
September 5, 2008

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

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

Dear Ms. Harmon:

The Calvert Group of Funds ("Calvert")[1] is writing to respond to certain questions that the Securities and Exchange Commission (the "Commission") presented for comment in Release No. IC-28327 (the "Release"), which proposed the deletion of references to ratings of Nationally Recognized Statistical Rating Organizations ("NRSROs") in several Commission regulations, including Rule 2a-7 under the Investment Company Act of 1940 ("Rule 2a-7").

Calvert is opposed to the Commission's proposal to delete NRSRO rating references in the Commission's regulations, and finds the proposals relating to Rule 2a-7 to be especially disconcerting. Accordingly, Calvert fully concurs with the letter filed with the Commission by the Investment Company Institute ("ICI") in response to the Release (the "ICI Letter"). The ICI Letter adeptly explains why the proposals in the Release are ill-conceived, and would not only not help the money market mutual fund industry (the "Industry") to better serve its shareholders, but might actually harm its ability to do so. However, while the ICI Letter does provide a useful history of Rule 2a-7, it does not really analyze how the Industry came to the point where it has to defend a rule to the Commission that has served the Industry, money market fund shareholders and the Commission so well for 25 years. To that end, it is instructive to examine the Release in detail insofar as it relates to Rule 2a-7, in particular (i) the Commission's assumption that money market mutual fund Boards and advisers are unduly relying upon NRSRO ratings and skirting their duty to conduct independent credit analysis, (ii) the Commission's cost-benefit analysis and (iii) the Commission's efficiency analysis.

Calvert also finds the Commission's proposal to delete NRSRO rating references from Rule 5b-3 under the Investment Company Act of 1940 ("Rule 5b-3") to be problematic. With respect to repurchase agreements, the proposals would likely result in the acceptance of riskier collateral securities by those money market funds that accept collateral other than cash and government securities. With respect to refunded securities, the proposals would force most money market funds to obtain the independent accountant's certification, which would introduce additional transaction costs and could undermine liquidity for refunded securities.

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[1] Calvert Group, Ltd. is a financial services firm specializing in fixed-income and sustainable and responsible investing, offering 41 mutual fund portfolios, with approximately $15 billion in assets under management. Calvert's philosophy is that shareholders can make sound investments without compromising their values. Accordingly, certain of Calvert's funds, in addition to assessing the economic viability of potential investments, evaluate companies according to specific environmental, social and governance criteria designed for each fund.

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## I. The Commission's Assumption That Money Market Mutual Fund Boards and Advisers are Unduly Relying Upon NRSRO Ratings and Skirting Their Duty to Conduct Independent Credit Analysis

The Commission has proposed to substantially alter Rule 2a-7, which has served the Industry and money market fund shareholders well through all types of market environments. Although the Release is 70 pages in length, the Commission offers just the following three paragraphs as its rationale for the proposed Rule 2a-7 amendments:

> Today's proposals comprise the third of these three rulemaking initiatives relating to credit ratings by an NRSRO that the Commission is proposing. This release, together with two companion releases, sets forth the results of the Commission's review of the requirements in its rules and forms that rely on credit ratings by an NRSRO. The proposals also address recent recommendations issued by the President's Working Group on Financial Markets ("PWG"), the Financial Stability Forum ("FSF") and the Technical Committee of the International Organization of Securities Commissions ("IOSCO"). Consistent with these recommendations, the Commission is considering whether the inclusion of requirements related to ratings in its rules and forms has, in effect, placed an "official seal of approval" on ratings that **could adversely affect** the quality of due diligence and investment analysis. The Commission believes that today's proposal **could reduce undue reliance** on credit ratings and result in improvements in the analysis that underlies investment decisions.
>
> Referring to NRSRO ratings in regulations was intended to provide a clear reference point to both regulators and market participants. Increasingly, we have seen clear disadvantages of using the term in many of our regulations. Foremost, **there is a risk** that investors interpret the use of the term in laws and regulations as an endorsement of the quality of the credit ratings issued by NRSROs, which **may have encouraged** investors to place undue reliance on the credit ratings issued by these entities. In addition, as demonstrated by recent events, there has been increasing concern about ratings and the ratings process. Further, by referencing ratings in the Commission's rules, market participants operating pursuant to these rules **may be vulnerable** to failures in the rating process. In light of this, the Commission proposes to amend regulations under the Investment Company Act and the Investment Advisers Act that use the term NRSRO or refer to NRSRO ratings.
>
> As discussed above, the proposed rule amendments are designed **to address the risk** that the reference to and use of NRSRO ratings in our rules is interpreted by investors as an endorsement of the quality of the credit ratings issued by NRSROs, and **may encourage** investors to place undue reliance on the NRSRO ratings. The proposed amendments to [R]ules 2a-7, 3a-7, 5b-3, and 10f-3 under the Investment Company Act and [R]ule 206(3)-(3)T under the Investment Advisers Act would eliminate the reference to and requirement for the use of NRSRO ratings in those rules.[2] [emphasis added]

