

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 270 and 275**

**[Release Nos. IC-28327; IA-2751 File No. S7-19-08]**

**RIN 3235-AK19**

**REFERENCES TO RATINGS OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** This is one of three releases that the Securities and Exchange Commission (“Commission”) is publishing simultaneously relating to the use in its rules and forms of credit ratings issued by nationally recognized statistical rating organizations (“NRSROs”). In this release, the Commission proposes to amend five rules under the Investment Company Act of 1940 and the Investment Advisers Act of 1940 that rely on NRSRO ratings. The proposed amendments are designed to address concerns that the reference to NRSRO ratings in Commission rules may have contributed to an undue reliance on NRSRO ratings by market participants.

**DATES:** Comments should be received on or before September 5, 2008.

**ADDRESSES:** Comments may be submitted by any of the following methods:

*Electronic comments:*

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-19-08 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the

instructions for submitting comments.

*Paper comments:*

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-19-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

**FOR FURTHER INFORMATION CONTACT:** Penelope Saltzman, Acting Assistant Director, or Vincent Meehan, Senior Counsel, (202) 551-6792, Office of Regulatory Policy, or Smeeta Ramarathnam, Senior Counsel, (202) 551-6792, Office of Special Projects, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5041.

**SUPPLEMENTARY INFORMATION:** The Commission is proposing for public comment amendments to rules 2a-7 [17 CFR 270.2a-7], 3a-7 [17 CFR 270.3a-7], 5b-3 [17 CFR 270.5b-3], and 10f-3 [17 CFR 270.10f-3] under the Investment Company Act of 1940 ("Investment

Company Act”),<sup>1</sup> and amendments to rule 206(3)-3T [17 CFR 275.206(3)-3T] under the Investment Advisers Act of 1940 (“Investment Advisers Act” or “Advisers Act”).<sup>2</sup>

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<sup>1</sup> 15 U.S.C. 80a. Unless otherwise noted, all references to rules under the Investment Company Act will be to Title 17, Part 270 of the Code of Federal Regulations [17 CFR 270], and all references to statutory sections are to the Investment Company Act.

<sup>2</sup> 15 U.S.C. 80b. Unless otherwise noted, all references to rules under the Investment Advisers Act will be to Title 17, Part 275 of the Code of Federal Regulations [17 CFR 275], and all references to statutory sections are to the Investment Advisers Act.

## I. INTRODUCTION

On June 16, 2008, in furtherance of the Credit Rating Agency Reform Act of 2006,<sup>3</sup> the Commission published for notice and comment two rulemaking initiatives.<sup>4</sup> The first proposes additional requirements for NRSROs<sup>5</sup> that were directed at reducing conflicts of interest in the credit rating process, fostering competition and comparability among credit rating agencies, and increasing transparency of the credit rating process.<sup>6</sup> The second is designed to improve investor understanding of the risk characteristics of structured finance products. Those proposals address concerns about the integrity of the credit rating procedures and methodologies of NRSROs in light of the role they played in determining the credit ratings for securities that were the subject of the recent turmoil in the credit markets.

Today's proposals comprise the third of these three rulemaking initiatives relating to credit ratings by an NRSRO that the Commission is proposing. This release, together with two companion releases, sets forth the results of the Commission's review of the requirements in its rules and forms that rely on credit ratings by an NRSRO. The proposals also address recent recommendations issued by the President's Working Group on Financial Markets ("PWG"), the Financial Stability Forum ("FSF") and the Technical Committee of the International

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<sup>3</sup> Pub. L. No. 109-291, 120 Stat. 1327 (2006).

<sup>4</sup> Proposed Rules for Nationally Recognized Statistical Rating Organizations, Securities Exchange Act Release No. 57967 (June 16, 2008) [73 FR 36212 (June 25, 2008)] ("NRSRO June 16, 2008 Proposing Release").

<sup>5</sup> As described in more detail below, an NRSRO is an organization that issues ratings that assess the creditworthiness of an obligor itself or with regard to specific securities or money market instruments, has been in existence as a credit rating agency for at least three years, and meets certain other criteria. The term is defined in section 3(a)(62) of the Securities Exchange Act of 1934 ("Exchange Act"). A credit rating agency must apply with the Commission to register as an NRSRO, and currently there are ten registered NRSROs.

<sup>6</sup> See Press Release No. 2008-110 (June 11, 2008).

Organization of Securities Commissions (“IOSCO”).<sup>7</sup> Consistent with these recommendations, the Commission is considering whether the inclusion of requirements related to ratings in its rules and forms has, in effect, placed an “official seal of approval” on ratings that could adversely affect the quality of due diligence and investment analysis. The Commission believes that today’s proposals could reduce undue reliance on credit ratings and result in improvements in the analysis that underlies investment decisions.

## II. BACKGROUND

The Commission first used the term “NRSRO” in our rules in 1975 in the net capital rule for broker-dealers, Rule 15c3-1 (“Net Capital Rule”)<sup>8</sup> under the Securities Exchange Act of 1934 (the “Exchange Act”)<sup>9</sup> as an objective benchmark to prescribe capital charges for different types of debt securities. Since then, we have used the designation in a number of regulations under the federal securities laws. Although we originated the use of the term NRSRO for a narrow purpose in our own regulations, ratings by NRSROs today are used widely as benchmarks in federal and state legislation, rules issued by other financial regulators, in the United States and abroad, and private financial contracts.

Referring to NRSRO ratings in regulations was intended to provide a clear reference point to both regulators and market participants. Increasingly, we have seen clear disadvantages of using the term in many of our regulations. Foremost, there is a risk that investors interpret the

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<sup>7</sup> See President’s Working Group on Financial Markets, *Policy Statement on Financial Market Developments* (March 2008), available at [www.ustreas.gov](http://www.ustreas.gov) (“PWG Statement”); *The Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (April 2008), available at [www.fsforum.org](http://www.fsforum.org) (“FSF Report”); Technical Committee of the International Organization of Securities Commissions, *Consultation Report: The Role of Credit Rating Agencies in Structured Finance Markets* (March 2008), p. 9, available at [www.iosco.org](http://www.iosco.org).

<sup>8</sup> 17 CFR 240.15c3-1.

<sup>9</sup> 15 U.S.C. 78a.

use of the term in laws and regulations as an endorsement of the quality of the credit ratings issued by NRSROs, which may have encouraged investors to place undue reliance on the credit ratings issued by these entities. In addition, as demonstrated by recent events,<sup>10</sup> there has been increasing concern about ratings and the ratings process. Further, by referencing ratings in the Commission's rules, market participants operating pursuant to these rules may be vulnerable to failures in the ratings process. In light of this, the Commission proposes to amend regulations under the Investment Company Act and the Investment Advisers Act that use the term NRSRO or refer to NRSRO ratings.<sup>11</sup>

### **III. DISCUSSION**

The credit ratings issued by NRSROs are used in four of the Commission's rules under the Investment Company Act – rules 2a-7, 3a-7, 5b-3, and 10f-3 – and one rule under the Investment Advisers Act – rule 206(3)-3T. These rules use the credit ratings issued by the NRSROs in different contexts, and for different purposes, to distinguish among various grades of debt and other rated securities. We propose to amend each rule to omit references to NRSRO ratings and, except with respect to one of the rules, substitute alternative provisions that are designed to appropriately achieve the same purpose as the ratings. Below we discuss these proposals in greater detail in the context of each rule we propose to amend.

#### **A. Rule 2a-7**

Rule 2a-7 under the Investment Company Act governs the operation of money market funds. Unlike other investment companies (“funds”), money market funds seek to maintain a stable share price, typically at \$1.00 per share. To do so, most money market funds use the

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<sup>10</sup> See NRSRO June 16, 2008 Proposing Release, *supra* note 4, at Section I.C.

<sup>11</sup> These regulations include rules 2a-7, 3a-7, 5b-3 and 10f-3 under the Investment Company Act and rule 206(3)-3T under the Investment Advisers Act.

amortized cost method of valuation (“amortized cost method”) or the penny-rounding method of pricing (“penny-rounding method”) permitted by rule 2a-7.<sup>12</sup> The Investment Company Act and applicable rules generally require funds to calculate current net asset value per share by valuing their portfolio instruments at market value or, if market quotations are not readily available, at fair value as determined in good faith by the board of directors.<sup>13</sup> These valuation requirements are designed to prevent unfair share pricing from diluting or otherwise adversely affecting the interests of investors.<sup>14</sup>

Rule 2a-7 exempts money market funds from these provisions but contains maturity, quality, and diversification conditions designed to minimize the deviation between a money market fund’s stabilized share price and the market value of its portfolio.<sup>15</sup> Among these conditions, rule 2a-7 limits a money market fund’s portfolio investments to securities that have received credit ratings from the “Requisite NRSROs” in one of the two highest short-term rating categories or comparable unrated securities (*i.e.*, “Eligible Securities”).<sup>16</sup> Rule 2a-7 further restricts money market funds to securities that the fund’s board of directors (which typically rely

<sup>12</sup> Under the amortized cost method, portfolio instruments are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. *See* rule 2a-7(a)(2). Share price is determined under the penny-rounding method by valuing securities at market value, fair value or amortized cost and rounding the per share net asset value to the nearest cent on a share value of a dollar, as opposed to the nearest one tenth of one cent. *See* rule 2a-7(a)(18).

<sup>13</sup> *See* section 2(a)(41) of the Investment Company Act (defining value) and rules 2a-4 (defining current net asset value) and 2a-7(c) thereunder (money market fund share price calculations).

<sup>14</sup> If shares are sold or redeemed based on a net asset value which turns out to have been either understated or overstated to the amount at which portfolio instruments could have been sold, then the interests of either existing shareholders or new investors will have been diluted. *See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Sen. Comm. on Banking and Currency, 76th Cong., 3d Sess. 136-138, 288 (1940).*

<sup>15</sup> Rule 2a-7 contains conditions that apply to each investment a money market fund proposes to make, as well as conditions that apply to a money market fund’s entire portfolio.

<sup>16</sup> The term “Eligible Security” is defined in rule 2a-7(a)(10). “Requisite NRSROs” is defined in rule 2a-7(a)(21).

on the fund’s adviser<sup>17</sup>) determines present minimal credit risks, and specifically requires that determination “be based on factors pertaining to credit quality in addition to any ratings assigned to such securities by an NRSRO.”<sup>18</sup>

We propose to eliminate references to ratings by amending rule 2a-7 in four principal ways.<sup>19</sup> In combination, these proposed amendments are designed to offer similar protections to the current rule’s reliance on NRSRO ratings.<sup>20</sup>

### *1. Minimal Credit Risk Determination*

Under the proposed amendments, we would rely on money market fund boards of directors to determine that each portfolio instrument presents minimal credit risks,<sup>21</sup> and whether the security is a “First Tier Security” or a “Second Tier Security” for purposes of the rule.<sup>22</sup> We believe that money market fund boards of directors 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. We expect that the boards of directors (or their

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

<sup>18</sup> Rule 2a-7(c)(3)(i). Thus, under the current rule, where the security is rated, having the requisite NRSRO rating is a necessary but not sufficient condition for investing in the security and cannot be the sole factor considered in determining whether a security presents minimal credit risks. See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991) [56 FR 8113 (Feb. 27, 1991)], at text preceding n.18.

<sup>19</sup> The proposed amendments would also make conforming amendments to rule 2a-7’s record keeping and reporting requirements. See proposed rule 2a-7(c)(11).

<sup>20</sup> In 2003, the Commission published a concept release in which we sought comment on the use of NRSRO ratings in our rules. See Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, Investment Company Act Release No. 26066 (June 4, 2003) [68 FR 35258 (June 12, 2003)]. Comments on the concept release are available at: <http://www.sec.gov/rules/concept/s71203.shtml>. As discussed above, recent events have highlighted the need to revisit our reliance on NRSRO ratings in the context of these developments. See also the extensive discussion of market developments in the NRSRO June 16, 2008 Proposing Release, *supra* note 4.

<sup>21</sup> See proposed rule 2a-7(a)(10).

<sup>22</sup> Rule 2a-7(c)(4) addresses portfolio diversification requirements for money market funds, including diversification requirements relating to First and Second Tier Securities.

delegates) would understand the basis for the rating and make an independent judgment of credit risks.

Under the proposed amendments, a security would be an Eligible Security if the board of directors determines that it presents minimal credit risks, which determination must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations.<sup>23</sup> A security would be a First Tier Security if the fund's board had determined that the issuer has the "highest capacity to meet its short-term financial obligations."<sup>24</sup> A security would be a Second Tier Security if it is an Eligible Security but is not a First Tier Security.<sup>25</sup> We have designed these proposed definitions to retain a degree of risk limitations similar to what is in the current rule.

We request comment on the proposed amendments. What are the advantages and disadvantages of eliminating the requirement to use NRSRO ratings from rule 2a-7? Would eliminating the rating requirements from rule 2a-7 affect the amount or nature of risks money market funds would be willing or able to take? What are the advantages and disadvantages of relying on minimum credit risk determinations? What are the advantages and disadvantages of having fund directors and investment advisers exclusively make credit quality determinations? Are we correct that the current rule's reliance on credit ratings discourages fund directors and

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<sup>23</sup> Proposed rule 2a-7(a)(10).

<sup>24</sup> Proposed rule 2a-7(a)(12).

