Consumer Federation of America

October 14, 2014

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

Re: File Number S7-07-11
Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule

Dear Secretary Murphy,

I am writing on behalf of the Consumer Federation of America (CFA)[1] to express our grave concerns with the Commission's re-proposal to remove credit rating references in the money market fund rule, and to offer our suggestions for improving the rule.[2] At best, this proposal will perpetuate the status quo, whereby money fund directors and advisers rely excessively on credit ratings to determine the creditworthiness of the securities that their funds seek to invest in; at worst, this proposal will serve to expand the scope of permissible securities that funds invest in, leading to riskier fund practices than are currently allowed. With relatively modest changes, however, the proposal could be significantly improved.

The most glaring deficiencies of the re-proposed rule are as follows:

- The removal of references to credit ratings without replacing those ratings with any concrete criteria limiting the securities that funds can invest in makes it more likely that funds will continue to rely excessively on credit ratings;
- The subjective standard and expansive discretion that is provided to money fund directors and advisers to decide what constitutes an eligible security for investment makes it more likely that funds will invest in riskier securities;
- The provision of optional, rather than mandatory, factors for money fund directors and advisers to consider makes it more likely that there will be a wide range in the quality and

[1] CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1968 to represent the consumer interest through research, advocacy and education.
[2] CFA expressed opposition to the Commission's original proposal, two of which were filed as joint comment letters with Fund Democracy. *See* September 5, 2008 Comment Letter from Mercer Bullard and Barbara Roper, http://www.sec.gov/comments/s7-19-08/s71908-47.pdf; *See also* September 8, 2009 Comment Letter from Bullard and Roper, http://www.sec.gov/comments/s7-11-09/s71109-79.pdf; *See also* April 25, 2011 Comment Letter from Roper, http://www.sec.gov/comments/s7-07-11/s70711-18.pdf.

breadth of credit analyses among money funds. This will likely lead some to perform inadequate credit analyses, which could jeopardize those funds and financial stability.

However, the following modest changes would strengthen the proposal significantly.

- First, instead of providing a list of factors that funds "may" or "should" consider when assessing the credit risk of a particular issue, issuer, or guarantor, the Commission should codify those factors and require funds to consider them. The Commission should also require funds to document their analysis of those factors, as well as any additional considerations they make, in determining that a certain security possesses an "exceptionally strong capacity to meet its short-term obligations" and is therefore "eligible" for investment. The exercise of considering those factors, and documenting the basis on which they reach their conclusions, will help to ensure that funds critically evaluate the policies and procedures that they implement in assessing the creditworthiness tied to the securities they invest in. As a result, this process should improve credit analysis on a firm-wide basis and make funds less reliant on credit ratings. It should also increase the credit quality for money funds system-wide, thereby benefiting financial stability.
- Second, the Commission should take steps to reduce the incentive for funds to invest in excessively risky securities. We appreciate the difficulties of producing a viable alternative standard of creditworthiness to substitute for credit ratings, but failure to do so leaves funds with significant latitude to invest in risky securities. Therefore, if the Commission cannot produce a standard that provides an objective limit on what funds can invest in, it should enhance the liability for directors and advisers in the event that a fund's security experiences a default, and as a result of that default, the fund's investors suffer loss. Adding the prospect of liability on the back-end for a fund's directors' and adviser's investment decisions would provide a meaningful deterrent to investing in excessively risky securities, thereby providing a certain amount of protection that the Commission has not provided on the front-end.

Subjective Standard

Rule 2a-7 requires money market funds (MMFs) to invest in "eligible securities," which possess minimal credit risk. The Commission proposes to re-define the appropriate standard of creditworthiness as possessing an "exceptionally strong capacity to meet its short-term obligations."[3] However, the Commission does not define what "exceptionally strong" means or provide any clear guidance for MMF directors and advisers about how that standard should be applied. Instead, the "exceptionally strong capacity" standard will be subjective and, as a result, susceptible to whatever interpretation a MMF's directors and adviser decide. This will invariably lead to inconsistent credit quality determinations across the MMF industry, with some funds' portfolios taking on imprudent amounts of credit risk. It will also increase uncertainty across the marketplace about which funds are performing high quality credit analysis and which are not. As we learned from the Reserve Primary experience, when confidence in one fund and its holdings deteriorates, it can infect the entire money fund market.

