The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 22667

July 8, 2008

SEC Proposes to Amend Rules and Forms that use Credit Ratings Issued by NRSROs; Conference Call Scheduled for July 15

[22667]

July 8, 2008

TO: EQUITY MARKETS ADVISORY COMMITTEE No. 29-08FIXED-INCOME ADVISORY COMMITTEE No. 18-08INST. MONEY MARKET FUNDS ADVISORY COMMITTEE No. 12-08MONEY MARKET FUNDS ADVISORY COMMITTEE No. 17-08MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 26-08SEC RULES COMMITTEE No. 45-08 RE: SEC PROPOSES TO AMEND RULES AND FORMS THAT USE CREDIT RATINGS ISSUED BY NRSROs; CONFERENCE CALL SCHEDULED FOR JULY 15

The Securities and Exchange Commission has proposed amendments to 38 of its rules and forms that refer to credit ratings issued by nationally recognized statistical rating organizations ("NRSROs").[1] The amendments comprise the third of three rulemaking initiatives relating to credit ratings by an NRSRO that the Commission is proposing. The first two initiatives address concerns relating to the integrity of the NRSROs' credit rating procedures and the differentiation between ratings for structured finance products.[2] The third set of proposed amendments, which are summarized in relevant part below, are designed to address concerns that the references to NRSRO ratings in Commission rules may have contributed to undue reliance on NRSRO ratings by market participants.

Comments on the proposed amendments are due to the SEC no later than September 5, 2008. We have scheduled a conference call for Tuesday, July 15, at 2:30 p.m. Eastern time to discuss the Institute's comment letter on the proposal. The dial-in number for the conference call will be 1-888-282-0171 and the passcode for the call will be 52076. If you

plan to participate on the call, please contact Jennifer Odom by email at jodom@ici.org or by phone at 202-326-5833. In the meantime, if you have any views on any of the issues discussed below, please contact Jane Heinrichs by email at jheinrichs@ici.org or by phone at 202-371-5410.

The proposed amendments would amend four rules under the Investment Company Act of 1940 – Rules 2a-7, 3a-7, 5b-3, and 10f-3 – and one rule under the Investment Advisers Act of 1940 – Rule 206(3)-3T – to omit references to NRSRO ratings, and except with respect to Rule 3a-7, substitute alternative provisions that are designed to achieve the same purpose.

Rule 2a-7 under the Investment Company Act governs the operation of money market funds and includes several conditions intended to minimize the deviation between a money market fund's stabilized share price and the market value of its portfolio. Currently, Rule 2a-7 limits a money market fund's portfolio investments to securities that have received credit ratings from the "Requisite NRSROs" in one of the two highest short-term rating categories or comparable unrated securities (i.e., "Eligible Securities"). [3] Rule 2a-7 further restricts money market funds to investments in securities that the fund's board of directors (or its delegate) determines present minimum credit risks. The proposal would amend Rule 2a-7 in four principal ways.

Under the proposed amendments, money market fund boards of directors would be required to determine that each portfolio instrument presents minimal credit risks, and whether the security is a "First Tier Security" or a "Second Tier Security" for purposes of the rule. The Investment Management Release notes that boards (or their delegates) would still be able to use quality determinations prepared by outside sources, including NRSRO ratings that they conclude are credible, in making credit risk determinations.

Under the proposed amendments, a security would be an Eligible Security if the board of directors determines that it presents minimal credit risks, which determination must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations. A security would be a First Tier Security if the fund's board determines that the issuer has the "highest capacity to meet its short-term financial obligations." A security would be a Second Tier Security if it is an Eligible Security but is not a First Tier Security. The Investment Management Release notes that the Commission has designed these proposed definitions to retain a degree of risk limitation similar to what is in the current rule.

