Securities Regulatory Proposals Stemming from the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada - Consultation Paper 11-405 of The Canadian Securities Administrators

The *Autorité des marchés financiers* (the "Authority") is publishing the following text:

- Securities Regulatory Proposals Stemming from the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada - Consultation Paper 11-405 of The Canadian Securities Administrators.

Request for comment

The CSA is publishing this consultation paper for a 75-day comment period. Please send your comments in writing on or before **December 20, 2008**. All submissions should refer to "CSA Consultation Paper 11-405". This reference should be included in the subject line if the submission is sent by e-mail. If you are not sending your comments by e-mail, you should also send us a diskette containing the submissions in Word in Windows format.

Please address your submission to the following securities regulators:

British Columbia Securities Commission
Alberta Securities Commission
Ontario Securities Commission
Autorité des marchés financiers

Please send your comments **only** to the addresses below. Your comments will be forwarded to the other CSA member jurisdictions.

Me Anne-Marie Beaudoin
Secrétaire de l'Autorité
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Québec
H4Z 1G3
Fax : (514) 864-6381
e-mail: consultation-en-cours@lautorite.qc.ca

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario
M5H 3S8
Fax: (416) 593-2318
e-mail: jstevenson@osc.gov.on.ca

All comments will be posted on the OSC website at www.osc.gov.on.ca and the websites of the other CSA jurisdictions. We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period.

Further information

Further information is available from:

Lucie J. Roy
Conseillère en réglementation
Service de la réglementation
Surintendance aux marchés des valeurs
Autorité des marchés financiers
(514) 395-0337, poste 4464
lucie.roy@lautorite.qc.ca

Mathieu Simard
Analyste
Service des fonds d'investissement
Surintendance aux marchés des valeurs
Autorité des marchés financiers
(514) 395-0337, poste 4475
mathieu.simard@lautorite.qc.ca

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October 2008

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Introduction

In August 2007, turmoil in international credit markets (referred to in this paper as the Credit Turmoil or the Credit Market Turmoil)[1] led to a seizure of the non-bank sponsored portion of the asset-backed commercial paper (ABCP) market in Canada.

In response, the Canadian Securities Administrators (CSA) took a number of immediate actions, including:

- conducting continuous disclosure reviews of reporting issuers that held material amounts of non-bank sponsored ABCP
- participating in various international initiatives, including the International Organization of Securities Commissions' (IOSCO) task forces on credit rating agencies and the subprime crisis
- conducting compliance reviews of certain portfolio managers and surveys of certain investment fund managers regarding investments in ABCP, and
- monitoring developments on the reorganization of the frozen non-bank sponsored ABCP market.

In January 2008, the Investment Industry Regulatory Organization of Canada (IIROC) undertook a regulatory review of non-bank sponsored ABCP programs in Canada and carried out a compliance "sweep" of all IIROC dealer members that manufactured and/or distributed ABCP to customers. A report of IIROC's findings is expected in the fall of 2008.

On December 20, 2007, the CSA announced the formation of a working group (the CSA ABCP Working Group or the Committee) to consider securities regulatory issues stemming from the Credit Turmoil and to make recommendations to the chairs of the CSA on appropriate regulatory responses. The Committee consists of representatives of the British Columbia Securities Commission, the Alberta Securities Commission, the Ontario Securities Commission and the Autorité des marchés financiers du Québec.

The chairs of the CSA asked the Committee to prepare and issue this consultation paper for public comment. The purpose of this paper is:

- to set out the Committee's proposed responses to the causes of the Credit Turmoil for which securities regulatory action is necessary or appropriate, and
- to seek public comment on the Committee's proposals.

Part one of the paper discusses the background of the Credit Turmoil, including the primary causes. Part two of the paper describes the Committee's proposals for responding to the Credit Turmoil.

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[1] The Credit Market Turmoil has been referred to in other sources as, among other things, the credit crunch, the credit squeeze or the credit crisis.

Summary of proposals

The following is a summary of the Committee's proposals.[2]

The Committee proposes to:

1. Implement a regulatory framework that applies to "approved credit rating organizations". Among other things, the framework would require credit rating agencies (CRAs) to comply with the "comply or explain" provision of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (the Code of Conduct). The framework would also give securities regulators authority to require changes to a CRA's practices and procedures. The Committee will consider whether, as part of this framework, to require disclosure of all information provided by an issuer to a CRA and used by the CRA in determining and monitoring ratings. The framework would define "approved credit rating organization" to include Nationally Recognized Statistical Rating Organizations (NRSROs) recognized by the U.S. Securities and Exchange Commission (SEC).

2. Amend the current short-term debt exemption to make it unavailable for distributions of asset-backed short-term debt. As a result, exempt distributions of asset-backed short-term debt would have to be made under other exemptions.

3. Conduct a separate CSA policy review to consider the appropriateness of (i) the income and net financial asset thresholds in the accredited investor definition, and (ii) the $150,000 exemption.

4. Consider reducing reliance on credit ratings in Canadian securities legislation.

5. Co-ordinate with IIROC the various regulatory initiatives focussed on addressing the role of intermediaries that are registrants in distributing asset-backed securities such as ABCP.

6. Review the definitions of "related issuer" and "connected issuer" in proposed *Regulation 31-103 respecting Registration Requirements* (Regulation 31-103) to ensure that these definitions capture issuers of ABCP and similar products.

7. Review:

   (i) whether a concentration restriction in *Regulation 81-102 respecting Mutual Funds* (Regulation 81-102) for money market funds is appropriate, and if so, whether the current 10% concentration restriction is appropriate

   (ii) whether to further restrict the types of investments (such as asset-backed short-term debt) a money market fund can make

   (iii) whether assets such as asset-backed short-term debt are appropriate as eligible assets in the definition of "cash cover" and "qualified security", and

[2] None of the Canadian securities regulatory authorities or provincial and territorial governments have approved the proposals in this paper.

(iv) whether short-term debt investments, including ABCP with a specified credit rating, should be permitted to be aggregated in a statement of investment portfolio.

Part one – Background

U.S. subprime mortgage crisis

Commentators agree that the continuing global credit market turmoil that began in the summer of 2007 originated from the subprime mortgage crisis in the United States. Subprime mortgages are mortgages extended to high-risk borrowers. These borrowers have lower incomes and/or weaker credit history than traditional or "prime" borrowers.

Over the last several years, the number of subprime mortgages underwritten in the U.S. increased significantly against a backdrop of rising house prices. U.S. investment banks packaged many of these mortgages into pools securing mortgage-backed securities that were sold to investors. However, a combination of lax lending standards, potential fraud, interest rate adjustments on adjustable rate mortgages and a softening of U.S. house prices led to a significant increase in the default and foreclosure rates for subprime mortgages.

As a result, it became clear that subprime mortgages were much riskier than the market anticipated. Financial institutions, hedge funds and other entities that held investments with exposure to subprime mortgages have suffered significant losses since mid-2007.

Spread of the Credit Turmoil to Canada

The subprime mortgage crisis in the U.S. is generally viewed as triggering the Credit Turmoil, while the securitization process is said to have "spread the contagion" throughout global credit markets. The securitization process has a number of important benefits such as the diversification of risk from originating mortgages or loans. Even though securitization allowed for the exposure to subprime assets, it is accepted that securitization will continue to play an important role in global credit markets.

In Canada, the limited transparency of securities in the exempt market, such as mortgage-backed securities, ABCP and collateralized debt obligations (CDOs), meant that investors could not easily identify the assets underlying these securities. Financial institutions and investors also found it difficult to identify the credit exposure of the counterparties they were dealing with.

This uncertainty led to a broad re-evaluation of risk, the collapse of the resale market for some structured products and the evaporation of liquidity. In Canada, the August 2007 freezing of the then $35 billion market for non-bank sponsored ABCP has been one of the most visible effects of the Credit Turmoil.

Impact on the ABCP market

ABCP is short-term debt (maturity of less than one year) that is generally serviced or backed by a pool of assets or securities. It is typically distributed on a prospectus exempt basis under the short-term debt exemption in section 2.35 of *Regulation 45-106 respecting Prospectus and Registration Exemptions* (Regulation 45-106).

According to IIROC, when the non-bank sponsored ABCP market froze, approximately 2,500 holders were retail (i.e. non-corporate) investors who purchased ABCP under the short-term debt exemption. Ninety-five percent of these investors were clients of five IIROC member dealers. IIROC estimates that approximately 55% of these investors held less than $50,000 of ABCP and approximately 24% held more than $150,000. In aggregate, these retail investors held approximately $372 million of the total outstanding non-bank sponsored ABCP. It is not clear what proportion of these investors could have qualified as accredited investors. What is clear is that the seizure of the ABCP market has caused investors significant hardship.

In a typical ABCP structure, the difference in maturities between the outstanding short-term ABCP and the longer-term underlying assets held by the issuer creates a risk of default that could prevent issuers from "rolling over" or issuing new notes to finance maturing debt. ABCP issuers typically require a liquidity facility to mitigate this risk.

In Canada, liquidity facilities for ABCP issuers had a "general market disruption" standard, meaning liquidity was provided only if commercial paper could not be issued at any price by any issuer. These "Canadian-style" liquidity provisions were based on the Office of the Superintendent of Financial Institutions (OSFI) guideline B-5 dated July 1994 (revised November 2004). For the purposes of calculating the bank's required capital charge, this guideline excluded the undrawn portions of a liquidity facility if a drawdown was permitted only in the event of a "general market disruption". Banks that provided broader "global-style" liquidity would have had capital charges applied to undrawn portions of the liquidity facilities they provided.

These capital rules were not unique to Canada. Indeed, some jurisdictions would not have required a capital charge for global-style liquidity facilities. Unique to Canada was that DBRS Limited (DBRS) assigned its highest rating to ABCP backed by a Canadian-style general market disruption liquidity facility. No other CRA would rate such ABCP. DBRS no longer rates ABCP with a Canadian-style liquidity facility.

On June 19, 2008, OSFI issued a draft advisory setting out its expectations for securitization activities of banks.[3] OSFI is proposing to eliminate the zero percent conversion factor for general market disruption liquidity facilities. This would result in such liquidity facilities being subject to the same capital treatment as global-style liquidity facilities.

When the Canadian non-bank sponsored ABCP market froze in August 2007, bank-sponsored ABCP issuers were able to continue rolling over their ABCP with minimal disruption. Banks bought back much of the ABCP from their related conduits and brought significant amounts of ABCP back onto their balance sheets. Because the banks were able to roll over their ABCP, some liquidity providers maintained that there was no general market disruption and did not provide liquidity to non-bank sponsored issuers on that basis. Without liquidity support, the non-bank ABCP market in Canada ceased to operate.