The Commission recognizes some of the concerns related to instituting a credit quality standard in which directors and advisers decide for themselves what securities possess minimal credit risk.

[3] Re-proposing release at 16.

For example, according to the re-proposing release, "Because the interpretation of this subjective standard may differ among fund boards and their advisers, the possible range of securities available for investment may differ from that under the current rule if the re-proposed standard is adopted."[4] However, the Commission provides no concrete safeguards in this proposal to address those concerns.

First Tier and Second Tier Securities

To make matters worse, the Commission proposes to remove a major limiting factor that currently exists in the money fund rules by abolishing the distinction between "first tier" and "second tier" securities. Currently, a fund is required to invest at least 97 percent of its total assets in first tier securities, those receiving the highest short-term rating category from an NRSRO, and no more than 3 percent of its total assets in lower rated second tier securities. The formulation of this rule was changed in 2010, when the Commission decided to reduce the relative amount of second tier securities that a MMF can hold, from 5 percent of total assets to 3 percent of total assets. The reason for making this change, according to the Commission's adopting release, was because the "additional risk created by the credit and liquidity profile of second tier securities increases the possibility that a fund holding these securities could break the buck in times of financial market turmoil, with a detrimental impact on fund investors."[5]

We recognize that the current framework must be overhauled, given that the tiers reference credit ratings; we further recognize that continuing to apply the current framework based on subjective, indistinguishable standards of what are "first tier" and "second tier" securities would prove unworkable. But given that the Commission has recognized the additional risk that could be created by a fund's investment in higher risk securities, it is troubling that the Commission fails to replace the current framework with another one that is designed to limit the relative amount of credit risk that a fund can take on. Under the terms of the rule, MMFs theoretically would be able to invest 100 percent of their portfolios in securities that receive second tier ratings, so long as the directors and adviser decide those securities possess an "exceptionally strong" capacity to be repaid.

The Commission acknowledges the concern that a fund's directors or adviser could invest in a larger proportion of riskier securities under the proposed rule than is currently allowed. According to the re-proposing release, by eliminating the rule's current limitations on investments in second tier securities, "a manager could invest a significantly greater portion of the fund's portfolio in second tier securities, which could result in an increase in the portfolio risk of some funds that is inconsistent with the relevant risk limitations in the current rule." However, here again, the Commission provides no concrete safeguards to address those concerns.

Flawed Assumptions

The Commission doesn't provide safeguards to address concerns that funds could increase their exposure to riskier securities because it appears not to believe any safeguards are necessary. It

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[4] Re-proposing release at 68.

[5] Money Market Fund Reform, Investment Company Act Release No. IC-29132, 17 CFR Parts 270 and 274 at 12-13 (February 23, 2010) http://www.sec.gov/rules/final/2010/ic-29132.pdf.

arrives at its conclusion based on the premise that MMF credit standards are unlikely to deteriorate, which in turn, is based on three flawed assumptions.

The Commission's first assumption appears to be that funds are likely to retain and continue operating according to their current investment policies, which incorporate credit ratings and include restrictions on the amount of second tier securities they can invest in. The assumption is based on the belief that fund managers may find having to perform additional credit research and analysis to justify their decisions burdensome, costly, and time consuming. Indeed, the Commission notes that, "We believe that many fund managers may not wish to invest in the additional resources necessary to make this assessment with respect to second tier securities unless the fund believes that the expected risk-adjusted return of doing so would be greater than the expected costs."[6] In short, the Commission appears to assume that the proposed standards are mere window dressing and that funds will continue to maintain their reliance on ratings. If this is the outcome that the Commission expects from this regulation, it directly undercuts the Commission's congressional directive to promulgate rules that actually reduce reliance on credit ratings and encourage more diligence in the market.

The Commission's second assumption is that, because many MMFs, constituting the significant majority of assets under management, do not currently invest in second tier securities to the extent permitted now, they would be unlikely to increase substantially their investment in riskier securities if the current limits were withdrawn. To support its hypothesis, the Commission notes that Form N-MFP filings from February 28, 2014 show that:

- Approximately 99.75 percent of aggregate money market fund assets were in first tier securities;[7]
- 24 out of 559 or "less than 5 percent" of all money market funds held the maximum amount of second tier securities permitted under rule 2a-7;[8] and
- "Only 6 prime funds out of 229 prime funds" held the maximum amount of second tier securities permitted under rule 2a-7.[9]

While these statistics do suggest the vast majority of MMFs are *currently* operating within a safe buffer, it is naïve to assume that they will *continue* to operate within that same buffer under different circumstances.

