Moody's Investors Service

7 World Trade Center at 250 Greenwich Street
New York, New York 10007

February 17, 2009

By Electronic Mail

To: **Alberta Securities Commission**
Autorité des marchés financiers du Québec
British Columbia Securities Commission
Ontario Securities Commission

Re: **Response to CSA Consultation Paper 11-405 - Securities Regulatory Proposals Stemming from the 2007-2008 Market Turmoil and Its Effect on the ABCP Market in Canada ("Consultation Paper")**

I. INTRODUCTION

Moody's Investors Service ("**MIS**") appreciates the opportunity to provide comments to the Canadian Securities Administrators ("**CSA**") and the CSA ABCP Committee ("**Committee**") on Proposals 1 and 4 relating to credit rating agencies ("**CRAs**") and the use of credit ratings in securities legislation ("**CRA Proposals**") set out in the Committee's Consultation Paper.

We believe that the critical examination of our industry and the broader market is a healthy process that can encourage best practices and support the integrity of the products and services our industry provides. As part of our self-examination, we have taken action to enhance the quality of our analysis and improve the reliability of our credit ratings in light of changing market dynamics. These initiatives include refining our rating methodologies, increasing the transparency of our analysis, and adopting new measures to reinforce and enhance existing processes and policies that address potential conflicts of interest. Among other things, we recently amended our Code of Professional Conduct ("**MIS Code**") to align it with the revised International Organization of Securities Commissions ("**IOSCO**") Code of Fundamentals for Credit Rating Agencies ("**IOSCO Code**").

We have set out a summary of our detailed submissions below. In addition, to assist the Committee and the CSA in their continuing review of the CRA Proposals, we have set out in an annex to our comment letter a discussion of MIS's role in financial markets and how our credit ratings are produced.

II. SUMMARY OF SUBMISSIONS

1. Committee Proposal 1 – CRA Framework

MIS does not object to more formal oversight of CRAs whose ratings are used for regulatory purposes. Moreover, we support and are committed to the success of the international regulatory architecture embodied by the IOSCO Code, which we believe provides an effective model for international convergence in the oversight of businesses that operate on a global scale. Consequently, we are pleased that the regulatory framework proposed by the Committee ("**CRA Framework**") is based upon the IOSCO Code. We believe that an oversight framework for CRAs that is principles-based and turns on transparency is better for the market than a prescriptive, rules-based regime providing for extensive day-to-day supervision for several reasons.

First, a principles-based regime is more adaptable to changes in the market. The proposed CRA Framework is comprehensive, dynamic and adaptable because it incorporates by reference the IOSCO Code, which can evolve in the future to reflect developments in the market.

Second, a principles-based regime, particularly one that is based on a "comply or explain" implementation mechanism, enables all CRAs, regardless of differences in size, business model or business practices, to adhere to the regime. This is preferable to a prescriptive, rules-based regime where securities regulators might find it necessary either to: (i) exclude certain CRAs (*e.g.* smaller CRAs or CRAs employing a particular business model) altogether on the basis that they cannot meet the rigid standards set for "approved CRAs", thereby raising regulatory barriers to entry; or (ii) exempt smaller CRAs from the more burdensome rules, thereby creating in a two-tiered regulatory system.

Third, a prescriptive, rules-based regime that provides for a significant degree of day-to-day supervision by securities regulators could inadvertently create the perception that such approved CRAs and their ratings are "fail-proof" because they have a regulatory "seal of approval". Such an outcome could lead to over-reliance on credit ratings, contrary to international efforts to reduce reliance on ratings and encourage investors to conduct their own analysis of investments.

Fourth, the more prescriptive a regime is, the greater the risk of regulatory intrusion into the substance of credit ratings, rating methodologies and rating practices.

We believe that the proposed CRA Framework generally is consistent with the desirable features of an oversight regime for CRAs outlined above. We are concerned, however, about three aspects of the Committee's proposal as follows.

- It is somewhat unclear from the Committee's definition of "approved credit rating organization" whether or not CRAs operating in Canada that met the definition automatically would become subject to the oversight regime. A CRA's credit ratings are, ultimately, just one organization's opinion of credit risk and, therefore, are similar to the opinions expressed by many financial market commentators in the media. MIS believes, therefore, that any formal oversight regime for CRAs should apply only to CRAs that wish their ratings to be "accredited" or "recognized" by authorities for regulatory purposes, for example, in ratings-based capital adequacy standards.

