The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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ICI Files Letter Regarding SEC's Re-Proposal to Remove References to Credit Ratings from Rule 2a-7 and Proposal to Amend Issuer Diversification Provisions

[28471]

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TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 30-14
MONEY MARKET WORKING GROUP
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 26-14
SEC RULES MEMBERS No. 40-14 RE: ICI FILES LETTER REGARDING SEC'S RE-PROPOSAL TO REMOVE REFERENCES TO CREDIT RATINGS FROM RULE 2a-7 AND PROPOSAL TO AMEND ISSUER DIVERSIFICATION PROVISIONS

The Investment Company Institute recently filed a letter with the Securities and Exchange Commission offering our views on its (i) re-proposed amendments to remove references to credit ratings of nationally recognized statistical rating organizations (NRSROs) from Rule 2a-7 and Form N-MFP under the Investment Company Act of 1940 and (ii) proposed amendments to Rule 2a-7 to make the issuer diversification provisions applicable to non-controlled persons that issue securities subject to a guarantee. [1] ICI's letter is attached and briefly summarized below.

Removal of Certain References to Credit Ratings

In March 2011, the SEC proposed certain amendments related to the removal of credit rating references in Rule 2a-7 and Form N-MFP. The proposed amendments were a step toward effectuating provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that call for the SEC to review any regulation that requires the use of an assessment of the credit-worthiness of a security or money market instrument and then amend such regulations to remove any references to, or requirement of reliance on, credit ratings and to substitute such standard of credit-worthiness as the SEC determines is appropriate.

In consideration of comments received on its initial proposal, including those from ICI, [2]

the SEC is re-proposing amendments to replace references to credit ratings in Rule 2a-7 and to modify provisions in Form N-MFP that reference credit ratings.

Rule 2a-7

The re-proposed amendments would affect five elements of Rule 2a-7: (i) determination of whether a security is an eligible security; (ii) determination of whether a security is a first tier security; (iii) credit quality standards for securities with a conditional demand feature; (iv) requirements for monitoring securities for ratings downgrades and other credit events; and (v) stress testing.

Eligible Securities and Treatment of First Tier Securities

The SEC's 2011 proposal would have eliminated the objective requirement that an eligible security be rated by an NRSRO or be of comparable quality while maintaining the distinction between first tier and second tier securities. ICI's 2011 comment letter recommended that the SEC combine the two criteria and require a single, uniform, very high standard of quality (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).

fter consideration of commenters' concerns, the re-proposal combines the two risk criteria into a single standard that is included as part of Rule 2a-7's definition of eligible security. Specifically, under the re-proposal an eligible security would be a security with a remaining maturity of 397 calendar days or less that the fund's board of directors (or its delegate) determines presents minimal credit risks, which determination includes a finding that the security's issuer has an "exceptionally strong capacity" to meet its short-term obligations. Also, because the re-proposal would eliminate the distinction between first and second tier securities, the SEC is re-proposing to remove the current prohibition on funds investing more than 3 percent of their portfolios in second tier securities.

ICI's letter suggests there are better modifiers than "exceptionally" to use in this context. "Exceptional" implies something unusual even though there are a large number of money market securities of very high credit quality. Instead, we think that "very strong" might better convey a very high standard of credit quality, which may nevertheless be subject to gradations. Use of "very," rather than "exceptional," also would be consistent with the re-proposed credit standard for a security underlying a conditional demand feature. This would confirm that the risk of default for such an underlying security should be as low as the risk of default for eligible securities generally.

Regardless of what modifier is used, the letter recommends that Rule 2a-7 expressly include a phrase that assessments of the credit quality of eligible securities may include sub-categories or gradations indicating relative standing. Rule 2a-7 currently uses this phrase in the definition of an NRSRO's rating category, which helps facilitate an understanding that grading the relative risks of two securities does not necessarily imply that they are not both of very high credit quality.

Proposed Minimal Credit Risk Factors

Although Rule 2a-7 does not set forth any specific factors that a board (or its delegate) should consider in determining minimal credit risks, the SEC staff has observed during money market fund examinations that most advisers to these funds evaluate some

common factors that bear on the ability of an issuer or guarantor to meet its short-term financial obligations. Based on these observations, as well as recommendations made by ICI's Money Market Working Group, [3] the release sets forth a non-exhaustive list of factors that the SEC believes generally should be included as part of a minimal credit risk assessment.

Although ICI supports the inclusion of general factors in the release adopting any final amendments, the letter expresses our belief that these factors should not be included in Rule 2a-7. The letter also recommends that the SEC should refrain from providing guidance regarding the assessment of particular types of securities (such as structured securities and repurchase agreements). Given the dynamic nature of the marketplace, the letter notes our belief that the risk of any such guidance becoming stale and outdated outweighs its potential benefits.

