Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London E14 5FA
+44 20 7772 1000 tel
+44 20 7772 5401 fax
www.moodys.com

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Per Electronic Submission

**COMMENTS ON ESMA CONSULTATION PAPER ON DRAFT TECHNICAL ADVICE ON THE FORMAT AND CONTENT OF THE PROSPECTUS (ESMA31-62-532)**

Moody's Investors Service ("**MIS**") wishes to thank the European Securities and Markets Authority ("**ESMA**") for the opportunity to provide comments on the Draft Technical Advice on the Format and Content of the Prospectus (the "**Consultation Paper**"). MIS supports initiatives to improve the information available to investors and market participants, such as the Prospectus Regulation[1] recently adopted by the European Union (the "**Prospectus Regulation**"). The Consultation Paper sets out proposals intended to simplify prospectus documents while taking into account the different information requirements of investors. While we believe that the market is best served when there are more, not fewer, available tools and resources for measuring and assessing credit risk, we are concerned that the Consultation Paper proposes that credit ratings be published in prospectus documents intended for retail investors. This approach is concerning because: (1) it may inadvertently misconstrue credit ratings as investment advice; (2) it positions credit ratings for use by the retail sector; and (3) it is inconsistent with the broader public policy agenda for reducing regulatory use and reliance on credit ratings. Below, we discuss each point in turn.

## I. Credit Ratings are not Investment Advice

Credit ratings are forward-looking probabilistic opinions about credit risk. MIS credit ratings address the likelihood that a financial obligation will not be honored as promised (i.e. probability of default), and any financial loss suffered in the event of default.[2] The role credit ratings play in the capital markets has been scrutinized over the past few years. That ratings are useful, and have fulfilled a market need, is widely accepted.

> *"CRAs play an important role and their ratings can appropriately be used as an input to firms' own judgement as part of internal credit assessment processes"*.[3]

While credit ratings can play a useful role in enabling financial market professionals to assess credit risk, credit ratings do not address many other significant factors in the investment decision

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1 Regulation (EU) 2017/1129 of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC (14 June 2017).

2 Analysis of these two factors together forms the basis of MIS' expected loss ("El") approach to credit risk. Obligations rated on Moody's global rating scale measure long-term credit risk, and our analytical focus is on the key factors that drive each issuer's ability over the long term to meet its obligations as they come due.

3 Financial Stability Board, Principles on Reducing Reliance on CRA Ratings, 27 October 2010, pg. 2.

process, including, for example, price, term, likelihood of prepayment, liquidity risk and relative valuation. The likelihood that debt will be repaid is just one relevant consideration, and in many cases may not be the most important consideration, in an experienced investor's decision-making process for buying credit-sensitive securities.

MIS consistently discourages market participants from using our ratings as indicators of price, as measures of liquidity, or as recommendations to buy, sell or hold securities – all of which are regularly influenced by factors unrelated to credit. For example, credit ratings issued by MIS are accompanied by a disclaimer containing the following clear statement:

> *"Moody's credit ratings and Moody's publications are not intended for use by retail investors and it would be reckless and inappropriate for retail investors to use Moody's credit ratings or Moody's publications when making an investment decision. If in doubt you should contact your financial or other professional adviser."*

## II. Credit Ratings are Intended for Professional Investors, not the Retail Sector

MIS is concerned that the Consultation Paper proposes to further leverage credit ratings to inform retail investors about credit risk. Credit ratings published by international credit rating agencies are intended for use solely by financial market professionals. Retail investors are considered to be at greater risk than financial market professionals of over-relying on credit ratings without performing an independent assessment of the appropriateness of, or risks relating to, an investment product. MIS intends for our ratings to promote dialogue among institutional investors and financial market professionals, who we expect will assess our opinions relative to their own credit judgment.

Credit ratings condense a significant amount of analysis into a symbol system and are, accordingly, appropriate for use only by investors who understand that the symbol must be taken within a broader context of opinions and risk indicators. Put differently, investors should not hold a false sense of security that just by knowing the credit rating they have sufficient information to buy, sell or hold a security. Credit ratings are not, and are not intended to be relied upon as, a suitability test or recommendation. Rather, credit ratings communicate one perspective about the future credit risk of debt issuers or securities relative to other debt issuers and securities and are not intended to be used in any way as a basis for retail investors to make an investment decision.

While MIS does not object to the use of credit risk measures for retail investors, we caution against disclosure mechanisms that do not fully reflect the complexity of the investment process. In particular, regulation should not create the false impression that investing is somehow "easy" and risk free. Investment decisions are complicated, and it is important for each individual investor to analyse and ensure that the risk exposure they are considering is consistent with their individual risk appetite.

