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

April 25, 2011

Ms. Elizabeth M. Murphy
Secretary
United States Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 20549

Re: References to Credit Ratings in Certain Investment Company Act Rules and Forms, File No. S7-07-11

Dear Ms. Murphy:

The Mutual Fund Directors Forum[1] ("the Forum") welcomes the opportunity to respond to the request for comments by the Securities and Exchange Commission ("Commission") on its recent rule proposal regarding the removal of references to credit ratings in certain Investment Company Act rules, particularly rule 2a-7, which governs money market funds.[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 and also serves as an independent vehicle through which Forum members can express their views on matters of concern. A significant number of the Forum's members are responsible for overseeing money market funds and so are highly interested in the ongoing debate regarding the appropriate regulation of money market funds.

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1 The Forum's current membership includes over 600 independent directors, representing 86 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 References to Credit Ratings in Certain Investment Company Act Rules and Forms, File No. S7-01-11 (Mar. 3, 2011) [76 FR 12896 (March 9, 2011)] .

I. Background

The Commission has twice before proposed eliminating references to credit ratings in rule 2a-7,[3] most notably in the context of those provisions that establish a minimum rating for a security to be considered eligible for inclusion in a money market fund's portfolio. As we have discussed in our prior comment letters on this issue,[4] we continue to believe that eliminating the existing reference to credit ratings in rule 2a-7 would be a mistake and that doing so has the potential to harm the money market fund industry and its investors. To reiterate our prior concerns:

- The pressure to eliminate this reference is based on the misperception among some that money market funds are simply relying on credit ratings to determine what securities to include in fund portfolios. This – as we and numerous other commentators have pointed out – is simply untrue. In contrast, the role of the credit rating reference is to eliminate from consideration certain lower-rated securities for possible inclusion in money market fund portfolios. Irrespective of how a security is rated, rule 2a-7 will continue to require an independent determination of the creditworthiness of a rated security and its inclusion in a money market fund portfolio.

- The reference to credit ratings in the current rule has served a beneficial purpose by limiting the ability of money market funds, which exist in a very competitive environment, to reach for yield by investing in less credit-worthy, higher-yielding securities. While most funds do not give into this temptation, there is always the risk that one or more funds will do so. Hence, in spite of the concern that has been expressed in recent years about the quality and independence of the ratings process, eliminating the reference will, in this case, have the perverse effect of increasing the risk that more aggressive or less well-managed funds will "break the buck." As we have seen in recent years, the breaking of the buck by a single fund can cause significant collateral damage to other money funds.

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3 *See References to Ratings of Nationally Recognized Statistical Rating Organizations*, Release No. IC-28327, 73 Fed. Reg. 40088 (July, 2008) and *Money Market Fund Reform,* Release No. IC-28807, 74 Fed. Reg. 32688 (July 8, 2009).

4 *See* the Forum's Comment Letter re: References to Nationally Recognized Statistical Rating Organizations dated September 5, 2008 (available at http://www.mfdf.com/site/pages/documents/s71908-30.pdf) and the Forum's Comment Letter re: Money Market Fund Reform dated September 8, 2009 (available at http://www.mfdf.org/images/uploads/newsroom/MFDF2a-7CommentLetterSept2009.pdf).

II. The Current Proposal

Up until now, presumably at least partly in response to the money fund industry's overwhelmingly negative reaction to the possibility, the Commission has declined to act on its prior proposals to abandon the use of credit ratings as a floor in rule 2a-7. As a result of the enactment of section 939A of the Dodd-Frank Act, however, we recognize that the Commission has lost significant flexibility in determining independently what role, if any, credit ratings should play in delimiting the range of securities that are potentially eligible for inclusion in money market fund portfolios. Specifically, section 939A requires the Commission "to remove any reference to or requirement of reliance on credit ratings" from its regulations.

The Commission thus proposes to eliminate all five remaining references to credit ratings from rule 2a-7. Most notably, in response to the need to maintain appropriate limits on the securities in which money market funds can invest and the separate requirement of section 939A that the Commission "seek to establish, to the extent feasible, uniform standards of credit-worthiness," the Commission proposes that the board or its delegee have sole responsibility for determining whether a security is an eligible security and, if so, whether it is a first-tier or second-tier security.

While, as outlined above, we continue to believe that removing these particular references to credit ratings is bad policy, this replacement approach, in and of itself, is not problematic.[5] Each money fund board (or, more realistically, the fund's adviser acting as the delegee of the board) is already required to determine the quality of securities in which its funds invest independently of credit ratings, and will continue to do so once the references to credit ratings in the rule are removed. We do have a number of more specific comments and suggestions, however.