Finally, the letter recommends that the SEC omit the phrase "worst case scenario" from the list of relevant factors. This scenario actually assesses the alternative sources of liquidity that would be available to the issuer in the event the issuer cannot draw on a back-up liquidity facility. Although alternative sources of liquidity generally should be considered when assessing the credit risk of a security, this is not the "worst case." A default is the worst case, the risk of which is the subject of a credit assessment—not just a scenario.

Conditional Demand Features

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. The rule requires this analysis of both the short-term and long-term credit aspects of the demand instrument because a security subject to a conditional demand feature combines both short-term and long-term credit risks.

Under the 2011 proposal, the SEC would have removed the credit rating requirement and amended 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 re-proposed standard differs in phrasing to more closely parallel the required finding in the SEC's re-proposed minimal risk determination. Under the re-proposal, a fund would have to determine, as with any other short-term security, that the conditional demand feature is an eligible security. A fund's board (or its delegate) also would have to evaluate the long-term risk of the underlying security and determine that it (or its guarantor) "has a very strong capacity for payment of its financial commitments."

The letter supports retaining a credit requirement for securities underlying conditional demand features. The letter also supports a standard of "very strong capacity for payment," provided this also is the standard for eligible securities generally.

Monitoring Credit Risks

Rule 2a-7 currently requires a money market fund board (or its delegate) promptly to reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks, and take such action as it determines is in the best interests of the fund and its shareholders. The 2011 proposal would have required the fund's board or its

delegate to reassess if it becomes aware of any credible information about a portfolio security or an issuer of a portfolio security that may suggest that the security is no longer a first tier or second tier security, as the case may be.

Most commenters, including ICI, asserted that the proposed standard was too vague and would be burdensome to administer. Instead, ICI and others recommended that the SEC eliminate the requirement for reassessing minimal credit risk when a security is downgraded by an NRSRO and include a general ongoing obligation to monitor the credit risks of portfolio securities, which would obviate the need for a separate requirement to identify specific triggers for reassessment. Consistent with this recommended approach, the re-proposal would require each money market fund to adopt written procedures that require the fund adviser to provide ongoing review of the credit quality of each portfolio security to determine that the security continues to present minimal credit risks.

The letter reiterates our continued support for a requirement under Rule 2a-7 that money market funds must continuously monitor the credit risks of their portfolios. The letter also supports the re-proposal to require funds to maintain records of the reassessment of minimal credit risk only "at such later times (or upon such events) that the board of directors determines that the investment adviser must reassess whether the security presents minimal credit risks." [4]

Finally, insofar as the re-proposed definition of eligible security would not require an assessment of shares of other money market funds, the letter recommends that shares of other money market funds be excluded from the monitoring requirement. This would be consistent with the re-proposal's treatment of government securities, which are excluded from the monitoring requirement.

Stress Testing

The recently adopted amendments to Rule 2a-7 require funds to test their ability based on certain hypothetical events, including a downgrade of particular portfolio security positions, to maintain weekly liquid assets of at least 10 percent and to minimize principal volatility (and, for stable NAV money market funds, the fund's ability to maintain a stable price per share). The 2011 proposal would have replaced the reference to ratings downgrades with the requirement that money market funds stress test their portfolios for an adverse change in the ability of a portfolio security issuer to meet its short-term obligations. Commenters, including ICI, urged the SEC not to eliminate the reference to a downgrade in the stress testing conditions.

The letter therefore expresses support for the SEC's re-proposal to require that money market funds stress test for an event indicating or evidencing credit deterioration of particular portfolio security positions, each representing various exposures in a fund's portfolio. The re-proposed amendments would describe the type of hypothetical event that funds should use for testing and include a downgrade or default as examples of that type of event.

Form N-MFP

With respect to each portfolio security, money market funds must disclose on Form N-MFP the name of each designated NRSRO for the portfolio security and the rating assigned to the security. The 2011 proposal would have eliminated items in the form that require disclosure of the ratings of the securities in the portfolio. In contrast, the re-proposal would

require that each money market fund disclose, for each portfolio security: (i) each rating assigned by any NRSRO if the fund or its adviser subscribes to that NRSRO's services, as well as the name of the agency providing the rating; and (ii) any other NRSRO rating that the fund's board (or its delegate) considered in making its minimal credit risk determination, as well as the name of the agency providing the rating.

ICI's letter expresses our belief that it would not be appropriate to base a disclosure requirement on an adviser's business decision to subscribe to an NRSRO. The fact that an adviser subscribes to an NRSRO does not imply that the adviser considers the NRSRO's rating when assessing the credit risk of every security rated by the NRSRO. The letter also explains that the re-proposed disclosure requirement would create a financial disincentive to subscribe to an NRSRO's rating service.