<sup>25</sup> *See* rule 2a-7(a)(22). The specific language of this provision would not change, but the definitions of "Eligible Security" and "First Tier Security" would change under the proposal. Consistent with the current rule, under proposed rule 2a-7, a money market fund that is not a tax exempt fund generally must limit its investments in Second Tier Securities to no more than five percent of fund assets, with investment in the Second Tier Securities of any one issuer being limited to the greater of one percent of fund assets or one million dollars. Proposed rule 2a-7(c)(3)(ii)(A) and (c)(4)(i)(C)(1). Tax exempt money market funds are subject to different limitations on investments in Second Tier Conduit Securities. Rule 2a-7(c)(3)(ii)(B) and (c)(4)(i)(C)(2).

investment advisers from performing independent credit risk assessments? What other alternatives could we adopt to encourage more independent credit risk analysis and meet the regulatory objectives of rule 2a-7's requirement of NRSRO ratings? Are the distinctions our proposed amendments would draw between First Tier and Second Tier Securities workable? Is there a better way to describe the characteristics of a First Tier Security without reference to ratings? Are we correct in our expectation that the proposed standards would not impose additional burdens on boards or investment advisers, or require new recordkeeping requirements?

## 2. *Portfolio Liquidity*

Under the proposed amendments, a money market fund must hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions in light of the fund's obligations under section 22(e) of the Investment Company Act and any commitments the fund has made to its shareholders.<sup>26</sup> In addition, the proposed amendments would expressly limit a money market fund's investment in illiquid securities to not more than 10 percent of its total assets.<sup>27</sup> The proposed amendments would define a Liquid Security as a security that can be sold or disposed

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<sup>26</sup> See proposed rule 2a-7(c)(5). Section 22(e) of the Investment Company Act prohibits registered investment companies from suspending the right of redemption or postponing the date of payment upon redemption of any redeemable security for more than seven days except for certain periods specified in the provision. While the Investment Company Act requires only that an investment company make payment of the proceeds of redemption within seven days, most money market funds promise investors that they will receive proceeds much sooner, often on the same day that the request for redemption is received by the fund.

<sup>27</sup> The proposed standard codifies the current standard regarding portfolio liquidity. See Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 21837 (Mar. 21, 1996) [61 FR 13956 (Mar. 28, 1996)] ("Rule 2a-7 1996 Amending Release"), at text accompanying n.108 ("The limit on money fund holdings of illiquid securities is ten percent of fund assets."); Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986) [51 FR 9773 (Mar. 21, 1986)] ("1986 Valuation Release"). Although credit ratings do not directly incorporate liquidity risks, they have been used as a proxy for liquidity because a security may lose liquidity if its credit rating falls.

of in the ordinary course of business within seven days at approximately the value ascribed to it by the money market fund.<sup>28</sup> These proposed provisions should be familiar to managers of money market funds. Past releases proposing, adopting and amending rule 2a-7 repeatedly emphasized the special duty of the board of directors of a money market fund to monitor purchases of illiquid instruments.<sup>29</sup> Money market funds often have a greater and perhaps less predictable volume of redemptions than other open-end investment companies. Further, the portfolio management of a money market fund may be impaired if a fund were forced to meet redemption requests by selling marketable securities that it would otherwise wish to retain in order to avoid attempting to dispose of illiquid portfolio instruments.<sup>30</sup> In light of these potential problems, the proposal would prohibit money market funds from acquiring illiquid securities representing more than 10 percent of their total assets.<sup>31</sup> In the event that changes in the money market fund's portfolio or other external events cause the fund's investments in illiquid instruments to exceed 10 percent of the fund's assets, the money market fund would have to take steps to bring the aggregate amount of illiquid securities back within the proposed limitations as

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<sup>28</sup> See proposed rule 2a-7(a)(17). See also 1986 Valuation Release, *supra* note 27 at text following n.21.

<sup>29</sup> See, e.g., Valuation of Debt Instruments and Computation of Current Price per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 12206 (Feb. 1, 1982) [47 FR 5428 (Feb. 5, 1982)] (proposing rule 2a-7); Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 13380 (July 11, 1983) [48 FR 32555 (July 18, 1983)] ("Rule 2a-7 Adopting Release"); 1986 Valuation Release, *supra* note 27.

<sup>30</sup> Rule 2a-7 Adopting Release, *supra* note 29, at text preceding, accompanying and following nn.37-39.

<sup>31</sup> Proposed rule 2a-7(c)(5). Money market funds must limit their investments in illiquid assets to not more than 10 percent of their net assets. See rule 2a-7 1996 Amending Release, *supra* note 27, at n.108 and accompanying text. An investment company's portfolio security is illiquid if it cannot be disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the investment company. See *id.* at n.107 and accompanying text.

soon as reasonably practicable. However, consistent with the current rule, this requirement generally would not force the money market fund to liquidate any portfolio security where the fund would suffer a loss on the sale of that instrument.<sup>32</sup>

We request comment on the proposed amendments. Should we include in rule 2a-7 an express requirement that money market funds limit their exposure to illiquid securities? Do the proposed requirements provide money market funds sufficient flexibility to retain securities that may be illiquid if the disposal of those securities would not be in the best interests of the fund? Are there alternative or additional provisions that we should consider to address the way in which money market funds should evaluate liquidity risk and determine whether to dispose of securities that present an increasing liquidity risk?

### 3. *Monitoring Minimal Credit Risks*

The proposed amendments would also amend rule 2a-7's downgrade and default provisions. We propose that in the event the money market fund's investment adviser becomes aware of any information about a portfolio security or an issuer of a portfolio security that suggests that the security may not continue to present minimal credit risks, the money market fund's board of directors would have to reassess promptly whether the portfolio security continues to present minimal credit risks.<sup>33</sup> This proposed requirement would replace the provisions in the current rule that generally require a money market fund board to promptly

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<sup>32</sup> See Rule 2a-7 Adopting Release, *supra* note 29, at n.38.

<sup>33</sup> Proposed rule 2a-7(c)(7) ("In the event the money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) 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, the board of directors shall reassess promptly whether such security continues to present minimal credit risks and shall cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders.").

reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks, and take such action as the board determines is in the best interests of the fund and its shareholders.<sup>34</sup> We 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. However, we would expect an investment adviser to exercise reasonable diligence in keeping abreast of new information about a portfolio security that is reported in the national financial press or in publications to which the investment adviser subscribes.

We request comment on the proposed amendments. Would the requirement that the board of directors reassess the credit risk of a security when investment advisers become aware of information that may suggest the security no longer presents minimal credit risks provide adequate investor protections? Would investment advisers be able to stay abreast of new information about their portfolio securities?

#### 4. *Commission Notice of Rule 17a-9 Transactions*

Finally, the proposed amendments would require that money market funds provide the Commission with prompt notice when an affiliate of the money market fund (or its promoter or principal underwriter) purchases from the fund a security that is no longer an Eligible Security, pursuant to rule 17a-9 under the Investment Company Act.<sup>35</sup> We believe that the current notice

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<sup>34</sup> Rule 2a-7(c)(6)(i)(A). This current assessment is not required, however, if the downgraded security is disposed of or matures within five business days of the specified event and in the case of events specified in rule 2a-7(c)(6)(i)(A)(2), the board is subsequently notified of the adviser's actions. Rule 2a-7(c)(6)(i)(B).

<sup>35</sup> Proposed rule 2a-7(c)(7)(iii)(B) (requiring notice to the Commission of any "purchase of a security from the fund by an affiliated person or promoter of or principal underwriter for the fund or an affiliated person of such a person in reliance on rule 17a-9"). See rule 17a-9 (exempting from section 17(a) of the Act the purchase of a security "that is no longer an Eligible Security (as defined in [rule 2a-7(a)(10)]) under certain conditions." Notification under this proposed provision would also be amended to require electronic mail, instead of the other means currently listed in rule 2a-7(c)(6)(iii). We believe this change is appropriate in light of recent changes in

provisions, which are triggered when a security held by a fund defaults, provide us with incomplete information about money market funds holding distressed securities, particularly those that have engaged in an affiliated transaction with an affiliated person. The additional notice, which we believe would impose little burden on money market funds or their managers, would enhance our oversight of money market funds especially during times of economic stress.

We request comment on the proposed amendments.

**B. Rule 3a-7**

Rule 3a-7 under the Investment Company Act excludes structured finance vehicles from the Act's definition of "investment company" subject to certain conditions.<sup>36</sup> In a typical financing, a sponsor transfers a pool of assets (such as residential mortgages) to a limited purpose entity, which in turn issues fixed income securities that are rated investment grade or higher by at least one NRSRO. Payment on the securities depends primarily on the cash flows generated by the pooled assets. As a result, these are often referred to as "asset-backed" securities.

Rule 3a-7 contains a number of conditions that differentiate investment companies from structured financings. The conditions include the requirement that structured financings offered to the general public are rated by at least one NRSRO in one of the four highest ratings

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telecommunications technology, and because most of the notices of default that we have received in the past year have been transmitted electronically.

<sup>36</sup> Structured financings meet the definition of investment company under section 3(a) of the Act because they issue securities and invest in, own, hold, or trade securities. Almost none of the structured financings, however, are able to operate under the Act's requirements. *See* Exclusion from the Definition of Investment Company for Structured Financings, Investment Company Act Release No. 19105 (Nov. 19, 1992) [57 FR 56248 (Nov. 27, 1992)] ("Rule 3a-7 Adopting Release").

categories.<sup>37</sup> The rule contains an exception under which asset-backed securities sold to accredited investors<sup>38</sup> and qualified institutional buyers<sup>39</sup> may be unrated, or may be rated less than investment grade, if the issuer and its underwriters use reasonable care to ensure that all excepted sales are to such persons.<sup>40</sup> We concluded that these persons are in a position to evaluate the structured financing vehicle and to take steps to protect themselves from the types of abusive practices against which the Investment Company Act was designed to protect.<sup>41</sup>

We understand that today most asset-backed securities are issued by special purpose vehicles that do not rely on rule 3a-7 to exclude them from the application of the Investment Company Act. Instead, they rely on section 3(c)(7), which was added to the Act in 1996, after the Commission adopted rule 3a-7, and provides an exception from the Act for companies whose securities are limited to any issuer, the outstanding securities of which are owned exclusively by persons who are qualified purchasers, and that is not making and does not at that time propose to make a public offering of such securities. Moreover, asset-backed securities issued by financing vehicles that rely on rule 3a-7, even when highly rated, generally are not marketed to retail

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<sup>37</sup> Rule 3a-7(a)(2).

<sup>38</sup> The exception permits the sale of asset backed fixed-income securities to “accredited investors” as defined in paragraphs (1), (2), (3) and (7) of rule 501(a) under the Securities Act [17 CFR 230.501(a)], and includes any entity in which of all of the equity owners come within such paragraphs. Rule 3a-7(a)(2)(i).

<sup>39</sup> The exception permits the sale of any asset backed securities to “qualified institutional buyers” as defined in rule 144A under the Securities Act [17 CFR 230.144A] and certain other persons involved in the organization or operation of the issuer or an affiliate, as defined in rule 405 under the Securities Act [17 CFR 230.405]. Rule 3a-7(a)(2)(ii).

<sup>40</sup> Rule 3a-7(a)(2).

<sup>41</sup> *See* Exclusion from the Definition of Investment Company for Certain Structured Financings, Investment Company Act Release No. 18736 (May 29, 1992) [57 FR 23980 (June 5, 1992)] (proposing rule 3a-7).

investors.<sup>42</sup> Accordingly, we propose to eliminate the rule's reliance on ratings by amending the rule to eliminate the exclusion for structured financings offered to the general public.

In addition, we are proposing to amend the part of the rule that addresses substitution of eligible assets to remove the reference to ratings downgrades. The rule permits the issuer to acquire additional eligible assets or dispose of assets only if, among other conditions, the acquisition or disposition of the assets does not result in a downgrading in the rating of the issuer's outstanding fixed-income securities.<sup>43</sup> We propose to require instead that the issuer have procedures to ensure that the acquisition or disposition does not adversely affect the full and timely payment of the outstanding fixed income securities.<sup>44</sup>

Finally, we propose to amend the portion of the rule that deals with the safekeeping of assets.<sup>45</sup> Among other requirements, the rule provides that cash flows from the asset pool periodically be deposited in a segregated account, consistent with the rating of the outstanding fixed income securities.<sup>46</sup> This provision was intended to ensure that the segregated account in which the cash flows are deposited and the length of time that the servicer holds the cash flows before depositing them in the segregated account would pose a minimal risk of loss to the fixed income security holders. We propose to change this provision to require that the cash flows be deposited in a segregated account consistent with the full and timely payment of the outstanding fixed income securities.<sup>47</sup> The proposed amendment is designed to minimize the risk of loss of

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<sup>42</sup> See *Credit & Finance Risk Analysis Asset Backed Securities and Structural Finance*, at <http://www.credfinrisk.com/assetsecure.html>.

<sup>43</sup> Rule 3a-7(a)(3)(ii).

<sup>44</sup> Proposed rule 3a-7(a)(3)(ii).

<sup>45</sup> Rule 3a-7(a)(4).

<sup>46</sup> Rule 3a-7(a)(4)(iii).

<sup>47</sup> Proposed rule 3a-7(a)(4)(iii). The proposed amendment would require the issuer to take "actions

cash flows pending payment to the fixed income securities holders.

