ReedSmith

Stephen A. Keen
Direct Phone: +1 970 689 3153
Email: skeen@reedsmith.com

Reed Smith LLP
Reed Smith Centre
225 Fifth Avenue
Pittsburgh, PA 15222-2716
+1 412 288 3131
Fax +1 412 288 3063
reedsmith.com

November 22, 2013

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Money Market Fund Reform; Amendments to Form PF, File Number S7-03-13

Dear Secretary Murphy:

This letter provides my comments and observations regarding the draft revisions to rule 2a-7 proposed in *Money Market Fund Reform [and] Amendments to Form PF* (the "Release," and the proposed versions of rule 2a-7 therein, "Proposed Rule 2a-7").[1] My comments exclusively address the wording of Proposed Rule 2a-7. This letter does not argue for or against the policies underlying the proposed changes to rule 2a-7 and should not be interpreted to endorse any of these changes. Instead, this letter represents my attempt to anticipate questions that may arise from confusing or ambiguous terms used in Proposed Rule 2a-7.

My firm represents several major mangers of money market funds, and I have provided legal counsel concerning rule 2a-7 for twenty-four years. During this period, I have assisted in developing compliance procedures for every reform to rule 2a-7 adopted by the Securities and Exchange Commission (the "Commission") since 1991. I also was a panelist on the Investment Company Institute's nationwide program to train investment personnel on the 1997 reforms. This has given me direct experience with the process for addressing interpretative questions that inevitably arises after reforms to rule 2a-7,[2] including the 1997 technical amendments required, in part, to address drafting problems with reforms adopted in 1996 but never put into effect.

My object in this letter is to recommend ways of keeping interpretive questions to a minimum following adoption of a final rule. Highlighting interpretive issues necessarily is a pedantic exercise, and some of my comments may seem trivial. I am sure, however, that the Commission appreciates that

[1] Investment Company Act Release No. 30551, 78 Fed. Reg. 36834 (June 19, 2013). Unless otherwise indicated, "Proposed Rule 2a-7" refers to the Alternative 1 version, as set forth at 78 Fed. Reg. 36997-37005. Capitalized terms are used in this letter with the definitions provided in Proposed Rule 2a-7(a).

[2] For example, the staff has issued three FAQ's addressing questions raised by the reforms adopted in 2010. Staff Responses to Questions about Money Market Fund Reform (August 7, 2012), http://www.sec.gov/divisions/investment/guidance /mmfreform-imqa.htm; Staff Responses to Questions about Rule 30b1-7 and Form N-MFP (July 29, 2011), http://www.sec.gov/divisions/investment/guidance/formn-mfpqa.htm; and Staff Responses to Questions about Information Filed on Form N-MFP (January 25, 2011), http://www.sec.gov/divisions/investment/guidance/formn-mfpqa-info.htm.

ReedSmith

attention to details and meticulous care are hallmarks of sound rulemaking. Moreover, any writer can benefit from feedback from a careful reader, no matter how prosaic the material.

I have not prepared this comment letter at the request or direction of any of my firm's clients, and the views expressed are my own. Nevertheless, regardless of what policies the Commission ultimately adopts, I like to think these comments reflect the concerns of everyone who will be called upon to implement such policies through compliance with rule 2a-7.

My principal recommendations may be summarized as follows:

1. The Commission's staff should use mock procedures as a means of testing requirements for ambiguous or confusing terms. By "mock" procedures, I mean a general analysis of the steps necessary to comply with a requirement—not a full-fledged compliance process. The proposed changes to stress testing provide several examples of how careful reflection on compliance with a proposed requirement reveals interpretive challenges.

2. When the Commission removes or curtails a requirement or exception from rule 2a-7, the staff should carefully review the rule to remove or modify all related definitions and provisions. Otherwise, rule 2a-7 will accumulate redundant or inoperative terms that attorneys may misinterpret. The proposed elimination of the "25% basket" for diversification of Demand Features and Guarantees illustrates the danger of redundant provisions.

3. Rule 2a-7 should be drafted with a view towards allowing requirements to be read and understood independently, without having to reread the entire rule. For example, if someone were trying to determine what procedures a fund's board of directors must adopt under rule 2a-7, it would be helpful it all such procedures were gathered under the paragraph headed "Required Procedures," rather than being scattered among defined terms and substantive requirements.

4. The Commission should clarify the intent underlying certain proposed changes.

5. The Commission should consider addressing certain ambiguities in the current definition and treatment of Eligible Securities.

