The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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SEC Proposes to Remove Credit Rating References from Rules 2a-7 and 5b-3; Conference Call Scheduled for March 17 at 3:00 pm Eastern time

[25008]

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TO:

MONEY MARKET FUNDS ADVISORY COMMITTEE No. 14-11
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 14-11
SEC RULES COMMITTEE No. 21-11

RE:

SEC PROPOSES TO REMOVE CREDIT RATING REFERENCES FROM RULES 2a-7 AND 5b-3; CONFERENCE CALL SCHEDULED FOR MARCH 17 AT 3:00 PM EASTERN TIME

The Securities and Exchange Commission recently proposed amendments that would remove references to credit ratings in Rule 2a-7, 5b-3 and Form N-MFP under the Investment Company Act of 1940.* The proposals stem from a provision in Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act that requires every federal agency to review rules that use credit ratings as an assessment of credit-worthiness and replace those credit-rating references with other appropriate standards.

Comments on the proposals, which are briefly summarized below, are due to the SEC on or before April 25, 2011.

We have scheduled a conference call for Thursday, March 17th at 3:00 pm Eastern time to discuss the SEC's proposal. The dial-in number for the call is 866-541-3298 and the passcode is 6501781. If you are able to participate on the call, please contact Jennifer Odom at jodom@ici.org.

Money Market Funds

Under the proposed amendments to Rule 2a-7, a security would be an eligible security for investment by money market funds only if the board of directors (or its delegate) 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. An eligible security would be a "first tier" security (regardless of the ratings it has received from any credit rating agency) if the fund's board (or its delegate) determines that the issuer (or in the case of a security subject to a guarantee, the guarantor) has the "highest capacity" to meet its short-term financial obligations. Like the current rule, a money market fund would be required to invest at least 97 percent of its assets in first tier securities. A security would be second tier if the board (or its delegate) has determined the security presents minimal credit risks, even if it is not a first tier security.

To meet the proposed standard, the Release notes that an issuer of a first tier security should have an "exceptionally strong ability" to repay its short-term debt obligations and the lowest expectation of default. The issuer of a second tier security should have a "very strong ability" to repay its short-term debt obligations, and a very low vulnerability to default.

The proposed amendments also would require that, in the event the money market fund's adviser (or any person to whom the board has delegated portfolio management responsibilities) 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, the board or its delegate would have to reassess promptly whether the portfolio security continues to present minimal credit risks. This requirement would replace the existing requirement that a board or its delegate must promptly reassess whether a security whose credit rating has been downgraded continues to present minimal credit risks. The Release notes that to satisfy the proposed standard, an investment adviser would be required to exercise reasonable diligence in keeping abreast of new information about a portfolio security that the adviser believes to be credible.

The proposal also would eliminate the credit rating requirement for securities with a conditional demand feature. Instead, the fund's board (or its delegate) would be required to determine that the underlying security is of "high quality and subject to very low credit risk."

The SEC also proposed amendments to Form N-MFP, which would eliminate items in the form that require disclosure of the ratings of the securities in the portfolio.

Repurchase Agreements

Current Rule 5b-3 allows funds – seeking to meet certain diversification requirements – to "look through" repurchase agreements in which they invest to the securities collateralizing the agreements. Such look throughs, however, are only permitted if, among other things, the collateral securities have received the highest credit rating, are unrated securities of comparable quality, or are government securities. Under the proposed amendments, the board of directors of the fund (or its delegate) would be required to determine that non-governmental collateral securities are issued by an issuer that has the "highest capacity" to meet its financial obligations and are sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days. The Release states that to satisfy the proposed standard, the fund's board (or its delegate) must determine that an issuer of collateral securities has an exceptionally strong capacity to repay its short or long-term debt obligations, as appropriate, the lowest expectation of default, and a capacity for repayment of its financial commitments that is the least susceptible to adverse effects of changes in circumstances.

The proposal does not change the requirements for money market funds seeking similar treatment with respect to the diversification requirements under Rule 2a-7. As part of the 2010 money market fund reforms, in order to qualify for such special treatment, a repurchase agreement is collateralized fully only if the collateral for the repurchase agreement consists entirely of cash or government securities.

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