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MUTUAL FUND DIRECTORS FORUM
The FORUM *for* FUND INDEPENDENT DIRECTORS

September 5, 2008

Ms. Florence E. Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

Re: Proposed Rulemaking Regarding References to Ratings of Nationally Recognized Statistical Rating Organizations, File No. S7-19-08

Dear Ms. Harmon:

The Mutual Fund Directors Forum ("the Forum")[1] appreciates the opportunity to comment on the proposed rulemaking by the Securities and Exchange Commission ("Commission" or "SEC") respecting "References to Ratings of Nationally Recognized Statistical Rating Organizations."[2]

The Forum, an independent, non-profit organization for investment company independent directors, is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through continuing education and other services the Forum provides its members with opportunities to share ideas, experiences, and information concerning critical issues facing investment company independent directors today and serves as an independent vehicle through which Forum members can express their views on matters of concern.

As we discuss below, while we welcome the Commission's focus on improving the process that Nationally Recognized Statistical Rating Organizations ("NRSROs") use to rate

1 The Forum's current membership includes six hundred and ten independent directors, representing seventy-nine independent director groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

2 Proposed Rulemaking: References to Ratings of Nationally Recognized Statistical Rating Organizations, Investment Co. Act Rel. No. 28327 (Jul. 1, 2008) [73 FR 40124 (Jul. 11, 2008)] ("Release").

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securities and the Commission's efforts to limit formal use of ratings to appropriate contexts, we are deeply troubled by the Commission's proposal to eliminate the ratings requirement from rule 2a-7. Even though ratings may be imperfect, this requirement has effectively protected investors in money market funds by limiting the range of securities in which money market funds can invest. Eliminating this requirement will, in our view, complicate the task of the directors of these funds and significantly reduce the protections investors now receive from the regulatory structure without producing any notable benefits. For the reasons outlined below, we therefore urge the Commission to retain this requirement even as it seeks to improve the quality of ratings.

Comments

Because of their ability to maintain a stable share price, money market funds are unique and important investment products. Given the significance of these products, it is important that the Commission, fund boards, and investment advisers work to maintain investors' confidence in money market funds. Although there is risk associated with investments in these funds and the share price can fall below $1.00, their success has created a near universal belief that money market funds will not "break the buck." Nonetheless, recent events have demonstrated the fact that these funds are not without risks. We therefore support the Commission's current efforts to protect fund investors and reinforce the importance of delving deeper into the quality of investments in money market fund portfolios.

Fund boards play a fundamental role in overseeing money market funds. Rule 2a-7 requires boards to adopt procedures designed to maintain a stable share price and to mark-to-market the value of a fund's portfolio securities. The rule also requires that fund boards take appropriate action when there is a material deviation between the market value of a security held in a money market portfolio and the amortized cost of the security. Given the key role of directors in the oversight of money market funds, the Forum welcomes the opportunity to comment on the proposed changes to rule 2a-7.

I. Credit Quality

As the Commission has indicated in this and other rule proposals over the past few months, it is attempting to address two problems regarding NRSROs. First, the Commission is seeking to mitigate various concerns it perceives in the ratings process. Second, it is also seeking to address the risk that, based on regulations that include references to ratings, investors will conclude that the Commission has implicitly approved the ratings process and will thereby place too much reliance on ratings in their investment-decision process. The Commission has therefore proposed eliminating all references to ratings and NRSROs in rule 2a-7, and would instead rely on boards to determine the credit quality and eligibility of potential portfolio investments by money market funds.

This rule proposal is clearly not intended to address the quality of the ratings process itself. The Commission, in response both to recent events and recent legislation, has commenced separate rulemakings to improve that process by addressing, among other things, conflicts of interest in the ratings process, the need for increased transparency in the process, and the need to

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increase investor understanding of the risk characteristics of complicated securities, particularly structured products, that go through the rating process. These are critical initiatives which, if successful, should produce important benefits for all investors, including money market funds and their shareholders, and for our capital markets generally. We commend the Commission for undertaking the important but difficult task of designing and implementing a regulatory structure that will improve the quality and transparency of the rating process.

