRSROs.

Furthermore, the final rule adopts as proposed a liquidity standard that is similar to the standard used in Rule 2a-7 governing money market funds. [4] According to the adopting release, the SEC expects that securities that actively trade in a secondary market at the time of the acquisition of the repurchase agreement will satisfy the liquidity component of the standard. The final rule also defines an "issuer" to include an issuer of an unconditional guarantee of a security.

Amendments to Forms N-1A, N-2, and N-3

Forms N-1A, N-2, and N-3 contain requirements for mutual funds and closed-end funds to report information about their activities to shareholders, including information about the credit quality of their portfolios. Currently, Forms N-1A, N-2, and N-3 require shareholder reports to include a table, chart, or graph depicting portfolio holdings by reasonably identifiable categories, including 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. As amended, Forms N-1A, N-2 and N-3 will no longer require the use of NRSRO credit ratings by funds that choose to use credit quality categorizations in the required table, chart, or graph of portfolio holdings. Instead, funds that choose to show credit quality categorizations in the required table, chart, or graph may use alternative categorizations that are not based on NRSRO credit ratings; however, funds may choose to continue to use NRSRO credit ratings.

In a change from the proposal, under the amended forms, funds that choose to continue to use credit ratings will no longer be restricted to using the credit ratings assigned by a single NRSRO. For example, for split-rated securities, a fund may choose which NRSRO's ratings to use (for example, the highest rating where there are multiple ratings by NRSROs), provided the choice is made consistently pursuant to a disclosed policy. The adopting release explains that it made this change in response to comments from ICI and others.

Funds that choose to depict portfolio holdings according to credit quality must include a description of how the credit quality is determined. This description should include a discussion of the credit quality evaluation process, the rationale for its selection, and an overview of the factors considered, such as the terms of the security (e.g., interest rate and time to maturity), the obligor's capacity to repay the debt, and the quality of any collateral. If a fund uses credit ratings to depict credit quality, the fund should explain how the credit ratings were identified and selected.

If a fund does not use credit ratings, but instead uses internally-assigned ratings, the adopting release states that it might be misleading for the fund to describe its portfolio holdings' quality using descriptions similar to the ratings nomenclature used by rating agencies (e.g., AAA or Aa) or to characterize the securities as "rated." The adopting release also states that a fund may choose to use median ratings from among multiple credit rating agencies (discarding the highest and lowest ratings) for split-rated securities, but that it may be misleading for a fund to use of the term "average credit quality" for split-rated securities because the credit rating agencies may use different criteria to evaluate the credit quality of an issuer.

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endnotes

[1] See Removal of Certain References to Credit Ratings Under the Investment Company Act, SEC Release Nos. 33-9506; IC-30847 (December 26, 2013) 79 FR 1316 (January 8, 2014). In a separate release, the SEC also adopted amendments to the net capital rule under the Securities Exchange Act of 1934 that would remove requirements that are based on certain NRSRO credit ratings. See Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, SEC Release No. 34-71194 (December 26, 2013) 79 FR 1522 (January 8, 2014). This memo focuses on the amendments to Rule 5b-3 and certain forms under the Investment Company Act.

[2] In the adopting release, the SEC notes that amended Rule 5b-3 does not affect the treatment of repurchase agreements owned by money market funds to measure diversification under Rule 2a-7 because for these funds only cash items and government securities qualify for the definition of "collateralized fully" in Rule 2a-7 (and those requirements are not changed by the amendments to Rule 5b-3).

[3] See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (April 25, 2011), available at http://www.sec.gov/comments/s7-07-11/s70711-11.pdf.

[4] Rule 2a-7 defines an illiquid security to mean a security that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund.

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