The frozen non-bank sponsored ABCP is the subject of a restructuring proposal under the *Companies' Creditors Arrangement Act*. Under the proposal, investors would be issued long-

[3] Available at http://www.osfi-bsif.gc.ca.

term notes in exchange for their non-bank sponsored ABCP. Conditional upon the successful completion of the restructuring, approximately 1,800 retail investors (i.e. those who invested less than $1 million in non-bank sponsored ABCP) are expected to have approximately $180 million of ABCP repurchased by IIROC member dealers at par value plus interest (to the extent it is payable under the restructuring plan). Moreover, according to information obtained from IIROC, approximately 600 investors have already had approximately $320 million of non-bank sponsored ABCP repurchased by IIROC member dealers.

The Ontario Superior Court approved the restructuring plan on June 5, 2008. The decision of the Ontario Superior Court was appealed to the Ontario Court of Appeal, which upheld the lower court decision on August 18, 2008. On September 19, 2008, the Supreme Court of Canada denied leave to appeal the two lower court decisions.

Global impact of the Credit Turmoil

(a) Impact on financial institutions

The Credit Turmoil has severely affected commercial and investment banks around the world in a number of ways.

First, a number of bank-sponsored issuers could not redeem their outstanding asset-backed securities at maturity. Many sponsoring banks provided support by buying back the securities from investors and bringing them back onto their balance sheets. One of the reasons that many commercial banks have reduced lending capacities is the capital adequacy requirements applicable to the debt obligations that the sponsoring banks brought back onto their balance sheets.

Second, counterparty risk has become a key consideration in lending decisions. Interbank lending has decreased, while interbank lending rates have increased. Financial institutions are increasingly reluctant to enter into lending transactions with other institutions when they cannot assess the other institution’s exposure to subprime or other potentially impaired assets. As a result, institutions facing liquidity issues due to the Credit Turmoil could not access interbank lending, a traditionally reliable source of capital.

Third, the contraction of credit reduced the availability of credit for leveraged buyouts. Traditionally, banks have supplied debt for leveraged buyouts and have securitized that debt and sold it to investors. Banks have been less willing to extend this type of credit because they might have to retain the loans on their balance sheets.

Finally, many banks that invested in asset-backed securities (including mortgage-backed securities and CDOs) have taken significant write-downs on their portfolios, including as a result of exposure to counterparties such as monoline insurers.

(b) Impact on capital markets

The Credit Turmoil has also significantly affected global equity markets. Stock prices have been affected by the extent to which public companies, including major financial institutions, have

had to write down their holdings in asset-backed securities and by speculation about the write-downs.[4]

This has resulted in a crisis of confidence in capital markets and a flight to safety by investors. Outside Canada, this has led to the collapse of, or the need for government intervention in, various financial institutions.[5] It is fair to conclude that financial institutions and capital markets in Canada have been less affected by the Credit Turmoil than institutions and markets in many other jurisdictions. Notwithstanding, the Credit Market Turmoil has had a significant impact in Canada.

Main causes of the Credit Turmoil

As previously noted, the subprime mortgage crisis in the U.S. is generally viewed as having triggered the Credit Turmoil, while the securitization process is said to have "spread the contagion" throughout global credit markets. While many factors contributed to the turmoil in the credit markets internationally, the following are generally accepted as the key factors.

1. **The disconnection of risk in the originate-to-distribute banking model.** By packaging loans into pools and selling them into special purpose off-balance sheet vehicles, the originator no longer bears the contractual risk of default. This "originate-to-distribute" banking model provides less incentive for lenders to carefully screen borrowers and has eroded the lending discipline of the traditional bank lending model. In addition, compensation structures in financial institutions created incentives for those involved in the securitization process to maximize short-term underwriting and structuring revenue with insufficient regard to the longer-term risks.

2. **The role of credit rating agencies.** Many investors relied on credit ratings issued by CRAs to make decisions to invest in asset-backed securities and other structured products. Several issues relating to CRAs and their ratings have been cited as contributing factors to the Credit Turmoil. These include:

    - concerns that CRAs relied on flawed rating methodologies in determining ratings for structured products

    - investor misunderstanding of credit ratings. A credit rating is intended to be a measure of credit risk, meaning the ability of the underlying assets to fund the principal and interest under the terms of the particular debt obligation. A credit rating

[4] In its April 2008 Global Financial Stability Report, the International Monetary Fund notes that losses from the subprime mortgage crisis may be as much as US$1 trillion. The Bank of England stated in its April 2008 report that actual losses could be closer to US$170 billion. It further stated that using a mark-to-market approach to value illiquid securities could significantly exaggerate the scale of losses that financial institutions might ultimately incur. Globally, over US$500 billion in write-downs have been taken to date.

[5] For example, in March 2008, The Bear Stearns Companies, Inc. was provided with a US$28 billion emergency loan from the Federal Reserve Bank of New York and JP Morgan Chase & Co. before being sold to JP Morgan Chase for US$10 per share. More recently, on September 7, 2008, the U.S. Federal Housing Finance Agency decided to place the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) into conservatorship, effectively taking these entities under government control. On September 15, 2008, Lehman Brothers Holdings Inc. filed for chapter 11 bankruptcy protection. On the following day, the U.S. Federal Reserve Bank extended an US$85 billion credit facility to American International Group, Inc.

is not a measure of the liquidity of the security (liquidity risk) or the price at which the security can be sold in the market (market risk). Many investors did not appreciate these distinctions and the relationship between liquidity risk, market risk and credit risk.

- potential conflicts of interest of CRAs, such as conflicts that arise because:

  (i) CRAs are paid by the issuers of the securities they rate

  (ii) CRAs are typically not paid unless a rated transaction is completed, which creates an incentive for CRAs to assign a high rating and the potential for "ratings shopping", and

  (iii) CRAs may provide ancillary services to the issuers of the securities they rate.

The SEC published a report in July 2008 summarizing issues identified in examinations in the U.S. of Fitch, Moody's and Standard & Poor's. In particular, SEC staff identified issues with how CRAs manage their conflicts of interest, particularly those arising from the "issuer pays" structure. For example, SEC staff noted that rating analysts participated in fee discussions despite CRA policies that prohibit this. The SEC recommended that each CRA that it examined consider and implement steps to address management of this conflict. Each of these CRAs stated that it would implement the recommendations.[6]

3. Undue reliance by investors and intermediaries on credit ratings. Many investors and intermediaries placed undue reliance on credit ratings when making investment decisions about structured products. Arguably, institutional investors did not perform adequate due diligence and underestimated the risks of these complex structured products.

4. Transparency and disclosure of underlying assets. Originators did not always disclose, and/or investors did not always demand, adequate information about the structure of, and assets underlying structured products including asset-backed securities such as ABCP and CDOs. This lack of transparency made it difficult for market participants to determine which products were backed by subprime mortgages and what the underlying asset mix was for any specific product. That contributed to the crisis of confidence and the flight to safety by investors.

5. The role of intermediaries

Know-your-client and suitability obligations. The Credit Turmoil and the frozen ABCP market in Canada have raised concerns about whether investment dealers and advisers complied with the "know your client" and "suitability" obligations when recommending structured products such as ABCP to their clients. In order to recommend the purchase of a security, intermediaries must understand the terms of, and risks associated with, the security. Some have alleged that intermediaries represented ABCP to investors as being

[6] "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies" by Staff of Compliance Inspections and Examinations Division of Trading and Markets and Office of Economic Analysis, United States Securities and Exchange Commission, July 2008. Available at www.sec.gov.

as safe as government-issued debt. This has raised questions about the approval process for new products at intermediaries. Securities regulators are investigating these issues as they relate to registrants.

Conflicts of interest. Some intermediaries may have had conflicts of interest because of their roles in both manufacturing and selling structured products. Intermediaries may face pressure to recommend securities issued by a related party.

6. Poor risk management. Many questions have arisen about whether risk management at banks and other financial institutions has kept up with innovations in lending and trading practices. In particular, some banks took large positions in structured products and related derivatives (including credit default swaps), apparently without understanding the risks of these instruments. The losses firms have taken on these positions have had substantial negative impact on their capital positions and their ability to commit to new business. This has led to more conservative lending, which has exacerbated the Credit Turmoil.

Risk management issues have also been identified with respect to the exposure to derivative instrumentssuch as credit default swaps. Many structured product issuers wrote or held credit default swaps to increase their exposure to underlying assets or as insurance against a downturn in credit markets. At the end of 2007, it is estimated that approximately US$62 trillion of credit default swaps had been written.[7] This far exceeded the outstanding debt underlying the credit default swaps.

7. Accounting-related issues

Off-balance sheet accounting. Through the securitization process, banks were able to move loan portfolios off their balance sheets into special purpose vehicles (SPVs). This allowed them to avoid capital requirements on the loan portfolio and to free more capital for other lending opportunities. In some cases, when SPVs defaulted, the sponsoring banks took the assets back onto their balance sheets to protect their clients.

When banks do this, they may reduce their participation in credit markets until they know how much more capital is needed to support those assets. Banks have become much more conservative in their lending practices as they seek to protect their deteriorating balance sheets amid write-downs of impaired assets.

Valuation. Under accounting rules, securities must be measured at fair value. The fair value of securities that do not have a quoted market price (such as ABCP, CDOs and similar structured products) must be estimated using appropriate valuation techniques as there is no standard model for determining fair value. Fair value determinations can differ significantly if inputs to the valuation techniques reflect different market expectations and risk-return factors of the financial instrument. This in turn can result in disagreement between management and auditors, and between borrowers and banks issuing margin calls. In this environment, the percentage of write-downs of ABCP by issuers has varied widely, with the majority of issuers taking write-downs from 25% to 45%.

[7] Figures obtained from the International Swaps and Derivatives Association at http://www.isda.org/statistics.

In addition, distressed sales of assets in response to margin calls can contribute to more negative fair-value adjustments. It has been suggested that the mark-to-market rules cause many structured products to be written down long before it is clear how much the ultimate recoverable amount will be. While these write-downs may be reversed in future periods when markets stabilize, a negative cycle can feed on itself and trigger responses from financial market participants, such as higher margin calls. Higher margin calls cause SPVs, hedge funds and other banks holding the loans to seek additional capital by liquidating assets or through other means, which perpetuates the cycle. This also may have contributed to the Credit Turmoil.

