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SEC Proposal to Remove Rating References From MMF Rule Sparks Concerns.

WASHINGTON — Market participants are concerned that language in the Securities and Exchange Commission's proposal to remove references to credit ratings from its Rule 2a-7 governing money market funds could be too restrictive on what securities MMFs could purchase.

Under the current rule, funds can only purchase eligible securities defined as those having a remaining maturity of 397 days or fewer that has received a rating from a designated nationally recognized statistical rating organization (NRSRO) in one of the two highest short-term rating categories. Funds must hold 97% of their assets in "first tier" securities, which have the highest short-term rating.

MMFs are huge investors in short-term muni debt, and recent regulatory scrutiny of them has raised apprehension amongst dealers, investors, and issuers.

The Dodd-Frank Act of 2010, in response to concerns that over-reliance on faulty credit ratings helped drive the financial crisis, required all federal agencies to review any regulations requiring the use of a credit worthiness assessment or a reference to credit ratings and consider not including them.

The commission first proposed changes to 2a-7 in March 2011, and was met by a hail of criticism from market groups that said the proposal to define a first-tier security as one the fund's board determined had "the highest capacity to meet its short-term financial obligations," would be too subjective and create a new, higher credit standard for first-tier securities.

The new proposal, floated in July, would eliminate the distinction between the two tiers of eligible securities and define an eligible security as one whose issuer the fund's board determines has "exceptionally strong capacity" to meet its short-term obligations. That would remove the ban on funds investing more than 3% of their portfolios in second tier securities. However, many commenters maintained their original concerns about removing the objective rating agency standard. They were especially with concerned about a requirement that a determination of minimal credit risk "must include a finding that the security's issuer has an exceptionally strong capacity to meet its short-term financial obligations."

"Our members object to the new language," wrote members of the Securities Industry and Financial Markets' asset management group, including managing director and associate general counsel Matthew Nevins and managing director Timothy Cameron. The letter was also signed by John Maurello, managing director of the SIFMA Private Client Group.

"We understand that the commission may intend the new standard to replicate the 'floor' provided by an external ratings standard, to prevent an adviser from investing in an issuer that poses inappropriate credit risk based on an outlier credit analysis," the SIFMA group said. "However, the proposed language does not serve that purpose for at least two reasons. First, a new subjective standard is not an effective floor, because the subjective standard is susceptible to an outlier

interpretation. Second, the phrase ‘exceptionally strong capacity to meet its short-term financial obligations’ does not seem to create a floor. Rather, it appears to impose a new, additional standard that may be more stringent than ‘minimal credit risk.’”

Investment Company Institute deputy general counsel for securities regulation Dorothy Donohue told the SEC that the ICI views the proposal as an improvement over the 2011 draft, but is concerned the wording could restrict the number of securities that could qualify as eligible.

“‘Exceptional’ implies something unusual that might be read as not including a large number of money market securities of very high credit quality,” she wrote. “The SEC requests comment on whether a finding that a security’s issuer has a ‘very strong’ capacity to meet its short-term financial obligations better reflects the current limitation in Rule 2a-7. We believe it does.”

Other commenters didn’t see a problem with the SEC’s approach.

“We believe that in its totality, the new standard together with previous changes to regulations, provide an appropriate substitute standard,” wrote James Allen and Matt Orsagh, head and director of capital markets policy, respectively, at the investment professional organization CFA Institute.

The rule would not become effective until after a vote by the commission and would then likely provide an adjustment period for funds to prepare to comply, sources said.

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