

August 29, 2008

Ms. Florence E. Harmon  
Acting Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-0609

Re: References to Ratings of Nationally Recognized Statistical Rating Organizations;  
File No. S7-19-08

Dear Ms. Harmon:

The Independent Directors Council<sup>1</sup> appreciates the opportunity to comment on the proposed amendments to rules under the Investment Company Act of 1940 (“1940 Act”) that refer to nationally recognized statistical rating organizations (“NRSROs”).<sup>2</sup> IDC strongly supports the Commission’s efforts to improve the credit ratings process, which it is addressing through a related rulemaking initiative.<sup>3</sup> Funds, including money market funds, utilize NRSRO ratings in making investment decisions, and the integrity and quality of the ratings process is critical.

IDC strenuously objects, however, to the proposed elimination of NRSRO ratings from the rule 2a-7 framework. As discussed more fully below, IDC sees no benefit to eliminating the ratings

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<sup>1</sup> IDC serves the fund independent director community by advancing the education, interaction, communication, and policy positions of fund independent directors. IDC’s activities are led by a Governing Council of independent directors of Investment Company Institute member funds. ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of \$12.24 trillion and serve almost 90 million shareholders. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

<sup>2</sup> See *References to Ratings of Nationally Recognized Statistical Rating Organizations*, SEC Release Nos. IC-28327 and IA-2751 (July 1, 2008) (available at <http://www.sec.gov/rules/proposed/2008/ic-28327.pdf>) (“Proposing Release”).

<sup>3</sup> The proposed amendments to the 1940 Act, as well as amendments to rules under the Investment Advisers Act of 1940, included in the Proposing Release, represent the third of three rulemaking initiatives of the Commission that address the role of NRSROs. See *Proposed Rules for Nationally Recognized Statistical Ratings Organizations*, SEC Release No. 34-57967 (June 16, 2008) (available at <http://www.scc.gov/rules/proposed/2008/34-57967.pdf>) (“NRSRO Proposing Release”).

criteria and great potential for harm to fund shareholders and to the money market fund industry as a whole. IDC believes that the Commission can address the policy concerns underlying the rule proposal through other, more appropriate means.

IDC wishes to bring to the attention of the Commission an important, broader regulatory concern for fund directors that is highlighted by the proposal. Fund board responsibilities have increased substantially over time as the industry has grown and evolved. In many instances, boards are required to make technical determinations that are more appropriately within the purview of the fund's adviser. Rule 2a-7 is an example: among other things, fund boards are responsible for determining whether a portfolio security presents minimal credit risks. The proposed amendments would make fund boards responsible for additional investment-related determinations.<sup>4</sup>

IDC urges the Commission to re-examine entirely the role of money market fund boards. As outlined below, IDC recommends that the Commission update rule 2a-7 to reflect that the appropriate role of boards is to oversee, and not to manage, funds.

IDC's specific comments on the proposal and its broader recommendations regarding the appropriate role of money market fund boards of directors are set forth below.

#### **1. The Rule 2a-7 Framework Should Continue to Include NRSRO Ratings**

Money market funds, which today have about \$3.5 trillion in assets, have provided fund shareholders with a liquid and stable investment option for over 25 years. Rule 2a-7's risk limiting provisions are designed to protect the money market fund and its shareholders, and they have worked extremely well over the years. Notably, while the recent market environment has been marked by investor losses and government intervention in the credit markets, investors have exhibited confidence in money market funds by pouring an additional \$700 billion into them since the credit crisis began over a year ago.

Removing the NRSRO rating requirement would weaken the investor protections embodied in rule 2a-7, to the detriment of money market fund shareholders. The rating is, in effect, one prong of a two-prong test for portfolio eligibility. Under the current rule, the determination as to whether a portfolio security presents minimal credit risks must be based on credit quality analysis independent of, and in addition to, any NRSRO rating. Removing one of the prongs would in and of itself weaken the rule.

