

September 5, 2008

Florence Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: References to Ratings of Nationally Recognized Statistical Rating
Organizations (File No. S7-19-08)

Dear Ms. Harmon:

In light of recent events in the credit markets, the Investment Company Institute¹ and its members strongly support the Securities and Exchange Commission's efforts to address concerns regarding the rating system through reforms to the oversight and operation of credit rating agencies.² We have a significant interest in the role that nationally recognized statistical rating organizations ("NRSROs") play in the U.S. securities markets, and the Commission's proposed reforms are essential to increasing the credibility and reliability of credit ratings, for the benefit of funds and other market participants that use these ratings in making their investment decisions.³

The Institute further supports the Commission's decision to institute a review of its rules in response to concerns about the appropriateness of using references to NRSRO ratings in rules, and

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 \$12.14 trillion and serve almost 90 million shareholders.

² See *Proposed Rules for Nationally Recognized Statistical Rating Organizations*, SEC Release No. 34-57967 (June 17, 2008), 73 FR 36211 (June 25, 2008). For a discussion concerning the Institute's positions on these initiatives, see Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission, dated July 25, 2008 ("July 25 ICI Letter").

³ Investment companies are substantial users of information from credit rating agencies, and the credit ratings published by rating agencies play an important— but not exclusive — role in funds' investment decisions. For a more detailed discussion of how mutual funds employ credit ratings, see July 25 ICI Letter, *supra* note 2, at 4-6.

about whether such references have, in effect, placed an “official seal of approval” on such ratings. We likewise understand the Commission’s desire to ensure that use of NRSRO ratings in its rules does not cause market participants to place “undue reliance” on NRSRO ratings or make them “vulnerable to failures in the ratings process.”⁴

Nonetheless, the Institute strongly opposes the Commission’s proposal to remove references to credit ratings of NRSROs from Rule 2a-7 under the Investment Company Act of 1940. For more than two decades, credit ratings, together with other requirements of the rule, have formed the basis for the tremendous success of money market funds, which currently hold over \$3.5 trillion in assets on behalf of nearly 40 million accounts.

The proposal to remove references to NRSRO ratings from Rule 2a-7 is unnecessary to address the Commission’s stated policy concerns, and it could have serious unintended consequences. It would weaken the investor protections embedded in Rule 2a-7, and it may create the potential to harm investor and market confidence in the entire money market fund industry, which has operated effectively under the safeguards provided by Rule 2a-7 for 25 years. Indeed, as illustrated below in our discussion of the history of Rule 2a-7, it has *never* been appropriate for money market funds to rely *solely* on a security’s NRSRO rating without also separately considering whether that security presents minimal credit risks. The ratings requirement in Rule 2a-7 thus provides a “floor,” below which investments may not be made, that serves to provide an additional and important layer of protection for investors.

Although the Commission also is proposing to remove references to NRSRO ratings from three other rules under the Investment Company Act, we have chosen in this letter to focus our comments on the proposed changes to Rule 2a-7 because ratings play a unique role in the regulation of money market funds and have contributed to the success of the industry.⁵

⁴ See *References to Ratings of Nationally Recognized Statistical Rating Organizations*, SEC Release No. IC-28327 (July 1, 2008), 73 FR 40124 (July 11, 2008) at 5-6 (“Release”). Page number citations in this letter reference the Release as posted on the Commission’s website, which is available at <http://sec.gov/rules/proposed/2008/ic-28327.pdf>. See also companion releases, *References to Ratings of Nationally Recognized Statistical Rating Organizations*, SEC Release No. 34-58070 (July 1, 2008), 73 FR 40087 (July 11, 2008) and *Security Ratings*, SEC Release No. 33-8940 (July 1, 2008), 73 FR 40106 (July 11, 2008).

⁵ In the event that the Commission determines to remove references to NRSRO ratings from Rule 2a-7 and/or the other Investment Company Act rules, Section II.B. of this letter recommends that the Commission clarify and, to the extent feasible harmonize, the intended scope of the credit standards that would replace the ratings references. The Commission also should provide specific examples of how funds might satisfy these standards. Without such guidance, it would prove difficult for fund advisers to craft – and fund boards to approve – policies and procedures that are reasonably designed to ensure compliance with the new standards.

