



**Americans for Financial Reform**  
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April 25, 2011

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

Re: RIN 3235-AL02: "Proposed Amendments to Remove References to Credit Ratings in Rule 2a-7 Under The Investment Company Act of 1940"

Dear Ms. Murphy:

American for Financial Reform ("AFR") appreciates this opportunity to comment on the Commission's "Proposed Amendments to Remove References to Credit Ratings in Rule 2a-7 Under the Investment Company Act of 1940". AFR is a coalition of over 250 national, state, local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, religious and business groups along with prominent economists and other experts.

This letter is in response to the Commission's request for comments on its recent proposal to remove credit rating references in Rule 2a-7 under the Investment Company Act, the rule governing the operations of money market funds.

Section 939A of Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) requires that the Commission remove references to Nationally Registered Statistical Rating Organizations (NRSROs) in regulations promulgated pursuant to the Investment Company Act of 1940. This step by Congress was a reaction to the over-reliance on credit ratings as a risk management tool, which played a key role in enabling the financial crisis.

However, we are concerned that eliminating the reference to NRSRO ratings from Rule 2a-7 without offering more concrete guidance on alternative means to assess risk could seriously weaken protections for investors in money market funds without truly addressing the systemic problem of institutional over-reliance on the rating agencies who failed during the financial crisis. We are also concerned that this rule does not satisfy the intent of Section 939A, which requires not only that regulatory agencies remove references to credit ratings but that they substitute an alternative "standard of credit-worthiness". The guidance offered in this rule does

not rise to the level of specificity necessary to be an objective standard of credit-worthiness, and leaves fund investors completely dependent on the subjective and opaque judgments of the fund directors.

The Commission is not the only agency facing the difficult question of how to provide guidance on credit-worthiness without the use of NRSRO ratings. Recent proposed rules by the prudential regulators have also requested public input on this issue.<sup>1</sup> In light of the complexity of this problem and the need for assistance across the financial regulatory community, AFR suggests that the Commission and other regulators convene a group of experts to provide advice and recommendations on ways to provide guidance to financial entities regarding objective standards of credit-worthiness that do not incorporate credit ratings. Convening such a group in concert with other regulators would also help the Commission to implement the statutory mandate in Section 939A to work toward uniform standards of credit-worthiness across the financial regulatory agencies (to the extent that this is feasible). The proposal currently does not address this statutory requirement.

#### Overreliance on Unreliable Ratings Was A Central Contributor to The Financial Crisis

Recent reports by the Financial Crisis Inquiry Commission (FCIC) and the Senate Permanent Subcommittee on Investigations have laid out in extensive detail the absolutely central role played by credit rating agencies as enablers of the financial crisis.<sup>2</sup> The FCIC summarized the case well in its Conclusions:

“...credit rating agencies were essential cogs in the wheel of financial destruction. The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. Investors relied on them, often blindly. In some cases, they were obligated to use them, or regulatory capital standards were hinged on them. This crisis could not have happened without the rating agencies. Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms.”

The “big three” rating agencies were paid by securities issuers and faced a fundamental conflict of interest. This conflict was perhaps especially salient in rating novel, complex asset-backed securities. The ratings for such securities were dependent on complex mathematical models that were not well understood by investors, and rested on numerous assumptions that could easily be

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<sup>1</sup> See discussion on p. 1903 of the proposed rule, [“Risk Based Capital Guidelines: Market Risk”](#), Federal Register Vol. 76, No. 7, January 11, 2011.

changed to give ratings the issuer desired. The FCIC report summarizes some statistics concerning the almost incredible breakdown of professionalism and reliability of NRSRO ratings prior to the crisis:

“From 2000 to 2007, Moody’s rated nearly 45,000 mortgage-related securities as triple-A. This compares with six private-sector companies in the United States that carried this coveted rating in early 2010. In 2006 alone, Moody’s put its triple-A stamp of approval on 30 mortgage-related securities every working day. The results were disastrous: 83% of the mortgage securities rated triple-A that year ultimately were downgraded.”

