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September 5, 2014

The Board of the International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Re: "Good Practices on Reducing Reliance on CRAs in Asset Management"

Dear Sirs/Madams:

The Asset Management Group (the "**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to comment on the consultation report entitled "Good Practices on Reducing Reliance on CRAs in Asset Management" (the "**Consultation Report**" or the "**Report**") published by the Board of the International Organization of Securities Commissions ("**IOSCO**"). The AMG's members are U.S. asset management firms, including some of the largest in the United States. In serving a wide range of clients, from institutions to individuals that invest in funds and retirement plans, our members follow extremely diverse objectives, policies and strategies and, in this regard, reflect the heterogeneity in the U.S. investment management industry and capital markets at large.

Our members appreciate the efforts of IOSCO in publishing the Consultation Report and generally support the principles and best practices outlined in the Report, which we believe are consistent with those currently employed by many U.S. asset managers. In light of our belief that U.S. asset managers generally already follow measures of the sort outlined in the Consultation Report, we are focusing on only one aspect of the Consultation Report: the picture it paints of the asset management business and its operations. We believe that picture is fundamentally inaccurate and does not describe the operations of our members. We are writing to correct these misconceptions about the asset management industry so that they do not undermine otherwise valid policy discussions like the one contained in the Consultation Report.

The Consultation Report bases its position that credit ratings should be removed from laws, regulations and market practices on the assertion that those ratings have "financial stability-threatening herding and cliff effects" that can arise from the "mechanistic reliance" on the ratings by

1 The AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.

market participants, including asset managers.[2] Underlying this assertion appears to be an assumption that the asset management business is monolithic in nature with all managers responding identically or substantially identically to changes in ratings. This underlying assumption reflects a mistaken view of asset managers that we are concerned is held by some policymakers and that, if not corrected, could lead to unproductive or even harmful regulation of participants in our industry. In particular, several studies and reports published since the financial crisis of 2008-2009 that consider regulating asset managers as "systemically important financial institutions" or "SIFIs" reflect this view.[3] We and our members are committed to sharing information with regulators and policymakers to clarify the record, and this letter is part of that effort.

The Consultation Report offers no objective support for its "mechanistic" picture of the asset management business and we submit that no such support exists. More importantly, we submit that the asset management industry is composed of firms following a multiplicity of objectives, strategies and policies that matches the diversity of their clients and causes the firms to respond very differently – frequently in opposition to one another – to ratings changes.

The AMG believes that any policy discussion regarding the asset management industry must be based on an objective and comprehensive analysis of the relevant participants and their activities. Only with such an analysis in hand can regulators determine whether regulatory action is required and what form it should take. Without such an analysis, regulators cannot demonstrate the need for additional regulation of asset managers or the industry in which they operate, let alone substantiate the benefits such regulation is supposed to confer on the capital markets and broader financial system.

We acknowledge regulators' interests in promoting efficient, resilient capital markets and encouraging safe investment practices, and welcome the opportunity to provide our views of proposed policies and regulations. Our views are based on our experience and information regarding our clients, the services we provide to them, and the capital markets in which we transact on their behalf. With our goal of providing information to help policymakers understand and address our industry and our concerns about the Consultation Report in mind, we set out the discussion that follows, which seeks (1) to express support for the principles-based, industry-wide regulatory approach outlined in the Consultation Report; (2) to explain the roles asset managers play for their clients and in the capital markets and in the asset management industry; (3) to explain how the Consultation Report greatly overstates the risks of "herding" and "cliff effects" allegedly linked to asset managers' use of credit ratings; and (4) to clarify the manner in which asset managers and their clients use credit ratings.

Relevance to Recent Regulatory Proposals: Setting the Record Straight

Although we have the concerns about the Consultation Report discussed below we agree with IOSCO's general approach to regulation of the asset management industry taken in the Consultation Report. The Consultation Report looks at the asset management industry and its clients broadly and recommends practices that would be relevant across the industry to all who rely on credit rating agencies, rather than a limited subset of participants. We support the structure of this approach and are hopeful that U.S. and non-U.S. regulators alike will follow a similar approach as they consider whether additional

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2 Consultation Report, page 1.

