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Via e-mail to consultation-2014-04@iosco.org

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Re: Consultation Report on Good Practices on Reducing Reliance on CRAs in asset management

ICI Global¹ appreciates the opportunity to comment on IOSCO's Consultation Report on Good Practices on Reducing Reliance on CRAs in asset management (the "Consultation").² ICI Global members include U.S. funds that are regulated under the Investment Company Act of 1940 ("Investment Company Act") and non-U.S. regulated funds publicly offered to investors³ (collectively, "Regulated Funds," or "Funds"). Regulated Funds are significant investors in the global securities markets and use credit ratings in a variety of ways as part of their investment process. As of March 31, 2014, Regulated Funds classified as bond mutual funds, money market mutual funds and "mixed" mutual funds (*i.e.*, those investing in equities and debt) had total

¹ The international arm of the Investment Company Institute ("ICI"), ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US\$18.6 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

² The Board of the International Organization of Securities Commissions, *Consultation Report CR04/14 on Good Practices on Reducing Reliance on CRAs in asset management*, available at www.iosco.org/library/pubdocs/pdf/IOSCOPD442.pdf.

³ For purposes of this letter, the term "non-U.S. regulated fund" refers to any fund that is organized or formed outside the United States, is authorized for public sale in the country in which it is organized or formed, and is regulated as a public investment company under the laws of that country. Generally, non-U.S. regulated funds are regulated to make them eligible for sale to the retail public, even if a particular fund may elect to limit its offering to institutional investors. Such funds, like U.S. registered investment companies, typically are subject to substantive regulation in areas such as disclosure, form of organization, custody, minimum capital, valuation, investment restrictions (*e.g.*, leverage, types of investments or "eligible assets," concentration limits and/or diversification standards). "Undertakings for Collective Investment in Transferable Securities," or UCITS, Canadian mutual funds, and Japanese investment trusts are examples of non-U.S. regulated funds.

worldwide assets of \$7.3 trillion, \$4.8 trillion, and \$3.8 trillion, respectively.⁴ As of December 31, 2013, U.S. registered investment companies held 15% of U.S. and international corporate bonds, 11% of U.S. Treasury and agency securities, 25% of U.S. municipal securities, and 45% of commercial paper.⁵ Thus, ICI Global and its members have a strong interest in IOSCO's Consultation and sound industry practices with respect to credit analysis.

I. Introduction

The Consultation seeks information about the views and practices of investment managers, institutional investors, and other interested parties, for purposes of developing a final set of good practices on reducing over-reliance on external credit ratings in the asset management industry. IOSCO notes that credit rating agencies ("CRAs") came under regulatory scrutiny following what it believes to have been market participants' over-reliance on CRA ratings in their assessments of financial instruments and issuers in the run-up to the 2007–2008 financial crisis. The Consultation summarizes the work done by the Financial Stability Board ("FSB") in the wake of these market events,⁶ stating that "[t]he goal of the [FSB's] *Principles* is to end mechanistic reliance on ratings by banks, institutional investors, and other market participants, thereby reducing the financial stability-threatening herding and cliff effects that could arise from CRA rating thresholds being hard-wired into laws, regulations, and market practices."⁷ IOSCO sees the Consultation and any subsequent finalized *Good Practices on Reducing Reliance on CRAs in asset management* (the "Final Report") as complementing the FSB's related work.

ICI Global supports IOSCO's efforts to set forth good practices for investment managers to consider with respect to their use of credit ratings. IOSCO's goals are consistent with ICI's long-standing support for CRA reform in the United States, including supporting the efforts of the U.S. Securities and Exchange Commission ("SEC") to address weaknesses in the ratings process and improve regulatory oversight of CRAs.⁸

⁴ Figures compiled by ICI, on behalf of the International Investment Funds Association, an organization of national mutual funds associations, available at www.ici.org/research/stats/worldwide/ww_03_14.

⁵ Investment Company Institute, *2014 Investment Company Fact Book* (54th ed., May 2014), Figure 1.5, available at www.icifactbook.org.

⁶ See, e.g., *Principles for Reducing Reliance on CRA ratings* (27 Oct. 2010) (the "Principles"), available at www.financialstabilityboard.org/publications/r_101027.pdf; *Roadmap and workshop for reducing reliance on CRA ratings* (5 Nov. 2012) (the "Roadmap"), available at www.financialstabilityboard.org/publications/r_121105b.pdf; and *Thematic Review on FSB Principles for Reducing Reliance on CRA ratings* (12 May 2014) ("Thematic Review"), available at www.financialstabilityboard.org/publications/r_140512.pdf. The Roadmap states that authorities should be working to promote incentives for the private sector to develop its own internal credit risk assessment approaches.