Update on continuous disclosure reviews

In the fall of 2007, the CSA began a targeted review of Canadian reporting issuers that held material amounts of non-bank sponsored ABCP. In particular, CSA staff are assessing whether issuers properly accounted for ABCP holdings in their financial statements and have appropriately disclosed the significant factors and assumptions in management's discussion and analysis of financial condition and results of operations (MD&A). CSA staff will continue these continuous disclosure reviews until the restructuring of the frozen non-bank sponsored ABCP has been completed.

CSA staff are also reviewing the disclosure by several Canadian banks to determine if they are complying with existing disclosure requirements. In particular, the CSA is looking at whether these banks have adequately discussed the business purpose and activities of off-balance sheet entities, the risks associated with these off-balance sheet entities and the valuation practices for securities that do not have an active market.

Based on reviews to date, disclosure has increased in the areas of off-balance sheet risks and the nature of the underlying assets in off-balance sheet vehicles. Other issuers with material holdings of ABCP have begun disclosing the factors and assumptions used to determine the fair value of securities that no longer have an active market.

Although disclosure is improving, CSA staff have asked a number of issuers to enhance disclosure of the factors and assumptions used when determining the fair value of financial instruments and the impact of holding ABCP on the issuer's liquidity and/or capital resources in their next filing of financial statements and MD&A.

CSA staff also conduct regular reviews of continuous disclosure to ensure that reporting issuers comply with existing disclosure obligations. As a result of these reviews, four issuers had to restate and refile their financial statements because valuation write-downs were inadequate and ABCP was not adequately classified on their balance sheet.

The MD&A form contains disclosure requirements for off-balance sheet arrangements and financial instruments. The CICA Handbook also contains disclosure requirements for off-balance sheet arrangements and financial instruments. Based on reviews to date, CSA staff have seen improved disclosure in these areas and as a result, have concluded that at this time changes in disclosure requirements are not necessary as a result of the Credit Turmoil.

Part two - Securities regulatory proposals

The Committee has reviewed the many factors that have been identified as causing, or contributing to, the Credit Turmoil. It has considered whether regulatory action is necessary or appropriate in the following five areas:

1. The role of CRAs (including whether to require disclosure of information received and used by CRAs in connection with ratings).

2. Proposed amendments to the short-term debt exemption.

3. The use of credit ratings in securities legislation.

4. The role of intermediaries.

5. Investments by mutual funds in ABCP.

The Committee applied the following four guiding principles in carrying out its work:

1. The CSA should identify any regulatory gaps or problems resulting from the Credit Turmoil and limit its response to addressing those issues.

2. The Committee should consider whether a particular issue should be addressed as a matter of securities law and whether the CSA has the jurisdiction to address that issue.

3. The CSA's approach to responding to the Credit Turmoil should be consistent with international developments, including initiatives led by, among others, the following entities:

    - IOSCO[8]
    - the SEC[9]
    - the Committee of European Securities Regulators (CESR)[10]
    - the Financial Stability Forum (the FSF)[11], and

[8] See "Code of Conduct Fundamentals for Credit Rating Agencies", revised May 2008, "The Role of Credit Rating Agencies in Structured Finance Markets", May 2008 and "Report of the Task Force on the Subprime Crisis", May 2008. These documents are available at www.iosco.org

[9] See "Proposed Rules for Nationally Recognized Statistical Rating Organizations", Release No. 34-57967, "Security Ratings", Release No. 33-8940, "References to Ratings of Nationally Recognized Statistical Rating Organizations", Release Nos. IC-28327; IA-2751 and "References to Ratings of Nationally Recognized Statistical Rating Organizations", Release No. 34-58070. These documents are available at www.sec.gov.

[10] See "Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance", May 19 2008, available at www.cesr-eu.org.

[11] See "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience", April 7, 2008 available at www.fsforum.org.

- the U.S. President's Working Group on Financial Markets[12].

4. The Committee should consider whether the market has adequately responded to a particular issue and whether such a response is sustainable.

1. The Rules applicable to CRAs

CRAs in Canada are not subject to formal securities regulatory oversight or to a statutory liability regime. Yet a number of Canadian securities rules and policies refer to or rely upon credit ratings.

While CRAs have played a role in the Credit Turmoil, they did not cause the Credit Turmoil and it is unlikely that regulating CRAs would have prevented it. As noted by CESR, there is no evidence that regulating the credit rating industry would have affected the issues that emerged with ratings of securities backed by subprime assets.[13] At the same time, it is important to address any regulatory issues identified as a result of the Credit Turmoil. The CSA proposal to implement a regulatory framework applicable to CRAs (the CRA Framework) is discussed below under "The CRA Framework".

(a) IOSCO Code of Conduct

The IOSCO task force on CRAs has revised the IOSCO Code of Conduct to address concerns about the credit-rating process that became evident from the Credit Turmoil. Representatives of the CSA participated actively in that process. The enhanced requirements of the amended Code of Conduct address issues such as conflicts of interest of CRAs[14] and misunderstandings by investors about what ratings mean (section 3.5).

The Code of Conduct also addresses other issues such as:

- adequate staffing of CRAs (sections 1.7 and 1.9)
- ensuring the quality of information used in making rating decisions (section 1.7)
- the ability to rate novel products (sections 1.7-1 and 1.7-3)
- differentiating ratings for different securities (section 3.5(b)), and
- providing public disclosure of historical information about the performance of ratings (section 3.8).

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[12] See "Policy Statement on Financial Market Development", March 2008, available at www.ustreas.gov.

[13] "Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance" released by CESR on May 19, 2008, p. 3.

[14] Conflicts of interest of CRAs are addressed generally in Part 2 of the Code of Conduct. In particular, the Code of Conduct addresses:

- conflicts of interest arising from rated issuers paying fees for their ratings (section 2)
- the need for CRAs to separate their rating business from consulting work (section 2.5), and
- the ability of CRAs to perform ancillary services (section 2.5).

In addition, section 1.14-1 of the Code of Conduct specifies that CRA analysts should not make proposals or recommendations regarding the design of structured products.

The Code of Conduct also includes a provision aimed at addressing the lack of transparency of the assets underlying structured products:

> CRAs as an industry should encourage structured finance issuers and originators of structured finance products to publicly disclose all relevant information regarding these products so that investors and other CRAs can conduct their own analyses independently of the CRA contracted by the issuers and/or originators to provide a rating. CRAs should disclose in their rating announcements whether the issuer of a structured finance product has publicly disclosed all relevant information about the product being rated or if the information remains non-public.[15]

Taking into account the recent amendments, the Committee thinks that the Code of Conduct is a comprehensive standard that substantially addresses concerns related to CRA governance and conduct. The CRA Framework discussed below would, among other matters, require CRAs to comply with the "comply or explain" provision of the Code of Conduct.

Consistent with its third guiding principle, the Committee will continue to monitor international developments on oversight of CRAs. The IOSCO task force on CRAs, on which the CSA is represented, has been asked to consider the question of how to ensure compliance with the Code of Conduct. In addition to noting that it favours a consistent global regulatory approach to CRAs, IOSCO recently announced the following measures aimed at improved monitoring of CRAs:

- The task force will work to develop mechanisms by which national regulators can co-ordinate their monitoring of compliance by CRAs with the substance of the Code of Conduct.

- The task force will review the adoption of revised codes of conduct by the CRAs against the May 2008 revised version of the Code of Conduct.

- The task force will examine the possibility of developing an international monitoring body to discuss issues with CRAs and to advance the expectations of the international regulatory community.[16]

The IOSCO task force is expected to release a report regarding the above measures in January 2009.

(b) SEC registration regime

A CRA in the U.S. is subject to regulatory oversight by the SEC under the 2006 Credit Rating Agency Reform Act. Under the act, a CRA can register as an NRSRO. The act also gives the SEC the power to regulate an NRSRO's internal processes for record-keeping and managing conflicts of interest. In June 2007, the SEC enacted rules that implemented the provisions of the 2006 Credit Rating Agency Reform Act. [17]

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[15] Section 2.8(c) of the Code of Conduct.
[16] See "IOSCO urges greater international coordination in the oversight of Credit Rating Agencies" released by IOSCO on September 17, 2008 and available at www.iosco.org.
[17] See SEC Release No. 34-55857, "Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations".

On June 16, 2008, the SEC proposed additional rules to address issues about CRAs that arose during the Credit Turmoil, including rules aimed at prohibiting or managing conflicts of interest.[18] The proposed amendments also include a requirement that the information provided to and used by an NRSRO to determine the credit rating of an asset-backed security must be disclosed through a means designed to provide a reasonably broad dissemination of the information. The Committee is considering whether to include a similar requirement as part of the CRA Framework.

The rating methodologies used by CRAs have come under intense scrutiny since the onset of the Credit Turmoil. In response, CRAs have taken steps to improve their rating methodologies.[19] In the U.S., the SEC is prohibited from regulating "the substance of credit ratings or the procedures and methodologies by which any NRSRO determines credit ratings".[20]

Consistent with the U.S. approach, the Committee thinks that securities regulators should not be in the business of regulating or second-guessing methodologies and assumptions used in the credit rating process. Rather, securities regulators should ensure that information about these methodologies and assumptions is publicly available thus allowing the market to judge their validity.

(c) Other international developments

The Australian Securities and Investments Commission has announced that, in conjunction with the Australian Treasury, it is conducting a broad review of how CRAs operate in Australia with the goal of determining whether the current regulatory framework for CRAs needs to be updated. The review will consider the extent to which investors rely on CRAs and whether the level of diligence and discussion undertaken by CRAs warrants this reliance. The review will also consider how CRAs deal with conflicts of interest.

On May 19, 2008, CESR released its "Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance". CESR proposed forming an international CRA standard-setting and monitoring body whose objectives would be:

- to develop international standards for the rating industry in line with the IOSCO standards, and

- to monitor the compliance of CRAs with IOSCO standards using full transparency for enforcement.

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[18] See SEC Release No. 34-57967, "Proposed Rules for Nationally Recognized Statistical Rating Organizations".
[19] For example, see "S&P announces new actions to enhance independence, strengthen the ratings process, and increase transparency to better serve global markets" released by Standard & Poor's on February 7, 2008, "Moody's Proposes Enhancements to Non-Prime RMBS Securitization" released by Moody's Investors Services on September 25, 2007 and "DBRS Revises Rating Approach for Canadian Structured Finance" released on May 27, 2008.
[20] Section 15E(c)(2) of the Securities Exchange Act of 1934.

