THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA
IFIC

BY ELECTRONIC MAIL

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

John Stevenson, Secretary
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Dear Sirs/Mesdames:

RE: CSA Consultation Paper *"Securities Regulatory Proposals Stemming from the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada" (the "Consultation Paper")*

We are writing to provide you with The Investment Fund Institute of Canada's comments on the Canadian Securities Administrators' (CSA's) Consultation Paper. We greatly appreciate that the CSA is consulting with stakeholders at the development stage of these proposals.

Issues relating to ABCP credit market turmoil are wide-ranging and affect all financial service providers. Despite a need for better oversight of systemic risks generally, we believe that the global market turmoil has not had the same magnitude of negative repercussions in Canada that has been experienced in other parts of the world in large part because of the robust financial services regulation and strong corporate governance practices already in place.

Our comments below are limited to those proposals that apply most directly to the mutual fund industry. Of course, the mutual fund sector, similar to other sectors, has been negatively affected by the economic downturn – the capital market's decline in value has been significant, and investors have sustained considerable market value losses as a result of market forces. However, in our view these market losses are not a result of inadequacies in the Canadian mutual fund regulatory regime. Mutual funds, and in particular money market funds which are discussed in the Consultation Paper, have been managed in an orderly fashion throughout these difficult times. Additional mutual fund regulation would not have stemmed this unprecedented crisis.

Accordingly, in this context, we note below our views on several issues raised in the Consultation Paper relating to the ABCP market.

<u>Credit Rating Agencies (CRAs) Framework</u>

We support reliable ratings of the credit quality of issuers that enhance the integrity of the capital markets, and support the revisions to the IOSCO Code of Conduct that address concerns about the credit-rating process and enhance transparency of the process. As the Consultation Paper notes CRAs did not cause the current credit turmoil, and regulating CRAs would not likely have prevented the credit turmoil from occurring. Accordingly, any measures in response to the breakdown in the third-party ABCP market should only be taken when and to the extent that they address problems or gaps and should not inadvertently hinder the functioning of the credit market.

Moreover, in light of recent events, we believe that the market on its own has already caused, and will continue to require CRAs to address identified deficiencies, even without increased regulation.

The CSA ABCP Working Group (the "Committee") is considering whether to reduce the reliance on credit ratings in Canadian securities legislation.

This proposal presupposes that fund managers do not perform any due diligence when purchasing an asset other than ensuring it has a certain credit rating. In reality, credit ratings are just one factor which mutual fund managers consider when undertaking their reviews and due diligence. Credit ratings do play a role in ensuring compliance – personnel in investment fund compliance departments utilize the credit ratings in determining ongoing compliance with stated prospectus risk objectives – and credit ratings of a minimum level are also required for portfolio securities held by money market funds. However, they are *not* the sole factor when making a decision as to whether to include, and to continue to hold, a specific product within a fund, and their important but limited role should be preserved.

We have concerns over the potential removal of credit ratings from securities regulation. The current practice of including credit ratings in securities regulation ensures a standardized, minimum floor (at least with respect to credit risk) in defining/selecting fixed income assets. CRAs also bring economies of scale to the marketplace for all market participants, and their ratings form a critical part of the credit quality assessments performed by buy-side participants.

Any alternative to the use of credit ratings in securities regulation would need to be clear, easily measured and well understood by all market participants in order to maintain the existing ubiquitous and common approach. We do not know of a meaningful alternative to CRAs at this time, and question whether the results of any reduction in reliance would be beneficial in any way to capital markets in the long term.

Rather than removing credit rating requirements from the legislation, regulators should perhaps consider enhancing investor education regarding the ratings system. For example, a better understanding by some market participants regarding the difference between liquidity risk and credit risk (rating agencies were providing an opinion only on the latter) may have resulted in enhanced due diligence, and likely a demand for a higher risk premium by those purchasing third-party ABCP.

Further, before credit rating use is diminished or altered, all alternatives should be studied – for example, what if issuers were required to disclose the fact that they had obtained but were not using ratings from other credit reporting agencies? What if two ratings were required for every non-bank sponsored ABCP product? While we are not recommending any specific proposed alternative at this time, consideration should be given to exploring the viability of such options.

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-based 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?

It will be important to carefully consider any inadvertent consequences of a requirement to disclose all information provided by an issuer and disclosed by a CRA in determining and monitoring a credit rating of a security issued as part of any asset-based securities transaction. We note that under this proposal bank-sponsored ABCPs are not differentiated, despite their significant differences from third-party ABCPs.