- Second, while we appreciate that the Committee has indicated that the proposed regulatory framework should not interfere with the substance of CRAs' independent opinions, methodologies or rating practices, we are concerned that some of the proposed supervisory and enforcement powers to be granted to securities regulators could be exercised in a manner that inadvertently undermines the ability of CRAs to express their independent opinions about credit risk.
- Third, we believe that granting securities regulators the power to require an approved credit rating organization to implement one or more specific provisions in the IOSCO Code is unnecessary to achieve such regulators' objectives and would undermine the flexibility that IOSCO intended the IOSCO Code to offer.

2. Committee Proposal 1 - Disclosure in Structured Finance Markets

MIS generally supports efforts by the private sector and regulators aimed at increasing transparency in structured finance markets. Originators and sponsors of asset-backed securities ("**ABS**") should be responsible for such disclosure, rather than CRAs. Moreover, we believe that securities regulators, with input from market participants, should determine and prescribe disclosure of the material information needed by investors to make informed decisions and/or facilitate transparent markets and that issuers should bear responsibility for making the prescribed disclosures. It would be inappropriate and impractical to define a new disclosure regime in terms of what is provided to and used by CRAs in determining and monitoring ABS ratings.

3. Committee Proposal 4 - Reducing Reliance on Ratings in Regulation

Historically, MIS has supported discontinuing the use of ratings in regulation. We continue to hold this view. We recognize, however, that in light of current market conditions, eliminating or reducing ratings-based criteria should be pursued very judiciously to avoid further disruption in already fragile markets. MIS, however, would welcome a public policy decision to effect a managed withdrawal of ratings-based criteria from regulation in a manner that reduces reliance on ratings without adversely affecting markets.

III. DETAILED SUBMISSIONS

1. Committee Proposal 1 – CRA Framework

> ***1. 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?***

A. IOSCO-Based Framework Appropriate

MIS recognizes that authorities globally have legitimate policy interests regarding the operations of CRAs whose ratings are used for regulatory purposes. Accordingly, if a regulatory framework for CRAs is introduced in Canada, we would favour the Committee's proposal for flexible, principles-based regime whose substantive requirements are incorporated by reference through a requirement for approved credit rating organizations to comply with Provision 1.4, the "comply or explain" provision, in the IOSCO Code. Such a regime enables all CRAs, regardless of differences in size, business model or business practices, to adhere to the regime. This is preferable to a more prescriptive regime where securities regulators might find it necessary either to: (i) exclude certain CRAs (*e.g.* smaller CRAs or CRAs employing a particular business model) on the basis that they cannot meet detailed standards set for "approved CRAs", thereby raising regulatory barriers to entry; or (ii) exempt smaller CRAs from the more burdensome rules, thereby creating a two-tiered regulatory system.

The proposed CRA Framework nevertheless is comprehensive since, in effect, it calls upon approved credit rating organizations to implement each of the 59 provisions in the IOSCO Code or explain how they achieve the objective underlying a particular provision through alternate means. Moreover, such a framework is dynamic because it would automatically keep pace with any future evolution of the IOSCO Code. It also would contribute to convergence in international regulatory norms and cooperation in oversight. We note that the original and revised IOSCO Code were developed by a global body of regulators, including those from Canada, after extensive consultations with market participants and the public.

B. Voluntary, Recognition-Based Regime

The Committee proposes to define "approved credit rating organization" to mean:

- DBRS Limited, Fitch, Inc., MIS and Standard & Poor's Rating Services; and
- a Nationally Recognized Statistical Rating Organization ("**NRSRO**") or any other credit rating organization that applies to, and is approved by, the securities regulator.

It is somewhat unclear from this definition of "approved credit rating organization" whether or not CRAs operating in Canada that met the definition would become automatically subject to the proposed oversight regime. A CRA's credit ratings are, ultimately, just one organization's opinion of credit risk and, therefore, are similar to the opinions expressed by many financial market commentators in the media. MIS believes, therefore, that any formal oversight regime for CRAs should apply only to CRAs that wish their ratings to be "accredited" or "recognized" by authorities for regulatory purposes, *e.g.* in ratings-based capital adequacy standards. In other words, a CRA that does not wish its ratings to be used for regulatory purposes in the jurisdiction should have the option not to be characterized as an "approved credit rating organization" and should not be required to obtain a licence.