More recently, European Union finance ministers have agreed on a framework for registering CRAs. They will appoint CESR or create a new agency as the registration and monitoring body. Proposed draft laws are expected in October 2008.

(d) The CRA Framework

Having considered the foregoing, the Committee is proposing that the CSA implement the CRA Framework described below.

CSA Proposal #1

1. ***The Committee proposes establishing a regulatory framework applicable to "approved credit rating organizations" that requires compliance with the "comply or explain" provision of the IOSCO Code of Conduct and provides securities regulators authority to require changes to a CRA's practices and procedures.***

   The Committee also will consider whether to require public disclosure of all information provided by an issuer that is used by a CRA in rating an asset-backed security.

(e) Jurisdiction

None of the jurisdictions represented on the Committee (Québec, Ontario, Alberta and British Columbia) currently has the legal authority to implement the CRA Framework. If the CRA Framework is to be implemented, each securities regulatory authority will need to obtain appropriate legislative amendments.

(f) Features of the CRA Framework

In developing the CRA Framework, the Committee considered what substantive regulatory requirements should apply to CRAs in Canada. All of the CRAs currently operating in Canada are subject to regulation by the SEC. The Committee is mindful of the potential cost and inefficiency of a CSA-specific registration regime. Implementing a Canadian registration regime that is similar to the U.S. model may offer little or no additional benefit.

Accordingly, the CRA Framework would require "approved credit rating organizations" to comply with the "comply or explain" provision of the IOSCO Code of Conduct. It would give the CSA appropriate power to regulate certain aspects of a CRA's business if that is desirable in the future. Section 4.1 of the Code of Conduct, the "comply or explain" provision, reads as follows:

> 4.1 A CRA should disclose to the public its code of conduct and describe how the provisions of its code of conduct fully implement the provisions of the IOSCO Principles Regarding the Activities of Credit Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. If a CRA's code of conduct deviates from the IOSCO provisions, the CRA should explain where and why these deviations exist, and how any deviations nonetheless achieve the objectives contained in the IOSCO provisions. A CRA should also describe generally how it intends to enforce its code of conduct

and should disclose on a timely basis any changes to its code of conduct or how it is implemented and enforced.

The CRA Framework would include the following additional provisions:

- An "approved credit rating organization" would be defined as:
    - DBRS, Fitch, Moody's and Standard & Poor's, and
    - an NRSRO, or any other credit rating organization that applies to, and is approved by, the securities regulator.
- Securities regulators would have the authority to make orders in the public interest that impose terms and conditions on the conduct of business of an approved credit rating organization (including an order requiring an approved credit rating organization to comply with any provision of the Code of Conduct). They would also have the authority to make orders that revoke, amend or modify a CRA's designation as an approved credit rating organization.
- An approved credit rating organization would be required to provide to securities regulators, on request, information about its business as a CRA and its compliance with the Code of Conduct, and any other information, documents, books and records related to its credit rating business.
- An approved credit rating organization could be required, if securities regulators consider it necessary, to submit to a review of its practices and procedures relating to its business as a CRA and its compliance with the Code of Conduct.
- An approved credit rating organization could be required to make any changes to its practices and procedures relating to its business as a CRA that are ordered by securities regulators.

(g) Disclosure of information provided to CRAs

As noted above, the Committee is considering whether to include as part of the CRA Framework a disclosure obligation similar to the proposed SEC requirement. The SEC is proposing that, as a condition to a NRSRO rating an asset-backed security, the information provided to the NRSRO and used by the NRSRO in determining and monitoring a credit rating be disclosed through a means designed to provide a reasonably broad dissemination of the information. If adopted by the CSA, the proposed requirement would apply to any rating of a security issued as part of any asset-backed securities transaction. In considering this disclosure requirement, the Committee has reviewed the market initiatives relating to disclosure referred to below under "Transparency of underlying assets generally".

For an initial credit rating, the required information would have to be publicly disclosed when the securities being rated are issued. When monitoring a credit rating, the required information would have to be publicly disclosed as soon as possible after the information is provided to the approved credit rating organization.

If a CRA disclosure requirement is adopted, a CRA would be prohibited from issuing a credit rating for an asset-backed security unless it reasonably concludes that the required information has been publicly disclosed. An approved credit rating organization would be required to withdraw a credit rating if the relevant information is no longer being publicly disclosed.

If adopted as part of the CRA Framework, the Committee expects that the disclosure requirement could:

- enhance transparency of the assets underlying asset-backed securities
- provide investors with greater access to information to conduct their own due diligence and make more informed investment decisions
- provide other CRAs with the information necessary to prepare a competitive rating for the same product. This could discourage ratings shopping and foster confidence in credit ratings.
- limit the regulatory burden on issuers and CRAs by imposing an obligation that is generally consistent with the SEC disclosure proposal. To avoid duplicate regulation, the CRA Framework would include an exemption from the disclosure obligation that would apply if disclosure has been made in compliance with the SEC's equivalent disclosure obligation.

On the other hand, the Committee has identified certain issues with imposing a disclosure requirement as part of the CRA Framework. For example, the disclosure requirement:

- would put the onus on CRAs rather than on issuers to ensure disclosure of information about asset-backed securities
- may have the potential to create a large volume of non-standardized, unconsolidated data being disseminated into the market that only certain investors may be able to evaluate. The format and specificity of the data CRAs use to rate issuers may differ from what investors need to evaluate an asset-backed security.
- may create various implementation issues that the CSA would have to address such as privacy concerns arising from the dissemination into the public domain of personal information or confidential business information, and
- would result in inconsistent treatment between rated asset-backed securities and other rated securities (for example, corporate debt).

The Committee will monitor any changes made to the SEC's proposed disclosure requirement as a result of the SEC's comment process. The Committee will take any such changes into consideration in formulating its final recommendation.

(h) Benefits of the CRA Framework

The Committee has identified the following benefits associated with the CRA Framework:

- It provides a mechanism to ensure that each approved credit rating organization complies with the enhanced standards of the revised IOSCO Code of Conduct.

- It provides a mechanism for the CSA to consider the compliance of an approved credit rating organization with the Code of Conduct and require changes if appropriate.

- It is an alternative to creating a comprehensive registration regime for CRAs (based on the U.S. model), which seems unnecessary given current and proposed U.S. regulation of CRAs.

- It avoids overlapping regulation of CRAs while providing the CSA with the ability to require changes to the rating business of approved credit rating organizations if that is desirable in the future.

(i) Request for comment

The Committee is seeking comments on the CRA Framework. We specifically seek comments in response to the following questions:

- Is the CRA Framework an appropriate regulatory scheme? Does it go far enough in imposing standards and obligations on CRAs? If a more comprehensive registration regime (similar to the U.S. model) is preferable, what other obligations or conditions of registration should be imposed on CRAs?

- Is a requirement to disclose all information provided by an issuer and used by a CRA in determining and monitoring a credit rating an appropriate way to address the lack of transparency of asset-backed securities? Should the CSA impose a disclosure obligation directly on issuers of asset-backed securities? Should a disclosure obligation apply regardless of whether such securities have a rating?

- The SEC's proposed disclosure requirement applies to a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction if the rating for the security or money market instrument was paid for by the issuer, sponsor or underwriter of the security or money market instrument. Is the scope of the SEC's proposed disclosure requirement appropriate? Does it include any transactions that should not require disclosure? Does it omit any transactions that should require disclosure?

- If the CRA disclosure obligation is adopted, should approved credit rating organizations be exempt from complying with such obligation if information has already been disclosed on a specific security in accordance with the SEC's requirements?

2. Proposed amendments to the short-term debt exemption

The distribution of ABCP in Canada is typically exempt from the registration and prospectus requirements under the short-term debt exemption in section 2.35 of Regulation 45-106:

> 2.35(1) The dealer registration requirement does not apply in respect of a trade in a negotiable promissory note or commercial paper maturing not more than one year from the date of issue, if the note or commercial paper traded:

(a) is not convertible or exchangeable into or accompanied by a right to purchase another security other than a security described in this section, and

(b) has an approved credit rating from an approved credit rating organization.

(2) The prospectus requirement does not apply to a distribution of a security in the circumstances referred to in subsection (1).

The current short-term debt exemption was adopted across Canada upon the implementation of Regulation 45-106 in September 2005. Until then, the conditions for an exempt distribution of short-term debt in Canada varied among jurisdictions.

Before Regulation 45-106 was implemented, distributions of short-term debt in several jurisdictions were exempt from the prospectus requirement if an individual bought a minimum amount of $50,000. No minimum amount applied if the purchaser was a corporation. In other jurisdictions, the exemption was not available if the purchaser was an individual. Providing an exemption based on a minimum amount did not ensure that purchasers were either sophisticated or could withstand the risk of loss of their investment.

Before Regulation 45-106, the short-term debt exemption generally reflected the rationale that sophisticated investors in this market could make investment decisions without the disclosure required in a prospectus and could withstand the risk of loss of their investment. Section 2.35 of Regulation 45-106 reflected a harmonized version of the short-term debt exemption that was adopted across the CSA to address investor protection concerns with the previous exemptions.

Adopting an approved credit rating as a condition for using the short-term debt exemption meant that the exemption was based on the nature of the security. The requirement for an approved credit rating was intended to ensure the high credit quality of the debt sold under the exemption. On that basis, the short-term debt could be distributed to any purchaser.

The Committee thinks that there are no public policy concerns for exempt distributions of traditional short-term corporate debt (such as commercial paper and banker's acceptance notes) that have the benefit of the creditworthiness of an issuer with an ongoing business and significant assets.[21] The Committee is satisfied with the rationale for not requiring prospectus level disclosure for distributions of these types of securities. In these cases, the short term of the security and the credit rating requirement restrict the exemption to distributions of securities for which a prospectus is not needed.

However, the current short-term debt exemption raises public policy concerns when relied on for distributions of more complex securities, such as ABCP, to retail investors. Issuers relied on the

[21] At June 30, 2008, approximately 62% of the Canadian short-term corporate debt market consisted of commercial paper that is not asset-backed and banker's acceptance notes. The short-term corporate debt market is composed as follows:

	millions $ outstanding	Percentage
ABCP	$64,169	38%
Commercial Paper	$44,610	26%
Bankers Acceptances	$60,504	36%
Total	$169,283	100%

Source: Bank of Canada Weekly Statistics. Excludes ABCP subject to the restructuring under the Companies' Creditors Arrangement Act.

short-term debt exemption to distribute complex ABCP to investors who did not otherwise qualify as exempt-market purchasers (for example, by being an accredited investor).

