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Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
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MOODY'S CANADA INC. COMMENTS ON THE CANADIAN SECURITIES ADMINISTRATORS' NOTICE AND REQUEST FOR COMMENT RELATING TO DESIGNATED RATING ORGANIZATIONS (NI 25-101)

Moody's Canada Inc. ("**Moody's Canada**") wishes to thank the Canadian Securities Administrators (the "**CSA**") for the opportunity to comment on proposed amendments to National Instrument 25-101 *Designated Rating Organizations* (**NI 25-101**) (the "**Proposed**

Amendments").[1] In an effort to be as constructive as possible, we have divided our comments into two categories based on the two stated objectives of the proposal. In Annex I, we provide our comments on: (i) the Proposed Amendments intended to reflect new European Union (**EU**) requirements in order to maintain EU-equivalency under the EU CRA Regulation[2]; and (ii) the Proposed Amendments intended to align NI 25-101 with new provisions of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (the "**IOSCO Code**") of the International Organization of Securities Commissions (**IOSCO**). Where possible, we have also endeavored to provide alternative text for specific provisions of the Proposed Amendments. In attached Annex II, we provide our views in response to specific questions included in the CSA Notice and Request for Comment on the Proposed Amendments.

While we recognize the CSA's efforts to align the Canadian regulatory framework with global standards, we have two primary concerns with the Proposed Amendments. First, provisions of the Proposed Amendments introduced to maintain EU-equivalency are premature, and in some instances, either unnecessary or not properly calibrated to achieve their purpose. Second, while the IOSCO-related provisions of the Proposed Amendments serve an important purpose, they may not be sufficiently tailored for application to the DRO framework.

EU-Equivalence

The Proposed Amendments introduce new rules into the Canadian regulatory framework before the European Securities and Markets Authority (**ESMA**) has finalized its endorsement guidelines, and which are not required to maintain EU-equivalence under its proposed guidelines. ESMA requires a comparable credit rating agency (**CRA**) regulatory framework in Canada for credit ratings issued by designated rating organizations (**DROs**) to be eligible for regulatory use in the EU. It does not require a like-for-like transposition of EU rules into Canadian law. The Proposed Amendments include various provisions where no benefit to the Canadian capital markets is disclosed other than the need for the retention of Canada's equivalence status.

One example are the Proposed Amendments relating to the potential conflicts of interests associated with the fees that DROs charge to issuers. The rationale for the provisions is unclear, and there has been no cost-benefit analysis published to support the inclusion of the provisions. Moreover, ESMA has given a clear indication that it will not require the EU fee provision to be included in third country regimes in order to maintain equivalence.[3] Canadian securities laws,

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1 Moody's Canada's comments are limited to those amendments being made to NI 25-101.The Proposed Amendments also relate to: National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations; National Instrument 33-109 Registration Information; National Instrument 41-101 General Prospectus Requirements; National Instrument 44-101 Short Form Prospectus Distributions; National Instrument 44-102 Shelf Distributions; National Instrument 45-106 Prospectus Exemptions; National Instrument 51-102 Continuous Disclosure Obligations; National Instrument 81-102 Investment Funds; National Instrument 81-106 Investment Fund Continuous Disclosure; Companion Policy 21-101CP Marketplace Operation; and Companion Policy 81-102CP Investment Funds.

2 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.

3 See paragraph 120 of the draft ESMA Updated Methodological Framework for assessing third-country legal and supervisory frameworks for the purposes of endorsement and equivalence (Article 4(3) and Article 5(6) of the CRA Regulation).

including the current DRO framework, already provide for extensive protection against conflicts of interest from interfering with the analytical process, including those caused by commercial relationships. In addition, fair competition is already addressed by Canada's competition law regime. There is no demonstrable need for these provisions to be included in the Canadian regulatory framework, and they should not be included in the final amendments.

IOSCO Code of Conduct

The Proposed Amendments are intended to reflect changes made to the IOSCO Code in 2015, but the provisions may not be sufficiently tailored for application to the DRO framework. It is important to recognize that the IOSCO Code and its provisions are not designed for direct implementation into national legislation, but rather "to offer a set of robust, practical measures as a guide to and a framework for CRAs with respect to protecting the integrity of the rating process, ensuring that investors and issuers are treated fairly, and safeguarding confidential material information provided them by issuers".[4] To this end, Moody's Canada has designed and implemented its Code of Professional Conduct to be broadly consistent with the IOSCO Code, while also being responsive to evolving market needs. We encourage the CSA to reconsider whether its proposed implementation of the IOSCO Code achieves the same objectives.

We would be happy to discuss our comments in more detail at your convenience.

Yours sincerely

/S/ Hilary Parkes

Hilary Parkes
Senior Vice President

[4] *IOSCO Code of Conduct Fundamentals for Credit Rating Agencies – Final Report* (March 2015).

ANNEX I

I. Proposed Amendments Related to EU-Equivalency

The Proposed Amendments are intended to introduce provisions included in the EU CRA Regulation into NI 25-101 with a view to retaining EU-equivalence status.

Moody's Canada notes that ESMA is not expected to finalize the updated Guidelines on Endorsement[5] until it publishes a final report in Q4 2017.[6] Until the final report is issued, there is no absolute certainty as to the approach ESMA will adopt with respect to its assessment of third-country regulatory regimes for endorsement and equivalence purposes. While we recognize the process to amend NI 25-101 requires time, we are concerned that the DRO regulatory regime in Canada may be premature pending ESMA's final guidance.

