Securities and Exchange Commission

17 CFR Parts 270 and 274

Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule; Proposed Rule
SEcurities and Exchange COMMISSION

17 CFR Parts 270 and 274


RIN 3235–AK61

Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule

AGENCY: Securities and Exchange Commission.

ACTION: Re-proposed rule; proposed rule.

SUMMARY: The Securities and Exchange Commission (“SEC” or “Commission”) is re-proposing certain amendments, initially proposed in March 2011, related to the removal of credit rating references in rule 2a–7, the principal rule that governs money market funds, and Form N–MFP, the form that money market funds use to report information to the Commission each month about their portfolio holdings, under the Investment Company Act of 1940 (“Investment Company Act” or “Act”). The re-proposed amendments would implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). We are issuing this re-proposal in consideration of comments received on our March 2011 proposal. In addition, we are proposing to amend rule 2a–7’s issuer diversification provisions to eliminate an exclusion from these provisions that is currently available for securities subject to a guarantee issued by a non-controlled person.

DATES: Comments should be received on or before October 14, 2014.

ADDRESSES: Comments may be submitted by any of the following methods:

- Electronic Comments:
  - Use the Commission’s Internet comment form (http://www.sec.gov/rules/proposed.shtml);
  - Send an email to rule-comments@sec.gov. Please include File Number S7–07–11 on the subject line; or
  - Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

- Paper Comments:
  - Send paper comments to Kevin M. O’Neill, Deputy Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–07–11. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet Web site (http://www.sec.gov/rules/proposed.shtml). Comments also are available for Web site viewing and printing in the Commission’s Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Erin C. Loomis, Senior Counsel; Amanda Hollander Wagner, Senior Counsel; Penelope W. Saltzman, Senior Special Counsel; Investment Company Rulemaking Office, at (202) 551–6792, Division of Investment Management, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549–8549.

SUPPLEMENTARY INFORMATION: We are proposing for public comment amendments to rule 2a–7 [17 CFR 270.2a–7] and Form N–MFP [17 CFR 274.201] under the Investment Company Act.1

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I. Background

A. Credit Rating References

Section 939A of the Dodd-Frank Act requires each Federal agency, including the Commission, to “review any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings.” 2 That section further provides that each such agency shall “modify any such regulations identified by the review . . . to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations.” 3

As a step toward implementing these mandates, in March 2011 we proposed to replace references to credit ratings issued by nationally recognized statistical rating agencies (“NRSROs”) in two rules and four forms under the Securities Act of 1933 (“Securities Act”) and the Investment Company Act, including rule 2a–7 and Form N–MFP under the Investment Company Act.4 The 2011 proposal preceded other amendments to rule 2a–7 and Form N–MFP that were adopted as a result of the requirements of the Dodd-Frank Act.

1 See References to Credit Ratings in Certain Investment Company Act Rules and Forms, Investment Company Act Release No. 29592 (Mar. 3, 2011) [76 FR 12896 (Mar. 9, 2011)] (“2011 Proposing Release”). Specifically, we proposed to:

• (i) Remove references to credit ratings in rules 2a–7 and 5b–3 under the Investment Company Act and replace them with alternative standards of creditworthiness; (ii) adopt new rule 6a–5 under the Investment Company Act that would establish a creditworthiness standard to replace the credit rating reference in section 6(a)(5) removed by the Dodd-Frank Act; (iii) eliminate required disclosures of credit ratings in Form N–MFP under the Investment Company Act; and (iv) remove the requirement that credit ratings used when portraying credit quality in shareholder reports from Forms N–1A, N–2, and N–3 under the Securities Act and the Investment Company Act. In December 2013, we adopted amendments removing references to credit ratings in rule 5b–3 and eliminating the required use of credit ratings in Forms N–1A, N–2, and N–3. See Removal of Certain References to Credit Ratings under the Investment Company Act, Investment Company Act Release No. 30847 (Dec. 27, 2013) [79 FR 1316 (Jan. 8, 2014)] (“2013 Ratings Removal Adopting Release”). We adopted new rule 6a–5 on November 19, 2012. See Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on an Investment Company Act Exemption, Investment Company Act Release No. 30268 (Nov. 19, 2012) [77 FR 70117 (Nov. 23, 2012)].

Rule 2a–7 under the Investment Company Act also contains a reference to ratings. In August 2011, in a concept release soliciting comments on the treatment of asset-backed issuers under the Investment Company Act, we sought comment on the rule, if any, that credit ratings should continue to play in the context of rule 2a–7. See Treatment of Asset-Backed Issuers under the Investment Company Act, Investment Company Act Release No. 29779 (Aug. 31, 2011) [76 FR 53508 (Sept. 7, 2011)] at section III.A.1.

The 2011 proposal preceded other amendments to rule 2a–7 and Form N–MFP

1 Unless otherwise noted, all references to statutory sections are to the Investment Company Act, and all references to rules under the Investment Company Act, including rule 2a–7, will be to Title 17, Part 270 of the Code of Federal Regulations [17 CFR 270].
MFPs that we proposed last year as part of our broader efforts to reform money market funds. At that time, we noted that we were not rescinding our 2011 proposal to remove ratings references from certain rules and forms under the Investment Company Act, but that we intended to address the matter at another time.

We received several comments on the 2013 Money Market Fund Proposing Release suggesting that we act on credit ratings as part of our broader money market fund reforms. And today in another release, we have adopted certain amendments to rule 2a–7 and Form N–MFP that we proposed last year. We also received comments on the 2011 Proposing Release that raised a number of concerns with respect to the proposed amendments and suggested alternative rule text for some provisions. We have determined to re-propose amendments to replace references to credit ratings in rule 2a–7 and to modify provisions in Form N–MFP that reference credit ratings, in consideration of the mandate of Dodd-Frank Act section 939A, the comments on the 2011 Proposing Release, and the broader money market fund reforms we have adopted today.

A number of other Federal agencies have also taken action to implement section 939A of the Dodd-Frank Act, including regulations proposed or adopted by the Commodity Futures Trading Commission, the Office of the Comptroller of the Currency ("OCC"), the National Credit Union Administration, the Federal Housing Finance Agency, the Department of Labor, and jointly by the OCC and Board of Governors of the Federal Reserve. In some of these initiatives, the references to ratings were or would be replaced with an alternative standard designed to retain the same degree of credit quality as reflected by the use of credit ratings. We have considered the actions taken by these other regulators in re-proposing the amendments discussed in this release.

B. Exclusion From the Issuer Diversification Requirement

As noted above, today we adopted amendments to rule 2a–7 as part of our broader money market fund reforms. These included amendments relating to the rule’s diversification provisions, which require a money market fund to diversify its investments with respect to issuers of the securities it acquires, as well as providers of demand features and guarantees related to those securities. As discussed in the 2014 Money Market Fund Adopting Release, we sought comment on specific amendments we proposed as well as more broadly on the issuer and guarantor diversification requirements. Some of the comments we received in response prompted us to re-evaluate the exclusion to the issuer diversification requirement for issuers subject to a guarantee issued by a non-controlled person. After careful consideration, and consistent with our reform goal of limiting concentrated exposure of money market funds to particular economic enterprises, we are proposing amendments that would eliminate this exclusion from the issuer diversification requirement of rule 2a–7.

II. Discussion

A. Rule 2a–7

The Investment Company Act and applicable rules generally require investment companies (“funds”) to calculate current net asset value per share by valuing their portfolio instruments at market value or, if market quotations are not readily available, at fair value as determined in good faith by the board of directors. These valuation requirements are designed to prevent unfair share pricing from diluting or otherwise adversely affecting the interests of investors.

Rule 2a–7 under the Investment Company Act, which governs the operation of money market funds, exempts certain money market funds from these valuation requirements. Until today, all money market funds have been permitted to value their portfolio securities using the amortized cost method of valuation ("amortized cost method") and to use the penny-rounding method of pricing ("penny-rounding method") to maintain a stable share price, typically $1.00 per share.

12 See section 2(a)(41) of the Investment Company Act (defining value), rule 2a–4 (defining current net asset value), and rule 22c–1 (generally requiring open-end funds to sell and redeem their shares at a price based on the funds’ current net asset value as next computed after receipt of a redemption, purchase, or sale order).

13 If shares are sold or redeemed based on a net asset value that has been either understated or overstated compared to the amount at which portfolio instruments could have been sold, then the interests of either existing shareholders or new investors will have been diluted. See Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] at text accompanying and following nn. 39–40; see also 2014 Money Market Fund Adopting Release, supra note 8, at section III.D (providing valuation guidance aimed at, among other things, promoting stronger valuation practices that may lessen a money market fund’s susceptibility to heavy redemptions by decreasing the likelihood of sudden portfolio write-downs that could encourage financially sophisticated investors to redeem early).

14 Under the amortized cost method, portfolio instruments are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. See rule 2a–7(a)(2). Share price is determined under the penny-rounding method by valuing securities at market value, fair value or amortized cost and rounding the per share net asset value to the nearest cent on a share price of a dollar, as opposed to the nearest one tenth of one cent as otherwise would be required. See Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), Investment Company Act Release No. 13380 (July 11, 1983) [48 FR 32555 (July 16, 1983)].
After the amendments adopted today go into effect, however, institutional prime and institutional municipal money market funds (collectively, “institutional prime funds”) will be required to sell and redeem shares at their net asset value calculated on the current market-based value of the securities in their underlying portfolios, rounded to the fourth decimal place \((\text{e.g., } \$1.0000)\), i.e., transact at a “floating” net asset value per share (“NAV”).

Rule 2a–7 contains “risk limiting” provisions designed to minimize the amount of risk a money market fund may assume. For those funds that are permitted to maintain a stable share price, these conditions help reduce the deviation between a money market fund’s stabilized share price and the market value of its portfolio. For floating NAV funds, these conditions help to limit the risk of loss by, among other things, reducing principal volatility. Any fund that holds itself out to investors as a money market fund or the equivalent of a money market fund also must comply with these conditions. Among these conditions, rule 2a–7 limits a money market fund’s portfolio investments to “eligible securities,” or securities that have received credit ratings from the “requisite NRSROs” in one of the two highest short-term rating categories or comparable unrated securities. A requisite NRSRO is an NRSRO that a money market fund’s board of directors has designated for use (a “designated NRSRO”) and that issues credit ratings that the board determines, at least annually, are sufficiently reliable for the fund to use in determining the eligibility of portfolio securities. Rule 2a–7 further restricts money market funds to securities that the fund’s board of directors (or the board’s delegate) determines present minimal credit risks, and specifically requires that determination “be based on factors pertaining to credit quality in addition to any ratings assigned to such securities by an NRSRO.” A money market fund is required to invest at least 97 percent of its total assets in eligible securities that have received a rating from the requisite NRSROs in the highest short-term rating category for debt securities (“first tier securities”) or unrated securities of comparable quality.

To implement the mandate of Dodd-Frank Act section 939A, we are re-proposing amendments to remove references to credit ratings in rule 2a–7. The re-proposed amendments would affect five elements of the rule: (i) Determination of whether a security is an eligible security; (ii) determination of whether a security is a first tier security; (iii) credit quality standards for securities with a conditional demand feature; (iv) requirements for monitoring securities for ratings downgrades and other credit events; and (v) stress testing.

1. Eligible Securities

In 2011, we proposed to eliminate the requirement that eligible securities be rated. Instead, the Commission would have required that fund boards: First, determine whether securities are eligible securities based on minimal credit risks; and second, distinguish between first and second tier securities based on subjective standards similar to those the ratings agencies have developed to describe their ratings.

We requested comments on this proposal, including comments on whether the Commission should limit money market funds to investing in securities solely based on a minimal credit risk determination, i.e., establish a single test for determining whether a fund could invest in a security.

A number of commenters objected to our proposal to retain the distinction between first and second tier securities...
They asserted that these proposed amendments were (i) unworkable because of the difficulty in differentiating between first and second tier securities and (ii) redundant because the amendments would require fund boards and their advisers to apply almost indistinguishable subjective judgments in determining whether securities were both eligible securities and first tier securities. Instead, they urged that we combine the two criteria and require a single, uniform, very high standard of quality. Specifically, several commenters suggested that the rule define an “eligible security” to mean a security with a remaining maturity of 397 calendar days or less that the fund’s board of directors (or the board’s delegate) determines presents minimal credit risks and include a determination that the security’s issuer has “the highest capacity” or “a strong capacity” to meet its short-term obligations. These commenters noted


31 See, e.g., Comment Letter of Fidelity Investments (Apr. 28, 2011) (“Fidelity Comment Letter”); (”Under the []standard for credit quality, if the issuer has the 'highest capacity' to meet obligations, it would be a 'strong capacity' standard to the extent feasible, we are re-proposing amendments to rule 2a–7. The re-proposal would combine the two risk criteria into a single standard, which would be included as part of the rule’s definition of eligible security. As re-proposed, an eligible security would be a security with a remaining maturity of 397 calendar days or less that the fund’s board of directors (or its delegate) determines present minimal credit risks, which determination includes a finding that the security’s issuer has an exceptionally strong capacity to meet its short-term obligations. Thus, under our re-proposal, a money market fund would be limited to investing in securities that the fund’s board (or its delegate) has determined present minimal credit risks, notwithstanding any rating the security may have.

7, noting that this standard reflects certain NSRRs’ highest short-term rating category, but also recommending that the Commission adopt an “exceptionally strong capacity” standard, which would be consistent with the definitions used by many NSRRs to define their highest long-term category, as an alternative substitute for the credit rating references in rule 5b–3; Vanguard Comment Letter, supra note 30 (advocating a determination that the issuer have the “highest capacity” to meet those obligations).

34 See id.

35 Currently, the requirement that the fund board (or its delegate) determine that a security presents minimal credit risks is set forth in rule 2a–7(d)(2)(ii) (requiring that the minimal credit risk be based on factors pertaining to credit quality in addition to any rating assigned by a designated NSRO). Under our re-proposal, the definition of eligible security in the rule would be restructured to include the minimal credit risk determination, and would include government securities and securities issued by money market funds, which are currently included in the definition of first tier security. See rule 2a–7(a)(14).

36 Re-proposed rule 2a–7(a)(11). The re-proposal would make a conforming change to the recordkeeping requirements under the rule to reflect that fund boards (or their delegates) would have the “highest capacity” to meet its short-term obligations could raise the standard above that in the current rule because this standard, if taken literally, does not contemplate any variations in the capacity of issuers to repay obligations. These commenters also maintain that the proposed standard for second tier securities, which was not tied to minimum rating requirements, could permit a fund to invest in securities that would not be eligible securities under the current rule.

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received. In addition, fund boards would no longer be required to designate NSRRs. The re-proposed determination is designed to retain a degree of credit risk similar to that in the current rule by allowing for gradations in credit quality among securities that meet a very high standard of credit quality, while limiting a money market fund’s investments in second tier securities to those the fund determines do not diminish the overall high quality of the fund’s portfolio. As a result of the single standard and elimination of the distinction between first and second tier securities we are re-proposing, we also are re-proposing to remove the current prohibition on funds investing more than 3 percent of their portfolios in second tier securities.
only have an acceptable or adequate ability to repay short-term obligations under rating agency standards, would satisfy the re-proposed “exceptionally strong capacity” standard.45 We therefore believe, as a practical matter, that the re-proposed standard would generally preclude funds from determining that securities rated “third tier” (or comparable unrated securities) would be eligible securities under rule 2a–7.

In determining whether a security presents minimal credit risks, a fund adviser could take into account credit quality determinations prepared by outside sources, including NRSRO ratings, that the adviser considers are reliable in assessing credit risk. In considering such sources, an adviser should understand the particular NRSRO’s methodology for determining the rating at issue and make an independent judgment of credit risks, and it should consider any outside source’s record with respect to evaluating the types of securities in which the fund invests.

We request comment on consolidating the credit quality standard and eliminating the distinction between first and second tier securities. Do commenters believe that the re-proposed standard is an appropriate standard of creditworthiness for rule 2a–7? Is the re-proposed “exceptionally strong capacity” standard an appropriate substitute for credit ratings in rule 2a–7? Is there another standard that would be a more appropriate substitute for credit ratings in rule 2a–7? Would the re-proposed consolidated standard, which requires a minimum credit risk determination and includes a finding that the issuer has an “exceptionally strong capacity” to meet its short-term obligations, provide sufficient clarity for money market fund boards and advisers making credit quality determinations? Would such a standard impact investors’ understanding of credit quality? Would it promote greater or less uniformity in credit quality determinations among funds than the standard we proposed in 2011? Would the 2011 proposal establish risk limitations more in line with those provided under the current rule? Is there an alternative standard for making credit quality determinations that is more objective than the re-proposed standard? We note that no commenters provided suggestions when we sought comment in the 2011 proposal on alternatives that would provide a more objective evaluation of credit quality; have commenters’ positions on this issue evolved since 2011?

We also request specific comment on the finding, required as part of the minimal credit risk determination, that the security’s issuer has an exceptionally strong capacity to meet its short-term financial obligations. What is this proposed standard likely to have on the overall risk of money market fund portfolios? What impact is this re-proposed “exceptionally strong capacity” standard likely to have on money market fund acquisitions of first tier securities? Does it permit sufficient variation among the most creditworthy issuers? Similarly, what impact is the re-proposed “exceptionally strong capacity” standard likely to have on money market fund acquisitions of second tier securities? Will this re-proposed standard, and the elimination of the distinction between first and second tier securities in rule 2a–7, lead money market funds to acquire more second tier securities than they do currently? Would a finding that a security’s issuer instead has a “superior,” “very strong,” or “strong” capacity to meet its short-term financial obligations better reflect the current risk limitation in rule 2a–7, or would it result in a standard that is less stringent than under the current rule? Our goal is to preserve a similar degree of risk limitation as in the current rule, and we note that the phrase “strong capacity” reflects the standard that one NRSRO articulates for securities with a second tier rating.46

As discussed above, we believe that the re-proposed standard would preclude funds from investing in securities rated third tier (or comparable unrated securities).47 Do funds agree? We do not believe that the re-proposed standard should significantly affect money market funds’ investment in unrated securities because we understand that money market funds hold few unrated securities.48 We
request comment about the potential reasons for this current practice. Specifically, is there currently a limited supply of unrated securities that qualify as eligible securities, or do money market funds hold few unrated securities for other reasons (e.g., investor or board of directors' requirements for ratings)? Would money market funds invest in more unrated securities under our re-proposed amendments?