We request comment on our proposed amendments to rule 3a-7. What are the advantages and disadvantages of eliminating the NRSRO rating requirement from the rule? Is our understanding that structured financings are generally not marketed to retail investors correct? If not, should we retain an exclusion for structured finance offerings to the general public? If so, what standards should we impose that could distinguish structured finance vehicles from investment companies for those investors? For example, should we permit offerings to the general public if a sponsor or trustee conducts an independent statistical analysis of the anticipated cash flows? Are we correct in our assumption that dropping the rating requirement from the rule will not blur the current distinction between structured finance vehicles and investment companies? If not, should the rule incorporate alternatives to the rule's rating requirement that would clarify the distinction? For example, should the rule contain specific requirements regarding abuses that the Act is designed to address, such as self-dealing and overreaching by the issuer? Does our proposal regarding the deposit of cash flows into a segregated account provide sufficient protection against the possibility of loss while the servicer is handling cash flows pending payment to the fixed income security holders? Would an alternative standard provide better protection?

### **C. Rule 5b-3**

Rule 5b-3 under the Investment Company Act permits a fund, subject to certain conditions, to treat a repurchase agreement as an acquisition of the securities collateralizing the

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necessary for the cash flows derived from eligible assets for the benefit of the holders of fixed-income securities to be deposited periodically in a segregated account that is maintained or controlled by the trustee consistent with the full and timely payment of the outstanding fixed income securities.”

repurchase agreement in determining whether the fund is in compliance with two provisions of the Act that may affect a fund's ability to invest in repurchase agreements.<sup>48</sup> Section 12(d)(3) of the Investment Company Act generally prohibits a fund from acquiring an interest in a broker, dealer, or underwriter. Because a repurchase agreement may be considered to be the acquisition of an interest in the counterparty, section 12(d)(3) may limit a fund's ability to enter into repurchase agreements with many of the firms that act as repurchase agreement counterparties. Section 5(b)(1) of the Act limits the amount that a fund that holds itself out as being a diversified investment company may invest in the securities of any one issuer (other than the U.S. Government). This provision may limit the number and principal amounts of repurchase agreements a diversified fund may enter into with any one counterparty.

Rule 5b-3 allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Act if the obligation of the seller to repurchase the securities from the fund is "collateralized fully."<sup>49</sup> A repurchase agreement is collateralized fully if, among other things, the collateral for the repurchase agreement consists entirely of (i) cash items, (ii) government

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<sup>48</sup> In a typical investment company repurchase agreement, a fund enters into a contract with a broker, dealer, or bank (the "counterparty" to the transaction) for the purchase of securities. The counterparty agrees to repurchase the securities at a specified future date, or on demand, for a price that is sufficient to return to the fund its original purchase price, plus an additional amount representing the return on the fund's investment. Repurchase agreements provide funds with a convenient means to invest excess cash on a secured basis, generally for short periods of time. Economically, a repurchase agreement functions as a loan from the fund to the counterparty, in which the securities purchased by the fund serve as collateral for the loan and are placed in the possession or under the control of the fund's custodian during the term of the agreement. *See* Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 25058 (July 5, 2001) [66 FR 36156 (July 11, 2001)] ("Rule 5b-3 Adopting Release").

<sup>49</sup> Rule 5b-3(a). The term "Collateralized Fully" is defined in rule 5b-3(c)(1). An investment company investing in a repurchase agreement primarily looks to the value and liquidity of the securities collateralizing the repurchase agreement rather than the credit quality of the counterparty for satisfaction of the repurchase agreement.

securities, (iii) securities that at the time the repurchase agreement is entered into are rated in the highest rating category by the “Requisite NRSROs” or (iv) unrated securities that are of a comparable quality to securities that are rated in the highest rating category by the Requisite NRSROs, as determined by the fund’s board of directors or its delegate.<sup>50</sup>

In proposing rule 5b-3, the Commission explained that the highest rating category requirement in the definition of collateralized fully was designed to ensure that the market value of the collateral would remain fairly stable and that the fund could more readily liquidate the collateral quickly in the event of a default.<sup>51</sup>

We propose to eliminate the requirement that collateral other than cash or government securities be rated by an NRSRO. As an alternative, we propose to require that if the collateral is not cash or government securities, the fund’s board of directors (or its delegate) determines that the collateral securities present minimum credit risks and are highly liquid. Specifically, the proposal would require collateral other than cash or government securities to consist of securities that the fund’s board of directors (or its delegate) determines at the time the repurchase agreement is entered into (i) are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time, (ii) are subject to no greater than minimal credit risk, and (iii) are issued by a person that has the highest capacity to meet its financial

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<sup>50</sup> Rule 5b-3(c)(1)(iv). The term “Requisite NRSROs” means any two NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer or, if only one NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the investment company acquires the security, that NRSRO. Rule 5b-3(c)(6). The term “unrated securities” means securities that have not received a rating from the Requisite NRSROs. Rule 5b-3(c)(8).

<sup>51</sup> *See* Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 24050 (Sept. 23, 1999) [64 FR 52476 (Sept. 29, 1999)] (“Rule 5b-3 Proposing Release”), at n.43 and accompanying text.

obligations.<sup>52</sup> Although the rule would no longer require the collateral to be rated by an NRSRO, we anticipate that evaluating credit risk and liquidity of the collateral could incorporate ratings, reports, analyses, and other assessments issued by NRSROs and other persons.<sup>53</sup>

NRSRO ratings are also used in a provision of rule 5b-3 that permits a fund to deem the acquisition of a “refunded security” as the acquisition of the escrowed government securities for purposes of section 5(b)(1)’s diversification requirements.<sup>54</sup> Under this provision, a debt security must satisfy certain conditions to be considered a refunded security under the rule. One of these conditions is that an independent certified public accountant must have certified to the escrow agent that the escrowed securities will satisfy all scheduled payments of principal, interest, and applicable premiums on the refunded securities.<sup>55</sup> This condition is not required, however, if the refunded security has received a debt rating in the highest rating category from an NRSRO.<sup>56</sup>

We are proposing to eliminate the exception to the certification requirement for securities that have received the highest rating from an NRSRO. Rule 5b-3 requires the certification by an independent certified public accountant (together with the other conditions) to ensure that the bankruptcy of the issuer of the pre-refunded securities would not affect payments on the

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<sup>52</sup> Proposed rule 5b-3(c)(1)(iv)(C). Under the proposal, the board would make credit quality determinations for all non-government collateral securities, rather than just unrated securities. As in the current rule, the proposed rule would permit the board to delegate this credit quality and liquidity determination.

<sup>53</sup> A fund that acquires repurchase agreements would have to adopt and implement a written policy reasonably designed to comply with this requirement under rule 38a-1 under the Investment Company Act. *See* rule 38a-1(a) (requiring registered funds to adopt and implement written policies and procedures reasonably designed to prevent the fund’s violation of federal securities laws).

<sup>54</sup> Rule 5b-3(b). Under the rule, a refunded security means a debt security the principal and interest payments of which are to be paid by U.S. government securities that have been irrevocably placed in an escrow account and are pledged only to the payment of the debt security. Rule 5b-3(c)(4).

<sup>55</sup> Rule 5b-3(c)(4)(iii).

<sup>56</sup> *Id.*

securities from the escrow account.<sup>57</sup> The Commission included this exception because in rating refunded securities, NRSROs typically require that an independent third party make the same determination.<sup>58</sup>

We request comment on the proposed amendments. How would the proposed elimination of the rating requirement from the definition of “collateralized fully” affect funds? Would the proposed board determinations sufficiently address our concerns that collateral securities be of high quality in order to limit a fund’s exposure to counterparties’ credit risks? If not, are there additional or alternative standards that would better address our concerns? How would the proposal to eliminate the exception for rated securities from the condition that refunded securities obtain a certification from an independent auditor affect funds? We expect that with respect to rated refunded securities, funds may be able to satisfy the certification requirement by determining that an NRSRO required an independent certified public accountant to make the same determination.<sup>59</sup> Would funds incur any costs in determining that a refunded security has received an accountant certification rather than relying on an NRSRO rating? Is there an alternative standard that would provide an equivalent evaluation? For example, should we permit the board to rely on another independent third party to provide the certification?

#### **D. Rule 10f-3**

Section 10(f) of the Investment Company Act prohibits a registered investment company from purchasing any security for which an affiliated underwriter is acting as a principal

<sup>57</sup> See Rule 5b-3 Adopting Release, *supra* note 48, at text accompanying n.25 (explaining that the conditions required in the definition of refunded security correspond to those in the definition of the term in rule 2a-7); Rule 2a-7 1996 Amending Release, *supra* note 31, at section II.D.2.

<sup>58</sup> See Technical Revisions to the Rules and Forms Regulating Money Market Funds, Investment Company Act Release No. 22921 (Dec. 2, 1997) [62 FR 64968 (Dec. 9, 1997)], at section I.B.2.c.

<sup>59</sup> See, e.g., STANDARD & POOR’S, PUBLIC FINANCE CRITERIA: DEFEASANCE: LEGAL DEFEASANCE CRITERIA, CASH FLOW VERIFICATION (Sept. 8, 2006).

underwriter<sup>60</sup> during the existence of an underwriting or selling syndicate for that security.<sup>61</sup> The prohibition was intended to address Congress's concern that underwriters were "dumping" otherwise unmarketable securities on affiliated funds, either by forcing the fund to purchase unmarketable securities from the underwriting affiliate itself, or by forcing or encouraging the fund to purchase the securities from another member of the syndicate.<sup>62</sup> Congress also expressed concern regarding the amount of underwriting fees earned by the sponsors and affiliated persons who placed the securities with the fund.<sup>63</sup>

The Commission adopted rule 10f-3 in 1958 to permit a fund that is affiliated with members of an underwriting syndicate to purchase securities from the syndicate if certain conditions are met.<sup>64</sup> We amended rule 10f-3 in 1979 to add municipal securities to the class of

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<sup>60</sup> The term "principal underwriter" means (in relevant part) an underwriter who, in connection with a primary distribution for securities: (i) is in privity of contract with the issuer or an affiliated person of the issuer; (ii) acting alone or in concert with one or more other persons, initiates or directs the formation of an underwriting syndicate; or (iii) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution. 15 U.S.C. 80a-2a(a)(29).

<sup>61</sup> Section 10(f) prohibits a fund from purchasing a security during the existence of an underwriting or selling syndicate if a principal underwriter of the security is an officer, director, member of an advisory board, investment adviser, or employee of the fund or is a person of which any such officer, director, member of an advisory board, investment adviser, or employee is an affiliated person. An affiliated person of a fund includes, among others: (i) any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of the fund; (ii) any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the fund; and (iii) any person directly or indirectly controlling, controlled by, or under common control with such other person. 15 U.S.C. 80a-2(a)(3)(A), (B) and (C).

<sup>62</sup> See REPORT OF THE SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 279, 76<sup>th</sup> Cong., 2d Sess., pt. 3, at 2581, 2589 (1939). The sales were also used to alleviate certain of an affiliated underwriter's financial difficulties. For example, an underwriter could benefit by rapidly turning over its securities inventory to produce working capital and to reduce the related expenses of carrying the inventory.

<sup>63</sup> See HEARINGS ON S.3580 BEFORE A SUBCOMMITTEE OF THE COMMISSION ON BANKING AND CURRENCY, 76<sup>th</sup> Cong., 3d Sess. 209, 212-23 (1940).

<sup>64</sup> Adoption of Rule N-10-F-3 Permitting Acquisition of Securities of Underwriting Syndicate Pursuant to Section 10(f) of the Investment Company Act of 1940, Release No. 2797 (Dec. 2,

securities that funds could purchase under the rule.<sup>65</sup> The rule defines municipal securities that may be purchased during an underwriting in reliance on the rule (“eligible municipal securities”) to include securities that have an investment grade rating from at least one NRSRO or, if the issuer or the entity supplying the revenues or other payments from which the issue is to be paid has been in continuous operation for less than three years (*i.e.*, a less seasoned security), one of the three highest ratings from an NRSRO.<sup>66</sup> The Commission explained that the rationale behind the rating requirement was to prevent the purchase of less seasoned securities and reduce the risk of unloading unmarketable securities on the fund.<sup>67</sup>

We propose to eliminate the references to ratings in rule 10f-3, and amend the rule’s definition of “eligible municipal security” to mean securities that are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time. In addition, the securities would have to be 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.<sup>68</sup>

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1958) [23 FR 9548 (Dec. 10, 1958)]. The rule codified the conditions of orders that the Commission had granted prior to 1958 exempting certain funds from section 10(f) to permit them to purchase specific securities.

<sup>65</sup> Exemption of Acquisition of Securities During the Existence of Underwriting Syndicate, Investment Company Act Release No. 10736 (June 14, 1979) [44 FR 36152 (June 20, 1979)] (“Rule 10f-3 1979 Adopting Release”). Rule 10f-3(c)(1)(iii).

<sup>66</sup> Rule 10f-3(a)(3).

<sup>67</sup> Exemption of Acquisition of Securities During the Existence of Underwriting Syndicate, Investment Company Act Release No. 10592 (Feb. 13, 1979) [44 FR 10580 (Feb. 21, 1979)] (“1979 10f-3 Amendments Proposing Release”).

