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September 8, 2009

By Electronic Mail

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

RE: MONEY MARKET FUND REFORM – FILE S7-11-09 (THE "RELEASE")

Dear Ms. Murphy:

1. INTRODUCTION

Moody's Investors Service ("**MIS**") appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**Commission**") on its proposed amendments to certain rules and forms governing money market funds ("**Money Market Rules**") as those proposed amendments relate to the regulatory use of credit ratings issued by Nationally Recognized Statistical Rating Organizations ("**NRSROs**"). Consistent with our historic views about the regulatory use of credit ratings, MIS believes that the Commission's ongoing dialogue with market participants about possible approaches to encourage more informed and careful use of credit ratings is important. We likewise remain supportive of efforts to discontinue or limit the use of ratings in regulation and the NRSRO system. We also recognize, however, that in light of current market conditions, eliminating or reducing NRSRO ratings-based criteria should be pursued judiciously as financial markets continue to show signs of weakness.

Below, we comment on related proposals contained in the Release regarding the regulatory use of NRSRO ratings in the Money Market Rules. Specifically, the Commission seeks comment on whether to limit money market funds to investing in a narrower range of "Eligible Securities", as that term is defined in the Release. In addition to its primary proposal, the Commission is seeking comments on alternative regulatory approaches, including:

- eliminating the requirement that asset-backed securities ("**ABS**") be rated by an NRSRO in order to be considered Eligible Securities;
- eliminating altogether references to NRSRO ratings in Rule 2a-7 and instead calling upon fund managers to make their own credit risk determinations as proposed last year (the "**2008 Proposal**");
- establishing a roadmap for phasing in the eventual removal of references to NRSROs and their ratings in Rule 2a-7;

- having a money market fund's board designate three or more NRSROs that the fund would look to for all purposes under Rule 2a-7 in determining whether a security is an Eligible Security and requiring the board to determine at least annually that the credit ratings of the NRSROs it had designated were sufficiently reliable for that use; and/or
- permitting a money market fund's board to designate credit rating agencies ("**CRAs**") or other credit evaluation providers that are not NRSROs.

We begin by discussing our general views on the use of ratings for regulatory purposes, as well as the 2008 Proposal and the related proposal to establish a roadmap for gradually eliminating references to ratings in the Mutual Fund Rules. We start with these broad views because they inform our opinions with respect to the Commission's recommended rule amendment and remaining, alternative proposals.

2. Regulatory Use of Ratings

MIS has long been concerned about the regulatory use of ratings. In light of the rapid and dramatic market changes in the last two years, MIS has reevaluated and reinforced our beliefs on such use of ratings. In 1995, MIS's former Executive Vice-President gave a speech to the Commission's fifth annual International Institute for Securities Market Development in which he addressed how the regulatory use of ratings can change the product provided by CRAs and ultimately hurt the integrity of that product. He stated:

> "By using securities ratings as a tool of regulation, governments fundamentally change the nature of the product agencies sell. Issuers then pay rating fees to purchase, not credibility with the investor community, but a license from a government. As a result, officially-recognized rating agencies have a product to sell even when they fail to maintain credibility with the investor community. The natural check against the weight of issuer fees has disappeared.
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> As regulators continually increase the use of ratings in regulation, they are steadily - if unwittingly - changing the relative weight of those regulatory benefits in the economics of the industry. The problems are most obvious in the newer areas of the financial markets, such as structured finance, where disclosure is weakest and investors have the least experience.
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> When regulators make use of ratings in regulation, they are operating on the assumption that they can simply piggyback on an existing system, and that it will remain unchanged.
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> The ratings are simply a set of symbols maintained by private businesses, who operate, not in a controlled laboratory, but in the real world of economic incentives. Regulatory use of ratings is changing the economic incentives of the industry, and that is starting to change the ratings themselves.... [I]f the present trends of regulatory use of ratings are not arrested, the credibility and integrity of the rating system itself will inevitably be eroded. That will be unfortunate, because it has been a very useful tool for investors, and those benefits will be lost if it is compromised."