We do not believe, however, that eliminating the ratings requirement from rule 2a-7 is an effective means of reducing unnecessary reliance on ratings in the investment-decision process. Moreover, we are concerned that the elimination of references to NRSRO ratings in the rule could have a number of unintended negative effects on money market funds and their investors.

Under current rule 2a-7, ratings are not intended to determine an investment decision, but rather serve as a backstop that eliminates certain potential investments from consideration. In other words, for a rated security to be included in a money market fund portfolio, it must be rated "in one of the two highest short-term rating categories."[3] However, meeting this requirement is not sufficient for a security to be included in a money market fund portfolio; rather, to be included in the portfolio, the fund's board of directors must also conclude that the security "present[s] 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)...."[4]

Hence, by incorporating credit ratings into its structure, current rule 2a-7 effectively creates a limited universe of securities that money market funds can potentially invest in, and then requires that directors (and those to whom they delegate this task) examine the credit quality of the securities in that limited universe to determine which of those securities their money market funds can, in fact, invest in. Boards, therefore, are already required to look beyond credit ratings to make sure a particular security is appropriate for a money market fund. This approach addresses the risk that a security is rated too highly – the board exercises its own judgment to reassess, using other factors, the credit quality of the security in question.[5]

The proposed amendments to the rule would turn this approach on its head. As we have outlined above, the current rule uses credit ratings to circumscribe the universe of securities that a money market fund can invest in – assuming that a security is sufficiently highly rated, directors then seek to determine, looking to other factors, whether the credit risks it poses are

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3 Rule 2a-7(a)(10).

4 Rule 2a-7(c)(3).

5 We recognize that boards, as they are permitted to do by current rule 2a-7, generally delegate the function of reviewing the credit quality of a security to the fund's adviser or to another entity (and oversee the procedures and process that their delegate uses) and that the proposed rule would continue to permit them to do so. Hence, references to "board" action in this letter should be understood to include actions taken by the board and its delegates. In spite of the ability to delegate, and in addition to the other concerns that we raise in this letter, removing the ratings requirement from rule 2a-7 will likely increase the complexity of, and time devoted to, the task of assessing the credit quality of money market fund investments without increasing investor protection or otherwise leading to an objectively better result.

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sufficiently small that the fund can purchase the security. In contrast, under the proposed rule, money market funds would be able to invest in *any* security so long as directors conclude that the security poses "minimal credit risks."[6] Indeed, the release suggests that if they find them "credible," directors will be permitted to rely on credit ratings as a factor in making this determination.[7] Under this structure, credit ratings will no longer serve the function of eliminating various unsuitable securities from consideration.

This could have two seemingly contradictory but equally negative results. First, in a manner contradictory to the Commission's stated goals, this change could result in an increased (and potentially unwarranted) reliance on credit ratings. Once credit ratings can potentially serve as an affirmative factor that directors can use in assessing the credit quality of a particular security, the door is open for directors (and others involved in the management of money market fund portfolios) to, in fact, rely on them overly heavily in the investment decision process.[8] Indeed, the more credible the ratings process appears to be, the greater the reliance permitted by the proposed rule. Hence, while eliminating the reference to credit ratings might seem to remove the Commission's "seal of approval" on those ratings, in this context, the revised rule is likely to increase (potentially significantly) -- rather than decrease -- reliance on ratings in the portfolio management process.

Second, and seemingly paradoxically, the proposed amendments could have the equally perverse effect of increasing the risk in money market fund portfolios, and thus increasing the risk faced by conservative money market fund investors. Competition for investor dollars among money market funds can be very fierce, and that competition is typically based on yield – advisers respond to investors' desires for higher yields on their cash. This can create an incentive, particularly when economic and market conditions are good, to invest in riskier securities in order to increase yield. Under current rule 2a-7, the ability of funds to do so is largely limited by ratings restrictions. Without that limitation, there may be times, at least at some funds, in which there is significant pressure to invest in the riskier securities in order to

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6 For money market fund boards with robust processes for assessing credit quality – and, based on the experiences of our members, we believe that most boards do have effective processes in place – this may not be a significant change. In most cases, boards already identify the factors that they deem most relevant, and apply those in determining whether a security presents minimal credit risks. But if the Commission's goal is to reduce unwarranted reliance on credit ratings, it is difficult to see how this change will help advance that goal.