The Commission seeks comment on several aspects of the proposed amendments including:

- the advantages and disadvantages of eliminating the requirement to use NRSRO ratings from Rule 2a-7 and relying exclusively on minimum credit risk determinations;
- whether eliminating the rating requirements from Rule 2a-7 would affect the amount or nature of risks money market funds would be willing or able to take;
- whether the current rule's reliance on credit ratings discourages fund directors and investment advisers from performing independent credit risk assessments;
- what alternatives could the Commission adopt to encourage more independent credit risk analysis and meet the regulatory objectives of Rule 2a-7's requirement of NRSRO ratings;
- whether the proposed distinctions between First Tier and Second Tier Securities are workable; and
- whether the proposed standards would impose additional burdens on boards or investment advisers, or require new recordkeeping requirements.
- Portfolio Liquidity

Under the proposed amendments, a money market fund must hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions in light of the fund's obligations under Section 22(e) of the Investment Company Act and any commitments the fund has made to its shareholders. In addition, the proposed amendments would expressly limit a money market fund's investment in illiquid securities to not more than 10 percent of its total assets. The proposed amendments would define a "Liquid Security" as a security that can be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the fund. The Investment Management Release explains that these proposed provisions should be familiar to managers of money market funds because past releases proposing, adopting, and amending Rule 2a-7 repeatedly emphasized the special duty of a money market fund's board of directors to monitor purchases of illiquid instruments.

The Investment Management Release further explains that in the event that changes in the money market fund's portfolio or other external events cause the fund's investments in illiquid instruments to exceed 10 percent of the fund's assets, the money market fund would have to take steps to bring the aggregate amount of illiquid securities back within the proposed limitations as soon as reasonably practicable. Consistent with the current rule, however, this requirement generally would not force the money market fund to liquidate any portfolio security where the fund would suffer a loss on the sale of that instrument.

The Commission seeks comment on the proposed amendments including:

- whether it should include an express requirement that money market funds limit their exposure to illiquid securities;
- whether the proposed requirements provide money market funds sufficient flexibility to retain securities that may be illiquid if the disposal of those securities would not be in the best interests of the fund; and

- alternative or additional provisions that the Commission should consider to address the way in which money market funds should evaluate liquidity risk and determine whether to dispose of securities that present an increasing liquidity risk.
- Monitoring Minimal Credit Risks

The proposed amendments also would amend Rule 2a-7's downgrade and default provisions. Specifically, in the event that a money market fund's investment adviser becomes aware of any information about a portfolio security or an issuer of a portfolio security that suggests that the security may not continue to present minimal credit risks, the proposed amendments would require the fund's board of directors to reassess promptly whether the portfolio security continues to present minimal credit risks. The proposed requirement would replace the provisions in the current rule that generally require a money market fund board to promptly reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks, and take such action as the board determines is in the best interests of the fund and its shareholders.

The Investment Management Release states the Commission's belief that the proposed amendments would not require investment advisers to subscribe to every rating service publication in order to comply with this proposal. The Commission would expect, however, an investment adviser to exercise reasonable diligence in keeping abreast of new information about a portfolio security that is reported in the national financial press or in publications to which the investment adviser subscribes.

The Commission requests comment on the proposed amendments including:

- whether the requirement that the board of directors reassess the credit risk of a security when investment advisers become aware of information that may suggest the security no longer presents minimal credit risks provides adequate protections and
- whether investment advisers would be able to stay abreast of new information about their portfolio securities.
- Commission Notice of Rule 17a-9 Transactions

The proposed amendments would require that money market funds provide the Commission with prompt notice via electronic mail when an affiliate of a money market fund (or its promoter or principal underwriter) purchases from the fund a security that is no longer an Eligible Security, pursuant to Rule 17a-9 under the Investment Company Act. The Investment Management Release states the Commission's belief that the current notice provisions in Rule 2a-7, which are triggered when a security held by a fund defaults, provide it with incomplete information about money market funds holding distressed securities, particularly those that have engaged in a transaction with an affiliated person. The Commission believes that the additional notice would enhance its oversight of money market funds especially during times of economic stress.

