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February 16, 2009

VIA EMAIL (jstevenson@osc.gov.on.ca)

Mr. John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, ON M5H 3S8

Dear Mr. Stevenson:

Re: Request for Comments – CSA Consultation Paper 11-405

We are pleased to submit this letter in response to the request for comment published October 6, 2008 regarding the proposed regulation of credit rating agencies ("**CRAs**"), amendments to NI 45-106 generally and the short term debt exemption in particular, the appropriateness of the use of credit ratings in securities regulation, and the regulation of money market mutual funds. We are providing these comments in a desire to assist you with development of new policies in regard to these topics. We are neither acting for, nor have we consulted, any clients in regard to our specific comments herein. These comments reflect the views of the undersigned authors and are not necessarily the views of Fasken Martineau DuMoulin LLP.

GENERAL

While we understand the perceived need for a regulatory review and response to the recent credit market turmoil and its effect of the asset backed commercial paper ("**ABCP**") market in Canada, we believe that the CSA's proposals could be critiqued by some as being an instance of fighting the specifics of the last war rather than looking forward generally to provide protection to investors from future battles involving potentially unfair market practices that may threaten to undermine fair and efficient capital markets and erode investor confidence. Unfortunately, in regard to the seizure of the non-bank sponsored portion of the ABCP market in Canada, the damage has been done and the generally unappreciated risks that were present have been highlighted for all to see. Ordinary market forces, including the education and awareness of market participants from retail investors to investment dealers to mutual fund managers to institutional investors, will arguably prevent a reoccurrence of these specific events. These market participants

are at least now generally aware of the limitations of credit ratings, the importance of risk management and independent due diligence of rated investments, and they now are even aware of the previously unheralded (from their perspective) differences between "general market disruption" liquidity provisions and "global-style" ones. Although it presents a challenging task, we believe the regulatory response to the recent turmoil should attempt to address future potential unfair market practices generally rather than narrowly address a specific practice that may arguably be remedied by natural market forces.

We have no conceptual objections to reducing the role of CRAs in securities regulation and we believe that a policy level review of the type of assets that money market mutual funds may invest in is also prudent and timely. We have some ideas and comments regarding the proposed means of improving transparency in the ABCP market and the role of CRAs in the disclosure process. When developing our comments, we considered: (i) the desire for timely, accurate and efficient disclosure of information; (ii) the desire to protect investors from unfair market practices and procedures, and (iii) the desire to achieve high standards of business conduct to ensure responsible conduct by market participants.

Please find below, our responses to the individual proposals and the specific requests for comments.

DETAILED COMMENTS

The CSA's Consultation Paper includes four separate sections of requests for comments. These sections address: the proposed CRA framework; potential revisions to NI 45-106; the reduction of the role of CRAs in Canadian securities regulation; and permitted investments for money market mutual funds. Our responses to each of the requests for comment are set out under separate section headings below.

1. CRA Framework

(i) 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?

We agree with the CSA's assessment that regulation duplicative of that imposed by the SEC may provide only a nominal benefit at a significant cost. Accordingly, we support the CSA's proposal not to institute a comprehensive registration regime for CRAs; although, we believe that some sort of registration system will be required in Canada in order to solidify the CSA's jurisdiction over CRAs and compel their compliance with the CRA Framework.

We are supportive of implementing the "comply or explain" approach and using the IOSCO Code of Conduct as an operating standard. We are also supportive of providing securities regulators with the authority to require changes to a CRA's practices and procedures, particularly in the area of public disclosure.

Insofar as our additional comments on the proposed CRA Framework pertain to the specific questions posed in the Consultation Paper, they are dealt with below.

(ii) 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?

Disclosure of "all information":

We do not believe that imposing an obligation on CRAs to disclose all information provided by an issuer to a CRA for the purpose of determining a credit rating is an appropriate means of making asset-backed securities more transparent. It is unclear what "all information" means – does it mean a copy of every document provided and a transcript of every informative telephone call, meeting or presentation made by the issuer or sponsor and used by the CRA? The disclosure of "all information" (regardless how broadly or narrowly that term is defined) provided by an asset-backed securities issuer or sponsor would likely result in a large volume of non-standardized, unconsolidated data being disseminated into the market that only certain investors may be able to evaluate. This disclosure obligation on a CRA in regard to the issuer's information would undoubtedly create various implementation issues such as concerns about privacy and confidential business information. For an issuer that is a reporting issuer, the requirement for a CRA to disclose all information may even result in the disclosure of material information about the issuer that has not yet been generally disclosed.[1] In addition, the Committee is correct to point out that this proposed disclosure requirement would result in inconsistent treatment between rated asset-backed securities and other rated securities (for example, corporate debt). Therefore, we do not believe a CRA should be required to disclose all information provided by an issuer of asset-backed securities. We believe a different approach to disclosure would be better.

