Consumer Federation of America

April 25, 2011

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

Re: File No. S7-07-11

Dear Secretary Murphy:

I am writing on behalf of the Consumer Federation of America (CFA)[1] to express our continued opposition to the Commission's proposal to eliminate the requirement that money market mutual funds limit their holdings to securities with the highest credit ratings.[2] While we sympathize with the challenge the Commission faces in fulfilling its congressional mandate to remove all regulatory references to ratings, we do not believe the current proposal satisfies that mandate, which specifically directs regulators to adopt alternative standards of credit-worthiness to substitute for reliance on ratings. Because the Commission proposal eliminates references to ratings without putting anything in their place, and because it continues to allow fund directors and managers to rely heavily on ratings in conducting their own evaluation of credit-worthiness, we do not believe it would result in the significantly reduced reliance on ratings that Congress intended. Nor would it make money market mutual funds safer. On the contrary, the rule proposal would throw open the door to even riskier investment practices by money market mutual funds. We therefore urge the Commission to withdraw this proposal until it can come up with an alternative approach that both reduces reliance on ratings and appropriately minimizes the risks money market funds may assume.

Recognizing that credit rating agencies had been key enablers of the financial crisis, Congress sought as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act both to improve the reliability of credit ratings and to reduce the financial system's vulnerability to a ratings failure. In pursuit of the latter goal, the Dodd-Frank Act eliminates references to credit ratings in federal financial statutes (Sec. 939) and directs regulators to eliminate references

[1] CFA is a non-profit association of nearly 300 pro-consumer organizations established in 1968 to represent the consumer interest through research, education, and advocacy.
[2] CFA had previously expressed opposition to this proposal in two joint comment letters with Fund Democracy. See September 5, 2008 Comment Letter from Mercer Bullard and Barbara Roper available here, http://www.sec.gov/comments/s7-19-08/s71908-47.pdf, and September 8, 2009 Comment Letter from Bullard and Roper, available here, http://www.sec.gov/comments/s7-11-09/s71109-79.pdf.

to ratings in their rules and regulations (Sec. 939A). The statute makes clear, however, that eliminating references to ratings is only half the equation. Both Sec. 939 and Sec. 939A direct regulators to develop alternative measures of credit-worthiness to use in ratings' place. While that is a daunting challenge, it is one that regulators must accept if this approach of reduced reliance on ratings is to make the system safer, as Congress intended.

It is precisely this challenge that the SEC rule proposal fails to meet. Although the Release states repeatedly that the Commission is proposing to replace references to ratings "with alternative standards of credit-worthiness that are designed to appropriately achieve the same purposes as the ratings requirements," even a casual review of the proposal makes clear that this is not the case. The only "alternative" measure of credit-worthiness proposed in the rule is a determination by the fund Board of Directors or its delegate that a security has the "highest capacity to meet its short-term obligations" for first tier securities or a "very strong" ability to meet its short-term debt obligations and a "very low" vulnerability to default, for second tier securities. But this simply restates the existing obligations of Boards of Directors and their delegates to ensure that money market funds invest only in appropriate investments. It does not impose any objective limits on securities money market funds could invest in. Nor does it provide any guidance on factors, beyond credit ratings, that boards would have to consider in arriving at their assessments of credit risks.

As a result, the best that can reasonably be hoped for under this approach is that nothing much will change. Many fund boards and managers will doubtless continue to rely heavily on ratings in judging credit-worthiness, as the rule proposal explicitly permits. This is particularly likely at smaller fund companies that lack the resources to conduct extensive, independent credit analysis of a multitude of securities in-house. Given the relatively problem-free history of money market mutual funds, this is not the worst possible outcome. But it is not consistent with congressional intent that elimination of references to ratings actually result in reduced reliance on ratings.