In various public communications in the intervening years, and most recently in 2008 when we submitted our last comment letter to the Commission on this issue, we reiterated our concerns about the use of ratings in regulation.[1] Specifically, we discussed how the use of ratings as a regulatory tool for the oversight of regulated entities can adversely affect the behavior of market participants as well as regulators. As we stated in that letter, we recognize that there are benefits from identifying and using objective, widely accepted standards for financial markets because this can facilitate efficient regulation. Credit ratings can be useful in this regard because they are easy to use, broadly disseminated, independent and reliably predictive opinions about relative creditworthiness. Nevertheless, we continue to believe that widespread regulatory use of ratings can unintentionally produce negative effects and create harmful incentives. Summarizing some of the views we expressed last year:

- Entities that are required to, or receive regulatory benefits from, holding securities that have an "approved" credit rating may have less of an incentive to conduct their own credit analysis and may be encouraged to over-rely on credit ratings.
- Issuers may be encouraged to "shop" for the highest rating among the officially recognized CRAs because, at least in the short term, credibility with investors is supported by official recognition of certain CRAs.
- The incentives for officially recognized CRAs to compete on the basis of ratings quality and performance may be diluted.
- The regulators' interest in comparable ratings can pressure CRAs to produce homogenous opinions and undermine their ability to provide diverse, independent opinions.
- Market participants may mistakenly perceive that ratings have a "government seal of approval" and inappropriately rely on them as a proxy for risks not measured by credit ratings.

We believe that these views are consistent with current efforts to identify ways to rely less on ratings and explore how they can be removed from regulation in the least disruptive and most effective and efficient manner. MIS fully supports these efforts.

For these reasons, MIS supports the 2008 Proposal insofar as it defines "Eligible Securities" without reference to NRSRO ratings and encourages money market fund managers to make independent judgments about the creditworthiness of securities. The 2008 Proposal would create better incentives for money market funds to use credit ratings as one of many factors in their own study and evaluation of each security under consideration for purchase, holding, or sale. Money market fund managers and boards would have greater incentives to reach an independent conclusion about whether a security presents minimal credit risk. We believe this regulatory approach would help to encourage money market fund managers to consider whether or not: (1) some of the risks they are seeking to measure and manage are addressed by the CRA's credit ratings that they propose to use; and (2) the CRA's ratings are reliably predictive of future credit risk.

This kind of careful analysis of the attributes of credit ratings could help restore confidence in the credit market by adjusting the economic incentives that can develop under the regulatory use model.[2] For instance, under this scenario, the incentives for issuers to engage in rating shopping might be eased

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1 See generally *Moody's Investors Service Comment Letter re Files S7-17-08, S7-18-08 and S7-19-08: References to Ratings of Nationally Recognized Statistical Rating Organizations* (September 5, 2008), available on the Commission's website and moodys.com.

2 Of course, introducing a new use for ratings (*i.e.*, regulatory use) did not necessarily exclude other existing uses. Ratings continue to be sought for other reasons. Accordingly, the incentives for issuers to seek ratings that are credible with investors and for CRAs to meet high performance standards have continued to operate and exert market discipline on the industry, although their impact on some CRAs may have been somewhat muted by the effect of incentives generated by the regulatory use of ratings.

because money market fund managers could be more incentivized to assess for themselves whether a CRA's ratings are of high quality, instead of presuming that designation of a CRA as an NRSRO is an endorsement of the quality of that NRSROs' ratings. Such demand could, in turn, have a greater disciplinary effect on issuers who might otherwise be inclined to shop for the highest rating from a CRA that has a "government seal of approval", regardless of whether that CRA's ratings are considered credible. CRAs, in turn, would have stronger incentives to compete based on the quality of their ratings.

As we stated in the Introduction, we recognize that in the midst of the current economic crisis, an overnight removal of NRSRO references from regulation could disrupt markets that continue to show signs of weakness. Accordingly, the Commission's proposal to create a roadmap for phasing in the eventual removal of references to NRSROs and their ratings in Rule 2a-7 may be an appropriate method to achieve the ultimate goal of removing NRSRO references. Under this approach, money market funds would have more time to develop or enhance the systems and resources needed to assess various providers of opinions on credit risk and develop their own opinions on such matters.

Through this lens, we address below the Commission's other, specific proposals.