The rating requirement also establishes an objective, industry-wide baseline for money market fund eligibility. The proposed elimination of the NRSRO rating requirement raises the potential for

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<sup>4</sup> The proposed amendments to rule 5b-3 present a similar problem in that it would require a board assessment of the credit quality of rated securities that collateralize repurchase agreements.

some money market funds to invest in securities that do not satisfy the objective, baseline standards. Indeed, the proposed amendments may enable a money market fund to hold riskier investments than permitted under the current rule. Consequently, these amendments would dilute rule provisions that the Commission believed were “necessary to ensure that money market funds meet investors’ expectations for safety, soundness and convenience by maximizing the likelihood that these funds will be able to maintain a stable net asset value . . . .”<sup>5</sup>

IDC submits that there are better approaches to address the policy considerations underlying the proposed amendments. To the extent the Commission is concerned about the integrity of NRSRO ratings, IDC suggests that the more appropriate method for addressing this concern is through improvements to the credit ratings process. A good first step in this regard is the Commission’s proposal to impose additional disclosure, reporting, and recordkeeping requirements on NRSROs.<sup>6</sup> In addition, to address what the Commission perceives as “undue reliance on credit ratings,” IDC recommends that, rather than eliminate altogether the part of the two-part test that the Commission believes has been given undue weight, the Commission should emphasize the need to satisfy the other part of the test – to conduct independent credit analysis. For example, Commission staff could, in consultation with the industry, update the factors that fund advisers should consider when evaluating the credit quality of a portfolio security.<sup>7</sup>

NRSRO ratings represent a valuable component of the credit quality requirements, and eliminating them as one part of the process is adverse to the best interests of money market fund shareholders.<sup>8</sup> The rating requirement should be retained, with improvements in the credit rating process that the Commission is addressing in a related rulemaking.<sup>9</sup>

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<sup>5</sup> Revisions to Rules Regulating Money Market Funds, SEC Release Nos. 33-6882 and IC-18005 (February 20, 1991) at 16 (“1991 Amendments”).

<sup>6</sup> See NRSRO Proposing Release, *supra* n. 3.

<sup>7</sup> Commission staff previously provided guidance regarding factors that should be taken into account in assessing credit risk. See Investment Company Institute, SEC No-Action Letter (pub. avail. December 6, 1989); Letter to Registrants, SEC No-Action Letter (pub. avail. May 8, 1990).

<sup>8</sup> We note that, in each amendment to the rule since 1983, the Commission has sought to tighten, rather than loosen, the risk limiting conditions of the rule. See 1991 Amendments, *supra* n. 5; and Revisions to Rules Regulating Money Market Funds, SEC Release Nos. 33-7275 and IC-21837 (March 21, 1996).

<sup>9</sup> See NRSRO Proposing Release, *supra* n. 3.

## 2. **The Commission Should Update Rule 2a-7 to Reflect the Board's Appropriate Oversight Role**

As noted above, the proposed amendments highlight an important, broader regulatory subject regarding the appropriate role of fund boards. The Commission's proposal would impose inappropriate obligations on fund boards and runs counter to previous and current efforts to better define the oversight role of boards. In its 1992 study of investment company regulation, the Commission's Division of Investment Management stated:

We believe that independent directors are unnecessarily burdened, however, when required to make determinations that call for a high level of involvement in day-to-day activities. Rules that impose specific duties and responsibilities on the independent directors should not require them to "micro-manage" operational matters. To the extent possible, operational matters that do not present a conflict between the interests of advisers and the investment companies they advise should be handled primarily or exclusively by the investment adviser.<sup>10</sup>

Based on this conclusion, the Commission adopted a number of rule amendments to limit fund board approval requirements in matters that do not involve conflicts of interest. While the 1992 study and subsequent rule amendments did not explicitly focus on the responsibilities of money market fund boards, we believe that they provide an appropriate model for evaluating them.

Because boards continue to be burdened by specific responsibilities relating to operational matters, Division of Investment Management staff has been reviewing this subject for the past year as part of the Division's Director Outreach Initiative, and IDC commends the staff for addressing this important matter.<sup>11</sup> This Initiative is based in large part on the staff's recognition that fund board responsibilities have increased substantially over time as the industry has grown and evolved. In response, the staff is evaluating areas in which board effectiveness may be enhanced through rule amendments or guidance relating to fund board responsibilities. As discussed below, rule 2a-7 presents an opportunity for the Commission to begin to address this important matter.

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<sup>10</sup> Division of Investment Management, Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* (1992) at 266.

<sup>11</sup> See Andrew J. Donohue, Keynote Address at the Investment Company Directors Conference (November 28, 2007) (available at <http://www.sec.gov/news/speech/2007/spch112807ajd.htm>); Letter from Independent Directors Council to Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission (February 26, 2008) (available at <http://www.idc1.org/getPublicPDF.do?file=22275>) ("IDC Letter").

a. *The Proposed Amendments Continue to Impose Inappropriate, Management-Level Responsibilities on Fund Boards*

The proposed amendments fall back on the tendency to adopt rules that place specific, management-level responsibilities on fund boards to address perceived regulatory issues. While enhanced board involvement may be appropriate in situations that involve conflicts of interest (thus allowing boards to address issues that might otherwise have to be dealt with in an exemptive application), it is an inappropriate role in day-to-day matters such as security selection.