1. The Commission's Staff Should Test Proposed Requirements with Mock Procedures

In my experience, I have found that developing a procedure for complying with a new or revised requirement provides the best means of exposing gaps and ambiguities in the drafting. Outlining compliance requirements is thus the first step taken by my firm following any reform to rule 2a-7. While I realize the Commission's staff may not have the experience or information required to develop full-scale compliance procedures,[3] they should at least delineate the steps required to comply with each proposed

[3] I should note that a member of the Commission's staff, Sharon Pichler, is a former money market fund portfolio manager with extensive experience. As she reviews Form N-MFP filings on a regular basis, she also has access to a wealth of information about money market fund portfolios. I would expect that she could provide valuable feedback to other staff members charged with drafting Proposed Rule 2a-7 regarding proposed or revised requirements.

or revised requirement. This exercise should clarify what the requirement will accomplish and whether this is the intended result.

The current and proposed stress testing requirements could benefit from this exercise. Let me reemphasize that, although I believe the Commission has overestimated the utility of stress tests, I am not commenting on the number or types of stress tests Commission proposes to require. I am suggesting that, for each test the Commission considers, the staff should work up an example of the test and draft the requirements based upon the example. The staff should also run sample data from Form N-MFP through the example, to get an idea of the potential utility of the results. This discipline is necessary because the wording of the stress testing requirements in Proposed Rule 2a-7 is so indistinct as to create a Rorschach blot for stress testing, which would leave everyone to their subjective understanding of the testing requirements.[4]

(a) Ambiguities in the Current Stress Testing Requirements

The stress testing requirements of the current rule already pose interpretive challenges. The relationships of the first two required hypothetical events ("change in short-term interest rates, [and] an increase in shareholder redemptions") and the result to be calculated ("the magnitude of [the] hypothetical event that would cause the deviation of the money market fund's net asset value calculated using available market quotations (or appropriate substitutes which reflect current market conditions) from its net asset value per share calculated using amortized cost to exceed ½ of 1 percent") are fairly clear. A rise in short-term interest rates would produce a decline in the "net asset value calculated using available market quotations" (often referred to as a money market fund's "shadow price"). Furthermore, as the shadow price is determined "per share," reductions in the number of shares (due to increased redemptions) would increase the deviation of the shadow price from $1.

The relationship between the third hypothetical event ("a downgrade of or default on portfolio securities") and a fund's shadow price is also intuitive, insofar as the event would cause the shadow price to fall. Defaults do not have a "magnitude," however, at least in the same sense as an increase in short-term interest rates or shareholder redemptions. A company that defaults on an obligation simply fails to pay when due; there is no more or less to this form of default.[5] Downgrades can have a magnitude in terms of the number of rating categories spanned by the downgrade (*e.g.*, a downgrade from A-1

[4] I analyze the stress testing requirements because they present the great challenges to interpreting Proposed Rule 2a-7. But even a simple change, like the removal of Amortize Cost from the definition of Total Assets, should be considered from a compliance perspective. This change has significant systems implications, as a money market fund will need to tie its compliance systems to the market values used to calculate the fund's daily net asset value, rather than using the amortized cost of the portfolio. The close proximity of amortized cost to the market value of portfolio securities makes it difficult to justify the expense of such system changes. The change also has the consequence of reducing the percentage of Total Asset invested in an issuer's securities as their market value decreases.

[5] Defaults might have a magnitude in terms of the number of portfolio securities that default. However, it is unlikely that an issuer would default on some securities rather than others, particularly as defaults typically arise from a bankruptcy proceeding that would prohibit preferential payments. A fund also might create a magnitude by assuming defaults by an increasing number of issuers. However, this seems inconsistent with Staff Responses to Questions about Money Market Fund Reform (August 7, 2012), *supra* note 2, Question III.A.3. ("This test should therefore be designed to assist the board of directors in assessing the effect of isolated stresses on a fund's shadow net asset value ….").

ReedSmith

to A-2 is of lesser magnitude than a downgrade from A-1 to A-3). There is no strict relationship, however, between the magnitude of a downgrade and the reduction in a security's market value. These factors prevent a money market fund from calculating the "magnitude" of a default or downgrade that "would cause" the shadow price to deviate by one-half cent from $1.

The only "magnitude" available for a hypothetical default or downgrade is the magnitude of the price change that might result from the event. This makes the stress test somewhat tautological: the magnitude of the price change from a default or downgrade that would cause the shadow price to deviate by one-half cent from $1 is one-half cent per share. This magnitude can be converted into price changes for individual portfolio holdings, however. The stress test thus works backward, taking a dollar amount equal to one-half cent per share and calculating the magnitude of the uniform change in the price of the portfolio securities issued by a company that would equal this dollar amount. For example, if a fund holds obligations from a bank equal to 2% of its net assets, the price of the holdings would have to fall to 75 cents on the dollar to cause the shadow price to deviate by one-half cent per share (2% x ($1-$0.75) = $0.005).