3 *See, e.g.*, "Asset Management and Financial Stability" published by the Office of Financial Research in the United States in September 2013 and "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" published by the Financial Stability Board and IOSCO in January 2014 and the letters of the AMG responding to those reports.

regulation of investment funds or their managers is warranted to address other potential concerns. We are encouraged, for example, that the U.S. Financial Stability Oversight Council appears to have recognized that SIFI designation of investment funds or their managers seems poised to shift its analysis of asset management away from individual funds or managers and toward activities, products and markets. That is a similarly broad structural approach to the one IOSCO has followed in the Consultation Report. Such an approach would more accurately reflect the basic structure and business model of the asset management industry, the mobility of financial assets, the easy substitutability of asset managers by their clients and the fact that investors, not asset managers, control asset allocation.[4]

The Roles of Asset Managers

Asset Managers Are Agents of Their Clients

Asset managers provide a host of different investment products and services that seek a wide variety of investment objectives, policies and strategies.[5] In providing products and services, an asset manager typically provides advice to, and acts as an agent on behalf of, one or more investors seeking exposure to any investment strategy or strategies and its or their attendant investment results. Asset managers are deemed fiduciaries under applicable law and, as such, must, among other things, invest client assets pursuant to investment mandates determined by clients. In this fiduciary capacity, asset managers actively manage risks associated with the particular investment mandates of their clients and evaluate investment opportunities on behalf of their clients. A client mandate may require an asset manager to employ an "active" management strategy in which the manager identifies, evaluates and invests in opportunities on behalf of the client, generally subject to guidelines that impose constraints and limits on the manager's ability to invest, or "passive" management strategies in which a client instructs the manager to generally replicate in its portfolio the performance of a designated index. Client mandates include various investment guidelines and restrictions, and may include criteria based on credit ratings.

Asset Managers Do Not Rely Mechanistically on Credit Ratings to Make Investment Decisions

Although bound by their clients' investment mandates and instructions, asset managers and the strategies they offer are not uniform or merely mechanical participants in the capital markets. Rather, asset managers develop and apply a variety of sophisticated and thoughtful investment techniques to evaluate investment opportunities and determine when to enter into or exit investments. Credit ratings are one of many criteria asset managers use to make investment decisions and they use them in different ways. As part of their investment management processes, asset managers also consider, to one degree or another, relevant market and economic indicators, business fundamentals of particular issuers (including the strength of companies' management teams and companies' strategic prospects and competitive positions), possible effects of regulation on companies' businesses, and a variety of other factors. Credit ratings are useful guidelines for investors describing risk tolerances and establishing investment

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4 SIFMA AMG, Letter to the U.S. Securities and Exchange Commission, re "'Asset Management and Financial Stability' Study by the Office of Financial Research", dated November 1, 2013.

5 On its website, the U.S. Securities and Exchange Commission, for example, explains: "[t]here are many varieties of mutual funds, including index funds, stock funds, bond funds, and money market funds. Each may have a different investment objective and strategy and a different investment portfolio." SEC, "Mutual Funds," *available at* http://www.sec.gov/answers/mutfund.htm. *See also* Frankel, Tamar and Kirsch, Clifford E., INVESTMENT MANAGEMENT REGULATION, Third Edition, page 11 ("With the proliferation of investments and investment companies, advisers offer not only numerous choices that would fit different investors but also advice on 'asset allocation,' that is, choice of investment companies to constitute the portfolio for particular individuals . . .").

guidelines, but, although those ratings can be useful to asset managers in assessing, for example, companies, they are not the only, or necessarily a determinative, variable managers consider when implementing clients' investment mandates. Asset managers employ sophisticated risk management procedures, and such procedures may rely on credit ratings to some extent. However, just as with investment guidelines, credit ratings are only one of numerous criteria managers evaluate to measure a client portfolio's risk level. For example, asset managers monitor the creditworthiness, pricing, regulatory oversight, and trading capacity of their clients' counterparties, monitor a number of other portfolio risk metrics, including duration, convexity, volatility, concentration risk and liquidity risk, and conduct stress tests and value-at-risk assessments.