Moreover, even if ESMA adopts updated Guidelines on Endorsement consistent with the proposals it set forth in its Consultation Paper published earlier this year[7], the Proposed Amendments may not be required to maintain EU equivalence. For example, ESMA's draft Updated Methodological Framework for assessing third-country legal and supervisory frameworks for the purposes of endorsement and equivalence (Article 4(3) and Article 5(6) of the CRA Regulation) (the "Updated Methodological Framework") does not require verbatim equivalence of the EU CRA Regulation for a number of the Proposed Amendments, including:

- **Initial reviews and preliminary ratings**: Section 4.7 of Appendix A of NI 25-101; see paragraphs 128-129 of the Updated Methodological Framework;
- **Rating categories (i.e. colour-coding):** Section 4.14 of Appendix A of NI 25-101; see paragraph 125 of the Updated Methodological Framework;
- **Rating methodologies:** Sections 2.12.1, 2.13.1, 4.8.1, 4.15.1, and 4.15.2 of Appendix A of NI 25-101; see paragraph 115 of the Updated Methodological Framework;
- **Significant security holders:** Section 1 of NI 25-101; paragraph 2.20(d) and section 3.6.1 of Appendix A of NI 25-101; see paragraph 70 of the Updated Methodological Framework; and

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5 The EU CRA Regulation establishes the endorsement regime so that EU financial firms can use ratings for regulatory purposes issued by non-EU CRAs. The proposed update of the 2011 Guidelines on Endorsement by ESMA is mainly driven by the need to reflect the changes to Articles 6-12 and Annex I introduced by the EU CRA Regulation, which will enter into force for the purposes of equivalence and endorsement on 1 June 2018. On that basis, ESMA will update the Methodological Framework on which ESMA relies for assessing a third-country legal and supervisory framework for the purposes of endorsement and equivalence.

6 ESMA Press Release, *ESMA Proposes Updates to Endorsement Guidelines for 3rd Country Credit Ratings*, (April 4, 2017) (available at: https://www.esma.europa.eu/press-news/esma-news/esma-proposes-updates-endorsement-guidelines-3rd-country-credit-ratings).

7 ESMA Consultation Paper, *Update of the guidelines on the application of the endorsement regime under Article 4(3) of the Credit Rating Agencies Regulation* (4 April 2017) (available at: https://www.esma.europa.eu/file/21990/download?token=wL6pD8aJ).

- **Fees**: Section 3.9.1 of Appendix A of NI 25-101; see paragraph 120 of the Updated Methodological Framework.

Instead, the Updated Methodological Framework calls for similar requirements that can be fulfilled through means other than the parallel EU requirement provided that the same underlying objectives are served. Before directly importing provisions of the EU CRA Regulation to meet expected equivalence requirements, we would encourage the CSA to consider whether the provisions provided in NI 25-101 already meet these objectives.

Below we set out our concerns with specific Proposed Amendments introduced for EU equivalence purposes.

A. Appendix A: Independence and Conflicts of Interest - Procedures and Policies

Section 3.9.1: Fees

The Proposed Amendments include new provisions related to DRO fees which require DROs to ensure both of the following:

(a) fees charged to rated entities for the provision of credit ratings and ancillary services, as referred to in section 3.5[8], do not discriminate among rated entities in an unfair manner and have a reasonable relation to actual costs;

(b) fees charged to rated entities for the provision of credit ratings must not depend on the category of credit rating or any other result or outcome of the work performed.

We would discourage adoption of these provisions for three reasons: (1) competition among DROs is already regulated under Canada's competition law regime; (2) introduction of "actual cost" as a consideration for DRO fees misapprehends the nature of credit ratings; and (3) the proposed fee provisions are not required for EU-equivalence.

a. Canadian Competition Act

The facilitation of fair competition in the credit market, including competition among DROs, is already adequately regulated under Canada's competition law regime.[9] It is our view that there is

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[8] Section 3.5 of NI 25-101states:

> The designated rating organization and its affiliates will keep separate, operationally, legally and, if practicable, physically, their credit rating business and their rating employees from any ancillary services (including the provision of consultancy or advisory services) that may present conflicts of interest with their credit rating activities and will ensure that the provision of such services does not present conflicts of interest with their credit rating activities. The designated rating organization will define and publicly disclose what it considers, and does not consider, to be an ancillary service and identify those that are ancillary services. The designated rating organization must disclose why it believes that those ancillary services do not present a conflict of interest with its credit rating activities. The designated rating organization will disclose in each ratings report any ancillary services provided to a rated entity, its affiliates or related entities.

[9] For example, section 79(1) of the Competition Act, RSC 1985 - Prohibition where abuse of dominant position:

not a sufficient policy rationale to extend the purview of provincial and territorial securities laws to competition in the credit market. Unlike the market participants in Canada who are subject to such restrictions or regulation, such as clearing agencies, stock exchanges and trade repositories, DROs: (a) do not have a monopoly or quasi-monopoly with respect to the services that they provide, and (b) do not provide services that are integral to the day-to-day operations of Canada's securities markets.

b. "Actual Costs" are the Wrong Measure to Assess DRO Fees

The introduction of "actual costs" misapprehends the nature of credit ratings. In particular, it suggests that credit ratings are equivalent to tangible goods that may be sold to individual consumers one-at-a-time. There are two reasons why this analogy is misleading. In contrast to tangible goods, credit ratings are intellectual property, more akin to the contents of books, which are widely disseminated and broadly consumed. As a result, DROs cannot easily:

1. track and allocate costs to a specific credit rating on a one-to-one basis; and
2. establish fees purely on the basis of cost and margin.

Importantly, differences in DRO fees cannot uniformly be tied to cost differences because costs are but one of a number of variable components of fees for credit ratings and ancillary services. Even where a significant deviation might be identified, cost differences alone might not be the driver of the deviation. Fee variables can include both cost and non-cost components and can be impacted by a number of factors including, for example, the nature of the product/service being provided, the analytical complexity of the product/service, competition and market dynamics, and customer negotiation.

Furthermore, a material portion of DRO costs constitute indirect costs. They also include contingent and deferred expenses that are recognized over longer time periods. Therefore, while a DRO could possibly endeavor to determine granular information about its costs, a ratings-level cost analysis would necessarily be based on a significant number of assumptions and judgments.

c. The Proposed Amendments are not Required for EU-Equivalence

In accordance with ESMA's Updated Methodological Framework, the introduction of Section 3.9.1 is not required to maintain equivalence. The Updated Methodological Framework indicates that, "If this requirement is not in place, ESMA considers that there should be other

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Where, on application by the Commissioner, the Tribunal finds that

(a) one or more persons substantially or completely control, throughout Canada or any area thereof, a class or species of business,

(b) that person or those persons have engaged in or are engaging in a practice of anti-competitive acts, and

(c) the practice has had, is having or is likely to have the effect of preventing or lessening competition substantially in a market,

the Tribunal may make an order prohibiting all or any of those persons from engaging in that practice.