ICI's letter nevertheless supports disclosing NRSRO rating information generally to investors in order to facilitate their assessment of the credit quality of a money market fund's portfolio. Specifically, we recommend that the SEC amend Rule 2a-7 to require summary disclosure on a money market fund's [5] website of the ratings assigned to the fund's portfolio securities by one or more NRSROs identified in the fund's prospectus. [6] We believe this approach would provide investors with more effective disclosure, rather than depicting security-by-security each rating assigned by an NRSRO merely because the fund or adviser subscribes to its services and other ratings an adviser has considered in making its minimal credit risk determination.

The letter explains that our proposed disclosure requirements also should be more effective in providing information regarding potential credit risks than the re-proposed amendments to Form N-MFP. Specifically, providing summary ratings information on a fund's website would provide concise and consistent information to investors in a readily available format, as well as an overall view of the ratings composition of the fund's portfolio, information that an investor would find particularly useful. On the other hand, the information conveyed by the re-proposed amendments may be inconsistent, as the ratings considered by the adviser may change from time to time. An adviser may be tempted to, for example, consider only the highest ratings whenever it assesses a security's credit risk. For these reasons, we believe it would be better to require a fund to pick one or more NRSROs in advance and to disclose in summary form all of their ratings on securities held by the fund on a consistent basis.

Issuer Diversification Proposal

Generally, money market funds must limit their investments in the securities of any one issuer of a first tier security to no more than 5 percent of total assets and their investments in securities subject to a demand feature or a guarantee to no more than 10 percent of total assets from any one provider. Notwithstanding the 5 percent issuer diversification provision, Rule 2a-7 does not require a money market fund to be diversified with respect to issuers of securities that are subject to a guarantee by a non-controlled person. This exclusion could allow, for example, a fund to invest a significant portion or all of the value of its portfolio in securities issued by the same entity if the securities were guaranteed by different non-controlled person guarantors such that none guaranteed securities with a value exceeding 10 percent of the fund's total assets.

In consideration of the SEC's reform goal of limiting concentrated exposure of money

market funds to particular economic enterprises (i.e., new amendments that require money market funds to limit their exposure to affiliated groups, rather than to discrete issuers [7]), the re-proposal would require each money market fund that invests in securities subject to a guarantee (whether or not the guarantor is a non-controlled person) to comply with both the 10 percent diversification requirement for the guarantor as well as the 5 percent diversification requirement for the issuer. As a result, except for the special provisions regarding single-state money market funds, no money market fund non-government portfolio security would be excluded from Rule 2a-7's limits on issuer concentration.

The letter notes that the release's cost/benefit analysis of this proposal is based on a single small sample of data from Forms N-MFP covering February 2014. Based on this data sample, the SEC believes that very few money market funds rely on the issuer diversification exclusion for securities subject to a guarantee by a non-controlled person. Despite the SEC's belief, our tax exempt money market fund members have indicated that they regularly rely on the exclusion for securities guaranteed by non-controlled persons to exceed the 5 percent issuer diversification limit. The letter suggests that the SEC's staff review the sample to make sure that it aggregated all holdings of each issuer's securities, not just those securities subject to guarantees by non-controlled persons. In any event, we anticipate that a broader sample would reveal more frequent reliance by tax exempt money market funds on this exception.

The letter explains that the proposal assumes a ready supply of securities supported by the same guarantor but having different issuers, so that a fund could comply with the issuer diversification requirement without reducing its holdings of the guarantor's securities. This is not the case, however, particularly in the tax exempt market. Repeal of this exception to the issuer diversification requirement is likely to both increase the number of guarantors held in a fund's portfolio (some of which may present marginally greater credit risks) and the number of unenhanced securities.

The letter expresses our belief that such a trade-off of credit quality for nominal diversification would not serve the interests of money market fund shareholders. Instead, the letter recommends that the SEC retain the exception for securities guaranteed by non-controlled persons, at least for tax exempt money market funds.

Jane G. Heinrichs
Senior Associate Counsel

Attachment

endnotes

[1] See SEC Release No. IC-31184 (July 23, 2014), 79 FR 51922 (September 2, 2014) (release).

[2] See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated April 25, 2011, available at http://www.ici.org/pdf/25144.pdf.

[3] See Appendix I of the Investment Company Institute, Report of the Money Market Working Group (March 17, 2009), available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[4] Re-proposed paragraph (h)(3).

[5] Government money market funds should not be required to disclose any ratings information, either on their websites or in Form N-MFP.

[6] We are not proposing to require the fund's board of directors to designate, monitor, or evaluate NRSROs. The decision of which NRSROs to identify in the prospectus will depend on a variety of factors, including the preferences of investors and intermediaries.

[7] See Rule 2a-7(d)(3)(ii)(F).