I must point out that this test has nothing to do with defaults or downgrades as such. It hypothesizes an idiosyncratic price change affecting securities issued by a single company. While a rapid deterioration in a company's financial condition, which may produce a downgrade of its credit ratings or a default, is likely to produce an isolated decline in the market value of the company's obligations, other events might produce the same result.

The final required hypothetical event ("the widening or narrowing of spreads between yields on an appropriate benchmark the fund has selected for overnight interest rates and commercial paper and other types of securities held by the fund") is truly a poser. While the directors clearly must select an overnight interest rate as the benchmark for the test, spreads on portfolio securities might widen or narrow from this benchmark in many ways. For example, a test assuming that the yield on every portfolio security widened or narrowed from the benchmark rate by a uniform number of basis points would appear to comply with this stress-testing requirement. Such a test would also produce identical results to the first stress test of a general change in short-term interest rates.

As it seemed unlikely that the Commission intended to mandate redundant stress tests, attorneys have advised money market fund advisers and directors to formulate other changes in spread relationships for purposes of this final required stress test. The only other guidance attorneys could offer is that the relationship should somehow relate to the "types of securities held by the fund." As a portfolio may be subdivided by various criteria, such as maturity, geographic and/or business sector, rating category, fixed or fluctuating rates, or type of instrument, advisers and directors have not found this guidance of much practical use. I have advised clients to choose a spread changes that best illustrates a plausible risk to the fund not already covered in the other stress tests. I have no idea if my advice reflects the Commission's intended objective for this stress test.

ReedSmith

(b) Problems with the Proposed Stress Testing Requirements

I found it interesting that the Release proposes to modify this "widening or narrowing of spreads" event, so that Proposed Rule 2a-7 would instead require funds to test "[t]he widening or narrowing of spreads among the indexes to which interest rates of portfolio securities are tied." Perhaps the change is intended to address the interpretive challenge posed by the current wording of the last hypothetical event. While more specific than the current provision, the revised wording also illustrates the importance considering how a money market fund would comply with this requirement as part of the drafting process.

If asked for guidance on testing the revised hypothetical event, I would first observe that it presupposes the fund holds securities the interest rates of which are "tied" to indices. "Tied" in this context appears to refer to Floating or Variable Rate Securities, the interest rates of which are adjusted by reference to an index rate, such as the effective Federal Funds rate ("Fed Funds") or the London Interbank Offered Rate ("LIBOR"). If a fund did not hold securities with interest rates based on index rates, it is not clear how it could conduct this stress test.

The requirement further assumes that the fund holds Floating or Variable Rate Securities with rates based on different indices; otherwise, there would not be indices among which spreads could widen or narrow. This implies that a municipal fund holding Variable Rate Securities set exclusively by the SIFMA Municipal Swap Index also might find it difficult to conduct this stress test.

Assuming that the money market fund holds Floating or Variable Rate Securities based on different indices (such as Fed Funds, one-month LIBOR and three-month LIBOR), the stress test should determine the magnitude of any widening or narrowing of the spreads among these indices that would cause the fund's shadow price to deviate from $1 by one-half of a cent. This cannot be determined, however, without making assumptions regarding the change in yield for the fixed-rate portion of the portfolio. If the fund assumes that changes in the spreads among indices reflects changes in general interest rates, such that an increase in the spread between one-month and three-month LIBOR reflects a general increase in three-month rates, then the test results would be the same as testing a hypothetical steepening of the yield curve. The Release provides some support for this interpretation, citing (at 36969) "a change in the shape of the yield curve" as an example of the risks addressed by the revised stress test.

The Release also suggests "a change in the interest rates of particular asset classes" as an alternative example of the risk the revised hypothetical event is intended to test. *Id.* This would correspond to the interpretation of the current wording of the requirement. (It also subsumes changes in the shape of the yield curve, if the fund classifies assets by maturity.) But it would not address the question of how advisers and boards should classify assets for purposes of this test. Another problem with both examples is that they would make this test partly duplicative of the new tests proposed in clauses (E) and (F).