Certain risk-averse market practices may not persist in the face of the search for yield, changing market dynamics, rising interest rates, or other stimuli that could induce MMFs to increase their risk profiles. For example, Reserve Primary had no exposure to Lehman Bros. in August 2007 and little to no exposure to the commercial paper market.[10] But in less than one year, it acquired $785 million worth of Lehman Bros. commercial paper and medium term notes and increased its investment in commercial paper generally from approximately 1 percent of total fund assets to

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[6] Re-proposing release at 70.
[7] Re-proposing release at 65.
[8] *Id*.
[9] *Id*.
[10] *See* Report of the Money Market Working Group, Submitted to the Board of Governors of the Investment Company Institute, March 17, 2009, http://www.ici.org/pdf/ppr_09_mmwg.pdf.

nearly 60 percent.[11] Perhaps the opportunity to increase its yield and grow its assets under management induced Reserve Primary to increase its risk profile drastically. Within months of changing its holdings, the fund's yield and assets grew considerably. By September 2008, the fund's 12-month yield was the highest among more than 2,100 money funds tracked by Morningstar – 4.04 percent versus an average of 2.75 percent.[12] Also by September 2008, Reserve Primary's assets under management more than doubled from the previous year.[13] Thus, as the instance most directly responsible for this rule change demonstrates, because the fact that funds are invested in relatively safe securities at one point in time cannot be construed to mean that funds will inevitably remain similarly invested in the future.

If funds increase their risk profiles, the resulting effects on the funds and their investors and on financial stability could be dangerous. And, as the Reserve Primary case demonstrated, it doesn't require a broad deterioration in standards across the fund class for those systemic risks to be triggered. Thus, the Commission must ask itself how the practices of the 24 total funds and 6 prime funds that are currently at the regulatory limit of the second tier securities they can invest in are likely to be affected by the proposed rule. Their willingness to operate at the limit may suggest a predilection toward pushing the envelope, and if there is no longer any mechanism to rein them in, their investment in riskier second tier securities may increase. If this were to happen, their overall vulnerabilities to destabilizing events would also increase.

The Commission offers no economic analysis regarding the point at which the percentage of funds or total assets under management can hit levels of credit risk that portend danger, either to the funds themselves or to the rest of the money fund market. However, the below figures suggest that it doesn't take a significant amount of additional risk to topple a fund and endanger the financial system:

- The $62 billion Reserve Primary Fund constituted roughly 2.6 percent of the nearly $2.4 trillion in money fund assets that the Treasury Department guaranteed through its Temporary Guarantee Program.[14]
- Reserve Primary held $785 million in Lehman commercial paper and medium term notes, which amounted to only 1.2 percent of Reserve Primary's assets;
- The amount of Lehman short term debt held by Reserve Primary constituted roughly 0.033 percent of the money fund market that the Treasury Department guaranteed;
- Reserve Primary's (just one fund's) breaking the buck caused mass panic and resulting runs across the money fund market;
- Reserve Primary was an outlier only insofar as it was unable to receive sponsor or affiliate support. Among the funds that were exposed to losses from debt securities issued by Lehman Bros. and structured investment vehicles ("SIVs"), which were in many cases backed by asset backed commercial paper collateralized by mortgage backed securities,

[11] *Id* at 57.
[12] *See* Steve Stecklow and Diya Gullapall, *A Money-Fund Manager's Fateful Shift*, WALL STREET JOURNAL, December 8, 2008, http://online.wsj.com/articles/SB122869788400386907.
[13] *See* Report of the Money Market Working Group, Submitted to the Board of Governors of the Investment Company Institute, March 17, 2009, http://www.ici.org/pdf/ppr_09_mmwg.pdf.
[14] *See* Press Release, "Treasury Announces Temporary Guarantee Program for Money Market Funds" (Sept. 29, 2008), http://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx.

all but one required support of some type to cover losses sufficient to prevent breaking the buck.[15]

The Commission cannot reasonably assume that current practices will continue into the future. Nor can it reasonably conclude that its proposed regulatory approach will be effective in reducing risks without analyzing this question regarding the point at which the percentage of funds or total assets under management can hit levels of credit risk that portend danger, either to themselves or to the rest of the money fund market.