[1] See s. 3.3(2)(g) and s. 3.3(7) of NP 51-201 "Disclosure Standards".

Disclosure by a registered CRA:

When a CRA provides either an initial rating or a ratings update, the CRA typically publishes a ratings report. The ratings report typically contains information about: the rating rationale, the rating considerations, the structure of the entity or investment, certain financial information, general economic factors, information about liquidity and credit support and certain disclaimers. We believe that, rather than have the CRA somehow disclose "all information" provided by an issuer, a CSA-registered CRA should be required to disclose in any ratings report published by it:

1. a detailed description of the scope of the review conducted by the CRA, including a summary of the type of information reviewed and relied upon (such as the documents reviewed, individuals interviewed, facilities visited, other expert reports considered and management representations concerning information requested and furnished to the CRA);
2. a description of any limitation on the scope of review and the implications of such limitation on the CRA's conclusions;
3. in the case of an asset-backed securities issuer, a detailed description of the underlying assets sufficient to allow the reader to understand the nature and liquidity of such assets as well as any other characteristics that would materially influence the CRA's opinion including, but not limited to, a description of the liquidity facilities that are available for use by a short term security that is expected to be rolled-over;
4. the key assumptions made by the CRA;
5. a description of the work performed by the CRA and the general approach and methodologies followed by it in support of its opinion or conclusion;
6. the limitations of a credit rating as opposed to and compared to an investment recommendation or a valuation;
7. the financial terms of the CRA's relationship with the issuer, any sponsor and any underwriter and the nature and extent of any and all conflicts of interest;
8. whether the disclosure in the ratings report and the activities of the CRA in regard to the subject of the report comply with the IOSCO Code of Conduct and explain if and where it does not;
9. a discussion of any other professional opinions known to the CRA pertaining to the securities being rated or the subject matter of the report that have been provided by another recognized CRA where the opinion or conclusion of such other CRA differs materially from that of the CRA issuing the report (including notice and a discussion of any opinion by another CRA that has expressly refused to provide a

rating on the subject securities or issuer due to an objection in regard to the structure or nature of the security or issuer); and

10. the ratings opinion of the CRA and its effective date as well as any other conclusions reached by the CRA.

While these above-listed disclosure requirements for a CRA's ratings report will undoubtedly increase the length of the typical ratings report, the information required is readily available to the CRA and should not impose any increased costs that are disproportionate to the significance of the regulatory objectives sought to be realized. This style of disclosure is also already common place in the capital markets as the disclosure requirements described above are consistent with the obligations imposed on an investment dealer that is subject to IIROC Rules 29.20 to 29.24 in regard to professional valuation or fairness opinions as well as IIROC Rule 3400 in regard to research reports.

Disclosure by an issuer:

We recommend that any issuer, sponsor, promoter or underwriter that pays a fee to a CRA to obtain a ratings report be required by a CSA rule to ensure that all material information about the issuer and the subject securities that may have a significant effect on the rating be provided to the CRA as well as any additional information that may reasonably be requested by the CRA.

Although the exempt market issuers of asset-backed securities are typically not reporting issuers, we recommend that any issuer (not just issuers of asset-backed securities) that is a reporting issuer, that pays a fee to a CRA (or has a fee paid on the its behalf) and is the subject of a ratings report be required to receive a copy of the ratings report from the CRA and file the report in full on SEDAR.