Most importantly, the "spreads among the indexes to which interest rates of portfolio securities are tied" have little to do with the "changes in the interest rates of particular asset classes." Assuming that "particular asset classes" refers to Floating and Variable Rate Securities (*i.e.*, securities tied to interest rate indices), the shadow prices of these securities are affected primarily by changes in the spreads of

ReedSmith

these securities *over* the index to which they are tied, not changes *among* their various indices. For example, if a one-year security's interest rate is reset monthly to equal three-month LIBOR plus 20 basis points, and the spread over LIBOR for such securities increases to 30 basis points, the security's market value will decrease, regardless of whether three-month LIBOR changes relative to other interest rate indices. If the Commission intends for funds to test the risks associated with their Floating and Variable Rate Securities, which corresponds to a fund's WAL, it should redraft this event to express its intent more clearly.

It would be tedious to analyze in similar depth the questions raised by the other changes to stress testing requirements proposed in the Release. Instead, I will list a few questions raised by the new provisions of Proposed Rule 2a-7(g).

- A money market fund would have to test its "ability to have invested at least fifteen percent of its total assets in weekly liquid assets" and report "the magnitude of *each hypothetical event* that would *cause* the money market fund to have invested less than fifteen percent of its total assets in weekly liquid assets." However, none of the hypothetical events has any direct relationship to the amount of weekly liquid assets held by a fund. In fact, only one of the hypothetical events, net redemptions, might have an indirect relationship to holdings of weekly liquid assets, if the fund assumes that it would use weekly liquid assets to pay net redemptions. How does the Commission envision money market funds testing the other hypothetical events for this result?

- In connection with testing an increase in shareholder redemptions, a money market fund would have to conduct "an assessment of how the fund would meet the redemptions." However, if the fund assumes that it can sell portfolio securities at their estimated shadow price, the assessment will not change the test result in terms of the deviation of the shadow price from $1. For example, if a security's estimated market value for purposes of shadow pricing were $99.80 (either based on current market conditions or on another hypothetical event), assuming it was sold for that price would not change the fund's shadow price. How would the required assessment affect the test results?

- In connection with testing downgrades and defaults, a money market fund would have to consider "the effects these events could have on other securities held by the fund." However, as explained above, this test does not require a fund to assume any underlying cause for the default or downgrade. Without a "back story" for the downgrade or default, how could a fund surmise what effects the event might have on other securities held by the fund? Perhaps the Commission only intends for funds to assess the potential "knock-on" effects of a company's insolvency, such as the nonpayment of receivables and loss of revenues that the company's vendors might experience. If so, it would be better to characterize the hypothetical event as an Event of Insolvency rather than a default. In addition, where would funds obtain the information required to assess such potential knock-on effects?

ReedSmith

- In connection with the proposed tests of combinations of hypothetical events, money market funds would have to take "into consideration the extent to which the fund's portfolio securities are correlated such that adverse events affecting a given security are likely to also affect one or more other securities (*e.g.*, a consideration of whether issuers in the same or related industries or geographic regions would be affected by adverse events affecting issuers in the same industry or geographic region)." Is this intended to require funds to generate the "back story" referred to in the previous comments? If so, how should funds formulate such far-reaching "adverse events" for each testing period? Alternatively, is this intended to require funds to break their portfolios down by business sectors and geographical regions and identify for the fund's directors the sectors and regions posing the most significant risks? If so, what criteria should funds use to define sectors and regions?

- Money market funds would have to test "[o]ther movements in interest rates that may affect the fund's portfolio securities, such as parallel and non-parallel shifts in the yield curve." Testing "increases in the general level of short-term interest rates" is the same as testing a parallel shift in the yield curve, so this aspect of new requirement would be redundant. With respect to non-parallel shifts, how many and what kinds of non-parallel shifts should be tested? Historically, what variations have been observed in the shape of the first thirteen months of the yield curve? Given the short duration of money market funds, how much variation in test results could these non-parallel shifts produce?

- Money market funds would have to test "[c]ombinations of these and any other events the adviser deems relevant." Would funds have to test every permutation of combined events? If not, what would be a sufficient number of combinations?

- In testing combinations of events, money market funds would have to assume "a positive correlation of risk factors." How would a fund determine how much of a positive correlation to assume in the combination tests? If the positive correlation is to be based on historical data, how long a period should a fund use to measure the correlation? What should a fund do if the historical data does not show a statistically significant positive correlation among events? How should a new fund without historical data determine the extent of any correlations?

These questions would only be starting points for examining whether and how money market funds and their directors could develop procedures to implement expanded stress testing requirements. As illustrated by my more detailed attempt to interpret the revised "changes in spreads" hypothetical, struggling with these questions can reveal confusing or ambiguous drafting. It may also help clarify what a new or modified stress test might accomplish. I therefore recommend that the Commission's staff engage in such exercises to test how effectively Proposed 2a-7 conveys the objectives of stress testing requirements.