<sup>68</sup> Proposed rule 10f-3(a)(3). The proposed rule would define “eligible municipal securities” to mean “‘municipal securities’ as defined in section 3(a)(29) of the Securities Exchange Act of 1934, that have sufficient liquidity such that they can be sold at or near their carrying value within a reasonably short period of time and either (i) are subject to no greater than moderate credit risk or (ii) if the issuer of the municipal securities, or the entity supplying the revenues or other payments from which the issue is to be paid, has been in continuous operation for less than three years, including the operation of any predecessors, the securities are subject to a minimal or low amount of credit risk.”

Unlike our proposals to amend other rules, we are not proposing to add a requirement that the board of directors make the determination regarding credit risk and liquidity. Rule 10f-3 already requires a fund's directors, including a majority of disinterested directors, to approve procedures regarding purchases made in reliance on the rule and to determine each quarter that all purchases were made in compliance with the procedures.<sup>69</sup> Accordingly, the board, including a majority of disinterested directors, already is required to review purchases of municipal securities made in reliance on the rule, and would continue to do so under our proposal. In addition, pursuant to its oversight role, the board would be required to approve procedures for ensuring that municipal securities meet the proposed conditions for credit quality and liquidity. Although the rule would no longer require municipal securities to be rated by an NRSRO, fund boards of directors would still be able to incorporate quality determinations prepared by outside sources, including ratings, reports, analyses, and other assessments issued by NRSROs and other persons, in their approval of procedures and in their review of transactions under the rule.

We request comment on the proposed amendment to rule 10f-3. What would be the effect of eliminating the rating requirement in the definition of "eligible municipal securities"? Is the proposed standard that municipal securities purchased in reliance on rule 10f-3 present no more than moderate credit risks and are highly liquid sufficient to limit the possibility underwriters may sell unmarketable securities to the fund? Is there an alternative that would

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<sup>69</sup> Rule 10f-3(c)(10). The Commission added the requirement that disinterested directors adopt procedures made in reliance on the rule and periodically review the fund's compliance with these procedures in 1979. *See* Rule 10f-3 1979 Adopting Release, *supra* note 65. At the time, we stressed that in determining specific procedures to be included in the guidelines for transactions in reliance on the rule, the board should be aware generally of the nature of any affiliation that the investment company (or any of its officers, directors, employees or adviser) may have with underwriters and any role the affiliate person would play in mounting the underwriting of a particular issue. *See* 1979 10f-3 Amendments Proposing Release, *supra* note 67, at text preceding n.23. Our proposal would not affect this existing requirement with respect to the purchase of municipal securities.

better address our regulatory concerns?

**E. Rule 206(3)-3T**

Rule 206(3)-3T under the Investment Advisers Act of 1940 establishes a temporary alternative means for investment advisers who are registered with the Commission as broker-dealers to meet the requirements of section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients.<sup>70</sup> That section makes it unlawful for any investment adviser, directly or indirectly “acting as principal for his own account, knowingly to sell any security to or purchase any security from a client . . . , without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.”<sup>71</sup> Rule 206(3)-3T contains several conditions that are designed to prevent overreaching by advisers by requiring an adviser to disclose to its client the conflicts of interest involved in principal transactions, inform the client of the circumstances in which the adviser may effect a trade on a principal basis, and provide the client with meaningful opportunities to refuse to consent to a particular transaction or revoke the prospective general consent to these transactions.<sup>72</sup>

An adviser generally may not rely on the rule for principal trades of securities if the investment adviser or a person who controls, is controlled by, or is under common control with the adviser (“control person”) is the issuer or is an underwriter of the security.<sup>73</sup> As we stated when we adopted the rule, the incentives associated with underwriting securities may bias the

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<sup>70</sup> Rule 206(3)-3T [17 CFR 275.206(3)-3T]. *See also* Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Investment Advisers Act Release No. 2653 (Sept. 24, 2007) [72 FR 55022 (Sept. 28, 2007)] (“Principal Trade Rule Release”).

<sup>71</sup> 15 U.S.C. 80b-6(3).

<sup>72</sup> *See* Principal Trade Rule Release, *supra* note 70, at text accompanying n.28.

<sup>73</sup> Rule 206(3)-3T(a)(2).

advice being provided or lead the adviser to exert undue influence on its client’s decision to invest in the offering or the terms of that investment.<sup>74</sup> The rule contains an exception to this “underwritten securities” exclusion for trades in which the adviser or a control person is an underwriter of non-convertible *investment-grade* debt securities.<sup>75</sup> We provided this exception because non-convertible investment grade debt securities may be less risky and therefore less likely to be “dumped” on clients.<sup>76</sup> The rule defines an “investment grade debt security” as a non-convertible debt security that, at the time of sale, is rated in one of the four highest rating categories of at least two NRSROs.<sup>77</sup>

We propose to amend rule 206(3)-3(T), to eliminate an adviser’s ability to rely exclusively on NRSRO ratings to determine whether a security is investment grade for purposes of the rule. Instead, the adviser would have to make its own assessment taking into account specified criteria, including that the security: (i) has no greater than moderate credit risk; and (ii) is sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time.<sup>78</sup>

Finally, as we stated when we adopted rule 206(3)-3T, an adviser subject to rule 206(4)-7 of the Advisers Act must adopt and implement written policies and procedures reasonably

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<sup>74</sup> Principal Trade Rule Release, *supra* note 70, at n.35 and accompanying and following text.

<sup>75</sup> *Id.* at text accompanying n.36. There is no exception if the adviser or a control person is the issuer of the securities.

<sup>76</sup> *Id.* at text following n.36. We also noted in the Principal Trade Rule Release that it may be easier for clients to identify whether the price they are being quoted for a non-convertible investment grade debt security is fair given the relative comparability, and the significant size, of the non-convertible investment grade debt markets. *Id.*

<sup>77</sup> Rule 206(3)-3T(c).

<sup>78</sup> Proposed rule 206(3)-3T(c). Although the proposed amendment would no longer require a security underwritten by an adviser or its control person to be rated by NRSROs to be eligible under the rule, investment advisers could refer to ratings, reports, analyses, and other assessments issued by NRSROs and other persons, for the purpose of evaluating credit risk and liquidity.

designed to prevent violations of the Advisers Act (and the rules thereunder) by the adviser or any of its supervised persons.<sup>79</sup> An adviser seeking to rely on rule 206(3)-3T, therefore, would have to adopt and implement policies and procedures that address the adviser's methodology for determining whether a security is investment grade quality.

We request comment on our proposed revised definition of "investment grade debt security." Is it appropriate for us to allow advisers seeking to rely upon the rule to determine whether a security is investment grade based on the criteria in the rule? Is there another definition of "investment grade" elsewhere in the federal securities laws that we should incorporate by reference into the rule? Are there alternative methods to ensure that advisers seeking to rely on the exception to the underwriting exclusion do so only with respect to investment grade debt? Are there alternative or additional factors we should require an adviser to consider in making its determination? In addition, we expect that advisers, in order to establish their eligibility to rely on the rule, would document their determination that a security is investment grade quality, as well as the process for making such a determination. Are we correct? Should we make such documentation an explicit requirement of the rule, or amend rule 204-2 under the Advisers Act<sup>80</sup> (the books and records rule) to require such documentation?

#### **IV. REQUEST FOR COMMENT**

We request comment on the rule amendments proposed in this release. We also request suggestions for additional changes to existing rules, and comments on other matters that might

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<sup>79</sup> Principal Trade Rule Release, *supra* note 70, at nn.56-58 and accompanying text. In that connection, an adviser seeking to rely on rule 206(3)-3T, as proposed to be amended, would need to adopt and implement policies and procedures reasonably designed to ensure that the adviser's methodology for determining investment grade quality is consistent with the adviser's legal obligations.

<sup>80</sup> 17 CFR 275.204-2.

have an effect on the proposals contained in this release. Commenters are requested to provide empirical data to support their views.

## **V. PAPERWORK REDUCTION ACT**

Certain provisions of the proposed amendments to rules 2a-7, 3a-7, 5b-3, and 10f-3 under the Investment Company Act, and rule 206(3)-(3)T under the Investment Advisers Act, contain “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>81</sup> The Commission is submitting this proposal to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The titles for the collections of information are: “Rule 2a-7 under the Investment Company Act of 1940, Money market funds” (OMB Control No. 3235-0268); “Rule 10f-3 under the Investment Company Act of 1940, Exemption for the Acquisition of Securities During the Existence of an Underwriting and Selling Syndicate” (OMB Control No. 3235-0226); and “Temporary rule for principal trades with certain advisory clients, rule 206(3)-3T” (OMB Control No. 3235-0630). There are currently no approved collections for rules 3a-7 and 5b-3, and the proposed amendments would not create any new collections. We adopted the rules pursuant to the Investment Company Act and the Investment Advisers Act.

Our proposed amendments are designed to address the risk that the reference to and required use of NRSRO ratings in our rules:

- is interpreted by investors as an endorsement of the quality of the credit ratings issued by NRSROs; and
- encourages investors to place undue reliance on NRSRO ratings.

An agency may not conduct or sponsor, and a person is not required to respond to, a

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<sup>81</sup> 44 U.S.C. 3501-3520.

collection of information unless it displays a currently valid control number.

**A. Rule 2a-7**

Rule 2a-7 under the Investment Company Act exempts money market funds from the Act's valuation requirements, permitting money market funds to maintain stable share pricing, subject to certain risk-limiting conditions. We propose to amend rule 2a-7 in four principal ways to: (i) rely on money market fund boards of directors (who usually rely on the funds' advisers) to determine that each portfolio instrument presents minimal credit risks, and whether the security is a "First Tier Security" or a "Second Tier Security;" (ii) add a portfolio liquidity requirement to the rule that would require that money market funds hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions, and expressly limit their investment in illiquid securities to not more than 10% of their total assets; (iii) in the event the money market fund's investment adviser becomes aware of any new 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, the proposal would amend rule 2a-7's downgrade and default provisions to require a money market fund's board of directors to reassess promptly whether the portfolio security continues to present minimal credit risks; and (iv) require a money market fund to notify the Commission of the purchase of a money market fund's portfolio security by an affiliated person in reliance on rule 17a-9 under the Investment Company Act.<sup>82</sup> The proposed amendments also would make conforming amendments to rule 2a-7's record keeping and reporting requirements.<sup>83</sup>

The proposed amendments to rule 2a-7 would impose a new reporting obligation on

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<sup>82</sup> See rule 17a-9.

<sup>83</sup> See proposed rule 2a-7(c)(11).

money market funds. The proposed reporting requirement to notify the Commission of the purchase of a money market fund's portfolio securities by an affiliated person in reliance on rule 17a-9 under the Investment Company Act is designed to assist Commission staff in overseeing money market funds' affiliated transactions that are otherwise prohibited. If adopted, the new collection of information would be mandatory for money market funds. Information submitted to the Commission related to a rule 17a-9 transaction would be accorded confidential treatment to the extent permitted by law.<sup>84</sup>

Commission staff estimates that there are 808 money market funds, all of whom are subject to rule 2a-7.<sup>85</sup> Of these money market funds, Commission staff estimates that an average of 10 funds per year would be required to provide notice to the Commission of a rule 17a-9 transaction, with the total annual responses per fund, on average, requiring .5 hours of an attorney's time at a cost of \$147.50.<sup>86</sup> Given these estimates, we estimate that the total annual burden of the proposed amendments to rule 2a-7 for all money market funds would be approximately 5 hours and \$1,475.<sup>87</sup>

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<sup>84</sup> See, e.g., 17 CFR 200.83.

<sup>85</sup> These include registered money market funds and series of registered money market funds. See Investment Company Institute, *Trends in Mutual Fund Investing April 2008*, May 29, 2008, available at [http://www.ici.org/stats/latest/trends\\_04\\_08.html](http://www.ici.org/stats/latest/trends_04_08.html).

<sup>86</sup> Based on information provided by money market fund representatives, Commission staff estimates the cost would equal 0.5 hours of an attorney's time at \$295 per hour (0.5 hours x \$295 per hour = \$147.50). The estimated hourly wages used in this PRA analysis were derived from reports prepared by the Securities Industry and Financial Markets Association. See Securities Industry and Financial Markets Association, *Report on Management and Professional Earnings in the Securities Industry – 2007* (2007), modified to account for an 1800-hour work year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead; and Securities Industry and Financial Markets Association, *Office Salaries in the Securities Industry – 2007* (2007), modified to account for an 1800-hour work year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

<sup>87</sup> These estimates are based on the following calculations: (10 money market funds x .5 hours) = 5 hours; (10 money market funds x 147.50) = \$1,475.

We seek comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide data that would allow us to make more accurate estimates.

**B. Rule 3a-7**

Rule 3a-7 under the Investment Company Act excludes structured finance vehicles from the Act's definition of "investment company" subject to certain conditions. The conditions include the requirement that structured financings offered to the general public are rated by at least one NRSRO in one of the four highest rating categories. The proposed amendments would: (i) eliminate rule 3a-7's reliance on ratings by eliminating the exclusion for structured financings offered to the general public; (ii) remove the reference to ratings downgrades in the section of the rule that addresses substitution of eligible assets; and (iii) amend the portion of the rule that deals with safekeeping of assets. Commission staff estimates that the proposal may result in a new collection of information but any collection of information would not have an associated burden. Although in the condition in rule 3a-7 dealing with the substitution of assets, the proposed amendments would require the issuer to have procedures to ensure that the acquisition or disposition of assets does not adversely affect the full and timely payment of the outstanding fixed income securities, Commission staff believes that almost all issuers currently have these procedures in place.