We recommend that any issuer, sponsor, promoter or underwriter that pays a fee to a CRA where the issuer is the subject of a ratings report containing the disclosure requirements specified above be required to make available to the purchasers and potential purchasers of the securities a copy of any such ratings report at no cost if the securities are exempt market securities.[2] We also recommend that if any offering memorandum is prepared in regard to a debt security, fixed income security or structured product security (including any asset-backed securities) that, in addition to the disclosure required by s. 6.3 of OSC Rule 45-501, the offering memorandum also disclose that either: (i) the issuer, sponsor, promoter or underwriter has not paid a CRA to provide a credit rating in regard to the issuer or the subject securities and no ratings report is available; or (ii) that a ratings report

[2] This requirement should only be applicable to exempt market distributions since in a non-exempt market distribution the prospectus is of course the disclosure document that is best suited for investors.

is available in regard to the issuer or the subject securities and how an investor may obtain a free copy.

(iii) 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-based 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 transaction that should require disclosure?

The scope of the SEC's proposed disclosure requirements seems appropriate.

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

If an issuer, sponsor or promoter publicly discloses all of the information it provides to a CRA, then the CRA should be exempt from having to comply with a duplicate disclosure obligation. The CRA should be able to comply with its disclosure requirement by making reference to where such publicly available information can be found.

2. Amendments to the short-term debt exemption

(i) 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?

This series of questions presupposes that the existing short-term debt exemption found at s. 2.35 of NI 45-106 be altered such that it does not cover asset-backed short-term debt, as contemplated in the Consultation Paper. We do not agree with the assessment that "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."[3] We feel this way in part for the

[3] Note that IIROC's report "Regulatory Study, Review and Recommendations concerning the manufacture and distribution by IIROC member firms of Third-Party Asset-Backed Commercial Paper in Canada" (October 2008) contains a finding that "Ninety-nine per cent of third-party ABCP distribution by dealer members was to institutional customers and inventory holdings" (page 70).

reason that it appears that almost none of the retail investors affected by the credit turmoil found themselves holding ABCP without an investment dealer acting as an intermediary. Dealers are obliged, under the "know-your client" and "suitability" rules, to ensure that the securities purchased (including third-party Canadian ABCP) by their clients are appropriate investments for such investors.[4] The proximate cause of the problems experienced by retail investors was arguably not a securities regulatory policy failure (i.e. that the short-term debt exemption was too broad), or even a failure of CRAs misjudging the securities and assets they were evaluating,[5] but was rather a failure of dealers to meet their suitability obligations (which include due diligence obligations in regard to the inherent "know-your-client" and "know-your-product" components of determining suitability).[6] Given the public black eye suffered by dealers who exposed their retail clients to third-party ABCP, the dealers' resulting improved appreciation of both the need to better understand complex products and the risk of relying on others, and the expected increased regulatory requirements and standards for investment dealers,[7] we find it unlikely that such a mistake will be repeated in regard to asset-backed short-term debt. Accordingly, we believe the existing short-term debt exemption does not need to be altered; rather, the disclosure recommendations we suggested in 1(ii) above should be implemented and the dealer suitability obligations should be better complied with and enforced.

We recommend that the short-term debt exemption found at s. 2.35 of NI 45-106 not be altered such that it does not cover asset-backed short-term debt. Rather, we recommend that the short-term debt exemption be altered so as to only include asset-backed short-term debt that has an approved credit rating and a "global-style" liquidity facility.

If the CSA does ultimately decide to restrict the short-term debt exemption to instruments other than asset-backed short-term debt, the result will be that issuers will be required rely on another exemption for investors to purchase asset-backed short-term debt. As the Consultation Paper points out, the reliance on certain other exemptions (e.g. the accredited

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[4] See s. 1.5 of OSC Rule 31-505, s. 5.5 of proposed NI 31-103, s. 5.4 of the Companion Policy to proposed NI 31-103, IIROC Rule 1300.1, Part I(B) of IIROC Rule 2700, and s. 3.1 of IIROC Rule 2800.

[5] It is our understanding that the majority of the Canadian third-party ABCP was backed by underlying assets which could support the necessary cash-flows in the long term (hence the rating provided by DBRS), with the primary problems being: (i) the "rollover" ability of these short-term securities directly related to the quality of the Canadian "general market disruption" liquidity facility as opposed to the broader "global style" liquidity facility; and (ii) the complexity and transparency of the structure and the underlying assets.