⁷ The FSB describes herding and cliff effects in the Principles as follows: "This in turn [*i.e.*, market reliance on CRA ratings] is a cause of the 'cliff effects' of the sort experienced during the recent crisis, through which CRA rating downgrades can amplify procyclicality and cause systemic disruptions. It can be also one cause of herding in market behaviour, if regulations effectively require or incentivise large numbers of market participants to act in similar fashion."

⁸ See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission, dated July 25, 2008 (generally supporting the SEC's proposed rules imposing additional disclosure, reporting, and recordkeeping requirements on nationally recognized statistical rating organizations ("NRSROs")); Statement of Paul Schott Stevens, President and CEO, Investment Company Institute, SEC Roundtable on Oversight of Credit Rating Agencies, dated April 15, 2009 (recommending,

We agree with the Consultation and prior FSB reports⁹ that external credit ratings serve a number of useful purposes for investment managers, investors, and other market participants.¹⁰ While we understand IOSCO's concerns about over-reliance on credit ratings, we urge IOSCO not to lose sight of these acknowledged benefits. We believe it is essential that IOSCO continue to recognize the ability of investment managers, investors, and other market participants to utilize credit ratings on a voluntary basis, without suggesting that such use is undesirable. Use of external credit ratings may be a valuable and appropriate component of an investment manager's internal investment management process generally and its credit assessment process in particular, and may be helpful to investors in selecting investments and reaching a common understanding with investment managers. Discouraging these beneficial uses of credit ratings would be detrimental to the investment management process and investors, and would not provide significant benefits to either. Instead, we recommend that IOSCO be more discerning in its evaluation of the utility of credit ratings and focus on offering suggestions for reducing inappropriate *over-reliance* on credit ratings.

Our comments on the Consultation follow. We first discuss generally investment managers' internal credit assessment processes. We then highlight some principal ways in which investment managers use credit ratings. Finally, we address certain specific questions posed in the Consultation.

II. Internal Credit Assessment Processes

A. Regulated Fund Managers' Internal Credit Assessment Processes

Regulated Funds hold debt obligations and have other forms of exposure to credit risk, and their managers consider credit analysis to be an integral part of their portfolio and risk management processes. ICI Global and its members agree that investment managers should have robust internal credit analysis processes, which may include consideration of CRA credit ratings and reports as a component.

Regulated Fund managers may differ considerably in their size and resources; in the types of investment strategies employed and investments made; and in their approaches to portfolio management and credit analysis. For all Regulated Funds, however, credit risk is only one source of risk that a Fund's investment manager assesses and monitors.¹¹ Furthermore, the importance of credit risk to the overall risk profile will be Fund-specific.

among other things, that the SEC improve disclosure about credit ratings and the rating process); and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated August 8, 2011 (generally supporting the SEC's proposed rules intended to enhance disclosure and transparency, address potential conflicts of interest, and increase the accountability of NRSROs for their ratings).

⁹ See *supra* note 6.

¹⁰ Credit ratings also serve useful purposes for boards of Regulated Funds.

¹¹ Regulated Fund managers also may assess interest rate risk (*i.e.*, the risk that an investment's market value will decline when market interest rates increase), call/prepayment risk (*i.e.*, the risk that an issuer could pay principal on an obligation earlier than expected, which could result in a fund reinvesting the proceeds in lower-yielding securities), extension risk (*i.e.*, the risk that an issuer could pay principal on an obligation later than expected, which could result in a decline in the obligation's market value and an inability to reinvest proceeds in higher-yielding securities), and

Regulated Fund managers rely on numerous sources of information as part of their credit analysis of debt obligations, including offering statements, secondary market disclosure by issuers of financial and non-financial information, conference calls, market-based indicators of credit quality such as credit spreads and pricing of credit default swaps, and non-CRA produced market and sector research. Credit ratings and reports issued by CRAs serve as a complementary source of information. Using these various inputs, Regulated Fund managers conduct quantitative and qualitative analyses of the credit quality of debt obligations. Based on that information and other relevant considerations (*e.g.*, other contractual terms such as maturity and yield provisions), Regulated Fund managers determine whether to buy, hold, or sell the debt obligations. Many of the sources of information listed above would be equally relevant to Regulated Fund managers' credit assessments of counterparties, guarantors, and collateral.