The only concrete market development referred to in the Commission's justification for the changes that it proposes in the Release relates to a breakdown in the ratings process, in particular the numerous conflicts of interest between the NRSROs and their clients. The Commission, however, has proposed to address these problems in Securities and Exchange Act Release No. 57967 (Proposed

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[2] *References to Ratings in Nationally Recognized Statistical Rating Organizations*, SEC Release No. IC-28327 (July 1, 2008), 73 FR 40124 (July 11, 2008) at 4-6 and 38 ("SEC Release No. IC-28327"). 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.

Rules for Nationally Recognized Statistical Rating Organizations), which Calvert fully supports. SEC Release No. 57967 clearly contemplates that integrity can be restored to the ratings process through the reforms that the Commission proposed therein, and Calvert agrees with that assessment. But if the ratings process can be fixed and the information imparted by NRSROs through their ratings can thereby be made more robust, then it doesn't make sense to use the ratings process breakdown as a justification for stripping from the Commission's regulations all references to NRSRO ratings.

The irony, of course, is that Rule 2a-7 is specifically designed to avoid the undue reliance on NRSRO ratings that the Commission seeks to avoid through the proposals in the Release. Paragraph (c)(3)(i) of Rule 2a-7 reads as follows:

> The money market fund shall limit its portfolio investments to those United States Dollar-Denominated securities that the fund's board of directors determines present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to any rating assigned to such securities by an NRSRO) and that are at the time of [a]cquisition Eligible Securities.[3]

Rule 2a-7 imposes a clear legal duty on a money market fund's board (or its delegate) to conduct adequate independent credit analysis to reach a determination that the fund's portfolio investments "present minimal credit risks". That unfortunately leaves only two possibilities with respect to the Release: either (i) the Commission's assumption is flawed, and mutual fund directors (or their delegates) are broadly in compliance with their legal obligations, are conducting the independent credit analysis that is required under Rule 2a-7 and are therefore, by definition, not unduly relying on NRSRO ratings, or (ii) the Commission's assumption is correct, and there is ongoing, widespread illegal conduct occurring in the Industry. Calvert believes that the former is clearly the case, but, in the unlikely event that the latter is true, Calvert believes that the appropriate remedy would be for the Commission to commence appropriate enforcement actions against those funds and not to delete NRSRO ratings from Rule 2a-7.

Calvert acknowledges that the Commission may regulate prophylactically to address perceived risks, and that it may do so without presenting empirical evidence in support of such regulation.[4] However, in the absence of any data the risk that the Commission will base regulation on potentially unwarranted assumptions is significantly higher. Unlike the potential risks identified in the Release, this risk should give the Commission pause. Calvert hopes that the Commission would agree that its first objective in making any change to Rule 2a-7 should be to do no harm. In a situation such as this, where the Commission proposes to uproot a basic element of Rule 2a-7 that has fostered and protected the Industry and money market fund shareholders for 25 years, it should take more than mere conjecture about potential board and adviser undue reliance on NRSRO ratings to initiate new regulation. And, in a situation such as this, where the Commission has correctly identified problems and proposed corrections with respect to the ratings process, it may well be that the wisest course of action – and the one with the fewest unintended consequences – is to do nothing beyond those proposals set forth in SEC Release No. 57967.

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[3] Rule 2a-7, Paragraph (c)(3)(i). *See also* ICI Letter at 7, noting that at the time the Commission added the parenthetical to Section 3(i) the Commission explained that the language was intended to underscore that "[p]ossession of a certain rating by an 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." *Revisions to Rules Regulating Money Market Funds*, SEC Release No. IC-18005 (February 20, 1991) at note 18 and accompanying text.