Here, credit ratings are published for use by retail investors in two separate prospectus documents. First, credit ratings continue to be incorporated into the Securities Note for retail debt and derivatives as "additional information" about the securities.[4] Second, the Consultation Paper proposes the introduction of an additional reference to credit ratings in the Registration

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[4] Item 7.3 of Annex 5: Retail Debt and Derivatives Securities Note.

Document with respect to the issuer.[5] In both instances, the credit rating is accompanied by a "brief explanation of the meaning of the ratings if this has previously been published by the rating provider."[6] This approach may unintentionally lead retail investors to believe that the investment process is simple, and that a comprehensive evaluation of credit risk is unnecessary. In addition to being inconsistent with the intended use of credit ratings, such an outcome would also compromise the objective of the Prospectus Regulation to "ensure investor protection" and to "enable investors to make an informed investment decision".[7]

As an alternative, we encourage an approach that recognises and incorporates information from a variety of credit risk measures. These could include, for example, market-based indicators such as market implied ratings and credit default spreads. By leveraging these and other available tools, the prospectus materials may provide retail investors with additional perspectives on the nature of the credit risk.

We also urge ESMA to ensure that there is a clear disclosure in the prospectus materials to the effect that, although credit ratings may be disclosed in the Registration Document, credit ratings are not designed for, or intended for use by, retail investors and it would be inappropriate for retail investors to rely on credit ratings in making investment decisions.

## III. The Proposal is Inconsistent with International Policy

The proposal set forth in the Consultation Paper to leverage credit ratings for both the Securities Note and Registration Document for retail debt and derivatives is wholly inconsistent with EU and broader international regulatory policy objectives to reduce reliance on credit ratings.

One of the primary objectives of the EU Regulation on credit rating agencies[8] (the "**CRA Regulation**") is to reduce the risk of over-reliance on credit ratings[9]. Specifically, the CRA Regulation restricts the ESAs from "refer[ing] to credit ratings in their guidelines, recommendations and draft technical standards where such references have the potential to trigger sole or mechanistic reliance on credit ratings."[10] The CRA Regulation also calls for the European Commission to review of all references to credit ratings in EU law with a view towards eliminating by 2020 those with potential to trigger sole or mechanistic reliance on credit ratings[11].

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5 Item 5.1.6 of Annex 3: Retail Debt and Derivatives Registration Document.

6 Item 7.3 of Annex 5: Retail Debt and Derivatives Securities Note.; Item 5.1.6 of Annex 3: Retail Debt and Derivatives Registration Document.

7 Recital 7 of the Prospectus Regulation.

8 Regulation (EC) No 1060/2009 of the European Parliament and of the Council as amended by Regulation (EU) No 513/2001 and Regulation (EU) No 462/2013.

9 *See* Recital 49 of the CRA Regulation.

10 Article 5b of the CRA Regulation.

11 Article 5c of the CRA Regulation states, in part:

> …the Commission shall continue to review whether references to credit ratings in Union law trigger or have the potential to trigger sole or mechanistic reliance on credit ratings by the competent authorities, the sectoral competent authorities, the entities referred to in the first subparagraph of Article 4(1) or other financial market participants with a view to deleting all references to credit ratings in Union law for

The provisions in the CRA Regulation are in line with the Financial Stability Board's ("FSB") principles to reduce reliance on credit ratings in standards, laws, and regulations.[12] The FSB principles are informed by three widely-accepted observations. First, because the mechanical use of ratings in regulation could have a detrimental effect on the markets – such as leading to herding behaviour by regulated entities – regulators should reduce instances of hardwiring ratings into oversight regimes. Second, ratings should not be perceived or treated as a "substitute"[13] for market participants' own assessment of credit or other risks. Finally, policymakers could inadvertently encourage broader market reliance on credit ratings through the overall "design" of regulatory regimes.[14]

The proposal in the Consultation Paper undermines these objectives by further embedding the use of credit ratings in regulation, and by encouraging the use of credit ratings by retail investors.

We would be pleased to discuss our views in more detail with you at your convenience.

Yours sincerely

**/s/ Monica Merli**

Managing Director
Regional Head: Europe, Middle East and Africa

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regulatory purposes by 1 January 2020, provided that appropriate alternatives to credit risk assessment have been identified and implemented.

12 *See* Financial Stability Board, Principles on Reducing Reliance on CRA Ratings, 27 October 2010.

13 *"While references to CRA ratings in internal limits, credit policies and mandates can sometimes play a useful role as broad benchmarks for transparency of credit policies, they should not substitute for investment managers' own independent credit judgments and that should be clear to the market and customers". Id.*

14 *Id.*