For example, the proposed amendments would require boards to determine whether a security is a “first-tier” security -- a determination that currently is made by an NRSRO with respect to rated securities. In order to make this determination under the proposed amendments, the board would need to determine whether an issuer “has the highest capacity to meet its short-term financial obligations” – a vague standard that would be difficult for a fund board to administer. In contrast, currently a fund board is responsible for making a determination of “first-tier” status only with respect to unrated securities. This determination is based on a readily ascertainable objective standard: comparability to a rated security.

In another example, the Proposing Release states that boards would “still be able to use quality determinations prepared by outside sources, including NRSRO ratings that they conclude are credible, in making credit risk determinations.”<sup>12</sup> Thus, under the proposed amendments, the use of an NRSRO rating would be predicated upon the board’s determination that the rating (or, possibly the NRSRO) is credible – a determination that would require expertise that fund boards are not expected to have.

The proposed amendments to the downgrade and default provisions likely would involve fund boards in the reassessment of the credit quality of portfolio securities on a more frequent basis. The proposed amendment would replace the current requirement that fund boards reassess whether a security continues to present minimal credit risks when it has been downgraded by an NRSRO, with a requirement that such a reassessment take place when the adviser “becomes aware of *any information* about a portfolio security or an issuer of a portfolio security that *may suggest* that the security may not continue to present minimal credit risks” (emphasis supplied).<sup>13</sup> It is not clear whether the proposed amendment lowers the threshold for involving boards in such reassessments (which would likely increase the frequency with which fund boards reassess the credit quality of portfolio securities); increases the threshold by allowing investment advisers to disregard a change in an NRSRO rating

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<sup>12</sup> Proposing Release, *supra* n. 2 at 8.

<sup>13</sup> Proposing Release, *supra* n. 2, at 12 and n. 33.

(which could result in money market funds becoming riskier); or does not change it at all (in which case, the amendment is unnecessary).<sup>14</sup>

In a somewhat convoluted manner, rule 2a-7 recognizes that boards should not be involved in management-level determinations: it permits fund boards to delegate some of the specific responsibilities imposed on them. As the Commission stated when adopting rule 2a-7, “the rule does not require that the board personally become involved in the day-to-day operations of the fund, nor does the rule require the board to be an insurer of the fund or the fund's investment adviser.”<sup>15</sup> And the Commission acknowledges in its Proposing Release that fund boards “typically rely on the fund's adviser” through the delegation provisions of the rule.<sup>16</sup>

Yet, even if a board can delegate the responsibility for making specific determinations, it still ultimately is responsible for the determinations that are made. IDC recommends that, rather than perpetuate the fiction of imposing responsibilities on fund boards that are expected to be delegated, the Commission revise rule 2a-7 to reflect the appropriate oversight role of fund boards.

*b. The Commission Should Update the Board Responsibilities Under Rule 2a-7*

IDC recommends that the Commission update rule 2a-7 by revising provisions of the rule that involve boards at an inappropriate level in the investment process. Boards should retain responsibility for determinations relating to the core functions of a money market fund, and the rule's delegation provision, which specifies the matters that may not be delegated, is a good place to start in identifying the matters for which a board should be directly responsible.<sup>17</sup>

The Commission's proposed approach with respect to the portfolio liquidity requirement may serve as a basis for a modification of the rule's architecture with respect to the role of the board. The proposed amendment requires that a money market fund hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions in light of the fund's obligations under Section 22(e) of the 1940 Act and any commitments the fund has made to its shareholders and would expressly limit a money market fund's investment in illiquid securities to not more than 10 percent of its total assets. The rule also provides a definition of “Liquid Security.” In neither case does the rule impose any

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<sup>14</sup> The Proposing Release states that “[w]e do not believe that the proposed amendments would require investment advisers to subscribe to every rating service publication in order to comply with this proposal,” suggesting that the Commission expects that the reassessment would continue to be triggered by a rating change. *See* Proposing Release, *supra* n. 2, at 13.

<sup>15</sup> *See* Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), SEC Release No. IC-13380 (July 11, 1983).

<sup>16</sup> *See* Proposing Release, *supra* n. 2, at 7-8 and n. 17.