ReedSmith

2. Revisions to Rule 2a-7 Should Not Leave Vestigial Provisions

Amending a complex and highly integrated regulation is a difficult task. It is particularly difficult to remove or limit an existing provision, because of the risk that other provisions in the regulation rely upon or incorporate elements of the excised terms. Such changes require a complete understanding of the structure of the regulation and the interaction of its provisions.

Nevertheless, it is important to remove inoperative terms completely. Giving effect to every term of a statute or regulation whenever possible is a canon of legal interpretation. This creates a risk of attorneys trying to give effect to terms that no longer serve any constructive purpose in the regulation, which may lead to serious unintended consequences.

The proposed removal of the so-called "25% basket" for Demand Features and Guarantees illustrates this problem. Currently, rule 2a-7(c)(4) has two separate provisions regulating diversification of portfolio securities. Subparagraph (i)(A) generally prohibits Acquisition of a security that would cause a fund to "have invested more than five percent of its Total Assets in securities issued by the issuer of the security." Subparagraph (iii)(A) generally prohibits Acquisition of a security subject to a Demand Feature and/or Guarantee that would cause a fund to "have invested more than ten percent of its Total Assets in securities issued by or subject to Demand Features or Guarantees from the institution that issued the Demand Feature or Guarantee." One reason for separating these diversification requirements is that subparagraph (iii)(A) applies only "with respect to seventy-five percent of [a fund's] Total Assets," whereas subparagraph (i)(A) applies to all of a fund's Total Assets. This creates a "25% basket" for securities subject to Demand Features and Guarantees that were Acquired in excess of the 10% limit otherwise imposed by subparagraph (iii)(A).

The Release proposes to eliminate this 25% basket, which would be effected by two changes in Proposed Rule 2a-7(d)(3) (which would corresponds to paragraph (c)(4) of the current rule). The first change would add to subparagraph (i)(A) a clause prohibiting Acquisition of a security that would cause a money market fund to have invested more than "Ten percent of its total assets in securities issued by or subject to demand features or guarantees from the institution that issued the demand feature or guarantee."[6] The second change would remove "with respect to seventy-five percent of its Total Assets" from subparagraph (iii)(A) and add Acquisition of "a security directly issued by the issuer of a demand feature or guarantee" to the Acquisitions that must comply with the subparagraph.

These proposed changes would result in Proposed Rule 2a-7(d)(3) having separate provision (the new subparagraph (i)(A)(*2*) and the existing subparagraph (iii)) limiting the Acquisition of securities subject to Demand Features and Guarantees to 10% of a fund's Total Assets. As the two provisions use different words to describe the same requirement, it is not clear whether the provisions are entirely redundant. Such uncertainty would invite attorneys to tease out subtle distinctions in the wording to give the provisions somewhat different effects. Assuming the Commission simply wishes to eliminate the

---

6 Corresponding changes would be made to the diversification requirements for Single State Funds and Second Tier Securities in subparagraphs (3)(i)(B) and (C), respectively.

ReedSmith

25% basket as stated in the Release, any distinctions draw between the two provisions would be unintended.

I support rewriting the diversification requirements of rule 2a-7 to make them less convoluted. Redrafting will not accomplish its purpose, however, without removing the convoluted language. The Commission's staff should decide whether to: (1) take the easy route of just modifying the terms of subparagraph (iii)(A) to remove the 25% basket and confirm that all Acquisitions must comply with the subparagraph, or (2) undertake the more difficult approach of consolidating both diversification requirements into subparagraph (i), removing subparagraph (iii), either renumbering subparagraph (iv) or combining it with subparagraph (ii), and making conforming changes to all affected cross-references. More work would be required for the second approach, insofar as Proposed Rule 2a-7(d)(3) would still exempt securities subject to a Guarantee Issued by a Non-Controlled Person from subparagraph (i) entirely, rather than just from subparagraph (i)(A)(*1*), and there is no clear antecedent for "*the* institution" referred to in subparagraph (i)(A)(*2*).

Other examples of incomplete revisions to Proposed Rule 2a-7 include changes to the following defined terms:

- Amortized Cost. As amortized cost would no longer relate to a method of valuation, "the value of a security at" is no longer relevant to the proposed definition.

