



P.O. Box 2600  
Valley Forge, PA 19482-2600

April 26, 2011

*Filed Electronically*

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

Re: References to Credit Ratings in Certain Investment Company Act Rules and Forms;  
Release No. IC-29592; File No. S7-07-11

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Dear Ms. Murphy:

We appreciate the opportunity to provide our comments to the Securities and Exchange Commission (the “Commission”) on the proposal to remove credit ratings from Rule 2a-7.<sup>1</sup> Vanguard<sup>2</sup> is an SEC-registered investment adviser that has managed money market mutual funds for 30 years. On behalf of our shareholders, who currently invest over \$190 billion in our money market funds, we are deeply committed to working with the Commission to seek regulatory solutions that will increase investor protection, strengthen investment standards, and diminish risk to the \$2.7 trillion<sup>3</sup> money market fund industry. We do not believe, however, that the removal of credit ratings from Rule 2a-7, and the proposed replacement standards of credit-worthiness, promote these goals.

As Vanguard has stated in response to previous proposals by the Commission<sup>4</sup>, we believe that credit ratings provide a valuable, independently established baseline for money market fund investments. The Dodd-Frank Act requires the Commission to replace credit ratings with “to the extent feasible,

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<sup>1</sup> In *References to Credit Ratings in Certain Investment Company Act Rules and Forms*, SEC Release No. IC-29592 (March 3, 2011) (the “Proposing Release”), the Commission proposed a new rule as well as rule and form amendments under the Securities Act of 1933 and the Investment Company Act of 1940 to implement provisions of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) that call for the modification of Commission regulations containing credit rating references. This comment letter will focus specifically on the elimination of credit rating references in Rule 2a-7 and related rules and forms.

<sup>2</sup> Vanguard offers more than 160 U.S. mutual funds with aggregated assets of approximately \$1.6 trillion.

<sup>3</sup> See Investment Company Institute, *Money Market Mutual Fund Assets* (April 14, 2011), available at [http://www.ici.org/research/stats/mmf/mm\\_04\\_14\\_11](http://www.ici.org/research/stats/mmf/mm_04_14_11).

<sup>4</sup> See, e.g., Vanguard Comment Letter, *Proposed Rules Regarding References to Ratings of Nationally Recognized Statistical Ratings Organizations*, SEC Release No. IC-28237 (July 1, 2008) (“Vanguard 2008 Comment Letter”).

uniform standards of credit-worthiness.”<sup>5</sup> We believe the Commission’s proposed credit standards may not adequately replace this baseline, and therefore, fail to achieve the stated goal of Congress. The replacement of the minimum, objective floor for eligibility under Rule 2a-7 with a subjective standard has the potential to create different standards of credit-worthiness. As a result, we urge the Commission to consider other alternatives, such as the one set forth in this letter, that may more effectively replace the objective standard provided by credit ratings and achieve Congress’ goal of uniformity.

Vanguard proposes that the Commission combine the “eligible securities” standard with the “first tier” standard, to create one high credit quality standard for all money market securities. Under our proposed standard, only those securities issued by an entity with the “highest capacity” to meet its short-term financial obligations, which also present minimal credit risk, would be eligible for purchase. The Commission should indicate that only those securities that would currently be assigned ratings in the highest short-term category (allowing for gradations or sub-categories within that category) by a nationally recognized statistical rating organization (“NRSRO”) would generally be expected to fall within this narrow band.

Finally, Vanguard recommends that funds be permitted to include the NRSRO ratings of their choosing in shareholder reports in accordance with a consistent, disclosed policy.<sup>6</sup> With respect to determinations of eligibility of securities with conditional demand features, monitoring minimal credit risks, and stress testing under the Rule, we concur with the recommendations set forth in the comment letter of the Investment Company Institute.<sup>7</sup>

### **The Proposed Amendments Fail to Establish a Uniform Standard of Credit-Worthiness**

In the Vanguard 2008 Comment Letter, we likened the removal of credit ratings from Rule 2a-7 to “outlawing seat belts with the hope that drivers will be less likely to be injured if a defective belt fails in a crash.”<sup>8</sup> Credit ratings, while imperfect, at least ensure a baseline uniformity across the industry, *i.e.*, that a “seat belt” meeting minimum safety standards is required for every portfolio. Under the proposed amendments, however, the determination of this standard will vary based on each advisor’s individual subjective assessment.

Under the proposed amendments, a “first tier” security would be a security whose issuer is determined to have the “highest capacity to meet its short-term financial obligations.”<sup>9</sup> The Commission further explains that such an issuer would have an “exceptionally strong” ability to repay its short-term obligations and the “lowest” expectation of default. A “second tier” security would continue to be an eligible security other than a first tier security, and would be expected to have a “very strong” ability to repay its short-term debt obligations and a “very low” vulnerability to default.<sup>10</sup> In addition to meeting these new standards, eligible securities must continue to present minimal credit risks. While the

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<sup>5</sup> Dodd-Frank Act, Section 939A(b).

<sup>6</sup> Under the current proposal, a fund would no longer be required to use a measure of credit quality in connection with its presentation of portfolio holdings in shareholder reports, however, if a fund chooses to do so, it must use the credit ratings assigned by a *single* NRSRO. *See* Proposing Release at 29-30.