As a result of the Credit Turmoil, it has become clear that exempting these types of distributions from the prospectus requirement based on a high credit rating cannot be justified. In the Committee's view, the fact that retail investors could buy complex products such as ABCP under the short-term debt exemption is a matter that should be addressed. Because of the complex nature of these securities, the Committee thinks that the short-term debt exemption should not be available for the distribution of these securities. The Committee proposes requiring prospectus exempt distributions of ABCP and similar short-term debt to be made only in reliance on other existing exemptions, such as the accredited investor exemption or the $150,000 exemption.

(a) Restricting exempt distributions of asset-backed short-term debt

CSA Proposal #2

2. The Committee proposes amending the current short-term debt exemption to make it unavailable to distributions of asset-backed short-term debt.

To give effect to the Committee's proposal, the existing short-term debt exemption would be amended to have the following conditions:

- The exemption would be available only for distributions of short-term debt that is not asset-backed short-term debt.

- Asset-backed short-term debt would be defined as negotiable promissory notes or commercial paper maturing not more than one year from the date of issue that is backed, secured or serviced by or from, a discrete pool of mortgages, receivables or other financial assets or interests designed to ensure the servicing or timely distribution of proceeds to holders of the security.

- The other conditions of the existing short-term debt exemption would continue to apply. This includes the requirement for an approved credit rating.

If the short-term debt exemption is not available for distributions of asset-backed short-term debt, issuers would need to rely on another exemption to distribute such debt without a prospectus.

Accordingly, exemptions from the prospectus requirement for this type of distribution would no longer be based on the nature of the security. Instead, asset-backed short-term debt would be treated the same as any other security that is not exempt based on its nature.

This would restrict prospectus exempt distributions of asset-backed short-term debt to purchasers who are presumed to be able to withstand the risk of financial loss resulting from an exempt transaction, such as an accredited investor. Accordingly, the Committee proposes that a credit rating would not be required for exempt distributions of asset-backed short-term debt.

(b) Exemption for asset-backed short-term debt

The Committee considered creating a separate registration and prospectus exemption for distributions of asset-backed short-term debt. It also considered whether any other conditions should apply to exempt distributions of asset-backed short-term debt. For example, the Committee is not proposing a disclosure requirement or a requirement for a credit rating for exempt distributions of asset-backed short-term debt.

If, as a result of public comments, the Committee concludes that a disclosure requirement would be appropriate, the Committee would prefer creating a separate exemption for asset-backed short-term debt.

(c) Form filing and fee requirements

The Committee's proposed amendments to the short-term debt exemption raise the question of whether Form 45-106F1 and fee requirements should apply to exempt distributions of asset-backed short-term debt. These form and fee requirements do not apply to the existing short-term debt exemption. However, other exemptions will need to be used to distribute asset-backed short-term debt if the Committee's proposal is implemented (such as the accredited investor exemption and the $150,000 exemption). Those exemptions require issuers to file Form 45-106F1 and pay the appropriate fees. The Committee is considering whether Form 45-106F1 and fee requirements should apply to exempt distributions of asset-backed short-term debt and whether to propose amendments to Part 6 of Regulation 45-106 to exempt these distributions from these requirements.

(d) Accredited investor thresholds and $150,000 exemption

CSA Proposal #3

3. The Committee proposes a separate policy review to consider the appropriateness of (i) the income and net financial asset thresholds in the accredited investor definition, and (ii) the $150,000 exemption.

The Committee's recommendation with respect to the short-term debt exemption would continue to allow accredited investors to purchase asset-backed short-term debt. As noted above, in the Canadian securities regime, accredited investors are presumed to be able to make investment decisions without the disclosure required in a prospectus and to withstand the risk of loss of an investment. In the aftermath of the Credit Turmoil, this presumption has been called into question for individuals who are accredited investors by virtue of the income and net financial asset thresholds of the accredited investor definition. Though investors that purchased frozen ABCP did so pursuant to the short-term debt exemption, some of them were accredited investors.

The Committee is concerned that the current levels at which the income and net financial asset thresholds are set under the accredited investor definition do not suggest that such investors have the ability to withstand the risk of loss from an investment. This led the Committee to be concerned that the current income and net financial asset thresholds for qualifying as an accredited investor may no longer be appropriate. The SEC is currently in the process of

increasing its thresholds under its accredited investor definition and the Committee thinks it would be advisable for the CSA to consider doing the same.

Similarly, a prospectus is not required for distributions to investors who purchase securities with an aggregate acquisition cost of not less than $150,000. The Credit Turmoil has also raised questions about whether the rationale underlying this exemption continues to be justifiable. Some holders of frozen ABCP were not accredited investors but purchased at least $150,000 of ABCP. These purchasers would continue to be able to purchase ABCP on an exempt basis after giving effect to the Committee's proposed amendments to the short-term debt exemption.

Accordingly, the Committee recommends that as a separate policy initiative, the CSA review the current income and net financial asset thresholds in the accredited investor exemption as well as the $150,000 exemption.

(e) Broad review of the exempt market regime

In the context of the Credit Turmoil, questions have been raised about the fundamental principles underlying Canada's exempt market regime. For example, as discussed above, does it continue to be appropriate not to require any form of disclosure for exempt market distributions of complex securities?

The Committee is reluctant to make proposals that could interfere with the exempt market, except to the extent that the Committee is satisfied that changes are necessary as a result of the Credit Turmoil. While the amendments proposed to the short-term debt exemption are intended to address the specific issue of the sale of asset-backed short-term debt in Canada, the question remains whether the Credit Turmoil has highlighted any deficiencies in the exempt market that go beyond the distribution of those specific securities.

As part of a separate policy review, the CSA will be considering whether the fundamental regulatory principles that underlie the exempt market regime continue to be sound and have kept pace with market developments. This review will look at the rationale for the current registration and prospectus exemptions and whether disclosure should be required in the exempt market.

(f) Resale requirements

Currently, securities distributed under the short-term debt exemption are not subject to any resale restrictions. This reflects the historically liquid nature of the short-term debt market. The Committee has no public policy concerns with non-asset-backed short-term debt remaining freely tradable.

However, the Committee's proposal with respect to exempt distributions of asset-backed short-term debt means that resale restrictions would apply to distributions of asset-backed short-term debt. The applicable resale restriction would depend on the exemption used. For example, distributions of asset-backed short-term debt made in reliance on the accredited investor exemption would be subject to the resale restrictions set out in section 2.5 of *Regulation 45-102 respecting Resale of Securities*. Without resale restrictions, these securities could be immediately resold into the public market, thereby undermining the public policy rationale for the conditions

of the exemption under which the initial distribution was made. Accordingly, the Committee supports resale restrictions applying to asset-backed short-term debt.

(g) Disclosure for asset-backed short-term debt

In connection with its proposed amendments to the short-term debt exemption discussed above, the Committee considered whether a disclosure obligation should be a condition for prospectus exempt distributions of asset-backed short-term debt. The Committee concluded that no disclosure obligation should be imposed, but we are requesting comments on that issue.

A disclosure requirement could have the following benefits:

- An obligation to provide disclosure at the time of purchase would help investors carry out appropriate due diligence and make more informed investment decisions. This also could be achieved if the Committee recommends a disclosure requirement as part of the CRA Framework.

- Issuers are relying on prospectus exemptions to distribute increasingly complex securities that the original architects of the various exemptions likely never contemplated. It may be appropriate to revisit the traditional view that no disclosure should be mandated in the exempt market.

- Liability may attach to disclosure made by an issuer in connection with a distribution. This would establish rights of action for investors if the disclosure contained misrepresentations.

Despite the potential benefits of imposing a disclosure requirement, the Committee is mindful of the rationale underlying the exempt market. The Canadian securities regime requires prospectus-level disclosure for a trade in a security that constitutes a distribution.[22] However, there are a number of exemptions from the prospectus requirement that issuers may rely on when distributing securities. Many of these are set out in Regulation 45-106.

Prospectus exemptions are based on the assumption that a prospectus is not required in the circumstances. In some cases, the nature of the security is the determining factor. Examples include the guaranteed debt exemption in section 2.34 and the short-term debt exemption in section 2.35 of Regulation 45-106. In other cases (for example, the accredited investor exemption in section 2.3 of Regulation 45-106), the underlying rationale is that the purchaser is presumed to be able to withstand the risk of loss of the investment.

In the Committee's view, if certain distributions qualify for a prospectus exemption when from a fundamental policy perspective they should not, the CSA should respond by restricting the exemption rather than by adding a disclosure requirement to the exemption.

The rationale for not requiring a prospectus under the short-term debt exemption is that the security is considered of sufficiently high credit quality by virtue of its short term to maturity and its credit rating. As a result of the Credit Turmoil, the rationale for applying this exemption to

[22] For example, see s. 53(1) of the *Securities Act* (Ontario).

asset-backed securities has been questioned. In the case of ABCP, securities may have been distributed to certain purchasers when neither the nature of the security nor the status of the purchaser justified the exemption.

As discussed above, the Committee is proposing to address this issue by amending the short-term debt exemption to ensure that more complex short-term debt such as ABCP could only be distributed on an exempt basis by relying on a different exemption. The Committee is satisfied that not requiring a prospectus for distributions of asset-backed short-term debt under these other exemptions can be justified. For example, accredited investors are presumed to be able to make investment decisions without the disclosure that would be included in a prospectus and to withstand the risk of loss of their investment.

In addition, the Committee has considered the following matters in arriving at its decision not to propose a disclosure requirement as a condition for exempt distributions of asset-backed short-term debt:

- The transparency of asset-backed securities would be significantly enhanced if a disclosure obligation is adopted as part of the CRA Framework by requiring disclosure of all information used by a CRA in determining and monitoring a rating for an asset-backed security.

- Intermediaries that are registrants have know-your-client and suitability obligations. They must understand the terms of a security and its risks, and they must be able to obtain sufficient information about the asset-backed securities in order to recommend them. If they cannot obtain such information, they should not recommend the security for purchase by their clients. One consequence of the Credit Turmoil has been greater focus by registrants on the information they need in order to recommend ABCP and similar asset-backed securities.

- It is not clear how other jurisdictions will address the transparency issue. In the U.S., for example, there is currently no disclosure obligation for exempt market distributions of asset-backed securities (SEC Regulation AB does not apply).[23] However, the SEC is proposing requiring disclosure of all information used by a CRA in determining and monitoring a credit rating.

