SHRIVER CENTER

Sargent Shriver National Center on Poverty Law

July 13, 2009

Ms. Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549-1090

RE: Proposed Rule on Money Market Reform, Fed. Reg. Vol. 74, No. 129, July 8, 2009

Dear Ms. Murphy:

I am writing from the Sargent Shriver National Center on Poverty Law ("Shriver Center"), a Chicago-based non-profit development and advocacy organization, to comment on the Securities and Exchange Commission's (SEC) proposed changes to 17 CFR 270 and 274, which would reform certain rules governing money market funds.

We commend the SEC for initiating these proposed rules[1] as an important first step in providing needed investor protections in financial products and services. As indicated in the proposed rules' commentary, there are more than 750 money market funds registered with the SEC which hold approximately $3.8 trillion in assets,[2] including over one-fifth of U.S. households' cash balances.[3] From 1998 to 2008 money market funds grew from approximately $1.4 trillion in assets to $3.8 trillion making money market funds' role in the capital market an extremely important one.[4] For these reasons, the regulation of such funds is important for both fund investors and the nation's economy as a whole.

[1] Fed. Register, Vol. 74, No. 129, July 8, 2009, pg. 32689 et. seq.

[2] Id. at page 32688 to 32689.

[3] Id.

[4] Id.

Unfortunately, the recent economic crisis has demonstrated that the regulatory oversight needed to ensure such funds' financial stability and, thereby, investors' and the economy's stability, was insufficient. The results of such lax regulatory oversight are apparent and the SEC's proposed regulations are a welcome attempt to place investor protections and financial stability above financial profit.

Yet, although welcome, the proposed rules can be strengthened to provide even more investor protections and financial stability as discussed below.

A. PORTFOLIO QUALITY

Whether or not to modify the provisions of Rule 2a-7 that incorporate minimum ratings by Nationally Recognized Statistical Rating Organizations (NRSROs) to reflect changes made to the federal securities laws by the Credit Rating Agency Reform Act of 2006 (Credit Reform Act).[5]

The Credit Reform Act provided far too much leeway for NRSROs. Although the SEC was granted exclusive enforcement authority over NRSROs, it also prohibited the SEC from regulating the substance of the credit rating procedures and methodologies by which NRSROs determine credit ratings. As SEC Chairman Cox noted about the Credit Reform Act "the law declares it is not [the SEC's] role to second guess the quality of [NRSROs] ratings," but rather to supervise NRSROs to ensure that they do what they claim they do.[6]

This lack of regulatory authority allowed NRSROs to determine their own appraisal methodologies which were greatly influenced by market incentives that encouraged NRSROs to provide overly favorable ratings. These overly optimistic appraisals were significant contributors to the financial crash of 2007-08.[7]

[5] Pub. L. 109-291, 120 Stat. 1327.

[6] International Monetary Fund, "*The Systemic Regulation of Credit Rating Agencies and Rated Markets*," Amadou N.R. Sy, June 2009.

[7] "*Why US Financial Markets Need a Public Credit Rating Agency,"* M. Ahmed Diomande et. al., The Economists' View, June 2009, pages 1-2 (citing economics journalist Roger Lowenstein for the New York Times -- "[Credit rating agencies put] gold seals on mortgage securities … this business was extremely lucrative. Their profits surged …. But who was passing judgment on the quality of the mortgages, on the equity behind them and on myriad other investment considerations? Certainly not the investors. They relied on a credit rating.").

Thus, rather than revise Rule 2a-7 pursuant to the Credit Reform Act the act itself must be revised and SEC regulation of NRSROs strengthened. As the Obama administration's proposed financial reform plan states, the SEC should require NRSROs to disclose conflicts of interest, differentiate between structured and unstructured debt and more clearly state the risks of financial products. Additionally, we would recommend that the SEC consider legislation which would prohibit NRSROs from providing any other products or services, including advice, other than rating since the conflict of interest in combining rating activities with advisory services or the sale of other lucrative services or products to customers looking for the best possible rating is obvious and inescapable. Finally, and perhaps most importantly, the SEC should prohibit a customer requesting a rating from paying the rating agency. Instead, the customer should pay the SEC, who would then allocate/auction the individual rating activity among the competing rating agencies. Rating agencies, in turn, should be paid in part in the securities they are rating and be required to hold such securities to maturity and not hedge them.