I. Money Market Funds and Rule 2a-7

Money market funds are open-end management investment companies that invest in short-term debt instruments. One unique feature of money market funds is that they seek to maintain a stable share price, typically one dollar per share.⁶ The Investment Company Act and applicable rules generally require mutual funds to calculate current net asset value per share by valuing their portfolio securities for which market quotations are readily available at market value and other securities and assets at fair value as determined in good faith by the board of directors.⁷ Rule 2a-7 exempts money market funds from these provisions but contains maturity, quality, and diversification conditions designed to minimize the deviation between a money market fund's stabilized share price and the market value of its portfolio. Among these conditions, Rule 2a-7 limits the types of securities in which money market funds can invest to those securities that qualify as "Eligible Securities"⁸ and that a fund's board (or its delegate) determines present minimal credit risks.

These limitations on the types of securities in which money market funds can invest help money market funds achieve the objective of maintaining a stable net asset value. Credit ratings form an integral part of these limitations. For example, money market funds may only invest in securities either rated by the "Requisite NRSROs"⁹ in one of the two highest short-term rating categories or, if unrated, as determined by the fund's board of directors (or its delegate) to be of comparable quality. In general, money market funds also cannot invest in certain securities, including most asset-backed securities and certain guarantees, unless they have been rated. Finally, Rule 2a-7 requires money market fund advisers to take certain actions in the event a security is downgraded. While Rule 2a-7 does not completely limit money market funds to investments in rated securities, it effectively requires fund advisers to incorporate any available ratings into the analysis of appropriate securities to be held by these funds.

Rule 2a-7 also requires that a fund's board (or its delegate) independently evaluate the credit quality of each portfolio investment and determine that each investment presents minimal credit risks. NRSRO ratings complement this determination by providing a third-party's evaluation of credit quality for the instruments in which money market funds may invest. In this important if limited way,

⁶ To maintain a stable price per share, money market funds use the amortized cost method of valuation and/or the penny-rounding method of pricing. Under the amortized cost method of valuation, money market funds value their portfolio securities by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. Under the penny rounding method of pricing, share price is determined by valuing securities either at market value, fair value, or amortized cost, and rounding the per share net asset value to the nearest cent on a share price of one dollar.

⁷ See Section 2(a)(41) of the Investment Company Act and Rules 2a-4 and 22c-1.

⁸ See Rule 2a-7(a)(10) for a definition of an "Eligible Security."

⁹ See Rule 2a-7(a)(21) for a definition of "Requisite NRSROs."

they are an integral part of the protections designed to manage the overall credit risks of a fund's holdings.

These exacting standards have contributed to the success of money market funds since the Commission adopted Rule 2a-7 25 years ago. In that time, money market fund assets have grown over 1800 percent, from \$179 billion to \$3.5 trillion. Today, retail and institutional investors alike rely on these funds as a cash management tool because of the high degree of liquidity, stability in principal value, and yield that they offer relative to other cash management vehicles.¹⁰ No government entity insures money market funds, as the FDIC does bank deposits. Nevertheless, as an estimated \$324 trillion flowed into and out of money market funds over the past 25 years, through some of the most volatile markets in our history, only once has such a fund failed to repay the full principal amount of its shareholders' investments. In that case, a small institutional money fund in 1994 "broke-the-buck" due to extensive derivatives-related holdings. The public's faith in money market funds also has been evident during the recent volatility in the credit markets. As a result of overall market volatility, retail and institutional investors alike have kept a greater proportion of their short-term investments in safe and liquid vehicles. Indeed, investors have added over a trillion dollars to money market funds since February 2007.

A. History of Rule 2a-7

As noted above, Rule 2a-7 is primarily an exemptive rule that permits money market funds to determine their net asset value using two types of valuation methods that facilitate the maintenance of a stable share price.¹¹ Prior to the adoption of the rule, money market funds had to obtain exemptive relief from the pricing and valuation provisions of the Investment Company Act.¹² These orders were the product of a lengthy process that included an evidentiary hearing on the issues associated with permitting mutual funds to use the amortized cost method of valuation. The Commission and the

¹⁰ The Commission staff also recognizes that money market fund shares generally are equivalent to cash items. *See Willkie Farr & Gallagher*, SEC No-Action Letter (pub. avail. October 23, 2000) (permitting operating companies to treat money market fund shares as "cash items" for purposes of determining whether the issuer is an investment company under the Investment Company Act and rules thereunder).

