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

September 14, 2014

Brent Fields, Esq.
Secretary
United States Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 20549

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

Dear Mr. Fields:

The Mutual Fund Directors Forum[1] ("the Forum") welcomes the opportunity to comment on the recent re-proposal of rule amendments by the Securities and Exchange Commission ("Commission") that would remove references to credit ratings from certain rules under Investment Company Act, particularly rule 2a-7, that govern 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 thus are highly interested in the ongoing discussion regarding the appropriate regulation of these funds.

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1 The Forum's current membership includes over 821 independent directors, representing 115 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 Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification in the Money Market Fund Rule, File No. S7-07-11 (July 23, 2014 ("Proposing Release").

I. Background

The current proposal represents the Commission's latest attempt to eliminate references to credit ratings from the money market fund rules while still effectively preserving the important role that credit ratings now play in delimiting the universe of securities in which money market funds can invest. Under the current rules, a security is not eligible for inclusion in a money market portfolio unless it has a sufficiently high rating; advisers to money market funds then invest in securities from within that universe that they believe offer an appropriate return while also presenting minimal credit risk. We continue to believe eliminating this role played by credit ratings is bad policy.[3] That said, we are equally aware that, as a result of section 939A of the Dodd-Frank Act, the Commission has little choice but to do so. In light of these realities, we conclude that, broadly speaking, the Commission's current proposal is an appropriate response to the Dodd-Frank mandate that retains, to the extent possible, the salutary benefits to shareholders of credit ratings. Hence, we reluctantly support the Commission's current proposal.

We do, however, have a number of comments on the proposal. First, we encourage the Commission to continue to emphasize the Board's ability to delegate, subject to appropriate oversight, the credit analysis function to the fund's adviser or other appropriate entity. We also encourage the Commission to use only general, broad-based and non-exclusive factors in describing how the credit analysis process should function. In addition, we support the Commission's understanding that boards and advisers will likely continue to use credit ratings in their own analysis, and believe that whether and how credit ratings are used should be left to the business judgment of boards and advisers. Finally, we agree that eliminating the distinction between first and second tier securities, as well as the minor amendments the Commission is making to the stress testing framework for money market funds are appropriate.

II. The Current Proposal

Until now, the Commission has declined to finalize its prior proposals to abandon the use of credit ratings as a floor in rule 2a-7. Nonetheless, section 939A of the Dodd-Frank Act requires the Commission "to remove any reference to or requirement of reliance on credit ratings" from its regulations. Hence, the Commission is again proposing to eliminate certain references to credit ratings from rule 2a-7.

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3 *See* the Forum's Comment Letter regarding 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 regarding Money Market Fund Reform dated September 8, 2009 (available at http://www.mfdf.org/images/uploads/newsroom/MFDF2a-7CommentLetterSept2009.pdf).

A. Credit Analysis

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 while at the same time eliminating the existing distinction between first- and second-tier securities.

While, as outlined above, we continue to believe that removing these particular references to credit ratings is bad policy, the Commission's proposed approach, in and of itself, is not problematic. 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, we appreciate the Commission's continuing emphasis on the board's ability to delegate the determination of the credit quality of the individual securities in which a money market fund invests,[4] and urge it to continue to highlight this crucial element of the proposed approach when it ultimately adopts the rules.[5] Directors are simply not in a position to themselves analyze the credit quality of individual securities. Instead, as the Commission recognizes, boards today delegate determinations of credit quality to the adviser and will certainly continue to do so under the new rule. As with other day-to-day activities of the funds they oversee, directors, however, can and do play an important role in approving policies and procedures, in reviewing the need to revise and update those policies and procedures, and in overseeing how the fund's adviser and the board's other delegees implement those policies and procedures.

While boards and advisers will need to make the ultimate determination on how to structure the credit analysis process, we do generally agree with the factors that the Commission identifies as relevant to analyzing the credit quality of potential and existing money market fund investments. These factors are consistent with best practice and are appropriately broad and generic, and hence will not prevent boards, acting in conjunction with advisers, from developing approaches consistent with the needs and objectives of the

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4 *See* Proposing Release at 10 & n.22.

5 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 while 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.

funds they oversee.[6] In addition, we agree with the Commission's conclusion that the factors should not be treated as exhaustive, and hence might include other factors "the board determines appropriate to the credit assessment."[7] Finally – and perhaps more importantly – by delineating fairly general factors focused on identifying securities that present minimal credit risks, the Commission provides the necessary flexibility for money market funds to adapt their approach to credit analysis as the markets and types of securities in which money market funds invest continue to evolve. In our view, the board should be allowed to exercise its business judgment to approve and oversee an approach to credit analysis that it concludes is most appropriate and in the best interests of the fund it oversees. We believe that the Commission's approach will achieve this goal.

