



April 25, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Dear Ms. Murphy:

Better Markets, Inc.¹ appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Securities and Exchange Commission ("Commission"). The Proposed Rules would remove references to credit ratings in certain rules and forms under the Investment Company Act ("ICA"), and it would substitute alternative standards of credit-worthiness. The Commission has issued these Proposed Rules in accordance with the requirements of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

INTRODUCTION

Credit ratings have existed for over a century, and they have become an extremely important fixture in our capital markets. They are relied upon not only by investors and other market participants, but also by regulators, and they are now embedded in our securities laws and regulations as shorthand standards of credit-worthiness. As stated in the Dodd-Frank Act, "credit rating agencies are central to capital formation, investor confidence, and the efficient performance of the United States economy."²

Although serving as important tools in our financial markets, credit ratings have also contributed to some of our most spectacular financial crises, including the collapse of Enron and the more recent market upheaval and economic recession that began in 2008. For years, the ratings industry has been fraught with conflicts of interest and anti-competitive behaviors. The issuer-pay model is the most problematic characteristic of the industry. A compensation system under which issuers pay for ratings of their debt

¹ Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

² Dodd-Frank Act § 931(1).

securities creates an inherent conflict of interest that perpetually threatens the accuracy and objectivity of credit ratings.

Establishing an effective regulatory regime for credit rating agencies has proven to be a long, slow, and challenging process, one that has not kept pace with the power of credit ratings to profoundly affect our markets. The process has been marked by long periods of study and evaluation, followed by Congressional enactments and waves of rulemaking activity. The Dodd-Frank Act represents the latest attempt to reform the credit ratings industry, while at the same time reducing reliance on ratings and promoting independent credit analysis and due diligence.

SUMMARY OF COMMENTS

The Proposed Rules would remove references to credit ratings in two rules under the ICA that use credit ratings as a test for determining the types of securities that money market funds may hold or the types of repurchase agreements that money market funds may enter into. In addition, the Proposed Rules would establish a new standard of credit-worthiness to replace reliance upon credit ratings in determining the types of securities that business and industrial development companies may acquire. Finally, the Proposed Rules would amend several forms that currently require credit ratings to be included in reports describing a fund's portfolio holdings.

The core challenge facing the Commission as it implements the Dodd-Frank mandate in Section 939A is to establish alternative "standards of credit-worthiness" that are appropriate substitutes for credit ratings. **Eliminating regulatory reliance upon credit ratings without providing adequate alternatives will only undermine effective regulation of our capital markets and put investors at greater risk, not less.** To protect investors, the standards must be strong, and to prevent evasion by market participants, they must also be clear and concrete.

In theory, incorporating alternative standards of credit-worthiness into the Commission's rules can be accomplished in one of two ways: Either incorporating by reference some reliable, external measure of credit-worthiness other than credit ratings, or setting forth in the rules the actual standards of credit-worthiness that market participants must apply. The first alternative offers the same advantages of efficiency conferred by credit ratings, but it also presents the same disadvantages—concerns about reliability, systemic risk arising from widespread reliance on a single measure of credit-worthiness, and the inhibition of independent credit analysis and due diligence. As a practical matter, a reliable and objective shorthand measure of credit risk, which could be incorporated by reference into the Commission's regulations, is not currently available.

The Commission therefore must develop new standards of credit-worthiness and incorporate them into its rules. The Proposed Rules are a commendable effort to accomplish this task, but they present three problems that must be addressed:

- First, the standards of credit-worthiness in the Proposed Rules that are used to replace credit ratings are overly vague and must be more detailed and concrete.

- Second, the Proposed Rules must clarify and limit the extent to which funds may continue to rely on credit ratings.
- Finally, the Proposed Rules must establish stronger documentation requirements, so that the Commission can determine whether a fund has correctly applied the new standards of credit-worthiness.

