January 22, 2009

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

c/o Mr. John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1903, Box 55
Toronto, Ontario, M5H 3S8

And/et

Madame Anne-Marie Beaudoin
Directrice du secrétariat
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Quebec H4Z 1G3

Dear Mr. Stevenson and Madame Beaudoin:

Subject: CSA Consultation Paper 11-405

The Canadian Advocacy Council of CFA Institute Canadian Societies (CAC)[1] is pleased to respond to the Request for Comments dated October 6, 2008 in which the Canadian Securities Administrators (CSA) invited interested parties to submit comments on **Securities Regulatory Proposals Stemming from the 2007-08 credit Market Turmoil and its Effect on the ABCP Market in Canada** (the Proposals).

General Comments

We would first like to commend the CSA for having been very proactive in dealing with this financial crisis in a timely manner. These have been unusual times and events in the financial markets and in prescribing solutions for the problems that have come to light there are several factors that we believe need to be considered.

We believe, first and foremost, that many of the problems with regard to third party, non-bank sponsored ABCP could have been avoided if the issuers, intermediaries and advisors involved in this market had adhered to a proper code of ethics. CFA Institute members are required to follow the ***Code of Ethics and Standards of Professional Conduct*** (which can be found in English at https://www.cfainstitute.org/centre/codes/ethics/pdf/english_code.pdf and in French at https://www.cfainstitute.org/centre/codes/ethics/pdf/french_code.pdf) of the CFA Institute. In particular, we would refer you to ***Standard III***, *Duties to Clients*, which includes the duty of suitability, and ***Standard V*** *Investment Analysis, Recommendations and Action*, which relates to diligence and having a reasonable basis for recommendations.

[1] The CAC represents the 12 Canadian member societies of the CFA Institute constituting over 11,000 members who are active in Canada's capital markets. Members of the CAC consist of portfolio managers, investment analysts, corporate finance professionals, and other capital markets participants. The CAC's has been charged by Canada's CFA Institute member societies to review Canadian regulatory, legislative and standard setting activities.

We believe that the proper test for any proposed solution is: if the changes were adopted, would this prevent a repeat of the problems? At the present time, we do not believe that the solutions contained in the Proposals meet this test. While the Proposals contain some useful suggestions, unless all the sources of the problems are fully identified, the solutions are not likely to work in practice.

We would recommend that the CSA conduct additional research and compile full information on what happened so as to assure itself that the true sources of the problem have been identified before fixes are prescribed. Any other approach is likely to impose additional costs on the marketplace without improving investor protection appreciably. For example, before requiring a fundamental change in how the CRAs do business, there should be a check on the assumptions of historical default rates provided by the originators of the underlying assets. Consideration should be given to backtesting the models used by the CRAs to determine their credit ratings. If the actual loan default rates experienced were plugged into these models, what would the ratings have been? Was the problem with the model or the underlying assumptions and/or data?

We also note that regulation cannot (and should not try to) eliminate all risks. The purpose of the capital markets is to deal with risk and allocate capital to investments appropriately. Without risk, there is no return to any investor. The regulatory focus should be on ensuring the investors who bear the risks have the appropriate information to understand those risks fully.

In searching for solutions, we would recommend that the CSA should develop a more general framework for assessing the appropriateness of the regulatory structure for a given product, which might then be useful for assessing other new products in the future. Focusing solely on ABCP and its specific characteristics may not be useful as the market for most ABCP is likely to be impaired for the foreseeable future.

We have identified some general gaps in the Proposals.

- No one is made expressly responsible for the assumptions (such as on the creditworthiness of the underlying assets) that underlie the ratings; the sponsors/originators come up with these estimates, but there's no liability imposed on them under the proposed scheme. In our view, the sponsors should be responsible for the validity of their estimates.
- The focus on CRAs is at too high a level. The real need is to address practical issues. The proposed liability on CRAs is similar to the one presently imposed on underwriters, which ends at the issue of the securities. If default rates change after issue, who's responsible?

Specific Comments

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.