safeguards to ensure that the objectives of avoiding conflicts of interests and promoting fair competition are achieved".[10]

NI 25-101, in both its current and proposed amended form, contains a range of comprehensive safeguards to ensure that the objectives of avoiding conflicts of interests and promoting fair competition are achieved. These safeguards are consistent with the IOSCO Code and include, for example:

> 3.1 The designated rating organization will not refrain from, or unnecessarily delay, taking a rating action based in whole or in part on the potential effect (economic or otherwise) of the action on the designated rating organization, a rated entity, an investor, or other market participant. (Proposed Amendment to add "or unnecessary delay" to existing NI 25-101 provision.)
>
> 3.2 The designated rating organization and its employees will use care and professional judgment to remain independent and maintain the appearance of independence and objectivity. (Existing NI 25-101 provision.)
>
> 3.3 The determination of a credit rating or rating outlook will be influenced only by factors relevant to the credit assessment. (Proposed Amendment to add "or rating outlook" to existing NI 25-101 provision.)
>
> 3.4 The designated rating organization will not allow its decision to assign a credit rating or rating outlook to a rated entity or rated securities to be affected by the existence of, or potential for, a business relationship between the designated rating organization or its affiliates and any other person or company including, for greater certainty, the rated entity, its affiliates or related entities. (Proposed Amendment to add "or rating outlook" to existing NI 25-101 provision.)

NI 25-101 also includes additional provisions designed to prevent potential conflicts of interest related to commercial considerations, the provision of non-credit rating services by the DRO, DRO affiliations, and DRO employees' affiliations. These include: provisions requiring the DRO and its affiliates to keep separate their credit rating business and their rating employees from any ancillary services that may present conflicts of interest (section 3.5); prohibitions on DROs assigning credit ratings or outlooks to a person or company that is an affiliate or associate of the organization or a ratings employee (section 3.6); and prohibitions on DROs assigning credit ratings or outlooks in circumstances involving significant security holders of the DRO or their officers or directors (proposed section 3.6.1).

These measures are further enhanced by provisions in NI 25-101 that require DROs to adopt specific policies and procedures designed to identify and eliminate or manage and publicly and promptly disclose any actual or potential conflicts of interest that may influence the opinions and

[10] Paragraph 120 of the Updated Methodological Framework.

analyses of ratings employees (sections 3.7, 3.7.1 and 3.8).[11] As amended, NI 25-101 would also require DROs to periodically monitor and review these policies and procedures in order to evaluate their effectiveness and assess whether they should be updated (section 3.11.1).

Finally, NI 25-101 currently requires DROs to disclose the general nature of its compensation arrangements with rated entities, as well as more detailed information including: (1) the percentage non-rating fees represent out of the total amount of fees received by the DRO or its affiliate from the rated entity, the affiliate or the related entity; and (2) whether the DRO or its affiliates receives directly or indirectly 10 percent or more of its annual revenue from a particular rated entity or subscriber, and the identification of the particular rated entity or subscriber.

Taken together, these safeguards surely ensure that the objectives of avoiding conflicts of interests and promoting fair competition are achieved. If, despite these existing and proposed measures, the CSA determines that additional provisions are required in order to achieve equivalence, we would encourage the following amendments to proposed section 3.9.1:

> A designated rating organization must ensure that ~~both of the following:~~
>
> ~~(a) fees charged to rated entities for the provision of credit ratings and ancillary services, as referred to in section 3.5, do not discriminate among rated entities in an unfair manner and have a reasonable relation to actual costs;~~
>
> ~~(b)~~ fees charged to rated entities for the provision of credit ratings must not depend on the ~~category~~ level of credit rating or any other result or outcome of the work performed.

In addition striking subsection (a), we also suggest that "category" be replaced with "level" in subsection (b) to make clear that reference in section 3.9.1 relates to the level of the credit rating itself, as opposed to the category of credit rating product or service.

B. Appendix A: Quality and Integrity of the Ratings Process

Section 2.12.1: Errors in Methodologies and Application of Methodologies

New section 2.12.1 requires DROs to take certain actions to notify the securities regulatory authority and the affected rated entities and to publish public notices with respect to "errors in a rating methodology or its application".

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[11] Section 3.7.1 specifically notes the following potential conflicts of interest subject to disclosure by the DRO: (a) the DRO is paid to issue a credit rating by the rated entity or a related entity; (b) the DRO is paid by subscribers with a financial interest that could be affected by a credit rating action of the designated rating organization; (c) the DRO is paid by rated entities, related entities or subscribers for services other than issuing credit ratings or providing access to the designated rating organization's credit ratings; (d) the designated rating organization provides a preliminary indication or similar indication of credit quality to a rated entity or related entity prior to being retained to determine the final credit rating for the rated entity or related entity; (e) the designated rating organization has a direct or indirect ownership interest in a rated entity or related entity; (f) a rated entity or related entity has a direct or indirect ownership interest in the designated rating organization.

First, as noted above, this provision need not be an exact replica of the parallel EU requirement for equivalency purposes. To the extent the provision is adopted by the CSA, we would recommend the introduction of a materiality threshold in section 2.12.1:

> If a designated rating organization becomes aware of material errors in a rating methodology or its application, the designated rating organization must do all of the following if the errors could have an impact on its ratings:
>
> (a) promptly notify the regulator or securities regulatory authority and all affected rated entities of the errors and explain the impact or potential impact of the errors on its ratings, including the need to review existing ratings;
>
> (b) promptly publish a notice of the errors on its website, where the errors have an impact on its ratings;
>
> (c) promptly correct the errors in the rating methodology or the application;
>
> (d) apply the measures set out in paragraphs 2.12 (a) to (d) as if the correction of the error were a change contemplated by that section.

Without a materiality threshold, DROs could be prompted to take steps (a) through (d) regardless of whether the error had an impact or a potential impact on credit ratings. Such an outcome would arguably create unnecessary noise in the market and undermine the purpose of the provision, which is to alert regulators and users of credit ratings of impactful errors.