- As a matter of principle, it is inconsistent for the CSA to require enhanced disclosure for exempt distributions of asset-backed short-term debt without doing the same for other complex products (for example, contracts for difference or CFDs).

- Typically, exempt market issuers of ABCP are not reporting issuers. Therefore, they are not subject to ongoing continuous disclosure obligations. If enhanced disclosure was required for

[23] In the U.S., commercial paper with a term to maturity of 270 days or less is typically distributed under section 3(a)(3) of the *1933 Securities Act*. The parameters of that exemption are discussed in SEC release no. 33-4412 and subsequent SEC "no-action" letters. The securities must also be a type not ordinarily purchased by the general public (typically accomplished by issuing the securities in large denominations) and must be of prime quality (evidenced by a credit rating). In addition, the proceeds from the distribution must be used for "current transactions", including the funding of operating expenses and the funding of current assets such as receivables and inventories.

ABCP, exempt market issuers would have to become reporting issuers or a continuous disclosure regime would have to be imposed on them.

(h) Transparency of underlying assets generally

The Committee considered the initiatives that various organizations are carrying out to improve transparency of asset-backed securities. In particular, IOSCO is currently reviewing the level and adequacy of disclosure with respect to structured finance products in both the public and exempt markets. Enhanced transparency resulting from these initiatives contributed to the Committee's decision not to propose disclosure for exempt distributions of asset-backed short-term debt.

Bank of Canada

On March 31, 2008, the Bank of Canada (the Bank) released its criteria for accepting ABCP as collateral under its standing liquidity facility. The Bank updated its criteria on September 11, 2008. In addition to its general eligibility criteria, the Bank's transparency requirements for issuers seeking to pledge ABCP under the Bank's standing liquidity facility require those issuers to:

- provide the Bank with a document that includes "all relevant investment information"
- make the document accessible to all investors, and
- provide investors with timely disclosure of any significant change to the information in the document.[24]

DBRS

DBRS also is responding to demands for increased disclosure. On May 7, 2008, DBRS announced that it would be launching a series of monthly reports in response to a demand by market participants to have more timely updates and greater transparency with respect to the assets in a securitization transaction.

The first of these reports provides general information about each ABCP conduit rated by DBRS and specific information about individual conduits on a deal-by-deal basis. The report includes performance measures of individual conduits, such as delinquency, default and loss ratios, and credit enhancement levels as reported by the conduit administrator. Other features include the asset class, the funded amount and the deal rating, and the seller's industry and rating. [25]

ICMA

Industry associations such as the International Capital Markets Association (ICMA) are taking measures to enhance transparency. In June 2008, ICMA released a voluntary code of conduct on disclosure in the ABCP market in Europe.[26] One of the requirements of the ICMA code is for

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[24] See "Securities Eligible as Collateral under the Bank of Canada's Standing Liquidity Facility", released March 31, 2008, updated September 11, 2008, available at http://www.bank-banque-canada.ca/en/notices_fmd.

[25] See "Securitization Servicer Report, Monthly Canadian ABCP Report", DBRS, first released in March 2008. The reports are available at www.dbrs.com.

[26] Available at http://www.icma-group.org

issuers to distribute monthly reports to existing investors that describe current assets, verify compliance with key programme tests or requirements and include information on total asset size, total commercial paper outstanding, asset type breakdown, credit enhancement and overall liquidity support.

Accounting initiatives

Enhanced off-balance sheet disclosure

Sponsors and originators of structured products generally do not consolidate off-balance sheet entities under existing accounting standards. As a result, they provide limited information in their continuous disclosure documents for these entities. This can create a lack of transparency for structured products. The Committee will monitor whether this gap is addressed by the current initiatives of the accounting standards setters.

As a result of the Credit Turmoil, accounting standards setters and banking regulators are considering disclosure enhancements for issuers with off-balance sheet entities. These initiatives would require disclosure generally to the market about structured product conduits, their underlying assets and the risks to the sponsors of the conduits.

On September 15, 2008, the U.S. Financial Accounting Standards Board (FASB) proposed amendments to the accounting and disclosure requirements for off-balance sheet transactions involving securitization arrangements. The proposal would introduce a new accounting model that will focus the consolidation analysis on qualitative indicators of control and reduce the reliance on mathematical calculations. The proposed amendments are expected to substantially modify the existing rules by requiring many vehicles that currently qualify for off-balance sheet treatment under U.S. generally accepted accounting principles to come onto the balance sheets of sponsoring institutions. The proposed amendments are more closely aligned with international standards than the current guidance. Most companies will be required to apply the changes in the reporting for off-balance sheet transactions on January 1, 2010.

The International Accounting Standards Board (IASB) is also revisiting its consolidation standards and is expected to issue an exposure draft by the end of 2008.

Unlike the sponsors of the structured products or the originators of the underlying assets, the structured product conduits generally are not reporting issuers. Accordingly, they are not subject to continuous disclosure requirements.

The Basel Committee for Banking Supervision (BCBS) has indicated that it will be issuing further guidance in 2009 to strengthen disclosure requirements applicable to financial institutions that have securitization exposures and off-balance sheet exposure, including liquidity commitments provided to off-balance sheet entities. The guidance will extend to disclosure of methodologies and uncertainties related to valuations of securities that are illiquid. OSFI is a member of the BCBS.

The Committee supports the initiatives by international standard setters to improve disclosure by reporting issuers of risks related to off-balance sheet entities.

Fair value measurement
Fair-value accounting has been criticized on the basis that fair value can be difficult to estimate and is, therefore, unreliable. In addition, the resulting write-downs have adversely affected market prices leading to further write-downs. These write-downs had consequences such as forcing some issuers to liquidate assets to respond to higher margin calls, which perpetuated the cycle.

The IASB and FASB published a discussion paper called "Reducing Complexity in Reporting Financial Instruments" in March 2008.[27] The purpose of the paper is to determine how to simplify and improve standards for financial reporting of financial instruments. It should be noted that the paper was not prepared in response to the Credit Turmoil. However, it is timely because it may have implications for reporting issuers with exposure to financial instruments, such as ABCP, that do not have a liquid market.

On September 16, 2008, the IASB Expert Advisory Panel issued a draft document, *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*. The draft document provides guidance for measuring and disclosing fair values.

The Committee will continue to monitor developments and other initiatives related to enhancing valuation practices and disclosure for fair valuation of financial instruments.

(i) Request for comment

The Committee is seeking comments on the proposed amendments to the short-term debt exemption. We specifically seek comments in response to the following questions:

- Should the CSA create a separate exemption for asset-backed short-term debt? If so, for what purpose? What should the terms of that exemption be? Should a requirement for an approved credit rating be included as a condition to exempt distributions of asset-backed short-term debt?

- One of the goals of the Committee is to prevent the use of the short-term debt exemption for distributions of complex products such as ABCP. Is the proposed definition of "asset-backed short-term debt" appropriate for defining the scope of the amended short-term debt exemption? If not, what is a more appropriate definition? Should the definition be tied only to multi-seller ABCP conduits or only to those that contain actual or potential exposure to previously securitized assets?

- Should distributions of asset-backed short-term debt be permitted under the accredited investor exemption or the $150,000 exemption in Regulation 45-106?

- Should the CSA impose a disclosure requirement on exempt distributions of asset-backed short-term debt? If so, should the disclosure requirement apply to all such distributions (including distributions to institutional investors) or only to certain purchasers, such as

[27] Available at www.iasb.org.

accredited investors who qualify by virtue of their income or net financial assets or investors who buy at least $150,000?

- If a disclosure obligation is imposed on exempt distributions of asset-backed short-term debt, what should the requirements be? How would they differ from the disclosure required in a prospectus? What ongoing disclosure should be required?

- If a disclosure obligation is imposed on exempt distributions of asset-backed short-term debt, should the CSA require the same disclosure for asset-backed securities that are not short-term? What about for other complex securities sold on an exempt basis?

- Should the requirement to file a form and pay fees apply to exempt distributions of asset-backed short-term debt?

3. The use of credit ratings in securities legislation

Canadian securities legislation includes a number of references to credit ratings. Some of these provisions permit different treatment based on the credit rating. For example, highly rated short-term debt securities can be distributed under an exemption from registration and prospectus requirements,[28] can be distributed by short-form prospectus[29] and are eligible investments for money-market funds.[30]

Some commentators have argued that, by using credit ratings in Canadian securities legislation, regulators have effectively endorsed the ratings. Some have also suggested that such use creates value in ratings for issuers seeking lighter regulatory treatment (e.g. short-form prospectus eligibility) and contributes to the significant market power of CRAs.

The SEC is reviewing references to credit ratings in U.S. legislation. On July 1, 2008, the SEC issued three releases that include proposals to eliminate a number of the credit rating references.[31] The Committee is analyzing whether the approach taken by the SEC could inform its proposals to maintain, modify or delete references to credit ratings in Canadian securities legislation. The Committee will monitor any changes made to the SEC's proposals following the SEC's comment process.

The European Commission has announced that it is also considering whether to reduce reliance on credit ratings in European legislation. The Committee will monitor any proposals made by the European Commission with respect to the use of credit ratings in European legislation.

In the current regulatory regime, CRAs are not subject to formal securities regulatory oversight or to a statutory liability regime. Though the Committee is proposing to address this through the CRA Framework, it thinks it is nonetheless appropriate at this time to consider whether to minimize the CSA's reliance on credit ratings because of the implications discussed above of relying on credit ratings in regulatory instruments.

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[28] See section 2.35 of Regulation 45-106.
[29] See sections 2.3, 2.4 and 2.6 of *Regulation 44-101 respecting Short Form Prospectus Distributions*
[30] See the definition of "money market fund" in section 1.1 of Regulation 81-102.
[31] See Release No. 33-8940; 34-58071, Release No. IC-28327; IA-2751 and Release No. 34-58070.

The Committee is considering how credit ratings are used in Canadian securities regulation. For each regulation or policy statement that contains references to credit ratings, the Committee is considering whether to maintain, eliminate or modify the reference and whether an alternative proxy to credit ratings is appropriate.

CSA Proposal #4

4. The Committee is considering whether to reduce the reliance on credit ratings in Canadian securities legislation.

For the following references to credit ratings, the Committee is considering specific possible alternatives to the use of credit ratings:

- as qualification criteria for the short form prospectus and shelf prospectus systems in *Regulation 44-101 respecting Short Form Prospectus Distributions* (Regulation 44-101) and *Regulation 44-102 respecting Shelf Distributions* (Regulation 44-102), respectively

- as a condition to the guaranteed debt exemption in section 2.34 of Regulation 45-106

- in the definition of "designated credit support securities" for the purposes of section 13.4 of *Regulation 51-102 respecting Continuous Disclosure Requirements* (Regulation 51-102), and

- as criteria for permitting the aggregation of short-term debt instruments in an investment fund's statement of investment portfolio under section 3.5 of *Regulation 81-106 respecting Investment Fund Continuous Disclosure* (Regulation 81-106) (discussed below under "Investments by mutual funds in ABCP").