As discussed in the 2014 Money Market Fund Adopting Release, we recognize that certain of the amendments to rule 2a–7 adopted today could affect money market fund managers' investment decisions. Under the newly adopted amendments to rule 2a–7, certain money market funds would be required to transact using a floating NAV. Managers of floating NAV funds, in an effort to limit volatility, might further limit their investments in relatively riskier portfolio securities, or conversely, in an effort to increase yield, might increase their investments in such securities. As described in more detail below, we request comment on the extent to which the re-proposed standard may affect the potential incentive for certain funds to invest in riskier securities (i.e., those securities that would be second tier under current rule 2a–7). Would a finding that issuers have an "exceptionally strong capacity" to meet their short-term obligations mitigate any risks associated with floating NAV funds' potential incentives to invest in riskier securities? Would a finding that issuers have a "superior," "very strong," or "strong" repayment ability be a sufficient risk mitigant?

Also under the amendments to rule 2a–7 we adopted today, all money market funds (including those still able to transact at a stable NAV) will be required to disclose daily the market value of their portfolios generally to the fourth decimal place. If a money market fund were to invest to a greater extent than its peer funds in riskier second tier securities, then that fund would have greater volatility in the price or market value of its shares, as compared to the volatility and price of its peer funds' shares. We request comment on whether potential incentives for increased investments in riskier second tier securities would be reduced by market discipline resulting from these newly required disclosures.

Rule 2a–7 does not set forth any specific factors that a board (or its delegate) should consider in determining minimal credit risks. In response to our 2011 proposal to replace an objective standard of an NSRRO rating for eligible securities with a subjective standard, some commenters advocated that we develop specific guidance in connection with assessments of credit quality. We have provided guidance before regarding certain factors to be considered in minimal credit risk determinations for asset-backed securities under rule 2a–7 and in our release removing references to credit ratings from the net capital rule under the Securities Exchange Act of 1934. Commission staff also has provided guidance in the past on factors that a board could consider in performing credit assessments under rule 2a–7.

Our staff also has had opportunities to observe how money market fund advisers evaluate minimal credit risk through its examinations of money market funds. Although staff has noted a range in the quality and breadth of credit risk analyses among the money market funds examined, staff also has observed that when performing their minimal credit risk determinations, most of the advisers to these funds evaluate some common factors that bear on the ability of an issuer or guarantor to meet its short-term financial obligations. Based on the staff's experience and in consideration of general criteria included in recommendations by an industry money market working group of best practices for making minimal credit risk determinations, we believe that an assessment of the strength of any issuer's or guarantor's ability to satisfy these obligations generally should include an analysis of the following factors to the extent appropriate: (i) The issuer or guarantor's financial condition, i.e., analysis of recent financial statements, including trends relating to cash flow, revenue, expenses, profitability, short-term and total debt service coverage, and leverage (including financial leverage and operating leverage); (ii) the issuer or guarantor's liquidity, including bank lines of credit and alternative sources of liquidity; (iii) the issuer or guarantor's ability to react to future events, including a discussion of a "worst case scenario," and its ability to repay debt in a highly adverse situation; and (iv) the strength of the issuer or guarantor's industry within the economy and relative to economic trends as well as the issuer or guarantor's competitive position within its industry (including diversification in sources of profitability, if applicable). In
addition, a minimal credit risk evaluation could include an analysis of whether the price and/or yield of a security is similar to that of other securities in the fund’s portfolio.  

The staff has also observed other factors that money market fund advisers may take into account when evaluating minimal credit risks of particular asset classes. To the extent applicable, fund advisers may wish to consider the following additional factors:

- For municipal securities: (i) Sources of revenue and demographics (favorable or unfavorable); (ii) the issuer’s autonomy in raising taxes and revenue; (iii) the issuer’s reliance on outside revenue sources, such as revenue from a state or Federal government entity; and (v) the strength and stability of the supporting economy.

- For conduit securities under rule 2a-7; Analysis of the underlying (advising that in making its minimal credit risk determination, a money market fund board of directors should take into account certain kinds of factors, such as the issuer’s or guarantor’s current and future credit quality; the strength of the issuer’s or guarantor’s industry within the economy and relative to economic trends; the issuer’s or guarantor’s market position within its industry; cash flow adequacy; the level and nature of earnings; financial leverage; asset protection; the quality of the issuer’s or guarantor’s accounting practices and management; the likelihood and nature of event risks, and the effect of any significant ownership positions; the degree of financial flexibility of the issuer or guarantor to cope with unexpected challenges and to take advantage of opportunities, as well as an assessment of the degree and nature of event risks; the likelihood of a sudden change in credit quality from external and internal sources); ICI Working Group Report, supra note 22, at Appendix I (recommended the same general criteria set forth in the 1990 Staff Letter for assessing the credit risks of issuers and securities in procedures for determining minimal credit risks as well as consideration of financial and other information provided by the issuer). See also OCC Guidance on Due Diligence Requirements in Determining Whether Securities are Eligible for Investment, 77 FR 35259 (June 13, 2012) (“OCC Guidance”) (matrix of examples of factors for national banks and Federal savings associations to consider as part of a robust credit risk assessment framework (“OCC credit risk factors”) for certain investment securities includes capacity to pay and assess operating and financial performance levels and trends).

58 Demographics could include considerations such as the type, size, diversity and growth or decline of the local government’s tax base, including income levels of residents, and magnitude of economic activity.

59 See 1989 Staff Letter, supra note 52 (additional factors such as repayment autonomy in raising taxes and revenue, reliance on outside revenue sources and strength and stability of the supporting economy should be considered with respect to tax-exempt securities); OCC Guidance, supra note 56.

60 Under rule 2a-7, a “conduit security” means a security issued by a municipal issuer involving an arrangement or agreement entered into, directly or indirectly, with a person other than a municipal issuer, which arrangement or agreement provides for or secures repayment of the security. Rule 2a-7(a)(7). A “municipal issuer” is defined under the rule to mean a state or territory of the United States (including the District of Columbia), or any political subdivision or public instrumentalities of a state or territory of the United States. Id. A conduit security does not include a security that is: (i) Fully and unconditionally guaranteed by a municipal issuer; (ii) payable from the general revenues of the municipal issuer or other municipal issuers (other than those revenues derived from an agreement or arrangement with a person who is not a municipal issuer that provides for or secures repayment of the security issued by the municipal issuer); (iii) related to a project owned and operated by a municipal issuer, or (iv) related to and under the control of an industrial or commercial enterprise that is part of a public project which, as a whole, is owned and under the control of a municipal issuer. Id.

61 See OCC Guidance, supra note 56 (OCC credit risk factors for revenue bonds include consideration of the obligor’s financial condition and reserve levels).


63 A variable rate demand obligation (which includes variable rate demand notes) is a security for which the interest rate resets on a periodic basis and holders are able to liquidate their security through a “put” or “tender” feature, at par. To ensure that the securities are able to be “put” or “tendered” by a holder in the event that a remarketing agent is unable to remarket the security, a VROD sells the underlying collateral (the obligation) at par, at a certain time or times prior to maturity or upon the occurrence of specified events or conditions. See Municipal Securities Rulemaking Board, Glossary of Municipal Securities Terms, Tender Option Bond, http://www.msbh.org/glossary/definition/tender-option-bond.aspx.

64 Under rule 2a-7(a)(5), for a repurchase agreement to be “collateralized fully,” among other requirements, the collateral must consist entirely of cash items or Government securities. See 55 Fed. Reg. 39750–39753 (1990).

65 Under rule 2a-7(3)(ii)(A), requiring the fund’s board of directors to evaluate the creditworthiness of the seller of a fully collateralized repurchase agreement when looking to the collateral issued for purposes of determining issuer’s diversification under the rule).

66 See ICI Working Group Report, supra note 22, at Appendix I (“When repayment of an obligation (such as a repurchase agreement) may depend on the liquidation of securities or other assets (Collateral), the credit analysis should include an assessment of the volatility and liquidity of the market for the collateral, especially in times of market stress. The analysis should also consider the process for liquidating the Collateral, which would be likely buyers of the Collateral, and how long it might take to complete the liquidation. These
• For repurchase agreements that are not fully collateralized under rule 2a–7, a financial analysis and assessment of the minimal credit risk of the counterparty, as described above, without regard to the value of the collateral, and consideration of the type of collateral accepted and the ability of the money market fund to liquidate the collateral.

This list is not meant to be exhaustive. We recognize that the range and type of specific factors appropriate for consideration could vary depending on the category of issuer and particular security or credit enhancement under consideration, and may include any factors in addition to those discussed above that the board determines appropriate to the credit assessment.

Individual purchases may require more or less analysis depending on the security’s risk characteristics. As discussed in greater detail below, we also would expect that the written record of the minimal credit risk determination generally would address any factors considered and the analysis of those factors.

We request comment on the factors discussed above for consideration, as appropriate, in the determinations that portfolio securities present minimal credit risk. Do commenters agree that these are relevant factors for advisers to consider in assessing whether portfolio securities present minimal credit risk? Are the factors sufficiently clear? Would it be helpful to describe any of the factors with additional specificity? To factors should be included in the analysis of the Collateral’s potential volatility and liquidity.

See supra text accompanying and following notes 55–70. As noted above, money market fund boards of directors may delegate minimal credit risk determinations to the fund’s adviser. See supra note 22. Rule 2a–7 requires money market fund boards to establish and periodically review written procedures regarding the delegation (including guidelines for determining whether securities present minimal credit risks) and to take measures reasonably necessary to assure that the guidelines and procedures are being followed. See rule 2a–7(i): see also rule 38a–1 (requiring funds to adopt and implement written policies and procedures reasonably designed to prevent a fund from violating the Federal securities laws). These policies and procedures generally should identify the process to be followed by the adviser in performing credit assessments, including, as appropriate, the types of data to be used or factors to be considered with respect to particular securities and the person(s) or position(s) responsible to the designated authority. They also generally should provide for regular reporting to the board, as appropriate, about these evaluations, to allow the board to provide effective oversight of the process. See 2013 Ratings Removal Adopting Release, supra note 14, at paragraph preceding paragraph accompanying n.3.

See infra section II.A.3; proposed rule 2a–7(h)(1)(i)(A) what extent do investment advisers currently consider these factors in making minimal credit risk determinations? Do commenters agree with our understanding that consideration of these factors is consistent with current industry practice? Are there factors we should omit or other factors we should consider including, such as credit spreads or the issuer or guarantor’s risk management structure? If so, why? In light of the amendments being considered in this re-proposal, would the guidance contribute to consistency in making and breadth of money market funds’ credit analyses? If so, would it reduce the potential for significant variations in money market funds’ risk profiles? Should the factors address other asset classes? If so, what types of securities should be included and what factors would be appropriate for consideration? We do not presently propose to codify the factors as part of rule 2a–7. We request comment, however, on whether codifying these factors would further ensure that funds use objective factors and market data in making credit quality determinations and thereby promote uniformity in making minimal credit risk determinations and/or assist money market fund managers in understanding their obligations pertaining to portfolio quality under rule 2a–7.

2. Conditional Demand Features

Rule 2a–7 limits money market funds to investing in securities with remaining maturities of no more than 397 days. A long-term security subject to a conditional demand feature may be determined to be an eligible security under rule 2a–7, which references would change under our re-proposed amendments. Specifically, we propose to amend two rules under the Act that reference the definition of “demand feature” and “guarantee” under rule 2a–7, which references would change under our re-proposed amendments. Specifically, we propose to amend: (i) Rule 12d3–1(d)(7)(v), to replace the references to “rule 2a–7(a)(6)” and “rule 2a–7(a)(15)” with “§ 270.2a–7(a)(16)” and “§ 270.2a–7(a)(16)” respectively; and (ii) Rule 31a–1(b)(1), to replace the phrase “as defined in § 270.2a–7(a)(8) or § 270.2a–7(a)(15) respectively” with “as defined in § 270.2a–7(a)(9)” or “§ 270.2a–7(a)(16) respectively”. Under our re-proposal, a fund would have to determine, as with any short-term security, that the conditional

74 These factors have been included in other guidance on making creditworthiness determinations. See 2013 Net Capital Rule Amendments, supra note 51; 1989 Staff Letter, supra note 52; OCC Guidance, supra note 56. 75 See Dreyfus Comment Letter, supra note 30. 76 See rule 2a–7(a)(12) (defining “eligible security” to mean, among other things, a security with a remaining maturity of 397 calendar days or less).

77 A conditional demand feature is a demand feature that at any time may be excluded from exercising because of the occurrence of a condition. See rule 2a–7(a)(6) (defining “conditional demand feature” as a demand feature that is not an unconditional demand feature); rule 2a–7(a)(10) and re-proposed rule 2a–7(a)(25) (defining “unconditional demand feature” as a demand feature that by its terms would be readily exercisable in the absence of a payment of principal or interest on the underlying security). For purposes of rule 2a–7, a demand feature allows the security holder to receive, upon exercise, the approximate amortized cost of the security, plus accrued interest, if any, at the later of the time of exercise or the settlement of the transaction, paid within 397 calendar days of exercise and no more than 30 calendar days’ notice. Rule 2a–7(a)(9), (or a first tier security) if among other conditions: (i) The conditional demand feature is an eligible security or a first tier security; and (ii) the underlying security (or its guarantee) has received either a short-term rating or a long-term rating, as the case may be, within the highest two categories from the requisite NRSROs or is a comparable unrated security. The rule currently requires this analysis of both the short-term and long-term credit aspects of the demand instrument because a security subject to a conditional demand feature combines both short-term and long-term credit risks. Our re-proposal would require a similar analysis, but consistent with section 939A of the Dodd-Frank Act would remove the requirement in the rule that the fund board (or its delegate) consider credit ratings of underlying securities. Under our re-proposal, a fund would have to determine, as with any short-term security, that the conditional

78 Rule 2a–7(d)(2)(iv). Although underlying securities are generally long-term securities when issued originally, they become short-term securities when the remaining time to maturity is 397 days or less. The quality of a conditional demand instrument depends both on the ability of the underlying security to make timely payments of principal and interest and upon the availability of sufficient liquidity to allow a holder of the instrument to recover the principal amount and accrued interest upon exercise of the demand feature. See Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14607 (July 1, 1985) [50 FR 27982 (July 9, 1985)], at n.33. The rule permits the determination of whether a security subject to an unconditional demand feature is an eligible or first tier security to be based solely on whether the unconditional demand feature is an eligible or first tier security because credit and liquidity support will be provided even in the event of default of the underlying security. See rule 2a–7(d)(2)(iii).

80 In a conforming change, we propose to remove two provisions in current rule 2a–7 that reference credit ratings in connection with securities subject to a demand feature or guarantee of the same issuer that are second tier securities: Rule 2a–7(d)(3)(i)(C) (limiting a fund’s investments in securities subject to a demand feature or guarantee of the same issuer that are second tier securities to 2.5% of the fund’s total assets); rule 2a–7(f)(1)(i)(ii) (providing that if, as a result of a downgrade, more than 2.5% of a fund’s total assets are invested in securities issued by or subject to demand features from a single institution that are second tier securities, a fund must reduce its investments in these securities to no more than 2.5% of total assets by exercising the demand feature at the next succeeding exercise date(s)). In other conforming changes, we are re-proposing to amend two rules under the Act that reference the definition of “demand feature” and “guarantee” under rule 2a–7, which references would change under our re-proposed amendments. Specifically, we propose to amend: (i) Rule 12d3–1(d)(7)(v), to replace the references to “rule 2a–7(a)(6)” and “rule 2a–7(a)(15)” with “§ 270.2a–7(a)(16)” and “§ 270.2a–7(a)(16)” respectively; and (ii) Rule 31a–1(b)(1), to replace the phrase “as defined in § 270.2a–7(a)(8) or § 270.2a–7(a)(15) respectively” with “as defined in § 270.2a–7(a)(9)” or “§ 270.2a–7(a)(16) respectively". 74 These factors have been included in other guidance on making creditworthiness determinations. See 2013 Net Capital Rule Amendments, supra note 51; 1989 Staff Letter, supra note 52; OCC Guidance, supra note 56. 75 See Dreyfus Comment Letter, supra note 30. 76 See rule 2a–7(a)(12) (defining “eligible security” to mean, among other things, a security with a remaining maturity of 397 calendar days or less).