General CAC comments:

Given the closeness of our markets to those in the US, relying on the CRA disclosure mandated by the SEC requirements is acceptable. The goal of any changes to the disclosure regime should be to enhance disclosure of material information, rather than creating requirements that produce an over saturation of information of lesser relevance.

There needs to be better disclosure of the portfolio assets that underlie asset backed securities. A summary breakdown of credit scores/quality will allow the CRA and other users to calculate the risk of the portfolio more reliably.

We believe the disclosure obligation should belong to the issuer. If the issuer is unable or unwilling to disclose to the public all of the necessary and required information, the CRA should not be permitted to rate the security. Only when the information is publicly available should a rating be permitted to be released.

The ***Code of Ethics and Standards of Professional Conduct*** sets out duties owed to the investing public, such as the duty to ensure advice is suitable for the client and to put the interests of clients first, that clearly were not followed by certain of the participants involved in the ABCP market to the detriment of investors.

CSA specifically seeks 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?

CAC comments

While we believe that unnecessary information can undermine the benefits of disclosure, we support full public disclosure of any material information disclosed by the issuer to the CRA. In our view, all this information should be available publicly so that someone else can make a reasoned assessment of the rating. The disclosure obligation should belong to the issuer of the instrument. The methodology used by the CRA to reach a rating assessment should not be part of the disclosure.

- 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?

CAC comments

We favour disclosure in virtually all cases. The only transactions that should not require full disclosure are those where all purchasers are private equity funds and the securities will not be

resold to a public entity such as a pension fund.

Disclosures should include information like that required in an analyst's report where the analyst's firm has acted as underwriter for the issuer. It is important for everyone to know who paid for the rating.

- 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?

CAC comments

We support this approach. So long as the disclosure has been made and is readily available to investors and advisors, imposing the requirement again is duplicative and unnecessary.

Proposal #2 & 3: Proposed amendments to the short-term debt exemption

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

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.

CAC comments:

The absence of any substantive proposals from the CSA to provide enhanced transparency on the underlying portfolio (which we view as a key source of problems with ABCP) is a weakness and until resolved exemptions should not be granted.

In our view, the proposal to reassess the exempt market regime for accredited investors (Proposal #3) would not be productive. The current system has the benefit of being very close to that in the US. The accredited investor exemption has always been a proxy for investment sophistication. We do have concern that there will be exceptions, such as the lottery winner or retired person consolidating their assets, who qualify under the strict definition but may not have much sophistication with respect to investments. However, these exceptions should be addressed by the proper application of the duty of suitability by the intermediaries and advisors involved in the sale.

We believe that informed investors should continue to be permitted to make their own investment decisions. But to make informed decisions, all material information must be disclosed and updated as material changes occur. The role of the CSA should be to ensure that the disclosures are made and that the appropriate suitability obligations apply and are fulfilled.

Proposal #4: The use of credit ratings in securities legislation

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

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?

CAC comments

We do not see a reason to change the use of credit ratings in other areas of securities regulation, such as the qualification for short form and shelf prospectus regimes; there really are no other practical proxies available to be used for being sufficiently liquid and seasoned. As noted elsewhere, we wonder if there had been full, ongoing disclosure of the underlying portfolio what ratings would the CRAs have given the ABCPs.

The CSA might consider requiring two credit ratings for issues. The additional costs should be negligible against the total costs of the offering, given the usual size of most of these distributions. Two independent CRAs would act as check on each other.

The CSA also should consider reintroducing the market capitalization test as a precondition for the use of the short form and shelf prospectus regimes**.**

Proposal #5 and 6: The role of intermediaries & conflicts of interest

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.

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

CAC comments:

As mentioned above, the ***Code of Ethics and Standards of Professional Conduct - Standard III***, *Duties To Clients* sets out the duties of a CFA Institute member regarding the suitability of investment recommendations and ***Standard V*** *Investment Analysis, Recommendations and Action* requires members to perform due diligence on investments and have a reasonable basis for any recommendations made. If these standards had been met, far fewer problems – particularly with retail investors – would have arisen when the ABCP market froze.