In the balance of this comment letter, we review prior attempts to regulate credit rating agencies, we highlight the applicable provisions of the Dodd-Frank Act on rating agencies, we summarize the alternative standards of credit-worthiness that the Proposed Rules would adopt in place of credit ratings, and we offer our comments.

HISTORY OF REGULATION

The Commission incorporated Nationally Recognized Statistical Rating Organization (“NRSRO”) credit ratings in its rules for the first time in 1975, as one factor to be used in calculating net capital requirements for broker-dealers.³ As the capital markets grew in volume and complexity, reliance on credit ratings in the securities laws and regulations increased, yet these important “gatekeepers” remained essentially unregulated for decades. In 1994, the SEC issued a concept release to explore the merits of establishing formal procedures for designating NRSROs and monitoring their activities.⁴ A 1997 rule proposal followed but was never adopted.

It took a financial crisis to initiate meaningful regulation of the credit rating industry. The spectacular collapse of Enron generated fresh concerns about the role of credit ratings and the need for oversight. The Congressional response included a 2002 Senate Committee on Governmental Affairs hearing. Among other issues, the hearing sought to explain why credit rating agencies continued to rate Enron a good credit risk until just four days before the firm declared bankruptcy.⁵ Congress also added a provision to the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley Act”) requiring the SEC to

³ References to Ratings of Nationally Recognized Statistical Rating Organizations, Release No. IC-28327 (July 1, 2008), 73 Fed. Reg. 40124 (July 11, 2008), at 40125.

⁴ Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002, U.S. Securities and Exchange Commission, January 2003 (“SEC Study”), at 11.

⁵ SEC Study at 16. The Enron episode highlighted the inherent conflict of interest arising from agencies being compensated by the issuers of the securities they rate. It also illustrated yet another type of conflict with implications for systemic risk: the inter-connectedness of the rating agencies with the derivatives markets. The credit rating agencies knew that a downgrade of Enron would have triggered an immediate call by Enron counterparties for full funding of margin on the enormous book of derivatives held by Enron. This would have instantaneously rendered Enron insolvent. Concerned about triggering these margin calls, the rating agencies delayed issuing their downgrades. The credit rating agencies were thus dangerously interconnected with the derivatives markets through margin credit triggers, similar to the contractual terms that brought AIG down. This interconnection still persists in a large portion of the un-cleared derivatives markets, and it emphasizes the need for reform of the credit rating system in accordance with the Dodd-Frank Act.

study the role of credit rating agencies, measures to improve transparency in the ratings field, and conflicts of interest in the operation of credit rating agencies.⁶

In 2002, the Commission conducted formal hearings on the operation of credit rating agencies, their conflicts of interest, and their appropriate regulatory treatment. In 2003, the Commission issued its report to Congress on the role of credit rating agencies in the securities markets in accordance with the mandate in Section 702 of the Sarbanes-Oxley Act.⁷

Congress responded to the Commission's report with passage of the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act").⁸ The statute created the first general framework for regulating NRSROs, although it was hardly comprehensive. The Rating Agency Act—

- Established a registration procedure for NRSROs;
- Prohibited various forms of misconduct, including misuse of nonpublic information and coercive practices intended to extract ratings business from issuers;
- Required NRSROs to manage conflicts of interest arising from compensation arrangements and other relationships;
- Enhanced corporate governance by requiring designation of a compliance officer; and
- Required submission of financial statements to the Commission.

In 2007, the Commission adopted rules implementing the Rating Agency Act.⁹ However, the financial crisis of 2008 confirmed that the credit ratings industry suffered from persistent structural flaws and that it required additional regulation. For example, major contributors to the crisis were the grossly inaccurate and fraudulent ratings that the NRSROs assigned to mortgage-backed securities laden with subprime mortgages. As a result, the NRSROs became the subject of lawsuits as well as additional Congressional and regulatory scrutiny.¹⁰

⁶ SOX § 702.

⁷ Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002, U.S. Securities and Exchange Commission, January 2003.

⁸ Codified at 15 U.S.C. § 78o-7.

