To: Securities and Exchange Commission

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Subject: S7-11-09 (Money Market Fund Reform)

The proposed rule requests comments regarding the use of NRSRO ratings for money market fund (MMF) portfolios (p. 33). These comments reflect my background as a former Federal Reserve Board staffer, World Bank Executive Director, and global foreign exchange manager, as well as an 18-year academic career.

Rationale for Discontinuing the Mandatory Use of NRSRO Ratings

Through its insistence on requiring NRSRO ratings in the design of MMF portfolios, the SEC has given a small, select group of rating agencies, with business models that do not put investors' well-being as their central drivers, a major (if not dominant) role in security selection. By making "first" and "second" tier rating agency classifications the most visible approach to MMF safety and soundness, the SEC has provided MMF trustees and managers an attractive way to devote fewer resources and less imagination to the tedious task of examining individual borrower creditworthiness.

This approach to regulating MMFs clearly contributed to the massive meltdown of the money fund sector in late 2008, when The Primary Fund, managed by the Reserve Fund group, "broke the buck" due to its holdings of $785 million in highly-rated Lehman Brothers' commercial paper. This event had an immediate impact on the entire MMF sector, necessitating massive intervention by the Treasury Department in the form of a blanket guarantee of all MMF accounts.

Academic studies of the value of rating agency opinions in predicting borrower default on short-term instruments are decidedly mixed. Some of the problem may be the inherent organizational process lags in making adjustments to new information, a highly relevant issue for short-term security ratings. The most recent comprehensive evaluation of credit agency ratings can be found in Langohr and Langohr

(2008). The authors conclude, "market-based measures may be better predictors of short-term default risk than agency ratings.[1]

An examination of the time line of commercial paper ratings of Lehman Brothers by Moody's and Standard & Poor's, the two dominant rating agencies, provides painful evidence of their inadequacies. While both agencies issued interim qualitative judgments, their bottom-line ratings kept Lehman Brothers commercial paper as "eligible securities" to the bitter end. Note that Standard & Poor's never wavered (and indeed, reaffirmed its top A-1 rating on 6/2/2008) from giving Lehman Brother's its highest rating.

Date	Moody's	Standard & Poor's
1/1/2008	P-1	A-1
6/2/2008	P-1	A-1 (affirmed)
7/17/2008	P-2	A-1
9/14/2008	P-2	A-1
9/15/2008	Lehman Brothers files for Chapter 11 bankruptcy	

In light of this record, it is somewhat surprising that the Request for Comments gives prominence to the Investment Company Institute's March 2009 "Money Market Working Group" statement that eliminating Rule 2a-7's ratings requirements would "remove an important investor protection . . . .. introduce new uncertainties and risks, and abandon a regulatory framework that has proven to be highly successful."[2]

How can a policy be called "highly successful" when it clearly contributed to the need, on 9/19/2008, for an emergency proclamation by the Treasury Department to guarantee, in effect, $3.4 trillion in MMF shares?

Implications of Discontinuing Mandatory Use of NRSRO Ratings

There is substantial precedent and reason to require that MMFs fully disclose the process by which they arrive at credit judgments (including the use of rating agency marks) in establishing their portfolios.

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[1] Herwig Langohr and Patricia Langohr, The Rating Agencies and their Credit Ratings, p. 356.
[2] ICI Report, p. 81.

However, there is little justification, from investors' perspectives, for mandating that investment managers use demonstrably imperfect rating agency judgments as a central part of that process. No doubt abandoning the mandated use of NRSRO ratings would increase the resources which the average MMF would have to devote to credit research, require considerably more attention by MMF trustees, and – perhaps – reduce MMF yields by a few basis points. The possibility of reducing somewhat MMF market share vv traditional depository institutions and others should not be considered in addressing the mandatory rating issue, given the SEC's mission of protecting investors.

As Professor Lawrence White has suggested, removing the special status of NRSROs would most likely stimulate the search for and further development of a large number of alternative sources of information on borrower creditworthiness, including credit spread analysis, the credit default swap market, investment banks and new entrants into the credit information business.[3]

Another impact of eliminating mandatory use of NRSRO ratings might be somewhat greater volatility in money flows out of individual funds. However, greater emphasis on requiring MMFs to maintain adequate liquidity should ameliorate this problem.

In conclusion, the central concern of the SEC Commissioners must continue to be individual investors and the security of their investments through full disclosure. Mandating the use of rating agency marks in designing MMF portfolios may reduce investment managers' expenses and make marketing MMFs easier, but substantial academic research and the events of the past year strongly suggest that it is poor public policy.

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[3] Lawrence J. White, statement for the "Roundtable to Examine Oversight of Credit Rating Agencies" U.S. Securities and Exchange Commission, April 15, 2009