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100 F Street, NE
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Re: Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule (File No. S7-07-11)

CFA Institute[1] appreciates the opportunity to respond to Securities and Exchange Commission's Consultation, *Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule* (the "Re-Proposal"). CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency, integrity and accountability of global financial markets.

Summary

We support the objective of the SEC to remove credit rating requirements from money market funds where such references could lead to an excessive reliance on credit ratings. One of the problems associated with the run-up to the financial crisis was the undue faith and reliance placed on credit ratings by some financial market stakeholders. This situation resulted, in some cases, with stakeholders effectively substituting independent due diligence for external ratings when assessing the credit quality of securities.

There has been unwarranted prominence attached to credit ratings in the financial system, both among financial market stakeholders and within legislation and regulation. Removing "mechanistic" references to credit ratings in legislative and regulatory documents should, therefore, alleviate excessive reliance on ratings and encourage market participants to look to other indicators of credit quality to supplement and substantiate credit ratings.

[1] CFA Institute is a global, not-for-profit professional association of more than 131,800 investment analysts, advisers, portfolio managers, and other investment professionals in 150 countries, of whom nearly 124,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 144 member societies in 69 countries and territories.

Specific Comments

In a May 2014 survey[2] of CFA Institute members with a primary investment practice in fixed-income instruments, investors indicated that they still don't fully trust the rating agencies. While 68% said they believe the validity of the ratings has improved, and 62% said they believe the rating agencies have adjusted their procedures on conflicts of interest as a consequence of the turmoil of the last decade, 82% of respondents still believe rating agencies are under pressure from issuers to give higher-than-deserved ratings due to the issuer-pays business model. As a consequence, 84% of respondents said they are more cautious in the way they use credit ratings today than they were seven years ago. Indeed, while most large investors say they once again give credence to the ratings of the CRAs, they now use them as one of a number of inputs into the investment decision-making process.

Answers to requests for comments

Do commenters believe that the re-proposed standard is an appropriate standard of creditworthiness for rule 2a-7? Is the re-proposed "exceptionally strong capacity" standard an appropriate substitute for credit ratings in rule 2a-7?

CFA Institute agrees with the re-proposal of rule 2a-7 that would combine the two risk criteria of first- and second-tier securities into a single standard, which would be included as part of rule 2a-7's definition of eligible security.

As re-proposed, an eligible security would be a security with a remaining maturity of no more than 397 calendar days and in which a fund's board of directors (or its delegate) determines presents minimal credit risks, including a finding that the issuer has an exceptionally strong capacity to meet its short-term obligations.

We believe that in its totality, the new standard together with previous changes to regulations, provide an appropriate substitute standard.

We also request specific comment on the finding, required as part of the minimal credit risk determination, that the security's issuer has an exceptionally strong capacity to meet its short-term financial obligations. What impact is this proposed standard likely to have on the overall risk of money market fund portfolios?

[2] 20,379 CFA Institute members with a primary investment practice in fixed-income instruments were invited via email to participate in an online survey. Of those surveyed, 398 valid responses were received.

In general, a determination that an issuer has “an exceptionally strong capacity to meet its short-term financial obligations” would suggest that the overall risk of money market fund portfolios would remain stable or perhaps rise somewhat. This view is due, in part, to the fact that each fund’s managers will have a different view on what constitutes such capacity. Certainly, we should expect that some funds will push the limits with regard to whether the capacity of individual issuers to meet their short-term financial obligations is exceptionally strong. So long as such funds are responsible for their determinations and make the reasons available to examine, investors should be able to assess the validity of those conclusions. In general, though, we believe that attempts to push the limits will lead to higher yields for funds engaged in that type of investing.

Would a finding that issuers have an “exceptionally strong capacity” to meet their short-term obligations mitigate any risks associated with floating NAV funds’ potential incentives to invest in riskier securities?

We recognize that breaking money market funds’ ties to a $1 NAV may lead some to seek competitive advantage by boosting yields through the acquisition of higher-risk instruments. However, such strategies are not strictly limited to variable NAV funds, as stable NAV funds adopted strategies to boost their yields prior to 2008, both by buying instruments with higher-risk characteristics and by extending average portfolio maturities with longer-dated instruments.

Statutory and regulatory mandates to rely upon credit ratings enabled money market and other funds to look to those ratings as a proxy for credit quality without having to conduct their own due diligence. Removing the mandated use of these ratings will make funds and their directors more accountable for poor due diligence and, consequently, creates “skin in the game” in the final assessment about credit quality, be it concerning issuers’ capacity to meet their obligations, or the ability of rating agencies to accurately assess that credit quality. Furthermore, removal of the required use of credit ratings will give funds an interest in determining whether a CRA’s ratings are sufficiently reliable to serve as a basis for an investment decision.

A finding that issuers have an “exceptionally strong capacity” to meet their short-term obligations, therefore, may mitigate some risks associated with floating NAV funds. However, the reasoning behind such findings needs to be clearly communicated. This process needs to include robust and transparent disclosures about how firms determine credit quality and meet the standard so that investors can assess whether a fund has taken steps to adequately analyze default risks.

We request comment on whether potential incentives for increased investments in riskier second tier securities would be reduced by market discipline resulting from these newly required disclosures.

We believe it would. Disclosure of daily NAV by institutional funds should ultimately highlight greater volatility resulting from a decision to invest in riskier, second-tier securities.