1. Second Tier Securities

Whether or not to eliminate the ability of money market funds to invest in second tier securities.

As the commentary on the proposed revisions to Rule 2a-7 explain, second tier securities were not directly implicated in the recent strains on money market funds and the economy.[8] Thus, prohibiting funds from investing in second tier securities seems unnecessary at the moment. Instead, the SEC should consider reducing the allowable percentage of such securities in a fund's portfolio. Additionally, as discussed above, the credit risk of such securities should be mitigated by ensuring that NRSROs' rating methodologies are regulated more effectively and that NRSROs' incentives to inflate ratings, whether for prime or secondary securities, are removed.

2. Eligible Securities

a. Use of NRSROs

[8] Fed. Register, Vol. 74, No. 129, July 8, 2009 at page 32695.

Whether or not the approach the SEC proposed last year regarding eliminating the use of NRSRO ratings in Rule 2a-7 and instead relying solely on a fund manager's credit risk determination, would provide safeguards with respect to credit risk that are comparable to the continued inclusion of NRSRO references in the rule.

Even though a NRSRO rating is not the only determinant of whether a security is an "eligible security" for a fund's portfolio, it is one of the factors in such a determination. Unfortunately, as indicated in the commentary of the proposed rule,[9] reliance on NRSROs' credit ratings proved to be largely ill advised.

Yet, adopting the SEC's proposal last year to eliminate the use of NRSRO ratings when determining eligibility for fund acquisitions and instead rely solely on a fund manager's credit-risk determination is equally ill advised. Recent events have highlighted the fact that most funds did not perform the due diligence needed to determine the creditworthiness of the securities, primarily asset backed securities (ABS), that they acquired.

To ensure that credit-risk determinations are independent and truly measure actual credit-risk, several checks and balances should be used. First, as discussed earlier, NRSROs' rating methodologies and incentives must be regulated and realigned before any such ratings are used. After such realignment, NRSRO ratings should provide a "floor" for investor protections which can be expanded upon. Finally, funds' boards should be required to make a quarterly determination that a NRSRO's credit rating is reliable based on monitoring and evaluation policies and procedures set forth by the SEC.

b. <u>Long-Term Unrated Securities</u>

Whether or not funds should be permitted to acquire long-term unrated securities if they have received long-term ratings in the highest two ratings categories to more narrowly limit the credit risk to which a money market fund may be exposed.

We express no opinion on this proposal.

[9] Id. at page 32697.

3. **<u>Credit Reassessment</u>**

Whether it is appropriate to proscribe that the only circumstances in which a fund's board of directors would be required to reassess whether a security continues to present minimal credit risks would be if, subsequent to its acquisition, the fund becomes aware that an unrated security has received a rating from any NRSRO below the highest short-term rating category.

Assuming that the ability to acquire second tier securities is eliminated, then limiting the circumstances for a fund's board to reassess such securities is acceptable.

4. **<u>Asset Backed Securities</u>**

Whether the SEC should provide additional guidance to funds on the required minimal credit risk evaluation with respect to ABSs.

Under the current Rule 2a-7, how a fund's board determines the credit-risk of an ABS or addresses the liquidity issues presented by ABS assets is not specifically addressed. Given that risky ABS' lie at the heart of the financial crash, it is clear that ABS' credit-risks must be regulated and not simply left to a fund manager.

In August 2007 the SEC initiated an in-depth examination of the three major rating agencies and over a month period uncovered significant deficiencies in NRSROs' policies, procedures and practices. Among these findings was the fact that none of the NRSROs examined had specific, comprehensive, written procedures for rating residential mortgage backed securities and collateralized debt obligations.