Section 2.20: Significant Security Holder – Recommendations to Rated Entities

The Proposed Amendments introduce a definition for "significant security holder"[12] and restrictions on activities related to significant security holders. While Moody's Canada does not object to the proposed definition of "significant security holder", we are concerned about the nature and scope of related restrictions that capture entities that are not DROs. In particular, the Proposed Amendments would revise section 2.20 to restrict a "significant security holder" of the DRO or of an affiliate[13] that is a parent of the DRO from making recommendations to a rated entity about the corporate or legal structure, assets, liabilities, or activities of the rated entity."

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[12] NI 25-101 defines "significant security holder" as follows: a person or company that has beneficial ownership of, or control or direction over, whether direct or indirect, or a combination of beneficial ownership of, and control or direction over, whether direct or indirect, securities of an issuer carrying more than 10 per cent of the voting rights attached to all of the issuer's outstanding voting securities.

[13] NI 25-101 defines "Affiliate" as follows:

(1) a person or company is an affiliate of another person or company if either of the following apply:

(a) one of them is the subsidiary of the other;

(b) each of them is controlled by the same person or company.

(2) For the purposes of paragraph (1)(b), a person or company (first person) is considered to control another person or company (second person) if any of the following apply:

Moody's Canada does not object to requirements that prohibit a DRO and its ratings employees from making recommendations to a rated entity about its corporate or legal structure, assets, liabilities, or activities. However, as drafted, we believe section 2.20 is already overly broad and impacts entities that do not provide credit rating services, have not applied for DRO status, and are otherwise outside the scope of the DRO regulatory framework. We would therefore recommend that existing subsection (b) and proposed subsection (d) of section 2.20 be revised as follows:

> A person or company listed below must not make a recommendation to a rated entity about the corporate or legal structure, assets, liabilities, or activities of the rated entity:
>
> (a) a designated rating organization;
> ~~(b) an affiliate or related entity of the designated rating organization;~~
> (c) the ratings employees of the designated rating organization ~~any of the above~~;
> (d) a significant security holder of the designated rating organization ~~or of an affiliate that is a parent of the designated rating organization.~~

C. Appendix A: Independence and Conflicts of Interest

Section 3.6.1: Significant Security Holder - Credit Ratings and Rating Outlooks

We request modification or clarification of proposed section 3.6.1(a). As currently drafted, proposed section 3.6.1 provides:

> A designated rating organization must not rate, or assign a rating outlook to, a person or company in any of the following circumstances:
>
> (a) a significant security holder of the designated rating organization, or of an affiliate that is a parent of the designated rating organization, is a significant security holder of the person or company, its affiliates or related entities;
>
> (b) an officer or director of a significant security holder of the designated rating organization, or of an affiliate that is a parent of the designated rating organization, is a significant security holder of the person or company, its affiliates or related entities.

In particular, the meaning of "is a significant security holder of the person or company, its affiliates or related entities" under subsection (a) is unclear and possibly overly broad. We propose the following modification to clarify its scope:

(a) the first person beneficially owns, or controls or directs, directly or indirectly, securities of the second person carrying votes which, if exercised, would entitle the first person to elect a majority of the directors of the second person, unless that first person holds the voting securities only to secure an obligation;

(b) the second person is a partnership, other than a limited partnership, and the first person holds more than 50% of the interests of the partnership;

(c) the second person is a limited partnership and the general partner of the limited partnership is the first person.

A designated rating organization must not rate, or assign a rating outlook to, a person or company in any of the following circumstances:

(a) a significant security holder of the designated rating organization, or of an affiliate that is a parent of the designated rating organization, is a significant security holder of the person or company, or an affiliate of the person or company that is a parent of the person or company; ~~its affiliates or related entities~~;

(b) an officer or director of a significant security holder of the designated rating organization, or of an affiliate that is a parent of the designated rating organization, is a significant security holder of the person or company, or an affiliate of the person or company that is a parent of the person or company ~~its affiliates or related entities~~.

An alternative interpretation of subsections (a) and (b) would suggest that DROs would somehow be required to know the holdings of a potentially limitless number of related entities.

Section 3.7: Conflicts of Interest – Policies and Procedures

Existing section 3.7 requires that DROs identify and eliminate or manage and publicly disclose any actual or potential conflicts of interest that may influence the opinions and analyses of ratings employees. The Proposed Amendments would modify section 3.7 to state:

The designated rating organization must identify and eliminate or manage and publicly disclose any actual or potential conflicts of interest that may influence the opinions and analyses of ratings employees, including opinions and analyses in respect of a credit rating or rating outlook.

While as a general matter Moody's Canada does not object to identifying and eliminating or managing and publicly disclosing any actual or potential conflicts of interest that may influence the opinions and analyses of ratings employees, we believe the amended section 3.7 could be further enhanced with the following modification:

The designated rating organization must identify and eliminate or manage and publicly disclose, as appropriate, any actual or potential conflicts of interest that may influence the credit rating methodologies, credit rating actions, or analyses of the CRA or the judgment and analyses of the CRA's employees. ~~the opinions and analyses of ratings employees, including opinions and analyses in respect of a credit rating or rating outlook.~~

First, the additional language provides needed flexibility for the DRO to appropriately respond to potential or actual conflicts of interest. Second, this modification would be consistent with language in proposed section 3.7.1 that requires the DRO to adopt, implement and enforce policies and procedures to identify and eliminate or manage and publicly disclose, "as appropriate", actual or potential conflicts of interest. Third, the language we propose would better align this section with IOSCO Code provision 2.6.

Section 3.11: Oversight of the DRO by a Rated Entity

Existing section 3.11 provides that if a DRO is subject to the oversight of a rated entity, the DRO must use different DRO employees to conduct rating actions in respect of the rated entity than the employees that are involved in the oversight. The proposed amendment to section 3.11 introduces methodologies, and seemingly broadens the general restriction to all employees subject to the oversight:

> If a designated rating organization is subject to the oversight of a rated entity, or an affiliate or related entity of the rated entity, the designated rating organization ~~will~~ must use different DRO employees to conduct the rating actions in respect of that entity, or to develop or modify methodologies that apply to that entity, than those ~~involved in~~ that are subject to the oversight.

This amendment would prevent DRO credit analysts from participating in credit rating activities related to the sovereign or sub-sovereign in which they are located. This outcome would appear inconsistent with efforts to ensure that the best qualified analysts are assigned to specific credit rating portfolios.