<sup>7</sup> *See* Investment Company Institute Comment Letter (April 25, 2011).

<sup>8</sup> Vanguard 2008 Comment Letter at 2.

<sup>9</sup> Proposing Release at 10.

<sup>10</sup> *Id.* at 11.

Commission believes that the proposed standards will generally limit money market funds to the same universe of securities as under the current rule,<sup>11</sup> the new subjective standard, by its nature, permits an advisor to reach a minimal credit risk determination on a new, expanded universe of securities.

If adopted as proposed, the amendments to Rule 2a-7 could result in disparate standards of eligibility across the industry, potentially resulting in more risk for risk-averse investors. The lack of uniformity will ultimately leave investors exposed to varying levels of risk, all of which ostensibly meet the new subjective standards of Rule 2a-7.<sup>12</sup> This inherent inconsistency fails to achieve the goal of uniformity as set forth by Congress in Dodd-Frank. Vanguard instead urges the Commission to consider other alternatives, such as the one set forth below, that may more effectively replace the objective standard provided by credit ratings and achieve Congress' goal.

### **The Commission Should Adopt a Consolidated Standard for Eligibility**

Vanguard proposes that a consolidated standard replace the revised method for determining eligibility set forth in the Proposing Release. Under this standard, only those securities issued by an entity with the "highest capacity" to meet its short-term financial obligations and that present minimal credit risks would be eligible for purchase. The Commission should indicate that only those securities that would currently be assigned ratings in the top short-term category (allowing for gradations or sub-categories within that category) by an NRSRO would generally be expected to fall within this definition. The practical result would be the elimination of second tier securities from Rule 2a-7.

Vanguard has supported the elimination of second tier securities in the past.<sup>13</sup> Quite simply, the acquisition of second tier securities introduces greater risks into funds and is not necessary to manage even the largest money market funds. We believe that if the ratings floor must be removed from Rule 2a-7, a combined and enhanced single eligibility standard would most effectively help prevent money market funds from holding anything less than the highest-quality securities. We believe our proposed consolidated standard is more likely to temper aggressive credit analysis than the Commission's proposed standards. Regardless of which new subjective standard the Commission adopts, it should ensure that funds adhere to the standard by, among other things, monitoring fund performance. This would allow the Commission to identify whether "outlier" funds with higher than average yields may be purchasing securities that fall outside of the new criteria.

### **Funds Should be Permitted to Disclose the Credit Ratings of their Choosing in Shareholder Reports**

Vanguard supports the Commission's proposal to permit – but not require – money market funds to present the credit quality of their portfolio holdings by disclosing NRSRO ratings of their choosing in shareholder reports in accordance with a consistent, disclosed policy. Instead of disclosing the credit ratings assigned by a *single* NRSRO, however, we believe that funds should be able to choose which ratings they disclose. This approach is consistent with current guidance from FINRA and would facilitate the disclosure of "split-rated" and internally rated securities. We believe shareholders would benefit from having this additional datapoint available as part of their evaluation of the credit quality of a fund. The

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<sup>11</sup> *Id.* at 10-12.

<sup>12</sup> As a result, the Commission may find it difficult to challenge such subjective assessments.

<sup>13</sup> See Vanguard Comment Letter, *Money Market Fund Reform*, SEC Release No. IC-28807 (June 30, 2009) at 1.

ability to harmonize this component of shareholder report disclosure with the NRSRO ratings disclosure on a fund's website or other marketing materials would be in the best interest of shareholders who would benefit from the consistent approach to disclosure.

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We commend the Commission for designing amendments to Rule 2a-7 that seek to achieve the goals of Congress as stated in Section 939A of the Dodd-Frank Act and that attempt to retain the same degree of risk limitation in money market funds and limit investment to the same universe of eligible securities.

Vanguard does not believe, however, that these goals can be achieved by removing references to credit ratings from Rule 2a-7 and replacing them with the proposed subjective standards. If references to credit ratings must be removed, however, the adoption of a consolidated standard of eligibility, along with the resulting elimination of second tier securities, would help ensure that funds restrict their purchases within a narrow range of high-quality securities. In addition, we support permitting funds to disclose the ratings of their choosing in shareholder reports pursuant to a consistent, disclosed policy, as these ratings provide an additional datapoint that investors can use to evaluate the relative risks of fund.

Whichever new subjective standards are adopted, the Commission should remain vigilant that money market funds do not purchase securities that may fall outside of the revised universe of eligible securities. This can be accomplished by monitoring fund yields. The returns of an “outlier” fund may be a signal that a fund is purchasing lesser-quality securities.

We appreciate the opportunity to comment on the Commission’s proposal. If you have any questions about Vanguard’s comments or would like any additional information, please contact Laura Merianos, Principal, at (610) 668-2627, or Nathan Will, Associate Counsel, at (610) 669-2689.

Sincerely,

/s/ Gus Sauter

Managing Director  
and Chief Investment Officer  
Vanguard

cc: Honorable Mary L. Schapiro, Chairman  
Honorable Kathleen L. Casey, Commissioner  
Honorable Elisse B. Walter, Commissioner  
Honorable Luis A. Aguilar, Commissioner  
Honorable Troy A. Paredes, Commissioner

Eileen Rominger, Director  
Robert E. Plaze, Associate Director  
Division of Investment Management