B. Alternative Organizational Models for Credit Assessment

The Consultation describes two organizational models for credit assessment. The first vests responsibility for both credit assessment and investment decisions with the same person (or group of persons), while the second separates the credit analysis function from the asset management function. The Consultation suggests that the first suffers from an inherent conflict of interest, because the objectivity of credit analysis could be impaired by the investment manager's interest in pursuing higher returns through less creditworthy investments.

We strongly disagree with this assertion, for which the Consultation offers no support. Our members view credit analysis as an integral part of risk and portfolio management, irrespective of their organizational models. In making an investment decision, a Regulated Fund manager carefully weighs potential risks (including but not limited to credit risk) and return potential, and the multi-faceted analysis results in a final decision to buy, sell, or hold the investment. The organizational model a firm uses generally is based on its management philosophy with respect to assigning responsibility for investment decisions. This may include determining the extent to which the investment process would be enhanced by either encouraging specialization of functions (*e.g.*, using dedicated credit analysts) or by concentrating functions in a single person or team, thereby allowing for a comprehensive perspective on all factors that may affect the relative value of a security (*e.g.* credit quality, yield, liquidity, etc.).

Furthermore, external credit ratings serve as an objective basis for investors and other third parties to assess the credit quality of a Regulated Fund's holdings. They act as a check on any potential conflicts of interest, as well as an important source of transparency. For example, Regulated Fund managers often report credit rating information for their Funds' underlying holdings to their investors and third parties (*e.g.*, Morningstar), and relatively risk-adverse investors may shy away from Funds that take on additional credit risk. Because of this transparency, deterioration in credit quality as measured by credit ratings of portfolio holdings would become readily apparent to investors and the marketplace generally, and market participants would then be able to evaluate those holdings. We do not see a correlation between the type of organizational model used and the inherent quality of the risk/return balancing that is

currency risk (*i.e.*, the risk that the currency in which an investment is denominated will decline in value), among others, along with a number of risks particular to the issuers and securities in which they invest.

part of the decision-making process, and therefore we see neither approach outlined in Chapter 2 of the Consultation as being inherently superior.

C. IOSCO's Final Recommendations Regarding Credit Assessment

Because both Regulated Funds and their managers differ considerably in the ways noted above, we strongly recommend that the Final Report not set forth overly prescriptive standards or guidance with respect to the means by which managers should conduct and document their credit analysis. We strongly agree with IOSCO that “standard setters and regulators should be wary of imposing regulations relating to standards for in-house credit assessment.” For example, while both small and large Regulated Fund managers engage in internal credit analysis, the resources each may have available to devote to it may differ. Smaller firms may not have dedicated credit analysts (portfolio managers may assume this responsibility), and if they do, they may have fewer than larger firms. Imposing on smaller Regulated Fund managers a model that may be more suitable for larger Regulated Fund managers could result in anti-competitive effects, and increased costs that ultimately would be borne by Fund shareholders. We therefore recommend that IOSCO's Final Report be sufficiently flexible to accommodate differences in approach.

III. **Uses of Credit Ratings**

The Consultation mentions the following ways in which investment managers use credit ratings: to guide asset selection in portfolio construction and optimization; to guide the selection of eligible collateral received from or posted to counterparties; to assess the overall financial health of counterparties, guarantors, and sponsors, along with their ability to uphold their obligations; as an element to estimate and manage portfolio risk; to communicate to investors the level of credit risk of a portfolio; to define investment policies; and as an indicator of liquidity (particularly in periods of market stress). The Consultation explains that investors use credit ratings to define the range of assets in which they may choose to invest (*e.g.*, they consult references to credit ratings contained in a fund's investment guidelines, or refer to them in setting investment guidelines with investment managers) and, more generally, rely on them as a type of “common language,” absent which investors would have to rely almost exclusively on investment managers' descriptions and assessments of whether a security is “investment grade” or of “high credit quality.” We discuss below how these uses (and others) apply in the context of Regulated Funds and address some of the particular points made and questions posed in the Consultation.