¹¹ Any fund that holds itself out as a money market fund, even if it does not rely on the exemptions provided by the rule to maintain a stable share price, also must comply with the rule's risk limiting conditions. The Commission adopted this approach to address the concern that investors would be misled if an investment company that holds itself out as a money market fund engages in investment strategies not consistent with the risk-limiting conditions of Rule 2a-7.

¹² *See e.g., In the Matter of Intercapital Liquid Asset Fund, Inc. et. al.*, SEC Release No. IC-10824 (August 8, 1979) (first exemptive order permitting the use of the amortized cost method of valuing shares).

applicants focused in particular on conditions relating to portfolio quality and the necessity for a rating requirement.¹³

In 1983, the Commission adopted Rule 2a-7, which generally codified the terms and conditions contained in the exemptive orders.¹⁴ The basic objective of Rule 2a-7 – then and now – is to limit a money market fund’s exposure to credit risks (*i.e.*, the exposure, through default or otherwise, of securities to risks associated with the creditworthiness of the issuer) and market risk (*i.e.*, the exposure of securities to significant changes in value due to changes in prevailing interest rates). One of the key conditions adopted in the rule to meet this objective was the requirement that a money market fund only invest in “high quality,” short-term dollar-denominated debt securities that the fund’s board has determined present minimal credit risks. “High quality” securities were generally considered to be those that had received one of the two top ratings by “any major rating service” (the term “NRSRO” then not being in widespread use) or, in the case of unrated securities, were of comparable quality.

In explaining the need for *both* a high quality rating and a minimal credit risk determination, the Commission observed the following:

The requirement that a security have a high quality rating provides protection by ensuring input into the quality determination by an outside source. However, the mere fact that an instrument has or would receive a high quality rating may not be sufficient to ensure stability. The Commission believes that the instrument must be evaluated for the credit risk that it presents to the particular fund at that time in light of the risks attendant to the use of amortized cost valuation or penny-rounding. Moreover, the board may look at some aspects when evaluating the risk of an investment that would not be considered by the rating services.¹⁵

In response to changing market conditions or various market events, the Commission has amended Rule 2a-7 several times. In all these cases, while noting the importance of the subjective test of the rule, the Commission has never suggested that money market funds have relied unnecessarily on NRSRO ratings or identified any abuses of the objective NRSRO ratings-based standard that would justify removing references to NRSRO ratings from the rule.

¹³ See *Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds)*, SEC Release No. IC-12206 (February 1, 1982), 47 FR 5428 (February 5, 1982) (proposing Rule 2a-7).

¹⁴ See *Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds)*, SEC Release No. IC-13380 (July 11, 1983), 48 FR 32555 (July 18, 1983) (“Rule 2a-7 Adopting Release”).

¹⁵ See *id.* at text preceding note 32.

For example, in late 1989 and early 1990, several money market funds held commercial paper of issuers that defaulted.¹⁶ In response to an Institute no-action request for the Commission to issue an interpretive release that, among other things, would list the factors that might be considered in determining whether a particular instrument presents minimal credit risks, the Commission staff agreed that “the [fund] board should take into account, as appropriate, the kinds of factors listed in [the Institute’s] letter,” but declined to take any further action.¹⁷ Continued concerns about defaults of commercial paper, however, led the Commission staff to issue a second letter in May 1990.¹⁸ In that letter, the staff reminded money market funds that they could not buy securities based upon NRSRO ratings alone. The 1990 Letter reiterated that Rule 2a-7 requires a two-part test (*i.e.*, a security must be both high quality *and* present minimal credit risks). The 1990 Letter also listed a number of elements of a minimal credit risk analysis.

Soon after the 1990 Letter, the Commission proposed amendments to Rule 2a-7¹⁹ to reflect significant changes in the financial markets since the rule’s adoption, including the expansion of the commercial paper market and the contemporaneous decline of the credit ratings of certain money center banks. In adopting these amendments, the Commission explained that they were

necessary to ensure that money market funds meet investors’ expectations for safety, soundness and convenience by maximizing the likelihood that these funds will be able to maintain a stable net asset value under the pricing procedures they are permitted to use.²⁰

The 1991 Amendments, which focused primarily on taxable money market funds, tightened the credit standards for eligible investments by breaking them into two categories (*i.e.*, First Tier and

¹⁶ The commercial paper had the second highest rating from one NRSRO when purchased by the funds and thus was eligible for investment under Rule 2a-7, as then in effect. Shareholders of the funds that held the commercial paper were not adversely affected because each fund’s investment adviser purchased the paper from its funds at amortized cost or principal amount or otherwise agreed to indemnify its fund.