[4] *Chamber of Commerce v. Securities and Exchange Commission*, 412 F.3d 133, 145 (D.C. Cir. 2005), citing *Certified Color Mfrs. Ass'n v. Mathews*, 543 F.2d 284, 296 (D.C. Cir. 1976).

## II. The Commission's Cost-Benefit Analysis

In the Release, the Commission explains that the "the principal benefit of the proposed amendments to [R]ule 2a-7 would be to emphasize the importance of money market funds making independent assessments of credit risks." The Commission goes on to acknowledge that "[t]hese benefits are difficult to measure quantitatively, but qualitatively we believe the potential benefits are significant."[5] With respect to the anticipated costs of the Rule 2a-7 proposals in the Release, the Commission states:

> In general, we expect that money market fund boards of directors (or their delegates) would incur no additional costs in making credit and liquidity risk determinations regarding portfolio securities because **the proposed rules would codify the determinations regarding credit risk and liquidity that we believe boards (or their delegates) make under the current rule**.[6] [emphasis added]

Thus, it appears that the Staff has found no widespread illegal conduct permeating the Industry. Moreover, since boards (or their delegates) are, by the Commission's own admission, already making the legally-required credit determinations, it stands to reason that the proposals in the Release would not have the significant qualitative benefits alleged by the Commission. Indeed, given that the legally-required credit determinations are already being made by fund boards, the Release, at least as it relates to Rule 2a-7, appears to be largely a solution in search of a problem.

The Commission's assessment that the proposals in the Release will result in no additional costs to funds is also unrealistic. The Rule 2a-7 procedures of most funds are currently based on systems that utilize NRSRO ratings (which, for the avoidance of doubt, does not mean that these funds rely on the ratings exclusively in making credit risk determinations). The proposals in the Release contemplate that boards will need to overhaul these systems as they develop and administer new procedures to (i) determine whether an issuer "has the highest capacity to meet its short-term financial obligations" and (ii) monitor for "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."[7] Contrary to the Commission's view, these vague standards are not the same as the credit determinations that funds currently make under Rule 2a-7 – they are, by virtue of their vagueness, substantially more burdensome. Accordingly, Calvert believes that the proposals in the Release would cause its money market funds to incur significant increases in costs, including hiring additional research analysts and subscribing to additional research services. Moreover, given the near impossibility of being certain that the aforementioned standards have been satisfied, Calvert's fund boards may also hire consultants to double- and triple-check the credit analysis that Calvert performs on their behalf. In fact, the fiduciary risks associated with the aforementioned standards are so extreme that fund boards are likely not to spare any expense in seeking to comply with them.

## III. The Commission's Efficiency Analysis

In Calvert's view, the efficiency analysis in the Release does not satisfy the Commission's "statutory obligation [under Section 2(c) of the Investment Company Act of 1940] to do what it can to apprise itself – and hence the public and the Congress – of the economic consequences of a proposed regulation before it decides whether to adopt the measure."[8] Some of the efficiency issues omitted from the Release include (i) the reduction of systemic default risk achieved through the incorporation of NRSRO ratings into the Commission's regulations and (ii) the efficiency realized when regulatory

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5 *See* SEC Release No. IC-28327, *supra* at 40.

6 *See id.* at 41.

7 *See id.* at 9 and note 33.

8 *See* Chamber of Commerce v. Securities and Exchange Commission, *supra* at 150.

requirements apply the same common language that market participants use in the conduct of their day-to-day business activity. These topics warrant further discussion.

A. Efficiency Realized by Reducing Systemic Risk to the Industry

To a very great extent, the Industry is built upon confidence – confidence that each dollar invested will be returned on demand. Although money market funds do not have the benefit of insurance, as do FDIC insured bank deposits, "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 current-relative yield that they offer."[9] This confidence is not accidental. It has been earned on a daily basis over the course of more than 25 years through a collaborative effort by both the Industry and the Commission. The Industry has contributed, among other things, talented management and steady improvements in operational systems. The Commission has contributed, among other things, vigilant oversight and a framework – Rule 2a-7 – that has created the environment for confidence in the Industry to grow by seeking to ensure that portfolio securities of money market funds are safe investments. Ultimately, the public's perception that money markets are generally safe investments is what enables investors to conclude that the yields they receive fairly compensate them for the risks they are taking and that an additional risk premium is not required.