[6] The IIROC report, *supra* note 3, includes the finding that "Dealer members and registered representatives gave little consideration to the attributes or risks of third-party ABCP. The critical factors in the acceptance of third-party ABCP by retail registered representatives (and their clients) were the credit rating and yield. … The dealer member product introduction processes reviewed [by IIROC] are generally inadequate…"

[7] See IIROC draft Guidance Notice 08-0149 "Best Practices for Product Due Diligence" (October 17, 2008).

investor or the $150,000 minimum amount investment exemptions) will result in the requirement to file a report with the applicable securities administrator. We believe the fees and expenses related to these filing requirements may hurt the efficiency and competitiveness of the Canadian capital markets since the turnover of asset-backed short-term debt is so frequent that the filing requirements may materially raise the cost of this capital in Canada as compared to other jurisdictions. Accordingly, if the CSA does decide to restrict the short-term debt exemption to instruments other than asset-backed short-term debt, we recommend that an additional subsection be added to section 6.2 of NI 45-106 providing for an exemption to the reporting requirements for a distribution of asset-backed short-term debt that has an approved credit rating and a "global-style" liquidity facility.

(ii) 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 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?

Given that the Canadian third-party ABCP credit turmoil has been diagnosed by some as being more an issue of liquidity rather than an issue of the quality of the assets underlying the offending ABCP, we suggest that the Committee consider a more restricted definition of "asset-backed short-term debt". We recommend that the "asset-backed short-term debt" that the Committee proposes to exclude from the short-term debt exemption should not include any asset-backed short-term debt with an approved credit rating that is either: (i) backed by sufficiently liquid assets that match the term and liquidity requirements of the debt; or (ii) supported by an unconditional "global-style" liquidity facility from a qualifying bank. Any asset-backed short-term debt meeting these criteria should still be eligible for the short-term debt exemption.

We also recommend that short-term debt exemption require that the issuer make a free copy of the ratings report available to the purchasers and potential purchasers and that the ratings report contain the disclosure recommended by us in 1(ii) above.

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

Yes; however, we believe it is important that the Committee's recommendation that a separate policy review be undertaken to consider the appropriateness of (i) the income and net financial asset thresholds in the accredited investor definition, and (ii) the $150,000 exemption be undertaken in the near term and as a priority. We believe that a separate policy review of the income and net financial asset thresholds in the accredited investor

definition may result in certain investor proficiency requirements being added for individuals attempting to qualify as accredited investors under those sections of the definition. The separate policy review may also result the $150,000 exemption only being available to individuals if the purchase is unlevered and does not result in a portfolio concentration beyond a prescribed level.

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

As mentioned above, in regard to disclosure requirements we recommend:

1. that any issuer, sponsor, promoter or underwriter that pays a fee to a CRA to obtain a ratings report be required by a CSA imposed rule to ensure that all material information about the issuer and the subject securities that may have a significant effect on the rating be provided to the CRA as well as any additional information that may reasonably be requested by the CRA;
2. that any ratings report prepared by a CSA registered CRA be required to contain the disclosure listed in our response to the CSA's question 1(ii) above;
3. that any issuer that is a reporting issuer, that pays a fee to a CRA (or has a fee paid on the its behalf) and is the subject of a ratings report be required to receive a copy of the ratings report from the CRA and file the report in full on SEDAR;
4. that any issuer, sponsor, promoter or underwriter that pays a fee to a CRA be required to make available to the purchasers and potential purchasers of the securities a copy of any ratings report issued by such CRA at no cost if the securities are exempt market securities;
5. that if any offering memorandum is prepared in regard to a debt security, fixed income security or structured product security (including any asset-backed securities) that, in addition to the disclosure required by s. 6.3 of OSC Rule 45-501, the offering memorandum should also be required to disclose that either: (i) the issuer, sponsor, promoter or underwriter has not paid a CRA to provide a credit rating in regard to the issuer or the subject securities and that no ratings report is available; or (ii) that a ratings report is available in regard to the issuer or the subject securities and how an investor may obtain a free copy; and
6. that dealers and their representatives comply with the suitability requirements which includes communicating to their clients the merits and risks of any investment recommendations made to their clients.

(v) 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?

See responses above.

(vi) 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?

See responses above.

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

See response to 2(i) above.

3. Use of credit ratings in Canadian securities rules and policies

(i) 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 in the Consultation Paper would be a better substitute for a credit rating?