A. Investment Managers' Use of Credit Ratings in Credit Analysis

External credit ratings are only one factor our members consider as part of the overall credit analysis process for Regulated Funds. We understand from some of our members that they first will typically conduct their own internal credit analysis prior to consulting the CRAs' analyses and ratings. Other members will use credit ratings and reports from CRAs as an initial screen, to help narrow the universe of securities that they will then analyze. Some view credit ratings as a useful third party check on their own analysis, and believe that the CRAs' reports provide additional color that supplements their overall analysis. Still others view credit ratings and reports in much the same way that they view “sell side” research that they may consult in

evaluating a security. In each case, use of credit ratings is only a part (albeit a potentially useful one) of the Regulated Fund managers' overall credit analysis.¹²

It follows from this that a credit rating, by itself, will not drive an investment decision. Even for Regulated Funds that include credit rating requirements as part of their credit quality-related investment policies—*e.g.*, “the fund may invest only in investment grade bonds, as rated by CRA X”—attainment of a particular rating is a necessary, but not a sufficient, condition for purchase of an investment. Using this particular example, a Fund could not invest in a bond with a rating from CRA X that was below investment grade (even if the investment manager disagreed with the rating), but it would not invest in a bond *merely because* it had a required rating from CRA X. Rather, the investment manager would then undertake its own assessment of the potential risks (including but not limited to credit risk) and returns of the investment and determine whether to purchase it. Put differently, a rating requirement in this case would establish a “floor” for the Regulated Fund manager’s purchase of debt securities, but does not alone account for the particular securities included in a Regulated Fund’s portfolio.

Regulated Fund managers also use credit ratings as part of their ongoing credit monitoring process. They pay careful attention to ratings changes, and such changes may result in managers revisiting their internal credit assessments. Even when a manager disagrees with a CRA’s revised credit assessment, changes in ratings can affect market prices of investments, so the manager will consider them on an ongoing basis.

Finally, we note that limitations with respect to the quantity and quality of available issuer disclosure in certain debt markets can affect Regulated Fund managers’ ability to conduct internal credit analysis. For example, in the U.S. municipal debt market, we have maintained that disclosure would benefit from becoming more comprehensive, standardized, timely, and accessible.¹³ Insofar as CRAs have better access to issuers than Regulated Fund managers, CRAs serve as important conduits of credit information, and may provide key information about an issuer that may otherwise be difficult to glean when issuer disclosure is lacking or not sufficiently timely.

B. Credit Analysis of Counterparties, Collateral, and Guarantors

Regulated Fund managers also engage in internal credit analysis with respect to current and prospective counterparties. This analysis may include reviews of credit ratings and related reports. The Consultation notes, for example, that private agreements with counterparties often include references to credit ratings, such as the inclusion of a downgrade or cancellation of a rating for a counterparty as an Additional Termination Event within an ISDA Master Agreement. Our

¹² Of course, not all debt securities have been rated by CRAs, so in those cases, investment managers would not have recourse to their research and opinions in assessing credit quality.

¹³ *See, e.g.*, Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth Murphy, Secretary, Securities and Exchange Commission, dated September 8, 2009 (supporting the SEC’s proposal to enhance the disclosure of information regarding municipal securities). *See also* the SEC’s *Report on the Municipal Securities Market*, dated July 31, 2012 (noting concerns among market participants regarding content and timeliness of financial information in primary offerings; timeliness and completeness of secondary market disclosure; access to issuer information; the presentation and comparability of information; and the existence/adequacy of disclosure controls and procedures).

members believe that these types of contractual provisions are beneficial to the parties to these agreements—they are clear, objective (*i.e.*, they do not rest on the subjective judgments of the parties to the agreement), widely-accepted by the industry, and leave little room for disagreement.

Moreover, if such a credit provision in an ISDA Master Agreement is triggered, the affected party has the *right*, but not the *obligation*, to terminate the agreement. Regulated Fund managers sometimes refrain from exercising this right, because in their independent assessment of the creditworthiness of the counterparty, such an action is not warranted. While a downgrade or cancellation of a counterparty's credit rating may cause a Regulated Fund manager to reevaluate its credit assessment of that counterparty, or perhaps limit additional exposure to that counterparty, termination of the agreement is not a *fait accompli*. The optional nature of these provisions, together with the Regulated Fund manager's exercise of its independent judgment, suggest that the cliff or herding effects resulting from credit rating downgrades are rather attenuated in this context.

Credit ratings also serve an important function with respect to Regulated Fund managers' assessments of collateral supporting either repurchase agreements or derivative transactions. In repurchase agreements and derivative transactions, Regulated Fund managers will carefully assess their counterparties' creditworthiness, as discussed above. They view the collateral backing a counterparty's obligation as a secondary source of protection, behind the counterparty's ability to fulfill its obligation. Nevertheless, Regulated Fund managers may insist that collateral supporting a repurchase agreement meet certain pre-determined criteria, and such criteria may include meeting a minimum credit rating requirement, among others.¹⁴ With respect to certain derivatives transactions, Regulated Fund managers may do the same, although in that context, the specified collateral may be so narrow (*e.g.*, for U.S. Regulated Funds, cash and U.S. Treasury obligations only) that credit ratings may not be a factor (or may be less relevant) in determining the collateral received.

