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Opening Remarks before the Commission Open Meeting by Andrew J. Donohue

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U.S. Securities and Exchange Commission

Speech by SEC Staff: Opening Remarks before the Commission Open Meeting

by

Andrew J. Donohue

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U.S. Securities and Exchange Commission

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Thank you Chairman Cox, Commissioner Atkins and Commissioner Casey.

Rules under the Investment Company and Investment Advisers Act use NRSRO ratings for various purposes intended to further our mandate of investor protection and the promotion of efficient markets. The uses made of NRSRO ratings in our rules is laudatory; nevertheless the trust and confidence that the industry and investors place in those ratings may be misplaced unless there is a better understanding of the basis of those ratings and some independent scrutiny of them.

The proposals you approved two weeks ago go a long way in providing a foundation for understanding the basis of the ratings and evaluating them. Our recommendations today compliment those earlier proposals by focusing on the purpose behind the use of NRSRO ratings for each of the rules that the Division of Investment Management administers and, with one exception, substituting for the references to credit ratings in those rules subjective requirements that are designed to achieve the intended purpose of each of those rules.

There are four rules under the Investment Company Act and one rule under the Investment Advisers Act that we recommend you propose to amend. Under the Investment Company Act, Rule 2a-7 uses credit ratings as one step to ensure quality controls for funds that hold themselves out as money market funds. Rule 3a-7 excludes from the Investment Company Act structured finance vehicles so long as, among other things, securities offered to retail investors (investors other than accredited investors and qualified institutional buyers) carry a high rating from an NRSRO. Rule 5b-3 allows investment funds seeking to meet the diversification requirements of the Investment Company Act to "look through" repurchase agreements in which they invest to the securities collateralizing the agreement so long as, among other things, those securities are highly rated or government issues. Rule 10f-3 permits investment companies to purchase municipal securities in an underwritten offering in which a fund affiliate is a member of the syndicate under certain conditions, including that the securities carry specified NRSRO ratings. Investment Advisers Act Rule 206(3)-3T provides an alternative means for investment advisers that also are registered broker-dealers to satisfy the notice and consent

requirements of Section 206(3) of the Advisers Act when they act in a principal capacity with certain of their advisory clients. The rule is available for transactions in non-convertible investment grade debt securities for which the adviser or a control affiliate is an underwriter of the security.

For each of these rules except Rule 3a-7, we recommend that you propose to eliminate the reference to credit ratings and instead require a subjective determination of the quality of the instruments at issue. More specifically, we recommend that you propose to amend those rules to require an investment company or investment adviser, as applicable, to make a determination that securities, that under current rules would be required to carry particular credit ratings, present minimal credit risks and are sufficiently liquid so that they may be sold at or near their carrying value within a short period of time.

With respect to Rule 3a-7, as part of this rulemaking initiative, we have reevaluated the use of credit ratings as a factor for excluding structured finance vehicles from the Investment Company Act and are recommending that you amend the rule to limit the type of investors that may participate in offerings of the securities of those vehicles to accredited investors and qualified institutional buyers to make the rule consistent with marketing practices relating to those vehicles. We also recommend that you substitute for the references to credit ratings in the rule certain procedures that are designed to protect the full and timely payment of outstanding fixed income securities and to require that cash flows from a structured finance vehicle's asset pool are deposited in a segregated account.

Because of the complexity and significance of Rule 2a-7, I'd like to discuss our recommended amendments for that rule with you in more detail.

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. These valuation requirements are designed to prevent the interests of investors from being diluted or otherwise adversely affected if fund shares are not priced fairly. 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. Money market funds subject to Rule 2a-7 today hold $3.5 trillion of investor assets.

Among the 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. Rule 2a-7 further restricts money market funds to securities that the fund's board of directors (or appropriate designee) determines present minimal credit risks. The rule specifically requires that the determination be based on factors pertaining to credit quality in addition to any ratings assigned to such securities by an NRSRO.

The proposed amendments to the Rule 2a-7 eliminate references to ratings by amending the rule in four principal ways. In combination, these proposed amendments are designed to offer similar protections to the current rule's reliance on NRSRO ratings. First, we propose to amend Rule 2a-7 to require that money market funds make the determination that each portfolio instrument presents minimal credit risks, and whether the security is a "First Tier Security" or a "Second Tier Security" for purposes of

the rule. We believe that money market funds would still be able to use credit quality determinations prepared by outside sources, including NRSRO ratings that they conclude are credible, in making credit risk determinations.

Second, the proposed amendments would require that 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. 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 adversely affected 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 on short notice. Accordingly, the proposed amendments would also expressly limit a money market fund's investment in illiquid securities to no more than 10 percent of its total assets and define a Liquid Security as 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.

Third, the proposed amendments would also revise 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. This proposed requirement would replace the provisions in the current rule that generally require a money market fund board to promptly 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.

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. We believe that the current notice provisions, which are triggered when a security held by a fund defaults, provide us with incomplete information about money market funds holding of distressed securities, particularly those that have engaged in an affiliated transaction with an affiliated person. The additional notice, which 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. The proposed amendments also would make conforming amendments to Rule 2a 7's record keeping and reporting requirements.

I would like to thank the many staff who contributed to this project. They include: Bob Plaze, Liz Osterman, Jennifer McHugh, Penelope Saltzman, David Blass, Vince Meehan, Matt Goldin, Greg Jaffray and Smeeta Ramarathnam. I would also like to thank our colleagues in the Divisions of Corporation Finance and Trading Markets as well as our colleagues in the Office of Economic Analysis and the Office of the General Counsel for their valuable assistance and consultation.

We are happy to answer any questions you have on our recommendations.

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