The Commission seeks comment on the proposed amendments.

Rule 3a-7 under the Investment Company Act excludes structured finance vehicles from the Act's definition of "investment company" subject to certain conditions. The conditions include the requirement that structured financings offered to the general public are rated by at least one NRSRO in one of the four highest ratings categories. The rule contains an exception under which asset-backed securities sold to "accredited investors"[4] and "qualified institutional buyers"[5] may be unrated, or may be rated less than investment grade, if the issuer and its underwriters use reasonable care to ensure that all excepted sales are to such persons.

The proposed amendments would eliminate the rule's reliance on ratings by eliminating the exclusion for structured financings offered to the general public. The Investment Management Release notes that most asset-backed securities are issued by special purpose vehicles that do not rely on Rule 3a?7, but instead sell their securities in non-public offerings to qualified purchasers in reliance on Section 3(c)(7), which was added to the Act in 1996, after the Commission adopted Rule 3a-7. Moreover, according to the Commission, asset-backed securities issued by financing vehicles that do rely on Rule 3a-7 generally are not marketed to retail investors.

The Commission also is proposing to amend the part of Rule 3a-7 that addresses the substitution of eligible assets to remove the reference to ratings downgrades. The rule currently permits the issuer to acquire additional eligible assets or dispose of assets only if, among other conditions, the acquisition or disposition of assets does not result in a downgrading in the rating of the issuer's outstanding fixed-income securities. The proposed amendments would require instead that the issuer have procedures to ensure that the acquisition or disposition does not adversely affect the full and timely payment of the outstanding fixed income securities.

Finally, the proposal would amend the portion of Rule 3a-7 that deals with the safekeeping of assets. The rule provides that cash flows from the asset pool periodically be deposited in a segregated account, consistent with the rating of the outstanding fixed income securities. The proposed amendment would change this provision to require that the cash flows be deposited in a segregated account consistent with the full and timely payment of the outstanding fixed income securities. According to the Investment Management Release, the proposed amendments are designed to minimize the risk of loss of cash flows pending payment to the fixed income securities holders.

The Commission seeks comment on various aspects of the proposed amendments including:

- the advantages and disadvantages of eliminating the NRSRO rating requirement from Rule 3a-7;
- whether it should permit offerings to the general public if a sponsor or trustee conducts an independent statistical analysis of the anticipated cash flow;
- whether dropping the rating requirement from Rule 3a-7 blurs the current distinction between structured finance vehicles and investment companies; and
- whether the proposal regarding the deposit of cash flows into a segregated account provides sufficient protection against the possibility of loss while the servicer is handling cash flows pending payment to the fixed income security holders.
- Rule 5b-3

Rule 5b-3 under the Investment Company Act allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of Sections 5(b)(1)[6] and 12(d)(3)[7] of the Investment Company Act if the obligation of the seller to repurchase the securities from the fund is "collateralized fully." A repurchase agreement is collateralized fully if, among other things, the collateral for the repurchase agreement consists entirely of (i) cash items, (ii) government securities, (iii) securities that are at the time the repurchase agreement is entered into are rated in the highest rating category by the "Requisite NRSROs," or (iv) unrated securities that are of a comparable quality as determined by the fund's board of directors or its delegate.

The proposed amendments would eliminate the requirement that collateral other than cash or government securities be rated by an NRSRO. The Commission instead proposes to require that if the collateral is not cash or government securities, the fund's board of directors (or its delegate) must determine that the collateral securities present minimum credit risks and are highly liquid. Specifically, the proposal would require collateral other than cash or government securities to consist of securities that the fund's board of directors (or its delegate) determines at the time the repurchase agreement is entered into (i) are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time, (ii) are subject to no greater minimal credit risk, and (iii) are issued by a person that has the highest capacity to meet its financial obligations. According to the Investment Management Release, the Commission anticipates that evaluating credit risk and liquidity of the collateral could still incorporate ratings, reports, analyses, and other assessments issued by NRSROs and other persons.