The CSA and IIROC should be making stronger statements about the suitability and know your client obligations of firms and advisers on the sale of all products, not just complex ones. The MFDA recently issued some guidance that sets out very clear parameters on who is responsible for vetting the suitability of the products offered by MFDA members. The CSA and IIROC might usefully mirror that guidance for the firms under their respective jurisdictions.

The CSA and the SROs should be placing a greater emphasis on requiring all firms to vet products prior to sale to ensure the products are suitable for their clients, even if someone is an accredited investor or the firm only sells prospectus exempt products. The responsibility to understand what is being sold should lie both with the firm and the individual representative. Neither the individual representative, nor the firm should be selling something as suitable for their clients if they don't understand the product. (See ***Standard V*** *Investment Analysis, Recommendations and Action*)

We believe that the CSA's emphasis should be on reinforcing the suitability and prudence obligations of issuers, intermediaries and individual advisors, not on trying to dictate what investments may be purchased by qualified investors.

Proposal #7 Investments by mutual funds in ABCP

7. The Committee proposes to review:

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

CAC Comments

One of the reasons cited by the CSA for considering a reduction in the concentration restriction is that U.S. domiciled money market funds are subject to a 5% concentration restriction. In our view, this proposal fails to take into consideration the relative size of the two markets.

The U.S. market is large enough to provide a steady supply of short-term securities from a wide variety of issuers to support the demands of its money market funds. It would not be appropriate to impose the same concentration restrictions on the Canadian market that is far more concentrated in terms of issuers and less than one-tenth the size of the American market.

This proposal also could lead to unintended consequences, such as effectively requiring managers to purchase from less than optimal issuers. Canadian-domiciled U.S. dollar money market funds at times have had trouble keeping within the current 10% concentration restrictions due to the small number of Canadian issuers issuing U.S. dollar paper. Restricting these funds to a 5% concentration limit would make it very difficult for fund managers to serve their unitholders properly and would be detrimental to investors.

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

CAC Comments

A drawback of the CSA proposal is that regular commercial paper, which is tied to the fortunes of just one corporation, would not be restricted, but asset-backed commercial paper, which is tied to large diversified pools of, for example, mortgages, credit cards, would be restricted. This proposal, if enacted, could be detrimental to money market product offerings, as the net risk to the funds might well be increased, rather than decreased.

So long as the investment objectives and permitted investments are clearly disclosed to investors, we see no need to place any new restrictions on what may be purchased by money market funds. Canadian investors currently can select from a number of 'T-bill' funds – funds which only invest in government treasury bills. Therefore, investors have the option of avoiding all forms of commercial paper in money market funds, if they so desire.

General Comments from CAC:

In general, we believe that the investment manager of the money market fund should be responsible for ensuring the quality of assets purchased lie within the investment objectives and parameters of the mutual fund. In the absence of an appropriate and reliable credit rating, the manager should have a minimum credit analysis on which to base the investment decision. If the CSA finds there is compelling evidence that someone else needs to be involved in the risk assessment process, the CSA might consider expanding the scope of responsibilities of the Independent Review Committees (IRC) to include assessing whether the proposed investment posed minimum risks to the mutual fund. The CSA would have to be satisfied that IRC personnel would have the right skills to make this assessment or they could be required to obtain

the appropriate advice.

Part of the problems seen with money market funds that invested in ABCP can be traced to the fact that many investors do not anticipate losing capital invested in a money market fund. They often assume there is an implied guarantee of this outcome. The CSA might consider whether the requirements for disclosure of the risks of loss and the lack of a guarantee of return of principal should be enhanced.

If an ABCP, or any other product, falls within the stated investment objectives/aims of the mutual fund, it should be permitted to be purchased. Any associated risk factors would also have to be disclosed in the fund's simplified prospectus.

Given that the problems with ABCP weren't readily apparent before the crisis, it is not clear that guidance from the CSA on factors to be considered in making investments for money market funds would be useful.

Concluding remarks

We thank you for the opportunity to provide the foregoing comments. We would be happy to address any questions you may have and we appreciate the time you are taking to consider our point of view. Please feel welcome to contact us at chair@cfaadvocacy.ca.

Regards,

(signed 'Ross Hallett')

Ross E. Hallett, CFA
Chair, Canadian Advocacy Council