77 A conditional demand feature is a demand feature that at any time may be excluded from exercising because of the occurrence of a condition. See rule 2a–7(a)(6) (defining “conditional demand feature” as a demand feature that is not an unconditional demand feature); rule 2a–7(a)(10) and re-proposed rule 2a–7(a)(25) (defining “unconditional demand feature” as a demand feature that by its terms would be readily exercisable in the absence of a payment of principal or interest on the underlying security). For purposes of rule 2a–7, a demand feature allows the security holder to receive, upon exercise, the approximate amortized cost of the security, plus accrued interest, if any, at the later of the time of exercise or the settlement of the transaction, paid within 397 calendar days of exercise and no more than 30 calendar days’ notice. Rule 2a–7(a)(9), (or a first tier security) if among other conditions: (i) The conditional demand feature is an eligible security or a first tier security; and (ii) the underlying security (or its guarantee) has received either a short-term rating or a long-term rating, as the case may be, within the highest two categories from the requisite NRSROs or is a comparable unrated security. The rule currently requires this analysis of both the short-term and long-term credit aspects of the demand instrument because a security subject to a conditional demand feature combines both short-term and long-term credit risks. Our re-proposal would require a similar analysis, but consistent with section 939A of the Dodd-Frank Act would remove the requirement in the rule that the fund board (or its delegate) consider credit ratings of underlying securities. Under our re-proposal, a fund would have to determine, as with any short-term security, that the conditional
demand feature is an eligible security.\textsuperscript{81} In addition, a fund’s board of directors (or its delegate) would have to evaluate the long-term risk of the underlying security and determine that it (or its guarantor) “has a very strong capacity for payment of its financial commitments.”\textsuperscript{82} This standard is similar to those articulated by credit ratings agencies for long-term securities assigned the second-highest rating.\textsuperscript{83} An issuer that the board determines has a very low risk of default, and a capacity for payment of its financial commitments, would satisfy the proposed standard for underlying securities. We do not believe that securities that are rated in the third-highest category for long-term ratings (or comparable unrated securities), which have expectations of low credit risk or whose obligors have only a strong capacity to meet their financial commitments, would satisfy the proposed standard for underlying securities.\textsuperscript{84} In making the credit quality determinations required under the re-proposed amendment, a fund adviser could continue to take into account analyses provided by third parties, including ratings provided by ratings agencies, that it considers reliable for such purposes.\textsuperscript{85}

The amendments that we are re-proposing to the provisions of rule 2a–7 affecting securities subject to a conditional demand feature are designed to reflect the same standard as the amendment we proposed in 2011.\textsuperscript{86} Specifically, in 2011, we proposed to remove the credit rating requirement from the rule 2a–7 provision setting forth the conditions under which a security subject to a conditional demand feature may be determined to be an eligible security and instead require that the fund’s board (or its delegate) determine that the underlying security be of high credit quality and subject to very low credit risk.\textsuperscript{87} The re-proposed standard differs in phrasing to more closely parallel the required finding in our re-proposed minimal risk determination.\textsuperscript{88} Comments we received on the 2011 proposal all urged us to retain the requirement that a security subject to a demand feature has received at least a second tier rating, to limit the risk that a demand feature might terminate if its underlying security receives a rating below investment grade (i.e., if the underlying security receives a downgrade of two ratings categories under the current rule).\textsuperscript{89} The re-proposed amendments are consistent with section 939A of the Dodd-Frank Act regarding the removal of ratings. Nevertheless, we recognize the risks of a money market fund investing in securities whose eligibility as portfolio securities depends on a demand feature that would terminate if downgraded by a single rating category, and we believe it would be prudent for a money market fund to avoid investing in these securities. A downgrade of this type would result in the loss of the demand feature, which would render the security no longer eligible for the portfolio and could lead to the increased interest rate risk associated with a long-term security. For this reason, we would retain the current rule 2a–7 requirements that a security subject to a conditional demand feature is an eligible security only if at the time it is acquired, the fund’s board (or the board’s delegate) determines that there is minimal risk that the circumstances that would result in the conditional demand feature terminating will occur, and that either (i) the conditions limiting the demand feature’s exercise can be monitored, or (ii) the fund otherwise receives notice of the occurrence of a limiting condition and the opportunity to exercise the demand feature in accordance with its terms.\textsuperscript{90}

We request comment on our proposed credit quality standard for securities with a conditional demand feature. Do commenters believe that this is an appropriate standard of creditworthiness? Is it consistent with our goal of retaining a similar degree of risk limitation as in the current rule? Are there alternative standards that would provide a more robust or objective evaluation of credit quality for an underlying security? How should such criteria be applied and/or used? Are there alternative subjective standards that would provide meaningful distinctions among underlying securities? Is our understanding of a fund’s ability to monitor for conditions that would terminate a demand feature correct? How do funds currently satisfy this monitoring condition? Are we correct in our assumption that removing references to ratings in the credit quality requirement for underlying securities is not likely to change fund investment policies significantly?

3. Monitoring Minimal Credit Risks

Rule 2a–7 currently requires a money market fund board (or its delegate) promptly to reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks, and take such action as it determines is in the best interests of the fund and its shareholders.\textsuperscript{91} In addition, rule 2a–7 requires ongoing review of the minimal credit risks associated with securities for which maturity is determined by reference to a demand feature.\textsuperscript{92}

In 2011, we proposed to amend the rule to require that, in the event the

\textsuperscript{81} See re-proposed rule 2a–7(d)(2)(iii)(A).

\textsuperscript{82} See re-proposed rule 2a–7(d)(2)(iii)(C).

\textsuperscript{83} See Fitch Ratings Scales, supra note 38, at 12, 15 (for corporate finance obligations, “‘AA’ ratings denote expectations of very low credit risk. They indicate very strong capacity for payment of financial commitments;” for structured, project and public finance obligations, “‘AA’ ratings denote expectations of very low default risk. They indicate very strong capacity for payment of financial commitments.”); Moody’s Rating Definitions, supra note 38, at 5 (on the global long-term rating scale, obligations “rated Aa are judged to be of high credit quality and are subject to very low credit risk.”); and S&P Ratings Definitions, supra note 38, at 3 (“An obligation rated ‘AA’ differs from the highest-rated obligations only to a small degree. The obligor’s capacity to meet its financial commitment on the obligation is very strong.”).

\textsuperscript{84} See Moody’s Rating Definitions, supra note 38, at 5 (long-term obligations “rated A are judged to be upper-medium grade and are subject to low credit risk.”); Fitch Ratings Scales, supra note 38, at 12 (long-term “A ratings denote expectations of low credit risk. The capacity for payment of financial commitments is considered strong.”); S&P Ratings Definitions, supra note 38, at 4 (a long-term obligation “rated A” is somewhat more susceptible to the effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor’s capacity to meet its financial commitment on the obligation is still strong.”).

\textsuperscript{85} See supra paragraph following note 45.

\textsuperscript{86} See 2011 Proposing Release, supra note 4, at section II.A.2.

\textsuperscript{87} See id. at n.36 and accompanying text.

\textsuperscript{88} See Schwab Comment Letter, supra note 30 (querying whether different language for proposed descriptions of second tier securities was intended to suggest different standards).

\textsuperscript{89} See, e.g., Federated Comment Letter, supra note 30; Fidelity Comment Letter, supra note 31; ICI Comment Letter, supra note 30.

\textsuperscript{90} See re-proposed rule 2a–7(d)(2)(iii)(B) (providing that a security subject to a conditional demand feature is an eligible security only if, at the time of the acquisition of the underlying security, the money market fund’s board of directors has determined that there is minimal risk that the circumstances that would result in the conditional demand feature not being exercisable will occur; and: (i) The conditions limiting exercise either can be monitored readily by the fund or relate to the taxability, under Federal, state or local law, of the interest payments on the security; or (ii) the terms of the conditional demand feature require that the fund will receive notice of the occurrence of the condition and the opportunity to exercise the demand feature in accordance with its terms).

\textsuperscript{91} Rule 2a–7(1)(10)(A). This current reassessment is not required, however, if the downgrade is imposed for causes other than the failure to meet the second business days of the specified event and in the case of certain events (specified in rule 2a–7(1)(10)(B)), the board is subsequently notified of the adviser’s actions. Rule 2a–7(1)(10)(i).

\textsuperscript{92} Rule 2a–7(g)(1).
money market fund’s adviser (or any person to whom the board has delegated portfolio management responsibilities) becomes aware of any credible information about a portfolio security or an issuer of a portfolio security that suggests that the security is no longer a first tier security or a second tier security, as the case may be, the board (or its delegate) would have to reassess promptly whether the portfolio security continues to present minimal credit risks.93

Most of those who commented on this proposed amendment objected to it.94 They asserted that the proposed standard is too vague and would be burdensome to administer.95 A number of commenters recommended that we instead eliminate the requirement for reassessing minimal credit risk when a security is downgraded by an NRSRO and include a general ongoing obligation to monitor the credit risks of portfolio securities, which would eliminate the need for a separate requirement to identify specific triggers.96

We have carefully considered commenters’ concerns and suggested modifications and have been persuaded to re-propose a different standard. In order to meet the requirements of section 939A of the Dodd-Frank Act, we re-propose to eliminate the requirement that a fund reassess credit risks of an issuer when a security is downgraded by an NRSRO.97 In consideration of our re-proposed standard for credit quality, and consistent with the approach suggested by a number of commenters, we instead re-propose to require that each money market fund adopt written procedures that require the fund adviser to provide ongoing review of the credit quality of each portfolio security (including any guarantee or demand feature on which the fund relies to determine portfolio quality, maturity, or liquidity) to determine that the security continues to present minimal credit risks.98 Ongoing monitoring of minimal credit risks would include the determination of whether the issuer of the portfolio security, and the guarantor or provider of a demand feature, to the extent relied upon by the fund to determine portfolio quality, maturity or liquidity, continues to have an exceptionally strong capacity to repay its short-term financial obligations.99

The review would typically update the information that was used to make the initial minimal credit risk determination and would have to be based on, among other things, any changes in the financial data of the issuer or provider of the guarantee or demand feature.100 We note that funds could continue to consider external factors, including credit ratings, as part of the ongoing monitoring process.101 Although rule 2a–7 does not explicitly require ongoing monitoring of whether a security presents minimal credit risks, as a practical matter, we believe most fund advisers currently engage in similar types of ongoing monitoring because (i) funds regularly “roll over” positions in portfolio securities, which triggers the obligation to make a new minimal credit risk determination102 (ii) rule 2a–7 requires funds to reassess whether a security presents minimal credit risks upon the occurrence of certain events103 (iii) events such as downgrades can result in a decrease in the mark-to-market value of the fund portfolio, threatening the ability of the fund to maintain a stable net asset value104 (iv) changes in credit ratings of a fund’s portfolio securities may threaten the fund’s own ability to maintain a rating from an NRSRO105 and (v) shareholders may be more likely to redeem if the credit quality of portfolio securities declines.106 We do not believe that the re-proposal for an explicit monitoring requirement would significantly change current fund practices in monitoring minimal credit risks in the portfolio. Moreover, we do not believe that the re-proposal to remove the credit reassessment requirement in the event of a downgrade would result in less diligence on the part of money market fund managers because, as discussed above, a decline in the quality of a fund’s portfolio securities could affect a fund’s own NRSRO rating and could increase shareholder redemptions.

We also note that a fund adviser’s obligation to monitor risks to which the

93 See 2011 Proposing Release, supra note 4, at section II.A.3.
94 But see Comment Letter of CFA Institute [July 13, 2011] (supporting the proposed monitoring standard).
95 See, e.g., ICI Comment Letter, supra note 30 (there are numerous sources of information about issuers, much of which is not relevant to the issuer’s ability to meet its short-term obligations); Invesco Comment Letter, supra note 30 (the ambiguity in the terms “credible information” and “suggest” will complicate enforcement of the rule); Schwab Comment Letter, supra note 30 (the word “suggest” is not constrained by a reasonableness or likelihood standard).
96 See, e.g., Federated Comment Letter, supra note 30; ICI Comment Letter, supra note 30; T. Rowe Price Comment Letter, supra note 30.
97 See rule 2a–7(g)(1).
98 See infra text following note 178 (discussing the Commission’s belief that the majority of funds would continue to refer to credit ratings in making minimal credit risk determinations).
99 See 2011 Proposing Release, supra note 4, at section II.B.2.
100 Rule 2a–7(d)(1) (requiring a money market fund’s board of directors to assess promptly whether a security continues to present minimal credit risks if (i) a first tier portfolio security has been downgraded (or is no longer of comparable quality to a first tier security), and (ii) the fund adviser becomes aware that any unrated security or second tier security has been given a rating below a second tier rating).
102 Funds must limit their portfolios to securities that, among other requirements, are eligible securities at the time of acquisition, which is defined to mean any purchase or subsequent rollover. Rules 2a–7(a)(1); 2a–7(d)(2).
103 Rule 2a–7(d)(1) (requiring a money market fund’s board of directors to assess promptly whether a security continues to present minimal credit risks if (i) a first tier portfolio security has been downgraded (or is no longer of comparable quality to a first tier security), and (ii) the fund adviser becomes aware that any unrated security or second tier security has been given a rating below a second tier rating).
104 See 2011 Proposing Release, supra note 4, at section II.C.4.
We request comment on the re-proposed monitoring requirement. Is our understanding of how funds currently monitor fund portfolio securities correct? If not, how are fund practices different? Would our proposed amendments, if adopted, impose additional or different costs on funds or their advisers, and if so, what would these costs be? Should the rule include specific objective events that would require a reevaluation of minimal credit risks? Would an explicit monitoring requirement change current fund priorities in monitoring minimal credit risks in the portfolio? Would the re-proposal assist funds to better position themselves to quickly identify potential risks of credit events that could impact portfolio security prices and ultimately, for certain funds, the ability of the fund to maintain its stable net asset value.\(^{109}\)

For the reasons discussed above, we believe this re-proposed requirement to monitor credit risk would essentially codify the current practices of fund managers, which are already explicit (and implicit) in several provisions of the rule discussed above. Our re-proposal to explicitly require that funds perform ongoing monitoring of credit risks designed, taking into account current market circumstances.\(^{108}\)

As under the current rule, the process undertaken by the fund’s board (or adviser) for establishing a credit policy and the records documenting that process would be subject to review in regulatory examinations by Commission staff. See Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934, Securities Exchange Act Release No. 64352 (Apr. 27, 2011) [76 FR 26550 (May 6, 2011)], at text following n.30. In the context of such an examination, a fund should be able to support each minimal credit risk determination it makes in light of financial data or market data it has considered with appropriate documentation to reflect that process and determination. A fund that acquires portfolio securities without having adopted, maintained, or implemented written policies and procedures reasonably designed to assess minimal credit risk, as required under rules 2a–7 and 38a–1, could be subject to disciplinary action for failure to comply with those rules. See id. See also Ambachtsheer Capital Management LLC, et al., Investment Company Act Release No. 30809 (Nov. 26, 2013) (alleging that money market fund adviser’s failure to (i) make and retain a written record of its minimal credit risk determination resulted in the fund’s violation of rule 22c–1 and (ii) follow the fund’s compliance procedures regarding the determination of minimal credit risk and the maintenance of records of the

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\(^{107}\) We use the term “relevant credit rating agencies” to mean those NRSROs whose downgrades would likely affect the value of a portfolio security.

\(^{108}\) See rule 2a–7(i)(2); rule 2a–7(g)(1) (requiring that for funds using amortized cost, the board, as part of its overall duty of care owed to its shareholders, adopt written procedures reasonably designed, taking into account current market conditions and the money market fund’s investment objectives, to maintain a stable net asset value per share).

\(^{109}\) In 2011, we proposed to replace this reference to ratings downgrades with the requirement that money market funds stress test their portfolios for an adverse change in the ability of a portfolio security issuer to meet its short-term credit obligations.\(^{112}\)

Commenters on the 2011 proposal who addressed this issue uniformly advocated against eliminating the reference to a downgrade in the stress testing conditions.\(^{113}\) They argued that the Dodd-Frank Act does not prohibit regulations, such as this stress testing provision, that refer to credit ratings without requiring an assessment of a security’s creditworthiness.

In consideration of the comments we received and the mandate in section 939A of the Dodd-Frank Act, we re-propose to replace the reference to ratings downgrades in the stress testing requirement with a hypothetical event that is designed to have a similar impact on a money market fund’s portfolio. Our re-proposed stress testing amendments would require that money market funds stress test for an event indicating or evidencing credit deterioration of particular portfolio security positions, each representing various exposures in a fund’s portfolio.\(^{114}\) The re-proposed amendments would describe the type of hypothetical event that funds should use for testing and include a downgrade or default as examples of that type of event. Thus, funds could continue to test their portfolios against a potential downgrade or default in addition to any other indication or evidence of credit deterioration they determine appropriate (and that might adversely affect the value or liquidity of a portfolio security).

We note that the 2013 Money Market Fund Reform Proposing Release requested comment on certain aspects of money market fund stress testing as it relates to our obligation under section 165(l)(2) of the Dodd-Frank Act to specify certain stress testing requirements for nonbank financial portfolio (with varying assumptions about the resulting loss in the value of the security), in combination with various levels of an increase in shareholder redemptions”); 2014 Money Market Fund Adopting Release, supra note 8, at section III.I.

\(^{112}\) See 2011 Proposing Release, supra note 4, at section II.A.4.

\(^{113}\) See, e.g., Dreyfus Comment Letter, supra note 30; IC Comment Letter, supra note 30.

\(^{114}\) Re-proposed rule 2a–7(g)(8)(i)(B) (the re-proposal would require stress testing for an event indicating or evidencing the credit deterioration, such as a downgrade or default, of a portfolio security position representing various portions of the fund’s portfolio (with varying assumptions about the resulting loss in the value of the security), in combination with various levels of an increase in shareholder redemptions).
companies\(^{115}\) that have total consolidated assets of more than $10 billion and are regulated by a primary Federal financial regulatory agency.\(^{116}\) As discussed in that release and the 2014 Money Market Fund Adopting Release, we intend to engage in a separate rulemaking to implement the requirements to section 165(i) of the Dodd-Frank Act.\(^{117}\) We request comment on our re-proposed amendment to the stress testing requirements. Should the rule require testing against specifically named events rather than an event the fund chooses that indicates or evidences credit deterioration? Does the re-proposed hypothetical event provide adequate guidance to funds? Is there a different hypothetical event, other than a downgrade, that we should specify?