For other uses of credit ratings in Canadian securities legislation, the Committee will continue to consider whether an appropriate alternative proxy can be identified and whether that proxy should be substituted for the credit rating use.

(a) Short-form and shelf prospectus eligibility

Under sections 2.3, 2.4 and 2.6 of Regulation 44-101, an approved credit rating is one of the qualification criteria for distributing the following types of securities by short-form prospectus:

- non-convertible debt-securities

- guaranteed non-convertible debt securities

- non-convertible preferred shares and non-convertible cash settled derivatives (if the guarantor does not have an equity listing), and

- asset-backed securities.

Sections 2.3, 2.4 and 2.6 of Regulation 44-102 include similar qualification criteria for shelf prospectuses.

The U.S. has similar investment-grade credit rating criteria for qualifying to register securities on Form S-3 or Form F-3. As part of its July 1, 2008 release[32], the SEC is proposing to delete the credit rating requirement and replace it with the requirement that the issuer has issued for cash more than US$1 billion in non-convertible securities, other than common equity, through registered primary offerings over the prior three years. The SEC considers that issuers that meet this criteria would have a wide following in the marketplace.

Prior to amendments effective December 30, 2005 (the December 2005 Amendments), Regulation 44-101 included a minimum market capitalization requirement as one of the short-form eligibility criteria. The December 2005 Amendments eliminated the capitalization thresholds as qualification criteria for short-form eligibility. At that time, the CSA's rationale for the amendments was to not exclude issuers from accessing the streamlined and efficient procedures of the short-form system based on size alone.

The December 2005 Amendments significantly broadened the number of equity issuers that could qualify for the short-form system without doing the same for debt-only issuers. Currently, an issuer is eligible to distribute any debt under a short-form prospectus, including unrated debt or debt rated below an approved credit rating, if the issuer has an equity listing (including a listing on the Toronto Stock Exchange, the TSX Venture Exchange or the CNQ) and meets the other basic qualification criteria set out in section 2.2 of Regulation 44-101.

The Committee is considering whether it would be appropriate to broaden the number of debt-only issuers that could qualify for the short-form system by eliminating the credit rating requirement in sections 2.3, 2.4 and 2.6 of Regulation 44-101 without introducing an alternative criterion. The Committee will also consider whether it is appropriate to make equivalent amendments to the credit rating uses in the qualification criteria of Regulation 44-102.

(b) Guaranteed debt exemption

The Committee is considering removing the reference to credit ratings for the guaranteed debt exemption in section 2.34 of Regulation 45-106. Currently, distributions of debt securities of a foreign government can be exempt from the prospectus requirement if the securities have an approved credit rating.

One possible alternative approach would be to limit the availability of the guaranteed debt exemption to debt securities issued or guaranteed by governments of countries whose risk of default in payment is comparable to that of Canadian governments. These countries would be identified in a list of designated foreign jurisdictions using a concept similar to the list of designated foreign jurisdictions in *Regulation 71-102 respecting Continuous Disclosure and Other Exemptions Relating to Foreign Issuers*.

(c) Alternative credit support

Section 13.4 of Regulation 51-102 allows a credit support issuer to rely on the continuous disclosure record of its credit supporter for the purposes of complying with its continuous

[32] See Release No. 33-8940; 34-58071.

disclosure obligations. The credit support issuer must, however, meet certain requirements, one of which is that they can only issue certain types of securities, including "designated credit support securities".

In order for a security to be considered a designated credit support security, the credit supporter must provide either "alternative credit support" or a full and unconditional guarantee of the payments to be made by the credit support issuer. To qualify, the alternative credit support must result in the securities receiving the same credit rating as, or a higher credit rating than, the credit rating they would have received if payment had been fully and unconditionally guaranteed by the credit supporter, or would result in the securities receiving such a rating if they were rated.

The purpose of this credit rating use is to provide the basis upon which issuers can conclude that the credit risk of a security for which alternative credit support has been provided is the same as the credit risk under a full and unconditional guarantee.

A possible alternative to the credit rating reference in the definition of "designated credit support securities" would be to require that the relative credit risk be determined by the issuer. In other words, to qualify, the alternative credit support would have to result in the securities having the same credit risk as, or a lower credit risk than, the credit risk they would have had if payment had been fully and unconditionally guaranteed by the credit supporter.

Under this scenario, credit ratings could continue to be used to inform this analysis. However, rather than implying that issuers should rely solely on credit ratings, the Committee expects that issuers would assess the credit risk associated with the alternative credit support compared with a full and unconditional guarantee and make an independent decision.

The Committee notes the definition of "full and unconditional credit support" in *Regulation 41-101 respecting General Prospectus Requirements* includes a similar concept. If amendments are made to the definition of "designated credit support securities" in Regulation 51-102, the equivalent amendments should be made in Regulation 41-101.

(d) Request for comment

The Committee is seeking comments on its preliminary views relating to the use of credit ratings in Canadian securities rules and policies. We specifically seek comments in response to the following questions:

- Should the CSA reduce its reliance on credit ratings in Canadian securities rules and policies?

- Do you think that any of the alternatives to credit rating uses identified above would be a better substitute for a credit rating?

4. The role of intermediaries

CSA staff have been conducting compliance reviews relating to the role of intermediaries that are registrants in the sale of ABCP to investors. Starting in August 2007, CSA staff reviewed bank-owned and non-bank owned investment counsel and portfolio managers to better understand their valuation methods and due diligence processes in recommending purchases of ABCP. As part of their regular compliance reviews, CSA staff are also asking registrants about any exposure to ABCP in their client holdings.

Also starting in August 2007, CSA staff sent surveys to investment fund managers and portfolio managers on exposure to ABCP in their money market funds and other mutual funds to understand the extent of exposure to, and valuation of, bank-sponsored and non-bank sponsored ABCP.

In January 2008, IIROC undertook a regulatory review of non-bank sponsored ABCP programs in Canada and carried out a compliance sweep of all IIROC dealer members that manufactured and/or distributed the product to customers. That compliance review is described in more detail below under "Know-your-client and suitability obligations".

As a separate enforcement matter, IIROC is investigating certain aspects of the distribution by registrants of ABCP. That enforcement effort includes inquiring into complaints made by purchasers of ABCP, including whether specific misrepresentations were made to investors in connection with the sale of ABCP. IIROC does not publicly comment on its investigations. IIROC will address each case to determine whether any specific regulatory or enforcement action is appropriate.

Depending on the outcome of these various initiatives, the CSA will work with IIROC to address any issues.

CSA Proposal #5

5. The Committee proposes that the CSA co-ordinate with IIROC the various regulatory initiatives focused on addressing the role of intermediaries that are registrants with respect to asset-backed securities such as ABCP.

There are two significant issues relating to the role of intermediaries that are registrants:

- whether investment advisers and dealers satisfied their know-your-client and suitability obligations in selling ABCP (including the representations or advice given in connection with the sale of ABCP), and

- the conflicts of interest faced by intermediaries in selling ABCP.

(a) Know-your-client and suitability obligations

The CSA is working closely with IIROC to evaluate the need to clarify and/or enhance the know-your-client and suitability obligations of registrants and the manner in which they are

implemented. This will ensure that any regulatory response directed at registrants is co-ordinated and consistently applied among all self-regulatory organization (SRO) member registrants and non-SRO member registrants.

The IIROC regulatory review and compliance sweep examines the liquidity crisis that resulted in the freezing of all Canadian non-bank sponsored ABCP in August 2007 and the effect on retail customer holdings. The compliance sweep covered all IIROC dealer members identified as either a manufacturer and/or distributor of non-bank sponsored ABCP. It covered know-your-client and suitability obligations, product due diligence, risk management processes, marketing materials and advisor training at these firms. It included the gathering of relevant policies, procedures and documents and interviews of dealer member personnel involved in all aspects of non-bank sponsored ABCP manufacturing and distribution. IIROC's findings and recommendations will be included in its report expected to be released in the fall of 2008.

(b) Conflicts of interest for intermediaries

CSA Proposal #6

6. The Committee will review the definitions of "related issuer" and "connected issuer" in Regulation 31-103 to ensure that these definitions capture issuers of ABCP and similar products.

Conflicts of interest can occur when one or more of the manufacturer, issuer, underwriter or dealer selling securities are related parties. Some dealers or advisers may have had potential conflicts of interest because of their roles in both manufacturing and selling these products. Conflicts can interfere with the basic objective of securities legislation that investors purchase securities through an objective process free from conflicts of interest. Related parties acting as dealer or adviser recommending ABCP and as the originator/seller in securitizing the assets underlying ABCP and similar products may create potential conflicts of interest that could affect pricing, standards of disclosure or suitability assessments.

Proposed Regulation 31-103 includes broad conflicts of interest provisions (Part 6 - Conflicts of Interest)[33] and imposes an obligation on registrants to identify and respond to all conflicts of interest. Proposed Regulation 31-103 also requires a registered firm to provide a disclosure statement that lists all related or, in the course of a distribution, connected issuers and a statement of the nature of the relationship with related or connected issuers.

However, the provisions of the proposed Regulation 31-103 rely on the definitions of "related issuer" and "connected issuer" found in *Regulation 33-105 respecting Underwriting Conflicts*. These definitions are premised on the relevant entities holding a specified percentage of voting rights. Currently, most issuers of ABCP and similar products are not structured as corporations, which means that the conflicts provisions in Regulation 31-103 may not apply to them. The Committee is reviewing these definitions to ensure that the conflicts regime applies to ABCP and similar structured products.

[33] Proposed Regulation 31-103 was released for comment on February 29, 2008.

5. Investments by mutual funds in ABCP

The impact of the Credit Turmoil has raised a number of issues specific to mutual funds. Our research showed that some retail money market funds were exposed to non-bank sponsored ABCP that was frozen in August 2007. A few of these funds held close to 10% of their net assets in one non-bank sponsored ABCP issuer. Three retail equity funds held almost one-third of their net assets in non-bank sponsored ABCP as cash cover for derivative positions entered into by the funds.