We request comment on whether issuers currently have these procedures in place.

**C. Rule 5b-3**

Rule 5b-3 under the Investment Company Act allows funds to treat the acquisition of a repurchase agreement as an acquisition of securities collateralizing the repurchase agreement for purposes of sections 5(b)(1) and 12(d)(3) of the Investment Company Act under certain conditions. We propose to amend rule 5b-3 by requiring a fund's board of directors, or its

delegate, to determine that the securities collateralizing a repurchase agreement present minimum credit risks and are highly liquid.<sup>88</sup> To that end, the fund's board of directors, pursuant to rule 38a-1 under the Investment Company Act, would have to develop procedures to ensure that at the time the repurchase agreement is entered into the securities meet the requirements for collateral outlined in the amendments to the proposed rule. These procedures are necessary to make sure that the market value of the collateral remains fairly stable and that the fund would be able to liquidate the collateral quickly in the event of a default.<sup>89</sup> This collection of information would be mandatory for funds that rely on rule 5b-3. Records of information made in connection with this requirement would be required to be maintained for inspection by Commission staff, but the collection would not otherwise be submitted to the Commission.

The existing rule provides that unrated securities are collateral if the fund's board, or its delegate, makes the determination that the unrated securities are comparable to securities that are rated in the highest rating category by the Requisite NRSROs.<sup>90</sup> Thus, fund boards may have existing procedures regarding credit quality determinations for unrated securities. In addition, as a matter of good business practice, we believe that some funds currently evaluate the credit risk and liquidity of rated securities. Thus, we believe that most funds already have procedures to evaluate collateral securities. As of March 31, 2008, 4,714 investment companies were registered with the Commission. Commission staff estimates that 90% of all registered investment companies, or 4,243 funds, currently have procedures for evaluating collateral securities. Commission staff therefore estimates that 471 funds would need to develop

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<sup>88</sup> Proposed rule 5b-3(c)(1)(iv)(C).

<sup>89</sup> See Rule 5b-3 Proposing Release, *supra* note 51, at text accompanying n.43.

<sup>90</sup> Rule 5b-3(c)(1)(iv)(D).

procedures and evaluate collateral securities, and the staff estimates this would involve a one-time burden of 942 hours and an ongoing burden of 5,652 hours, at a cost of approximately \$1,294,308.<sup>91</sup>

We seek comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide data that would allow us to make more accurate estimates.

#### **D. Rule 10f-3**

Rule 10f-3, permits funds that are affiliated with members of an underwriting syndicate to purchase securities from the syndicate if certain conditions are met. We are proposing to amend the rule's definition of "eligible municipal securities" to include credit quality and liquidity requirements.

Under the current rule, fund boards are required to approve procedures regarding purchases made in reliance on the rule and to determine each quarter that all purchases were made in compliance with the procedures.<sup>92</sup> Accordingly, the board currently reviews purchases of municipal securities made in reliance on the rule, and would continue to do so under our proposal. Pursuant to the amendments to the proposed rule, fund boards would need to approve additional procedures for ensuring that municipal securities meet the standards for credit quality and liquidity. These procedures are necessary to eliminate any possibility that an affiliated underwriter may "unload" otherwise unmarketable securities on a fund. This collection of

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<sup>91</sup> Commission staff estimates that each fund board would incur a one-time burden of 2 hours to develop procedures for evaluating credit and liquidity risks (471 boards x 2 hours = 942 hours). Commission staff believes that any incidental costs incurred by boards of directors would be incorporated into funds' overall board costs and would not add any particular costs. In addition, staff estimates that a board delegate would spend an average of 1 hour to evaluate the credit risks for the collateral for each of an average of 12 repurchase agreements each year (471 funds x 12 hours = 5,652 hours). Assuming the evaluation would be performed by a senior business analyst (at \$229 per hour), the total cost estimate would be \$1,294,308.

<sup>92</sup> Rule 10f-3(c)(10).

information would be mandatory for funds that rely on rule 10f-3. Records of information made in connection with this requirement would be required to be maintained for inspection by Commission staff, but the collection would not otherwise be submitted to the Commission.

In our most recent PRA submission, we estimated that approximately 350 funds engage in rule 10f-3 transactions each year. We further estimated that each fund would, on average, take two hours to review and revise, as needed, written procedures for rule 10f-3 transactions. We believe that any revisions funds would have to make to comply with the proposed amendments would be incorporated in the two hours of review. Accordingly, we do not believe that the proposed amendments to rule 10f-3 would change the burdens currently approved for rule 10f-3.

We seek comment on these estimates. If commenters believe these estimates are not reasonable, we request they provide data that would allow us to make more accurate estimates.

**E. Rule 206(3)-3T**

Rule 206(3)-3T under the Advisers Act establishes a temporary alternative means for investment advisers who are registered with the Commission as broker-dealers to meet the requirements of section 206(3) of the Advisers Act when they act in a principal capacity in transactions with certain of their advisory clients. So long as each condition of the rule is met, an eligible adviser may provide the transaction-by-transaction disclosure required under section 206(3) of the Advisers Act either orally or in writing. One condition of the rule is that an adviser generally may not rely on rule 206(3)-3T for principal trades of securities if the investment adviser or a person who controls, is controlled by, or is under common control with the adviser (“control person”) is the issuer or is an underwriter of the security. The rule contains an exception to this “underwritten securities” exclusion for trades in which the adviser or a control person is an underwriter of non-convertible *investment-grade* debt securities. The proposed

amendment to rule 206(3)-3T would modify the definition of “investment grade debt security” to mean a non-convertible debt security that, at the time of sale, the investment adviser has determined to be subject to no greater than moderate credit risk and sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time.

Under the proposed amendment to rule 206(3)-3T, there is a single new collection burden. Pursuant to its obligations under rule 206(4)-7 under the Advisers Act, an adviser seeking to rely on rule 206(3)-3T must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act that address the adviser’s methodology for determining whether a security is investment grade quality pursuant to the definition. This collection of information is designed to minimize the incentives associated with underwriting securities that may bias the advice being provided or may lead the adviser to exert undue influence on its client’s decision to invest in the offering or the terms of that investment. Although the rule does not call for any of the information collected to be provided to us, to the extent advisers include any of the information in a filing, such as Form ADV, the information would not be kept confidential.

We anticipate that the burden associated with this collection would mostly be borne upfront as advisers develop their policies and procedures for how to identify non-convertible investment grade debt securities in connection with the credit risk and liquidity elements specified under the rule. This would require drafting the policies and procedures, potentially subjecting them to review of outside counsel, implementing them, and explaining their contours in the adviser’s Form ADV.

We estimate that the average burden for drafting the required policies and procedures for each eligible adviser that chooses to rely on the rule in connection with underwritten securities in

particular, would be approximately 10 hours on average. Further, we expect the drafting burden would be uniform with respect to each eligible adviser regardless of how many individual non-discretionary advisory accounts that adviser administers or seeks to engage with in principal trading. As of June 1, 2008, there were 639 advisers that were eligible to rely on the temporary rule (*i.e.*, also registered as broker-dealers), 409 of which indicate that they have non-discretionary advisory accounts.<sup>93</sup> We estimate that 90% of those 409 advisers, or a total of 368 of those advisers, rely on the rule.<sup>94</sup> Of those, we estimate that only 50% would seek to engage in principal trades with clients of securities they or a control person underwrote. Thus, we estimate that the total number of advisers who would rely on the non-convertible investment grade debt exception to the “underwritten securities” exclusion under the rule would be approximately 185.

Accordingly, we estimate that the total burden for creating initial policies and procedures under the proposal for the estimated 185 advisers that would rely on the rule would be 1,850 hours.<sup>95</sup> We also estimate an average one-time cost for the preparation of the policies and procedures for approximately three hours of outside legal counsel time of \$1,200 per eligible adviser on average,<sup>96</sup> for a total of \$222,000.<sup>97</sup>

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<sup>93</sup> IARD data as of June 1, 2008, for Items 6.A(1) and 5.F(2)(e) of Part 1A of Form ADV.

<sup>94</sup> We anticipate that most investment advisers that are dually registered as broker-dealers will make use of the rule to engage in, at a minimum, riskless principal transactions to limit the need for these advisers to process trades for their advisory clients with other broker-dealers. We estimate that 10% of these advisers will determine that the costs involved to comply with the rule are too significant in relation to the benefits that the adviser, and their clients, will enjoy.

<sup>95</sup> This estimate is based on the following calculation: 10 hours per adviser x 185 eligible advisers that will rely on the rule = 1,850 total hours.

<sup>96</sup> Outside legal fees are in addition to the projected 10 hours per adviser burden discussed in note 95 and accompanying text.

<sup>97</sup> This estimate is based on the following calculation: (\$400 per hour x 3 hours x 185 advisers = \$222,000).

**F. Request for Comments**

We request comment on whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and should send a copy to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-19-08. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-19-08, and be submitted to the Securities and Exchange Commission, Public Records Management Office Room, 100 F Street, NE, Washington, DC 20549-1110.

## **VI. COST-BENEFIT ANALYSIS**

The Commission is sensitive to the costs and benefits imposed by its rules. We have identified certain costs and benefits of the proposed amendments and request comment on all aspects of this cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in this analysis. We seek comment and data on the value of the benefits identified. We also welcome comments on the accuracy of the cost estimates in each section of this analysis, and request that commenters provide data that may be relevant to these cost estimates. In addition, we seek estimates and views regarding these costs and benefits for particular covered institutions, including small institutions, as well as any other costs or benefits that may result from the adoption of these proposed amendments.

As discussed above, the proposed rule amendments are designed to address the risk that the reference to and use of NRSRO ratings in our rules is interpreted by investors as an endorsement of the quality of the credit ratings issued by NRSROs, and may encourage investors to place undue reliance on the NRSRO ratings. The proposed amendments to rules 2a-7, 3a-7, 5b-3, and 10f-3 under the Investment Company Act and rule 206(3)-(3)T under the Investment Advisers Act would eliminate the reference to and requirement for the use of NRSRO ratings in these rules.

### **A. Benefits**

The Commission anticipates that one of the primary benefits of the proposed amendments, if adopted, would be the benefit to investors of reducing their possible undue reliance on NRSRO ratings that could be caused by references to NRSROs in our rules. An over-reliance on ratings can inhibit independent analysis and could possibly lead to investment decisions that are based on incomplete information. The purpose of the proposed rule amendments is to encourage investors to examine more than a single source of information in

making an investment decision. Eliminating reliance on ratings in the Commission's rules could also result in greater investor due diligence and investment analysis. In addition, the Commission believes that eliminating the reliance on ratings in its rules would remove any appearance that the Commission has placed its imprimatur on certain ratings.

More specifically, the principal benefit of the proposed amendments to rule 2a-7 would be to emphasize the importance of money market funds making independent assessments of credit risks. The benefit of the proposed amendments to rule 3a-7 would be to emphasize that ratings are not necessary for accredited investors and qualified institutional buyers to protect themselves in evaluating structured finance vehicles issued under the rule. Similarly, the benefit of the proposed amendments to rules 5b-3 and 10f-3 would be to emphasize the importance to funds that acquire repurchase agreements or securities in an affiliated underwriting of making an independent evaluation of the credit risks associated with the collateral or the underwritten security, respectively. In addition, by moving away from a required reliance on credit ratings in our rules, funds may benefit by acquiring a wider range of securities that present attractive investment opportunities and the requisite level of credit risks, although they do not meet the current rules' ratings requirements. The principal benefit of the proposed amendment to rule 206(3)-3T would be to allow advisers to consider factors other than only a rating by NRSROs of the credit quality of a debt security for purposes of eligibility of the rule. Advisers would determine, based upon established criteria of whether the security presents no more than moderate credit risk and has sufficient liquidity, whether a security is investment grade for purposes of the rule. Investment advisers could, in addition to considering NRSRO ratings, weigh various factors and consider a security's credit quality based on those qualitative and quantitative elements it deems most relevant. An additional benefit of the proposed amendment

would be that non-discretionary advisory clients of advisers also registered with us as broker-dealers may have easier access to a wider range of securities. This, in turn, would increase liquidity in the markets for these securities and promote capital formation in these areas. These benefits are difficult to measure quantitatively, but qualitatively we believe the potential benefits are significant.

We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. Commenters are also requested to identify sources of empirical data that could be used for the metrics they propose.

## **B. Costs**

We anticipate that funds and investment advisers could incur certain costs if the proposed amendments are adopted. Funds and investment advisers may incur additional costs if they perform a more detailed and comprehensive analysis before making an investment decision. Such costs are difficult to measure, but we believe that they would be justified by the benefits related to a more informed investment decision as discussed in the previous section. In addition, the purpose of the proposal is to emphasize that it is not the Commission's intent to encourage investors to place undue reliance on NRSRO ratings in making investment decisions. In many cases, investors may still choose to rely solely on NRSRO ratings without incurring additional costs.

Additionally, in proposing to remove the ratings requirements from our rules, we would broaden the set of potential investments available to funds and investment advisers. For example, under the proposed amendments to rule 2a-7, money market funds would be able to invest in securities that have received credit ratings outside of the two highest short-term rating categories. It is possible that some investors, funds, or investment advisers may incur additional costs if funds and investment advisers use this expanded discretion to purchase (or sell in the

case of principal transactions under rule 206(3)-3T) risky or illiquid securities. We believe that these potential costs would be mitigated, however, by market forces, including, in the case of money market funds, investors' desire to maintain the principal value of their investments.