NRSRO ratings also are used in a provision of Rule 5b-3 that permits a fund to deem the acquisition of a "refunded security" as the acquisition of the escrowed government securities for purposes of Section 5(b)(1)'s diversification requirements. Under this provision, a debt security must satisfy certain conditions to be considered a refunded security under the rule, including a condition that an independent certified public accountant must have certified to the escrow agent that the escrowed securities will satisfy all scheduled payments of principal, interest, and applicable premiums on the refunded securities. This condition is not required, however, if the refunded security has received a debt rating in the highest rating category from an NRSRO.

The proposed amendments would eliminate the exception to the certification requirement for securities that have received the highest rating from an NRSRO. The Investment Management Release explains that Rule 5b-3 requires the certification by an independent certified public accountant to ensure that the bankruptcy of the issuer of the pre-funded securities would not affect payments on the securities from the escrow account. The Commission included this exception because in rating refunded securities, NRSROs typically require that an independent third party make the same determination.

The Commission seeks comment on several aspects of the proposed amendments including:

- how the proposed elimination of the rating requirement from the definition of "collateralized fully" would affect funds;
- whether the proposed board determinations sufficiently address the Commission's concerns that collateral securities be of high quality in order to limit a fund's exposure to counterparties' credit risks;
- how the proposal to eliminate the exception for rated securities from the condition that refunded securities obtain a certification from an independent auditor would affect funds;
- whether funds would incur any costs in determining that a refunded security has received an accountant certification rather than relying on an NRSRO rating; and
- as an alternative, should the Commission permit the board to rely on another independent third party to provide the certification.
- Rule 10f-3

Section 10(f) of the Investment Company Act prohibits a registered investment company from purchasing any security for which an affiliated underwriter is acting as a principal underwriter during the existence of an underwriting or selling syndicate for that security. Rule 10f-3 permits a fund that is affiliated with members of an underwriting syndicate to purchase securities, including municipal securities, from the syndicate if certain conditions are met. The rule defines municipal securities that may be purchased during an underwriting in reliance on the rule ("eligible municipal securities") to include securities that have an investment grade rating from at least one NRSRO or, if the issuer or the entity supplying the revenues or other payments from which the issue is to be paid has been in continuous operation for less than three years, one of the three highest ratings from an NRSRO.

The proposed amendments would eliminate the references to ratings in Rule 10f?3, and amend the rule's definition of "eligible municipal security" to mean securities that are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time. In addition, the securities would have to be either: (i) subject to no greater than moderate credit risk; or (ii) if they are less seasoned securities, subject to a minimal or low amount of credit risk. Unlike the proposals to amend other rules, the

Commission is not proposing to add a requirement that the board of directors make the determinations regarding credit risk and liquidity. This is because Rule 10f-3 already requires a fund's directors to approve procedures regarding purchases made in reliance on the rule and to determine each quarter that all purchases were made in compliance with the procedures. The Investment Management Release notes that the board, pursuant to its oversight role, would be required to approve procedures for ensuring that municipal securities meet the proposed conditions for credit quality and liquidity. The Release also notes that the fund's directors would still be able to incorporate quality determinations prepared by outside sources, including ratings, reports, analysis, and other assessments issued by NRSROs and other persons, in their approval of procedures and in their review of transactions under Rule 10f-3.

The Commission seeks comment on the proposed amendments including:

- the effect of eliminating the rating requirement in the definition of "eligible municipal securities" and
- whether the proposed standard that municipal securities purchased in reliance on Rule 10f?3 present no more than moderate credit risks and are highly liquid is sufficient to limit the possibility that underwriters may sell unmarketable securities to the fund.
- Rule 206(3)-3T

Rule 206(3)-3T under the Investment Advisers Act establishes a temporary alternative means for investment advisers who are registered with the Commission as broker-dealers to meet the requirements of Section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients. An adviser generally may not rely on Rule 206(3)-3T for principal trades of securities if the investment adviser or a person who controls, is controlled by, or is under common control with the adviser is the issuer or is an underwriter of the security. The rule contains an exception to this "underwritten securities" exclusion for trades in which the adviser or a control person is an underwriter of non-convertible investment grade

debt securities. The rule defines an "investment grade debt security" as a non-convertible debt security that, at the time of sale, is rated in one of the four highest rating categories of at least two NRSROs.