The Commission's third assumption is that the newly adopted, yet untested July 2014 MMF reform rules will protect against the potential risks that may result from these rules. According to the re-proposal, the threat that fees and gates could be imposed and the increased disclosure of daily fund performance will cause fund directors and advisers to more closely monitor their holdings. Also according to the re-proposal, requiring institutional prime funds to float their NAV will remove their structural flaw such that they can't break the buck. It's possible that the rules will operate as intended, but it's also possible that they will exacerbate runs and cause widespread fire sales. It seems imprudent for the Commission to depend on such an indefinite and untested backstop.

The Commission Should Prescribe Consideration of Factors to Assess Creditworthiness

In our previous comment letter, we offered one possible approach that the Commission could take, whereby the Commission would provide specific direction regarding the types of information that fund boards or their delegates would have to consider in arriving at their minimal credit risk determinations. In its re-proposal, the Commission identifies the types of factors that we believe would foster better quality credit analysis. They include basic questions that any minimally competent board or its delegate would seek to answer, not simply best practices that a board or its delegate should strive to answer.

However, instead of prescribing factors for consideration, the Commission makes the consideration of those factors optional, saying that "the guidance is not intended to define the parameters of an appropriate credit quality assessment; that is for the fund's board and its adviser to determine with respect to each particular portfolio security."[16] While it would, of course, be appropriate to permit funds to consider additional factors beyond those identified by the Commission, and to reach their own conclusions about the relative importance of those factors, the proposal doesn't even provide a minimum standard that all funds must meet in considering relevant factors. Relying on discretionary factors as the basis for funds' inherently subjective credit assessments is insufficient to adequately address the range in the quality and breadth of credit analyses among the money market funds that the Commission staff has observed. Without a firm mandate, there is little reason to believe that all funds will undertake the kind of high quality credit analyses that is needed to foster increased fund stability and resiliency.

Instead of providing a list of factors that funds may, in their discretion, consider when assessing the credit risk of a particular issue, issuer, or guarantor, the Commission should codify those

[15] Money Market Fund Reform, Investment Company Act Release No. IC-29132, 17 CFR Parts 270 and 274 at 5-6 (February 23, 2010) http://www.sec.gov/rules/final/2010/ic-29132.pdf.

[16] Re-proposing release at 74.

factors and require funds to consider them. The Commission should also require funds to document their analysis of those factors, as well as any additional considerations they make, to determine that a certain security possesses an "exceptionally strong capacity to meet its short-term obligations" and is therefore "eligible" for investment. The exercise of considering those factors and documenting the basis for their conclusions will help to ensure that funds critically evaluate the policies and procedures that they implement in assessing the creditworthiness tied to the securities they invest in. As a result, this process should improve credit analyses on a firm-wide basis and make funds less reliant on credit ratings. It should also promote credit analysis uniformity and increase the credit quality for money funds across the money fund market, thereby benefiting financial stability.

The Commission Should Enhance Liability Provisions for MMF Directors and Advisers
In addition, if the Commission cannot produce bright line standards relating to eligible securities' credit risk, the Commission must take steps to reduce incentives to invest in excessively risky securities. One way to achieve this would be to enhance the liability for money fund directors and advisers in the event that a fund's security experiences a default, and as a result of that default, the fund's investors suffer loss. The loss conceivably could come as a result of a fund's directors' having to impose gates or fees or a run on a floating NAV fund. One approach that the Commission could take is by adding a provision to 2a-7, establishing a prima facie violation of the rule if a fund's security experiences a default, and as a result of that default, the fund's investors suffer loss. Then, the burden would shift to the fund's directors to prove that they in fact did undertake a minimal credit analysis of the affected security. Under this framework, the directors would be required to introduce their documented analysis of the factors prescribed by the Commission, as well as any additional considerations they made, to prove that, as far as the directors knew or should have known, the affected security possessed an "exceptionally strong capacity to meet its short-term obligations." In addition, the Commission should make clear that: 1) a fund's exclusive reliance on credit ratings to determine whether the affected security possessed minimal creditworthiness will not, in itself, rebut the presumption; and 2) a fund should not view its mere consideration of the factors set out by the Commission as a safe harbor that proves that the fund complied with its obligation to undertake a minimal credit determination. Adding the prospect of liability on the back-end for a fund's directors' and adviser's investment decisions will provide a meaningful deterrent to invest in excessively risky securities, thereby providing a certain amount of protection that the Commission has not provided on the front-end.

