

PUBLICATION

SEC Proposes Revisions to Rules Relating to Reliance on Credit Ratings

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On July 2, 2008, the United States Securities and Exchange Commission (SEC) released proposed amendments to the Investment Advisers Act of 1940 (RIA Act) and the Investment Company Act of 1940 (IC Act) to reduce the reliance of investment managers on credit ratings of fixed income securities. Under the proposed revisions, the SEC seeks to "improve the analysis that underlies investment decisions" by investment professionals by imposing additional due diligence obligations on the Boards of Directors of mutual funds, as well as investment advisers who are also registered as broker-dealers. The SEC proposes the following changes:

- Rule 2a-7 of the IC Act would require the Board of Directors of money market funds to determine whether instruments purchased by their fund have "minimal credit risk." In addition, the term "liquid" would mean that a security could be disposed of in seven days at the price marked by the money market fund. Finally, the revised Rule 2a-7 would impose a reporting requirement to the SEC of purchases of an ineligible security from a money market fund by a virtually affiliated entity.
- Rule 3a-7 of the IC Act would eliminate the ability of investment companies to rely on credit rating for structured finance vehicles and would impose additional duties upon investment managers to ascertain a security's credit worthiness.
- Rule 5b-3 of the IC Act would require investment companies to implement additional procedures to ascertain whether repos are able meet all collateral requirements.
- Rule 10f-3 of the IC Act would substantially limit the ability of fund managers to rely upon the credit ratings of municipal securities as the sole basis of credit-related decisions.
- Rule 206(3)-3T of the RIA Act would require those investment advisers also registered as broker-dealers to implement policies and procedures to address the methodology used in determining the credit quality of a security.

Investment managers are urged to review the SEC's proposed rule changes to ascertain whether their current policies and procedures adequately document the credit review process by their analysts and traders. In particular, investment managers should identify the sources of information used in addition to credit ratings to analyze securities. Further, investment companies should take particular care to make their Boards of Directors aware of the proposed changes and the additional obligations and liabilities that may be imposed upon them with respect to credit-related decisions on the securities a fund may purchase.