We request comment on these costs. Would eliminating the rating requirements from our rules affect the amount or nature of risks that investment companies and investment advisers would be willing or able to take? We request comment on available metrics to quantify these costs and any other costs the commenter may identify. Commenters are also requested to identify sources of empirical data that could be used for the metrics they propose.

*Rule 2a-7.* We anticipate that the proposed amendments to rule 2a-7 would impose minimal new costs on a portion of money market funds. In general, we expect that money market fund boards of directors (or their delegates) would incur no additional costs in making credit and liquidity risk determinations regarding portfolio securities because the proposed rules would codify the determinations regarding credit risk and liquidity that we believe boards (or their delegates) make under the current rule. Some money market funds, however, would incur costs to notify the Commission regarding rule 17a-9 transactions. For purposes of the PRA analysis, Commission staff estimates that on average 10 money market funds each year are likely to provide notices regarding rule 17a-9 transactions, at a cost of approximately \$1,475.<sup>98</sup> We request comment on these cost estimates. Do commenters foresee additional or alternative costs if the proposed amendments to rule 2a-7 are adopted? Have we accurately estimated the number of money market funds that would have to report rule 17a-9 transactions annually? Have we accurately estimated money market funds' potential costs in reporting rule 17a-9 transactions?

*Rule 3a-7.* Our proposed amendments to rule 3a-7 under the Investment Company Act

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<sup>98</sup> See *supra* note 87 and accompanying text.

may impose minor costs. Specifically, retail investors who are able, because of the rule, to buy structured finance products would no longer be able to participate in the market. We understand that these products generally are not marketed to retail investors, however, and the number of retail investors affected, if there are any, may be quite low. The proposed amendments also may result in more limited access to capital for issuers of structured financings to the extent there is a retail market that is eliminated under the proposed amendments. All investors who hold structured finance products bought under the existing rule may bear some costs of reduced liquidity to the extent a retail market no longer exists because the pool of potential buyers in the secondary market may be reduced. These costs are difficult to assess given that any existing market may be very small.

Commission staff estimates the following potential costs associated with the proposed amendments to rule 3a-7:

- *Costs to retail investors* – Retail investors may incur certain opportunity costs under the proposal because they would not be able to purchase the securities of structured finance vehicles that rely on rule 3a-7. These potential costs may be mitigated, however, because we understand, based on staff experience that this market, if it exists, represents a very small amount of all structured finance products (perhaps less than 1% of the \$306.7 billion in asset-backed securities issued in 2007).<sup>99</sup>
- *Procedures for the acquisition or disposition of assets* – Although we are proposing to remove rule 3a-7's rating requirement, we anticipate that structured

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<sup>99</sup> See Worldwide ABS Issuance, Asset-Backed Alert: The Weekly Update on Worldwide Securitization (June 13, 2008), p.11.

financing vehicles would be rated by the NRSROs. We expect that market participants generally will continue to require that issuers obtain ratings.

Accordingly, as a matter of good business practice, Commission staff estimates that almost all issuers will continue to have procedures in place to ensure that the acquisition or disposition of assets does not adversely affect the full and timely payments to outstanding security holders. Thus, Commission staff believes that the proposed amendments would not impose any new cost burdens on issuers.

- *Deposits in segregated accounts* –We believe that almost all issuers have already taken the actions necessary for cash flows to be deposited in segregated accounts consistent with the full and timely payment of outstanding fixed income securities in meeting the current rule’s ratings requirement. Commission staff does not anticipate any new costs associated with this provision of the proposal.

We request comment on these cost estimates. Are structured financings offered to the retail market under rule 3a-7? If so, how large is the retail market for these products? What costs would retail investors incur if the proposed amendments are adopted? How would retail investors sell or dispose of their current structured finance vehicle holdings if the proposed amendments were adopted? How should any opportunity costs investors may face if the proposed amendments are adopted be quantified? Would there be any new costs associated with developing procedures for the acquisition or disposition of assets and deposits in segregated accounts?

*Rule 5b-3.* Our proposed amendments to rule 5b-3 under the Investment Company Act may impose costs on funds that rely on the rule. Specifically, a fund’s board of directors, or its delegate, pursuant to rule 38a-1 under the Investment Company Act, would be required to

develop written policies and procedures to ensure that at the time the repurchase agreement is entered into the collateral meets the requirements outlined in the amendments to the proposed rule.<sup>100</sup> The proposal would require collateral other than cash or government securities to consist of securities that the fund's board of directors (or its delegate) determines at the time the repurchase agreement is entered into: (i) are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time; (ii) are subject to no greater than minimal credit risk, and (iii) the issuer of which has the highest capacity to meet its financial obligations. The existing rule provides that collateral may consist of unrated securities if the fund's board, or its delegate, makes the determination that the unrated securities are comparable to securities that are rated in the highest rating category by the Requisite NRSROs. Consistent with the requirements of rule 38a-1 under the Investment Company Act, we expect that fund boards would have existing procedures regarding credit quality determinations for unrated securities. In addition, as a matter of good business practice, we believe that most funds currently evaluate the credit risk and liquidity of rated securities. Thus, we believe that most funds already have procedures to evaluate collateral securities. For purposes of the PRA analysis, Commission staff estimates that 90% of all investment companies, or 4,243 funds, currently have procedures for evaluating collateral securities.<sup>101</sup> Commission staff therefore estimates that 471 funds would need to develop procedures and evaluate collateral securities, at an annual cost of approximately \$1,294,308.<sup>102</sup>

Our proposed amendments to rule 5b-3 may result in another cost to affected funds.

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<sup>100</sup> Rule 38a-1(a).

<sup>101</sup> *See supra* text preceding note 90.

<sup>102</sup> *See supra* note 91.

Currently, NRSRO ratings are used in a provision of rule 5b-3 that permits a fund to deem the acquisition of a “refunded security” as the acquisition of the escrowed government securities for purposes of section 5(b)(1)’s diversification requirements.<sup>103</sup> Under this provision, a debt security must satisfy certain conditions to be considered a refunded security under the rule. One of these conditions is that an independent certified public accountant must have certified to the escrow agent that the escrowed securities would satisfy all scheduled payments of principal, interest, and applicable premiums on the refunded securities.<sup>104</sup> This condition is not required, however, if the refunded security has received a debt rating in the highest rating from an NRSRO.<sup>105</sup>

We propose to eliminate the exception to the certification requirement for securities that have received the highest rating from an NRSRO. As previously discussed, the Commission included this exception because in rating refunded securities, NRSROs typically require that an independent third party make the same determination.<sup>106</sup> As previously noted, Commission staff believes that market pressures currently require almost all issuers to have refunded securities certified by an independent accountant. To the extent that refunded securities are rated, and the rating agency requires certification by an independent certified public accountant, funds would not incur additional costs in determining whether a security had been certified in accordance with the rule. Accordingly, we do not expect there would be a change in current costs to issuers as a

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<sup>103</sup> Under the rule, a refunded security is defined as a debt security the principal and interest payments of which are to be paid by U.S. government securities that have been irrevocably placed in an escrow account and are pledged only to the payment of the debt security. Rule 5b-3(c)(4).

<sup>104</sup> Rule 5b-3(c)(4)(iii).

<sup>105</sup> *Id.*

<sup>106</sup> See rule 5b-3 Proposing Release, *supra* note 51.

result of this proposal.

We request comment on these cost estimates. Do commenters foresee additional or alternative costs if the proposed amendments to rule 5b-3 are adopted? Have we accurately estimated current and future costs for collateral procedures? Are we correct in estimating that funds are unlikely to incur any additional costs in determining that a refunded security has received an accountant certification?

*Rule 10f-3.* We do not believe that our proposed amendments to rule 10f-3 would impose costs on funds that rely on rule 10f-3 to purchase municipal securities. Under the current rule, fund boards are required to adopt procedures regarding purchases made in reliance on the rule and to determine each quarter that all purchases were made in compliance with the procedures.<sup>107</sup> Commission staff estimates that these costs would not change. As noted above in our analysis of the PRA, we currently estimate that boards spend, on average, two hours each year to review and revise their procedures for acquiring securities in compliance with the conditions in rule 10f-3. We believe that any changes funds would make to their procedures in order to comply with the proposed amendments to the rule would be included in this annual review and revision.

We request comment on these cost estimates. Have we accurately estimated the costs associated with the proposal's required additional procedures for purchases of municipal securities? Do commenters foresee additional or alternative costs if the proposed amendments to rule 10f-3 are adopted?

*Rule 206(3)-3T.* In lieu of relying exclusively on credit ratings to determine eligibility for principal trading of underwritten securities under the rule, advisers would need to make a determination of a security's credit risk and liquidity. This determination would impose some

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<sup>107</sup> Rule 10f-3(c)(10).

costs on advisers. Advisers seeking to rely on the exception would need to develop and implement procedures regarding their eligibility determinations in accordance with their responsibilities under Advisers Act rule 206(4)-7. And, in making their determinations, many advisers would expend resources beyond merely obtaining credit ratings from NRSROs, as is required under the current rule.

Commission staff estimates that the costs of preparing the procedures for making the determinations of credit quality and liquidity under the rule would be borne upfront. Once generated, reviewed, and implemented by eligible advisers, advisers would be able to follow them for purposes of making further determinations of eligibility for underwritten securities under the requirements of the rule. For purposes of the PRA analysis, our staff has estimated the number of hours and costs the average adviser would spend in the initial preparation of its policies and procedures.<sup>108</sup> Based on those estimates, our staff estimates that advisers would incur costs of approximately \$1,820 on average per adviser, including legal consultation.<sup>109</sup> Assuming there are 185 eligible advisers (*i.e.*, advisers that also are registered broker-dealers) that would prepare relevant policies and procedures, our staff estimates that the total costs would be \$336,700.<sup>110</sup>

We request comment on these cost estimates. Are the cost estimates accurate regarding

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<sup>108</sup> See *supra* note 97 and accompanying text. We estimate the following burdens and/or costs: (i) for drafting the policies and procedures, approximately 10 hours on average per eligible adviser, of which we estimate there are 185, for a total of 1,850 hours; and (ii) for utilizing outside legal professionals in the preparation of the policies and procedures, approximately \$1,200 on average per eligible adviser, for a total of \$222,000.

<sup>109</sup> We estimate that the internal preparation function will most likely be performed by a compliance clerk at \$62 per hour. \$62 per hour x 10 hours = \$620 on average per adviser of internal costs for preparation of the policies and procedures. \$620 on average per adviser of internal costs + \$1,200 on average per adviser of costs for outside legal counsel = \$1,820 on average per adviser.

<sup>110</sup> This estimate is based on the following calculation: \$1,820 on average per adviser x 185 advisers = \$336,700 in total costs for preparation of the policies and procedures.

the proposed procedures for making credit quality determinations? Do commenters foresee additional or alternative costs if the proposed amendments to rule 206(3)-3T are adopted?

### **C. Request for Comment**

We request comment on all aspects of this cost-benefit analysis, including comment as to whether the estimates we have used in our analysis are reasonable. We welcome comment on any aspect of our analysis, including the estimates and the assumptions we have described. In particular, we request comment as to any costs or benefits we may not have considered here that could result from the adoption of the proposed amendments. We also request comment on the numerical estimates discussed above, and request comment on specific costs and benefits from covered institutions that have experienced any of the situations analyzed above.

## **VII. CONSIDERATION OF PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION**

Investment Company Act section 2(c) and Investment Advisers Act section 202(c) require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.<sup>111</sup> If adopted, the Commission believes that these amendments would reduce the potential for over-reliance on ratings, and thereby promote investor protection. The Commission anticipates that these proposed amendments would improve investors' ability to make informed investment decisions, which would therefore lead to increased efficiency and competitiveness of the U.S. capital markets. The Commission expects that this increased market efficiency and investor confidence also may encourage more efficient capital formation.

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<sup>111</sup> 15 U.S.C. 80a-2(c) and 15 U.S.C. 80b-2(c).

*Efficiency.* As discussed above, the proposed amendments could result in additional costs for investment companies and registered investment advisers, which could affect the efficiency of these institutions. The proposed amendments to rule 2a-7 may slightly decrease the efficiency of certain money market funds, to the extent that any funds may be relying exclusively on credit ratings to make current minimal credit risk determinations. We believe that independently generated assessments of credit risks are important, however, and a slight decrease in efficiency may be warranted. Our proposed amendments to rule 3a-7 may reduce market efficiency by limiting the ability of retail investors who invest in structured financing vehicles. However, the proposal to eliminate sales of structured finance vehicles to the retail market would clearly delineate investors who are eligible to buy these products, which may increase market efficiency.

Ratings provide a standard for retail investors, funds, and advisers alike. By eliminating reliance on ratings, the proposed amendments may have a negative impact on efficiency by eliminating an objective standard in credit quality determinations. The proposed amendments also could decrease efficiency to the extent that funds acquired securities that do not meet the particular ratings requirement and that result in the concerns that the rating requirements were designed to address. On the other hand, the proposed amendments may result in some increased market efficiency by affording funds access to securities that do not meet the rating requirements in the current rules, but that would satisfy the credit risk and liquidity standards in the proposed amendments. We do not anticipate that the proposed amendments to rules 2a-7, 5b-3, and 10f-3 would have other impacts on the efficiency of funds that rely on those rules. The proposed amendments to rule 206(3)-3T may increase efficiency by affording clients access to certain investment grade debt securities underwritten by the adviser or its affiliate that they might not have had access to under the standard requiring NRSRO ratings.