Further it is not clear why under this proposal a CRA should bear the burden of concluding that the required information has been publicly disclosed before it could issue a credit rating for an asset-backed security – it seems reasonable to place that burden on an issuer, not on a CRA. This proposal also seems to shift the burden to performing full credit quality reviews on each buy-side participant, greatly reducing the efficiencies that exist in having third-party CRAs perform such reviews.

If the role of CRAs were to be diminished, there would be an increased need placed on buy-side participants to obtain access to the same non-public information that CRAs currently access – which would create practical limitations to accessibility and would potentially lead participants to be restricted to transact in related debt or equity securities.

CSA Proposal #2: Short-Term Debt Exemption

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.

We are concerned with the sweeping use of the term "asset-backed short-term debt" in this policy recommendation. The policy objective fails to distinguish between third-party ABCP and bank-sponsored ABCP, although the distinction is referenced in the Consultation Paper. In addition, the Consultation Paper fails to distinguish between traditional ABCP based on credit cards, mortgages, etc. and ABCP that held credit derivatives, CDOs and other, riskier products.

Any changes to the short-term debt exemption would likely only affect the well established traditional ABCP product as the market for the third-party ABCP product essentially no longer exists in Canada.

CSA Proposal #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

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 limited 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 support a short term debt market that, at year end 2007, had $1 trillion dollars in U.S. marketable bills (versus $116 billion in Canadian treasury bills for the same time period in the Canadian market). For a market that size, a 5% concentration restriction is reasonable. It would not be appropriate to impose the same concentration restrictions on a Canadian market that is more concentrated and less than one-tenth that size.

This proposal also could lead to unintended consequences, such as effectively requiring managers to purchase from less optimal issuers. Canadian-domiciled U.S. money market funds at times have had trouble meeting the current 10% concentration restrictions due to the small amount of Canadian originated bank-sponsored ABCP denominated in U.S. dollars. Restricting these funds to a 5% concentration restriction would make it very difficult for fund managers to properly serve their unitholders, and would lead to lower returns with no equivalent offset in risk reduction for investors. Furthermore, had the 5% concentration restriction been in effect before August 2007, it is more likely that Canadian-domiciled U.S. money market funds would have had to resort to buying the same U.S. originated asset-backed securities which have given money market funds domiciled in the United States so much trouble over the past 18 months.

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

We believe that the CSA has not fully delineated between the third-party ABCP market (the demise of which resulted from the liquidity crisis) and the bank-sponsored ABCP market which continues to function normally to this day. Third-party ABCP products suffered from a major design flaw; their liquidity guarantees were not as comprehensive as those included in similar bank-sponsored ABCP products.

As a result of this design flaw, the third-party ABCP product no longer exists in Canada. Accordingly, if the CSA were to proceed with enacting this proposal, the CSA would only be removing from the permitted holdings of money market funds an asset (bank-sponsored ABCP) that has proven its resilience through one of the worst credit crises since the Great Depression.

A serious flaw with the current CSA proposal is that regular commercial paper – paper tied to the fortunes of just one corporation – would not be restricted, but asset-backed commercial paper – paper tied to large diversified pools of, for example, mortgages, credit cards, etc. – would be restricted. We do not see how this proposal, if enacted, would strengthen the money market product.

Within the money market fund product line, Canadian investors currently can select from a number of 'T-bill' funds – funds which only invest in government treasury bills. Thus, investors already have the option of avoiding all forms of commercial paper in money market funds if that is their preference.

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

This CSA proposal appears to be aimed at limiting the risk involved when taking on derivatives positions and when participating in securities lending or repurchase transactions. The degree of risk that is taken on by the fund has more to do with the particular derivatives positions taken on or the counter-party risk to the lending/repurchase transaction, rather than which asset is used as cash cover. Furthermore, any discussion on this matter needs to make a clear distinction between third-party ABCP and bank-sponsored ABCP.

Further restricting the scope of what constitutes cash cover for the purposes of NI 81-102 is not in the best interests of a fund. The "cash cover" component of a portfolio is managed, like the rest of a fund's portfolio, to ensure appropriate diversification and credit quality. In many cases, bank sponsored ABCP has higher credit quality and lower credit and liquidity risk than other categories of "cash cover" and therefore eliminating all ABCP as an option may ultimately increase the risk profile of a fund's cash cover.