¹⁷ See *Investment Company Institute*, SEC No-Action Letter (pub. avail. December 6, 1989).

¹⁸ See *Letter to Registrants*, SEC No-Action Letter (pub. avail. May 8, 1990) (“1990 Letter”).

¹⁹ See *Revisions to Rules Regulating Money Market Funds*, SEC Release No. IC-17589 (July 17, 1990), 55 FR 30239 (July 25, 1990) (“1990 Proposing Release”).

²⁰ See *Revisions to Rules Regulating Money Market Funds*, SEC Release No. IC-18005 (February 20, 1991), 56 FR 8113 (February 27, 1991), at text immediately following note 19 (“1991 Amendments”).

Second Tier Securities),²¹ limiting the amount of Second Tier Securities that could be purchased by taxable money market funds, and adding a diversification requirement for taxable funds.²²

The 1991 Amendments also included the only substantive change ever made to the wording of the minimal credit risk requirement. The Commission added the parenthetical “(which determination must be based on factors pertaining to credit quality in addition to the rating assigned to such instruments by a NRSRO)” at the end of the requirement. The Commission explained that this language was intended to underscore the following:

Possession of a certain rating by a NRSRO is not a ‘safe harbor.’ Where the security is rated, having the requisite NRSRO rating is a necessary but not sufficient condition for investing in the security and cannot be the sole factor considered in determining whether a security has minimal credit risks.²³

The last major amendments to Rule 2a-7 were proposed in 1993²⁴ and adopted in 1996.²⁵ The primary purpose of the 1996 Amendments was to tighten the investment restrictions on tax-exempt money market funds to more closely parallel those conditions imposed on taxable money market funds under the 1991 Amendments. Among other things, the 1996 Amendments required that most asset-backed securities have a rating from an NRSRO to be eligible for fund investment.²⁶

²¹ See Rule 2a-7(a)(12) and (22) for definitions of a “First Tier Security” and a “Second Tier Security.”

²² In addition, the 1991 Amendments broadened the role of the fund board in overseeing compliance with the rule by requiring the board to reassess a security’s minimal credit risks whenever it ceased to qualify as a First Tier Security, or whenever a Second Tier Security or a previously unrated security was rated by any NRSRO below its second highest short-term rating category.

²³ See 1991 Amendments, *supra* note 20, at note 18 and accompanying text.

²⁴ See *Revisions to Rules Regulating Money Market Funds*, SEC Release No. IC-19959 (December 17, 1993), 58 FR 68585 (December 28, 1993). In this release, the Commission also confirmed a long-held view of the Commission and of most money market fund managers that “[f]unds have a continuing duty under rule 2a-7 to ensure that all securities in their portfolios continue to present minimal credit risks.” *Id.* at note 126 and accompanying text.

²⁵ See *Revisions to Rules Regulating Money Market Funds*, SEC Release No. IC-21837 (March 26, 1996), 61 FR 13955 (March 28, 1996) (“1996 Amendments”).

²⁶ The 1996 Amendments also imposed a number of new procedural and recordkeeping requirements on all money market funds, and were designed to restrict further the amount of credit and interest rate risk that a money market fund can assume. Finally, the 1996 Amendments clarified the credit quality, diversification, and maturity determination standards applicable to synthetic tax-exempt securities and asset-backed securities.

B. Eliminating References to NRSRO Ratings

The Commission proposes to eliminate all references to NRSRO ratings from Rule 2a-7 and replace them with new subjective standards for evaluating and monitoring securities under the rule.²⁷ For the reasons outlined below, we strongly believe that the proposal is unnecessary to address Commission concerns regarding NRSRO ratings and would result in an unacceptable weakening of the rule, to the detriment of money market fund investors.