Although we have no objections to reducing reliance on credit ratings in securities regulation, we are hard pressed to find a robust alternative. The suggestions in the Consultation Paper of maintaining a list of eligible governments in respect of the guaranteed debt exemption, and having the issuer determine if default risk of the a credit support security is the same as securities unconditionally guaranteed by the credit supporter are, to our minds, not better than the current regime.

In the case of the guaranteed debt exemption, while we agree that the maintenance of a list of qualified governments should work in principal, there may be a concern regarding whether the CSA is well-suited for this task. However, if the CSA determines it has the resources to undertake the practice of monitoring the default risk of government issuers of debt on a timely basis, this seems to be a workable alternative.

In the case of credit support issuers, having issuers self assess credit risk seems risky, as issuers are arguably more likely to be aggressive with their assessments of credit risk than CRAs. The CRAs, who have a commercial desire to maintain a strong reputation, and

their independence from the issuer add an important level of protection for investors. CRAs are one of the gatekeepers in the capital markets and reliance on their work (even though it is subject to various limitations and conflicts) is not unreasonable when compared to reducing the role of this gatekeeper in exchange for increased responsibility on the parts of issuers and investors.

4 Ancillary Committee proposals

(i) 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 for investment eligibility? 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?

We believe that relying on credit ratings provided by CRAs is the best available option in regard to determining investment eligibility for money market mutual funds. CRAs are one of the important gatekeepers in the capital markets and they are inherently well qualified and in the best position to make assessments of credit risk (assuming they are given adequate information). The ratings provided by each CRA are standardized and well-known and understood by market participants; whereas, a money market fund's tests or criteria for "minimal credit risk" may not be uniform enough or applied properly or consistently enough to achieve the regulatory objective of such an assessment. There is also no assurance that a money market fund could obtain better disclosure from an issuer than could a CRA in regard to the information provided to undertake the credit risk assessment. We believe the use of ratings provided by CRAs would likely be more efficient and would likely provide better confidence to capital markets participants as opposed to an in-house determination by a money market fund.

If the CSA decides to implement a "minimal credit risk" test similar to that proposed by the SEC, the natural candidate in Canada to perform this function for a money market fund may be the fund's independent review committee. However, we believe that those charged with making a decision in regard to a "minimal credit risk" determination (whether it be the members of an independent review committees or the board of directors of the money market fund) may choose to outsource this decision by retaining the services of a CRA to assist with the determination. These individuals may choose to proceed in such a manner due to: (i) an unfamiliarity with determining credit risk; (ii) time constraints; or (iii) a desire to reduce their personal liability by retaining an expert to review the matter and

provide their opinion. If the effect of implementing an in-house "minimal credit risk" test for money market funds is that the money market funds tend to outsource the determination to CRAs, then the result of the change in policy from using a CRA determined rating to relying on an in-house "minimal credit risk" test will have been negligible.

(ii) 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 for their money market funds?

We suggest that the CSA consider restricting money market funds from holding asset-backed debt unless the asset-backed debt: (i) has a term to maturity of less than 365 days; (ii) has an approved credit rating; and (iii) is either (a) backed by sufficiently liquid assets that match the term and liquidity requirements of the debt; or (b) supported by an unconditional "global-style" liquidity facility from a qualifying bank.

Additional Comments

As stated at the outset, we believe that some may consider that certain of the Committee's proposals are attempts to fix specific problems which the market may fix on its own within the existing regulatory framework. Dealers' increased mindfulness of liquidity risk, as distinct from credit risk (to quote the Consultation Paper "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"), their knowledge that "Canadian style" liquidity guarantees are inadequate, and increased attention in regard to their suitability obligations should protect retail investors from undue exposure to directly similar risks going forward. Moreover, the notoriety of the Canadian ABCP crisis and the US sub-prime credit crunch have generally allowed institutional investors to gain a deep appreciation of the risks associated with such complex investment products. Accordingly, we have tried to make our comments and recommendations herein as forward thinking as possible to allow the CSA to both respond to these past events as well as design a better system of CRA reliance and disclosure that will perform better in the future and achieve the objectives of securities legislation regardless of the crisis that may emerge next.

Thank you for this opportunity to comment on the proposed changes to regulations and policy. If you have any questions concerning this letter, we would be pleased to speak with you at your convenience.

Respectfully submitted,

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