<sup>17</sup> *See* rule 2a-7(e).

specific responsibilities on fund boards. Thus, the determination of whether a fund's portfolio is sufficiently liquid, and whether a security is liquid would not require specific board determinations concerning security liquidity. Presumably the board would exercise general oversight with respect to these matters.<sup>18</sup>

IDC recommends that the Commission take a similar approach in revisions to requirements relating to the investment process under rule 2a-7. For example, rather than limit investments to securities that the "fund's board of directors determines present minimal credit risks," the rule should be revised to simply limit investments in securities "that present minimal credit risks."<sup>19</sup> The adviser, who has the technical expertise in this area, would make the credit quality determination, subject to fund board oversight. Similarly, the provision relating to ratings downgrades should be revised to eliminate the specific responsibilities imposed on fund boards and permit fund boards to exercise oversight over the responses to ratings downgrades through, for example, the adoption and oversight of policies and procedures.<sup>20</sup>

IDC believes that it is appropriate for fund boards to retain the following responsibilities, which appropriately involve fund boards in determinations essential to the operation of a money market fund:

- the initial determination that it is in the best interests of the fund and its shareholders to maintain a stable net asset value by virtue of either the amortized cost method or the penny-rounding method (paragraph (c)(1));
- the establishment of required procedures under the amortized cost or penny-rounding method (paragraphs (c)(7)(i), (c)(8) and (c)(9));

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<sup>18</sup> With respect to the inclusion of the proposed liquidity requirement in rule 2a-7, IDC understands that the Commission is planning to publish for comment guidance relating to fair valuation of fund portfolio instruments, which will discuss issues relating to liquidity. Because that discussion is likely to illicit more thorough comments on a liquidity requirement than the proposal at hand, which many interested parties may overlook inasmuch as it is not explicitly related to NRSRO ratings requirements, IDC recommends that the Commission defer taking final action on the liquidity requirement until it has had an opportunity to consider those comments.

<sup>19</sup> See rule 2a-7(c)(3)(i).

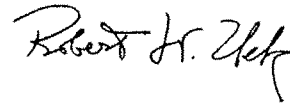
<sup>20</sup> See rule 2a-7(c)(6)(i). Other provisions that involve boards in the investment process include, but are not limited to, paragraphs (c)(3)(iv) (determination that there is minimal risk that the circumstances that would result in the Conditional Demand Feature not being exercisable will occur); (c)(4) (certain determinations with respect to money market funds in which the fund invests); (c)(5) (determination that certain demand features will not be relied upon); and (c)(6)(i)(C) (determination that disposal of certain securities subject to demand features that are downgraded would not be in the best interest of the fund).

- determinations made in response to defaults of portfolio securities (paragraph (c)(6)(ii)); and
- establishment and review of shadow pricing procedures (paragraphs (c)(7)(ii)(A-C)).

The Commission's consideration of the appropriate oversight role of fund boards should not stop with rule 2a-7. IDC has suggested modifications to rule 5b-3 and 10f-3 in this regard, as well as other rules, in communications with the staff.<sup>21</sup> IDC urges the Commission to incorporate the appropriate oversight role of fund boards in any rulemaking it undertakes now and going forward.

If you have any questions about our comments, please contact Amy B.R. Lancellotta, Managing Director, Independent Directors Council, at 202-326-5824.

Sincerely,



Robert W. Uek  
Chair, IDC Governing Council

cc: The Honorable Christopher Cox, Chairman  
The Honorable Kathleen L. Casey  
The Honorable Elisse B. Walter  
The Honorable Luis A. Aguilar  
The Honorable Troy A. Paredes

Andrew J. Donohue, Director  
Robert E. Plaze, Associate Director  
Division of Investment Management

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<sup>21</sup> See IDC Letter, *supra* n. 11. As noted above in note 4, the proposed amendments to rule 5b-3, if adopted, would clearly be a step in the wrong direction and would not address our concerns. We also believe that, notwithstanding the Commission's statement in the Proposing Release to the contrary, the amendments to rule 10f-3 would effectively increase burdens on a fund board by requiring it, in connection with its quarterly review of transactions under the rule, to inquire into subjective judgments that the investment adviser has made with respect to municipal securities. The board would have to consider whether the fund complied with its policies to acquire securities that were, "sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time" and either (i) subject to no greater than moderate credit risk or (ii) if they are less seasoned securities, subject to a minimal or low amount of credit risk. See Proposing Release, *supra* n. 2, at 23. This would replace a relatively easy-to-oversee requirement that is tied to the security's NRSRO rating.