Notwithstanding the long collaborative history between the Industry and the Commission, the Commission now argues that efficiency gains can be realized by "affording funds access to securities that do not meet the rating requirements in the current rules, but that would satisfy the credit risk and liquidity standards in the proposed amendments."[10] This, however, runs contrary to the main purpose of Rule 2a-7, which is to limit credit risk and avoid a "race to the bottom" where money funds reach for more and more yield in a downward, risk-promoting spiral.

Without a "floor" provided by the NRSRO ratings requirement in Rule 2a-7, the entire Industry will only be as strong as its weakest link. Even if only a handful of funds "break-the-buck" the Industry will suffer irreparable damage. Calvert does not believe that it is prudent to "wager" over 25 years of confidence building and efficiency gains that have resulted in hundreds of billions of dollars of money market investments on the ability of one person in a start-up money market fund to correctly assess whether a particular portfolio security "presents minimal credit risks". Investors in one money market mutual fund should not have to bear the risk that the board of another money market mutual fund in which they have not invested has adopted a risky interpretation of what it means for a portfolio security to "present minimal credit risks". The proposals in the Release, if adopted, will prompt investors to reevaluate the confidence they have in the Industry and, by extension, the safety of the assets they have invested in money market funds, and they are likely to conclude that money market yields do not adequately compensate them for the heightened level of systemic risk.

B. Efficiency Realized by Using a Common Market Language and Incorporating That Language into Applicable Regulations

Enhancements in our ability to communicate more effectively have driven many of mankind's greatest technological achievements and have enhanced our productivity and business efficiency. Communication is most efficient when people speak the same language, a language that is easily understood and that can quickly be implemented with a minimum of effort.

The NRSRO rating system is, for all practical purposes, a common language used by all of the participants in the financial markets. As the Commission recognized in the Release, "ratings by NRSROs today are widely used as benchmarks in federal and state legislation, rules issued by other financial regulators, in the United States and abroad, and private financial contracts."[11] Through the

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[9] *See* ICI Letter at 4.

[10] *See* SEC Release No. IC-28327, *supra* at 49; *see also* ICI Letter note 39 and preceding text at 13.

[11] *See* SEC Release No. IC-28327, *supra* at 5.

use of a rating system's discrete set of signals, market participants are able to synthesize and communicate a vast amount of information relating to the potential credit quality of a particular borrower. These signals – especially changes in these signals – are an essential tool for monitoring the creditworthiness of borrowers.[12] In the absence of this language, financial market communication would be much more complicated and less efficient.

With the benefit of hindsight, market participants are no longer so naïve as to rely on the NRSRO rating system language exclusively to the exclusion of all other information. Users of the NRSRO rating system language, like users of all languages, have come to understand that communications using the language are subject to human error, may on occasion breakdown and sometimes fail to impart complete or wholly accurate information. Accordingly, market participant's now understand that the rating system language is simply one element, albeit an important one, in the arsenal of information that they should use to make financial decisions.

The proposals in the Release would undercut the efficiency associated with the use of a common market language by delinking a money market's regulatory compliance standard from that language. All of the portfolio securities that money market funds invest in will continue to be rated based on the NRSRO rating language, many of the fund's procedures will continue to be written in that language and fund business will continue to be generally conducted in that language. The proposals in the Release would nonetheless require fund boards to establish their own separate standards for determining whether each portfolio security "presents minimal credit risks" and whether the security is a "First Tier Security" or a "Second Tier Security". According to the Commission, "money market fund boards of directors 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."[13] However, funds that take this approach would be just as "vulnerable to failures in the ratings process" as they would be if the NRSRO ratings appeared in the Commission's regulations. Indeed, it is reasonable to expect that these funds would be in exactly the same position as they are today vis-à-vis NRSRO ratings, except for the fact that, as discussed above, the Industry as a whole would be subject to a heightened level of systemic risk.

