INVESTMENT COMPANY INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

August 20, 2013

Submitted Electronically: *e-OED@dol.gov*
Office of Exemption Determinations
Employee Benefits Security Administration
Room N-5700
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Re: Proposed Amendments to Class Prohibited Transaction Exemptions to Remove Credit Ratings Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (RIN 1210-ZA18)

Ladies and Gentlemen:

The Investment Company Institute[1] is pleased to provide the following comments in response to the Department of Labor's proposed amendments to certain class prohibited transaction exemptions (PTEs) to remove references to credit ratings pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The proposed amendments are the result of the Department's review of its class exemptions to identify those including references to, or requiring reliance on, credit ratings. Our comments focus on the Department's proposed amendment to PTE 2006-16, and as is further discussed below, we recommend that the Department await the Security and Exchange Commission's (SEC) issuance of final amendments to rules 2a-7 and 5b-3 prior to finalizing the amendment to Section V(f)(2) of PTE 2006-16.

In drafting the proposed PTE amendments, the Department considered and relied upon several SEC alternatives to credit ratings set forth in three recent SEC releases. The Department states in the preamble that it believes that the alternatives described in the SEC releases are instructive in developing appropriate alternatives for credit ratings referenced in the PTEs, in part because of the similar manner in which the SEC's rules and the PTEs make use of such ratings, and also because of the similar standards of credit quality currently required in the rules and the class exemptions.[2]

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $14.9 trillion and serve more than 90 million shareholders.

[2] The preamble states that the Department will consider the SEC's treatment of comments received in response to its proposals modifying the use of credit ratings as part of its compliance with section 939A and 939(c) of Dodd-Frank.

The proposed amendments, if adopted, will likely have a significant impact on plan fiduciaries and services providers seeking to utilize the PTEs with respect to the transactions covered therein. For example, with respect to PTE 2006-16, the Department proposes to replace the currently applicable credit rating standard, *i.e.*, an objective standard based on nationally recognized statistical rating organization ratings, with a more subjectively applied standard. The preamble states that "[T]he Department recognizes that, where a fiduciary has neither the expertise nor the time to make an informed determination of credit quality, it may be appropriate as a matter of prudence for such fiduciary to seek out the advice and counsel of third parties." The proposed change to Section V(f)(2) of PTE 2006-16, from an objective standard based on credit ratings, to a standard based on a subjective credit-worthiness determination, will likely require a fiduciary to seek out the advice and counsel of third parties, leading to increased costs associated with complying with the conditions of PTE 2006-16. As is explained further below, given that the Department considered and appears to have relied upon amendments to two SEC rules that have been proposed (but not yet adopted) with respect to the proposed amendment to Section V(f)(2) of PTE 2006-16, we urge the Department to await issuance of final rules from the SEC prior to finalizing the proposed amendment to Section V(f)(2) of PTE 2006-16.

PTE 2006-16 and SEC's Proposed Rule 2a-7 and 5b-3 Amendments

The preamble to the proposed amendments states that the Department considered the proposed amendments to SEC rules 2a-7 and 5b-3 in developing the proposed amendment to Section V(f)(2) of PTE 2006-16. PTE 2006-16 generally provides relief from ERISA's prohibited transaction provisions (and the taxes imposed by Section 4975 of the Internal Revenue Code) for the lending of securities that are plan assets to certain banks and broker-dealers that are parties in interest to the plan and for the payment to a fiduciary of compensation for services rendered in connection with securities lending, if certain conditions are met. One such condition requires the lending plan to receive from the borrower, by the close of the lending fiduciary's business on the day in which the securities lent are delivered to the borrower, either "U.S. Collateral" or "Foreign Collateral." Foreign Collateral must be in value equal to 102 percent of the then market value of the securities lent as valued on a recognized securities exchange on which the securities are primarily traded if the collateral posted is denominated in the same currency as the securities lent. If the collateral posted is denominated in a different currency than the securities lent, the value must be equal to 105 percent of the then market value of the securities lent as valued on a recognized securities exchange on which the securities are primarily traded.

Section V(f)(2) of PTE 2006-16 includes several alternative definitions of the term Foreign Collateral. Section V(f)(2) provides that Foreign Collateral may include "foreign sovereign debt securities provided that at least one nationally recognized statistical rating organization has rated in one of its two highest categories either the issue, the issuer or guarantor." The Department proposes to change this definition to "foreign sovereign debt securities that are (i) subject to a minimal amount of credit risk, and (ii) sufficiently liquid that such securities can be sold at or near their fair market value in

the ordinary course of business within seven calendar days." The Department does not provide a definition of "minimal credit risk" and states only that "an issuer that would satisfy the credit-worthiness requirement associated with foreign sovereign debt securities should have a strong ability to repay its debt obligations and a very low vulnerability to default." Although the Department includes factors (derived from a recent SEC release regarding proposed changes to the Securities Exchange Act of 1934) that it believes a fiduciary should consider that may be applicable in making credit-worthiness determinations, the Department does not provide additional guidance on how a fiduciary may determine if an issuer has a "strong ability to repay its debt obligations" or a "very low vulnerability to default." Inasmuch as the proposed change to Section V(f)(2) requires a subjective determination of credit-worthiness of Foreign Collateral, we recommend that the amendment to Section V(f)(2) include a definition of "minimal credit risk," as that term is used in the proposed amendment to Section V(f)(2) of PTE 2006-16 to assist a fiduciary in making the proposed required subjective credit-worthiness determination.