*Competition.* If investors believe the proposed amendments to rule 2a-7 would make the rule less rigorous in part because of the loss of an independent third party check on money market fund investments, they may turn to other cash investment vehicles they perceive as offering greater protections. In addition, investors in money market funds may unduly rely on ratings of the money market funds themselves as a proxy for the quality and safety of these funds' portfolio securities. This may potentially increase costs to money market funds that would not otherwise seek ratings. The proposed amendments to rule 3a-7, may impact certain issuers of structured finance vehicles that, for example, may specialize in the retail market if they had some competitive advantage, such as a distribution channel. Eliminating the exclusion for structured finance vehicles offered to retail investors may make these issuers less competitive in this market. The proposed amendments to rule 206(3)-3T may promote competition because, by providing a more subjective standard for the underwritten securities exception, they may increase the alternative sources of the security for the client without diminishing the adviser's best execution obligations, thereby potentially improving price. We do not believe the proposed amendments to rules 5b-3 or 10f-3 would significantly affect competition because these amendments would apply to all money market funds and other funds.

*Capital formation.* We do not believe the proposed amendments to the rules would have a significant effect on capital formation. To the extent potential money market fund investors may react positively to money market funds' independent credit risk assessments and management of risks, we believe any effect the proposed amendments to rule 2a-7 may have on capital formation would be positive. Our proposed amendments to rule 3a-7 would limit capital formation for issuers that offer structured finance products to retail investors in reliance on rule 3a-7. The proposed amendments would have no effect on the ability of issuers who rely on rule

3a-7 to offer structured financings to accredited investors and qualified institutional buyers to raise capital. We do not expect that the proposed amendments to rules 5b-3 or 10f-3 would have an adverse effect on capital formation. If the proposed amendments to rule 206(3)-3T have any effect on capital formation, it is likely to be positive, although indirect. Providing a means for advisers, consistent with their fiduciary obligations, to offer their clients underwritten investment grade securities sold as principal, might serve to broaden the potential universe of purchasers of securities, opening the door to greater investor participation in the securities markets with a potential positive effect on capital formation.

We request comment on all aspects of this analysis, and specifically request comment on any effect the proposed amendments might have on the promotion of efficiency, competition, and capital formation that we have not considered. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

#### **VIII. REGULATORY FLEXIBILITY ACT CERTIFICATION**

Section 3(a) of the Regulatory Flexibility Act of 1980<sup>112</sup> (“RFA”) requires the Commission to undertake an initial regulatory flexibility analysis (“IRFA”) of the proposed rule amendments on small entities unless the Commission certifies that the rule, if adopted, would not have a significant economic impact on a substantial number of small entities.<sup>113</sup> Pursuant to Section 605(b) of the RFA, the Commission hereby certifies that the proposed amendments to rules 2a-7 and 3a-7 under the Investment Company Act, would not, if adopted, have a significant economic impact on a substantial number of small entities. The proposal would:

- (a) Amend rule 2a-7 under the Investment Company Act to: (i) rely on money

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<sup>112</sup> 5 U.S.C. 603(a).

<sup>113</sup> 5 U.S.C. 605(b).

market fund boards of directors (who usually rely on the funds' advisers) to determine that each portfolio instrument presents minimal credit risks, and whether the security is a "First Tier Security" or a "Second Tier Security;" (ii) add a portfolio liquidity requirement to the rule that would require that money market funds hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions, and expressly limit their investment in illiquid securities to not more than 10% of their total assets; (iii) in the event the money market fund's portfolio manager becomes aware of any new 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, the proposal would amend rule 2a-7's downgrade and default provisions to require a money market fund's board of directors to reassess promptly whether the portfolio security continues to present minimal credit risks; and (iv) require a money market fund to notify the Commission of the purchase of a money market fund's portfolio securities by an affiliated person in reliance on rule 17a-9 under the Investment Company Act. The proposed amendments also would make conforming amendments to rule 2a-7's record keeping and reporting requirements; and

- (b) Amend rule 3a-7 under the Investment Company Act to: (i) eliminate the rule's reliance on ratings by eliminating the exclusion for structured financings offered to the general public; (ii) remove the reference to ratings downgrades in the section of the rule that addresses substitution of eligible assets; and (iii) amend the portion of the rule that deals with safekeeping of assets.

Based on information in filings submitted to the Commission, we believe that there are

no money market funds that are small entities.<sup>114</sup> In addition, we are not aware of any issuers that currently rely on rule 3a-7 that are small entities. For these reasons, the Commission believes the proposed amendments to rules 2a-7 and 3a-7 under the Investment Company Act would not, if adopted, have a significant economic impact on a substantial number of small entities.

We encourage written comments regarding this certification. The Commission solicits comment as to whether the proposed amendments to rules 2a-7 and 3a-7 could have an effect on small entities that has not been considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

## **IX. INITIAL REGULATORY FLEXIBILITY ANALYSIS**

This IRFA has been prepared in accordance with 5 U.S.C. 603. It relates to proposed amendments to rules 5b-3 and 10f-3 under the Investment Company Act and rule 206(3)-(3)T under the Investment Advisers Act. The proposed amendments would remove references to and the required use of NRSRO ratings from these rules.

### **A. Reasons for the Proposed Action**

As discussed above, the proposed rule amendments are designed to address the risk that the reference to and use of NRSRO ratings in our rules is interpreted by investors as an endorsement of the quality of the credit ratings issued by NRSROs, and may encourage investors to place undue reliance on the NRSRO ratings.

### **B. Objectives of the Proposed Action**

Our proposed amendments are designed to address the risk that reference to and use of

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<sup>114</sup> Under the Investment Company Act, an investment company is considered a small entity if it, together with other investment companies in the same group of related investment companies, have net assets of \$50 million or less as of the end of its most recent fiscal year. *See* 17 CFR 270.0-10.

NRSRO ratings in our rules:

- is interpreted by investors as an endorsement of the quality of the credit ratings issued by NRSROs; and
- encourages investors to place undue reliance on the NRSRO ratings.

### **C. Legal Basis**

The Commission is proposing amendments to rule 5b-3 under the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c) and 80a-37(a)]. The Commission is proposing amendments to rule 10f-3 under the authority set forth in sections 10(f), 31(a) and 38(a) of the Investment Company Act [15 U.S.C. 80a-10(f), 80a-30(a) and 80a-37(a)]. The Commission is proposing amendments to rule 206(3)-(3)T under the authority set forth in sections 206A and 211(a) of the Investment Advisers Act [15 U.S.C. 80b-6A, 80b-11(a)].

### **D. Small Entities Subject to the Proposed Rule Amendments**

The proposed amendments to rules 5b-3 and 10f-3 under the Investment Company Act and rule 206(3)-(3)T under the Investment Advisers Act would affect funds and registered investment advisers, including entities that are considered to be a small business or small organization (collectively, “small entity”) for purposes of the RFA. Under the Investment Company Act, a fund is considered a small entity if it, together with other funds in the same group of related funds, has net assets of \$50 million or less as of the end of its most recent fiscal year.<sup>115</sup> Under the Investment Advisers Act, a small entity is an investment adviser that: (i) manages less than \$25 million in assets; (ii) has total assets of less than \$5 million on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under

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<sup>115</sup> 17 CFR 270.0-10.

common control with another investment adviser that manages \$25 million or more in assets, or any person (other than a natural person) that has had total assets of \$5 million or more on the last day of the most recent fiscal year.<sup>116</sup> Based on Commission filings, we estimate that 122 investment companies may be considered small entities. We also estimate that as of June 1, 2008, 572 investment advisers were small entities.<sup>117</sup> The Commission assumes for purposes of this IRFA that 19 of these small entities (those that are both investment advisers and broker-dealers) could rely on rule 206(3)-3T,<sup>118</sup> and that 50% of these, or 10 advisers, will seek to engage in principal trades with clients of securities they or a control person underwrote.

#### **E. Reporting, Recordkeeping, and Other Compliance Requirements**

The proposed amendments to rule 5b-3 would require collateral for repurchase agreements other than cash or government securities to have minimal credit risk and be highly liquid. Specifically, the proposal would require collateral other than cash or government securities to consist of securities that the fund's board of directors (or its delegate) determines at the time the repurchase agreement is entered into: (i) are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time; (ii) are subject to no greater than minimal credit risk, and (iii) the issuer of which has the highest capacity to meet its financial obligations.<sup>119</sup> The proposed amendments to rule 10f-3 would amend the rule's definition of "eligible municipal security" to mean securities that are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time. In addition, the securities would have to be either: (i) subject to no greater than moderate credit risk; or (ii) if

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<sup>116</sup> 17 CFR 275.0-7.

<sup>117</sup> IARD data as of June 1, 2008, for Item 12 of Part 1A of Form ADV.

<sup>118</sup> IARD data as of June 1, 2008, for Items 6.A(1) and 12 of Part 1A of Form ADV.

<sup>119</sup> Proposed rule 5b-3(c)(1)(iv)(C).

they are less seasoned securities, subject to a minimal or low amount of credit risk.<sup>120</sup> The proposed amendments to rule 206(3)-3T would impose a new compliance requirement in connection with advisers' obligations relating to written policies and procedures under rule 206(4)-7 under the Advisers Act.

Small entities registered with the Commission as investment companies or investment advisers seeking to rely on each of the rules as it is proposed to be amended would be subject to the same requirements as larger entities. With respect to rule 206(3)-3T, in each case, however, an investment adviser, whether large or small, would only be able to rely on the rule as it is proposed to be amended if it also is registered with us as a broker-dealer. As noted above, we estimate that 19 small entities are advisers that are also registered as broker-dealers and therefore only those small entities are eligible to rely on the rule. In developing the requirements of the proposed amendments to each of rules 5b-3 and 10f-3 under the Investment Company Act, and rule 206(3)-3T under the Investment Advisers Act, we considered the extent to which the proposed amendments would have a significant impact on a substantial number of small entities.

We encourage written comments regarding this analysis. We solicit comments as to whether the proposed amendments could have any effect that we have not considered. We also request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

#### **F. Duplicative, Overlapping, or Conflicting Federal Rules**

Rule 31a-1 under the Act requires the retention of ledger accounts for each portfolio security and each person through which a portfolio transaction is effected. Although some of the procedures under the proposed amendments to rules 5b-3 and 10f-3 may overlap with

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<sup>120</sup> Proposed rule 10f-3(a)(3).

information in the ledgers, the rule 5b-3 and 10f-3 procedures would contain additional information specifically related to the concerns underlying these rules.

The Commission believes that there are no rules that duplicate or conflict with the proposed amendments to rule 206(3)-3T.

#### **G. Significant Alternatives**

The RFA directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small entities. Alternatives in this category would include: (i) establishing different compliance or reporting standards or timetables that take into account the resources available to small entities; (ii) clarifying, consolidating, or simplifying compliance requirements under the rule for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of the rule, or any part of the rule.

With respect to rules 5b-3 and 10f-3, the Commission preliminarily believes that special compliance requirements or timetables for small entities, or an exemption from coverage for small entities, may create a risk that those entities could acquire repurchase agreements with collateral that may not retain its market value or liquidity in the event of a counterparty default. We do not expect that the requirement that refunded securities be certified by a certified public accountant would result in any costs or burdens for either small or large entities. With respect to rule 10f-3, we preliminarily believe that special compliance requirements or timetables for small entities, or an exemption from coverage for small entities, may put those entities at greater risk for purchasing unmarketable municipal securities in an affiliated underwriting. We preliminarily believe, therefore, that it is important for the credit quality and liquidity considerations required by the proposed amendments to rules 5b-3 and 10f-3 to apply to all funds relying on the rules,

not just those that are not considered small entities. Further consolidation or simplification of the proposals for funds that are small entities would be inconsistent with the Commission's goals of fostering investor protection.

With respect to rule 206(3)-3T, the Commission preliminarily believes that special compliance or reporting requirements or timetables for small entities, or an exemption from coverage for small entities may create the risk that the investors who are advised by and effect securities transactions in underwritten securities through such small entities may not receive adequate protection combined with access to securities. We believe, therefore, that it is important for the investment quality consideration required by the proposed amendments to apply to all advisers, not just those that are not considered small entities. Further consolidation or simplification of the proposals for investment advisers that are small entities would be inconsistent with the Commission's goals of fostering investor protection.

We have endeavored through the proposed amendments to rules 5b-3, 10f-3 and 206(3)-3T to minimize the regulatory burden on all entities eligible to rely on the respective rules, including small entities, while meeting our regulatory objectives. It was our goal to ensure that eligible small entities may benefit from the Commission's approach to the proposed amendments to the same degree as other funds or eligible advisers, as appropriate.

We request comment on whether it is feasible or necessary for small entities to have special requirements or timetables for, or exemptions from, compliance with the proposed amendments to each of the rules. In particular, could any of the proposed amendments be altered in order to ease the regulatory burden on small entities, without sacrificing the effectiveness of the proposed amendments?

## **H. Request for Comments**

We encourage the submission of comments with respect to any aspect of this IRFA. In particular, we request comments regarding: (i) the number of small entities that may be affected by the proposed amendments; (ii) the existence or nature of the potential impact of the proposed amendments on small entities discussed in the analysis; and (iii) how to quantify the impact of the proposed amendments. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments. Comments should be submitted to the Commission at the addresses previously indicated.