The related mutual fund managers or other related entities voluntarily bought all of the frozen ABCP from the funds at par plus accrued interest. This ensured that retail mutual fund investors would not incur losses from these investments.

CSA Proposal #7

7. The Committee proposes to review:

i. whether a concentration restriction in Regulation 81-102 for money market funds is appropriate, and if so, whether the current 10% concentration restriction is appropriate

ii. whether to further restrict the types of investments (such as asset-backed short-term debt) a money market fund can make

iii. whether assets such as asset-backed short-term debt are appropriate as eligible assets in the definition of "cash cover" and "qualified security", and

iv. whether short-term debt investments, including ABCP with a specified credit rating, should be permitted to be aggregated in a statement of investment portfolio.

(a) Money market funds

Under Regulation 81-102, a mutual fund must meet certain criteria to call itself a money market fund. The definition of "money market fund" limits the types of investments that the fund can make, the term to maturity of those investments (which must be 365 days or less) and the dollar-weighted average term to maturity of the entire investment portfolio (which must not exceed 90 days). In addition, retail mutual funds (including money market funds) are prohibited from investing more than 10% of their net assets in any one issuer.

ABCP that has an "approved credit rating" is an eligible investment for money market funds. Therefore, a money market fund could invest up to 100% of its assets in ABCP of 10 different ABCP issuers, if all the ABCP had an "approved credit rating".

In reviewing whether any changes are required to the money market fund regime, the Committee noted that U.S. money market funds are subject to a 5% concentration limit on investments in

one single issuer[34]. Given the recent events in the credit markets and the commonly held view that money market funds are low-risk investments, the Committee proposes reassessing the concentration limits for mutual funds to determine whether existing concentration limits are an effective means of ensuring money market funds are adequately diversified, maintain an appropriate low-risk profile, and are able to meet redemption demands.

The Committee also proposes consideration of whether our rules should further restrict money market funds from investing in other types of assets, including ABCP.

(b) Cash cover and investment of cash collateral

Retail mutual funds are required to hold cash cover for derivatives positions.[35] They may reinvest cash received under a securities lending or repurchase transaction in a list of qualified securities.[36] ABCP with an approved credit rating is an eligible asset for both cash cover and investment of cash proceeds under securities lending and repurchase transactions. The Committee proposes reconsidering the types of assets that are eligible for cash cover or as a qualified security, including ABCP.

(c) Statement of investment portfolio

Regulation 81-106 permits investment funds to aggregate in their statement of investment portfolio all short-term debt instruments issued by banks and trust companies and short-term debt instruments that have an investment rating within the highest or next highest categories of an approved credit rating organization.[37] This provision permits investment funds to aggregate their ABCP holdings if the instrument meets the rating requirement.

The Committee will consider whether it is appropriate to remove the option for investment funds to aggregate disclosure of short-term instruments in the statement of investment portfolio.

(d) Request for comment

The Committee is seeking comments on these proposals. In addition, we specifically seek comments in response to the following questions:

- One of the goals of the Committee is to reduce reliance on credit ratings in securities legislation, where appropriate. Is the SEC proposal to replace the ratings test for money market funds with a "minimal credit risk" test (as determined by the board of directors of the money market fund) for investment eligibility a better approach than relying on credit ratings

[34] The 5% concentration restriction for U.S. money market funds is not part of the recently published SEC proposals (see Release No. IC-28327). The primary focus of the SEC proposals affecting U.S. money market funds is to eliminate a number of the credit rating references, including the use of credit ratings as part of the factors for determining the eligibility of investments for money market funds. The credit ratings test for eligibility has been replaced by a "minimal credit risk" test. The board of directors of the money market fund would be charged with making this determination.

[35] See definition of "cash cover" in subsection 1.1 and section 2.8 of Regulation 81-102.

[36] See definition of "qualified securities" in subsection 1.1, and the use of that term in clauses 2.12(1)6(b), 2.12(2)(a) and 2.13(2)(a) of Regulation 81-102.

[37] Subsection 3.5(4) of Regulation 81-106.

for investment eligibility? [38] If so, given that most mutual funds in Canada do not have a board of directors, who would perform this function? Would a "minimum credit risk" test make it more difficult to manage a money market fund or create greater uncertainty and unintended risks?

- Given the impact of ABCP on mutual funds, are any other regulatory changes needed? Would guidance be more effective at helping mutual fund managers and portfolio managers understand the factors they need to consider when determining an appropriate investment mix for their money market funds?

Factors that the CSA will continue to monitor

The Committee is making proposals in areas that directly involve the securities regulatory regime. The Committee proposes that the CSA not directly address at this time the following factors that contributed to the Credit Turmoil. Instead, the Committee will continue to monitor these factors and consider whether the CSA should be involved, depending on the market and other regulatory responses.

(i) **The disconnection of risk in the originate-to-distribute banking model.** The originate-to-distribute model relates to structural issues affecting the banking and financial sectors. These issues are best addressed by banking regulators who can impose substantive rules on the process of mortgage origination, if appropriate. Proposals to improve this model include the requirement that an originator of a structured product retain some interest in an investment (i.e. to "keep skin in the game"). This issue has been less important in the Canadian market because subprime mortgages were generally not originated in Canada.

(ii) **Reliance on potentially flawed CRA rating methodologies for structured products.** Each of the major CRAs has announced initiatives to improve their rating methodologies. The Committee thinks that securities regulators should not directly regulate CRA methodologies and assumptions. The proposed CRA Framework reflects this approach. As discussed above, the SEC is restricted from directly regulating rating methodologies.

(iii) **Poor risk management processes of banks.** Banking regulators and other organizations such as the FSF are examining responses to the identified failures of risk management that became apparent in some institutions as a result of the Credit Turmoil. IIROC is also considering risk management practices as part of its review of the role of intermediaries that are registrants.

(iv) **Undue reliance on credit ratings by investors and intermediaries.** The Code of Conduct requires better disclosure by CRAs of the meaning of a rating, and CRAs are taking steps to improve that disclosure. In addition, as a result of the Credit Turmoil, investors should now have a better understanding of the meaning of a credit rating and the diligence required on their part in buying ABCP. The CSA is indirectly addressing this issue through its proposal for a CRA Framework that will require compliance with the "comply or explain" obligation of the IOSCO Code of Conduct. In addition, the Committee expects that, if a disclosure requirement is adopted as part of the CRA

[38] See SEC release IC-28327; IA 2751.

Framework, that requirement should provide investors with information that can assist them in performing their own due diligence.

(v) **Accounting-related issues.** As discussed above, FASB has proposed amendments to disclosure of off-balance sheet interests. The IASB is expected to issue an exposure draft on its consolidation standards by the end of 2008. The accounting standards setters will also determine whether additional guidance is necessary around fair value accounting.

(vi) **Derivative instruments.** The Federal Reserve Bank of New York and other international supervisors are looking to improve the infrastructure of the over-the-counter derivatives market. The FSF has also made recommendations in this area. The main objectives of these initiatives include standardizing and automating trade processing, and developing a central counterparty for credit default swaps with robust risk management oversight.

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Request for comments

The CSA is publishing this consultation paper for a 75-day comment period. Please send your comments in writing on or before December 20, 2008. All submissions should refer to "CSA Consultation Paper 11-405". This reference should be included in the subject line if the submission is sent by e-mail. If you are not sending your comments by e-mail, you should also send us a diskette containing the submissions in Word in Windows format.

Please address your submission to the following securities regulators:

British Columbia Securities Commission
Alberta Securities Commission
Ontario Securities Commission
Autorité des marchés financiers

Please send your comments **only** to the addresses below. Your comments will be forwarded to the other CSA member jurisdictions.

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario
M5H 3S8
Fax: (416) 593-2318
e-mail: jstevenson@osc.gov.on.ca

Me Anne-Marie Beaudoin
Secrétaire de l'Autorité
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse

Montréal, Québec
H4Z 1G3
Fax : (514) 864-6381
e-mail: consultation-en-cours@lautorite.qc.ca

All comments will be posted on the OSC website at www.osc.gov.on.ca and the websites of the other CSA jurisdictions. We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period.

Questions
Please refer your questions to any of:

Erez Blumberger
Manager, Corporate Finance
Ontario Securities Commission
(416) 593-3662
eblumberger@osc.gov.on.ca

Jeffrey Klam
Legal Counsel, Corporate Finance
Ontario Securities Commission
(416) 595-8932
jklam@osc.gov.on.ca

Neeti Varma
Senior Accountant, Corporate Finance
Ontario Securities Commission
(416) 593-8067
nvarma@osc.gov.on.ca

Paul Redman
Acting Manager, Economic Analysis, Strategy & Project Planning
Ontario Securities Commission
(416) 593-2396
predman@osc.gov.on.ca

Pat Chaukos
Assistant Manager, Compliance & Registrant Regulation
Ontario Securities Commission
(416) 593-2373
pchaukos@osc.gov.on.ca

Darren McKall
Assistant Manager, Investment Funds
Ontario Securities Commission
(416) 593-8118
dmckall@osc.gov.on.ca

Maxime Paré
Senior Legal Counsel, Market Regulation
Ontario Securities Commission
(416) 593-3650
mpare@osc.gov.on.ca

Charles Piroli
Legal Counsel, Compliance & Registrant Regulation
Ontario Securities Commission
(416) 593-8243
cpiroli@osc.gov.on.ca

Lucie J. Roy
Conseillère en réglementation
Service de la réglementation
Surintendance aux marchés des valeurs
Autorité des marchés financiers
(514) 395-0337, poste 4464
lucie.roy@lautorite.qc.ca

Mathieu Simard
Analyste
Service des fonds d'investissement
Surintendance aux marchés des valeurs
Autorité des marchés financiers
(514) 395-0337, poste 4475
mathieu.simard@lautorite.qc.ca

Tom Graham
Director, Corporate Finance
Alberta Securities Commission
(403) 297-5355
tom.graham@seccom.ab.ca

Barb Thompson
Securities Analyst, Corporate Finance
Alberta Securities Commission
(403) 355-3892
barb.thompson@seccom.ab.ca

Daniel Richard
Legal Counsel, Corporate Finance
Alberta Securities Commission
(403) 297-4890
daniel.richard@seccom.ab.ca

Christina Wolf
Economist
British Columbia Securities Commission
(604) 899-6860
cwolf@bcsc.bc.ca

Ami Iaria
Senior Legal Counsel
Legal Services, Corporate Finance
British Columbia Securities Commission
(604) 899-6867
aiaria@bcsc.bc.ca

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