⁹ 17 C.F.R. § 240.17-1 *et seq.*

¹⁰ See, e.g., "Calpers Sues Over Ratings of Securities," NYT.com (July 14, 2009); Thomas Lee Hazen, Law of Securities Regulation, § 14.27, at 1 & n. 5.5 (in the aftermath of the 2008 credit crisis, calls for increased regulation of credit agencies continued).

THE DODD-FRANK ACT

The Dodd-Frank Act represents a Congressional attempt to institute regulatory measures that will finally and effectively address the decades-old challenges posed by credit ratings. The statute includes three fundamentally important reforms.¹¹

First, it builds on the regulatory requirements that were implemented in the Rating Agency Act by adding provisions relating to the registration process, corporate governance, compliance examinations, conflicts of interest, and public disclosure of ratings and methodologies.

Second, the Dodd-Frank Act substantially increases the accountability of NRSROs by increasing their exposure not only to enforcement remedies, such as monetary fines, but also to liability in private actions.

Finally, in Section 939A, the Dodd-Frank Act seeks to reduce reliance upon credit ratings by requiring the Commission and other federal agencies to review their regulations, to remove any references to, or requirement of reliance on, credit ratings in those regulations, and to substitute appropriate standards of credit-worthiness in place of credit ratings. The relevant section of the statute provides as follows:

- (a) AGENCY REVIEW.—Not later than 1 year after the date of the enactment of this subtitle, each Federal agency shall, to the extent applicable, review—
 - (1) any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument; and
 - (2) any references to or requirements in such regulations regarding credit ratings.
- (b) MODIFICATIONS REQUIRED.—Each such agency shall modify any such regulations identified by the review conducted under subsection (a) **to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations.** In making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness.

¹¹ See generally Dodd-Frank Act §§ 931-939H.

The Congressional determination to reduce reliance on credit ratings is justified on several grounds. First, the reliability of credit ratings is inherently suspect. Regardless of how much regulation is brought to bear on the credit rating agencies, the quality of their ratings will remain subject to question due to the conflicts of interest they face.

Second, regulatory reliance upon credit ratings heightens systemic risk. Incorporating ratings into regulatory standards inevitably magnifies the impact of erroneous or fraudulent ratings, since market participants subject to those regulatory standards rely on the same flawed ratings.

Finally, the use of credit ratings as regulatory benchmarks undermines thorough and independent credit analysis and due diligence by market participants. The incorporation of credit ratings into statutory and regulatory provisions is perceived as a governmental endorsement or seal of approval. This, in turn, induces an excessive reliance and a sense among market participants that independent credit analysis and due diligence are unnecessary. The Commission recognized all of these concerns prior to the enactment of the Dodd-Frank Act, and for that reason, in 2008, it began the process of removing references to credit ratings from its rules.¹²

OVERVIEW OF THE PROPOSED RULES

Our comments apply generally to the Proposed Rules, so we briefly summarize all of the new credit-worthiness standards that the Proposed Rules would substitute for credit ratings.

Proposed Rule 2a-7: Permitted Portfolio Holdings.

Rule 2a-7 under the ICA is the core provision that limits the types of securities that a money market fund may hold as a condition of using certain accounting methods for calculating price per share. Rule 2a-7 contains several references to credit ratings that the Proposed Rules would remove and replace with alternative standards of credit-worthiness.

“Eligible” Securities. Under current Rule 2a-7, a money market fund’s portfolio investments are limited to securities that meet two tests: They must be determined by the fund’s board of directors to “present minimal credit risks,” and they must be “eligible securities.” To be an “eligible security,” an investment must have received a rating from an NRSRO “in one of the two highest short-term rating categories.”

The Proposed Rules would eliminate the ratings requirement from the definition of “eligible security.” In its place, the Proposed Rules would simply incorporate the existing requirement that the Board determine the security to **“present minimal risk.”**

¹² References to Ratings of Nationally Recognized Statistical Rating Organizations, Release No. IC-28327 (July 1, 2008), 73 Fed. Reg. 40124 (July 11, 2008).

