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A legal update from Dechert's Financial Services Group

SEC Proposes to Remove NRSRO Ratings from Rule 2a-7 and Other Investment Company Act Rules and Forms

Introduction

The U.S. Securities and Exchange Commission ("SEC") recently proposed amendments to certain rules, including Rule 2a-7, under the Investment Company Act of 1940 ("Investment Company Act") that would remove references to credit ratings issued by nationally recognized statistical rating organizations ("NRSROs") (the "Proposal").[1] These references would be replaced with new, more subjective standards of creditworthiness, which, according to the Proposing Release, are intended to achieve the same purposes as the ratings requirements. The Proposal is intended to implement certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").[2]

The comment period for the Proposal runs through April 25, 2011.

Proposed Amendments to Rule 2a-7

Rule 2a-7 currently permits a money market fund ("money fund") to maintain a $1.00 share price, subject to certain risk-limiting conditions, including portfolio quality requirements that limit a fund's portfolio holdings to investments that: (1) are denominated in U.S. dollars, (2) pose minimal credit risk to the fund[3] and (3) are Eligible Securities as defined in the rule.[4]

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1 *See* References to Credit Ratings in Certain Investment Company Act Rules and Forms, Investment Company Act. Rel. No. 29592 (Mar. 3, 2011) (the "Proposing Release"), *available at* http://www.sec.gov/rules/proposed/2011/33-9193.pdf. The Proposal would also remove references to credit ratings from Forms N-MFP, N-1A, N-2 and N-3. The SEC also proposed new Rule 6a-5 under the Investment Company Act to establish a new creditworthiness standard to replace the credit rating references in Section 6(a)(5), which exempts certain business and industrial development companies from provisions of the Investment Company Act.

2 Section 939A of the Dodd-Frank Act directed the SEC to: (1) review its rules for any references to or requirements regarding credit ratings that require the use of an assessment of the creditworthiness of a security or money market instrument; (2) remove these references or requirements; and (3) substitute in place of the credit ratings in those rules other standards of creditworthiness that the SEC deems appropriate.

3 The determination of minimal credit risk must be based on factors pertaining to credit quality in addition to any rating assigned by an NRSRO. *See* Rule 2a-7(c)(3).

4 Capitalized terms herein have the meaning given to them in Rule 2a-7 under the Investment Company Act, unless otherwise defined. The requirements of Rule 2a-7 and the application of other provisions of the Investment Company Act and the rules and forms thereunder to money funds are discussed in more detail in Jack W. Murphy, Douglas P. Dick and Kevin K. Babikian, *Money Market Funds* in PLI Financial Product Fundamentals, Chapter 22-1 (May 3, 2010), *available at* http://www.dechert.com/library/Money%20Market%20Funds%20JMurphy%20DDick%20KBabikian%2005-10.pdf.

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The board of directors or trustees ("board") of a money fund (or the board's delegate)[5] bears the responsibility under the rule to promptly reassess whether a portfolio security that experiences a ratings downgrade from an NRSRO continues to present minimal credit risks.[6] In addition, money funds are required to conduct periodic "stress tests" to estimate the impact on the ability of the fund to maintain a stable share price of certain hypothetical events, including a downgrade of portfolio securities.

The Proposal would remove references to credit ratings from Rule 2a-7, impacting five elements of the rule:

- Determination of whether a portfolio security is an Eligible Security;
- Determination of whether a portfolio security is either a First Tier Security or Second Tier Security;
- Credit quality standards for portfolio securities with conditional demand features[7];
- Requirements to monitor portfolio securities for ratings downgrades and other credit events; and
- Requirement to periodically stress test a money fund's ability to maintain a stable net asset value per share.

Defining Eligible Securities

Rule 2a-7 limits the portfolio holdings of a money fund to securities that are denominated in U.S. dollars, that pose minimal credit risk to the fund (which determination must be based on factors pertaining to credit quality in addition to any NRSRO rating), and that are Eligible Securities as defined in the rule.[8] Eligible Securities are currently defined to include short-term securities that, at the time of acquisition, are rated in one of the two highest short-term rating categories by the Requisite NRSROs[9] or, if unrated, have been determined to be of comparable quality. Eligible Securities are further divided into First Tier Securities and Second Tier Securities.[10]

The Proposal would continue to limit money fund portfolio investments to securities that present minimal credit risks to the fund,[11] and that are either First Tier or Second Tier Securities. However, the Proposal would eliminate the requirement that an Eligible Security be rated by an NRSRO or, if unrated, be determined to be of comparable quality.