With respect to repurchase agreement arrangements¹⁵ and derivative transactions for which they receive collateral, Regulated Fund managers negotiate parameters for permitted collateral but are not otherwise free to select the collateral supporting the counterparty's obligation. They receive collateral reports, but their due diligence with respect to credit generally involves ensuring that the collateral meets the pre-determined specifications. Doing more could

¹⁴ Other criteria may include or relate to diversification (*i.e.*, percentage limits designed to ensure that there is not excessive exposure to any particular issuer), "haircuts" (*i.e.*, the difference between the value of the cash lent and the collateral accepted, which depends on the nature and quality of the collateral), and restrictions on collateral issued by an affiliate of the counterparty (which may not serve to mitigate credit exposure to the counterparty). Also, if Regulated Funds wish to make use of Investment Company Act Rule 5b-3, forms of collateral other than cash items or government securities must satisfy a liquidity test. Specifically, securities must be "sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days." In Europe, UCITS are subject to collateral management requirements in connection with their over-the-counter financial derivatives transactions and efficient portfolio management techniques (*e.g.*, repurchase agreements), which relate to: liquidity, valuation, issuer credit quality, correlation, diversification, risk management, custody, stress testing, haircut policies, and prospectus disclosure. See *Guidelines on ETFs and other UCITS issues*, ESMA/2012/832, paragraphs 41 through 47. See also *Final Report on Revisions of the provisions on diversification of collateral in ESMA's Guidelines on ETFs and other UCITS issues*, ESMA 2014/294.

¹⁵ See, *e.g.*, *Repo and Securities Lending*, Federal Reserve Bank of New York Staff Report No. 529 (December 2011, revised February 2013), for a general discussion of the U.S. repurchase agreement market.

be impracticable, given the constantly changing nature of the collateral. Thus, Regulated Fund managers typically do not monitor and assess the credit quality of collateral in the same way that they monitor and assess debt securities held in their portfolios. In this context, use of credit ratings has importance in establishing with counterparties (and relevant third parties) what constitutes acceptable collateral. Credit ratings are the most efficient means of implementing a credit-based criterion for collateral, insofar as ratings are publicly available, commonly understood by market participants, and easily incorporated into collateral management systems.

Practices differ among our members regarding their credit analyses and use of credit ratings in assessing guarantors or other providers of credit support. Some evaluate guarantors in much the same way that they evaluate issuers of debt securities or counterparties, and the evaluation can be a key determinant in whether to purchase or continue holding the underlying debt security. Evaluating credit ratings and reports from CRAs may be part of this analysis. Others focus less on guarantors, because they will purchase (and continue to hold) a security only if the issuer is deemed sufficiently creditworthy, and therefore they view any guarantees associated with the security as only a supplemental layer of protection that is not integral to the investment decision. More generally, credit ratings of guarantors help facilitate the bond insurance process. As a practical matter, an issuer will seek insurance from a guarantor only if that guarantor has a strong credit rating that exceeds that of the bond in question—otherwise, the insurance would not improve the bond’s credit rating and thus its marketability to investors. In this way, credit ratings help market participants assess the value of a guarantee from a third party.

C. Credit Ratings in Investor Communications

Regulated Fund managers (and in their experience, Fund boards and investors) find references to credit ratings to be useful in communicating credit quality information. For instance, the SEC requires U.S. Regulated Funds to include in their annual and semi-annual reports to shareholders graphical representations of portfolio holdings. For Regulated Funds that invest primarily in debt securities, these representations often depict the credit quality of the Funds’ holdings.¹⁶ Although the SEC recently abolished the *requirement* for U.S. Regulated Funds to depict credit quality based on the ratings assigned by a CRA, they may now voluntarily refer to external credit ratings *or* use alternative means of categorization.¹⁷ We agree with the SEC’s approach: Regulated Funds should have the flexibility to present credit ratings in a manner that clearly explains the credit quality of their portfolios and the method by which they determined that quality. Notwithstanding this regulatory change, we expect that many of our U.S. Regulated Fund members will continue to present credit quality information in these reports by reference to CRA credit ratings. Regulated Funds often present similar information in their marketing materials as well. The benefits to using credit ratings for these forms of communication are that they are objective (*i.e.*, they do not rest on the subjective judgment of the investment manager), easily understood by investors, and facilitate comparisons of credit quality among funds for the benefit of fund investors.

¹⁶ See, e.g., Item 27(d)(2) of Form N-1A.