Although hindsight may call into question the ratings assigned to certain non-bank sponsored ABCP, appropriate due diligence by investment managers and an ongoing assessment of portfolio risks are the appropriate mechanisms to address this issue, rather than eliminating ABCP as an option altogether. Our view is that ABCP is an appropriate source for cash cover and it has a role in a professionally managed mutual fund. The problems associated with having individuals investing a significant portion of their savings directly in third party ABCP are clearly distinguishable from how professionally managed mutual funds use ABCP in managing the credit risk of their cash cover.

Cross-Jurisdictional Analysis

Some of the discussion in the CSA's consultation paper appears to have been triggered by regulatory activity in other jurisdictions responding to the local consequences they have suffered as a result of the global crisis. We have discussed with our industry colleagues in other jurisdictions proposals under consideration by their regulatory bodies. Interestingly, we have been advised that no initiatives resulting from the financial market turmoil are underway or under public consideration that relate directly to the regulation of the mutual fund product; to date, regulatory developments under consideration have been limited to banking and Credit Rating Agency reforms.

For example, in November 2008 the European Commission released a proposal for regulation of credit rating agencies which included a registration requirement for CRAs whose ratings are used by firms within the EC, conditions for the issuance of credit ratings, and rules on conflicts of interest, quality of the rating methodology and the ratings and enhanced transparency.

In the US, the SEC has proposed a series of amendments to the regulatory structure already in place for CRAs, two of which are similar to the proposals in the Consultation Paper. One was to require CRAs to release publicly all information provided by an issuer and used by a CRA in determining and monitoring a credit rating, similar to the CSA proposal. This particular proposal has been withdrawn. The second was to remove references to credit ratings from Rule 2a-7 of the *Investment Company Act* which contains investment rules for money market funds. The industry opposes this change as there was no failure in the operation of the rules. This was confirmed by the results of the SEC's sweep of money market funds which uncovered no serious deficiencies in funds' independent credit review processes.

Additionally, given that the Canadian experience has been different from other jurisdictions, we strongly encourage Canadian regulators to apply reforms only when and to the extent that they address problems or gaps in the Canadian regulatory regime - not simply because they mirror global initiatives.

Future Reform

We understand the need for securities regulators to review the current Canadian regulatory framework in light of the unprecedented global market declines. It is our belief, though, that additional regulation would not have prevented the market impact on the mutual fund product; moreover, regulation neither can nor should seek to eliminate all risk from the capital markets.

We believe that the mutual fund industry can continue to meet widely varying investor profiles, needs and preferences in the future. However, to do so, and to remain competitive in the capital markets, regulators must provide the industry with the tools to meet investor needs. We urge the securities commissions to work towards enacting reforms that will meaningfully enhance the mutual fund industry for investors. We highlight some of the most critical areas below.

Regulatory Reform - Proposed National Instrument 31-103, in part, will streamline the registration requirements applied by the thirteen regulatory jurisdictions, which will in turn provide greater clarity, consistency of application, and increased efficiencies. We fully support these goals and encourage and anticipate providing input on the uniform and timely implementation of such reforms.

Amendments to National Instrument 81-102 – IFIC supports the CSA's project to codify frequently granted relief under NI 81-102, and appreciates the opportunity to provide to the CSA Investment Funds Committee the industry's suggested technical amendments to the Rule – our association's submission on proposed technical amendments to enhance NI 81-102 will be shared with the CSA in the coming weeks. We also trust that in the near future the CSA will be open to modernizing in a more substantive manner the regulatory framework of NI 81-102, to ensure that innovation can take place within the retail mutual fund product.

Disclosure Reform – The CSA Investment Funds Committee has expressed interest in working with IFIC on potential disclosure reform, in the latter half of 2009. IFIC supports undertaking a comprehensive review of current disclosure requirements with a view to helping determine the appropriate disclosure regime that will foster both investor protection and efficient capital markets.

Financial Literacy – We are pleased to see that in the most recent federal Budget there is a commitment to establish an independent task force to make recommendations on a cohesive national strategy on financial literacy. We encourage all regulators to work towards implementing initiatives that will improve investor financial literacy.

Self-Regulatory Organization (SRO) Harmonization – We continue to recommend that SROs work towards achieving greater harmonization in their regulatory approaches, and to adopt a more principles-based approach that provides both direction and flexibility. Securities regulators should continue to work with SROs to ensure that a consistent and reasoned approach is taken regarding all areas of capital market regulation.

Thank you for providing us with an opportunity to comment. If you have any questions regarding this submission, please contact me directly by phone at 416-309-2300 or by email at jdelaurentiis@ific.ca or Ralf Hensel, Director, Policy – Manager Issues by phone at 416-309-2314 or by email at rhensel@ific.ca.

Yours truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

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