The only new component that the Proposed Rules would add is a clarification that **the board's determination "must be made based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations."**

"First Tier" Securities. Current Rule 2a-7 also distinguishes two types of eligible securities, "first tier" and "second tier." The distinction is important because the ICA strictly limits the percentage and duration of second tier securities that a money market fund may hold. First tier securities are defined to include those that have received a rating from an NRSRO in the "highest short-term rating category." The Proposed Rules would remove the reference to ratings from the definition of "first tier" security, and would instead require that the fund's board determine that **the issuer of the security "has the highest capacity to meet its short-term financial obligations."**

Securities with a Conditional Demand Feature. Under current Rule 2a-7, a security subject to a conditional demand feature may nevertheless be considered an eligible security or a first tier security provided, among other criteria, the underlying security has received certain specified ratings from an NRSRO. The Proposed Rules would remove the credit rating requirement and amend the provision to require that the fund's board determine that the underlying security be of **"high quality and subject to very low credit risk."**

Downgrades. Under current Rule 2a-7, when a security is downgraded by an NRSRO, the fund's board must promptly assess whether the security continues to present "minimal credit risk" and take appropriate action. The Proposed Rules would remove the reference to a credit rating downgrade and provide instead that, in the event a fund's adviser becomes aware of any credible information about a portfolio security or issuer thereof suggesting that the security is no longer a first or second tier security, the fund's board "must reassess promptly **whether such security continues to present minimal credit risks**" and take appropriate action.

Stress Testing. Rule 2a-7 currently requires money market funds to conduct periodic testing of the fund's ability to maintain a stable net asset value per share upon the occurrence of certain hypothetical events, including a downgrade of portfolio securities. The Proposed Rules would remove this reference to credit rating downgrades and instead require the stress testing to include **"an adverse change in the ability of the issuer of a portfolio security to meet its short-term obligations."**

Proposed Rule 5b-3: Fully Collateralized Repurchase Agreements.

Rule 5b-3 currently allows funds to treat the acquisition of a repurchase agreement as an acquisition of the securities collateralizing the repurchase agreement if the obligation of the counterparty to repurchase the securities is "collateralized fully." A repurchase agreement is collateralized fully if, among other criteria, the collateral consists of securities rated in the highest category by an NRSRO.

The Proposed Rules would remove the reference to rated securities and replace it with a two-part test: The securities would have to be (1) issued by an issuer that **has the highest capacity to meet its financial obligations**, and (2) sufficiently liquid that they

can be sold at approximately their carrying value in the ordinary course of business within seven calendar days.

Proposed Rule 6a-5: Business and Industrial Development Companies.

Section 6(a)(5) of the ICA exempts certain business and industrial development companies (“BIDCOs”) from having to register as investment companies, subject to certain conditions. Prior to the passage of the Dodd-Frank Act, one of those conditions was that the BIDCO would invest in the debt securities of investment companies or private funds only if those securities were “rated investment grade” by at least one NRSRO. Section 939(c) of the Dodd-Frank Act eliminated the reference to “rated” securities as a condition for the exemption, and replaced it with a requirement that those securities meet “such standards of credit-worthiness as the Commission shall adopt.”

Proposed Rule 6a-5 would enable a BIDCO to invest in the debt securities of an investment company or a private fund if the board of the BIDCO determined that the debt security is (1) **subject to no greater than moderate risk** and (2) **sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time.**

COMMENTS ON THE PROPOSED RULES

The Alternative Standards of Credit-Worthiness in the Proposed Rules Must Be More Detailed and Concrete.

The alternative standards of credit-worthiness incorporated throughout the Proposed Rules are too vague. For example, phrases such as “minimal credit risk” and “highest capacity to meet its short-term financial obligations” are extremely general descriptions that simply identify certain levels of credit quality. They offer no concrete formulas or guidance that a fund’s board could use to identify securities that actually meet the posited standards.