¹⁷ See *Removal of Certain References to Credit Ratings Under the Investment Company Act*, SEC Release Nos. 33-9506; IC-30847 (Dec. 27, 2013) (adopting amendments to Investment Company Act Rule 5b-3 and Forms N-1A (registration statement for open-end registered funds), N-2 (registration statement for closed-end funds), and N-3 (registration statement for registered separate accounts offering variable annuity contracts)).

D. Investors' Use of Credit Ratings

Regulated Funds may use credit ratings in formulating investment policies that relate to portfolio credit quality (*e.g.*, to establish a minimum credit quality threshold). We support the use of credit ratings for this purpose because ratings provide a “common language” and allow Regulated Funds (and their boards and investors) and investment managers to reach a clear and common understanding regarding permissible investments. The Consultation suggests that “regulators could encourage investment managers, as applicable, to include in investment mandate agreements references to alternative credit information sources.” As noted above, for credit quality-related investment policies that refer to credit ratings, however, attainment of a particular rating is a necessary, but not a sufficient, condition for purchase of the investment. Rather, an investment must satisfy the ratings-based policy *and* the investment manager’s internal assessment. And once again, use of credit ratings in investment policies facilitates comparisons of Regulated Funds’ credit quality policies and provides some predictability with respect to Funds’ resulting credit profiles—without references to third party ratings, “investment grade” Funds could have very different credit profiles across the industry, to the detriment of investors.

E. Additional Uses of Credit Ratings

In addition to those uses of credit ratings previously discussed, many Regulated Funds use credit ratings in the valuation of Fund holdings. Many Regulated Funds use pricing services in valuing debt securities, some of which trade only infrequently. The rating assigned to a security by a CRA may be one piece of data utilized by a pricing service in valuing that security, which may, as a result, affect the calculation of the net asset value of Regulated Funds that hold such securities. We believe that pricing services’ use of credit ratings for valuation purposes is valuable to the market, and recommend that IOSCO acknowledge this important use.

Regulated Fund managers also use credit ratings as part of their attribution analyses, *i.e.*, as a factor that helps explain Fund performance. Knowing how debt securities grouped by credit rating have performed can provide important insights into relative Fund performance for managers and investors alike.

IV. **Additional Issues Raised in the Consultation**

A. Fund Disclosure on Uses of Credit Ratings

As the Consultation notes, it is common practice for a fixed income fund to describe its universe of permissible investments by referring to a minimum external credit rating. When such an investment policy is in place, the related disclosure should clearly and accurately describe the policy and fully explain the manner in which external credit ratings are relied upon.

Additionally, we note that Regulated Funds are already required to provide disclosure about their investment strategies and risks in their offering documents. We believe that broad disclosure requirements such as these can accommodate the types of disclosures that IOSCO contemplates in Chapter 3.1.4 of the Consultation. For instance, the SEC requires a U.S. registered open-end fund prospectus to provide disclosure about the fund’s principal investment strategies (including the type or types of securities in which the fund invests or will invest principally), the principal risks of investing in the fund, and how the fund’s investment manager

decides which securities to buy and sell; the fund's statement of additional information must provide disclosure describing any investment strategies, including a strategy to invest in a particular type of security, used by an investment adviser of the fund in managing the fund that are not principal strategies, and the risks of those strategies.¹⁸ Similarly, a UCITS fund must include in its prospectus disclosure about the fund's risks and risk profile; the categories of assets in which it is authorized to invest; and its investment objectives, financial objectives, and investment policies.¹⁹

IOSCO suggests, as a possible good practice in the Consultation, that “[r]egulators could encourage investment managers to disclose the use of external credit ratings and describe in an understandable way how these complement or are used with the manager’s own internal credit assessment methods.” It further suggests that the information disclosed could contain some or all of the elements that IOSCO lists in Chapter 3.1.4.²⁰ We generally agree with how IOSCO has framed the considerations in Chapter 3.1.4, *i.e.*, as elements that prospectuses “could contain...as appropriate,” and we believe that the substance, frequency, and amount of disclosure on any given topic, including credit analysis and credit ratings, should be commensurate with the materiality of that information to investors. The extent of Regulated Fund disclosure on credit analysis and credit ratings should be reasonably related to their relative importance to understanding a Fund’s overall portfolio management approach and risks.²¹

We strongly disagree with the second recommendation in this section²² and urge that it not be included in the Final Report. Investment managers and Regulated Funds that rely on credit ratings should understand the relevant CRAs’ methodologies, but recommending that they describe those methodologies in the *Funds’* disclosures could subject them and certain of their related persons to liability for misstatements that may be the fault of the CRAs.²³ Moreover, attempts to fulfill such a recommendation would be met with practical difficulties. A given CRA may use a number of distinct methodologies, depending on the sector or type of security, which

¹⁸ See Items 4(a), 4(b)(1)(i), 9(b) and (c), and 16(b) of Form N-1A.

