# FURTHER DETAIL ON THE REPROPOSAL TO REMOVE RATINGS

The Reproposal affects five elements of the Rule, each of which are designed to remove references to, or requirement of reliance on, credit ratings: (i) the determination of whether a security is an eligible security; (ii) the 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 with ratings downgrades and other credit events; and (v) stress testing. [1] The first two elements are combined into one in the Reproposal.
The Reproposal also revises Form N-MFP, the form funds file monthly with the SEC to disclose portfolio holdings and other information.

## 1. Eligible Securities

The 2011 Proposal contemplated a requirement for fund boards to (i) first, determine whether securities are eligible securities based on minimal credit risks; and (ii) second, distinguish between first and second tier securities based on subjective standards. Rather than requiring a two-part determination, the Reproposal would combine the two risk criteria into a single standard for determining whether a fund could invest in a security, limiting investments to securities in which the fund's board has determined present minimal credit risk, notwithstanding any rating the security may have received. Specifically, the definition of "Eligible Security" relating to ratings would be replaced, in relevant part, by a requirement that an "Eligible Security" is a security "[w]ith a remaining maturity of 397 calendar days or less that the fund's board of directors determines presents minimal credit risks, which determination includes a finding that the security's issuer has an exceptionally strong capacity to meet its short-term financial obligations."

As a result of the single standard and elimination of the distinction between first and second tier securities, the Reproposal removes the current prohibition on funds investing more than 3 percent of their portfolios in second tier securities (and no more than 1/2 percent in any one second-tier issuer), thereby theoretically permitting funds to invest in second tier securities to a greater extent.

Further, the Release indicates that if a fund does continue to consider ratings, the adviser may need to conduct due diligence regarding the ratings. Specifically, the Release indicates that in order for fund boards to continue to rely on ratings, the SEC would expect the fund board to "understand the particular [rating agency]'s methodology for determining the rating at issue and make an independent judgment of credit risks, and…consider any outside source's record with respect to evaluating the types of securities in which the fund invests."

Fund boards typically delegate the day-to-day responsibility for credit quality determinations under the Rule to the investment adviser. If the Reproposal is adopted, however, advisers and boards will need to consider whether their procedures reflect the revised standards and whether reports to the board need to be modified to reflect the revised standards. The SEC says a fund is expected to keep a written record of the minimal credit determination that includes the data considered with appropriate documentation to reflect the process and determination. The SEC also expects the record would address any factors considered and the analysis of those factors.

[1] The Reproposal also makes conforming amendments to the Rule's recordkeeping and reporting requirements.

## 2. Conditional Demand Features

Currently, the Rule provides that a long-term security subject to a conditional demand feature[2] (underlying security) may be considered an eligible security if (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 within the highest two categories from the requisite nationally recognized statistical rating organizations (NRSROs) or is a comparable unrated security. The Reproposal requires a similar analysis, but, consistent with the Dodd-Frank Act, removes the requirement that the fund board consider the credit ratings of underlying securities and requires the adviser, instead, to determine that the conditional demand feature is an eligible security.[3]

The adviser would have to evaluate the long-term risk (or short-term risk, as applicable) of the underlying security and determine that it "has a very strong capacity for payment of its financial commitments." The Release states that an issuer determined to have a very low risk of default and a capacity for payment of its financial commitments that is not significantly vulnerable to reasonably foreseeable events would satisfy the proposed standard. The Release further states that the SEC does not believe that securities rated in the third-highest category for long-term ratings (or comparable unrated securities) would satisfy the proposed standard. The Release also advises against investing in securities whose eligibility as portfolio securities depends on a demand feature that would terminate if downgraded by a single rating category.[4]

## 3. Monitoring Minimal Credit Risks

The 2011 Proposal would have revised provisions of the Rule requiring reassessment of whether a portfolio security poses minimal credit risks following a downgrade by substituting a more subjective requirement for reassessment when the board's delegate "becomes aware of any credible information about a portfolio security or an issuer of a portfolio security that may suggest that the security is no longer a First Tier Security or a Second Tier Security." The Reproposal, however, revises provisions of the Rule by replacing the requirement that a fund reassess credit risks of an issuer when a security has been downgraded by an NRSRO with the requirement that each fund adopt written procedures requiring the fund adviser to provide ongoing review of the credit quality of each portfolio security to determine that the security continues to present minimal credit risks.

The Release provides that such ongoing monitoring would include the determination of whether the issuer continues to have an exceptionally strong capacity to repay its short-term financial obligations. The review would also update the information used to make the initial minimal credit risk determination and would be based on, among other factors, financial data of the issuer.

The Reproposal eliminates the requirement that the board be notified about a security that receives a rating below second tier that the fund disposes of without a credit reassessment. The Release expressly provides that, nevertheless, as part of the board's oversight of the investment adviser, the board should establish procedures for the adviser to notify the board should the adviser decide to keep a portfolio security that has been downgraded from second tier status.

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2 A conditional demand feature is defined as a demand feature that is not an unconditional demand feature. An unconditional demand feature, in turn, is defined as a demand feature that by its terms would be readily exercisable in the event of a default in payment of principal or interest on the underlying security.

3 The Reproposal concerning conditional demand features reflects the same standard as in the 2011 Proposal, revised to reflect the Reproposal's different minimal risk determination.

4 The Reproposal retains the current requirement 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.

## 4. Stress Testing

The Rule currently requires stress testing based on certain hypothetical events, including downgrades of particular portfolio securities. The 2011 Proposal would have replaced the reference to ratings downgrades with a requirement that funds stress test their portfolios for an adverse change in the ability of an issuer to meet its short-term credit obligations. The Reproposal would replace the reference to ratings downgrades in the stress testing requirement with a hypothetical event designed to have a similar impact on a fund's portfolio, specifically, "an event indicating or evidencing credit deterioration … of particular portfolio security positions, each representing various portions of a fund's portfolio (with varying assumptions about resulting loss in the value of the security) in combination with various levels of an increase in shareholder redemptions." The proposed rule gives downgrades and defaults as examples of such events.

## 5. Form N-MFP

The 2011 Proposal would have eliminated the form items requiring a fund to: (i) identify whether a portfolio security is a first tier or second tier security, or an unrated security, and (ii) identify the requisite NRSROs for each security. The Reproposal instead requires that each 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 ratings, 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.

The Release provides that if a fund's adviser has considered more than one NRSRO rating in making a minimal 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).