The ‘blind reliance’ on untrustworthy credit ratings is addressed in two ways in the Dodd-Frank Act. The first is through increased supervision of NRSROs, including more mandated disclosures. Hopefully these steps will make NRSRO ratings more reliable and help investors better understand the ratings process. The second is by mandating the removal of references to credit ratings in laws and regulation. This will hopefully lessen blind or uncritical reliance on ratings by the investor community.

Improving ratings quality and reducing uncritical overreliance on ratings are crucial parts of financial reform. However, the proposed rule seems unlikely to accomplish this goal.

#### Eliminating Ratings References Without Providing Sufficient Guidance on Objective Standards of Credit Worthiness Is Risky and Does Not Accomplish Statutory Goals

Currently, Rule 2a-7 requires a money market fund to hold top-quality securities in its portfolio. The board of directors of a mutual fund is charged with determining that portfolio investments present “minimal credit risk” based on factors pertaining to credit quality, in addition to any credit ratings on a security. In other words, securities must satisfy a two-tiered test: 1) they must be highly rated—an objective determination; and 2) they must pass the scrutiny of the board of directors—a subjective determination.

Under the current proposal, an NRSRO rating would no longer be a required element for determining which securities are permissible investments for a money market fund. Instead, a security would be an eligible investment for a money market fund if the fund’s board or its delegate determines that the security presents minimal credit risks. The Commission does not introduce new guidelines or objective standards to guide the board in determining asset risk.

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<sup>2</sup> The Financial Crisis Inquiry Commission, [The Financial Crisis Inquiry Report](#), January, 2011; Permanent Subcommittee on Investigations, [Wall Street And The Financial Crisis: Anatomy of a Financial Crisis](#), United States Senate Committee on Homeland Security and Government Affairs, April 13, 2011.

Instead, the rule simply restates the existing obligations of the money market fund Directors to ensure that the fund invests only in securities with minimal credit risk.

Thus, the current proposal effectively eliminates the objective standard, credit ratings, and expands the subjective standard-- the board of directors' internal determination. A rule that increases reliance on subjective determinations of risk is not likely to increase investor protection and market stability in a sector such as money market funds, where investors place an extremely high priority on the ability to retrieve all of their funds on short notice.

As several commentators have suggested, the elimination of credit ratings without the substitution of some other external measure of risk will seriously undermine the Commission's ability to determine whether mutual funds are in compliance with Rule 2a-7 due to the difficulty of policing subjective standards. This is especially true since requirements to document board decisions are limited, and this proposed rule does not increase them. If the Commission chooses to move forward with this proposal, it is absolutely essential to take steps to ensure that fund boards can clearly document, and regulators can review, the basis for their determination that a security poses "minimal credit risk."

An inability to police consistent standards of credit-worthiness at money market funds raises the risk of a dangerous 'race to the bottom' among fund managers, where a few funds certify higher-yielding securities as minimally risky in order to pay higher returns and attract investors away from more conservative funds. Without clearer yardsticks of asset quality it is unclear how investors will know how to avoid such risky behaviors.

The proposed rule also does not satisfy the statutory requirement that the Commission shall "substitute...such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations." Instead, the rule simply maintains in place the internal due diligence standard and eliminates the external standard based on credit ratings without replacing it with any alternative standards.

We also generally share the concern, recently expressed by Commissioner Aguilar, that the current proposal creates uncertainty regarding the extent to which market participants will continue to rely on credit ratings.<sup>3</sup> While this current proposal is designed to reduce reliance on ratings, it explicitly permits the board of directors of a mutual fund to continue to rely on credit ratings in making its own subjective determinations of risk.<sup>4</sup> Indeed, the Commission several times appears to state its expectation that money market funds will continue to do "business as usual" and unofficially rely on credit ratings:

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<sup>3</sup> <http://www.sec.gov/news/speech/2011/spch030211laa-ratings.htm>

<sup>4</sup> "In making these credit quality determinations, money market funds would continue to be able to use analyses provided by third party parties, including ratings provided by ratings agencies, that the funds conclude are reliable for such purposes." References to Credit Ratings in Certain Investment company Act Rules and Forms, Investment Company Act Release, March 2, 2011.