¹⁹ See UCITS Directive 2009/65/EC, Articles 69(1) and 70(1) and Schedule A of Annex I.

²⁰ These elements include:

- The sensitivity of the invested portfolio to changes in the assigned credit ratings, downgrades on the return/risk profile and redemptions from the fund. Such description could include the likely effects resulting from changes in the external credit quality of collateral or of a counterparty, or where appropriate, of a guarantor or sponsor where this could have a material impact on the portfolio;
- A description (or reference to public availability) of the methodology underlying any CRA ratings on which the manager relies, with the main assumptions;
- Where the investment manager performs its own internal assessment, a general description of its methodology, including its underlying assumptions, including, if appropriate, the use of external credit ratings.

²¹ See, e.g., *Registration Form Used by Open-End Management Investment Companies*, SEC Release No. IC-23064 (Mar. 13, 1998) (directing U.S. mutual funds, whenever possible, to “avoid a disproportionate emphasis on possible investments or activities of the fund that are not a significant part of the fund’s investment operations”).

²² See the second bullet in *supra*, note 20.

²³ For instance, under Sections 11(a) and 12(a)(2) of the U.S. Securities Act of 1933, investors who purchase shares of a mutual fund while the fund’s registration statement contains a material misleading statement have broad legal recourse.

means that a Regulated Fund with a broad mandate would have to describe or cite numerous methodologies, which are subject to change. And of course a Regulated Fund manager might rely to varying degrees on ratings from multiple CRAs, which would only compound these problems. Regulated Funds and investment managers should not be responsible for the accuracy of the CRAs' methodology-related disclosures.

B. Understanding CRAs' Methodologies and Transparency Generally

A number of jurisdictions substantively regulate CRAs and impose disclosure requirements that enhance transparency of their methodologies and operations generally. For example, the United States Congress and the SEC,²⁴ the European Parliament, the Council of the European Union, and the European Securities and Markets Authority,²⁵ and the Hong Kong Legislative Council and the Securities and Futures Commission²⁶ have taken important steps over the past several years to improve this transparency. Because of the public nature of certain applicable disclosure requirements, and the international presence of the larger CRAs, investors and market participants worldwide benefit from these types of legislative and regulatory developments. We agree with IOSCO that investment managers that use credit ratings should understand how CRAs produce them, and we believe that the efforts of legislators and regulators have been helpful to that end. Our members have indicated that they have an adequate understanding of the CRAs' methodologies. They appreciate the improvements made in this area in recent years, including the disclosure that registered CRAs make publicly available on the SEC's Form NRSRO (which, among other things, requires applicants or registered CRAs to provide a description of the procedures and methodologies they use to determine credit ratings), the European Union transparency reports that registered CRAs publish annually (that disclose, among other things, information about the methodologies, models and key ratings assumptions used in credit rating activities (and material changes thereto); potential conflicts of interest; compensation arrangements; and historical default rates of CRAs' rating categories), and CRAs' circulating for review and comment proposed changes to methodologies.

Our members have also noted the usefulness of CRA rating history and statistical performance information (*e.g.*, statistics showing frequency of upgrades or downgrades or defaults,

²⁴ The Credit Rating Agency Reform Act of 2006, Title IX, Subtitle C of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), and the SEC's related rulemaking were intended in part to increase the transparency of registered CRAs' procedures, methodologies, business practices, and credit rating performance through public disclosure. Last week, the SEC adopted new rules and rule amendments to implement certain related provisions of the Dodd-Frank Act. Among other things, the new rules and rule amendments address registered CRAs' internal controls, conflicts of interest, disclosure of credit rating performance statistics, procedures to protect the integrity and transparency of rating methodologies, disclosures to promote the transparency of credit ratings, and standards for training, experience, and competence of credit analysts. *See Nationally Recognized Statistical Rating Organizations*, SEC Release No. 34-72936 (Aug. 27, 2014).

²⁵ *See, e.g.*, Regulation (EC) No 1060/2009 (requiring, among other things, that registered CRAs publish annual transparency reports).

