The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 25144

April 25, 2011

ICI Comment Letter on SEC's Proposal to Remove NRSRO References from Rules 2a-7 and 5b-3

[25144]

April 25, 2011

TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 28-11
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 23-11
SEC RULES COMMITTEE No. 37-11 RE: ICI COMMENT LETTER ON SEC'S PROPOSAL TO REMOVE NRSRO REFERENCES FROM RULES 2a-7 AND 5b-3

The Investment Company Institute has filed a comment letter with the Securities and Exchange Commission on its proposal 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.

Although the Release states that the amendments “are designed to offer protections comparable to those provided by the NRSRO ratings,” [2] ICI’s letter expresses concern that the proposed alternative standards of credit-worthiness in Investment Company Act Rules 2a-7 and 5b-3 may have the unintended consequence of raising some credit standards and lowering others. While the elimination of standards based on credit ratings must necessarily alter these regulations to some degree, the letter suggests some different approaches that would keep these regulations more in line with their current standards. We also offer a recommendation that would permit funds to use NRSRO ratings to disclose credit quality information in shareholder reports in a manner that is consistent with their investment policies.

In summary, our recommendations are as follows:

Rule 2a-7

- We recommend that Rule 2a-7 define an eligible security as “a security with a remaining maturity of 397 days or less that the fund’s board of directors determines presents minimal credit risks and the issuer of which the fund’s board of directors determines has a strong capacity to meet its short-term obligations.” The proposed standard would eliminate the “first tier” and “second tier” categories from the rule 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 short-term rating category, which would be first tier securities under the current rule).
- For a security subject to a conditional demand feature, we recommend that if the demand feature provides for its termination upon a downgrade of the underlying security by a credit rating agency, the rule prohibit a money market fund from acquiring 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. We do not believe that Section 939A of the Dodd-Frank Act should preclude the SEC from recognizing in its regulations that demand features may terminate as a result of ratings changes and the risk associated with such terminations.
- We recommend that the requirement to reassess minimal credit risk under paragraph (c)(7)(i) be eliminated and that paragraph (c)(10)(i) be redrafted to include a general, ongoing obligation to monitor the credit risks of portfolio securities. An express requirement for funds to review their credit assessments under Rule 2a-7 on an ongoing basis would obviate the need for a separate requirement to identify specific triggers for reassessment.
- We do not believe that Section 939A of the Dodd-Frank Act precludes the SEC from promulgating regulations that simply refer to existing credit ratings without requiring an assessment of a security’s credit-worthiness, such as in the stress testing paragraph of Rule 2a-7. Accordingly, we recommend that the SEC retain the stress testing provision in its current form.

Rule 5b-3

- We recommend that at the time a fund enters into a repurchase agreement, the fund’s board (or delegate) be required to determine that the issuer of any underlying non-government securities have an “exceptionally strong capacity” to repay financial obligations, which would be consistent with the definitions used by many rating agencies to define their highest long-term rating category. We would not object to the additional proposed requirement that the underlying securities qualify as liquid securities.

Form N-MFP

- Although the references to credit ratings in Form N-MFP are to existing credit ratings and are merely a collection of data points so regulators and investors will better understand funds’ portfolios, we would not object to the removal of this information

from Form N-MFP, 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.

Shareholder Reports

- We support the SEC's proposal that would permit funds to present the credit quality of their portfolio holdings by disclosing NRSRO and/or internal credit ratings in shareholder reports. Given the range of ways that funds can and do portray credit risk associated with certain bonds, however, we recommend 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

- We recommend that the SEC include a statement in the adopting release acknowledging that funds may continue to refer to credit ratings in their policies and procedures, investment strategies, reports to their directors and shareholders, and marketing literature.

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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.

[2] Id. at 8.

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