7 As the Commission stated in its proposing release, "[w]e believe that 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. We expect that the boards of directors (or their delegates) would understand the basis for the rating and make an independent judgment of credit risks." Release at 40125 – 26.

8 We note that we are in no way criticizing the Commission's suggestion that directors should "understand the basis for [a security's] rating," *id.*, and that they should have a good understanding of how the ratings process works generally. Directors of money market funds should have a clear understanding of how the ratings process works, and we believe that virtually all money market fund directors recognize that they need to do so.

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increase yield to bring additional assets into the fund.[9] Some funds and advisers may well succumb to this pressure; their doing so would increase the likelihood that problems, potentially serious, will arise in more difficult economic times.

In this context, while we certainly understand the Commission's desire to eliminate any regulations that suggest it has implicitly bestowed a "seal of approval" on ratings or the ratings process,[10] we believe that the proposed amendments would potentially weaken the regulatory structure governing money market funds without advancing the Commission's stated goals. We therefore encourage the Commission either to abandon these regulatory changes or, at the very least, defer action on these proposals until it has completed its initiatives aimed at improving the ratings process and has had time to assess the effect of those initiatives.[11] We continue to believe that the ratings limitation in the rule provides important protections for investors in money market funds.[12]

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9 In all likelihood, problems of this sort would occur, if at all, at only a small minority of funds. However, we note that if any retail-oriented money market fund were to "break the buck," the damage caused to investor confidence and to money market funds generally could be significant. We therefore believe that it is important from an industry-wide perspective that the Commission take care not to take steps that increase the risk of any fund breaking the buck.

10 We note that in the companion release eliminating references to securities ratings from rules under the Securities Exchange Act of 1934, the Commission chose not to amend certain rules primarily related to non-public reporting or recordkeeping requirements used by the Commission. In that release, the Commission noted that those areas did not risk undue reliance on the ratings by market participants. *See* Proposed Rule: References to Ratings of Nationally Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 58070 (July 1, 2008) [73 FR 40088 (July 11, 2008)]. We believe that not only can the Commission make a similar finding here, but that it should conclude that by limiting the types of securities in which money market funds can invest, the continued inclusion of the ratings requirement advances important investor protection goals.

11 We also note that the proposed rule does not provide substantive definitions for a number of the terms it employs. For example, although the proposed rule would require directors to further divide eligible securities into two tiers, and attempts to define the top tier in terms of whether the issuer has the "highest capacity to meet its short-term financial obligations," neither the rule text nor the release text provide any real substance to guide directors in making these decisions. Although the term has been used for a long period of time in rule 2a-7, the Commission's continuing reliance on the term "minimal credit risks" potentially has the same problems. The ambiguity in these terms makes it difficult for directors to determine whether they are complying with the rule and, moreover, should something go wrong, may well increase the litigation risk that they face. The Commission may wish to provide further guidance on the meaning of these terms and/or make clear that the standard is rooted in conceptions of prudence and the business judgment of directors, particularly if it ultimately does decide to eliminate the use of credit ratings as a limiting factor in rule 2a-7.

12 Moreover, we note that retaining the ratings requirement is structurally consistent with other provisions of the rule, most notably the liquidity and maturity provisions, each of which has an objective floor plus an additional subjective standard. For example, the rule's maturity provisions establish 397 and 90 day average maturity limits and, at the same time, require that a security's maturity be consistent with a stable net asset value. *See* rule 2a-7(c)(2).

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Finally, if the Commission's real concern is that boards, advisers and others are placing undue reliance on credit ratings and are not engaging in robust analyses of credit quality apart from reliance on ratings, there are more effective ways to address this problem than by amending the rule.[13] For example, the Commission could provide additional interpretive guidance regarding proper practice under rule provision 2a-7(c)(3), or could take other steps to remind boards and funds of their obligation to perform an independent credit analysis pursuant to that provision. This type of approach would be more effective in addressing any concerns that the Commission may have about current board practices, and would not pose the risks that eliminating credit ratings from the rule would.