**B. Form N–MFP**

As part of the money market fund reforms adopted in 2010, money market funds must provide to the Commission a monthly filing of portfolio holdings information on Form N–MFP.\(^{118}\) The information that money market funds must disclose with respect to each portfolio security (and any guarantee, demand feature, or other enhancement associated with the portfolio security) includes the name of each designated NRSRO for the portfolio security and the rating assigned to the security.\(^{119}\)

In 2011, we proposed to eliminate the form items that currently require a fund to identify whether a portfolio security is a first tier or second tier security or is an unrated security, and that require the fund to identify the “requisite NRSROs” for each security (and for each demand feature, guarantee or other credit enhancement). Several commenters strongly objected to removing ratings disclosures in Form N–MFP. They argued that the Dodd-Frank Act does not require us to eliminate these disclosures because these references to ratings do not require the use of an assessment of creditworthiness.\(^{120}\) We have carefully considered these comments and are re-proposing instead to require that each money market fund disclose, for each portfolio security, (i) each rating assigned by any NRSRO if the fund or its adviser subscribes to that NRSRO’s services, as well as the name of the agency providing the rating, and (ii) any other NRSRO rating that the fund’s board of directors (or its delegate) considered in making its minimal credit risk determination, as well as the name of the agency providing the rating.\(^{121}\)

The first prong of this requirement reflects our assumption that a fund manager subscribes to the services of a particular NRSRO because the manager has confidence in that NRSRO’s analysis and, therefore, when assessing the credit quality of a portfolio security, would consider any ratings the NRSRO assigns to the security. If a fund’s adviser has considered more than one NRSRO rating in making the credit risk determination for a particular portfolio security, the Form N–MFP disclosure would need to reflect each rating considered (in addition to each rating assigned by an NRSRO if the fund or its adviser subscribes to its services). If the fund and its adviser subscribe to no NRSRO ratings services, and no other rating was considered in making a minimal credit risk determination, the fund would disclose no rating for the portfolio security. We believe this information on ratings may be useful both to the Commission and to investors to monitor credit ratings that funds use in evaluating the credit quality of portfolio securities and to evaluate risks that fund managers take.\(^{122}\)

Disclosures of individual portfolio securities ratings would provide investors, Commission staff, and others with a snapshot of potential trends in a fund’s overall risk profile, which could in turn prompt those monitoring to research or evaluate further whether that profile is changing.

We seek comment on the re-proposed disclosures relating to credit ratings in Form N–MFP. Are we correct in our assumption that as part of its minimal credit risk determination a fund manager would consider each rating assigned to a portfolio security by an NRSRO to whose services the fund or the manager subscribes? Would the proposed disclosures assist investors in monitoring credit risks in money market fund portfolios? Would the disclosures be more useful if they required funds that consider any rating to disclose the highest and lowest rating assigned to the portfolio security, regardless of whether the fund considered that rating? Should fund managers that consider more than one credit rating in their credit evaluations be required to disclose only one rating and its source? Would disclosure of only one rating limit an investor’s ability to monitor the fund’s credit risk if another rating assigned to a portfolio security differs from the rating disclosed by the fund in Form N–MFP (i.e., the security is split-rated)? Under such an approach, if a portfolio security is split-rated, which rating should the fund have to disclose, or should a fund be able to choose the rating it discloses? If a fund could choose, would any funds disclose a lower rating assigned by an NRSRO? We took a similar approach in recent amendments removing the required use of credit ratings in Forms N–1A, N–2 and N–3. Under those amendments, funds that choose to use credit quality to present their portfolio securities in shareholder reports and use credit ratings to depict credit quality may use credit ratings assigned by different rating agencies (including credit rating agencies that are not NRSROs), provided that the fund also describes how it determines the credit quality of portfolio holdings and how ratings are identified and selected.\(^{123}\) Would a similar disclosure describing how a money market fund determines the credit quality of portfolio holdings, including how ratings are identified and selected be appropriate considering the format of Form N–MFP? If not, would disclosure in another form, such as Form N–1A, appropriately mitigate the risk that a fund could “cherry-pick” the rating to disclose on Form N–MFP? Would investors find disclosure about

\(^{115}\)For a definition of “nonbank financial companies” for these purposes, see Definition of “Predominantly Engaged in Financial Activities” and “Significant” Nonbank Financial Company and Bank Holding Company, Board of Governors of the Federal Reserve System [78 FR 20756 (Apr. 5, 2013)].

\(^{116}\)See 2013 Money Market Fund Proposing Release, supra note 5, at section III.L.

\(^{117}\)See id. at section III.L; 2014 Money Market Fund Adopting Release, supra note 8, at section III.L.5.

\(^{118}\)See rule 30b1–7; see also 2010 Money Market Fund Adopting Release, supra note 41, at n.301 and accompanying and preceding text.

\(^{119}\)See Form N–MFP Items 34 (requiring disclosure of each designated NRSRO for a portfolio security and the credit rating given by the designated NRSRO for each portfolio security); 37b–c (requiring disclosure of each designated NRSRO and the credit rating given by the designated NRSRO for each portfolio security demand feature); 38b–c (requiring disclosure of each designated NRSRO and the credit rating given by the designated NRSRO for each portfolio security guarantee); and 39c–d (requiring disclosure of each designated NRSRO and the credit rating given by the designated NRSRO for each portfolio security enhancement).

\(^{120}\)See, e.g., Federated Comment Letter, supra note 30; Dreifus Comment Letter, supra note 30.

\(^{121}\)See Form N–MFP Item C.8 to require disclosure of whether the portfolio security is an eligible security.

\(^{122}\)See Comment Letter of BlackRock, Inc. (Apr. 25, 2011) (“BlackRock Comment Letter”) (“this disclosure facilitates investors’ ability to evaluate [money market fund] portfolios and to compare [money market funds] to each other.”).

\(^{123}\)Form N–1A Item 27(d); Form N–2 Item 24, Instruction 6(a); Form N–3 Item 28(a), Instruction 6(i); see also 2013 Ratings Removal Adopting Release, supra note 4, at section III.B.
the source of the credit rating to be useful information?

C. Exclusion From the Issuer Diversification Requirement

In addition to the provisions regarding credit quality discussed above, rule 2a-7’s risk limiting conditions require a money market fund’s portfolio to be diversified, both as to the issuers of the securities it acquires and providers of guarantees and demand features related to those securities. Generally, money market funds must limit their investments in the securities of any one issuer of a first tier security (other than government securities) to no more than 5 percent of total assets.125 They must also generally limit their investments in securities subject to a demand feature or a guarantee to no more than 10 percent of total assets from any one provider.126

We adopted these requirements in order to limit the exposure of a money market fund to any one issuer, guarantor, or demand feature provider.127

124 See rule 2a-7(d)(3). The diversification requirements of rule 2a-7 differ in significant respects from the requirements for diversified management investment companies under section 5(b)(1) of the Investment Company Act. A money market fund that satisfies the applicable diversification requirements of paragraph (d)(3) of rule 2a-7(d) is also required to satisfy the requirements of section 5(b)(1). Rule 2a-7(d)(3)(v).

Subchapter M of the Internal Revenue Code contains other diversification requirements for a money market fund to be a “regulated investment company” for Federal income tax purposes. 26 U.S.C. 851 et seq.

125 Rule 2a-7(d)(3)(i)(A) and (B). A single state tax-exempt fund, however, may invest up to 25% of its total assets in the first tier securities of any single issuer. Rule 2a-7(d)(3)(ii)(B). A fund also may invest no more than 5% of its total assets in the first tier securities of any single issuer, subject to a second tier security. Rule 2a-7(d)(3)(iii)(C). The rule provides a safe harbor under which a taxable and national tax-exempt fund may invest up to 25% of its total assets in the first tier securities of any single issuer for a period of up to three business days after acquisition (but a fund may use this exception for only one issuer at a time). Rule 2a-7(d)(3)(iii)(A).

Under our re-proposal, which would eliminate the distinction between first and second tier securities, the issuer diversification requirements would apply regardless of a portfolio security’s rating and the safe harbor would be available with respect to any portfolio security regardless of its rating. See supra note 36.


127 See supra note 131 (recommending 2.5% issuer limit).

128 Comment Letter of John C. Barber, KeyBank, NA (Sept. 16, 2013) (“J. Barber Comment Letter”).

129 See id.


132 Comment Letter of Phillip S. Gillespie, Executive Vice President and General Counsel, State Street Global Advisors (Sept. 17, 2013) (opposing the alternative because existing diversification limits are already challenging due to the short-term market’s current supply structure); Comment Letter of Investment Company Institute (Sept. 17, 2013) (“ICI 2013 Comment Letter”). One of the issues in the comment letter is that further restricting diversification limits may potentially force money market funds to invest in less creditworthy issuers, which could have the effect of increasing the risk within money market funds’ portfolios, rather than decreasing it. See id.

133 See 2013 Money Market Fund Proposing Release, supra note 5, at sections III.J.1–2.

134 Rule 2a-7(d)(3)(ii)(B). A fund may use this exception for only one issuer at a time. Rule 2a-7(d)(3)(ii)(B).

135 We specifically asked whether the guarantor should be treated as the issuer and subject to a 5 percent funds’ risk exposure.130 These alternatives included requiring money market funds to be more diversified by reducing the current 5 percent and 10 percent diversification thresholds of rule 2a-7 and by imposing industry concentration limits. Several commenters supported some of these tighter diversification requirements.131 One of these commenters suggested limiting any one corporate issuer to 2.5 percent of the fund’s total assets rather than the current 5 percent issuer diversification requirement, while two others supported additional sector diversification requirements.132 Others, however, argued against further narrowing the diversification provisions of rule 2a-7 relating to issuers and guarantors.133

We also asked in the 2013 Money Market Fund Proposing Release more generally whether we should continue to distinguish between a fund’s exposure to guarantors and issuers by providing different diversification requirements for these exposures.134 We explained that rule 2a-7 permits a money market fund, when determining if a security subject to a guarantee satisfies the credit quality standards, to rely exclusively on the credit quality of the guarantor.135 We specifically asked whether the guarantor should be treated as the issuer and subject to a 5 percent diversification requirement.136

FR 32688 (July 8, 2009)] (“2009 Money Market Fund Proposing Release”) at n.220 and accompanying text (recommending 2.5% issuer limit); R. Comment Letter of John C. Barber, KeyBank, NA (Sept. 16, 2013) (“J. Barber Comment Letter”).

136 See supra note 131.
diversification requirement whenever the money market fund is relying exclusively on the credit guarantee of the guarantor. No commenters specifically addressed this issue, and we decided not to propose amendments that would implement this approach, or any of the alternative diversification approaches about which we sought comment as discussed above.

In considering the comments we received on the proposed amendments to the diversification provisions and the alternatives discussed above, we noted that money market funds also may effectively rely exclusively on the credit quality of certain guarantors for purposes of the diversification requirements. Notwithstanding the 5 percent issuer diversification requirement, rule 2a–7 does not require a money market fund to be diversified with respect to issuers of securities that are subject to a guarantee by a non-controlled person.136 This exclusion could allow, for example, a fund to invest a significant portion or all of the value of its portfolio in securities issued by the same entity if the securities were guaranteed by different non-controlled person guarantors such that none guaranteed securities with a value exceeding 10 percent of the fund’s total assets. By diversifying solely against the guarantor, the fund could be relying on the guarantors’ credit quality or repayment ability, not the issuer’s. Thus, the fund would effectively substitute the credit of the guarantor for that of the issuer for diversification purposes, without imposing the tighter 5 percent requirement that rule 2a–7 generally applies for issuer diversification. The fund also would have a highly concentrated portfolio and would be subject to substantial risk if the single issuer in whose securities it had such a significant investment were to come under stress or default.

We are concerned that a money market fund relying on the exclusion from the issuer diversification provision need only comply with the 10 percent guarantor diversification requirement, notwithstanding the credit substitution discussed above. In consideration of our reform goal of limiting concentrated exposure of money market funds to particular economic enterprises, we no longer believe that ignoring a fund’s exposure to the issuer in these circumstances is appropriate.137 Rather than subject these guarantors to a unique 5 percent requirement, however, we believe that a better approach would be to restrict risk exposures to all issuers of securities subject to a guarantee or demand feature under rule 2a–7 in the same way. That is, under today’s proposed amendment, each money market fund that invests in securities subject to a guarantee (whether or not the guarantor is a non-controlled person) would have to comply with both the 10 percent diversification requirement for the guarantor as well as the 5 percent diversification requirement for the issuer. As a result, except for the special provisions regarding single-state money market funds, no money market fund non-government portfolio security would be excluded from rule 2a–7’s limits on issuer concentration.

We recognize that the proposed removal of this exclusion and tightening of issuer diversification requirements for securities subject to a guarantee by a non-controlled person could impact issuers of these securities and the fund’s risk profile (although we note that fewer than 2 percent of money market funds appear to be relying on this exclusion).138 The proposed amendments could occasionally prevent some issuers from selling securities to a money market fund that would otherwise invest in the issuer’s securities above the 5 percent diversification requirement. In addition, while we recognize that removing the exclusion could cause some money market funds to invest in securities with higher credit risk, we note that a money market fund’s portfolio securities must meet certain credit quality requirements, such as posing minimal credit risks, as discussed above.139 We therefore believe that the substantial risk limiting provisions of rule 2a–7 would mitigate the potential that these money market funds would significantly increase their investments in securities with higher credit risk. We also believe that eliminating this exclusion would more appropriately limit money market fund risk exposures by limiting the concentration of exposure that a money market fund could have otherwise had to a particular issuer.140

We request comment on our proposal to eliminate the exclusion from the issuer diversification requirement. Do commenters agree with our approach to treat securities subject to a guarantee by a non-controlled person similar to other securities with a guarantee or demand feature under rule 2a–7? Should we, instead, as discussed above, require that a guarantor be treated as the issuer and subject to a 5 percent diversification requirement when a money market fund is relying exclusively on the credit quality of the guarantor or when the security need not meet the issuer diversification requirements? Or should we impose a higher limit on issuer exposure when the security is guaranteed by a non-controlled person? If so, what would be an appropriate limit? For example, would a 10 percent, 15 percent, or some other limit be appropriate? What limit would appropriately balance the interests discussed above—allowing greater flexibility for funds with respect to indirect exposures to providers of guarantees and demand features because of the potential that tighter diversification provisions could lead to investments in lower quality securities and limiting exposure risk when a fund is relying solely on such a provider for repayment? Could commenters provide empirical analysis to support a particular percentage? Do commenters agree with our understanding that most money market funds do not currently rely on the issuer diversification exclusion for securities subject to a guarantee issued by a non-controlled person? Do commenters believe that many money market funds have used this exclusion in the past or may do so in the future absent our proposed amendment? We note that most of the funds whose portfolios have greater than 5 percent exposure to an issuer are tax-exempt funds, and that most of these funds exceed the 5 percent threshold by less than 2 percent of fund assets. In addition, none of the funds that appear to have relied on the exclusion is a single state fund.141 As a result, we have assumed that tax-exempt funds do not

136 Rule 2a–7(d)(3)(i). A guarantee issued by a non-controlled person means a guarantee issued by: (i) A person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the guarantee; or (ii) a sponsor of a special purpose entity with respect to an asset-backed security. Rule 2a–7(a)(10). Control has the same meaning as in section 2(a)(9) of the Investment Company Act, 15 U.S.C. 80a–2(a)(9).

137 See 2014 Money Market Fund Adopting Release, supra note 8, and accompanying n.1601. The exclusion from the 5% issuer diversification requirement for certain guaranteed securities was adopted in the 1996 money market fund amendments to provide flexibility in municipal investments, and was premised on the ability of a money market fund to rely on the guarantee if an issuer became distressed. See 1996 Money Market Fund Adopting Release, supra note 62. Since 1996, our amendments have generally scaled back on the amount of additional flexibility focused on the municipal markets, particularly where money market funds do not heavily rely on the exclusion. See, e.g., 2010 Money Market Fund Adopting Release, supra note 41.

138 See infra section V.C.2.

139 See infra section V.C.2.

140 See infra section V.C.2.

141 As noted above, rule 2a–7 currently permits a single state fund to invest up to 25% of its assets in any single issuer, thus these funds appear not to need the exclusion. See supra note 125.
need this exclusion. Is this assumption correct? Is the supply of high quality eligible municipal investments sufficiently limited such that we should preserve the exclusion for tax-exempt or single state funds? Are there any other particular types of funds for which the current exclusion from the issuer diversification requirement should be preserved? Is the proposed amendment likely to result in money market funds investing in securities that present higher credit risk, or not, given the credit quality requirements of rule 2a–7?

III. Compliance Period for the Proposed Rule and Form Amendments

We anticipate that the compliance date for the re-proposed amendments to rule 2a–7 and Form N–MFP and the proposed amendments to the issuer diversification requirements would be [INSERT DATE 18 MONTHS AFTER JULY 2014 MONEY MARKET FUND RULES’ EFFECTIVE DATE]. We expect that this compliance date should provide an adequate period of time for money market funds to review and revise their policies and procedures for complying with rule 2a–7, as funds deem appropriate in connection with the re-proposed and proposed amendments, if adopted.\(^\text{142}\) We note that this compliance date would coincide with the compliance date for the rule 2a–7 amendments relating to diversification and stress testing adopted in the 2014 Money Market Fund Adopting Release, as well as the Form N–MFP amendments also adopted in that release. As discussed below, we believe that coordinating the compliance date of the re-proposed amendments with the compliance date of certain related amendments adopted in the 2014 Money Market Fund Adopting Release should reduce costs to the extent feasible by consolidating changes to be made to a fund’s policies and procedures, as well as changes to Form N–MFP, at a single time.\(^\text{143}\) We request comment on this compliance date.

IV. Paperwork Reduction Act Analysis

Certain provisions of our proposal contain “collections of information” within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).\(^\text{144}\) The titles for the existing collections of information are: (1) “Rule 2a–7 under the Investment Company Act of 1940, Monthly report for money market funds” (OMB Control No. 3235–0657); and (3) “Form N–MFP under the Investment Company Act of 1940, Monthly schedule of portfolio holdings of money market funds” (OMB Control No. 3235–0657). The Commission is submitting these collections of information to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

The agency has submitted the proposed collections of information to OMB for approval. Comments on the proposed collections of information should be directed to: (i) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10102, New Executive Office Building, Washington, DC 20503, or by sending an email to: Shagufta.Ahmed@omb.eop.gov; and (ii) Thomas Bayer, Chief Information Officer, Securities and Exchange Commission, c/o Remi Pavlik-Simon, 6432 General Green Way, Alexandria, VA 22312 or send an email to: PRA_Mailbox@sec.gov. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–07–11, and be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street NE., Washington, DC 20549–2736.

