ICI VIEWPOINTS

APRIL 27, 2011

ICI Suggests Fixes for Proposal to Eliminate Ratings Requirement from Money Market Fund Rules

By Jane Heinrichs

Unintended and undesirable consequences could result from a Securities and Exchange Commission proposal to eliminate credit ratings as a required element in determining which securities are permissible investments for money market funds. In a recent comment letter, we suggested a few ways that the SEC can change its proposal to head off these unintended consequences. One outcome in particular that we want to avoid is a possible weakening of credit standards in Rule 2a-7, the rule governing money market funds.

The starting point here is the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires federal agencies to review regulations and replace credit ratings as an assessment of creditworthiness. This requirement has implications for money market funds. Under current law, money market funds conduct their own thorough credit risk analysis for investments through a two-part test. First, a money market fund can only invest in securities that are “first-tier” or “second-tier” securities, based on a rating agency granting those securities the highest or second-highest short-term credit rating (or a determination by the fund that the securities are of comparable quality). Under the second test, a money market fund’s board of directors (or its delegate) must determine that a security presents minimal credit risks, based on factors relating to credit quality.

Our comment letter addresses the many ways that the SEC’s proposal could affect elements of Rule 2a-7. One important effect would be to remove the objective ratings agency requirement from the first part of that two-part test. However, the SEC proposal would maintain the distinction between first-tier and second-tier securities.

We are concerned that the SEC’s proposed approach could be interpreted to raise the credit standards for first-tier securities and lower them for second-tier securities. For one thing, the proposal does not seem to contemplate any variation in creditworthiness among issuers of first-tier securities. Under the proposal, a security would be a “first-tier security” if the fund’s board (or its delegate) determines that the issuer has the “highest capacity to meet its short-term financial obligations.” The emphasis on “highest” sets up a tighter standard than the current rules, which allow modest variation within the highest category of credit ratings. (For instance, a security is a first-tier security if it receives an A-1+ or an A-1 rating from a ratings agency.)

On the other hand, the proposed standard for second-tier securities may weaken the rule’s credit standards by permitting a fund to invest in a security that would not have qualified under the rule’s current standards. That increases the potential for harm to shareholders.

So we proposed a fix. We recommend defining an eligible security to mean “a security with a remaining maturity of 397 days or less that the fund’s board of directors determines presents minimal credit risks and the issuer of which the fund’s board of directors determines has a strong capacity to meet its short-term obligations.”

Our proposed standard would eliminate the first-tier and second-tier categories and effectively limit money market fund purchases to those securities that meet one uniform—but very high—standard. In other words, the securities would be generally comparable to securities rated in the highest short-term rating category (the first-tier securities under the current rule).

We think our proposal would allow for the necessary alterations of the regulations, while helping money market funds preserve the fundamental characteristics that investors need: seeking to maintain a stable $1.00 net asset value achieved by investing in high-quality, liquid, short-term securities.

- Read ICI's letter.
- Read the SEC's proposal.
- Read other comments on the proposal.
- Visit ICI's money market funds resource center.
- Visit ICI's resource center on financial services regulatory reform.

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