II. Monitoring of Ongoing Credit Quality

The Commission has also proposed to amend the rule regarding the monitoring of the credit quality of securities held in a money market fund's portfolio. More specifically, the Commission proposes to replace the current requirement that boards reassess the credit quality of a held security following a downgrade with a requirement that they do so whenever the fund's adviser becomes aware of information that suggests that the security may present greater than minimal credit risks. While this amendment may place greater burdens on both boards and advisers, the result would be to parallel the review process that the current rule requires for securities that the fund proposes to purchase. We are concerned, however, that a board's and fund's decision to continue to hold a security (or to not review the credit quality of a particular security) will be an easy one to judge harshly in hindsight following a negative credit event. As in other areas where directors act on behalf of shareholders, the Commission should seek to protect boards in the exercise of their business judgment. Overall, however, we agree that this is an appropriate way to approach securities whose credit quality may be deteriorating.

III. Portfolio Liquidity

In addition to the changes outlined above, the Commission is also proposing to codify existing guidance by expressly stating that a money market fund may not purchase an illiquid security if, as a result, more than 10% of the value of its portfolio would consist of illiquid securities. Given the need to deal with constant inflows and outflows of assets in money market fund portfolios, combined with the Commission's clear guidance on this issue, we believe that virtually all money market funds already abide by this requirement. Accordingly, codifying the requirement should not result in any significant change in the manner in which money market funds are managed or the regulatory burdens associated with doing so.

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13 We note, in this connection, that the Commission specifically asks "[a]re we correct that the current rule's reliance on credit ratings discourages fund directors and investment advisers from performing independent credit risk assessments?" As our analysis suggests, we do not believe that this is correct; our experience is that directors and their delegates – typically, money market fund advisers -- work together under the current rule to perform just this sort of analysis – that is, that the board's delegate, subject to the board's oversight, does perform a rigorous and independent credit risk assessment. However, as detailed in this paragraph, if this is the Commission's real concern, we believe that there are better ways to address it that would pose less risk to money market funds and their investors.

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We do note, however, that the current turmoil in the credit markets demonstrates both how difficult it is to determine whether a security is liquid and, even more importantly, how quickly the liquidity of a particular security (or class of securities) can change. Given this, determining whether a security can be sold within seven days can be a difficult task. Hence, although this is the traditional approach to determining whether a security is liquid, the Commission may wish to consider whether a more detailed and more nuanced approach to determining liquidity is warranted.

IV. Rule 17a-9 Notice Requirements

The Commission has also proposed amending rule 17a-9 to require that prompt notice be furnished to the Commission whenever a fund affiliate purchases a security from the fund that is no longer an "eligible security." We agree with the analysis in the Release that this amendment would effectively supplement the Commission's ability to monitor money market funds without imposing any significant burden on funds that become subject to the requirement. We thus support adoption of this proposed amendment.

V. Proposed Amendments to Rule 5b-3

Rule 5b-3 governs, in certain circumstances, the securities that can be used to collateralize a repurchase agreement entered into by any investment company. Similarly to its proposed approach under rule 2a-7, the Commission is proposing to replace provisions solely based on credit ratings with requirements that directors independently analyze the credit quality of the underlying collateral. In particular, for collateral other than cash and government securities, the Commission proposes that directors examine whether the securities are highly liquid, whether they are subject to no greater than minimal credit risk, and whether they are issued by an issuer with the "highest capacity to meet its financial obligations."

We agree that the criteria identified by the Commission are highly relevant in determining whether a particular security should be used to collateralize a repurchase agreement. However, as with current rule 2a-7, we believe that ratings can serve a useful purpose in supplementing this analysis by delimiting, in the first instance, the securities that can serve as collateral. We therefore suggest that the Commission revise its approach by retaining the existing credit rating requirement and supplementing it with a requirement that directors then perform the independent analysis of the type described in the Proposing Release.

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Again, the Forum very much appreciates the opportunity to comment on this important proposal. We would be happy to discuss any of the issues raised in our comment letter with you or the Commission's staff at any time.

Sincerely,

David B. Smith, Jr.
Executive Vice President and General Counsel

cc: The Honorable Christopher Cox
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

Andrew J. Donohue, Director, Division of Investment Management

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