A. Rule 2a–7

As discussed above, we are re-proposing to remove references to credit ratings in rule 2a–7, which would affect five elements of the rule: (i) Determination of whether a security is an eligible security; (ii) determination of whether a security is a first tier security; (iii) credit quality standards for securities with a conditional demand feature; (iv) requirements for monitoring securities for ratings upgrades and other credit events; and (v) stress testing. These amendments involve collections of information, and the respondents to the collections of information are money market funds.

This collection of information would be mandatory for money market funds that rely on rule 2a–7, and to the extent that the Commission receives confidential information pursuant to the collection of information, such information will be kept confidential, subject to the provisions of applicable law.\(^\text{145}\)

1. Eligible Security Determinations for Money Market Fund Portfolio Securities, Including Securities That Are Subject to a Conditional Demand Feature

Rule 2a–7 limits a money market fund’s portfolio investments to “eligible securities,” which are currently defined as securities that have received credit ratings from a requisite NRSRO in one of the two highest short-term rating categories, or comparable unrated securities.\(^\text{146}\) The rule also restricts money market fund investments to securities that the fund’s board, or its delegate, determines present minimal credit risks, and requires a fund to adopt policies and procedures regarding minimal credit risk determinations.\(^\text{147}\) As discussed above, we are re-proposing amendments to rule 2a–7 that would remove any reference to, or requirement of reliance on, credit ratings in rule 2a–7 and modify the credit quality standard to be used in determining the eligibility of a money market fund’s portfolio securities, including securities that are subject to a conditional demand feature. Specifically, the re-proposed amendments would eliminate the current requirement that an eligible security be rated in one of the two highest short-term rating categories by an NRSRO or be of comparable quality, and would combine the current “first tier” and “second tier” credit risk categories into a single standard, which would be included as part of rule 2a–7’s definition of eligible security. A security would be an eligible security only if the money market fund’s board of directors (or its delegate) determines that it presents minimal credit risks, which determination would include a finding that the security’s issuer has an exceptionally strong capacity to meet its financial obligations.

142 See infra note 219 and accompanying text.
143 See infra note 233 and accompanying text.
145 See, e.g., 5 U.S.C. 552 (Exemption 4 of the Freedom of Information Act provides an exemption for “trade secrets and commercial or financial information obtained from a person and privileged or confidential.” 5 U.S.C. 552(b)(4). Example 8 of the Freedom of Information Act provides an exemption for matters that are “contained in or related to examination, operating, or condition reports prepared by, or on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.” 5 U.S.C. 552(b)(8)).
146 See rule 2a–7(a)(12).
147 See rules 2a–7(d)(2)(i); 2a–7(j)(1); 38a–1.
short-term obligations. The re-proposed amendments also would require that, with respect to a security (or its guarantee) subject to a conditional demand feature, the underlying security (or its guarantee) must have a very strong capacity for payment of its financial commitments.

Money market funds are required to have written policies and procedures regarding minimal credit risk determinations. Thus, each money market fund complex would incur one-time costs to comply with these re-proposed amendments, if adopted. Specifically, each fund complex would incur costs to review the amended provisions of rule 2a–7 and, as it determines appropriate in light of the re-proposed amendments, revise its policies and procedures to incorporate the amended credit quality standards to be used in determining the eligibility of a money market fund’s portfolio securities, including securities that are subject to a conditional demand feature. As discussed below, we anticipate that many funds are likely to retain their investment policies as currently required under rule 2a–7, which incorporate NRSRO ratings and which would be permitted under the re-proposed rule amendments. Some funds, on the other hand, may choose to revise their investment policies to remove references to NRSRO ratings and to incorporate the standards provided in the re-proposal, if adopted. Even if funds choose to eliminate references to ratings in their investment policies, funds’ investment policies may not change substantially, as funds are already required to assess credit quality apart from ratings as part of their minimal credit risk determinations.

In addition to revisions concerning NRSRO ratings, some funds may choose to revise their policies and procedures to address certain factors discussed above (to the extent those factors are not considered currently) in their credit assessment policies and procedures. While we cannot predict with precision the extent to which funds may revise their policies and procedures for determining minimal credit risk, we estimate that each money market fund complex on average would incur a one-time burden of 9 hours at a cost of $2,838 to review and revise, as appropriate, its policies and procedures. Using an estimate of 84 money market fund complexes, we estimate that money market funds would incur, in aggregate, a total one-time burden of 756 hours at a cost of $238,392 to comply with the amended provisions of rule 2a–7 modifying the credit quality standard to be used in determining the eligibility of a fund’s portfolio securities. Amortizing these hourly and cost burdens over three years results in an average annual increased burden for all money market fund complexes of $2,838. We do not believe that funds would newly implement or change any annual review of policies and procedures that they currently perform as a result of the re-proposed amendments. There would be no external costs associated with this collection of information.

2. Monitoring Minimal Credit Risks

Rule 2a–7 currently requires a money market fund board (or its delegate) promptly to reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risk. As discussed above, we are re-proposing amendments to rule 2a–7 that would eliminate the current use of credit ratings in the rule’s downgrade and default provisions. Rule 2a–7 instead would require a money market fund to adopt written procedures requiring the fund adviser, or any person to whom the fund’s board of directors has delegated portfolio management responsibilities, to provide ongoing review of each portfolio security to determine that the issuer continues to present minimal credit risks. To comply with these re-proposed amendments, if adopted, a fund complex would incur one-time costs to review the amended provisions of rule 2a–7 and adopt policies and procedures providing for ongoing review to determine whether a money market fund’s portfolio securities continue to present minimal credit risks. Money market funds are not currently required to maintain policies and procedures that specifically address ongoing minimal credit risk monitoring. Although we understand, based on staff experience, that many money market funds currently monitor portfolio securities for minimal credit risk on an ongoing basis, we are assuming that all money market fund complexes would need to adopt new written policies and procedures to provide for this ongoing review in order to comply with the amended provisions of rule 2a–7.

We estimate that each money market fund complex on average would incur a one-time burden of 5 hours, at a cost of $2,838. All estimated wage figures discussed here account for bonuses, firm size, employee benefits, $2,838. All estimated wage figures discussed here account for bonuses, firm size, employee benefits, and overhead.

This is based on the following calculation: 16 hours (mid-point of 4 hours and 8 hours incurred by a compliance manager) × $283 (rate for a compliance manager = $1,698) + 3 hours (mid-point of 2 hours and 4 hours incurred by an attorney) × $380 (rate for an attorney = $1,140) = $2,838. All estimated wage figures discussed here and throughout this Release are based on published rates that have been taken from SIFMA’s Management & Professional Earnings in the Securities Industry 2013, available at http://www.sifma.org/research/item.aspx?id=6589540603, modified by Commission staff to account for an 1800 hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

Based on data from Form N–MFP and iMoneyNet data as of February 28, 2014.

This estimate is based on the following calculation: 9 hours × 84 money market fund complexes = 756 hours.

This estimate is based on the following calculation: $2,838 × 84 money market fund complexes = $238,392.

This estimate is based on the following calculation: 756 hours × 3 years = 252 hours.

This estimate is based on the following calculation: $238,392 × 3 years = $79,464.

Continued
of $3,619,164 to adopt policies and procedures for ongoing review of minimal credit risks. Using an estimate of 84 money market fund complexes, we estimate that money market funds would incur, in aggregate, a total one-time burden of 378 hours, at a cost of $303,996, to comply with the amended provisions of rule 2a-7. Amortizing these hourly and cost burdens over three years results in an average annual increased burden for all money market fund complexes of 126 hours, at a cost of $101,332. There would be no external costs associated with this collection of information.

3. Stress Testing

Rule 2a-7 currently requires money market funds to adopt written stress testing procedures and to perform stress tests according to these procedures on a periodic basis. We are re-proposing amendments to rule 2a-7 that would replace the reference to ratings downgrades in the rule’s stress testing provisions with a hypothetical event that is designed to have a similar impact on a money market fund’s portfolio. The re-proposed amendment is designed to retain a similar standard for stress testing as under current rule 2a-7. Specifically, while rule 2a-7 currently requires a fund to stress test its portfolio based on certain hypothetical events, including a downgrade of portfolio securities, the re-proposed amendment would require a fund to stress test for an event indicating or evidencing credit deterioration in a portfolio security, and would include a downgrade or default as examples of that type of event. As discussed below, we recognize that a money market fund could use its current policies and procedures to comply with the re-proposed amendment, and could continue to use credit quality evaluations prepared by outside sources, including NRSRO downgrades, in stress tests. Because the rule currently requires testing for a downgrade as a hypothetical event, we do not believe that funds would take any additional time to review and revise their policies and procedures with respect to the continued use of downgrades in stress testing. Accordingly, we do not expect the proposed amendments would significantly change current collection of information burden estimates for rule 2a-7.

\[ \text{Total Burden for Rule 2a-7} = \left( \frac{\text{current annual burden estimate}}{\text{current annual aggregate burden}} \right) \times \text{current approved collection of information burden estimates for rule 2a-7} \]

The burden estimate for rule 2a-7 is currently 517,606 hours annually for all funds. This estimate is based on the following calculation: 517,228 hours (current approved collection of information burden estimates for rule 2a-7) ÷ 517,228 hours (current approved collection of information burden estimates for rule 2a-7) = 517,606 hours annually for all funds.

4. Request for Comment

We request comment on these assumptions and estimates. If commenters believe these assumptions or estimates are not accurate, we request they provide specific data that would allow us to make more accurate estimates.

B. Rule 30b1-7 and Form N-MFP

Rule 30b1-7 requires money market funds to file a monthly report electronically on Form N-MFP within five business days after the end of each month. The information required by the form must be data-tagged in XML format and filed through EDGAR. Preparing Form N-MFP is a collection of information under the PRA. The respondents to this collection of information are money market funds. A fund must comply with the requirement to prepare Form N-MFP in order to hold itself out to investors as a money market fund or the equivalent of a money market fund in reliance on rule 2a-7. Responses to the disclosure requirements of Form N-MFP are not kept confidential.

Money market funds are currently required to disclose on Form N-MFP, with respect to each portfolio security, whether the security is a first or second tier security or is unrated, as well as the “designated NRSROs” for each security (and for each demand feature, guarantee, or credit enhancement). We believe that the majority of funds would continue to refer to credit ratings in making minimal credit risk determinations, we do not believe the re-proposed amendments to Form N-MFP would result in material changes to the ongoing burden for most funds. However, we believe that funds will incur one-time costs to re-program their filing software to reflect the new requirements of Form N-MFP. We estimate that each fund will incur a one-time burden of 3 hours, at a cost of $943 per fund, to comply with these requirements.

\[ \text{Total Burden for Rule 30b1-7} = \left( \frac{\text{current annual burden estimate}}{\text{current approved collection of information burden estimates for rule 30b1-7}} \right) \times \text{current approved collection of information burden estimates for rule 30b1-7} \]

This estimate is based on the following calculation: 378 hours (current approved burden) × 252 hours (eligible security determinations for money market fund portfolio securities, including securities that are subject to a conditional demand feature) = 94,080 hours annually for all funds. This estimate is based on the following calculation: $2,188,880 (cost of preparing Form N-MFP) ÷ 252 hours (eligible security determinations) = $8,683 per hour. If the revised collection of information for rule 30b1-7 in connection with the 2014 Money Market Fund Adapting Release is approved, this estimate would be increased. The re-proposed amendments to rule 2a-7 as discussed in this release, the collection of information for rule 2a-7 would increase to 619,031 hours (617,653 hours + 252 hours + 126 hours). This estimate is based on the following calculation: 378 hours (current approved burden) × 252 hours (eligible security determinations) = 94,080 hours annually for all funds.
the amended disclosure requirements of Form N–MFP, if adopted. Using an estimate of 559 money market funds that are required to file reports on Form N–MFP, we estimate that money market funds would incur, in the aggregate, a total one-time burden of 1,677 hours, at a cost of $527,137, to comply with the amended disclosure requirements of Form N–MFP. Amortizing these hourly and cost burdens over three years results in an average annual increased burden for all money market funds of 559 hours at a cost of $175,712. There would be no external costs associated with complying with the amended disclosure requirement of Form N–MFP.

The current approved collection of information for Form N–MFP is 45,214 annual aggregate hours and $4,424,480 in external costs. The aggregate additional hours associated with the re-proposed amendments to Form N–MFP increase the burden estimate to 45,773 hours annually for all funds. Because

\[
\text{programme} = \frac{380}{3} + \frac{380}{380} \times \text{rate for an attorney} = $380 = $943.
\]

This estimate is based on the following calculation: 3 hours × 559 money market funds = 1,677 hours.

This estimate is based on the following calculation: $943 × 559 money market funds = $527,137.

This estimate is based on the following calculation: 1,677 hours × 3 years = 559 hours.

We understand that a certain percentage of money market funds that report information on Form N–MFP license a software solution from a third party that is used to assist the funds to prepare and file the required information, and that a certain percentage of money market funds retain the services of a third party to provide data aggregation and validation services as part of the preparation and filing of reports on Form N–MFP. See 2014 Money Market Fund Adopting Release, supra note 8, at text accompanying nn. 234–236.

We recognize that, in general, software service providers that modify their software may incur additional external costs, which they may pass on to money market funds in the form of higher annual licensing fees. See id. at text accompanying n. 2340. However, on account of the relatively low per-fund one-time hour burden that we estimate in connection with the amended disclosure requirements of Form N–MFP, we expect that any increase in licensing fees will be insignificant, and thus we estimate that there are no external costs associated with the amended Form N–MFP disclosure requirements.

The Commission has submitted an application to the OMB for revision of the current approved collection of information for Form N–MFP in connection with the 2014 Money Market Fund Adopting Release. When and if approved, the collection of information for Form N–MFP will increase to 83,412 hours.

This estimate is based on the following calculation: 45,214 hours (current approved burden) + 559 hours = 45,773 hours. If the revised collection of information for Form N–MFP in connection with the 2014 Money Market Fund

we estimate no external costs associated with complying with the amended Form N–MFP disclosure requirements, the annual external costs associated with the Form N–MFP collection of information would remain $4,424,480.

We request comment on these estimates. If commenters believe these estimates are not accurate, we request they provide specific data that would allow us to make more accurate estimates.

V. Economic Analysis

As discussed above, we are re-proposing amendments to rule 2a–7 and Form N–MFP under the Investment Company Act to implement section 939A of the Dodd-Frank Act, which requires the Commission, to “review any regulation issued by [the Commission] that requires the use of an assessment of the credit-worthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings.” That section further provides that the Commission shall “modify any such regulations identified by the review . . . to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as [the Commission] shall determine as appropriate for such regulations.”

We also are proposing to amend rule 2a–7 to eliminate the exclusion to the issuer diversification requirement for securities subject to a guarantee issued by a non-controlled person. As a result, most non-government securities subject to a guarantee (including an asset-backed security with a presumed sponsor guarantee) would have to comply with both the 5 percent diversification requirement for issuers (including SPE issuers) and the 10 percent diversification requirement for guarantors and providers of demand features.

Adopting Release is approved, as well as the collection of information associated with the re-proposed amendments to Form N–MFP as discussed in this release, the collection of information for Form N–MFP would increase to 83,971 hours (83,412 hours + 559 hours). See supra note 188.

Public Law 111–203 § 939A(a)(1)–(2). Section 939A of the Dodd-Frank Act applies to all Federal agencies.

Public Law 111–203 § 939A(b). Section 939A of the Dodd Frank Act provides that agencies shall seek to establish to the extent feasible, uniform standards of creditworthiness, taking into account the entities the agencies regulate and the purposes for which those entities would rely on such standards.

As discussed above, the asset-backed security presumed guarantee is counted toward the 10% limitation on guarantees and demand features provided by the same institution. Up to 15% of the value of securities held in a tax-exempt money market fund’s portfolio may be subject to guarantee or demand features for a single institution, and up to 25% of the value of securities held in a single state money market fund portfolio may be issued by any single issuer. See supra notes 125–126.

The re-proposed rule also would make conforming amendments to rule 2a–7’s recordkeeping and reporting requirements. See re-proposed rule 2a–7(h)(3).

The economic baseline for our economic analysis is the regulatory framework as it exists immediately before the re-proposal, that is, the regulatory framework after the amendments to rule 2a–7 were adopted today in the 2014 Money Market Fund Adopting Release. As discussed in more detail below, that adopting release makes material changes to money market fund regulation that we believe may result in material changes to the money market fund industry. Because there is an extended compliance period for those amendments, we do not know how market participants, including money market fund managers selecting portfolio securities, may react as a result. Thus, we are not able to provide quantitative estimates for the incremental effects of our re-proposal. For example, under the baseline, institutional prime money market funds have floating NAVs and maintain the distinction between first and second tier securities. We are unable to estimate how institutional prime funds will choose to allocate their portfolios among first and second tier securities under our re-proposal when they have floating NAVs. We can describe potential economic effects of complying with the re-proposed and proposed amendments to the rule, but without knowing how fund portfolio allocations may change, we cannot quantify these potential effects. For the remainder of our economic analysis, we discuss separately the re-proposed rule 2a–7 amendments to remove and replace ratings references, the re-proposed Form N–MFP amendments, and the proposed amendments to rule 2a–7’s issuer diversification provision.