Defining "First Tier" and "Second Tier" Securities

The Proposal would continue to require that a money fund invest at least 97 percent of its total assets in First Tier Securities, and invest not more than 3 percent in Second Tier Securities.[12] However, the Proposal would change the definition of First Tier Securities to eliminate the requirement that a First Tier Security receive a short-term rating from the Requisite NRSROs in the highest short-term rating category or, if unrated, that the security be of comparable quality. Instead, securities would be deemed to be First Tier Securities if the board determines that the issuer (or the guarantor, in the case of a security subject to a guarantee)[13] "has the *highest capacity* to meet its short-term financial

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5 Rule 2a-7 permits the board to delegate to the fund's adviser or officers responsibility for most of the determinations required by the rule. *See* Rule 2a-7(e). References to the board in this OnPoint should be read to refer to the board or its delegate, as appropriate.

6 *See* Rule 2a-7(c)(7)(i)(A).

7 A conditional demand feature is a demand feature that does not provide, by its terms, that it would be readily exercisable in the event of a default in payment of principal or interest on the underlying security. *See* Rule 2a-7(a)(6) and (a)(28).

8 *See* Rule 2a-7(a)(12).

9 *See* Rule 2a-7(a)(23).

10 First Tier Securities are currently defined as those securities that: (1) have received a short-term rating from the Requisite NRSROs in the highest short-term rating category for debt obligations or, if unrated, are of comparable quality; (2) are issued by a registered investment company that is a money fund; or (3) are U.S. government securities. Second Tier Securities are those Eligible Securities that are not First Tier Securities.

11 This determination must be based on factors pertaining to credit quality and, if the Proposal is adopted, the issuer's ability to meet its short-term financial obligations. The Proposal shifts the minimal creditworthiness determination directly into the definition of Eligible Security. *See* Proposing Release, at Section II.A.1.

12 *See* Rule 2a-7(c)(3)(ii).

13 The Proposal would eliminate the requirement that a guarantor or guarantee of portfolio securities be rated by an NRSRO.

obligations."[14] Second Tier Securities would continue to be defined as those Eligible Securities that are not First Tier Securities.

The Proposing Release elaborates on these revised definitions, stating that "[a]n issuer of a first tier security that would satisfy [the rule's] proposed standard should have an *exceptionally strong* ability to repay its short-term debt obligations and the *lowest expectation* of default," and that an "issuer of a second tier security ... should have a *very strong ability* to repay its short-term debt obligations, and a *very low vulnerability* to default." [15] The SEC stated that the credit risk between a First Tier and Second Tier Security should differ "only to a small degree."[16]

If the Proposal is adopted, a money fund's board would be allowed to consider quality determinations (including ratings) by NRSROs and other sources when determining whether portfolio securities present minimal credit risks to the fund. The SEC expects, however, that "fund advisers [will] ... understand the method [employed by the NRSRO] for determining the rating and make an independent judgment of credit risks, and ... consider an outside source's record with respect to evaluating the types of securities in which the fund invests."[17]

Securities Subject to a Conditional Demand Feature

Currently, under Rule 2a-7, a security that is subject to a Conditional Demand Feature may be determined to be an Eligible Security (or First Tier Security, as applicable) only if, among other things, the Underlying Security or any Guarantee of the security has received a rating from the Requisite NRSROs in the two highest categories (short- or long-term, as applicable) or, if unrated, has been determined by a money fund's board to be of comparable quality.[18] Under the Proposal, however, the credit rating requirement would be eliminated and instead the fund's board would be required to determine that the Underlying Security or any Guarantee of the security "is of high quality and subject to very low credit risk."[19] In this regard, the Proposing Release states that "[a]n issuer that is determined to have a *very strong* capacity to meet its financial commitments, a *very low* risk of default, and a capacity for payment of its financial commitments that is *not significantly vulnerable* to *reasonably foreseeable* events would satisfy [this proposed standard]."[20]

Monitoring for Ratings Downgrades and Minimal Credit Risks

Currently, under Rule 2a-7, a money fund's board is generally required to promptly reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks and to take such action as the board determines to be in the best interests of the fund and its shareholders.[21] Under the Proposal, if a money fund's investment adviser becomes aware of "any credible information about a portfolio security or an issuer of a portfolio security that may suggest that the security is no longer a First Tier Security or a Second Tier Security," the board would be required to promptly reassess whether the security continues to present minimal credit risks and cause the fund to take such action as the board determines to be in the best interests of the fund and its shareholders.

The Proposing Release states that "an investment adviser would be required to exercise reasonable diligence in keeping abreast of new information about a portfolio security that the adviser believes to be credible."[22] The SEC stated its belief that money funds currently exercise a similar degree of diligence.[23]

Stress Testing

Money funds are currently required to conduct periodic stress tests to simulate the impact of certain hypothetical events, including a credit ratings downgrade on

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14 *See* Proposed Rule 2a-7(a)(13) (emphasis added).