Most significantly, NRSRO ratings play a vital role under Rule 2a-7 by providing a “clear reference point” for money market funds, both large and small, by which to measure compliance with the rule’s requirements. By acting as a floor, these ratings keep all money market funds operating at or above the same level and restrain any particular money market fund from taking greater risks than other competing funds to increase yield (thus gaining competitive advantage in a highly yield-sensitive market). They also discourage funds from “stretching” the minimal credit risk definition to include investment opportunities that do not have a “high quality” rating and that could prove to be inappropriate in light of the fund’s objective of maintaining a stable net asset value. When it adopted Rule 2a-7, the Commission did not think permitting such “stretching” would be wise, and, as noted above, it has effectively reconfirmed this position when considering changes to the rule on several subsequent occasions. As the rule’s regulatory history demonstrates, NRSRO ratings are only one factor to be considered. A money market fund’s board (or its delegate) also must affirmatively determine that each security purchased presents minimal credit risks. Indeed, our members have confirmed that they use NRSRO ratings as a critical baseline from which to *start* their own internal credit review process.

It appears that the Commission’s proposal to up-end this well established framework is not based upon perceived failures in the operation of Rule 2a-7, but instead upon a more generalized desire to remove references to NRSRO ratings from all rules. In fact, Commission staff recently conducted a sweep examination of the money market fund industry and has not reported any serious deficiencies in funds’ independent credit review processes. For these reasons, we emphatically disagree with the

²⁷ Specifically, the proposal would revise the definition of Eligible Security to mean a security that “the fund’s board of directors determines 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).” The proposal would revise the definition of First Tier Security to mean “a security the issuer of which the fund’s board of directors has determined has the highest capacity to meet its short term financial obligations.” Consistent with the current rule, the proposal would retain the definition of and limitations on investments in, Second Tier Securities. A new standard of review for monitoring credit risks is also being proposed. This new standard would require a fund’s board to reassess a security if it becomes aware of “any information about a portfolio security or issuer of a portfolio security that may suggest that the security may not continue to present minimal credit risks.”

unsubstantiated suggestion in the Release that “the current rule’s reliance on credit ratings discourages fund directors and investment advisers from performing independent credit risk assessments.”²⁸

The proposal has the potential to weaken the investor protections embodied in the rule, to the detriment of money market fund shareholders. Specifically, as discussed above, the objective NRSRO ratings test is but one prong of a two-prong test to determine the eligibility of portfolio securities. Removing the objective prong would, in and of itself, weaken the rule. Similarly, the subjective judgments that would replace the two-prong test would require, among other things, a determination that an issuer has the “highest capacity to meet its short-term financial obligations.” The factors used for this determination are not listed in the Release, and thus will vary from fund to fund and from adviser to adviser. Accompanying this expanded discretion is a risk that a fund may invest in a security that would not have qualified under the rule’s current standards, thereby raising the potential for harm to not only the shareholders in that particular fund, but to the entire money market fund industry.

Removing NRSRO ratings from Rule 2a-7 also raises broader regulatory concerns for fund directors. For example, the proposed amendments would require boards to determine whether a security is a First Tier Security. In order to make this determination, the board (or its delegate, although the board still retains oversight responsibility) would need to determine whether an issuer meets the standard discussed above, *i.e.*, “has the highest capacity to meet its short-term financial obligations.” This standard would be difficult for a fund board (or its delegate) to administer, and determinations made pursuant to such standard could be subject to significant second-guessing. In contrast, a fund board currently is responsible for making a determination of First Tier Security status only with respect to unrated securities, which is based on a more readily ascertainable standard, *i.e.*, comparability to a rated security. The proposal therefore would make fund boards (or their delegates) responsible for additional investment-related determinations that do not appear to involve conflicts of interest, contrary to the Commission’s stated intent to reduce the everyday burdens of fund directors in these situations.²⁹

²⁸ Release, *supra* note 4, at 9-10. Given the express requirement in the rule for an independent credit analysis, we find it puzzling that the Commission, in its cost-benefit analysis, would conclude that the costs associated with the proposed amendments are likely to be minimal because, among other things, “[i]n many cases, investors may still choose to rely *solely* on NRSRO ratings without incurring additional costs.” Release, *supra* note 4, at 40 (emphasis added). At no time in the twenty-five years since Rule 2a-7 was adopted have money market fund boards or investment advisers been able to rely solely on NRSRO ratings in determining whether securities are eligible for money market fund investment.