However, disclosure only works if it is easily accessible and used by investors. It is therefore incumbent upon money market funds to be disciplined in their investing and transparent in their policies and procedures that govern their investing decisions. Disclosures specifically describing how funds make their credit quality determinations and the conclusions reached from these efforts are needed to enable investors to make informed decisions about the quality of the funds' investment practices.

We request comment on the factors discussed above for consideration, as appropriate, in the determinations that portfolio securities present minimal credit risk. Do commenters agree that these are relevant factors for advisers to consider in assessing whether portfolio securities present minimal credit risk? Are the factors sufficiently clear? Would it be helpful to describe any of the factors with additional specificity?

CFA Institute agrees that in order to determine whether a security presents minimal risk a fund or fund adviser must understand:

1. The issuer or guarantor's financial position,
2. The issuer or guarantor's liquidity, including bank lines of credit and alternative sources of liquidity,
3. The issuer or guarantor's ability to react to future events including "worst case scenarios,"
4. The strength of the issuer or guarantor's industry within the economy,
5. Whether the price and/or yield of a security is similar to that of other securities in the fund's portfolio.

We believe this list should consider two other important factors. First, it should note the need for advisers to consider the existence, nature and magnitude of such counterparty relationships issuers may have. Secondly, we believe the list should consider the effects on credit risk arising from rising interest rates. Both of these factors can significantly affect the credit quality of an issuer.

We request comment on our proposed credit quality standard for securities with a conditional demand feature. Do commenters believe that this is an appropriate standard of creditworthiness? Is it consistent with our goal of retaining a similar degree of risk limitation as in the current rule?

Under the SEC's re-proposal, a fund would have to determine, as with any short-term security, that the conditional demand feature is an eligible security. A fund's board (or delegate) would have to evaluate the long-term risk of the underlying security and determine that it (or its guarantor) "has a very strong capacity for payment of its financial commitments."

In general, we see the re-proposed credit quality standards as appropriate. Nevertheless, we are concerned with the role the re-proposal places on fund boards. The Commission specifically notes that a security subject to a demand feature will qualify as eligible if, at the time of acquisition, "the fund's board (or its delegate)… determines that there is minimal risk" that the issuer will lose the demand feature as a consequence of a ratings downgrade.

In general, we support this view. However, such determinations, particularly at the time of investment, are rarely the decisions of fund boards. Nor do we believe it should be the board's responsibility to determine at acquisition the long-term credit characteristics of a security. Such activities are inconsistent with the role fund directors should play. Such determinations are the role of investment managers, and their portfolio managers and investment analysts. Boards, on the other hand, should set investment policies, monitor their funds' investment portfolio composition, and oversee the managers charged with investing the funds. As part of this role, boards should ensure that the investment managers are required to make and justify such determinations for the benefit of the boards.

We request comment on the re-proposed monitoring requirement. Is our understanding of how funds currently monitor fund portfolio securities correct? If not, how are fund practices different?

CFA Institute agrees with the re-proposed standard, which eliminates the requirement that a fund reassess credit risk of an issuer when a security is downgraded by an NRSRO. We agree with the SEC's proposal to require each money market fund to adopt written procedures that require the fund adviser to provide ongoing review of the credit quality of each portfolio security. A fund should be permitted to base its reevaluation of a security on the actions of an NRSRO, but it should not be required to do so by regulation.

Should the rule require testing against specifically named events rather than an event the fund chooses that indicates or evidences credit deterioration? Does the re-proposed hypothetical event provide adequate guidance to funds? Is there a different hypothetical event, other than a downgrade, that we should specify? Does the re-proposed hypothetical event provide adequate guidance to funds?

In the re-proposed standard, the SEC proposes to replace the reference to ratings downgrades in the stress testing requirement with a hypothetical event that is designed to have a similar impact on a money market fund's portfolio. The re-proposed amendment would require that money market funds stress test for an event indicating credit deterioration of particular portfolio security positions, each representing various exposures in a fund's portfolio. The re-proposed amendments would describe the type of hypothetical event that funds should use for testing and include a downgrade or default as examples of that type of event.

CFA Institute is comfortable with allowing funds to choose hypothetical events when describing the events they are looking at to test for credit deterioration. Proscribing a specifically named event, such as a credit downgrade, would likely result in that specifically named event becoming the default disclosure. Allowing for varied disclosure makes it incumbent upon investors to demand a high level of transparency and forthrightness from the funds in which they invest.

We seek comment on the re-proposed disclosures relating to credit ratings in Form N-MFP. Are we correct in our assumption that as part of its minimal credit risk determination a fund manager would consider each rating assigned to a portfolio security by an NRSRO to whose services the fund of the manager subscribes? Would the proposed disclosures assist investors in monitoring credit risks in money market fund portfolios?

The SEC is re-proposing to require that each money market fund disclose, for each portfolio security:

1. The rating assigned to each security by any NRSRO if the fund or its adviser subscribes to that NRSRO's services, as well as the name of the agency providing the rating, and
2. Any other NRSRO rating that the fund's board (or its delegate) considered in making its minimal credit risk determination, as well as the name of the agency providing the rating.

Unlike the fund managers, who presumably have knowledge, experience, expertise and resources to help them assess the credit quality of a variety of investment instruments, investors in these funds will likely have to rely upon credit ratings as a means of verification for the fund’s assessment. To this end, therefore, CFA Institute agrees that this information can be helpful to investors and prospective investors.

Concluding Remarks

CFA Institute welcomes the initiative to remove references to credit rating requirements from money market funds where such references could lead to sole or mechanistic reliance on credit ratings. Please do not hesitate to contact us should you wish further elaboration of the points raised.

Sincerely,

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