²⁶ *See* Amendment of Schedule 5 of the Securities and Futures Ordinance (1 June 2011) and the Code of Conduct for Persons Providing Credit Rating Services (June 2011) (the "Code"). Among other things, the Code requires a licensed CRA to provide public disclosure about its ancillary services; the general nature of its compensation arrangements with rated entities; its ratings and updates; material modifications to its methodologies and significant practices, procedures, and processes; and its internal control mechanisms.

by the CRA's rating categories). This information is valuable in highlighting historical strengths and weaknesses of CRAs, and facilitating comparisons among the CRAs. If a CRA has a history of being relatively inaccurate in its assessments of a particular type of security, a Regulated Fund manager will take this into account in determining how much weight to give those credit ratings in the manager's internal credit assessment. Finally, in addition to reviewing publicly available information about CRAs, some Regulated Fund managers actively interact with CRAs, both to discuss and challenge methodologies and ratings. Over time, Regulated Fund managers develop nuanced views of the operations and relative strengths and weaknesses of CRAs and value their ratings and reports accordingly.

C. Ratings of Funds

The Consultation notes that in some cases investment managers may be incentivized to request credit ratings for their funds; that downgrades in underlying holdings could cause rated funds to sell them, to preserve the funds' ratings; and expresses concern that investors may use fund ratings in place of independent due diligence, and as a result could respond negatively to downgrades or negative actions taken with respect to fund ratings. The Consultation also points out that fund credit ratings are generally not used in rules and regulations. Because this is not a required practice, and because investment managers often seek ratings for their Regulated Funds for business reasons after carefully considering their advantages and disadvantages, we do not believe that this is an area where IOSCO needs to make recommendations. We understand that certain institutional investors, of their own accord, *require* that funds be rated as a condition to investing. The desire to attain and maintain a particular fund rating can indeed place additional restrictions on investment managers of Regulated Funds (*e.g.*, if a CRA downgrades a portfolio holding, the investment manager may have an incentive to dispose of the holding). Insofar as fund ratings are not legally required, we believe that investment managers and their Regulated Funds are best positioned to balance the benefits of fund ratings with the additional restrictions on portfolio management that could result in practice.

D. Managing Changes in Credit Ratings

A concern of IOSCO and the FSB is that credit rating downgrades by CRAs could lead to cliff effects among market participants. Thus, IOSCO favors investment policies that do not automatically result in sales of securities that CRAs downgrade. In this regard, the practices of our members vary (*e.g.*, forced sales would not be required by the U.S. regulatory regime²⁷), which mitigates any potential cliff effects. For U.S. Regulated Funds with minimum credit rating requirements (for all or a portion of the portfolio), it is common for the investment restriction to

²⁷ Even under Investment Company Act Rule 2a-7, a downgrade would require the money market fund's board to reassess promptly whether such security continues to present minimal credit risks and cause the fund to take such action as the board determines is in the best interests of the fund and its shareholders. The determination will not necessarily result in a sale of the security. Under recently proposed amendments to Rule 2a-7, a downgrade would no longer require this prompt reassessment, although the amended Rule would require each money market fund to adopt written procedures that would 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. *See Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule*, SEC Release No. IC-31184 (July 23, 2014).

be applied at the time of purchase only.²⁸ If a Fund takes this approach, a downgrade would not trigger a sale, although the Fund could be precluded from purchasing more of that security. Of course, a Regulated Fund could voluntarily adopt a more restrictive policy and therefore be required to sell a downgraded security that no longer meets the Fund's internal credit rating requirement within a reasonable period of time. Thus, while a downgrade by a CRA may result in some sales of the security in question, the downgrade would not result in a uniform action by Regulated Funds to sell the security, thereby mitigating IOSCO's concerns regarding cliff effects.

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ICI Global supports IOSCO's efforts to set forth good practices for investment managers to consider with respect to their use of credit ratings. We recommend that, rather than seeking to broadly discourage reliance per se, IOSCO focus on offering suggestions for reducing inappropriate *over-reliance* on credit ratings. We appreciate the opportunity to comment on the Consultation. Please do not hesitate to contact me at 44-203-009-3101, Susan Olson at (202) 326-5813, Sarah Bessin at (202) 326-5835, or Matthew Thornton at (202) 371-5406 if you have any questions.

Sincerely,

/s/ Dan Waters

Dan Waters
Managing Director
ICI Global

²⁸ See, e.g., Investment Company Act Rule 35d-1(b) ("The requirements . . . of this section apply at the time a Fund invests its Assets . . . If, subsequent to an investment, these requirements are no longer met, the Fund's future investments must be made in a manner that will bring the Fund into compliance . . .").