A. Rule 2a–7

The re-proposed amendments to rule 2a–7 would affect five elements of the rule. These are: (i) Determination of whether a security is an eligible security; (ii) determination of whether a security is a first tier security; (iii) credit quality standards for securities with a conditional demand feature; (iv) requirements for monitoring securities for ratings downgrades and other credit events; and (v) stress testing. The re-proposed amendments, which are similar to those we proposed in 2011,
are designed to remove any requirement of reliance on credit ratings and to substitute standards of creditworthiness that we believe are appropriate.

1. Economic Baseline

As discussed above, the credit risk limitations in rule 2a–7 currently require that money market funds undertake a two-step analysis before acquiring a portfolio security. First, funds must determine whether a security has received credit ratings from the “requisite NRSROs” in one of the two highest short-term rating categories or, if the security is unrated, determine that it is of comparable quality. A money market fund must invest at least 97 percent of its portfolio in first tier securities, which are eligible securities that have received a rating from the requisite NRSROs in the highest short-term rating category for debt obligations (or unrated securities of comparable quality). Second, the fund’s board of directors (or its delegate) must determine if the security presents minimal credit risks, “based on factors pertaining to credit quality in addition to any rating assigned to such securities by a designated NRSRO.” In addition, under rule 2a–7, a security subject to a conditional demand feature may be determined to be an eligible security or a first tier security if, among other conditions: (i) The conditional demand feature is an eligible security or a first tier security, and (ii) the underlying security (or its guarantee) has received either a short-term rating or a long-term rating, as the case may be, within the highest two categories from the requisite NRSROs or is a comparable unrated security.

Based on Form N–MFP filings from February 28, 2014, the Commission estimates that 99.75 percent of aggregate money market fund assets are in first tier securities, 0.24 percent of aggregate money market fund assets are in second tier securities, and 0.01 percent of aggregate money market fund assets are in unrated securities. Among the 559 funds that filed Form N–MFP that month, we estimate that 488 funds held only tier one rated securities, 503 funds held no tier two rated securities, and 537 funds held no unrated securities. In addition, less than 5 percent of all money market funds, and only 6 prime funds out of 229 prime funds held the maximum amount of second tier securities permitted under rule 2a–7.

Using additional data from the Federal Reserve Board, we estimate that money market fund holdings of second tier commercial paper represent 5.1 percent of the outstanding issues of second tier commercial paper. Second, the credit risk limitations of rule 2a–7 currently require that money market funds stress test their portfolios. Under the rule, a money market fund’s board of directors must adopt written procedures to test the ability of a fund to maintain at least 10 percent of its total assets in weekly liquid assets and minimize principal volatility (and, in the case of a money market fund using the amortized cost method of valuation or penny rounding method of pricing, the fund’s ability to maintain a stable share price per share) based on certain hypothetical events, including a downgrade or default of particular portfolio security positions, each representing various portions of the fund’s portfolio. We believe that funds stress test at least monthly.

2. Economic Analysis

The re-proposed amendments to rule 2a–7 would assist in further implementing section 939A of the Dodd-Frank Act. These amendments are designed to establish credit quality standards similar to those currently in the rule. By replacing references to credit ratings, the re-proposed amendments may, particularly when considered together with other amendments the Commission has adopted that remove credit ratings references in other rules and forms under the Federal securities laws, contribute to the Dodd-Frank Act goals of reducing perceived government endorsement of NRSROs and over-reliance on credit ratings by market participants.

Eligible securities. Under the re-proposal, a money market fund board (or its delegate) would be required to determine minimal credit risk by applying a subjective credit quality standard. Because the interpretation of this subjective standard may differ among fund boards and their advisers, the possible range of securities available for investment may differ from that under the current rule if the re-proposed standard is adopted. Aggressive risk assessments may result in a broader set of securities holdings through investments in more second tier securities with a wider range of credit quality, while conservative risk

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194 See supra notes 20–25 and accompanying text. The credit risk limitations of rule 2a–7, as well as the other specific provisions of rule 2a–7 that reference credit ratings, were not changed by the adoption of the amendments discussed in the 2014 Money Market Fund Adopting Release.


196 An underlying long-term security would become a short-term security when its remaining time to maturity is less than 307 days. See supra note 78. These estimates are based on a random sample of 10% of the securities that have demand features that were reported in February 2014 Form N–MFP filings.

197 See supra notes 91–92 and accompanying text.

198 See, e.g., Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher, a report by staff of the Division of Risk, Strategy, and Financial Innovation (Nov. 30, 2012), available at http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf, at 14–16 (discussing events such as credit rating downgrades that have led money market fund sponsors to choose to provide support to the fund or to seek staff no-action assurances permitting such support).

199 See supra notes 102–106 and accompanying text.
assessments may result in a more restricted set of securities holdings with a narrower range of credit quality. We believe that fund managers are generally unlikely to increase exposure of their funds to riskier second tier securities in light of both current market practices and amendments to rule 2a–7 adopted in the 2014 Money Market Fund Adopting Release.\(^{203}\) First, we anticipate that many money market funds are likely to retain their current investment policies, which incorporate NRSRO ratings and would be permitted under the re-proposed rule amendments. Indeed, we understand that many funds today have investment policies that are more restrictive than rule 2a–7 requires, including policies that, for example, limit investments to first tier securities.\(^{204}\) As a result, we do not expect that these money market funds would change current policies and procedures they have adopted that limit their investments to those assigned the highest NRSRO ratings. We also note that according to Form N–MFP filings from February 28, 2014, fund assets in second tier securities represented 0.24 percent of total money market fund assets and that 24 funds (out of a total of 559) currently hold the maximum amount of second tier securities permissible under rule 2a–7. We do not anticipate that money market funds representing the significant majority of assets under management are likely to increase substantially their investments in riskier securities as a result of our proposal because these funds do not currently invest in second tier securities to the extent permitted now.

Second, as discussed above, the new amendments to rule 2a–7 may reduce the potential that funds would invest in riskier securities. Under the reforms, money market funds other than government money market funds are subject to fees and gates, while institutional prime money market funds will be required to transact at a floating NAV.\(^{205}\) We believe that these amendments may encourage non-government funds to more closely monitor fund liquidity and hold more liquid securities to increase the level of daily and weekly liquid assets in the fund because doing so will tend to lessen the likelihood of a fee or gate being imposed. The newly-adopted money market fund reforms also require each fund daily to disclose its market value rounded to four decimal points (or an equivalent level of accuracy for a fund using a share price other than $1.0000)\(^{206}\) and to depict historical information about its daily NAV for the previous six months. These disclosures may increase informational efficiency by allowing investors to see variations in share value that are not apparent in the share price and compare the principal volatility among funds over time. As a result, to the extent that institutional investors continue to value price stability and can see these variations in share value, we believe that institutional prime funds will endeavor to reduce NAV fluctuations.

Third, funds are permitted to refer to credit ratings while making their minimal credit risk determinations. A first tier credit rating might help support the fund’s determination that the security is an eligible security, while a second tier credit rating might not support the same determination. Thus, fund managers may have to perform additional credit research and analysis on the issuers of second tier securities in order to determine whether the investment would be permitted under the re-proposed amendments. We believe that many fund managers may not wish to invest in the additional resources necessary to make this assessment with respect to second tier securities unless the fund believes that the expected risk-adjusted return of doing so would be greater than the expected costs.

The re-proposal would eliminate the current limitations on fund investments in second tier securities.\(^{207}\) As a result, funds may increase their holdings of second tier securities despite the considerations discussed above. We believe that, to the extent money market funds increase investments in riskier securities, institutional prime funds are more likely than stable-NAV funds to do so because only stable-NAV funds will break the buck if the economic value of the underlying portfolio changes too much. While some shareholders may continue to demand price stability rather than high yield from institutional prime funds, if enough shareholders prefer yield over price stability, institutional prime funds will be incentivized to increase their investments in second tier securities. Allocative efficiency may improve if such preferences result in relatively riskier securities moving from the portfolios of stable-NAV funds to the portfolios of institutional prime funds because the reallocation may enable money market fund shareholders to choose funds that better match their preferences for risk and return. We do not, however, know whether institutional prime funds with floating NAVs, which will have to compete with other money market funds, including stable-NAV government funds, will focus on maintaining comparatively stable NAVs or on generating comparatively high yields.

Under the assumption that money market funds would increase their relative holdings of second tier securities if the re-proposed amendments were adopted, the effects on competition and capital formation will depend, in part, on whether the increased second tier investments come from new assets outside the funds, which when invested by money market funds are disproportionately invested in second tier securities or whether the increased second tier investments will come from a shift of assets from first tier securities to second tier securities. If the former, the effects of competition between issuers of first and second tier securities might be small, and capital formation might improve in the second tier market as the size of the new investment increases. If the latter, an increase in capital formation from issuers of second tier securities may result in a corresponding decrease in capital formation from issuers of first tier securities, which, in turn, may lead to increased competition between issuers of first and second tier

\(^{203}\) As noted above, we do not believe fund managers are likely to invest in third tier securities (or comparable unrated securities) because those securities would not satisfy the re-proposed standard that the security’s issuer have an exceptionally strong capacity to meet its short-term financial obligations. See supra note 45 and accompanying and following text.

\(^{204}\) As of February 28, 2014, 179 money market funds, representing approximately 50% of all money market funds assets (88% of all institutional money market fund assets) were invested in money market funds that were themselves rated by credit rating agencies, and approximately 98% of rated money market funds were rated first tier. For a money market fund to receive a first tier rating, credit rating agencies generally require the fund to limit its portfolio securities to first tier securities. See, e.g., FitchRatings, Global Money Market Fund Rating Criteria (Mar. 26, 2013), available at http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=704145 (registration required) (stating that its “AA” “A+” top rating requires that a money market fund have 100% of its portfolio securities rated first tier (“F1+” or “F1”)); Standard & Poor’s, Methodology: Principal Stability Fund Ratings (June 8, 2011), available at https://www.shilling.com/prime/portals/0/RiskMan_Oversight/FundProfile/201106_SPPrincipalStabilityFundRatingsMethodology.pdf (stating that “[i]n order for a fund to be eligible for an investment-grade rating, all investments should carry a Standard & Poor’s short-term rating of ‘A–1+’ or ‘A–1’ (or SP–1+ or SP–1), or Standard & Poor’s will consider all of the investments to be of equivalent credit quality”).

\(^{205}\) Rule 2a–7(a)(16) defines a government money market fund as a money market fund that invests 99.5% or more of its total assets in cash, government securities, and/or repurchase agreements that are collateralized fully. See supra note 15.

\(^{206}\) See supra note 49.
securities. We are unable to estimate these effects because we do not know how shareholders and funds will respond to the elimination of the current limitation on fund investments in second tier securities.

The re-proposed amendments to Form N–MFP, which are discussed in more detail below, may reduce the potential that fund boards (or managers) that use credit ratings will increase significantly fund investments in second tier securities beyond the level desired by fund shareholders. We would require each money market fund to disclose on Form N–MFP those NRSRO ratings the fund’s board (or its delegate) has considered, if any, in determining whether a security presents minimal credit risks. The disclosure to investors of these risk indicators may have the effect of penalizing funds that assume a level of risk that is different from that which is desired by their shareholders.

As discussed above, the vast majority of money market funds held no second tier securities on February 28, 2014, and few funds held the maximum permissible 3 percent. We therefore believe that a reduction or even elimination of second tier securities from the money market fund industry’s aggregate portfolio will not likely have a material effect on issuers of either first or second tier securities. However, removing second tier securities from the portfolios of individual money market funds may negatively affect yields in certain funds, especially during periods when second tier securities offer substantially higher yields than the yields offered by first tier securities.

One commenter suggested that eliminating references to credit ratings in the definition of eligible security would lead to more unrated securities issuances in the market. The commenter argued that some issuers of money market instruments might forego the expense of ratings because they would face greater uncertainty as to market acceptance under the subjective determinations of money market fund advisers. In addition, some issuers of instruments that might not receive a rating in the highest category might choose not to obtain a rating. This commenter opined that such a result would make it more difficult to retain a degree of risk limitation similar to that in the current rule.

We believe that most money market funds would not likely change their current investment policies if the re-proposed amendments were adopted. Nevertheless, we recognize that some fund boards might choose not to consider NRSRO ratings in their credit assessments or as noted above, fewer securities may be rated. If, as a result, the demand for NRSRO ratings were reduced significantly, NRSROs might invest less in producing quality ratings. The importance attached to NRSRO ratings currently as a result of the history of their use in regulatory requirements may impart franchise value to the NRSRO rating business. By eliminating references to NRSRO ratings in Federal regulations, section 939A of the Dodd-Frank Act could reduce these franchise values and reduce NRSROs’ incentives to produce credible and reliable ratings. In addition, eliminating the required use of credit ratings in Commission rules and forms may reduce the incentive for credit rating agencies to register as NRSROs with the Commission, which registration subjects them to Commission oversight and the statutory and regulatory requirements applicable to NRSROs. If the quality and accuracy of NRSRO ratings were adversely affected yet the ratings continued to be used by enough other parties, the capital allocation process and economic efficiency might be impaired.

Another commenter stated that our re-proposal to eliminate references to credit ratings could increase investor reliance on credit ratings. This commenter stated that to the extent that investors cannot be reassured that money market funds are investing in rated securities, they can reasonably be expected to seek the “reassurance” ratings provide in other ways. Specifically, investors could seek rated funds in even greater numbers “as the ratings, and the investment guidelines that underlie them, will provide an objective standard that investors can use to distinguish amongst funds,” which would encourage more funds to become rated. If, as a result of the re-proposed amendments, currently unrated money market funds obtain ratings to compete in the market, it could increase their costs. Such a result also might increase rather than reduce investor reliance on credit ratings. To the extent that funds continue to use ratings, which we believe most will, investors would be able to determine the ratings of fund portfolio securities from the disclosures required under the re-proposed amendments to Form N–MFP.

In our discussion above, we have suggested guidance that a fund board (or its delegate) should consider in making credit quality assessments. As we noted, based on staff observations in examinations and prior staff guidance, we assume that most money market fund managers currently take these factors into account, as appropriate, when they determine that a portfolio security presents minimal credit risks. Moreover, as noted above, the guidance is not intended to define the parameters of an appropriate credit quality assessment; that is for the fund’s board and its adviser to determine with respect to each particular portfolio security. Thus, we do not anticipate that the re-proposal’s discussion of factors that a fund manager should consider would significantly change the process for evaluating credit quality or that consideration of the factors listed above would significantly impact the holdings in money market fund portfolios. For these reasons, we believe that the guidance will not have a material effect on efficiency, competition, or capital formation. Funds may, however, consider whether their policies and procedures for credit quality assessment should be revised in light of the guidance, and, as a result, may update them.

Conditional Demand Feature. The re-proposed amendments would replace the current objective standard for determining the credit quality of an underlying security with a subjective standard, which is based on the qualitative standard NRSROs use to describe a security with the second-highest long term rating. We recognize that fund managers could interpret this subjective standard in different ways, which could widen the range of credit quality in underlying securities in which money market funds invest. However, we do not believe that fund managers will likely interpret this subjective standard in a manner that results in funds increasing the risk profiles of their underlying securities. For the reasons discussed above, we do not believe that securities that are rated by NRSROs in the third-highest category for long-term ratings (or comparable unrated securities) would satisfy the proposed standard that the issuer of underlying securities have a very strong capacity to meet its financial commitments.

We also note that...
funds currently can invest exclusively in underlying securities rated in the second-highest category if the instrument meets the other conditions for eligibility.\textsuperscript{212} We estimate that most underlying securities held by money market funds (81 percent) are rated in the second-highest long-term category, and a smaller portion (19 percent) are rated in the highest long-term category.\textsuperscript{213} For these reasons, we have no reason to anticipate that funds are likely to increase the portion of their underlying securities that are rated in the second-highest long-term category as a result of the re-proposed amendments. Because we believe that our re-proposal will result in only small changes to the behavior of funds with respect to investments in securities with conditional demand features, we believe that this re-proposed amendment will result in little to no effect on efficiency, competition, or capital formation for either funds or issuers.

As discussed above, we believe that if the re-proposed amendments to rule 2a–7 were adopted, money market fund complexes would incur certain costs in reviewing and updating their policies and procedures. Specifically, each complex would review the amendments to the credit quality standards in rule 2a–7 and, as it determines appropriate in light of the amendments, revise its policies and procedures to incorporate the amended credit quality standards to be used in determining the eligibility of a money market fund’s portfolio securities, including securities that are subject to a conditional demand feature.

Monitoring Minimal Credit Risk. As discussed above, we believe the re-proposed requirement that each money market fund adopt written policies and procedures for ongoing monitoring of minimal credit risks for each portfolio security essentially codifies the current practices of fund managers, which are already explicit (and implicit) in several provisions of the rule and are discussed above.\textsuperscript{214} Although based on staff experience we believe that most, if not all, money market funds currently monitor portfolio securities for minimal credit risk on an ongoing basis (as rule 2a–7 requires\textsuperscript{215}), we note that money market funds are not currently required to maintain written policies and procedures that specifically address monitoring. We believe that to the extent that some money market funds may not have written procedures to regularly monitor minimal credit risks, our re-proposal to require such procedures is designed to ensure that funds are better positioned to identify quickly potential risks of credit events that could impact portfolio security prices. The costs associated with the re-proposed minimal credit risk monitoring requirement, as discussed above, will vary based on the extent to which funds’ existing procedures need to be transcribed and reviewed.\textsuperscript{216} We believe that the written-procedure requirement in the re-proposal will not materially affect efficiency, competition, or capital formation because we expect no material changes in how funds invest.