The SEC should, therefore, adopt regulations which require, among other factors: (i) an examination of the criteria used to select underlying assets, (ii) the credit quality of the put providers, (iii) the conditions and agreements between the parties to the arrangements, and (iv) additional special attention/analysis give to pooled ABS' such as credit card receivables and/or mortgages. Had such credit risk analysis guidelines such as these been in place previously, it is conceivable that the entire ABS meltdown would not have occurred or would have been significantly less severe.

Additionally, you requested comment on whether Rule 2a-7 should be amended to eliminate the requirement that any ABS be rated by an NRSRO in order to be an eligible security in light of the NRSROs' recent rapid downgrading of these securities.

As discussed previously, while it is clear that NRSROs' ratings were overblown, eliminating such a rating requirement would only increase the potential investment risks to both the economy as a whole and to individual investors. Instead, NRSROs' credit rating methodologies should be more stringently regulated so that they are accurate and reliable.

B. PORTFOLIO MATURITY

1. Weighted Average Maturity

Whether the weighted average maturity limit should be reduced to 60 days.

We have no comment on this proposal.

2. Weighted Average Life

Whether the proposed weighted average life limitation is proper.

We have no comment on this proposal.

3. Maturity Limit for Government Securities

Whether it is appropriate to eliminate the provision that permits a fund that relies exclusively on the penny-rounding method of pricing to acquire Government securities with remaining maturities of up to 762 days, rather than the 397 day limit otherwise provided by the rules.

We have no comment on this proposal.

4. Maturity Limit for Other Portfolio Securities

Whether or not the maximum maturity for individual non-government securities acquired by a fund should be reduced from 397 days to 270 or some other period.

We have no comment on this proposal.

C. PORTFOLIO LIQUIDITY

1. Limitations on Acquisition of Illiquid Securities

Whether or not to preclude funds from acquiring illiquid assets.

As indicated in the commentary to the proposed rule, in September 2008 the markets for both traditional and ABS securities essentially froze and many funds' portfolios became illiquid when buyers of ABS' fled the market at the same time that such funds received large volumes of redemption requests. The proposed rule's general goal is to add new risk-limiting conditions that are designed to improve funds' ability to meet significant redemption demands.

While we agree with the need to create such risk-mitigation measures, the first priority should be eliminating the risk in the first place. In other words, the credit-risk analysis of and rating methodology for ABS' must be stringent and rigorous. Without a robust initial evaluation of risk any attempts to limit the illiquid assets of a fund would be fruitless.

2. Cash and Securities That Can Be Readily Converted to Cash

Whether or not new liquidity tests should be adopted as set forth below.

a. Minimum Daily Liquidity Requirement

Whether a five percent minimum liquidity standard is appropriate in light of the liquidity needs of retail money market funds, as well as whether institutional funds should be subject to a higher daily liquidity requirement, 10 percent, than retail funds and if tax exempt funds should not be required to meet any minimum daily liquidity requirements.

Maintaining a minimum daily liquidity reserve is a priority for ensuring that funds are financially stable. Although retail money market funds experienced relatively modest redemption demands as a result of the economic crisis, the potential effects if such a situation had occurred would have been disastrous.

Retail money market funds are those which service individual investors – working Americans investing for their futures. If the economic crisis had lead to a run on retail fund redemptions such funds would have had a “fire sale” thereby reducing the assets available for such redemptions. Ultimately, such individual investors’ investments would have decreased significantly.

In order to protect consumers it is imperative that funds be required to maintain a minimum daily liquidity reserve. The amount of such reserve should be based not only on the type of fund, but also on the strength of the fund’s credit-risk analysis policies and procedures and the types of assets and percentages of each assets held (e.g., prime securities versus ABS). Additionally, the daily liquidity reserve requirements should be adjusted depending on the results of stress tests proposed below.

b. <u>Minimum Weekly Liquidity Requirement</u>

Whether a 15 percent of total assets for retail funds and 30 percent of total assets for institutional funds would be the appropriate thresholds for a weekly liquidity requirement.