“We do not anticipate that the proposed amendments would significantly change collection of information requirements under rule 2a-7 because we believe funds would likely rely on their current policies and procedures to comply with the proposed amendments. Under current rule 2a-7, money market fund boards, or their delegates, are required to perform a minimal credit risk evaluation with respect to each of the fund’s portfolio securities.... As we have noted above, with respect to each of the amendments we propose today, money market funds could continue to consider evaluations of outside sources, including credit ratings, in making credit quality determinations, monitoring and stress testing. Moreover, we anticipate that funds would likely continue to rely on their current policies and procedures with respect to credit quality determinations, monitoring for credit events and stress testing because that is likely to be less costly than revising policies.” [p. 33 of proposed rule]

Thus, there is some risk that this proposal could create the “worst of both worlds” by exposing investors to new risks without solving the serious problem of overreliance on credit ratings.

#### The Commission And Other Regulators Should Devote More Effort To Developing Objective Guidance for Credit Risk Assessment

The current proposal relating to Rule 2a-7 is only the beginning of the Commission’s arduous task of reducing regulatory reliance on credit rating agencies. This task is now being faced by other financial regulatory agencies as well. The SEC and other regulators will be repeatedly confronted with similar concerns about how to replace references to NRSROs in federal rules. It would benefit both regulators and the markets for the Commission to give more thought to identifying externally-verifiable measures of risk other than credit ratings.

Such metrics could serve as the basis for guidance on best practices to be offered to fund managers in performing their required due diligence, and could restrain the risk referred to above of a ‘race to the bottom’ among money market fund managers. There are a variety of approaches this guidance could take. One would be to identify a range of “plain vanilla” securities as permissible for investment, whose risks and liquidity are well understood and can be assessed. Should the Commission wish to be less prescriptive, it could identify the range of data that should be considered in assessing securities risk and the minimal tests that should be performed on this data. Fund managers could then be required to document their examination of this data in the purchase and monitoring of their investments.

The Commission’s task in providing 2a-7 guidance to money market funds could be one of the better areas to begin this effort to provide guidance and standards for asset evaluation. That is because fund directors are not required to determine fine gradations of risk, but only to designate

the safest possible assets (“minimally risky”) for investment. This task is complex, but it is still much simpler than assessing all possible gradations of risk. In addition, guidelines for risk assessment in this area could avoid the need to analyze the most novel and complex types of structured finance on the grounds that such new innovations are unlikely to be well understood enough to be ‘minimally risky’.

Since the NPRM requests input from commenters on standards for risk assessment, it is clear that the Commission desires more assistance in this area. But it seems unlikely that regulatory comments are the best setting to do the technical work that needs to be brought to bear on these questions. There is considerable effort already being devoted to risk assessment in academia and in the private sector. This work will be given additional impetus by the new disclosure requirements established by the Dodd-Frank Act for asset-backed securities offerings, which will make much more information publicly available for assessing securities risk. The Commission would benefit from convening a range of experts from academia and the financial industry to develop more objective guidelines for asset evaluation for money market funds.

Such a group of experts could also be convened as a part of a broader effort by financial regulators to develop uniform guidance for standards of credit-worthiness that do not directly reference credit ratings. An effort to develop uniform standards to the extent feasible is required by Section 939A of the Dodd Frank Act.

Thank you again for this opportunity to comment on this NPR. If you have the further questions, please contact Marcus Stanley, the Policy Director of Americans for Financial Reform at (202) 466-3672.

Sincerely,

Americans for Financial Reform

## **Following are the partners of Americans for Financial Reform.**

*All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.*

- A New Way Forward
- AARP
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans for Fairness in Lending
- Americans United for Change
- Calvert Asset Management Company, Inc.
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute

- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- United Food and Commercial Workers
- United States Student Association
- USAction

- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

***Partial list of State and Local Signers***

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH

- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG

- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