There is every reason to believe, however, that the current proposal will actually expose investors to increased risks, at least at some funds. In a highly competitive market, where offering even a slightly higher return gives funds a distinct competitive edge, some funds will inevitably be tempted to test the edge of the envelope with their investment practices. Under the current proposal, there will be nothing but the good judgment of the fund board and manager to prevent them from doing so. Even regulators prepared to closely oversee and strictly police fund company investment practices would find it difficult to prevent such actions. Experience suggests, however, that regulators are likely to take a more hands-off regulatory approach. Regulators have traditionally shown themselves to be highly reluctant to challenge such management judgments. Indeed, the fact the Commission has failed even to offer an alternative measure of credit-worthiness as part of this rule proposal strongly suggests that it will not be willing to challenge fund companies' credit assessments. In addition, even if the Commission were willing to take a more aggressive approach, it is unlikely to be funded at a level that would make such close supervision possible. As a result, any regulatory action to constrain risk-taking is likely to come only after disaster has struck. If that were to occur, it could severely undermine investor confidence in money market mutual funds, including those that had previously followed sound investment practices.

While credit ratings have been an imperfect measure of credit-worthiness, their use in this context at least puts an identifiable outside limit on the investments that a money market mutual fund can hold. In developing an alternative to reliance on credit ratings, the Commission must create some similar concrete limitation on money market fund investments. While we are not experts in risk assessment, two approaches suggest themselves. The first would be to prohibit money market mutual funds from investing in certain categories of investments, such as structured finance products that are too new to have a proven track record of performance under varied market conditions or products that are insufficiently transparent to allow a thorough and objective assessment of their risks. Doubtless there are other prohibitions the Commission could impose to ensure that money market mutual funds restrict themselves to appropriately plain vanilla investments. Properly implemented, such an approach would actually increase investor protections by counteracting precisely the weakness Congress sought to address with its credit rating agency reforms – the willingness of rating agencies to grant investment grade ratings to securities whose risks they did not understand and could not calculate.

Another alternative would be to maintain the general approach taken in this rule proposal but with more specific direction regarding the types of information that fund boards or their delegates would have to consider in arriving at credit-risk determination. Under such an approach, the Commission would need to identify the types of objective data that credit rating agencies and other risk assessment specialists consider or should consider when they develop credit ratings for short-term securities of the types held by money market mutual funds. The Commission could then specifically require that fund boards or their delegates review those types of data and be prepared to document the basis on which they determined that a particular security or category of securities had the "highest capacity to meet its short-term obligations," as described in the rule proposal for first tier securities, or a "very strong" ability to meet its short-term debt obligations and a "very low" vulnerability to default for second-tier securities. Moreover, the information considered and the degree of review required could be determined at least in part by the type of security being considered – with newer, less transparent, more complex securities requiring a more in-depth review. This approach would be more difficult to enforce than the previous approach, but it would be more easily adapted to changing market conditions.

During the legislative debate that led to passage of Dodd-Frank, CFA supported efforts to reduce reliance on ratings. However, we favored an approach that provided regulators with greater flexibility to determine the best approach to reducing reliance. In particular, we sought flexibility for regulators to consider approaches to supplement reliance on ratings if that offered the best protection for investors. Our purpose in arguing for greater regulatory flexibility was to avoid precisely the kind of perverse outcome presented by this proposal, where elimination of references to ratings leaves investors with fewer protections and makes the financial system less safe. While we did not win the battle to provide greater regulatory flexibility, we believe the statutory language directing regulators to come up with alternative measures of credit-worthiness demands and more robust response from the Commission than this proposal provides. Specifically, both the statutory language and congressional intent demand that the Commission come up with an alternative that is at least as protective of investors as the current law.

For these reasons, we urge you to table this proposal until the Commission is prepared to offer a meaningful alternative that satisfies the congressional mandate and, at the very least, does not expose investors to greater risks than they currently face when they invest in money market mutual funds.

Respectfully submitted,

Barbara Roper

Barbara Roper
Director of Investor Protection

cc: Chairman Mary Schapiro
Commissioner Luis Aguilar
Commissioner Kathleen Casey
Commissioner Troy Paredes
Commissioner Elisse Walter