As discussed in the previous section, the fact that retail money market funds experienced relatively modest redemption demands does not diminish the potentially disastrous results such a situation could have had on individual investors. The potential of a “fire sale” would have lead to significant losses to individual investors.

Thus, both minimum daily and weekly liquidity reserves should be required and the amount of such reserves should be based not only on the type of fund, but also on the strength of the fund’s credit-risk analysis policies and procedures and the types of assets and percentages of each assets held (e.g., prime securities versus ABS). Additionally, the weekly liquidity reserve requirement should adjusted depending on the results of the stress tests proposed below.

c. <u>General Liquidity Requirements</u>

Whether specific objective standards for liquidity should be incorporated into any liquidity requirements and if the SEC should provide guidance to funds to assist them in determining the adequacy of their policies and procedures to assure that appropriate measures are taken to identify risk characteristics of shareholders.

As discussed previously, reliance on NRSROs' credit ratings and on fund managers' assessments of credit-risk provided to be inadequate protections for investors. The methodologies used by both NRSROs and fund managers were focused more on profits than on financial stability and investor protection. Given this, guidance by the SEC to funds on the objective standards to be included in their policies and procedures for ensuring appropriate liquidity is critical.

3. <u>Stress Testing</u>

Whether stress tests should be required, including, whether or not there should be at least one baseline stress test that would test the fund portfolio against a combination of two or more events, the minimum frequency for testing and if minimum liquidity requirements should be based on the results of such stress tests.

Stress testing, though not a cure for bad rating and credit-risk analysis, is an important feature of monitoring the financial soundness of a financial institution. Had such stress tests been performed previously, it's conceivable that weaknesses in the money market fund system would have been detected earlier and the economic meltdown prevented.

To ensure that a similar crisis does not occur again the first priority is reforming NRSROs' ratings and funds' internal risk analysis procedures and methodology. At the same time, a baseline stress test would provide a measure from which to view future deviations, for better or worse, in a fund's stability and would provide a threshold for adjusting minimum liquidity requirements as appropriate.

With respect to the timing of such stress tests, as the commentary on the proposed rule noted, although funds make quarterly reports on portfolio holdings information to the SEC quarterly, this information quickly becomes outdated. The result is that the SEC is not aware of a fund's current economic status and cannot take immediate corrective action when necessary. Conducting stress test at least quarterly, if not monthly, would provide regulators with a more accurate picture of a fund's current financial status.

Finally, stress tests are entirely worthless if the results of such testing are not tied to repercussions and rewards. Thus, adjusting liquidity reserve requirements based on stress test results will not only provide incentives (e.g., lesser liquidity reserve requirements) for funds to operate in a financially sound manner, but will also provide protections (e.g., higher liquidity reserve requirements) when financial stability is threatened.

D. DIVERSIFICATION

Whether further restrictions on the diversification limits of the current rule should be enacted.

Currently, funds must limit their investments in the securities of any one issuer to no more than five percent of total fund assets. The purpose of these diversification provisions is to limit a fund's exposure to any one issuer or guarantor. Although, diversification was not the cause of the financial crisis, many funds were heavily exposed to either a few major securities firms or type of issuer. It would be prudent, therefore, for the SEC to require even greater diversification within a fund's holdings.

E. REPURCHASE AGREEMENTS

Whether limiting money market funds to investing in repurchase agreements collateralized by cash items or Government securities in order to obtain special treatment under the diversification provisions of Rule 2a-7 and requiring that money market funds' board of directors evaluate the creditworthiness of the counterparty to a repurchase agreement, regardless of whether or not the repurchase agreement is collateralized fully.

Although we have no comment on whether or not funds should be limited in investing in repurchase agreements, we do believe that a funds' board of directors must be required to evaluate a counterparty in a repurchase agreement and that the minimum standards/criteria of such an evaluation should be set and regulated by the SEC.

F. <u>DISCLOSURE OF PORTFOLIO INFORMATION</u>

1. <u>Public Website Posting</u>

Whether or not to require monthly portfolio disclosures.