Economic Analysis
Overall, the Commission's re-proposal comes across largely as window dressing over the prior proposal. It does not materially alter what is expected or required of funds and indeed asserts that that most, if not all, funds are already doing what will be required of them under the rule. One need look no further than the Commission's economic analysis for evidence that the Commission largely expects that the proposed rule will maintain the status quo. For example, the re-proposal states:

- "[W]e anticipate that many funds are likely to retain their investment policies as currently required under rule 2a-7, which incorporate NRSRO ratings and which would be permitted under the re-proposed rule amendments. Some funds, on the other hand, may choose to revise their investment policies to remove references to NRSRO ratings and to incorporate the standards provided in the re-proposal, if adopted. Even if funds choose to eliminate references to ratings in their investment policies, funds' investment policies may not change substantially, as funds are already required to assess credit quality apart from ratings as part of their minimal credit risk determinations."[17]

- "[W]e estimate that each money market fund complex on average would incur a one-time burden of 9 hours, at a cost of $2,838, to review and revise, as appropriate, its policies and procedures."[18]
- "We believe that most money market funds would not likely change their current investment policies if the re-proposed amendments were adopted."[19]
- "As discussed above, money market funds have written policies and procedures for complying with rule 2a-7, including policies and procedures for determining and reassessing minimal credit risk and for stress testing the portfolio. Although our re-proposal would not require changes to these policies and procedures for most money market funds, we anticipate that funds would likely review them and may revise them in consideration of the standard provided in the re-proposal, if adopted. We also anticipate that after such a review, many fund boards and advisers would retain investment policies tied to NRSRO ratings required under the current rule."[20]
- "[T]he guidance is not intended to define the parameters of an appropriate credit quality assessment; that is for the fund's board and its adviser to determine with respect to each particular portfolio security. Thus, we do not anticipate that the re-proposal's discussion of factors that a fund manager should consider would significantly change the process for evaluating credit quality or that consideration of the factors listed above would significantly impact the holdings in money market fund portfolios. For these reasons, we believe that the guidance will not have a material effect on efficiency, competition, or capital formation."[21]

Thus, the re-proposal appears not to impose any new meaningful burdens on fund directors and advisers to undertake appropriate credit risk assessments, and anticipates business as usual. But maintaining the status quo, while not an acceptable outcome, may not be the worst possible outcome under the rule proposal. The more dangerous outcome would be if, without any meaningful criteria imposed on directors and advisers, they use that flexibility to take excessive risks that undermine their funds' risk profile, increasing the likelihood of harm to their investors, to the money fund market, and to the financial system.

Conclusion

CFA continues to strongly support Dodd-Frank's mandate to remove references to credit ratings from federal laws and statutes, and to meaningfully reduce reliance on credit ratings by all market participants. For this rule to have its intended beneficial effects, however, stronger and more reliable measures of creditworthiness must be put in their place. However, the Commission's re-proposal only accomplishes the first goal of eliminating references to ratings. It does nothing to reduce MMFs' reliance on ratings; in fact, it may reinforce reliance on ratings.

[17] Id. at 54.
[18] Id.
[19] Id. at 73.
[20] Id. at 78.
[21] Id. at 77.

Moreover, because it eliminates current restrictions on fund investments without providing any substitute limitations, it provides the basis for funds' investing in riskier securities.

With several modest changes, the rules can be strengthened significantly, and we urge the Commission to make the proposed changes that we've outlined.

Respectfully submitted,

Micah Hauptman
Financial Services Counsel

cc: The Honorable Mary Jo White, Chair
The Honorable Luis Aguilar, Commissioner
The Honorable Daniel Gallagher, Commissioner
The Honorable Michael Piwowar, Commissioner
The Honorable Kara Stein, Commissioner