15 *See* Proposing Release, at Section II.A.1 (emphasis added).

16 *See* id.

17 *See* Proposing Release, at Section II.A.1.

18 *See* Rule 2a-7(c)(3)(iv).

19 *See* Proposed Rule 2a-7(c)(3)(iv)(C). Responsibility for making this determination could be delegated to the fund's adviser or officers.

20 *See* Proposing Release, at Section II.A.2 (emphasis added).

21 *See* Rule 2a-7(c)(7)(i)(A).

22 *See* Proposing Release, at Section II.A.3.

23 *See* id.

portfolio securities, on the fund's ability to maintain a stable net asset value per share.[24] The Proposal would amend this requirement to replace the reference to a credit ratings downgrade with an assessment *based on "an adverse change in the ability of* the issuer of a portfolio security to meet its short-tem financial obligations."[25] However, the Proposal would permit a money fund to continue to monitor and perform additional stress testing in connection with the hypothetical effect of a credit ratings downgrade of portfolio securities.

Proposed Amendments to Rule 5b-3

Rule 5b-3 under the Investment Company Act permits registered investment companies, under specific, limited conditions, to treat repurchase agreements as an acquisition of the collateral for purposes of: (1) section 5(b)(1) of the Investment Company Act (which limits the amount of securities of any one issuer in which a fund may invest if the fund holds itself out as "diversified"); and (2) section 12(d)(3) of the Investment Company Act (which generally prohibits investments in underwriters and broker-dealers). If a fund could not rely on Rule 5b-3, sections 5(b)(1) and 12(d)(3) would limit an investment company's ability to enter into repurchase agreements with a counterparty because a repurchase agreement could be considered an acquisition of an obligation of the counterparty.

Under Rule 5b-3, a fund is permitted to "look through" to the securities collateralizing the repurchase agreement if, among other things, the obligation of the counterparty to repurchase the securities from the fund is "collateralized fully." To be considered to be collateralized fully under the current rule, the repurchase agreement collateral must consist entirely of: (1) cash items; (2) U.S. government securities; (3) securities that, at the time the agreement was entered into, are rated in the highest rating category by the Requisite NRSROs; or (4) unrated securities of comparable quality.[26] The Proposal would remove from this definition collateral that is rated in the highest rating category by the Requisite NRSROs and unrated securities of comparable quality. Instead, the Proposal would introduce a standard under which an investment company's board would have to determine that, at the time the repurchase agreement is entered into: (1) the collateral is from an issuer[27] that has the "highest capacity to meet its financial obligations"; and (2) the securities are "sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days."[28]

The Proposing Release states that "[a]n issuer of collateral securities that the board (or its delegate) determined has an *exceptionally strong* capacity to repay its short or long-term debt obligations, as appropriate, the *lowest expectation* of default, and a capacity for repayment of its financial commitments that is *the least susceptible* to adverse effects of changes in circumstances would satisfy the proposed standard."[29]

Conclusion

Although the Proposal would remove NRSRO ratings from Rule 2a-7 and Rule 5b-3 under the Investment Company Act, the Proposing Release indicates that a fund could continue to look to those ratings if the fund's board concludes that the ratings establish standards that are similar to those proposed and are credible and reliable, and those determinations are reflected in the fund's procedures. This continued ability to make use of NRSRO credit ratings in an informative capacity, combined with the proposal of new, subjective standards that are closely analogous to those currently used by NRSROs, suggests that a shift in the universe of securities in which a money fund may invest is not intended. Nevertheless, by eliminating NRSRO ratings from Rule 2a-7, the Proposal would remove an objective test that fund investments must satisfy and replace it with a more flexible standard that arguably could allow a money fund to invest in portfolio securities that would not qualify as fund investments

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[24] *See* Rule 2a-7(c)(10)(v).

[25] *See* Proposed Rule 2a-7(c)(10)(v)(A).

[26] *See* Rule 5b-3(c)(1)(iv).

[27] Under Proposed Rule 5b-3(c)(4), the definition of an issuer would include an issuer of an unconditional guarantee of the security. Accordingly, collateral securities subject to unconditional guarantees would satisfy the proposed standard if the guarantor satisfied the proposed credit standard.

[28] *See* Proposed Rule 5b-3(c)(1)(iv)(C). The SEC stated that it expects that securities that trade in the secondary market at the time of the acquisition of the repurchase agreement would satisfy this proposed liquidity standard.

[29] *See* Proposing Release, at Section II.C (emphasis added).

under the current rule. These new, subjective standards could introduce greater ambiguity into both disclosure and regulatory compliance.

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