The commentary to the proposed rule notes that, although funds are required to provide quarterly portfolio holdings information to the SEC, this information is quickly outdated. Timely information is needed to help the SEC react quickly to both a particular fund's financial instability and also to evaluate the systemic risk of the money market fund system as a whole. Investors must also be provided with the most current information to assist them in their investment decisions. Thus, requiring funds to disclose information about their portfolios on a monthly basis through their websites is a sound proposal which should be adopted.

2. <u>Reporting to the Commission</u>

Whether or not to require funds to provide the SEC with a monthly electronic filing of more detailed portfolio holdings information than currently required.

The SEC's need for information for regulatory oversight and action heavily outweighs a fund's need for a competitive advantage.

3. <u>Amendment to Rule 30b1-5</u>

Whether or not funds should be exempted from filing schedules of investments pursuant to Item 1 of Form N-Q in light of the proposed rule's new reporting requirements.

Assuming that the proposed reporting requirements are adopted as written, an exemption from Rule 30b1-5's reporting requirements is appropriate.

G. PROCESSING TRANSACTIONS

Whether or not each fund's board should be required to make a good faith determination, at least once each calendar year, that the fund has the capacity to redeem and sell its securities at a price based on the current net asset value per share.

The fact that a fund is not currently required to determine its redemption capacity of its securities at their current net asset value demonstrates the lack of regulatory oversight and protection under which these funds have previously operated. As a basic operating tenant a fund should know whether or not it is able to meet its redemption requirements and the value required to do so. Given the constantly changing nature of funds assets and redemption requirements, such an assessment should occur on a quarterly rather than annual basis and perhaps, if there are special factors, even more frequently. Given that a fund's board's analysis of such redemption requirements is likely to be overly optimistic the SEC must provide guidance on the criteria for such a self-examination.

H. EXEMPTION FOR AFFILIATE PURCHASES

1. Expanded Exemptive Relief

Whether or not to a fund should be permitted to sell a portfolio security that has defaulted to an affiliated person, even though the security continues to be an eligible security.

We express no opinion on this proposal.

2. New Reporting Requirement

Whether or not notice should be required not only for the fact of the purchase, but also the reasons for the purchase.

Although we express no opinion on whether or not such purchases should be permitted, in the event that they are permitted notification to the SEC of the reasons behind such purchase should be given.

I. <u>FUND LIQUIDATION</u>

1. <u>Proposed Rule 22e-3</u>

Whether a new proposed rule to permit a fund to suspend redemptions if (i) the fund's current price per share is less than the fund's stable net asset value per share, (ii) its board of directors, including a majority of disinterested members, approve the liquidation, and (iii) the fund, notifies the SEC of its decision to liquidate and suspend redemptions, is appropriate.

We express no opinion on this proposal.

2. <u>Request for Comment on Other Regulatory Changes</u>

a. <u>Temporary Suspensions for Exigent Circumstances</u>

Whether a new proposed provision permitting fund directors to temporarily suspend redemptions during certain exigent circumstances other than liquidation of a fund would be appropriate and, if so, how such a temporary suspension should operate.

We express no opinion on this proposal.

b. <u>Options for Shareholders in Liquidating Funds</u>

Whether there should be any conditions regarding the treatment of shareholders in a liquidation such as requiring funds to be distributed on a pro rata basis.

In the event of liquidation individual investors are the most vulnerable and therefore must be protected to the greatest extent possible. Pro rata distributions would be one approach for ensuring investor protection; however, we would also encourage the SEC to consider other alternatives as well.

Once again, we commend the SEC on the proposed regulations as an important first step toward ensuring the safety, soundness and investor protection of the US money market system. Many of the regulation's proposals offer hope for increased financial stability and investor protections. With the suggested revisions suggested herein, the proposed regulations can be made even stronger.

Thank you for the opportunity to provide comments on the SEC's proposed regulations and please feel free to contact me if you have any questions regarding these comments by the Shriver Center.

Sincerely,

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