3. THE COMMISSION'S OTHER, SPECIFIC PROPOSALS

A. Proposed Redefinition of "Eligible Securities"

In our view, the Commission's proposal to allow money market funds to acquire only those securities that receive the highest (rather than the highest two) short-term debt ratings from recognized NRSROs further embeds ratings into regulation. MIS therefore believes that this modification runs counter to efforts to rely less on ratings. Such an amendment could further exacerbate the potentially negative incentives that can be created by regulatory use of ratings, as outlined above. For instance, requiring money market funds to invest in securities that receive only the "highest rating" could exaggerate the possible perception that ratings can be equated with a government-endorsed assurance, which in turn decreases incentives for an investor to conduct an independent credit analysis. It would also almost certainly lead to an increase in rating shopping by corporate issuers, since the rule, if adopted, could decrease issuers' willingness to accept any rating other than the highest rating.[3] In short, the proposal would significantly increase incentives both for investors and issuers to shop for ratings since only the highest available would qualify for regulatory purposes.

B. Removal of Requirement that Eligible ABS Have an NRSRO Rating

For similar reasons, we believe that an amendment to permit money market funds to hold non-rated ABS could encourage money market fund portfolio managers to conduct their own credit analysis and use (but not rely solely on) diverse opinions in the market place. It is equally important, however, to recognize that, to date, independent analysis of structured finance products has been stymied because structured finance issuers are not required to disclose to the market all relevant information needed by investors to make their own informed decisions. We believe that the resulting opacity that exists in structured finance markets may result in some regulators and investors inappropriately treating structured finance credit ratings as a proxy for issuer disclosures and/or as a measure of non credit-related risks. MIS therefore strongly supports regulatory initiatives that would level this playing field by

[3] Issuers might be less willing to accept any rating other than the highest rating because the Commission's proposal could polarize market access for issuers by making it significantly more difficult for issuers that cannot obtain the highest rating from an NRSRO to raise capital.

requiring issuers to make available to market participants the same level of information that exists in the corporate market.[4]

C. Designation of Three or More NRSROs and Designation of non-NRSROs

Consistent with our views above, we believe that requiring a money market fund's board to designate three (or possibly more) NRSROs that the fund would look to for all purposes under Rule 2a-7 in determining whether a security is an Eligible Security could be a move in the direction toward the ultimate goal of eliminating references to ratings in the Money Market Rules as long as the designation is based on the board's assessment of ratings' attributes, such as quality, comparability and historical performance. At the same time, we believe that this alternative proposal does not adequately address the issue of over-reliance on ratings. Therefore, in our view, larger mutual funds, which presumably have more resources, should only be permitted to use this approach as an intermediate step.

As detailed above, the quality of ratings can be harmed under the regulatory use model because this model can: (1) weaken incentives for NRSROs to compete based on ratings quality and performance; and (2) discourage diverse ratings opinions by creating an environment that commoditizes ratings by creating incentives for investors to treat all of the highest ratings as interchangeable. The Commission's alternative proposal could help reverse these negative effects and strengthen market discipline if mutual fund boards make these designations based on careful analysis of ratings quality and performance.[5] Specifically, such a designation process could strengthen incentives: (1) for issuers to select NRSROs with the best reputations of ratings quality and performance; and (2) for NRSROs to compete based on ratings quality and performance.[6] For these reasons, we believe this alternative could be an improvement over the current system. Absent requirements that mutual fund boards designate NRSROs based on robust criteria relating to ratings quality and ratings performance, however, there is a risk that mutual fund boards could designate NRSROs for other reasons.[7]

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4 We discuss this issue in greater detail in *Moody's Investors Service Comment Letter re File No. S7-04-09: Re-proposed Rules for Nationally Recognized Statistical Rating Organizations, Release No. 34-59343* (March 28, 2009) at 11-13, which is available on the Commission's website and moodys.com.

5 In particular, we believe that the board should be expected to make its decision based on thorough assessments, conducted by or on behalf of the board, of the various NRSROs' methodologies, ratings performance metrics and any other factors the board considers relevant to an assessment of whether the NRSROs' ratings are useful and of high quality.

6 The Investment Company Institute ("**ICI**") Report of the Money Market Working Group ("**ICI Report**"), upon which the Commission's proposal appears to be based, emphasizes that this proposal would encourage competition among NRSROs to achieve the designation. (See ICI Report, at 82 (March 17, 2009), available at http://gmm.ici.org/pdf/ppr_09_mmwg.pdf.) While we support proposals to encourage competition, we believe it is also important to promote the right kind of competition, *i.e.*, quality-based competition.