²⁹ In its landmark study of mutual fund regulation, the Commission’s Division of Investment Management stated that “independent directors are unnecessarily burdened . . . when required to make determinations that call for a high level of involvement in day-to-day activities. Rules that impose specific duties and responsibilities on the independent directors should not require them to “micro-manage” operational matters. To the extent possible, operational matters that do not present a conflict between the interests of advisers and the investment companies they advise should be handled primarily or exclusively by the investment adviser.” Division of Investment Management, Securities and Exchange Commission, *Protecting Investors: A Half-Century of Investment Company Regulation* (1992) at 266. Based on this conclusion, the Commission adopted a number of rule amendments to limit fund board approval requirements in matters that do not

The proposal also would present significant compliance challenges. For example, the proposal would establish a new standard for monitoring credit risk that would put fund boards and investment advisers in the untenable position of having to monitor for “*any* information about a portfolio security or an issuer of a portfolio security that *may suggest* that the security may not continue to present minimal credit risks”³⁰ Currently, Rule 2a-7 requires a money market fund board to reassess promptly whether a security continues to present minimal credit risks if either (i) the security ceases to be a First Tier Security or (ii) the money market fund’s investment adviser becomes aware that any Unrated Security³¹ or Second Tier Security held by the money market fund has, since the security was acquired by the fund, been given a rating by any NRSRO below the NRSRO’s second highest short-term rating category. This provision was added to the rule in 1991 “to assure that a money market fund will remain sensitive to, and take appropriate action in response to, perceived changes in the credit quality of Second Tier and Unrated Securities after they have been acquired by the fund.”³² It provides a clear trigger for a reassessment of a security’s minimum credit risks and assures that actions by an NRSRO receive appropriate attention.

By removing this objective trigger and setting the standard for reassessment of a security’s eligibility under the rule to the mere *suggestion* of an adverse credit development, the proposal would require investment advisers to monitor and maintain records of any new potentially relevant information about a portfolio security or an issuer, including numerous changes to credit assessments, which in many instances would not provide indications of true adverse developments. Funds would have to bear the costs and risks of being second-guessed for failing to respond to information that later proves to have had significant credit implications. In addition, a money market fund’s board of directors must currently establish *reasonable* procedures for monitoring the minimal credit risks of portfolio securities, which may be tailored to the circumstances of an individual fund or investment adviser. The Release offers no justification for eliminating the objective trigger and taking discretion from the board of directors by uniformly imposing an untenable standard for monitoring credit risks.³³

involve conflicts of interest. *See also* Andrew J. Donohue, Director, Division of Investment Management, Securities and Exchange Commission, Keynote Address at the Investment Company Directors Conference (November 28, 2007).

³⁰ Release, *supra* note 4, at 12 (emphasis added).

³¹ *See* Rule 2a-7(a)(28) for a definition of an “Unrated Security.”

³² *See* 1991 Amendments, *supra* note 20, at text immediately following note 72. The provision codified guidance that the Commission had provided to fund boards concerning the actions that should be taken if securities ceased to be “high quality.” *See* 1990 Proposing Release, *supra* note 19, at note 54 and accompanying text.

³³ To the extent that funds must hire additional staff or expend additional resources to comply with the enhanced monitoring requirements, the proposal could impose more than “minimal new costs,” as the Commission suggests. *See* Release, *supra* note 4, at 41.

Finally, in seeking to achieve its stated policy objectives, the Commission should not lose sight of the rationale for adopting Rule 2a-7 – to provide an exemption from the requirement that mutual fund share price be based on market value and to facilitate a money market fund’s stable net asset value. When Rule 2a-7 was adopted, and each time that it has been amended, the Commission has concluded that the rule satisfies the standards of Section 6(c) of the Investment Company Act – specifically, that the exemption is “necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Investment Company Act].” The conditions in Rule 2a-7 relating to credit quality – both the objective threshold provided by reference to NRSRO ratings and the subjective requirement of a minimal credit risk determination by the fund board or its delegate – have formed a major basis for these findings by the Commission under Section 6(c). These important conditions in Rule 2a-7 should not be compromised in order to achieve objectives (*i.e.*, improving the quality of credit analysis) that would be better accomplished through other means.