The vague formulations of credit-worthiness in the Proposed Rules have two profound drawbacks. First, they undermine the reliability of a board’s credit risk determinations. Without better guidance, there can be little assurance that even a well-meaning board is making accurate and consistent judgments about the credit-worthiness of debt securities.

Of even greater concern, this approach will undermine accountability. Without more concrete standards, boards will enjoy a de facto immunity for the credit risk determinations they make. Boards that have made reckless or even fraudulent decisions regarding the selection of debt securities in their portfolios will have an easy time justifying their actions in light of the amorphous standards of credit-worthiness set forth in the Proposed Rules. The Commission, as well as private plaintiffs, will be hard pressed to hold such boards to account.

Establishing more concrete alternative standards of credit-worthiness to replace credit ratings may pose challenges, but the guiding principles are clear. The Proposed Rules should identify specific factors or tests that the fund's board must apply when performing its credit analysis. For example, as some commentators have previously suggested, market-based information regarding debt instruments—including credit spreads and prices for credit default swaps—can be useful tools for assessing credit quality and risk.¹³

In addition, there are well-established criteria that, at a minimum, any fund should consider when evaluating the credit-worthiness of an issuer or a debt security. For example, factors relating to issuers would include the following:

- Financial condition, including profitability, cash flows, and debt;
- Management and corporate governance;
- Track record and repayment history;
- Exposure to derivative prices and counterparty risk; and
- Market and regulatory conditions, including industry trends and forecasts, growth prospects, and regulatory climate.

Factors relating to debt securities would include—

- The terms of the instrument;
- Its seniority and prospects for payment upon default; and
- Enhancements such as collateral and guarantees.

The Proposed Rules must include such concrete and detailed criteria to satisfy the Dodd-Frank Act, which requires agencies not only to remove references to credit ratings from their regulations, but also “to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate . . .”¹⁴

The Proposed Rules Should Clarify and Limit the Extent to Which Funds May continue to Rely on Credit Ratings.

In the Release, the Commission repeatedly states that under the Proposed Rules, funds may still consider third party credit ratings when making credit risk determinations. For example, the Release explains that, when evaluating “eligible” and “first tier” securities, “[f]und boards . . . would still be able to consider quality determinations prepared by outside sources, including NRSRO ratings, that fund advisers

¹³ Comments of Prof. Frank Partnoy on Release No. IC-28327, References to Ratings of Nationally Recognized Rating Organizations (submitted to the Commission on Dec. 5, 2008).

¹⁴ Dodd-Frank Act § 939A.

conclude are credible and reliable...."¹⁵ The same point is made with respect to all of the Proposed Rules: Boards would still be able to consider third party analyses when assessing conditional demand features, funds could continue to stress test portfolios by treating a ratings downgrade as a credit event, boards would still be able to consider credit ratings when determining if a repurchase agreement is fully collateralized, and BIDCO boards would still be able to consider credit ratings when identifying investment company and private fund securities eligible for investment.¹⁶

In addition, the Release repeatedly notes that nothing in the Proposed Rules would prohibit a fund from continuing to rely on its own policies and procedures that incorporate credit ratings, as long as the ratings incorporated in the policies and procedures establish standards similar to those in the Proposed Rules and are reliable for that use.¹⁷

These comments in the Release are inconsistent with the language and intent of the Dodd-Frank Act. The Dodd-Frank Act expressly requires not only that the Commission remove references to credit ratings from its regulations, but that it also "substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate" The clear intent of this language is that market participants must apply **new** standards of credit-worthiness that the Commission substitutes for credit ratings. Allowing market participants to continue to rely on credit ratings as they make credit risk determinations would conflict with this mandate.