- Conduit Security. Prior to the 2010 amendments, "Conduit Security" was used in two contexts: (1) to specify the issuer of the security for purposes of diversification and (2) to allow Tax Exempt Funds to invest a higher percentage of their Total Assets in non-Conduit Securities that were Second Tier Securities. Consequently, the term "Conduit Security" appeared in three separate provisions of rule 2a-7. The 2010 amendments imposed uniform limits on all Second Tier Securities for all money market funds. As a result, Conduit Security now appears only in subparagraph (d)(3)(ii)(C) of Proposed Rule 2a-7. The Commission could incorporate the provisions of this definition directly into this subparagraph and eliminate the definition, so the requirements for diversification could be understood without having to refer back to the definitions.

- Demand Feature. Proposed Rule 2a-7(a)(9) would clarify the definition of a Demand Feature by recognizing a period of time must elapse between the exercise of a Demand Feature (*i.e.*, giving notice to the provider) and settlement of the resulting trade (*i.e.*, receiving payment from the provider). The proposed removal of the 30-day limit on this period, however, eliminates the need to refer to "the time of exercise" in the definition, particularly as, unless the provider of the Demand Feature is clairvoyant, "the settlement of the transaction," will necessarily be later than "the time of exercise." To remove "the time of exercise," I recommend inserting "which exercise price is due within 397 calendar days of exercise of the Demand Feature" after "if any."

- Guarantee. The description of an Unconditional Demand Feature in the definition of "Guarantee" in paragraph (a)(16) is unnecessary. The "in the case of an Unconditional

Demand Feature" clause is the last item in a list of times by which a Guarantee payment must be made. All the last clause should do is to prescribe when payment following exercise of a Demand Feature is due. This could be accomplished by replacing "an obligation that entitles the holder to receive upon the later of exercise or the settlement of the transaction the approximate amortized cost of the underlying security or securities, plus accrued interest, if any" with "upon the required settlement date following exercise of the Unconditional Demand Feature."

3. It Should Be Possible to Interpret a Provision without Rereading the Entire Rule

No one should attempt to interpret any provision of rule 2a-7 without having read the entire rule, carefully, a couple of times. Nevertheless, it would be helpful if attorneys could respond to questions concerning specific requirements of rule 2a-7 without having to reread the entire rule. The Commission could facilitate this by: (a) not placing substantive requirements in defined terms, and (b) continuing to capitalize defined terms.

(a) Substantive Requirements Do Not Belong in Defined Terms

As a rule, definitions should explain what a term means rather than what someone must do. The terms defined in paragraph (a) of rule 2a-7 follow this rule for the most part, but the current definition of "Designated NRSRO" and the revision to the definition of "Guarantee" proposed in the Release depart from this approach. As a result, attorneys must remember to check the definitions when trying to determine what procedures the board of directors must adopt or how Asset-Backed Securities must be diversified, rather than just consulting provisions under the applicable headings.

The inclusion of board findings in defined terms dates back to the definition of an "Eligible Security," which includes "An Unrated Security that is of comparable quality to a security meeting the requirements for a Rated Security in [the definition], as determined by the money market fund's board of directors...." (*See, also*, the definition of "First Tier Security.") This exception proves the rule. The bulk of the definitions of "Eligible Security" and "First Tier Security" specify what ratings and other provisions a security must have, rather than what anyone must do. The reference to the board of directors is necessary to address when an Unrated Security is an Eligible Security. This should not be problematic, insofar as anyone answering a question like "Can a money market fund acquire this security?" should look back at the definition of Eligible Security when she encounters the term in paragraph (c)(2)(i). In contrast, someone trying to determine the procedures a board of directors must adopt under Proposed Rule 2a-7 will not find the term "Designated NRSRO" in any provision under the heading "Required Procedures" in paragraph (g). This may cause someone to overlook the directors' responsibility to designate NRSROs.[7]

---

[7] This has not been a problem, because the Commission has suspended the requirement to designate NRSROs pending its decision on the proposed elimination of references to NRSROs from Rule 2a-7. While the definition of Designated NRSRO will probably disappear from the final rule, it still serves as a useful example of the hazards of including substantive requirements in defined terms.

ReedSmith

The change to the definition of "Guarantee" is more problematic, insofar as it would treat an Asset-Backed Security without credit enhancements as though the sponsor had Guaranteed the security. The definition is sufficiently counterintuitive that a person reviewing the diversification requirements for an Asset-Backed Security without any credit enhancements may not realize that the term applies to the security, particularly in light of the detailed instructions for diversification of Asset-Backed Securities provided in subparagraph (ii)(D). Moving the text of Proposed Rule 2a-7(a)(16)(ii) to paragraph (d)(3) would reduce the risk of overlooking the new diversification requirement.