In addition, the proposed amendment is inconsistent with section 2.11 of the IOSCO Code which states:

> In instances where rated entities or obligors (e.g., sovereign nations or states) have, or are simultaneously pursuing, oversight functions related to the CRA, the employees responsible for interacting with the officials of the rated entity or the obligor (e.g., government regulators) regarding supervisory matters should be separate from the employees that participate in taking credit rating actions or developing or modifying credit rating methodologies that apply to such rated entity or obligor.

We would encourage the CSA to reconsider the proposed amendments to section 3.11 and adopt the IOSCO Code provision.

D. Appendix A: Responsibilities to the Investing Public and Issues - Transparency and timeliness of ratings disclosure

Section 4.14: Colour Coding for Non-Participation

Amended section 4.14 would require DROs to disclose whether the rated entity and its related entities participated in the ratings process and whether the DRO had access to the accounts, management and other relevant internal documents of the rated entity or its related entities. In addition, each credit rating without that access would need to be identified as such using a clearly distinguishable colour code for the rating category.

We note first that in accordance with ESMA's Updated Methodological Framework, the proposed amendment to section 4.14 is not required to maintain equivalence. The Updated Methodological Framework indicates that, "whilst required by the CRA Regulation, it is not necessary that it is a legal requirement in the third country that [unsolicited and non-participating

credit ratings are] indicated using a clearly, distinguishable different colour code for the rating category".[14]

Second, we note that the proposed amendment to section 4.14 is not consistent with the parallel EU provision, and could create confusion among users of credit ratings. The EU CRA Regulation requires the use of a distinguishable colour code when a credit rating is both unsolicited and is issued without the participation of the rated entity. The EU requirement is as follows:

> Where a credit rating agency issues an unsolicited credit rating, it shall state prominently in the credit rating, using a clearly distinguishable different colour code for the rating category, whether or not the rated entity or a related third party participated in the credit rating process and whether the credit rating agency had access to the accounts, management and other relevant internal documents for the rated entity or a related third party.[15]

To the extent the CSA believes it necessary to adopt a colour coding requirement, we would urge it do so in a manner that is consistent with other similar global requirements. Should the CSA and other global regulators take a different approach, users of credit ratings will encounter multiple colour coding disclosure regimes with variable meanings. Such an outcome would arguably undermine the purpose of enhanced disclosure requirement.

E. Form 25-101F1: Designated Rating Organization Application and Annual Filing

The Proposed Amendments include changes to DRO annual filing requirements, including new information required under Item 13 of Form 25-101F. This information includes:

- Revenue from non-credit rating services provided to persons that also obtained credit rating services,
- Revenue from credit rating services for different asset classes, and
- Revenue from credit rating services and non-credit rating services provided to persons located in Canada.

First, we note that the Updated Methodological Framework indicates that the revenue information required by the EU need not be replicated in third-country jurisdictions for equivalence purposes.[16] Second, we would suggest that the third piece of data regarding revenue

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[14] Paragraph 125 of the Updated Methodological Framework.

[15] Article 10(5) of the EU CRA Regulation.

[16] Paragraph 146 states, in part: "The level of detail concerning the disclosures mentioned in letter g) do not need to be identical to the EU requirements." Paragraph 145 (g) includes: financial information on the revenue of the credit rating agency, including total turnover, divided into fees from credit rating and ancillary services with a comprehensive description of each, including the revenues generated from ancillary services provided to clients of credit rating services and the allocation of fees to credit ratings of different asset classes. Information on total turnover shall also include a geographical allocation of that turnover to revenues generated in the Union and revenues worldwide.

from credit rating services and non-credit rating services provided to persons located in Canada be amended as follows:

- Revenue from credit rating services and non-credit rating services provided by the designated rating organization. ~~to persons located in Canada~~.

It may be impracticable for DROs to determine whether an entity or person that purchases credit rating services or non-credit rating services should be classified as "located in Canada". Entities that purchase credit rating and non-credit rating services often have complex global legal and organizational structures. As a result, it may be difficult to ascribe meaning to "located in Canada" for regulatory reporting purposes.

In addition, the regulatory framework for DROs, and CRAs generally, is applied based on the location of the lead analyst, rather than the location of the issuer. Revenue reporting tied directly to the DRO and the location of the lead analyst (in Canada) would be most consistent with the regulatory framework for DROs.

II. Proposed Amendments to Reflect New IOSCO Code Provisions

Moody's Canada supports the CSA's efforts to bring NI 25-101 in line with the current IOSCO Code as amended in March 2015. The Moody's Canada Code of Professional Conduct is designed to be substantially aligned with the IOSCO Code, and we have updated it to reflect the amendments made to the IOSCO Code in 2015. While we broadly support the most recent amendments to the IOSCO Code, we would encourage the CSA to consider modifications to certain of its provisions before introducing them to NI 25-101.

A. Part 5; Item 12 – Compliance Officer

Section 1.1: Officer of the DRO

New section 1.1 requires that the DRO's compliance officer be designated as an officer of the DRO, or a DRO affiliate that is a parent of the designated rating organization, under a by-law or similar authority of the designated rating organization or the DRO affiliate. We understand that the purpose of the provision is to ensure that the compliance officer is a senior level employee. We have no objection to the underlying purpose of the provision, but would suggest that section 1.1 be modified to also include officers of DRO affiliates, as follows:

> The compliance officer must be designated as an officer of the designated rating organization, an affiliate of the DRO, or a DRO affiliate that is a parent of the designated rating organization, under a by-law or similar authority of the designated rating organization or the DRO affiliate.

This more flexible language would not undermine the purpose of the provision, particularly given the additional requirements for the DRO compliance officer as set forth in new section 1.2:

> The compliance officer must have the education, training and experience that a reasonable person would consider necessary to competently perform the activities of the

compliance officer required under this Instrument and the designated rating organization's code of conduct.

B. Part 6; Item 13 - Books and Records

Section 1.1: Records to Reconstruct the Credit Rating Process

Moody's Canada does not object to requirements for DROs to maintain for a prescribed period of time the books, records and other documents that support its credit process. However, we would suggest that proposed section 1.1 be revised to state:

> A designated rating organization must keep such books and records and other documents that are sufficiently detailed to ~~reconstruct~~ document the credit rating process and describe the basis for any credit rating action.