Allowing continued reliance on credit ratings also undermines one of the core objectives of Section 939A of the Dodd-Frank Act. Simply removing references to credit ratings from the Commission's regulations helps accomplish one goal of the statute, which is to eliminate the governmental imprimatur on credit ratings. But Congress also sought to promote another policy objective, namely reducing actual reliance on credit ratings and encouraging independent due diligence and credit analysis. It therefore required the Commission to establish new standards that market participants would have to apply in making independent judgments about credit-worthiness. Establishing such new standards, while at the same time allowing market participants to continue their traditional reliance on credit ratings, would do nothing to accomplish this second Congressional objective. That approach simply would not reduce reliance on credit ratings or promote independent credit analysis.

Therefore, the Proposed Rules should explicitly address the extent to which market participants may continue to rely on credit ratings. It may not be possible or even desirable to prohibit market participants from **considering** credit ratings as they conduct their own credit analysis. For example, a significant discrepancy between a fund's credit analysis and the applicable credit rating might serve as a useful signal to the fund's board that anomalies or flaws may exist in their credit analysis. This would presumably have

¹⁵ Release at 12898.

¹⁶ Release at 12899, 12900, 12902, and 12903.

¹⁷ Release at 12899 n. 32 & n. 38; 12902 at n. 58.

the positive effect of causing the fund board to reexamine its credit analysis and make necessary corrections.

However, the Proposed Rules must make clear that funds **may not rely** on credit ratings, and that credit risk determinations under the Commission's new standards must be justifiable entirely on the basis of those new standards, without regard to credit ratings.

The Proposed Rules Should Expand the Recordkeeping Requirements So that All Determinations Under the New Credit-Worthiness Standards Are Fully Documented.

Rule 2a-7 currently requires a fund to maintain a written record of any determination "that a portfolio security presents minimal credit risks," as well as a record of the NRSRO ratings used to determine the status of the security as eligible, first tier, or second tier. The Proposed Rules would preserve this requirement only as to eligible securities, and it would remove the recordkeeping requirement as to credit determinations for first tier securities. Furthermore, the Proposed Rules do not address recordkeeping requirements for the credit risk determinations that must be made under the other provisions of Proposed Rule 2a-7, or under the provisions of Proposed Rule 5b-3 or 6a-5.

The recordkeeping requirement should be expanded in several respects. First, the Proposed Rules should require funds to maintain written records of **any** credit risk determinations that are made under the new standards substituted for credit ratings. Accordingly, the Proposed Rules should require funds to maintain records demonstrating how a fund has applied the new standards of credit-worthiness, not just to eligible securities, but also to first tier securities and securities with a conditional demand feature.

In addition, the recordkeeping requirements should extend to reassessments of the credit-worthiness of securities that the fund believes may no longer constitute first or second tier securities (Proposed Rule 2a-7), to the credit-worthiness of the collateral underlying repurchase agreements (Proposed Rule 5b-3), and to the credit-worthiness of the investment company and private fund securities that BIDCOs may acquire (Proposed Rule 6a-5).

Finally, the recordkeeping requirements should make clear, as noted above in the context of continued reliance on credit ratings, that market participants must document how a credit risk determination meets the new standards for credit-worthiness **without regard to credit ratings**.

These enhancements to the recordkeeping requirements are necessary for two reasons. They will help ensure that each fund or other market participant applies the new standards of credit-worthiness correctly and without regard to credit ratings. In addition, they will promote accountability by enabling regulators—or aggrieved private parties as the case may be—to determine whether a market participant has properly fulfilled its duty to conduct credit risk analysis in accordance with the new standards

mandated under the Dodd-Frank Act. Both of these goals are important elements in the effort to reform the way credit ratings are used in our markets.

CONCLUSION

The Proposed Rules will help achieve the goal of reforming our credit rating system in accordance with the Dodd-Frank Act, provided that the alternative standards of credit-worthiness set forth in the Proposed Rules provide more detailed guidance, the continued role of credit ratings is clarified and limited, and boards are required to fully document their credit risk determinations without reliance on credit ratings.

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,


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