Placing the text in paragraph (d)(3) would also avoid the need for the conforming change to the definition of "Guarantee Issued by a Non-Controlled Person." I am not certain the Commission fully appreciates the consequences of the proposed change to this definition. Clause (ii) of the current definition of "Guarantee Issued by a Non-Controlled Person" includes "a Guarantee issued by ... A sponsor of a Special Purpose Entity with respect to an Asset Backed Security." If the Commission eliminates the 25% basket, the primary effect of this clause would be to exclude an Asset-Backed Security fully Guaranteed (under the current definition) by its sponsor from the diversification requirements of paragraph (d)(3)(i). This exclusion makes sense insofar as the credit risk of the Asset-Backed Security would principally derive from the sponsor and not from the Qualifying Assets.

Proposed Rule 2a-7 would amend clause (ii) of the definition so a sponsor's Guarantee would be a Guarantee Issued by a Non-Controlled Person only "if the money market fund's board of directors has made the findings described in paragraph (g)(6) of this section." The findings described in paragraph (g)(6)[8] are "that the fund is not relying on the sponsor's financial strength or its ability or willingness to provide liquidity, credit or other support in connection with the asset-backed security." This revision of clause (ii) would have three consequences:

- It would prevent the exclusion of Asset-Backed Securities from the diversification requirements of paragraph (d)(3)(i) based on the Guarantee the sponsor is deemed to provide under clause (ii) of the proposed definition of "Guarantee;"
- It would change the current rule, so that Asset-Backed Securities that are actually Guaranteed by their sponsors (*i.e.*, Guaranteed within the meaning of clause (i) of the proposed definition) would become subject to the diversification requirements of paragraph (d)(3)(i); and
- It would exclude an Asset-Backed Security from the diversification requirements of paragraph (d)(3)(i) based on findings that the fund is *not* relying on the sponsor's credit support.

I expect that the first consequence was the reason for revising clause (ii) of the definition of "Guarantee Issued by a Non-Controlled Person." If the Commission proposes to impose the diversification limits of paragraph (d)(3)(iii) on the sponsor of an Asset-Backed Security without removing the

---

[8] It is not clear why the existing provisions of Proposed 2a-7(e) would not be sufficient for this exception to the deemed Guarantee by a sponsor of its Asset-Backed Securities.

ReedSmith

Asset-Backed Security from the limits of paragraph (d)(3)(i), then it must override the exemption of securities subject to a Guarantee Issued by a Non-Controlled Person in paragraph (d)(3)(i). On the other hand, I cannot find any indication in the Release that the Commission intended to change the current rule exempting Asset-Backed Securities actually Guaranteed by their sponsors, which are already subject to the diversification requirements of paragraph (d)(3)(iii), from paragraph (d)(3)(i). Thus, the second consequence appears unintended.

The third consequence would exempt any Asset-Backed Security for which the board of directors has made paragraph (g)(6) findings from *any* diversification requirements.[9] The board's findings would *exclude* an Asset-Backed Security from having a Guarantee subject to diversification under paragraph (d)(3)(iii). The findings would also *include* the Asset-Backed Security in the definition of Guarantee Issued by a Non-Controlled Person, so the Asset-Backed Security would be excluded from paragraph (d)(3)(i). I cannot believe the Commission intended this result, but it is the logical consequence of defining a security that the directors have found, in effect, not to be Guaranteed as nevertheless subject to a Guarantee Issued by a Non-Controlled Person.

Another strong indication that the provisions of clause (ii) do not belong in the definition of "Guarantee" is the need to list four paragraphs in which the expanded definition would not apply. Moving the provisions of clause (ii) to paragraph (d)(3)(iv) (headed, "Diversification rules for demand features and guarantees") would therefore be less confusing for readers, in addition to preventing unintended consequences.

(b) Capitalization of Defined Terms

The Release proposes to convert all defined terms to lower case. Capitalizing defined terms alerts the reader to the possibility that the terms may not be used with their ordinary meanings and are defined elsewhere in the document. While attorneys should familiarize themselves with the definitions in paragraph (a) of Proposed Rule 2a-7, they may not always recall which terms have been defined. A reader might forget, for example, that the term "U.S. dollar denominated" is defined in paragraph (a)(28) and includes requirements beyond the currency for repayment. I recommend retention of capitalized defined terms as an aid to readers that should facilitate compliance with the rule.