The requirement to "reconstruct" the credit rating process is broad and may inadvertently suggest that DROs must maintain every book, record or other document that may have been considered or reviewed as part of the credit rating process, regardless of whether it was incidental to the credit rating process and the credit rating action. We believe our proposed modifications make clear that the objective is to maintain those materials that are relevant to the credit rating process and the resulting credit rating action.

C. Appendix A: Quality and Integrity of the Rating Process

Sections 2.28.1 and 2.28.2: Role of Compliance Officer

New sections 2.28.1 and 2.28.2 require that the DRO's compliance officer monitor and evaluate the adequacy and effectiveness of the DRO's policies, procedures and controls to ensure that the DRO and its employees comply with the DRO code of conduct and securities legislation.

First, we suggest modifying proposed section 2.28.1 to make clear that the oversight related to "securities legislation" is not overly broad, and is intended to address those aspects of securities legislation that are relevant to the DROs activities. Specifically, we propose the following modification to 2.28.1:

> A designated rating organization must adopt, implement and enforce policies, procedures and controls reasonably designed to ensure that the organization and its DRO employees comply with the organization's code of conduct and securities legislation as applicable to the activities of the designated rating organization as a credit rating organization.

Second, the DRO compliance officer is not solely responsible for the monitoring and evaluation activities described in section 2.28.1. These activities are conducted by the DRO's internal control functions. Therefore, we recommend the following modification to sections 2.28.2:

> The designated rating organization's ~~compliance officer~~ internal control functions must monitor and evaluate the adequacy and effectiveness of the designated rating organization's policies, procedures and controls referred to in section 2.28.1.

Sections 2.6 and 2.6.1: "False" Credit Rating Actions and Reports

Credit ratings are forward-looking opinions about credit risk. They are not statements of absolute fact. Moody's Canada's credit ratings address the probability that a financial obligation will not be honored as promised, and any financial loss suffered in the event of default. By definition, a credit rating in an opinion therefore cannot be "false." However, the Proposed Amendments contain provisions that suggest they can be.

Under existing section 2.6, DROs, its ratings employees and its agents must take all reasonable steps to avoid issuing a credit rating, action or report that is "false or misleading as to the general creditworthiness of a rated entity or rated securities". Proposed section 2.6.1 requires the DRO to adopt, implement and enforce policies, procedures and controls reasonably designed to avoid issuing a credit rating, action or report that is "false or misleading as to the general creditworthiness of a rated entity or rated securities".

To eliminate the suggestion a credit rating can be "false", we would recommend the following adjustment to existing section 2.6:

> The designated rating organization, its ratings employees and its agents must take all reasonable steps to avoid issuing a credit rating, action or report that is ~~false or~~ misleading as to the general creditworthiness of a rated entity or rated securities.

Similarly, we would suggest the following adjustment to proposed section 2.6.1:

> The designated rating organization must adopt, implement and enforce policies, procedures and controls reasonably designed to avoid issuing a credit rating, action or report that is ~~false or~~ misleading as to the general creditworthiness of a rated entity or rated securities.

Section 2.9: Appropriate Information, Knowledge or Expertise

The Proposed Amendments would revise section 2.9 to restrict the DRO from issuing or maintaining a credit rating for structures, instruments, securities or entities for which it does not have appropriate information, knowledge or expertise. Moody's Canada does not object to the underlying objective of amended section 2.9, but we suggest modifying it, in part, to recognize the role that affiliates of DROs may play in the credit rating process.

At Moody's Canada, credit ratings are determined collectively by rating committees by a majority vote, and not by any individual analyst. Rating committees, which are constituted individually for each issuer and obligation, have members who may be based in different MIS offices around the world. Rating committees that determine credit ratings assigned by Moody's Canada consist of analysts who have the appropriate knowledge and experience to address the analytical perspectives relevant to the issuer and obligation. Factors considered in determining the make-up of a rating committee may include the size of the issue, the complexity of the credit, and the introduction of a new instrument. This approach to the composition of rating committees helps Moody's Canada provide high quality credit ratings that are comparable across sectors, regions and countries.

Therefore, we propose to amend section 2.9 as follows:

> The designated rating organization must not issue or maintain a credit rating for structures, instruments, securities or entities for which it and its affiliates, collectively, does not have appropriate information, knowledge or expertise….

Section 2.19.1: Prohibition of Promises or Threats to Influence Rated Entities

New section 2.19.1 prohibits a DRO from making "promises or threats" to influence rated entities, related entities, other issuers, subscribers, users of the designated rating organization's ratings or other market participants to pay for credit ratings or other services. Moody's Canada does not object to the underlying purpose of this provision, but we are concerned that it appears to prohibit commercially reasonable practices. Presumably, the intention for this prohibition is to apply only to the ratings or outlooks that would be assigned by the DRO, rather than the commercial side of the business. We believe the following modification to section 2.19.1 would be consistent with this objective:

> A designated rating organization or a DRO employee must not make promises or threats about potential credit ratings or rating outlooks to influence rated entities, related entities, other issuers, subscribers, users of the designated rating organization's credit ratings or other market participants to pay for credit ratings or other services.

Section 2.25: DRO Board of Directors

Amended section 2.25 would require the board of directors of the DRO or a DRO affiliate that is a parent of the DRO to monitor compliance by the DRO and its employees with the DRO's code of conduct and with securities legislation. Consistent with our comments on proposed section 2.28.1, we recommend clarifying the scope of section 2.25 to limit it to securities legislation as it relates to the activities of the DRO as a credit rating organization:

> The board of directors of a designated rating organization or a DRO affiliate that is a parent of the designated rating organization must monitor all of the following:
>
> […]
>
> (e) the compliance by the designated rating organization and its DRO employees with the organization's code of conduct and with securities legislation as applicable to the activities of the designated rating organization as a credit rating organization.

Applying a broader or undefined scope would task the board of directors with monitoring activities that have nothing to do with its business as a DRO.