In sum, we reiterate our support for the Commission’s efforts to address weaknesses in the rating process and improve regulatory oversight of NRSROs. Reforms of this nature will increase the usefulness, credibility, and reliability of ratings. For its part, the Institute is taking steps to provide its members with additional guidance concerning minimal credit risk determinations that accompany the NRSRO ratings test of Rule 2a-7. We have gathered information regarding our members’ existing procedures, which we are using to update previous Commission staff guidance concerning minimal credit risk determinations when evaluating the credit, legal, and structural risks of a security suitable to be held by a money market fund. Together with the Commission’s efforts to address weaknesses in the rating process and to improve regulatory oversight of NRSROs, these efforts should further improve the quality of credit analyses by money market funds. This approach, we believe, is likely to better address Commission concerns about catching “failures in the ratings process” than would the draconian step of removing NRSRO ratings from Rule 2a-7 altogether. Ratings – even if occasionally flawed – protect investors by establishing an important floor below which investments may not be made. By eliminating this floor, the Commission would remove an important investor protection from Rule 2a-7, abandon a regulatory framework that has proven highly successful, introduce new uncertainties and risks, and put in jeopardy a form of mutual fund that has served investors highly successfully for a generation.

II. Other Comments

A. Rule 17a-9 Transactions

The proposal 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 Release states the Commission’s belief that the current notice provisions in Rule 2a-7, which are triggered when a portfolio security defaults, provide

the Commission with incomplete information about money market funds holding distressed securities, particularly those funds that have engaged in a transaction with an affiliated person under Rule 17a-9.³⁴ We support the proposal and agree with the Commission that the proposed notice would enhance its oversight of money market funds, especially during times of economic stress.³⁵

We also recommend that the Commission propose amendments to Rule 17a-9. Currently, the rule only permits a fund's affiliate to purchase a security that is no longer an Eligible Security. Our experience during the recent credit market turmoil has taught us that fund shareholders may be better protected if an affiliate could exercise its ability to purchase a portfolio security at other times (*e.g.*, when market conditions have caused the security to be illiquid but still an Eligible Security) and Commission staff resources could be allocated to other tasks if not required to assess requests for these purchases. Expanding Rule 17a-9 in this manner also may enable affiliates to better provide money market funds with needed liquidity to meet redemptions during times of market stress.³⁶ We therefore recommend that the Commission propose amendments to Rule 17a-9 that would expand the securities eligible to be purchased by an affiliate under the rule (*e.g.*, to those securities subject to events specified in Rule 2a-7(c)(6)(ii)³⁷).

B. Clarify Proposed Standards for Credit Determinations

The Commission proposes to create several new standards by which credit determinations would be made without reliance on NRSRO ratings. First, as discussed above, the proposal would amend Rule 2a-7 to require that a fund board (or its delegate) determine that each portfolio security is a First Tier Security (*i.e.*, that the security "presents minimal credit risks" and that its issuer has "the highest capacity to meet its short-term financial obligations") or a Second Tier Security (*i.e.*, that the security "presents minimal credit risks"). Second, under Rule 5b-3 under the Investment Company Act, a fund board (or its delegate) would be required to determine that certain securities serving as collateral for a repurchase agreement "are subject to no greater than minimal credit risk." Third, under Rule 10f-3 under the Investment Company Act, a fund would be permitted to purchase municipal securities in a syndicate in which an affiliate was a participant in reliance on the rule only if such

³⁴ Absent a Commission exemption, Section 17(a)(2) of the Investment Company Act prohibits an affiliated person of a fund from knowingly purchasing a security from the fund.

³⁵ We note, however, that the proposed notice requirement would be more effective if the obligation to provide notice is based upon an objective trigger common to all funds. This would be accomplished by retaining the reference to NRSRO ratings in the definition of Eligible Security.

³⁶ Any such expansion, however, should in no way suggest that affiliated persons of funds have any legal obligation to enter into such transactions.

³⁷ These events include situations in which a portfolio security has defaulted, has ceased to be an Eligible Security, or has been determined to no longer present minimal credit risks. It also includes a situation where the issuer of the security experiences an insolvency event.

securities are either “subject to no greater than moderate credit risk” or, in the case of less seasoned securities, “subject to a minimal or low amount of credit risk.”