Stress Testing. As discussed above, the re-proposed amendments are designed to retain similar standards for stress testing as under current rule 2a–7. Specifically, while the re-proposed amendments would replace the current reference to ratings downgrades in the rule 2a–7 stress testing requirement, the amendments would instead require funds to test for an event indicating or evidencing credit deterioration of particular portfolio security positions, each representing various positions of the fund’s portfolio, and include a downgrade or default as examples of such an event. Consequently, we recognize that a money market fund could use its current policies and procedures for stress testing, including testing for a downgrade, to comply with the proposed amendments. And we believe that funds will do so because a downgrade by a relevant NRSRO may impact the price of a portfolio security.\textsuperscript{217} Because we believe that funds will not change their stress testing policies and procedures in response to this re-proposed amendment, we do not believe there would be any costs associated with it.\textsuperscript{218} Thus we do not anticipate that this re-proposed amendment is likely to impact efficiency, competition, or capital formation.

Policies and Procedures. As discussed above, money market funds have written policies and procedures for complying with rule 2a–7, including policies and procedures for determining and reassessing minimal credit risk and for stress testing the portfolio.\textsuperscript{219} Although our re-proposal would not require changes to these policies and procedures for most money market funds, we anticipate that funds would likely review them and may revise them in consideration of the standard provided in the re-proposal, if adopted. We also anticipate that after such a review, many fund boards and advisers would retain investment policies tied to NRSRO ratings required under the current rule.\textsuperscript{220} Although we cannot predict the number of funds that would review and revise their policies and procedures or the extent to which funds may do so, we estimate that each fund would incur, at a minimum, the collection of information costs discussed in the Paperwork Reduction Act section for a total average one-time cost of approximately $2,838 per fund complex.\textsuperscript{221} These minimum costs assume that a fund would review its policies and procedures in consideration of the re-proposed amendments and make minor changes to conform with revised rule text, but would not change significantly the policies and procedures relating to the fund’s credit quality assessments, monitoring for minimal credit risk or stress testing, which currently include consideration of NRSRO ratings.

As noted above, we believe that while funds monitor for minimal credit risks on an ongoing basis currently, we assume that funds do not have written policies and procedures to address monitoring.\textsuperscript{222} We estimate the average one-time costs to adopt those written policies would be $3,619 per fund.\textsuperscript{223} Because we anticipate that our re-proposal is not likely to change these fund policies significantly, we believe it is not likely to have a significant impact on efficiency, competition, or capital formation.

3. Alternatives

In addition to the re-proposed amendments to rule 2a–7, we\textsuperscript{219} See rule 38a–1(a).
\textsuperscript{220} See supra paragraph including note 151. We also note that most commenters on the 2011 proposal supported permitting funds to continue to use ratings, and some asked us to clarify that ratings continue to be a permissible factor for boards or their delegates to consider in making credit quality determinations. See, e.g., BlackRock Comment Letter, supra note 122; IDC Comment Letter, supra note 30. Our re-proposed amendments to Form N–MFP, discussed above, reflect our clarification that ratings continued to be a permissible factor to use in making credit quality determinations.
\textsuperscript{221} See supra note 154.
\textsuperscript{222} See supra notes 102–106 and accompanying text.
\textsuperscript{223} See supra note 164.
considered adopting the amendments we proposed in 2011. That proposal would have required fund boards first to determine whether securities are eligible securities based on minimal credit risks, and second to distinguish between first and second tier securities based on objective standards, and fund advisers are likely to make many of the same considerations in evaluating first and second tier securities.\(^{224}\) In addition, on balance, we believe that the re-proposed single standard may better reflect the risk limitation in the current rule. The 2011 Proposing Release described the standard for second tier securities in language similar to the descriptions NRSROs use for second tier securities, which fund managers might interpret as permitting funds to invest in riskier second tier securities to a greater extent than under our re-proposal, which is designed to limit investments in very high quality second tier securities. Such increased investments in riskier second tier securities would increase the risk profile of money market funds.

We also considered proposing a single standard that would require a minimal credit risk determination, but with a finding different from what we are re-proposing today. For example, the board could be required to find that the issuer or guarantor has a repayment capacity that reflects the standard that NRSROs articulate for second tier securities. We did not re-propose this alternative because of concerns that such a standard could lower the credit quality of money market fund portfolios. Under this single standard, there would be no distinction between first tier and second tier securities and no limitation on fund holdings of second tier securities, unlike the current rule, which limits a money market fund's invest no more than 3 percent of its total assets in second tier securities. Without that investment limitation, a manager could invest a significantly greater portion of the fund’s portfolio in second tier securities, which could result in an increase in the portfolio risk of some funds that is inconsistent with the relevant risk limitations in the current rule. Both this alternative single standard approach and the two-tier approach discussed above could have different effects on competition and capital formation than the effects on competition and capital formation stemming from the re-proposed approach, as a result of ensuing increased or decreased investments in second tier securities. However, we are unable to estimate the relative effects on competition or capital formation because we do not know how shareholders and funds would respond to these approaches as compared to the re-proposed elimination of the current limitation on fund investments in second tier securities.

With respect to replacing the reference to ratings in determining the eligibility of underlying securities (i.e., those that are subject to a conditional demand feature), we considered a qualitative standard that NRSROs use to articulate long-term securities in the highest rating category. We note generally that few issuers or guarantors have received long-term ratings in the highest category.\(^{225}\) Moreover, issuers assigned a first tier short-term rating may have received a long-term rating in the second-highest category.\(^{226}\) Because of the limited NRSRO assignments of the highest long-term ratings to issuers, managers might interpret this alternative to preclude fund investments in a security subject to a conditional demand feature (that is itself an eligible security) if the underlying security’s issuer or guarantor is rated in the second-highest category. Such an interpretation could significantly deviate from the credit quality standards in the current rule, which is not our intent. It also would likely reduce money market fund investments in these securities.

In re-proposing to eliminate the current reference to ratings downgrades in the monitoring standard of rule 2a–7, we considered the rule 2a–7 amendments that we proposed in 2011.\(^{227}\) These proposed amendments would have required that, in the event the money market fund advisor (or any person to whom the board has delegated portfolio management responsibilities) becomes aware of any credible information about a portfolio security or an issuer of a portfolio security that suggests that the security is no longer a first tier security or a second tier security, as the case may be, the board or its delegate would have to reassess promptly whether the security continues to present minimal credit risks.\(^{228}\) Most of those who commented on this proposed amendment objected to it as an inefficient method of notifying funds if a portfolio security is potentially impaired. As discussed in more detail above, we have been persuaded by commenters’ concerns in re-proposing a different standard than that proposed in 2011.\(^{229}\)

Finally, we also considered removing the current reference to ratings downgrades in the stress testing provisions of rule 2a–7 and replacing this reference with the requirement that money market funds stress test their portfolios for an adverse change in the ability of a portfolio security issuer to meet its short-term credit obligations. As discussed above, we proposed this alternative in 2011, and commenters on the 2011 proposal who addressed this issue uniformly advocated against removing the reference to a downgrade in the stress testing conditions.\(^{230}\) We believe that the 2011 proposed standard, as compared to the standard we re-propose in this release, was less clear and that it would lead to more burdensome monitoring and greater inefficiencies in developing hypothetical events for stress testing. In light of these commenters’ concerns, we have thus decided to re-propose amendments to the stress testing provisions of rule 2a–7 that would permit funds to continue to test their portfolios against a potential downgrade or default, as discussed in more detail above.\(^{231}\)

4. Request for Comment

We request comment on our estimates and assumptions regarding the costs and benefits of the re-proposed amendments to rule 2a–7 and the effects of these amendments on efficiency, competition, or capital formation. For purposes of the Small Business Regulatory Enforcement

\(^{224}\) See supra note 31 and accompanying text.

\(^{225}\) See supra note 91–93 and accompanying text.

\(^{226}\)See Moody’s Ratings Definitions, supra note 38, at 6 (showing the linkage between short-term and long-term ratings when such long-term ratings exist); Standard & Poor’s, About Credit Ratings (2012), http://www.standardandpoors.com/aboutcreditratings/RatingsManual_PrintGuide.html (each short-term rating corresponds to a band of long-term ratings. For instance, the A–1 short-term rating generally corresponds to the long-term ratings of ‘A+,’ ‘A,’ and ‘A–’); FitchRatings, Ratings Definitions (2014), https://www.fitchratings.com/jsp/general/RatingsDefinitions.faces?context=5&detail=5076&context=l=5&detail=l=500 (indicating the relationship between short-term and long-term ratings with a table and acknowledging that “lower relative short-term default risk, perhaps through factors that lend the issuer’s profile temporary support, may coexist with higher medium-or longer term default risk”).
Fairness Act of 1996 (“SBREFA”), we also request information regarding the potential annual effect of the re-proposed amendments to rule 2a–7 on the U.S. economy. Commenters are requested to provide empirical data to support their views.

In addition to our general request for comment on the costs and benefits of the re-proposed amendments, we request specific comment on certain aspects of the amendments. What additional operational costs, if any, may result from making minimal credit risk determinations based on a subjective credit quality standard? Specifically, would the potentially broader range of securities available for investment that could result from a board’s interpretation of this standard produce additional or different costs than the current costs of determining minimal credit risks? Likewise, what additional operational costs, if any, may result from using a subjective standard for determining the credit quality of securities subject to a conditional demand feature? Would the potentially broader range of underlying securities available for investment produce additional or different costs than the current costs of evaluating the credit quality of underlying securities?

We have given guidance on the factors that advisers should consider, as appropriate, in determining that a fund’s portfolio securities present minimal credit risk. To the extent that consideration of these factors is not consistent with current industry practice, how would funds benefit from consideration of these factors? Would this guidance result in money market funds or their advisers incurring additional costs, such as costs to change the process for evaluating credit quality? What type of costs would funds and advisers incur, and how much? With respect to our proposed requirement for money market funds to adopt written policies and procedures for ongoing monitoring of minimal credit risks to what extent do commentators currently have written policies and procedures covering this type of monitoring?

We also request comment on our re-proposed stress test amendments. Do commentators agree with our assessment that, under the amendments to rule 2a–7 that we re-propose, funds would retain downgrades by relevant NRSROs as hypothetical events for stress testing, as under current rule 2a–7? What hypothetical events are funds likely to use in addition to or in place of downgrades and why?

Finally, we request comment on the costs and benefits of the alternatives to the re-proposed amendments discussed above.

B. Form N–MFP

The re-proposed amendments would require money market funds to disclose NRSRO ratings in certain circumstances. Specifically, a fund would have to disclose for each portfolio security (i) each rating assigned by any NRSRO if the fund or its adviser subscribes to that NRSRO’s services, as well as the name of the agency providing the rating, and (ii) any other NRSRO rating that the fund’s board of directors (or its delegate) considered in making its minimal credit risk determination, as well as the name of the agency providing the rating. NRSRO ratings provide one indicator of riskiness of a fund’s portfolio securities and, as discussed above, we anticipate that they will continue to be considered by many money market fund managers in performing credit quality assessments. We believe this ratings information may be useful to the Commission, to investors, and to various third parties as they monitor and evaluate the risks that fund managers take in both stable-NAV and institutional prime funds. We believe that this ratings information might be especially useful during periods in which funds impose fees and/or gates even though ratings are not immediately updated.

1. Economic Baseline

Under the economic baseline outlined above, money market funds are required to disclose in Form N–MFP the credit ratings for each portfolio security. More specifically, the baseline form requires a fund to identify whether a portfolio security is a first or second tier security or is unrated, and it requires the fund to identify the “designated NRSROs” for each security (and for each demand feature, guarantee, or other credit enhancement). This disclosure requirement was not changed by the 2014 Money Market Fund Adopting Release.

As noted above, based on Form N–MFP filings from February 28, 2014, the Commission estimates that 99.75 percent of aggregate money market fund assets are invested in first tier securities, 0.24 percent of aggregate money market fund assets are invested in second tier securities, and 0.01 percent of aggregate money market fund assets are invested in unrated securities. Among the 550 funds that filed that month, we estimate that 488 funds held only tier one securities, 503 funds held no tier two securities, and 537 funds held no unrated securities.

2. Economic Analysis

We anticipate that our re-propose is likely to have two primary benefits. First, it may contribute to eliminating perceived government endorsement of NRSROs and reducing over-reliance on credit ratings, particularly when considered together with other amendments the Commission has adopted that remove credit ratings references in other rules and forms under the Federal securities laws.

Second, it will provide transparency on whether or not specific funds use credit ratings when making investment decisions, and, if credit ratings are used, it allows shareholders and other interested parties to use those ratings to make their own risk assessments.

We anticipate that our re-propose is likely to have two primary costs. First, it may impose administrative costs on funds that need to re-program their Form N–MFP filing software. Second, because only funds that choose to consider credit ratings in assessing minimal credit risk will be permitted to disclose NRSRO ratings on Form N–MFP, our re-propose may reduce transparency of risks taken by funds that do not choose to consider credit ratings. This loss of transparency could create additional servicing costs for such funds if shareholders demanded new communications regarding the credit quality of the portfolio.

The net effect of the re-proposed amendments to Form N–MFP is that funds could not disclose credit ratings if credit ratings are not considered in determining whether a security is eligible for the portfolio. However, as discussed above, we believe that our re-proposal will not result in any material changes for the majority of funds because they will, we believe, continue to refer to credit ratings. We believe, therefore, that the re-proposal’s effects on efficiency, competition, and capital formation likely will be negligible. To the extent that money market funds continue to consider NRSRO ratings in making their minimal credit risk determinations, the re-proposed amendments to Form N–MFP may reduce the potential that fund managers


233 See supra notes 180–181 and accompanying text (discussion of re-programming costs in PRA analysis).

234 See Dreyfus Comment Letter supra note 30 (opposing the elimination of credit ratings disclosures in Form N–MFP because of the potential that the fund would bear increased shareholder servicing costs to provide additional communications regarding the credit quality of the portfolio).
will increase significantly fund investments in riskier second tier securities; a fund would be required to disclose ratings considered in those credit determinations, and the ratings would reflect that increased risk. As a result, the disclosure to investors of these risk indicators may have the effect of penalizing funds that assume more risk.

3. Alternatives

In considering how to meet our obligations under the Dodd-Frank Act with respect to Form N–MFP, we evaluated two primary alternatives. In 2011, we proposed to completely eliminate the following two form items: the item that requires a fund to identify whether a portfolio security is a first tier security, a second tier security, or an unrated security; and the item that requires the fund to identify the “requisite NRSROs” for each security (and for each demand feature, guarantee, or other credit enhancement). We are not re-proposing this alternative because we now believe that completely eliminating such disclosure requirements masks not only the credit ratings but also information on whether or not the fund uses credit ratings when making its investment decisions.

We also considered not removing the disclosure requirement as recommended by several commenters to the 2011 Proposing Release.235 We elected not to leave the current disclosure requirements as is, but instead to re-propose the required disclosure of NRSRO ratings only in certain circumstances. We believe this re-proposal would be in keeping with Congressional intent underlying section 939A of the Dodd-Frank Act to reduce perceived government endorsement of credit ratings.

4. Request for Comment

We request comment on our estimates and assumptions regarding the costs and benefits of the re-proposed amendments to Form N–MFP and the effects of these amendments on efficiency, competition, or capital formation. As discussed above, we believe that most, if not all, money market funds will continue to consider NRSRO ratings in some form. We request comment on whether any funds expect that they will not report NRSRO ratings and, on shareholders’ and third parties’ likely response to funds that do not report NRSRO credit ratings. We also request comment on our assumption that the costs to money market funds to reprogram their Form N–MFP filing software, in order to comply with the re-proposed amendments, would be the same costs that we discuss in the Paperwork Reduction Act analysis of this release.236 Finally, we request comment on the costs and benefits of the alternatives to the re-proposed amendments discussed above.

For purposes of SBREFA, we also request information regarding the potential annual effect of the re-proposed amendments to Form N–MFP on the U.S. economy. Commenters are requested to provide empirical data to support their views.

C. Exclusion From the Issuer Diversification Requirement

1. Economic Baseline

As discussed above, most money market fund portfolio securities that are subject to a guarantee by a non-controlled person are currently subject to a 10 percent diversification requirement on guarantors but no diversification requirement on issuers, while non-government securities with guarantees that do not qualify as non-controlled persons are generally subject to both a 5 percent diversification requirement with respect to issuers and a 10 percent diversification requirement with respect to guarantors.237 Today, we adopted amendments to rule 2a–7 that deem sponsors of asset-backed securities to be guarantors of the asset-backed security (unless the fund’s board rebuts the presumption). As a result, under rule 2a–7’s definition of a guarantee issued by a non-controlled person, both non-asset-backed securities and asset-backed securities subject to such a guarantee (including asset-backed securities with a presumed sponsor guarantee) are excluded from the rule’s issuer diversification requirement. That is, non-asset-backed securities and asset-backed securities subject to a guarantee by a non-controlled person are subject to a 10 percent diversification requirement on guarantors, but they are not subject to a 5 percent issuer diversification requirement on the issuer.238

2. Economic Analysis

We believe that there are very few money market funds that rely on the issuer diversification exclusion for securities subject to a guarantee by a non-controlled person. This belief is based on our analysis of February 2014 Form N–MFP data, which shows that only 8 out of 559 money market funds held securities with a guarantee by a non-controlled person that exceeded the 5 percent diversification requirement for issuers. We believe that these and only these funds in February 2014 relied on the exclusion from the 5 percent issuer diversification requirement with respect to issuers of securities that are subject to a guarantee issued by a non-controlled person. However, we recognize that changes in fund assets could mask which funds rely on this exclusion at acquisition: a fund might be above the 5 percent limit today solely due to a decline in fund assets after acquisition, and a fund might be below the 5 percent limit today solely due to an increase in fund assets after acquisition.239 Whatever the cause, a money market fund that has invested more than 5 percent of its assets in an issuer of securities subject to a guarantee issued by a non-controlled person in reliance on the current exclusion under current rule 2a–7 would, when those investments mature, have to reinvest the proceeds over 5 percent elsewhere. Based on the February 2014 Form N–MFP filings, we believe that only a few funds would have to make changes to their portfolios to bring them into compliance with the proposed amendments. These changes may or may not require the funds to invest in alternative securities, and the alternative securities may or may not be inferior because they offer, for example, lower yields, lower liquidity, or lower credit quality. It appears that the proposed elimination of the exclusion would have affected only 8 funds in February 2014. Five of these 8 funds exceeded the 5 percent issuer concentration limit by less than 1 percent of fund assets, 2 of the 8 exceeded that limit by less than 2 percent.