Section 2.29: Risk Management Committee

New section 2.29 would require that a DRO establish and maintain a risk management committee made up of one or more senior managers or DRO employees with the appropriate level of experience. Moody's Canada agrees that DROs benefit from a formal senior level risk management function. However, the size and infrastructure of DROs vary. In some instances, it may be impracticable to establish a senior level risk management committee. Instead, it may be more effective for the DRO to leverage the infrastructure of an affiliate of the DRO, or an

affiliate that is a parent of the DRO. Therefore, we would suggest amending Section 2.29 to permit DROs to leverage the risk management infrastructure of its affiliates, including its parent company.

> A designated rating organization must establish and maintain a risk management committee made up of one or more senior managers or DRO employees, or senior managers or employees of an affiliate of the DRO, or an affiliate that is the parent of the DRO, with the appropriate level of experience responsible for identifying, assessing, monitoring, and reporting the risks arising from its activities, including legal risk, reputational risk, operational risk, and strategic risk. The committee must be independent of any internal audit system and make periodic reports to the board of directors of the designated rating organization, or of a DRO affiliate that is a parent of the designated rating organization, and senior management to assist the board and senior management in assessing the adequacy of the policies and procedures the designated rating organization adopted, and how well the organization implemented and enforces the policies and procedures to manage risk, including the policies and procedures specified in the organization's code of conduct.

D. Appendix A: Independence and Conflicts of Interest

Sections 3.7.1 and 3.8: Disclosure of Unique or Specific Conflicts of Interest

Moody's Canada fully supports the disclosure of actual and potential conflicts of interest, and agrees that such disclosures should be made in a complete, timely, clear, concise, specific and prominent manner. We are concerned, however, that the proposed amendment to section 3.8 that requires disclosure of unique or specific actual or potential conflicts of interest may be redundant and impracticable.

First, section 3.7 of NI 25-101 already requires DROs to identify and publicly disclose any actual or potential conflicts of interest that may influence the options and analyses of ratings employees, including opinions and analyses in respect of a credit rating or rating outlook. Second, it is unclear which actual or potential conflicts of interests should be considered unique or specific relative to those already identified and disclosed through section 3.7. Third, it is difficult to envisage a scenario where a DRO could issue a credit rating or rating outlook subject to section 3.8 that is not otherwise prohibited or restricted by other sections of NI 25-101, including, for example, sections 3.2, 3.3, 3.6, and 3.6.1. Finally, it may also be impracticable to tailor disclosure at the granular level this provision seems to require. Therefore, we recommend that section 3.8 be modified as follows:

> The designated rating organization must disclose the actual or potential conflicts of interest it identifies under the policies, procedures and controls referred to in section 3.7.1 in a complete, timely, clear, concise, ~~specific~~ and prominent manner. ~~If the actual or potential conflict of interest is unique or specific to a credit rating action with respect to a particular rated entity or related entity, the conflict of interest must be disclosed in the same form and through the same means as the relevant credit rating action.~~

In addition, we suggest amending proposed section 3.7.1(e) which, in operation with section 3.8, would require a DRO to disclose as a potential conflict of issue when a rated entity or related entity has a direct or indirect ownership interest in the DRO. We do not object to the underlying purpose of the provision, but would recommend an introduction of a materiality threshold to section 3.7.1(e) as follows:

> A designated rating organization must adopt, implement and enforce policies, procedures and controls to identify and eliminate, or manage and disclose, as appropriate, any actual or potential conflicts of interest that may influence the credit rating methodologies, credit rating actions, or analyses by the designated rating organization or the judgment, opinions or analyses by ratings employees. Without limiting the generality of the foregoing, the policies, procedures and controls must address all of the following conflicts and ensure that no conflict influences the designated rating organization's credit rating methodologies or credit rating actions:
>
> (e) a rated entity or related entity has a <u>significant</u> direct or indirect ownership interest in the designated rating organization.

The absence of a materiality threshold would suggest that a DRO must disclose even the most remote ownership interest as a potential conflict of interest. This could result in over-disclosure and ultimately undermine the purpose of the provision.

E. <u>Appendix A: Responsibilities to the Investing Public and Issues - Transparency and timeliness of ratings disclosure</u>

Section 4.5(c): Disclosures for Structured Finance Products

The proposed amendment to section 4.5(c) is inconsistent with the limited role of DROs, and should not be incorporated into NI 25-101. The proposed amendment requires that DROs disclose "whether the issuer of the structured finance product has informed the [DRO] that it is publicly disclosing all relevant information about the product being rated or whether the information remains non-public."

Credit ratings play an important, but limited, role in the markets. Moody's Canada's credit ratings are forward-looking opinions that speak only to the relative credit risk of fixed income instruments; namely their relative probability of default and the potential severity of any financial losses to creditors. Over the past several years, the broader public policy agenda has focused on ensuring that credit rating agencies are very clear about what they are able to do, and the limitations of their role.

Furthermore, DROs are independent entities and are not advisors to the issuer or on the transaction. It is inconsistent with the role of DROs to: (1) encourage issuers to disclose information; and/or (2) disclose with their credit rating what the issuer has advised the DRO that it intended to disclose to the market. Having DROs make such disclosures may contribute to the incorrect perception that DROs are gatekeepers, which can lead to over-reliance on DROs. Instead of imposing obligations on DROs, we believe regulators should enhance the mandatory

disclosure and enforcement regime with respect to issuers' disclosures if they believe the existing framework is inadequate.

Accordingly, we discourage inclusion of section 4.5(c) in amended NI 25-101.

Sections 4.8.1 and 4.10: Plain Language

The Proposed Amendments introduce two provisions that require DROs to use "plain language" in public disclosures about its credit ratings. Moody's Canada does not object to the underlying disclosures required by the Proposed Amendments, but we are concerned with the requirement that the DRO use "plain language" in providing them.

Section 4.8.1 would require the DRO to use "plain language" when disclosing the assumptions, parameters, limits and uncertainties surrounding the methodologies and models it uses in its credit rating activities. Section 4.10 requires the DRO also use "plain language" when describing the attributes and limitations of each credit rating, and the risks of relying on the credit rating to make investment or other financial decisions.

The plain language requirement in sections 4.8.1 and 4.10 could lead to confusion among market participants about how credit ratings should and should not be used. Plain language requirements in financial services regulation are typically associated with products and services intended for use by retail customers. Credit ratings, however, are intended for use by market professionals. Financial market professionals have the resources and ability to request that DROs communicate their views in ways that they find useful. If a DRO does not communicate in ways that market professionals find helpful, credit ratings may be considered less useful and their credibility discounted.