Furthermore, the potential effects of credit ratings actions are well known and market participants have developed strategies to capitalize on opportunities that they may present to buy or sell affected securities. A relatively unconstrained asset manager employing an active management strategy, for example, may invest in an asset or class of assets after or in anticipation of a reduction in its credit rating if the manager perceives an opportunity to invest in a high quality asset at a favorable price. This type of investment behavior acts as a ballast against the behavior of other managers who may be constrained in their ability to invest in relatively low-rated assets on behalf of their clients. The recent financial crisis created this type of opportunity for unconstrained managers who were able to achieve strong performance results as asset prices recovered.

Investors, Not Asset Managers, Dictate Investment Allocations

Asset managers offer a wide range of investors (a term we use to refer generally to persons that own assets managed by asset managers, including retail investors, high net worth individual investors, pension funds, insurance companies, sovereign wealth funds and endowments) access to sophisticated investment techniques and market expertise. Investors generally interact with their asset managers in setting parameters for investment and periodically evaluate their investment performance and options and cause their assets to be moved into and out of different types of investments in response to asset managers' performance and fees relative to other investment opportunities, market trends and economic changes, and changes in personal circumstances and liquidity requirements. Certain investors are subject to direct regulation relevant to the management of their assets. For example, certain U.S. pension plans and U.S. insurance companies, which represent a significant portion of assets managed in separate accounts, are subject to the Employee Retirement Income Security Act ("**ERISA**") and state laws, respectively, that create unique investment restrictions. Reallocation of assets by investors occurs continually without causing significant disruption to global capital markets. Investors, for instance, moved over $19 trillion into and out of global mutual funds in 2013 without disrupting markets.[6] In the first quarter of 2014, U.S. mutual funds and exchange-traded funds alone reported $80.6 billion in new investments. In the same period, a single mutual fund reported in excess of $15 billion in outflows.[7] These flows did not disrupt markets.

If they choose professional third-party management rather than self-managing their assets, investors have almost countless options in selecting among separate or collective investment vehicles and asset managers, and in changing asset managers. That asset managers are highly substitutable facilitates investors' periodic reallocation of assets. Third-party custody arrangements and

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6 BlackRock, *Who Owns the Assets?*, May 2014, page 11 (citing data compiled by ICI Global).

7 Min Zeng and Kirsten Grind, *Pimco Mutual Funds Have Outflow of $7.3 Billion in March*, Wall Street Journal, April 2, 2014, available at http://online.wsj.com/news/articles/SB10001424052702303847804579477373468395890.

the ability to redeem managed assets in kind also facilitate the substitution of asset managers. In the case of separate accounts, for example, clients may change asset managers in the event of unsatisfactory performance or in seeking to pursue different investment strategies by removing trading discretion from one manager and granting it to another. Indeed, in those cases, assets may never move from an existing custody bank and assets may not be sold immediately into the market. Investors in U.S. registered funds may likewise move their assets at any time from one fund to another fund or investment product, including a substitute fund or product sponsored by a different asset manager.

Because investors can and do reallocate their investments freely and determine the investment strategies that asset managers pursue, investors' allocation decisions arguably have greater effects on capital markets than the decisions of asset managers or the criteria on which those decisions are based.[8] A significant economic change, such as an increase in interest rates, that could affect the current values of certain classes of assets might, for example, cause investors to change their asset allocations, but would not cause asset managers to exit investments if doing so would be inconsistent with the investment instructions they, as fiduciaries, are bound to follow. We believe that investors, who track asset and market performance and are sensitive to economic trends and cycles, will position themselves to reach their unique investment goals in any market conditions and that regulators should be keen not to undervalue different investor objectives and risk appetites. Regulators should recognize that, when there are sellers of a distressed asset at a loss, there are generally buyers having the potential to realize a gain, perhaps a significant one, over time once the value of the asset recovers.