First, as we have consistently commented in the past, the Commission must continue to recognize that money fund boards will not themselves determine the

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5 We understand that an argument can be made that because section 939A of Dodd-Frank refers to reliance on credit ratings, and rule 2a-7 does not mandate reliance on credit ratings but rather uses credit ratings to circumscribe the outside boundary of potentially eligible securities, the Commission is not, in fact, required to eliminate this particular reference to credit ratings. Moreover, since rule 2a-7 will now necessarily place the responsibility of assessing the credit quality of money market securities on each individual board, the rule will have the effect of introducing more variation into money fund practice rather than establishing the "uniform standards of credit-worthiness" that section 939A sets as a goal.

Given the pressure that has been brought to bear on the Commission through the enactment of section 939A and otherwise, the Commission may well be reluctant to embrace this possibility. Nonetheless, insofar as the Commission's failure to remove references to credit ratings as proposed in prior rulemakings suggests that it agrees that the change is not desirable, carefully considering the possibility that elimination of the references is not the only possible way of complying with section 939A may well be warranted.

creditworthiness of individual money market securities. Rather, consistent with the provisions of rule 2a-7, boards will delegate this task in virtually all circumstances to the fund's adviser.[6] Hence, the real impact of the rule change will be to obligate money market fund boards to develop procedures that will permit them to oversee effectively the adviser's performance of this critical task – in essence, each board will need to understand and develop confidence in the processes and procedures that its adviser uses to evaluate money market securities. With the elimination of the bright-line demarcation inherent in the use of credit ratings as a floor to eliminate securities from inclusion in a money market fund portfolio, boards and directors will be even more dependent on having effective oversight procedures. The Commission should take care to continue to recognize this reality in its final rule and the accompanying release.

Second, we believe that it is critical that the Commission reiterate in the final rule release – as it has stated in the proposing release – that boards and advisers can continue to use credit ratings as part of their own processes to the extent that they find those ratings to be credible and useful in their own process. A failure to do so could lead to the implication that the elimination of the reference to credit ratings in the rule itself is somehow intended to ban their use in the portfolio management process entirely. Funds will need to be wary, as they currently are required to be, of relying exclusively on credit ratings in determining whether a particular security presents minimal credit risks. Nonetheless, credit ratings can play a critical role in either supplementing the analytic process or, to the extent that any individual fund's board and adviser find appropriate, continuing to serve as a delimiting factor that conclusively eliminates less-highly rated securities from consideration for inclusion in money market fund portfolios. The final rule release should not, even inadvertently, cast doubt on the appropriateness of this very beneficial use of credit ratings.

Third, although we believe that maintaining the distinction between first and second tier securities remains useful as a risk-limiting condition in the rule, the Commission's current description of the difference comes dangerously close to establishing a distinction that is more semantic than substantive. In particular, while the definitional distinction is clear, there is not an immediately obvious quantitative difference between an issuer with an "exceptionally strong ability to repay its short-term debt obligations" and one with a "very strong ability" to do so. We therefore urge the Commission to consider whether there are more precise means of distinguishing between first and second tier eligible securities.

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[6] We continue to believe that it would be preferable for the Commission to amend rule 2a-7 to make clear that boards should oversee this and other portfolio management functions of money market funds rather than giving boards direct responsibility for tasks that they are not well-situated to perform but then permitting delegation of the task to the adviser. We recognize, however, that this rulemaking is not the appropriate context to consider this type of broad-based change. Nonetheless, we encourage the Commission to return to this issue in the near future.

We do recognize that this will be a difficult if not impossible task. As a result, the provision will likely result in additional subjectivity being injected into the credit assessment process and may well lead to less uniformity in practice between different fund groups. That said, we do not suggest that, as an alternative, the Commission eliminate the distinction between first and second tier securities. Requiring funds to engage in a process to distinguish between degrees of risk present in eligible securities will tend to increase the level of detail and care that funds put into the credit quality assessment process, and thus will have a beneficial impact on limiting unnecessary risk in money market fund portfolios.

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In conclusion, while the proposed change, effectively mandated by Congress, may be relatively minor in the broader context of rule 2a-7 and the regulation of money market funds, it has the potential to create additional risks to money market funds. It also demonstrates the importance of the broader, ongoing debate on the future regulation of money market funds, and we are pleased that the Commission continues to take these issues seriously. We look forward to continuing to participate in this ongoing discussion, as independent directors have an important role to play in ensuring a healthy and robust money market fund industry. If you would like to discuss our comments further, please feel free to contact either me or Susan Wyderko, Executive Director of the Forum, at 202-507-4488.

Sincerely,

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

cc: The Honorable Mary L. Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
Eileen Rominger, Director, Division of Investment Management