The proposal would amend Rule 206(3)-3T to eliminate an adviser's ability to rely exclusively on NRSRO ratings to determine whether a security is investment grade for purposes of the rule. Instead, the adviser would have to make its own assessment taking into account specified criteria, including that the security: (i) has no greater than moderate credit risk; and (ii) is sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time. The Investment Management Release also notes that an adviser seeking to rely on Rule 206(3)-3T would have to adopt and implement policies and procedures that address the adviser's methodology for determining whether a security is investment grade quality.

The Commission seeks comment on its proposed amendments including:

- whether it is appropriate to allow advisers seeking to rely upon Rule 206(3)-3T to determine whether a security is investment grade based on the criteria in the rule;
- whether there is another definition of "investment grade" in the federal securities laws that the Commission should incorporate by reference into Rule 206(3)-3T; and
- alternative methods to ensure that advisers seeking to rely on the exception to the underwriting exclusion do so only with respect to investment grade debt.

The proposed amendments would remove references to NRSROs in various rules and forms under the Securities Exchange Act of 1934. In particular, the proposal would remove all references to NRSROs from Rule 15c3-1, the Net Capital Rule. Rule 15c3-1 includes references to NRSRO ratings in Rule 15c3-1(c)(vi), which prescribes specific percentage deductions (known as haircuts) for various classes of securities. The paragraphs of the rule relating to commercial paper, nonconvertible debt securities, and cumulative, non-convertible preferred stock, refer to NRSRO ratings for determining the haircuts allowed for those classes of securities. The proposal would remove references to NRSRO ratings in each of these paragraphs and replace them with new standards. For commercial paper, the proposal would replace the current NRSRO ratings-based criterion – being rated in one of the three highest rating categories by at least two NRSROs – with a requirement that the instrument be subject to a minimal amount of credit risk and have sufficient liquidity such that it can be sold at or near its carrying value almost immediately. For nonconvertible debt securities and cumulative, non-convertible preferred stock, the proposal would replace the current NRSRO ratings-based criterion – being rated in one of the four highest rating categories by at least two NRSROs – with a requirement that the instrument be subject to no greater than moderate credit risk and have sufficient liquidity such that it can be sold at or near its carrying value within a reasonably short period of time.

The Trading and Markets Release notes that the new standards should continue to advance the purpose the NRSRO ratings standards were designed to advance, which is to enable broker-dealers to make net capital computations that reflect the market risk inherent in the positioning of those particular types of securities. The Commission believes that broker-dealers have the financial sophistication and the resources necessary to make the basic determinations of whether or not a security meets the requirements in the proposed amendments and to distinguish between securities subject to minimal credit risk and those subject to moderate credit risk.

Notwithstanding this, the Commission believes it would be appropriate, as one means of complying with the proposed amendments, for broker-dealers to refer to NRSRO ratings for purposes of determining haircuts under the rule. As such, if the Commission adopts the proposed amendments, after considering comments, the Trading and Markets Release notes that the Commission expects to take the view in the adopting release that securities rated in one of the three highest categories by at least two NRSROs would satisfy the requirements of the proposed new standard for commercial paper and the securities rated in one of the four highest rating categories by at least two NRSROs would satisfy the requirements of the proposed new standards for nonconvertible debt securities and cumulative, non-convertible preferred stock.

The proposal also would remove references to NRSROs in Securities Exchange Act Rule 3a-1, Rule 10b-10, Rule 15c3-3, Rules 101 and 102 of Regulation M, Regulation ATS, Form ATS-R, Form Pilot, and Form X-17A-5 Part IIB.