The Release fails to provide guidance as to how these different standards should be interpreted and, in fact, sends conflicting signals about how the Commission itself views these proposed standards.³⁸ On the one hand, the Release contains a broad statement that the standards “are designed to appropriately achieve the same purpose as the ratings” requirement currently included in each rule.³⁹ This would seem to suggest, for example, that the “subject to no greater than minimal credit risk” standard proposed for Rule 5b-3 is meant generally to replicate the current requirement in the rule that securities be rated in the highest rating category.⁴⁰

On the other hand, there are suggestions in the Commission’s cost-benefit analysis that the proposed standards are meant to be more expansive than the NRSRO ratings categories they would replace. The Commission remarks, for example, that

by moving away from a required reliance on credit ratings in [Commission] rules, funds may benefit by acquiring a wider range of securities that present attractive investment opportunities and the requisite level of credit risks, although they do not meet the current rules’ rating requirements.⁴¹

The cost-benefit analysis also refers to funds’ “expanded discretion” under the proposal and states that, “[f]or example, under the proposed amendments to Rule 2a-7, money market funds would be able to invest in securities that have received credit ratings outside of the two highest short-term rating categories.”⁴² Our members do not desire this flexibility, and in fact view it as a cost rather than a

³⁸ This is particularly true for the proposed requirement that a security under Rule 2a-7 would be a First Tier Security if the fund’s board has determined that the issuer has the “highest capacity to meet its short-term financial obligations.” There is no guidance on whether an issuer would have to have the same capacity as, for example, the United States government (which is generally understood to have the “highest capacity” to meet its short-term obligations) or whether fund boards would have the flexibility to assess capacity based on the criteria that the NRSROs apply in issuing their highest ratings.

³⁹ Release, *supra* note 4, at 6.

⁴⁰ For Rule 10f-3, it would appear that the “subject to a minimal or low amount of credit risk” standard proposed for less seasoned municipal securities is intended to replicate the existing requirement in the rule that such securities be rated in one of the three highest categories by an NRSRO, and the “subject to no greater than moderate credit risk” standard proposed for all other municipal securities is intended to replicate the existing requirement that such securities be rated in one of the four highest categories by an NRSRO (*i.e.*, an investment grade rating).

⁴¹ Release, *supra* note 4, at 39.

⁴² Release, *supra* note 4, at 40. The Release goes on to suggest that funds “may incur additional costs if [they] . . . use this expanded discretion to purchase . . . risky or illiquid securities. We believe that these potential costs would be mitigated, however, by market forces, including, in the case of money market funds, investors’ desire to maintain the principal value of their investments.” *Id.* at 40-41. In the Institute’s view, this statement appears to be at odds with the underlying intent of

benefit. Many investors buy money market funds based solely on yield, providing a strong temptation for a fund to “chase yield” by taking more risk than its peers. Our members view the ability to take these risks as potentially detrimental to the market’s perception of money market funds as a whole, and strongly oppose efforts to expand the universe of Eligible Securities.

If the Commission determines to remove references to NRSRO ratings from any of these Investment Company Act rules, the Institute recommends that the Commission clarify and, to the extent feasible, harmonize the intended scope of the credit standards that would replace such references. The Commission also should provide specific examples of how funds might satisfy these standards. Without such guidance, it would prove difficult for fund advisers to craft – and fund boards to approve – policies and procedures that are reasonably designed to ensure compliance with the new standards. A lack of clear guidance also would leave funds vulnerable to the possibility that the policies and procedures they do adopt, and the credit determinations made pursuant to them, could be subject to second-guessing by third parties with the benefit of hindsight.

* * * * *

We look forward to working with the Commission as it continues to examine these critical issues. In the meantime, if you have any questions, please feel free to contact me at (202) 326-5901 or Karrie McMillan, the Institute’s General Counsel, at (202) 326-5815.

Sincerely,

/s/ Paul Schott Stevens

Paul Schott Stevens
President & CEO
Investment Company Institute

these three rules, which is to emphasize the importance of credit quality and liquidity of the fund’s investments (in the case of Rules 2a-7 and 10f-3) and of the securities serving as collateral for the fund’s investments (in the case of Rule 5b-3). It is profoundly at odds with Rule 2a-7’s objective of assuring that money market fund portfolio investments are limited to “those instruments that have a low level of volatility and thus will provide a greater assurance that the money market fund will continue to be able to maintain a stable price per share that fairly reflects the current net asset value per share of the fund.” See Rule 2a-7 Adopting Release, *supra* note 14, at notes 7-8 and accompanying text.

Ms. Florence Harmon

September 5, 2008

Page 15 of 15

cc: The Honorable Christopher Cox, Chairman
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The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

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