The proposals in the Release would also make it more difficult for investors to easily and efficiently compare different money market funds. Without NRSRO ratings in the Commission's rules, it is likely that there will be great variability across the Industry with respect to board established procedures regarding minimum credit risk determinations. This will likely prompt investor confusion and outflows of assets into more user-friendly investment vehicles that provide comparable levels of safety.

## IV. The Commission's Rule 5b-3 Proposals

Calvert is similarly opposed to the proposals in the Release relating to Rule 5b-3. These proposals would (i) with respect to repurchase agreements, fundamentally alter the definition of "fully collateralized" and (ii) with respect to refunded securities, force funds into the unworkable position of having to obtain the independent accountant's certification regarding the sufficiency of the escrow prior to bidding on refunded securities.

Calvert, like most money market funds, only accepts government securities as collateral under repurchase agreements. For those funds that accept collateral other than government securities, the proposals in the Release would substantially weaken the current standard that requires collateral

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[12] Most fund advisor's subscribe to NRSRO ratings services electronically and receive electronic notification of ratings actions and outlook changes. These services are a valuable tool for assessing initial creditworthiness of a borrower and signaling when a possible change in risk has occurred so that a prompt reassessment of the affected portfolio security can be made to determine if it continues to "present minimal credit risks" as required by Paragraph (c)(6)(i) of Rule 2a-7.

[13] *See* SEC Release No. IC-28327, *supra* at 8.

securities to have only the highest NRSRO rating. As the Commission noted, this requirement "was designed to ensure that the market value of the collateral would remain fairly stable and that the fund could more readily liquidate the collateral quickly in the event of a default."[14] Like the Rule 2a-7 proposals in the Release, the proposals relating to Rule 5b-3 would eliminate the "floor" that applies to collateral securities and would replace it with a subjective standard approved and administered by fund boards. Calvert believes that this regulatory approach will introduce systemic risk and could potentially have spillover effects into the market for repurchase agreements collateralized by government securities and cash. Furthermore, if the proposals are adopted, the Commission "anticipate[s] that evaluating credit risk and liquidity of the collateral could incorporate ratings, reports, analyses, and other assessments issued by NRSROs and other persons".[15] Therefore, it would once again appear that these funds would utilize the NRSRO rating language that they know and are familiar with to conduct the necessary credit analysis, with the principal change being the acceptance of lower quality collateral by certain funds and an overall heightened level of systemic risk.

Under Rule 5b-3, a fund that invests in a refunded security rated in the highest NRSRO rating category may deem that purchase to be an acquisition of the escrowed government securities for purposes of the diversification requirements of Section 5(b)(1) of the Investment Company Act of 1940, even if the fund has not obtained the independent accountant's certification that the escrow is sufficient to defease the security. The Commission's proposal would revoke this ability since the fund could no longer rely on the NRSRO rating, thereby forcing money market funds to obtain the accountant's certification. Calvert is opposed to this proposal because the NRSRO rating exception greatly facilitates the trading of refunded securities. Since NRSROs that rate refunded securities require the verification of the sufficiency of the escrow as one of their rating criteria, the rating is an efficient method of signaling the market that a particular refunded security has met the accountant's certification requirement. Requiring funds to obtain these certifications would be extremely inefficient and could raise fund expenses because funds incur direct and indirect costs when they are required to obtain the certification. And in many cases the accountant's certification is not even readily available, which may cause funds to forego bidding on certain refunded securities resulting in reduced liquidity for those securities.

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In summary, except for the proposals relating to Rule 17a-9 under the Investment Company Act of 1940, Calvert is opposed to the proposals in the Release. The proposals are the regulatory equivalent of using a sledgehammer when a surgeon's scalpel would do. The problem at hand is that NRSRO ratings weren't as robust as they were believed to be because of failures, including conflicts of interest, in the rating process. The proper response to this situation is to fix the problem at its source, as the Commission has proposed to do in SEC Release No. 57967, and not to completely disassociate its regulations from NRSRO ratings. Fixing the problem in this manner will restore the meaning and purpose underlying the Commission's regulations and make the common language used by financial market participants more vibrant, without inflicting harm upon the Industry.

If you have any questions about Calvert's views or would like additional information, please contact us at 301-951-4881.

Sincerely,

/s/ William Tartikoff
General Counsel

/s/ Andrew Niebler
Assistant General Counsel

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[14] *See id.* at 19.

[15] *See id.* at 20.