Use of Credit Ratings in Investment Guidelines

We acknowledge that investment guidelines, developed by or for investors to instruct asset managers about how to invest investor assets, can and often do contain references to credit ratings. Investment guidelines are a crucial term in the contract between an investor and an asset manager and provide the asset manager the set of instructions it must follow to implement the investor's strategy. Investment guidelines can, by way of example, enable an investor, who may not possess the expertise to invest directly in complex products or the resources to manage a portfolio of assets actively, to provide guideposts to his or her professional investment manager as to the general levels of risk to which he or she desires his or her funds to be exposed. Investors more generally use credit ratings to establish parameters and to describe their risk tolerance and the types of investments that an asset manager may undertake on their behalf.

While recognizing the role of credit ratings in developing investment decisions, we think it is important to note that, in our collective experience, asset managers implementing investment guidelines that reference credit ratings do not typically rely solely on credit ratings in making investment decisions. In short, credit ratings allow investors to set boundaries in clear terms understood by both the investors and their managers, but those ratings do not typically dictate investment decisions.

Asset Managers Are Not Subject to "Herding" and "Cliff Effects" in Using Credit Ratings Because They Pursue Different Investment Objectives

As noted above, typical asset managers, in our members' experience, review investment opportunities to determine whether those opportunities are consistent with their clients' investment objectives and are suitable for clients in light of each client's risk tolerance and investment goals. Investors' goals are highly diverse and asset managers offer products and services reflecting a wide range of investment strategies. Asset managers simply do not seek out the same investment opportunities on

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8 BlackRock, *Who Owns the Assets?*

behalf of all of their clients and do not react the same way on behalf of all clients to market events such as changes in credit ratings.

An asset manager's obligation to pursue a client's investment strategy continues regardless of the performance of a client's target market. A client account following a strategy of investing in the securities of companies located or operating in emerging market countries, for instance, continues to invest in the securities even if they underperform other sectors. A fund whose objective is to invest principally in fixed income instruments will likewise continue to invest in those instruments notwithstanding that equity securities might be outperforming those instruments at a particular time. Finally, a passively managed index fund will track the performance of its underlying index regardless of the performance of the index. Investors may reallocate their assets, but asset managers, as fiduciaries bound to follow the instructions of their clients, cannot invest in an asset class on behalf of clients if doing so would violate the clients' investment instructions. These attributes of the investment management model make the manager an inappropriate focus for any concern about "herding" into asset classes in response to market changes and "cliff effects." Furthermore, in our experience, asset reallocations are unlikely occurrences in response to ratings changes.

The concern articulated in the Consultation Report (and in other regulatory publications for that matter[9]) that asset managers' "herding" into certain asset classes could destabilize capital markets seems not to account for several fundamental regulatory restrictions applicable to investment funds and other accounts managed by asset managers. Mutual funds in the United States registered with the U.S. Securities and Exchange Commission (the "**SEC**") under the U.S. Investment Company Act of 1940 (the "**1940 Act**"), for instance, must maintain at least 85% of their portfolios in liquid securities.[10] U.S. insurance company accounts are managed pursuant to sets of stringent investment guidelines that generally prevent them from aggregating assets into illiquid instruments or instruments with high levels of credit risk. As these examples illustrate, asset managers are not free to invest in whatever assets they choose and may not "pile" their clients' assets into investments without reference to applicable investment restrictions.

We have observed that investment mandates typically have counter-mandates. For example, the action of an asset manager investing on behalf of a client with a high risk tolerance pursuing an aggressive investment strategy may be countered by an asset manager that invests on behalf of a client with a low risk tolerance and conservative strategy. The first adviser may invest in debt instruments having relatively low credit ratings issued by small, fast-growing companies with short operating

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9 *See, e.g.*, "Asset Management and Financial Stability," Office of Financial Research.

10 The SEC has historically taken the position that a 1940 Act registered open-end fund (*i.e*., a mutual fund) must limit its holdings of illiquid securities (that is, those that cannot be sold within seven days at current value) to no more than 15% of the fund's assets. *See, e.g.*, Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9828 (Mar. 20, 1992). In addition, such funds are required to pay out redemptions within seven days. *See* Section 22(e) of the 1940 Act.