235 See BlackRock Comment Letter, supra note 122; Dreyfus Comment Letter, supra note 30; Federated Comment Letter, supra note 30; Comment Letter of the Securities Industry and Financial Markets Association (Apr. 18, 2011).

236 See supra notes 180–187 and accompanying text.

237 We note that single state funds may invest up to 15% of the value of portfolio securities invested in securities subject to guarantees or demand features issued by a single provider that is a non-controlled person. Rule 2a–7(d)(1)(ii)(B); 2a–7(d)(3)(ii)(B).

238 See rule 2a–7(a)(18) (definition of guarantee); rule 2a–7(a)(19) (definition of guarantee issued by a non-controlled person); rule 2a7(d)(3)(ii)(B) (issuer diversification).

239 All of rule 2a–7’s diversification limits are applied at the time of acquisition. For example, a fund may not invest in a particular issuer if, after acquisition, the fund’s aggregate investments in the issuer would exceed 5% of fund assets. But if the fund’s aggregate exposure after making the investment was less than 5%, the fund would not be required to later sell the securities if the fund’s assets decreased and the fund’s investment in the issuer came to represent more than 5% of the fund’s assets.
percent, and the remaining fund exceeded the limit by slightly more than 5 percent. In most cases, the fund exceeded the 5 percent diversification requirement with respect to only one issuer (one fund exceeded the requirement by less than 1 percent with respect to two issuers, and two funds had greater than 5 percent exposure to the same issuer). Because of the less than significant impact on these funds, we believe that the potential lower yields, less liquidity or increased risks associated with the proposal would be small for the affected funds.

We assume that all funds would incur costs associated with updating their systems to reflect the proposed amendment, as well as the associated compliance costs, if their systems already incorporate this issuer diversification exclusion. We believe that these costs would be small for all funds because we believe that all funds currently have the ability to monitor issuer diversification to comply with rule 2a–7’s limits on issuer concentration.

Our proposed amendment offers two primary benefits. First, the amendment simplifies rule 2a–7’s diversification requirements by eliminating the exclusion for securities with a guarantee issued by a non-controlled person. This would lower certain compliance and operational costs to the extent that funds no longer have to keep track of the securities that have such guarantees and would be eligible for the exclusion. Second, by requiring greater issuer diversification for those funds that rely on the exclusion, the proposed amendments will reduce concentration risk in those funds and may make it easier for funds to maintain or generate liquidity during periods when they impose fees and/or gates.

We estimate that 8 funds exceeded the 5 percent issuer diversification limit in February 2014; nevertheless, we recognize that these amendments may constrain more funds in the future that otherwise would have less issuer diversification.

Because we believe that the universe of potentially affected funds and issuers is small, we believe that our proposed amendments will have only negligible effects on efficiency, competition, and capital formation. Although we recognize that our proposed amendments may affect more funds and more issuers in the future, we estimate that they will affect only 8 funds and 8 issuers today. These 8 funds exceed the proposed issuer diversification limit by only a small amount for the 8 issuers. We believe that the 8 funds will find comparable alternative securities for the amount that exceeds 5 percent, and we believe that the 8 issuers will find other investors willing to buy the amount that exceeds the 5 percent for a comparable price.

3. Alternatives

As an alternative to eliminating the exclusion from issuer diversification for securities with a guarantee issued by a non-controlled person, we considered requiring money market funds to be more diversified by lowering a fund’s permitted exposure to any guarantor or provider of a demand feature from 10 percent to 5 percent of total assets. We discussed potential benefits and costs of this alternative approach, and we requested comment on it in the 2013 Money Market Fund Proposing Release. As discussed in more detail above, we decided that the current requirements for diversification of guarantors and providers of demand features together with the issuer diversification requirement if applied generally to all securities, as under the proposed amendment, appropriately address our concerns relating to money market fund risk exposures. We also believe that the potential costs of this alternative approach would likely be more significant than the costs of our proposal. As of the end of February 2014, we estimate that 107 (of 229) prime money market funds had total exposure to a single entity (including directly issued, asset backed commercial paper sponsorship, and provision of guarantees and demand features) in excess of 5 percent. Under the alternative, any fund that had exposure to an entity greater than 5 percent when those assets matured would have to reinvest the proceeds of the securities creating that exposure in different securities or securities with a different guarantor. Those changes may or may not require those funds to invest in alternative securities, and those securities might present greater risk if they offered lower yields, lower liquidity, or lower credit quality. The alternative approach would appear to affect many more funds than would the proposed amendment. As a result, we believe that a better approach to achieving our reform goal would be to restrict risk exposures to all non-government issuers of securities subject to a guarantee or demand feature in the same way, and to require money market funds (other than tax-exempt and single state funds as described above) that invest in non-government securities subject to a guarantee to comply with the 5 percent issuer diversification requirement and the 10 percent diversification requirement on guarantors and demand feature providers.

4. Request for Comment

We request comment on our estimates and assumptions regarding the costs and benefits of the proposed amendments to rule 2a–7 that would remove the issuer diversification exclusion for securities subject to a guarantee by a non-controlled person, as well as the effects of this amendment on efficiency, competition, and capital formation. For purposes of SBREFA, we also request information regarding the potential annual effect of this proposed amendment to rule 2a–7 on the U.S. economy. Commenters are requested to provide empirical data to support their views.

In addition to our general request for comment on the costs and benefits of the proposed amendment, we request specific comment on certain aspects of the amendment. Are we correct in assuming that funds would not make substantial changes to their securities holdings as a result of the proposal? Do commenters expect that funds would incur operational costs in addition to, or that differ from, the costs we outlined above? What would be the costs of making such changes? Do commenters expect that money market funds would encounter any difficulties in finding alternative investments under our proposal that have suitable characteristics? Why or why not? How would this proposal affect fund yields and the stability of fund NAVs and liquidity? Will any of these or other effects be large enough to affect the behavior of money market fund shareholders? How will shareholders...
respond? Would any of these effects be different in floating NAV funds than they would be in non-floating NAV funds? Would our proposed amendments have a differential effect on funds that impose fees and/or gates? Do commenters agree that our proposed amendments will have only negligible effects on issuers? Why or why not? Are there benefits or costs in any part of the money market fund industry that we have not identified or discussed? If so, what are those costs or benefits? Are we correct in our belief that there will be only negligible effects on efficiency, competition, and capital formation? If not, what are the effects that we overlooked?

VI. Regulatory Flexibility Act Certification

Section 3(a) of the Regulatory Flexibility Act of 1980 246 Pursuant to the Commission certifies that the rule, if adopted, would not have a significant economic impact on a substantial number of small entities.

We encourage written comments regarding this certification. We solicit comment as to whether the re-proposed and proposed amendments to rule 2a–7 and the re-proposed amendments to Form N–MFP could have an effect on small entities that has not been considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

Statutory Authority

The Commission is proposing amendments to rule 2a–7 under the authority set forth in sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a–6(c), 80a–37(a)] and section 939A of the Dodd–Frank Act. The Commission is proposing amendments to Form N–MFP under the authority set forth in sections 8(b), 30(b), 31(a) and 38(a) of the Investment Company Act (15 U.S.C. 80a–8(b), 80a–29(b), 80a–30(a) and 80a–37(a)] and section 939A of the Dodd–Frank Act.

List of Subjects in 17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Rule and Form Amendments

In accordance with the foregoing, 17 CFR parts 270 and 274, as amended elsewhere in this issue of the Federal Register, are proposed to be amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for Part 270 continues to read, in part, as follows:


2. Section 270.2a–7 is amended by:

a. In paragraph (a)(5), removing the words “and (D)”;

b. Removing paragraph (a)(11);

c. Redesignating paragraphs (a)(12) through (a)(13) as (a)(11) through (a)(12);

d. Revising newly designated paragraph (a)(11);

e. Removing paragraph (a)(14);

f. Redesignating paragraphs (a)(15) through (a)(21) as (a)(13) through (a)(19);

g. In newly designated paragraph (a)(16);

i. Removing the phrase “(a)(12)(iii) (definition of eligible security)” from paragraph (a)(16)(ii);

ii. Removing the phrase “(d)(2)(iii)” and adding in its place “(d)(2)(ii)” in paragraph (a)(16)(ii);

h. Revising newly designated paragraph (a)(17);

i. Removing paragraph (a)(22);

j. Redesigning paragraph (a)(23) as paragraph (a)(20);

k. Removing paragraph (a)(24);

l. Redesigning paragraph (a)(25) as paragraph (a)(21);

m. Removing paragraph (a)(26);

n. Redesigning paragraphs (a)(27) through (a)(31) as paragraphs (a)(22) through (a)(26);

o. Removing paragraph (a)(32);

p. Redesigning paragraphs (a)(33) and (a)(34) as paragraphs (a)(27) and (a)(28);

q. Revising paragraph (d)(2)(i);

r. Removing paragraph (d)(2)(ii);

s. Redesigning paragraphs (d)(2)(iii) and (d)(2)(iv) as paragraphs (d)(2)(ii) and (d)(2)(iii).

t. Designating paragraphs (d)(2)(ii);

u. In newly designated paragraph (d)(2)(i);

i. Removing the words “or a first tier security” from the introductory text;

ii. Removing the words “or first tier security, as the case may be” from paragraph (A);

v. Revising newly designated paragraph (d)(2)(iii)(C);

w. Adding paragraph (d)(2)(iii)(D);

x. In paragraph (d)(3);

i. Removing the words “and securities subject to a guarantee issued by a non-controlled person” in paragraph (d)(3)(i);

ii. Removing the words “first tier” in paragraph (d)(3)(i)(A)(i);

iii. Removing paragraph (d)(3)(i)(A)(ii);

iv. Removing paragraphs (d)(3)(i)(A)(iii) and (d)(3)(i)(B);

v. In paragraph (f);

i. Removing the word “Downgrades,” from the paragraph heading;

ii. Removing paragraph (f)(1);

iii. Redesigning paragraphs (f)(2) through (f)(4) as paragraphs (f)(1) through (f)(3);

iv. Removing the words “and other events” in the heading of newly designated paragraph (f)(1);

v. In the introductory text of newly designated paragraph (f)(1), removing the phrase “paragraphs (f)(2)(i) through (iii)” and adding in its place paragraphs (f)(1)(i) through (iii); and in the phrase paragraphs (f)(1)(i) through (iii); and in the phrase paragraphs (f)(1)(ii) through (iii);

vi. Revising newly designated paragraph (f)(1)(ii);

vii. Removing newly designated paragraph (f)(1)(iii) and redesigning paragraph (f)(1)(iv) as paragraph (f)(1)(ii);

viii. In the heading of newly designated paragraph (f)(3), removing the phrase “paragraphs (f)(2) and (3)”

245 5 U.S.C. 605(b).

246 Under the Investment Company Act, an investment company is considered a small business or small organization if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year. See 17 CFR 270.0–10.
and adding in its place “paragraphs (f)(1) and (2)”;■ ix. In the introductory text of newly designated paragraph (f)(3), removing the phrase “paragraphs (f)(2) and (3)” and adding in its place “paragraphs (f)(1) and (2)”;■ x. In newly designated paragraph (f)(3)(iii), removing the phrase “paragraph (a)(18)(i)” and adding in its place “paragraph (a)(16)(i)”;■ z. Revising paragraph (g)(3);■ aa. Revising paragraph (g)(4)(i)(B);■ bb. Revising paragraph (h)(3);■ cc. In paragraph (j);■ i. Removing the words “(a)(11)(i) (designation of NRSROs)” in the introductory text; and■ ii. Removing the phrase “(f)(2)” and adding in its place “(f)(1)” in the introductory text;■ iii. Removing the phrase “in paragraph (d)(2)” and adding in its place the phrase “in paragraphs (d)(2) and (g)(3)” in paragraph (1);■ iv. Removing the phrase “(f)(3)” and adding in its place “(f)(2)” in paragraph (2).

The additions and revisions read as follows:

§ 270.2a–7 Money market funds.  
(a) * * *  
(11) Eligible security means a security:  
(i) With a remaining maturity of 397 calendar days or less that the fund’s board of directors determines presents minimal credit risks, which determination must include a finding that the security’s issuer has an exceptionally strong capacity to meet its short-term financial obligations;  
(ii) That is issued by a registered investment company that is a money market fund; or  
(iii) That is a government security.  
* * * * *  
(17) Guarantee issued by a non-controlled person means a guarantee issued by a person that, directly or indirectly, does not control, and is not controlled by or under common control with the issuer of the security subject to the guarantee (control means “control” as defined in section 2(a)(9) of the Act) (15 U.S.C. 80a–2(a)(9)).  
* * * * *  
(d) * * *  
(2) * * *  
(i) General. The money market fund shall limit its portfolio investments to those United States dollar-denominated securities that are at the time of acquisition eligible securities.

(ii) Securities subject to guarantees. A security that is subject to a guarantee may be determined to be an eligible security based solely on whether the guarantee is an eligible security, provided however, that the issuer of the guarantee, or another institution, has undertaken to promptly notify the holder of the security in the event the guarantee is substituted with another guarantee (if such substitution is permissible under the terms of the guarantee).

(iii) * * *  
(C) The fund’s board of directors determines that the issuer of the underlying security or any guarantor of such security has a very strong capacity for payment of its financial commitments; and  
(D) The issuer of the conditional demand feature, or another institution, has undertaken to promptly notify the holder of the security in the event the conditional demand feature is substituted with another conditional demand feature (if such substitution is permissible under the terms of the conditional demand feature).  
* * * * *  
(f) * * *  
(1) * * *  
(ii) A portfolio security ceases to be an eligible security (e.g., no longer presents minimal credit risks); or  
* * * * *  
(g) * * * * *  
(3) Ongoing review of credit risks. The written procedures must require the adviser to provide ongoing review of each security (other than a government security) to present minimal credit risks. The review must:  
(i) Include an assessment of each security’s credit quality, including the issuer’s capacity to meet its short-term financial obligations; and  
(ii) Be based on, among other things, financial data of the issuer of the portfolio security or provider of the guarantee or demand feature, as the case may be, and in the case of a security subject to a conditional demand feature, the issuer of the security whose financial condition must be monitored under paragraph (e)(2)(iii) of this section, whether such data is publicly available or provided under the terms of the security’s governing documents.  
* * * * *  
(8) * * *  
(i) * * *  
(B) An event indicating or evidencing credit deterioration, such as a downgrade or default, of particular portfolio security positions, each representing various portions of the fund’s portfolio (with varying assumptions about the resulting loss in the value of the security), in combination with various levels of an increase in shareholder redemptions;  
* * * * *  
(h) * * *  
(3) Credit risk analysis. For a period of not less than three years from the date that the credit risks of a portfolio security were most recently reviewed, a written record must be maintained and preserved in an easily accessible place of the determination that a portfolio security is an eligible security, including the determination that it presents minimal credit risks at the time the fund acquires the security, or at such later times (or upon such events) that the board of directors determines that the investment adviser must reassess whether the security presents minimal credit risks.  
* * * * *  
3. Section 270.12d–3(1)(d)(7)(v) is amended by removing the phrase “§§ 270.2a–7(a)(8) and 270.2a–7(a)(15)” and adding in its place the phrase “§§ 270.2a–7(a)(9) and 270.2a–7(a)(16)”;  
4. Section 270.31a–1(b)(1) is amended by removing the phrase “(as defined in § 270.2a–7(a)(8) or § 270.2a7(a)(15) respectively)” and adding in its place the phrase “(as defined in § 270.2a–7(a)(9) or § 270.2a–7(a)(16) respectively)”.

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

5. The authority citation for Part 274 continues to read, in part, as follows:  
Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a–8, 80a–24, 80a–26, and 80a–29, unless otherwise noted. * * * * *
4. Form N–MFP (referenced in § 274.201) is amended by:  
(a) Revising Item C.9;  
(b) Revising Item C.10;  
(d) Removing Items C.14.b and C.14.c;  
f. Adding new Item C.14.e;  
g. Removing Items C.15.b and C.15.c;  
h. Redesignating Item C.15.d as Item C.15.b;  
i. Adding new Item C.15.c;  
k. Redesignating Item C.16.e as Items C.16.c; and  
l. Adding new Item C.16.d.

The revisions read as follows:  
Note: The text of Form N–MFP does not, and this amendment will not, appear in the Code of Federal Regulations.
FORM N–MFP

Item C.9 Is the security an Eligible Security? [Y/N]

Item C.10 Security rating(s) considered. Provide each rating assigned by any NRSRO to whose services the fund or its adviser subscribes (together with the name of the assigning NRSRO), and any other NRSRO rating that the fund’s board of directors considered in determining that the security presents minimal credit risks (together with the name of the assigning NRSRO). If none, leave blank.

Item C.14 * *

e. Rating(s) considered. Provide each rating assigned to the demand feature(s) or demand feature provider(s) by any NRSRO to whose services the fund or its adviser subscribes (together with the name of the assigning NRSRO), and any other NRSRO rating assigned to the demand feature(s) or demand feature provider(s) that the board of directors considered in evaluating the quality, maturity or liquidity of the security (together with the name of the assigning NRSRO). If none, leave blank.

Item C.16 * *

d. Rating(s) considered. Provide each rating assigned to the enhancement(s) or enhancement provider(s) by any NRSRO to whose services the fund or its adviser subscribes (together with the name of the assigning NRSRO), and any other NRSRO rating assigned to the enhancement(s) or enhancement provider(s) that the board of directors considered in evaluating the quality, maturity or liquidity of the security (together with the name of the assigning NRSRO). If none, leave blank.

By the Commission.


Kevin M. O’Neill,
Deputy Secretary.

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