The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

December 8, 2009

ICI Comment Letter on SEC's Proposal to Remove References to Credit Ratings from Rule 5b-3 (pdf)

December 8, 2009 Ms. Elizabeth M. Murphy Secretary Securities and Exchange Commission 100 F Street, NE Washington, DC 20549-1090 Re: References to Ratings of Nationally Recognized Statistical Rating Organizations (File Nos. S7-17-08, S7-18-08, and S7-19-08) Dear Ms. Murphy: The Investment Company Institute1 appreciates the opportunity to offer its views to the Securities and Exchange Commission regarding its proposal to remove references to credit ratings of nationally recognized statistical rating organizations ("NRSROs") from certain rules under the Investment Company Act of 1940—most significantly, from Rule 5b-3, the rule governing repurchase agreements.2 The Institute believes that the proposal to remove NRSRO ratings from Rule 5b-3 is unnecessary to address SEC concerns about ratings and fails adequately to consider the role that NRSRO ratings play under the rule. The proposal is intended to address the SEC's concerns that the reference to and use of NRSRO ratings in SEC rules could be interpreted by investors as an "endorsement" of the quality of 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $11.33 trillion and serve almost 90 million shareholders. 2 See References to Ratings of Nationally Recognized Statistical Rating Organizations, SEC Release Nos. 33-9069, 34-60790, IA-2932, and IC 28940 (October 5, 2009), 74 FR 52374 (October 9, 2009) ("Release"), available on the SEC's website at http://sec.gov/rules/proposed/2009/33-9069.pdf. The SEC is re-opening the comment period on certain of the proposed rule amendments to remove references to ratings of NRSROs proposed in SEC Release No. IC-28327 (July 1, 2008), 73 FR 40124 (July 11, 2008); SEC Release No. 34-58070 (July 1, 2008), 73 FR 40087 (July 11, 2008); and SEC Release No. 33-8940 (July 1, 2008), 73 FR 40106 (July 11, 2008). In a companion release, the SEC adopted amendments to certain of its rules and forms to remove references to NRSRO credit ratings. See Release Nos. 34-60789 and IC-28939 (October 5, 2009), 74 FR 52374 (October 9, 2009), available on the SEC's website at http://sec.gov/rules/final/2009/34-60789.pdf. Ms. Elizabeth M. Murphy December 8, 2009 Page 2 of 3 credit ratings issued by NRSROs, and may encourage investors to place "undue reliance" on NRSRO ratings.3 To this end, we strongly support the SEC's recent efforts to address concerns regarding the ratings process through reforms designed to strengthen its oversight of credit ratings agencies, enhance disclosure, and improve the quality of credit ratings.4 The Institute and its members have a

significant interest in the role that NRSROs play in the U.S. securities markets and the SEC's recent amendments and proposed reforms regarding the ratings process are essential to increasing the credibility and reliability of credit ratings for the benefit of funds and other market participants that use these ratings. The proposal to remove references to NRSRO ratings from Rule 5b-3, however, is unnecessary to address the SEC's concerns, and could have serious unintended consequences. Rule 5b-3 under the Investment Company Act allows a fund, for purposes of determining compliance with two provisions of the Act that may affect a fund's ability to invest in repurchase agreements,5 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 is "collateralized fully." For a repurchase agreement to be "collateralized fully," the collateral must consist entirely of cash items, government securities, securities that are rated in the highest rating category by the requisite NRSROs, or unrated securities of a comparable quality as determined by the fund's board of directors or its delegate. Among other things, the SEC is proposing to replace the reference to NRSRO ratings with a requirement that the fund board (or delegate) must determine that non-government securities held as collateral present minimum credit risks and are highly liquid. 3 See Release, supra note 2 at 3. 4 The Release represents one of several recent SEC rulemaking initiatives addressing the role of NRSROs. The SEC's other actions include amendments requiring NRSROs to disclose their history of ratings actions and ensuring all NRSROs have access to similar information. See Amendments to Rules for Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-61050 (November 23, 2009), 74 FR 63832 (December 4, 2009), available at: http://www.sec.gov/rules/final/2009/34-61050.pdf. In addition, the SEC has proposed a series of amendments to its disclosure rules to provide investors with additional information to understand the scope and meaning of credit ratings as well as their limitations, including specific information regarding credit ratings used by registrants, certain information about potential conflicts of interest, preliminary credit ratings, and changes to credit ratings. See Credit Ratings Disclosure, SEC Release Nos. 33-9070, 34-60797, and IC-28942 (October 7, 2009), 74 FR 53086 (October 15, 2009), available on the SEC's website at http://sec.gov/rules/proposed/2009/33-9070.pdf and Proposed Rules for Nationally Recognized Statistical Rating Organizations, SEC Release No. 34-61051 (November 23, 2009), 74 FR 63866 (December 4, 2009), available on the SEC's website at http://www.sec.gov/rules/proposed/2009/34-61051.pdf. The SEC also seeks comment on whether it should propose to repeal the exemption for NRSRO credit ratings from being considered a part of the registration statement for purposes of liability under Section 11 of the Securities Act of 1933. See Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933, SEC Release Nos. 33-9071, 34-60798, and IC-28943 (October 7, 2009), 74 FR 53114 (October 15, 2009), available on the SEC's website at http://sec.gov/rules/concept/2009/33-9071.pdf. 5 Section 5(b)(1) of the Investment Company Act 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). Section 12(d)(3) of the Act 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. Ms. Elizabeth M. Murphy December 8, 2009 Page 3 of 3 This provision in Rule 5b-3 was designed to "ensure that the market value of the collateral will remain fairly stable and that the fund will be able to liquidate the collateral quickly in the event of a default."6 This objective is consistent with the purpose of the rule—to permit funds to "look through" certain repurchase agreements to the underlying collateral for purposes of the Investment Company Act's diversification provisions and

limitations on investments in broker-dealers. It is unclear why the SEC has chosen to remove references to NRSRO ratings from this provision of Rule 5b-3, other than as an overall desire to remove references to ratings from SEC rules. There is no suggestion in the Release that this provision has not proven to be effective and efficient. To the contrary, removing this objective standard and replacing it with a subjective, discretionary test would impose additional burdens on fund boards and investment advisers in assuring compliance with the rule. It also may increase uncertainty or cause confusion among investors who could no longer depend on a consistent and transparent standard across all funds. For these reasons, the Institute opposes removing references to NRSRO ratings from Rule 5b-3. * * * * We look forward to working with the SEC as it continues to examine these critical issues. In the meantime, if you have any questions, please feel free to contact me directly at (202) 326-5815 or Jane Heinrichs, Senior Associate Counsel, at (202) 371-5410. Sincerely, /s/ Karrie McMillan Karrie McMillan General Counsel cc: The Honorable Mary L. Schapiro The Honorable Kathleen L. Casey The Honorable Elisse B. Walter The Honorable Luis A. Aguilar The Honorable Troy A. Paredes Andrew J. Donohue, Director Robert E. Plaze, Associate Director Division of Investment Management 6 Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, SEC Release No. IC-25058 (July 5, 2001), 66 FR 36156 (July 11, 2001).