## **X. STATUTORY AUTHORITY**

The Commission is proposing amendments to rules 2a-7, 3a-7, and 5b-3 under the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-37(a)]. The Commission is proposing amendments to rule 10f-3 under the authority set forth in sections 10(f), 31(a) and 38(a) of the Investment Company Act [15 U.S.C. 80a-10(f), 80a-30(a), 80a-37(a)]. The Commission is proposing amendments to rule 206(3)-(3)T under the authority set forth in sections 206A and 211(a) of the Investment Advisers Act [15 U.S.C. 80b-6A, 80b-11(a)].

### **List of Subjects**

17 CFR Parts 270

Investment companies, Reporting and recordkeeping requirements, Securities.

17 CFR Part 275

Reporting and recordkeeping requirements, Securities.

**TEXT OF PROPOSED RULE AMENDMENTS**

For reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

**PART 270--RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940**

1. The authority citation for Part 270 continues to read in part as follows:

**Authority:** 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

\* \* \* \* \*

2. Section 270.2a-7 is amended by:
  - a. Revising paragraphs (a)(10), (a)(12), and (a)(17);
  - b. Removing paragraph (a)(19);
  - c. Redesignating paragraph (a)(20) as paragraph (a)(19);
  - d. Removing paragraph (a)(21);
  - e. Redesignating paragraphs (a)(22) through (a)(27) as paragraphs (a)(20) through (a)(25);
  - f. Removing paragraph (a)(28);
  - g. Redesignating paragraph (a)(29) as paragraph (a)(26);
  - h. In paragraphs (b)(1) and (b)(2), revising the phrase “(c)(2), (c)(3), and (c)(4)” to read “(c)(2), (c)(3), (c)(4), and (c)(5)”;
  - i. Revising paragraphs (c)(3)(i), (c)(3)(iii), and (c)(3)(iv)(C);
  - j. Adding paragraph (c)(3)(iv)(D);
  - k. In paragraph (c)(4)(v), revising the phrase “requirements of paragraphs (c)(4) and (c)(5)” to read “requirements of paragraphs (c)(4) and (c)(6)”;
  - l. Redesignating paragraphs (c)(5) through (c)(10) as paragraphs (c)(6) through

(c)(11);

- m. Adding new paragraph (c)(5);
- n. In newly redesignated paragraph (c)(6), revising the phrase “(pursuant to paragraphs (c)(9)(ii) and (c)(10)(vi) of this section)” to read “(pursuant to paragraphs (c)(10)(ii) and (c)(11)(vi) of this section)”;
- o. In newly redesignated paragraph (c)(7):
  - i. revising the paragraph heading;
  - ii. revising paragraph (i);
  - iii. in the introductory text of paragraph (ii), revising the phrase “paragraphs (c)(6)(ii)(A) through (D)” to read “paragraphs (c)(7)(ii)(A) through (C)”;
  - iv. adding “or” at the end of paragraph (ii)(B);
  - v. removing paragraph (ii)(C) and redesignating paragraph (ii)(D) as paragraph (ii)(C);
  - vi. revising paragraph (iii);
  - vii. revising the heading to paragraph (iv); and
  - viii. in paragraph (iv), revising the phrase “For purposes of paragraphs (c)(6)(ii) and (iii)” to read “For purposes of paragraphs (c)(7)(ii) and (iii)”;
- p. Revising newly designated paragraph (c)(10)(ii);
- q. In newly redesignated paragraph (c)(11):
  - i. in paragraph (i), revising the phrase “paragraphs (c)(6) through (c)(9)” to read “paragraphs (c)(7) through (c)(10)”;
  - ii. revising paragraph (iii);
  - iii. in paragraph (iv), revising the phrase “paragraph (c)(9)(iii) of this

section” to read “paragraph (c)(10)(iii) of this section”;

iv. in the introductory text of paragraph (v), in the first sentence, revising “paragraph (c)(9)(iv) of this section” to read “paragraph (c)(10)(iv) of this section”;

v. in paragraph (vi), revising the phrase “paragraph (c)(9)(ii)” to read “paragraph (c)(10)(ii)”;

vi. in paragraph (vii), in the first sentence, revising the phrase “this paragraph (c)(10)” to read “this paragraph (c)(11)”;

vii. in paragraph (vii), in the second sentence, revising the phrase “paragraphs (c)(6)(ii) (with respect to defaulted securities and events of insolvency) or (c)(7)(ii)” to read “paragraphs (c)(7)(ii) (with respect to defaulted securities and events of insolvency) or (c)(8)(ii)”;

r. Revising the introductory text of paragraph (e) and in paragraph (e)(2) revising the phrase “paragraph (c)(6)(iii) of this section” to read “paragraph (c)(7)(iii) of this section”.

These additions and revisions read as follows:

**§ 270.2a-7 Money market funds.**

(a) \* \* \*

(10) *Eligible Security* means a security with a remaining maturity of 397 calendar days or less that the fund’s board of directors determines presents minimal credit risks (which determination must be based on factors pertaining to credit quality and the issuer’s ability to meet its short-term financial obligations).

\* \* \* \* \*

(12) *First Tier Security* means a security the issuer of which the fund’s board of directors has determined has the highest capacity to meet its short-term financial obligations.

\* \* \* \* \*

(17) *Liquid Security* means a security that can be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the money market fund.

\* \* \* \* \*

(c) \* \* \*

(3) \* \* \*

(i) *General.* The money market fund shall limit its portfolio investments to those United States Dollar-Denominated securities that are at the time of Acquisition Eligible Securities.

\* \* \* \* \*

(iii) *Securities Subject to Guarantees.* A security that is subject to a Guarantee may be determined to be an Eligible Security or a First Tier Security based solely on whether the Guarantee is an Eligible Security or First Tier Security, as the case may be; *Provided, however,* that the issuer of the Guarantee, or another institution, has undertaken to promptly notify the holder of the security in the event the Guarantee is substituted with another Guarantee (if such substitution is permissible under the terms of the Guarantee).

(iv) \* \* \*

(C) The issuer of the Demand Feature, or another institution, has undertaken to promptly notify the holder of the security in the event the Demand Feature is substituted with another Demand Feature (if such substitution is permissible under the terms of the Demand Feature); and

(D) The fund's board of directors determines that the Underlying Security or any

Guarantee of such security presents minimal credit risks (which determination must be based on factors pertaining to credit quality).

\* \* \* \* \*

(5) *Portfolio Liquidity.* The money market fund shall hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of the fund's obligations under section 22(e) of the Act (15 U.S.C. 80a-22(e)) and any commitments it has made to shareholders; *Provided, however,* immediately after the Acquisition of any security, a money market fund shall not have invested more than ten percent of its Total Assets in securities that are not Liquid Securities.

\* \* \* \* \*

(7) *Monitoring, Defaults and Other Events.*

(i) *Monitoring.* In the event the money market fund's investment adviser (or any person to whom the fund's board of directors has delegated portfolio management responsibilities) 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, the board of directors shall reassess promptly whether such security continues to present minimal credit risks and shall cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders.

\* \* \* \* \*

(iii) *Notice to the Commission.* The money market fund shall promptly notify the Commission by electronic mail directed to the Director of the Division of Investment Management of any:

(A) Default with respect to one or more portfolio securities (other than an immaterial

default unrelated to the financial condition of the issuer) or an Event of Insolvency with respect to the issuer of the security or any Demand Feature or Guarantee to which it is subject, where immediately before default the securities (or the securities subject to the Demand Feature or Guarantee) accounted for 1/2 of 1 percent or more of a money market fund's Total Assets, of such fact and the actions the money market fund intends to take in response to such situation; or

(B) Purchase of a security from the fund by an affiliated person or promoter of or principal underwriter for the fund or an affiliated person of such a person in reliance on §270.17a-9.

\* \* \* \* \*

(iv) *Defaults for Purposes of Paragraphs (c)(7) (ii) and (iii).* \* \* \*

\* \* \* \* \*

(10) \* \* \*

(ii) *Securities Subject to Demand Features or Guarantees.* In the case of a security subject to one or more Demand Features or Guarantees that the fund's board of directors has determined that the fund is not relying on to determine the quality (pursuant to paragraph (c)(3) of this section), maturity (pursuant to paragraph (d) of this section) or liquidity (pursuant to paragraph (c)(5) of this section) of the security subject to the Demand Feature or Guarantee, written procedures shall require periodic evaluation of such determination.

\* \* \* \* \*

(11) \* \* \*

(iii) *Credit Risk Analysis.* For a period of not less than three years from the date that the credit risks of a portfolio security were most recently reviewed, a written record of the determination that a portfolio security presents minimal credit risks used to determine the status

of the security as an Eligible Security shall be maintained and preserved in an easily accessible place.

\* \* \* \* \*

(e) *Delegation.* The money market fund's board of directors may delegate to the fund's investment adviser or officers the responsibility to make any determination required to be made by the board of directors under this section (other than the determinations required by paragraphs (c)(1) (board findings); (c)(7)(ii) (defaults and other events); (c)(8)(i) (general required procedures: Amortized Cost Method); (c)(8)(ii)(A) (shadow pricing), (B) (prompt consideration of deviation), and (C) (material dilution or unfair results); and (c)(9) (required procedures: Penny Rounding Method) of this section) provided:

\* \* \* \* \*

3. Section 270.3a-7 is amended by:
  - a. Revising paragraph (a)(2) introductory text;
  - b. In paragraph (a)(2)(i) revising the phrase “Any fixed-income securities may be sold” to read “Any fixed-income securities sold”;
  - c. In paragraph (a)(2)(ii), revising the phrase “Any securities may be sold” to read “Any securities sold”;
  - d. In the undesignated paragraph after paragraph (a)(2)(ii), revise the phrase “persons specified in paragraphs (a)(2)(i) and (ii) of this section” to read “persons specified in this section”;
  - e. Revising paragraph (a)(3)(ii); and
  - f. Revising paragraph (a)(4)(iii).

The revisions read as follows:

**§ 270.3a-7 Issuers of asset-backed securities.**

(a) \* \* \*

(2) Securities sold by the issuer or any underwriter thereof are:

\* \* \*

(3) \* \* \*

(ii) The issuer has procedures to ensure that the acquisition or disposition does not adversely affect the full and timely payment of the outstanding fixed-income securities; and

\* \* \*

(4) \* \* \*

(iii) Takes actions necessary for the cash flows derived from eligible assets for the benefit of the holders of fixed-income securities to be deposited periodically in a segregated account consistent with the full and timely payment of the outstanding fixed-income securities.

\* \* \*

4. Section 270.5b-3 is amended by:

- a. Adding “or” at the end of paragraph (c)(1)(iv)(B);
- b. Revising paragraph (c)(1)(iv)(C);
- c. Removing paragraph (c)(1)(iv)(D);
- d. Revising paragraph (c)(4)(iii);
- e. Removing paragraphs (c)(5), (c)(6), and (c)(8); and
- f. Redesignating paragraph (c)(7) as paragraph (c)(5).

The revisions read as follows:

**§ 270.5b-3 Acquisition of repurchase agreement or refunded security treated as acquisition of underlying securities.**

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(iv) \* \* \*

(C) Securities that the investment company's board of directors, or its delegate, determines at the time the repurchase agreement is entered into:

(1) Are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time;

(2) Are subject to no greater than minimal credit risk; and

(3) The issuer of which has the highest capacity to meet its financial obligations; and

\* \* \* \* \*

(4) \* \* \*

(iii) At the time the deposited securities are placed in the escrow account, or at the time a substitution of the deposited securities is made, an independent certified public accountant has certified to the escrow agent that the deposited securities will satisfy all scheduled payments of principal, interest and applicable premiums on the Refunded Securities.

\* \* \* \* \*

5. Section 270.10f-3 is amended by:

a. Revising paragraph (a)(3);

b. Removing paragraph (a)(5); and

c. Redesignating paragraphs (a)(6), (a)(7), and (a)(8) as paragraphs (a)(5), (a)(6), and (a)(7).

The revision reads as follows:

**§ 270.10f-3 Exemption for the acquisition of securities during the existence of an underwriting or selling syndicate.**

(a) \* \* \*

(3) *Eligible Municipal Securities* means “municipal securities,” as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29)), that are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short period of time and either:

(i) Are subject to no greater than moderate credit risk; or

(ii) If the issuer of the municipal securities, or the entity supplying the revenues or other payments from which the issue is to be paid, has been in continuous operation for less than three years, including the operation of any predecessors, the securities are subject to a minimal or low amount of credit risk.

\* \* \* \* \*

**PART 275 -- RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940**

6. The authority citation for Part 275 continues to read in part as follows:

**Authority:** 15 U.S.C. 80b-2(a)(11)(G), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

\* \* \* \* \*

7. Section 275.206(3)-3T is amended by revising paragraph (c) to read as follows:

**§ 275.206(3)-3T Temporary rule for principal trades with certain advisory clients.**

\* \* \* \* \*

(c) For purposes of paragraph (a)(2) of this section, an *investment grade debt security* means a non-convertible debt security that, at the time of sale, the investment adviser has determined to be subject to no greater than moderate credit risk and sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time.

\* \* \* \* \*

By the Commission.

Florence E. Harmon  
Acting Secretary

Dated July 1, 2008