In a survey recently published by the AMG, asset managers participating in the survey, with combined total assets under management of approximately $11.2 trillion, reported that less than 2.0% of the separate accounts they manage with assets under management of $75 million or more are invested in illiquid securities. SIFMA AMG, Letter to the Secretariat of the Financial Stability Board re "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions"; "Asset Management and Financial Stability" Study by the Office of Financial Research, dated April 4, 2014. For purposes of the survey, illiquid securities were defined as tradeable securities that cannot be sold in 30 days or less at the price at which the security is currently valued.

histories, and may seek to sell the instruments when each company's performance stabilizes and credit ratings improve. On the other hand, on behalf of a client with a lower risk tolerance and focus on large and established companies, the second asset manager may purchase debt instruments issued by the same companies only after the companies have matured and their performance has stabilized. What these examples show is that investment strategies focusing on short-term income or long-term capital appreciation contemplate different types of investments and that an asset manager executing one of these strategies would make investments that differ from those made by an asset manager executing the other strategy.

In the collective experience of our members, individual portfolio managers at large diversified asset managers make decisions to buy, sell or hold securities without firm-level direction. Each portfolio manager typically decides whether a security is best suited for a client given his, her or its investment objective and limitations. Portfolio managers regularly take opposing views on one security or another. Reported conduct of the large mutual fund manager, Fidelity Investments, confirms this point. Fidelity has reported that, in 2013, more than 100,000 security trades took place between Fidelity-managed mutual funds and other accounts. In each case, at least one Fidelity portfolio manager placed an order to buy a security while another Fidelity portfolio manager placed an order to sell that same security contemporaneously.[11]

We note finally that the concern expressed by IOSCO with respect to potential herding and cliff effects arising out of the use in regulations of credit ratings appears not to be shared by the SEC. The SEC recently proposed for public comment an amendment in its rules governing money market mutual funds removing from those rules certain references to credit ratings.[12] Nowhere in its publication describing its proposal does the SEC mention anything about seeking to address herding and cliff effects. We submit that the absence of any mention of such dynamics in the SEC's proposal indicates their immateriality or nonexistence with respect to the conduct of asset managers.

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11 *See* Fidelity Investments, Letter to IOSCO re Consultative Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, dated April 7, 2014. In its letter, Fidelity explains:

> At Fidelity, decisions to buy, sell or hold securities are made independently by each portfolio manager, without firm-level direction. Each portfolio manager decides whether a security is best suited for a fund given its investment objectives and prospectus limitations. Many times, portfolio managers at Fidelity take opposing views on one security or another. For example, in 2013, there were more than 100,000 security trades between Fidelity mutual funds and accounts. In each case, at least one Fidelity portfolio manager placed an order to buy a security while another Fidelity portfolio manager placed an order to sell that same security contemporaneously. Of course, because lot sizes and trading days do not always correspond, and because regulations restrict some funds and accounts from trading between each other, there were even more instances in which two Fidelity funds traded in the opposite direction in the same security during the period.

12 SEC, Proposed Rule, *Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule*, Release No. IC-31184 (June 23, 2014).

Conclusion

While we applaud IOSCO for its general regulatory approach to participants in the asset management industry with respect to reliance on credit ratings, we hope that this letter clarifies the nature of risk in the industry and the actual ways in which asset managers and their clients use credit ratings. In particular, we hope that this letter clarifies that it is incorrect to interpret asset managers' use of credit ratings as "mechanistic reliance" by asset managers on credit ratings and that the assumptions in the Consultation Report about "herding" and "cliff effect" risks in the industry are exaggerated and misconstrued.

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We appreciate the opportunity to comment afforded to us by IOSCO, and stand ready to provide any additional information or assistance that IOSCO might find useful. Should you have any questions, please do not hesitate to contact Tim Cameron of AMG at 212-313-1389.

Sincerely,

Timothy W. Cameron, Esq.
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Securities Industry and Financial Markets Association