SEC Proposes to Remove Credit Ratings References from Money Market Fund Rule

In order to implement Sections 939 and 939A of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act"), the Securities and Exchange Commission (the "SEC") has proposed amendments to several rules and forms under the *Investment Company Act of 1940* (the "Investment Company Act") and the *Securities Act of 1933* (the "Securities Act") in order to remove key references to credit ratings. Arguably the most important of these proposed amendments is the removal of references to credit ratings in Rule 2a-7 under the Investment Company Act, which sets minimum quality standards for money market fund investments.

The removal of references to credit ratings in Rule 2a-7 affects several provisions of the rule, including (i) the determination of whether a security is an eligible security, (ii) the determination of whether a security is a first tier or second tier security and (iii) requirements for monitoring securities for ratings downgrades and other credit events.

Under the current rule, a money market fund may invest only in securities that are (i) determined by its board or its delegate (typically the fund's investment adviser) to present minimal credit risks (which determination must be based on factors pertaining to credit quality in addition to any credit ratings) and (ii) "eligible securities." Eligible securities are generally securities that have received credit ratings from certain ratings agencies in one of the two highest short-term rating categories, and are divided into first tier securities and second tier securities based largely on such ratings.

The proposed amendments would define "eligible security" in terms of the required determination of minimal credit risks, effectively replacing the objective standard of credit ratings with a subjective determination by a fund's board (or its delegate). Under the rule as proposed, the determination of minimal credit risk needed to qualify as an eligible security must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations.

Eligible securities still would be subdivided into first tier securities and second tier securities, and second tier securities would continue to be limited to three percent of total fund assets. However, a "first tier security" would be defined not by credit rating, but by a determination by the fund's board (or its delegate) that the issuer (or guarantor, if subject to a guarantee) has the "highest capacity to meet its short-term financial obligations." The SEC would expect the issuer of a first tier security to have "an exceptionally strong ability to repay its short-term debt obligations and the lowest expectation of default." A second tier security would be any other eligible security, though the SEC expects that even the issuer of a second tier security would have "a very strong ability to repay its short-term debt obligations" and "a very low vulnerability to default."

The proposed definition of first tier security may well draw comment from industry participants. A determination that an issuer has the *highest* capacity to meet its short-term financial obligations may not necessarily be viewed as consistent with the current standards for receiving a rating in the highest short-term ratings category insofar as it does not, taken literally, contemplate any variation in creditworthiness among issuers of first tier securities, which the current rule expressly does. However, some comfort may be taken

from the SEC's expressed intention that the proposed amendments "offer protections comparable to those provided by the [credit] ratings…." Additionally, the proposed amendments would not prevent consideration of "quality determinations prepared by outside sources, including [credit] ratings, that [boards or their delegates] conclude are credible and reliable." The proposing release also expressly stated that "nothing in the proposed rule would prohibit a money market fund from relying on policies and procedures it has adopted to comply with the current rule as long as the board (or its delegate) concluded that the ratings specified in the policies and procedures establish similar standards to those proposed, and are credible and reliable for that use."

The rule, as amended, also would create a somewhat more burdensome credit quality monitoring obligation. Currently, a fund's board (or its delegate), with respect to a rated security, must reassess its determination that a security presents minimal credit risks when the security's credit rating is downgraded. Under the rule as proposed, the board (or its delegate) would have to reassess its determination of any portfolio security whenever it becomes aware of any credible information about the security or its issuer that suggests that the security is no longer a first tier security or a second tier security, as applicable.

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The release proposing the amendments to Rule 2-a7 can be found here. Comments on the proposed amendments should be submitted to the SEC by April 25, 2011.

If you have any questions about the SEC's proposals, please contact the Ropes & Gray attorney who normally advises you.