The Commission seeks comment on all aspects of the proposed elimination of the use of NRSRO ratings in the Net Capital Rule and the other rules and forms noted above.

The proposed amendments would replace various rule and form requirements under the Securities Act and Securities Exchange Act that use credit ratings by NRSROs with alternative requirements.

In particular, the proposal would replace the Securities Act Form S-3 eligibility (and shelf registration) criteria for offerings of investment grade asset-backed securities. Instead, an asset-backed offering would be Form S-3 eligible, regardless of the credit rating of the securities, if initial and subsequent sales of the securities are made in denominations of at least $250,000 and initial sales are made only to qualified institutional buyers, as defined in Rule 144A under the Securities Act. In addition, the proposal would revise the reference in Rule 415 under the Securities Act to “mortgage related securities” so that delayed offerings of mortgage backed securities would be permitted in the same way, provided that initial and subsequent sales of the securities are made in denominations of at least $250,000 and initial sales are made only to qualified institutional buyers.

The proposal also would replace the Securities Act Forms S-3 and F-3 eligibility provisions for primary offerings of investment grade non-convertible securities. Instead of an investment grade rating requirement, a primary offering of non-convertible securities would be S-3 or F-3 eligible, regardless of the credit rating, if the issuer has issued for cash, as of a date within 60 days prior to the filing of the registration statement, more than $1 billion in non-convertible securities, other than common equity, through registered primary offerings, within the prior three years. The proposal uses the same method and threshold by which a debt issuer that does not meet the requisite public float threshold is defined in the Securities Act rules as a "well-known seasoned issuer."

Several other rule and form requirements that are based on investment grade ratings also would be replaced with the new proposed criteria for Form S-3 and F-3 eligibility. This would include Forms F-9, S-4, and F-4, Schedule 14A, Item 1100 of Regulation AB and Securities Act Rules 138, 139, and 168.

The Commission seeks comment on all aspects of its proposal.

Jane G. Heinrichs
Associate Counsel

hr align="left" size="1" width="33%"
[1] See References to Ratings of Nationally Recognized Statistical Rating Organizations, SEC Release Nos. IC-28327 and 34-58070 (July 1, 2008) ("Investment Management Release" and "Trading and Markets Release," respectively) and Security Ratings, SEC Release No. 33-8940 (July 1, 2008) ("Corporation Finance Release" and together with the Investment Management Release and Trading and Markets Release, "Releases"). The Releases are available on the SEC's website at: http://sec.gov/rules/proposed/2008/ic-28327.pdf; http://sec.gov/rules/proposed/2008/34-58070.pdf; and http://sec.gov/rules/proposed/2008/33-8940.pdf.

[2] See Proposed Rules for Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-57967 (June 17, 2008), which is available on the SEC's website at: http://sec.gov/rules/proposed/2008/34-57967.pdf. For a summary of this release, see Memorandum to SEC Rules Members No. 54-08, dated June 19, 2008 [22623].

[3] The term "Eligible Security" is defined in Rule 2a-7(a)(10). "Requisite NRSROs" is defined in Rule 2a-7(a)(21).

[4] "Accredited investors" are defined in paragraphs (1), (2), (3) and (7) of Rule 501(a) under the Securities Act of 1933.

[5] "Qualified Institutional buyers" are defined in Rule 144A under the Securities Act.

[6] Section 5(b)(1) limits the amount that a fund that holds itself out as being a diversified investment company may invest in the securities of any one issuer (other than the U.S. Government). This provision may limit the number and principal amounts of repurchase agreements a diversified fund may enter into with any one counterparty.

[7] Section 12(d)(3) generally prohibits a fund from acquiring an interest in a broker, dealer, or underwriter . Because a repurchase agreement may be considered to be the acquisition of an interest in the counterparty, Section 12(d)(3) may limit a fund's ability to enter into repurchase agreements with many of the firms that act as repurchase agreement counterparties.