We also agree with the Commission's statement that many boards and funds will – and should be able to -- use credit ratings as part of their individual analyses of credit quality. Credit ratings, particularly when obtained from a source that the board and adviser conclude is reliable, play an important role in identifying appropriate securities for investment and, even more importantly, from eliminating riskier securities from consideration. Indeed, while boards and their delegees will continue to need to exercise independent judgment in identifying securities that present minimal credit risks, the manner in which credit ratings are often used as an initial limiting factor adds important efficiencies to the process. Separately, the downgrade of a security by a reliable credit rating agency provides an important indication that the credit quality of that issuer's securities should be carefully reevaluated if held by the fund. The statutory requirement that the Commission no longer rely on credit ratings in its rules should not preclude funds, boards and advisers from using credit ratings in a manner that they determine best aids in the credit analysis process.[8]

We also concur with the Commission's decision to collapse the distinction between first and second tier securities. While we expressed concern in the past that doing so could create, particularly in benign macroeconomic environments, a "reach for yield" by more

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6 Factors that the Commission suggests such as analysis of the "issuer or guarantor's financial condition" or the "issuer or guarantor's liquidity," *see* Proposing Release at 21, are all fairly general and clearly relevant to a determination of credit quality. This seems equally true of the factors that the Commission suggests for specific types of securities. *See id.* at 22-25.

7 *Id.* at 25.

8 While we concur with the Commission that it makes sense for an adviser to understand both an NRSRO's "methodology for determining the rating at issue" and the "outside source's record with respect to evaluating the types of securities in which the fund invests," *see* Proposing Release at 16, we caution the Commission against being too prescriptive in this area. Advisers and boards are best able to determine what factors warrant relying (or not relying) on a particular NRSRO's ratings, and we urge the Commission to permit them to exercise their business judgment to make this decision rather than being required to meet a set of standards determined by the Commission or other regulatory authority.

aggressive fund managers that would undercut the risk-limiting goals of rule 2a-7,[9] we believe that the credit quality standard that the Commission is proposing – that a security "presents minimal credit risks" and that its issuer "has an exceptionally strong capacity to meet its short-term obligations" – is appropriately strong and thus obviates the need to maintain the distinction.

That said, we agree that under the proposed rule, "funds theoretically could invest in second-tier securities to a greater extent than permitted today."[10] In large part, as we have suggested previously, this risk arises from the openness of the subjective standards quoted above – as they are interpreted by individual boards and individual advisers, these somewhat subjective standards will inevitably be applied in slightly differing ways, thus undermining the Commission's important goal of achieving uniformity. The Commission helps mitigate this risk by noting that the new standard "is designed to preserve the current degree of risk limitation in rule 2a-7,"[11] which should lead to funds comparing their portfolio construction under the new standard to that which would have been permitted under the current standard. As an additional protection for money market funds, we urge the Commission to continue to monitor the portfolios of money market funds so that it may appropriately address any divergence from the risk-limiting approach of rule 2a-7.[12]

B. Stress Testing

The Commission is also proposing relatively minor amendments to the stress-testing provisions of rule 2a-7. Specifically, the Commission would replace the existing requirement to stress test the portfolio in light of the downgrade of an owned security with a requirement to stress test for an event "indicating or evidencing credit deterioration of particular portfolio security provisions."[13] While we agree with previous commenters that retaining the reference to a credit downgrade would be preferable,[14] we believe that the new standard will not significantly change the substance of existing stress tests, and thus do not oppose the proposed amendment.

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9 *See* the Forum's Comment Letter regarding Money Market Fund Reform dated September 16, 2013 (available at http://www.mfdf.org/images/uploads/newsroom/MMF_Reform_20130916.pdf).

10 Proposing Release at 15.

11 *Id.*

12 In light of this issue, we certainly understand the Commission's desire to include disclosure of information regarding NRSROs and specific credit ratings that a fund and its adviser may have used during the credit analysis process. While we do not specifically object to including these reporting requirements in the rule, we urge the Commission to carefully consider whether the information is necessary to help it monitor the activities of money market funds, whether it will result in the highly duplicative reporting regarding the credit ratings assigned to particular securities and whether, in light of these two issues, it will impose unnecessary costs and burdens on money market funds.

13 Proposing Release at 38.

14 *See id.* at 37 & n. 113.

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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, the proposal is not without risks. Moreover, this proposal should not be viewed in isolation, but is rather part of the ongoing discussion regarding the future regulation of money market funds. We are pleased that the Commission continues to take the lead in this discussion. We look forward to continuing to participate, 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, President of the Forum, at [redacted].

Sincerely,

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

cc: The Honorable Mary Jo White
The Honorable Luis A. Aguilar
The Honorable Daniel M. Gallagher
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar
Norm Champ, Director, Division of Investment Management