Furthermore, because there is no objective standard for "plain language," DROs could be encouraged to over-simplify a necessarily complex analysis, which would not benefit users of credit ratings or the market as a whole.

We propose that sections 4.8.1 and 4.10 be amended to state that the required disclosures must be made "using language that investors and other users of credit ratings can understand".

Section 4.15: Changes to Methodologies

Section 4.15 is being amended to require that any disclosure of material modifications to a DRO's methodologies, models and key rating assumptions be made in a non-selective manner. We have no objection to the underlying objective of the provision, but would note that the amendment does not bring section 4.15 into alignment with the current IOSCO Code. The revisions to the IOSCO Code in 2015 included removal of the language note below.

> The designated rating organization must publicly disclose, in a timely fashion, any material modification to its methodologies, models, key ratings assumptions and significant systems, resources or procedures. Where a reasonable person would consider it feasible and appropriate, disclosure of such material modifications must be made before they go into effect. Any disclosure of such material modifications must be made in a non-selective manner. ~~The designated rating organization must carefully consider the~~

~~various uses of credit ratings before modifying its methodologies, models, key ratings assumptions and significant systems, resources or procedures.~~

We would encourage the same language be removed from proposed section 4.15.

F. Appendix A: Responsibilities to the Investing Public and Issues - Treatment of Confidential Information

Section 4.16: Measures to Protect Non-Public and Confidential Information

Amended section 4.16 requires DROs and DRO employees to take all reasonable measures to protect both:

(a) non-public information about a credit rating action, including information about a credit rating action before the credit rating or rating outlook is publicly disclosed or disseminated to subscribers;

(b) the confidential nature of information shared with them by rated entities under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially.

We note first that subsection (a) does not explicitly recognize section 4.12 which requires DROs to inform the issuer of "the critical information and principal considerations upon which a credit rating or rating outlook will be based" before the publication of the credit rating or rating outlook. We would suggest the following modification to amended section 4.16:

(a) except to the extent prior disclosure to the rated entity is required by section 4.12, non-public information about a credit rating action, including information about a credit rating action before the credit rating or rating outlook is publicly disclosed or disseminated to subscribers;

In addition, while we recognize that NI 25-101 is intended to provide the oversight framework for DROs, we would encourage the CSA to consider additional provisions that would impose a similar restriction on issuers to protect non-public and confidential credit rating information prior to its publication or dissemination to subscribers.

G. Appendix A: Responsibilities to the Investing Public and Issues

Section 4.25: Treatment of Complaints

New section 4.25 requires a DRO to establish and maintain a committee charged with receiving, retaining, and handling complaints from market participants and the public. It also requires that the DRO establish policies and procedures to handling the complaints, as well as a process for escalation to senior management and the board of directors of the DRO or an affiliate that is a parent of the DRO.

First, we propose aligning section 4.25 with the IOSCO Code by replacing "committee" with "function". In addition to being consistent with the IOSCO Code, this modification would also support the underlying purpose of the provision which is to establish a process whereby

complaints are received, retained and handled by employees independent of those responsible for rating actions, or for methodology development, revisions or approvals.

Second, it may impracticable for DROs to establish a committee or function charged with receiving, retaining, and handling complaints from market participants and the public. In some instances, it may be more effective for the DRO to leverage the infrastructure of one of its affiliates. In recognition of this, NI 25-101 already permits DROs to leverage the governance infrastructure of its affiliates or an affiliate that is a parent of the DRO in other circumstances (e.g. the board of directors).

We would therefore recommend the following modification to proposed section 4.25:

> A designated rating organization or an affiliate of the DRO, or a DRO affiliate that is the parent of the DRO, must establish and maintain a ~~committee~~ function charged with receiving, retaining, and handling complaints from market participants and the public. The designated rating organization must adopt implement and enforce policies, procedures and controls for receiving, retaining, and handling complaints, including those that are provided on a confidential basis. The policies and procedures must specify the circumstances under which a complaint must be reported to one or both of the following:
>
> (a) senior management of the designated rating organization;
>
> (b) the board of directors of the designated rating organization or of a DRO affiliate that is a parent of the designated rating organization.

What would be the implications to Canadian market participants if the EU did not continue to recognize the Canadian regulatory regime in NI 25-101 as "equivalent" for regulatory purposes in the EU? We are interested in details of how you would be impacted.

The EU CRA Regulation establishes the endorsement regime so that EU firms can use ratings for regulatory purposes issued by non-EU CRAs. This framework has succeeded in providing certainty and stability for CRAs, third-country regulators and the users of credit ratings. As noted in Moody's Investors Service response to ESMA's Consultation Paper on the endorsement regime[17], we believe the proposed changes could result in a number of significant unintended consequences including, for example: (1) regulatory inconsistency and arbitrage; (2) extra-territorial application of regulation; and ultimately, (3) market confusion with respect to the meaning of endorsement and uncertainty with respect to the standards applied by individual CRAs in different jurisdictions.

It is difficult to predict with any precision the potential impact of a non-equivalence finding by ESMA for Canada and its DRO framework. In our view, a non-equivalence finding regarding any jurisdiction is likely to be more immediately impactful on the capital markets, particularly the EU market, than on specific DROs. In the short-term, for example, it is likely that debt instruments rated by DROs would be ineligible for use by EU financial firms to satisfy capital regulatory requirements. At the same time, however, credit ratings issued by DROs would otherwise continue to be available for use by global market participants as they are today. Over the longer term, however, it is possible that issuers placing debt into the EU market may request that credit ratings be assigned by CRAs located in jurisdictions recognized as equivalent by ESMA. In that respect, a non-equivalence finding regarding Canada could adversely impact the ability for issuers rated by DROs to participate in the EU capital markets, and perhaps even more broadly. In turn, DROs may see a reduced demand for credit ratings produced in accordance with Canadian regulation, but not available for endorsement.

[17] Moody's Investors Service Comments on ESMA's Consultation Paper on the Update of the Guidelines on the Application of the Endorsement Regime (3 July 2017) *available at* https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_196628.