In addition, certain NRSROs may issue high quality ratings in limited areas. If these distinctions are not recognized (*e.g.*, through a rule that permits a money market fund board to designate an NRSRO for some, but not all, classes of securities), then greater competition can be harder to achieve. At the same time, however, we note that the more narrowly defined the categories of ratings for which a designation can be obtained, the easier it could be for mutual funds to game the system, *e.g.*, by dropping an NRSRO from its list of designated NRSROs for a particular class of ratings because that NRSRO has introduced a more conservative ratings methodology.

7 Investors, like other users of credit ratings, may want ratings assigned and maintained in a manner that is most beneficial to their interests, and those wishes might conflict with the "right" rating. For example, a money market fund that has primarily long positions in securities may prefer lower ratings before it purchases a security to obtain higher yields. Following a purchase, it likely wants to have ratings maintained or raised, rather than lowered. It is conceivable, therefore, that a mutual fund board could have an incentive to, *e.g.*, designate an NRSRO that downgrades securities less frequently or less severely than its peers or to drop as a designated NRSRO an NRSRO that introduces a more conservative methodology.

If the Commission adopts a proposal along these lines, we recommend that the Commission adopt the variation that permits mutual fund boards to designate CRAs and/or credit evaluation providers that are not registered as NRSROs, since this could promote greater competition and reduce the risk that investors could inappropriately treat the NRSRO designation as a "government stamp of approval." The Commission, however, would still need to be satisfied that mutual fund boards were applying robust quality-based criteria in their designation processes.

We do not have an opinion on exactly how many CRAs and/or credit evaluation providers should be designated by mutual fund boards. The regulatory objective should be to encourage market discipline focusing on ratings quality in order to discourage rating shopping. For example, if the rule provided that the mutual fund could invest in a security so long as *at least one* of the designated CRAs or credit evaluation providers had assigned a rating in its highest rating category, then issuers would still have strong incentives to shop for the highest rating. On the other hand, if the rule provided that the mutual fund could invest in a security only if *every* designated CRA and credit evaluation provider that had assigned a rating assigned in its highest rating category, then requiring a mutual fund to designate more than one CRA likely would create incentives for money market fund boards to designate several CRAs with the least conservative methodologies, so that the money market fund would have the maximum flexibility with respect to its investments.

Even if safeguards are in place to promote competition based on quality and to discourage rating shopping, we still believe that this alternative proposal does not reduce the risk of over-reliance on credit ratings (or other credit opinion providers) because it does not strengthen incentives for a mutual fund's manager or board to conduct their own, independent credit analysis of investments. We recognize that it might not be feasible for smaller funds to devote the time and resources required to conduct this type of analysis, but we believe that the credit market would benefit from creating stronger regulatory requirements and incentives for larger funds to conduct their own credit analysis. For this reason, with respect to larger funds that presumably have greater resources, we believe that the Commission's alternative proposal is suitable only as a temporary measure pending the larger funds' development or enhancement of the systems and resources needed to develop their own assessments of credit risk.

In summary, we believe that this alternative proposal could enhance market discipline by encouraging money market funds to analyze and compare CRAs based on ratings quality, but only if mutual fund boards are called upon to show that they have designated CRAs based on quality-related factors. While we support these aspects of the proposal, in our view, it does not go far enough in terms of requiring or encouraging money market fund managers and/or boards to conduct their own credit analysis. Accordingly, we believe that larger mutual funds should only be permitted to use this approach as an intermediate step.

4. CONCLUSION

In conclusion, we appreciate the Commission's ongoing efforts to analyze carefully the potential, direct and indirect consequences of retaining or removing particular references to ratings. We support the healthy dialogue that the Commission has facilitated through the Release and believe it will encourage all users of ratings, whether they are market participants or regulators, to consider carefully: (1) what are the desirable attributes of a CRA's ratings that make them suitable for use in the first place; (2) what are the risks that the user is seeking to measure and manage in using the CRA's ratings; and (3) whether the CRA's ratings performance merits such ratings' continued use for regulatory and other purposes. In our view, this type of analysis should be conducted periodically, since new risks can emerge, the relative importance of risks can change, new assessment tools are developed and the needs of market participants and regulators can evolve.

Ultimately, ratings are simply one tool that is available to market participants and regulators. We do not believe, and never have recommended, that they should be used as anything other than opinions about credit risk.

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Once again, we appreciate the opportunity to comment on the Release. We would be pleased to discuss our comments further with the Commission or its staff.

Sincerely,

Michael Kanef
Chief Regulatory and Compliance Officer
Moody's Investors Service