4. Other Ambiguities in Proposed Rule 2a-7

The following provisions create uncertainty as to the Commission's intent:

- New clause (iv) of the definition of Daily Liquid Assets and clause (v) of the definition of Weekly Liquid Assets require payments to be due "unconditionally." Payments are usu-

[9] There is a circular reading of the definitions that might partially avoid this consequence. As clause (ii) of the definition of "Guarantee Issued by a Non-Controlled Person" applies only to Guarantees, and as an Asset-Backed Security subject to the findings described in paragraph (g)(6) would not be treated as Guaranteed under clause (ii) of the proposed definition of "Guarantee," the Asset-Backed Security would not be subject to a Guarantee Issued by a Non-Controlled Person. However, this interpretation has the effect of reading clause (ii) out of the definition of "Guarantee Issued by a Non-Controlled Person," as there could never be a Guarantee that would be subject to the clause.

ally conditioned upon performance by the fund, however, such as delivery of securities at settlement. Would payments subject to standard settlement conditions nevertheless be "unconditional" for purposes of these new clauses?

- Paragraphs (b)(1) and (2) would replace references to specific paragraphs of Proposed Rule 2a-7 with a general requirement to "comply with this section." This change will treat funds that fail to comply with a procedural or recordkeeping requirement as having made "untrue statements of material fact" and as using "materially deceptive or misleading names." How are shareholders being misled in such circumstances?

- Did the Commission intend to remove the required board of directors findings currently required in rule 2a-7(c)(1) from the Alternative 1 version of Proposed Rule 2a-7? Did the Commission intend to remove the requirement that "the money market fund will continue to use [the penny rounding] method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share" from the Alternative 2 version of Proposed Rule 2a-7?

- Would a feeder fund that invests exclusively in a master fund that complies with the requirements of Proposed Rule 2a-7(c)(2) also qualify for this exception?

5. Ambiguities Regarding Eligible Securities

The Commission might also address two long-standing interpretative questions in any final rulemaking. First, the definition of "Eligible Security" in Proposed Rule 2a-7(a)(10) has a maturity component as well as a quality component, insofar as subparagraph (i) requires a Rated Security to have "a remaining maturity of 397 calendar days or less ...." Subparagraph (ii) only requires Unrated Securities to comply with the quality component, however. Normally, omission of the maturity requirement does not matter, because of the general maturity limitation imposed by Proposed Rule 2a-7(d)(1)(i). It could matter, however, if the maturity of a portfolio security were extended beyond 397 days (due to the termination of a Demand Feature, for example). A Rated Security would no longer be an Eligible Security in this circumstance, which would trigger the actions required by Proposed Rule 2a-7(f)(2). The current definition of "Eligible Security" leaves it unclear whether an Unrated Security should be treated in the same manner.

The maturity component of the definition of Eligible Security also impacts the treatment of securities subject to Conditional Demand Features under Proposed Rule 2a-7(d)(2). While clause (iii) of this paragraph provides "A security that is subject to a Guarantee may be determined to be an Eligible Security or a First Tier Security based solely on whether the Guarantee is an Eligible Security or a First Tier Security," clause (iv) provides "A security that is subject to a Conditional Demand Feature ('Underlying Security') may be determined to be an Eligible Security or a First Tier Security only if" the Conditional Demand Feature and the Underlying Security meet additional conditions. This seems to imply that the Underlying Security must qualify as an Eligible Security independently of the Conditional Demand Feature. Underlying Securities commonly have maturities in excess of 397 days, however, and would not qualify as Eligible Securities without the maturity shortening effects of the Conditional Demand

ReedSmith

Feature. If the Conditional Demand Feature meets the conditions of clause (iv), I recommend that the Underlying Security's status as an Eligible Security also be "based solely on whether the Conditional Demand Feature is an Eligible Security."

6. Conclusion

I expect that some of my comments misconstrue or misunderstand the proposed changes to rule 2a-7. But this is the point of my comments: if a reader fails to comprehend the meaning of a text, the writer should at least consider how to express the meaning more clearly. Rather than listing a series of technical comments, I have suggests techniques that the Commission's staff might use to improve the quality of revisions to rule 2a-7. My suggestions boil down to thoughtful consideration of how to make it easier to follow the rule on a daily basis. This includes considerations of (1) what steps the rule would require (through analysis of mock procedures), (2) how to avoid confusion (through elimination of redundant and inoperative provisions) and (3) how to make it easier to find requirements (through proper use of defined terms). While these techniques are useful in drafting any regulation, they are particularly important when revising a regulation as long and complicated as rule 2a-7.

Thank you for considering my comments. Please contact me if you have any questions.

Very truly yours,

Stephen A. Keen

SAK