Further, it appears that the Department considered and relied upon proposed amendments to SEC rules 2a-7[3] and 5b-3[4] with regard to the proposed amendment to Section V(f)(2) of PTE 2006-16. Specifically, the preamble states that, with respect to the proposed amendment to Section V(f)(2), the Department believes that the "minimal" credit risk standard in the proposed alternative to credit ratings in the proposed amendment to SEC rule 2a-7 is an appropriate model for the proposed alternative standard of credit quality in Section V(f)(2) of PTE 2006-16 as the current level of credit-worthiness under both provisions reflects credit ratings in one of the two highest rating categories. Further, the Department states that it believes that the liquidity requirement in the proposed amendment to SEC rule 5b-3 (sufficiently liquid that such securities can be sold at or near their fair market value in the ordinary course of business within seven calendar days) is appropriate for inclusion in the alternative standard of credit quality proposed in Section V(f)(2) because the "economic

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[3] Rule 2a-7 under the Investment Company Act governs the operation of money market funds and contains numerous risk-limiting conditions intended to help a fund achieve the objective of maintaining a stable net asset value. Among these conditions, rule 2a-7 restricts money market funds to securities that the fund's board (or a delegate) determines presents minimal credit risks. Rule 2a-7 further limits a money market fund's portfolio investments to securities that have received credit ratings from the requisite nationally recognized statistical rating organizations in one of the two highest short-term rating categories or comparable unrated securities (*i.e.* "eligible securities"). Rule 2a-7 also divides eligible securities into first tier and second tier securities, and imposes more stringent portfolio and diversification limits on second tier securities.

[4] Rule 5b-3 under the Investment Company Act allows a fund, for purposes of meeting the diversification requirements in section 5(b)(1) and the limitation on investment in broker-dealers in section 12(d)(3) of the Act, to treat the acquisition of a repurchase agreement as an acquisition of the securities collateralizing that agreement if the obligation of the seller to repurchase the securities is "collateralized fully." For funds other than money market funds, "collateralized fully" means that the collateral must consist entirely of cash items, government securities, securities that are rated in the highest rating category by the requisite nationally recognized statistical rating organizations, or unrated securities of a comparable quality as determined by the fund's board of directors or its delegate.

considerations and regulatory framework underpinning securities repurchase agreements is similar to that supporting securities lending transactions."

The SEC proposed amending the references to credit ratings in rules 2a-7 and 5b-3 in March, 2009. Specifically, the SEC proposed amending rule 2a-7 to combine the eligible security and minimal credit risk determinations, so that any security determined by the fund's board (or its delegate) to present minimal credit risk, which determination must be based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations, would be an eligible security. Additionally, the proposed amendment to rule 2a-7 would provide that a security would be a "first tier security" (regardless of the ratings it has received from any credit rating agency) if the fund's board (or its delegate) determines that the issuer has the "highest capacity to meet its short-term financial obligations." The SEC proposed to amend rule 5b-3 to replace the references to credit ratings with a requirement that non-government collateral consists of securities that the fund's board (or its delegate) determines at the time the fund enters into the repurchase agreement are both issued by an issuer that has the highest capacity to meet its financial obligations and are sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days.

The Institute provided comments to the SEC in response to its proposed amendments to rules 2a-7 and 5b-3. In its comment letter, the Institute expressed concerns that the proposed alternative standards of credit-worthiness in Investment Company Act rules 2a-7 and 5b-3 may have the unintended consequence of raising some standards while lowering others.[5] More specifically, the Institute questioned whether the proposed amendments could be interpreted to raise the credit standards for first tier securities and lower them for second tier securities. Others in the financial services industry providing comments regarding rule 2a-7 questioned whether the SEC's proposed alternative standards provide uniform standards of credit-worthiness as required by Dodd-Frank.[6]

Given the significant issues raised in the comments submitted to the SEC, and the fact that the SEC has not as of this date finalized the amendments to rules 2-a7 and 5b-3, it is possible that the SEC's final rules with respect to rules 2a-7 and 5b-3 will be different from the proposed rules upon which the Department relied in developing the alternative credit standards for Section V(f)(2) of PTE 2006-16. As such, we recommend that the Department await issuance of final amendments to rules 2a-7 and 5b-3 prior to adopting the final amendment to Section V(f)(2) of PTE 2006-16.

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[5] *See* http://www.sec.gov/comments/s7-07-11/s70711-11.pdf (Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth Murphy, Secretary, Security and Exchange Commission, dated April 25, 2011).

[6] *See, e.g.,* Letter from Gus Sauter, Managing Director and Chief Investment Officer, Vanguard, to Elizabeth Murphy, Secretary, Security and Exchange Commission, dated April 26, 2011, available at http://www.sec.gov/comments/s7-07-11/s70711-22.pdf; Letter from William M. Tartikoff, Senior Vice President and General Counsel and Lancelot A. King, Assistant Vice President and Associate General Counsel, Calvert Investments, to Elizabeth Murphy, Secretary, Security and Exchange Commission, dated April 25, 2011, available at http://www.sec.gov/comments/s7-07-11/s70711-8.pdf.

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Thank you for considering our comments on this matter. The Institute is available to provide additional information and clarification regarding these issues. Please do not hesitate to contact Howard Bard at 202-326-5810 (howard.bard@ici.org) or the undersigned at 202-326-5920 (david.abbey@ici.org).

Sincerely,

/s/ David M. Abbey

David M. Abbey
Senior Counsel, Pension Regulation