With respect to the process for becoming an approved credit rating organization, we would support an approach that permits CRAs that have been recognized or approved in other jurisdictions to submit relevant documentation prepared in accordance with other jurisdictions' requirements to Canadian securities regulators in satisfaction of some or all of the Canadian requirements applicable either to initial applications to become approved credit rating organizations or ongoing filing requirements. Such an approach would reduce the initial and ongoing costs for CRAs that wish to be approved credit rating organizations in Canada while preserving Canadian securities regulators' discretionary authority to determine whether or not to recognize a particular CRA as an approved credit rating organization for one or more classes of ratings.

C. Supervisory and Enforcement Powers

In the Consultation Paper, the Committee proposed that securities regulators would have certain supervisory and enforcement powers with respect to approved credit rating organizations.[1] MIS recognizes that the powers described in the Consultation Paper are similar to the powers that some CSA members already can exercise with respect to regulated market participants. Moreover, MIS considers most of these powers[2] to be appropriate, provided that the oversight regime is a voluntary, recognition-based regime (rather than a mandatory licensing regime).

We also support the Committee's recommendation that securities regulators " ... should not be in the business of regulating or second-guessing methodologies and assumptions used in the credit rating process."[3] A key attribute of credit ratings is their independence. To produce high quality, independent opinions about credit risk, CRAs must have full control over the substance of their opinions, methodologies and rating procedures.

We are concerned, however, that two of the powers that the Committee recommends be granted to securities regulators could be exercised in a manner that inadvertently undermines the ability of CRAs to provide independent credit opinions. These are the proposed powers of securities regulators to:

- make orders in the public interest imposing terms and conditions on the conduct of business of an approved credit rating organization, including an order requiring the approved credit rating organization to comply with any provision of the IOSCO Code; and
- require an approved credit rating organization to make any changes to its practices and procedures relating to its business as a CRA.

As these powers are so broadly worded, it is conceivable that a securities regulator could impose terms and conditions on an approved credit rating organization or require it to make changes in its practices or procedures that would interfere with the substance of the CRA's methodologies or rating procedures.

We note that, in the United States, Congress addressed this concern about interference with the independence of NRSROs' opinions by providing in the *Credit Rating Agency Reform Act of 2006* that:

> "The rules and regulations that the Commission may prescribe ... shall be narrowly tailored to meet the requirements of this title ... [and notwithstanding] ... any other provision of law, neither the Commission nor any State may regulate the substance of

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1 See Consultation Paper at 17.

2 These are the proposed powers of a Canadian securities regulator to: (1) require an approved credit rating organization to provide it with information about its business as a CRA, information about its compliance with the IOSCO Code, and any other information, document, books and records relating to its credit rating business; (2) require an approved credit rating organization to submit to a review of its practices and procedures relating to its business as a CRA and its compliance with the IOSCO Code; and (3) revoke, amend or modify a CRA's designation as an approved credit rating organization.

3 Consultation Paper at 15.

credit ratings or the procedures and methodologies by which any [nationally recognized statistical rating organization] determines credit ratings."

We believe that incorporating similar language into Canadian legislation would help mitigate concerns that any rule-making, supervisory and/or enforcement powers granted to Canadian securities regulators and/or the courts would not be exercised in a way that jeopardized the independence of the credit opinions expressed by approved credit rating organizations. A provision such as the following would address concerns regarding both rule-making and the exercise of supervisory and enforcement powers:

> "The regulations and rules that may be prescribed shall be narrowly tailored to meet the requirements of this Part of the Securities Act. Notwithstanding any other provision in the law, no body shall regulate, or make any order that affects, the substance of credit ratings or the procedures and methodologies by which any credit rating organization determines credit ratings."

We also are concerned by the Committee's proposal that Canadian securities regulators be granted the power to require an approved CRA to comply with a provision in the IOSCO Code. We realize that the Technical Committee of IOSCO has stated that it expects CRAs to give full effect to the IOSCO Code. At the same time, the existence of a "comply or explain" provision in the IOSCO Code also makes it clear that a CRA can "achieve the objectives" contained in the IOSCO Code through alternative means. Authorizing securities regulators to require compliance with specific provisions in the IOSCO Code introduces rigidity and undermines the flexibility that IOSCO intended the IOSCO Code to offer. We believe instead that the CSA's regulatory objectives can be achieved through powers to:

- order approved credit rating organizations to comply fully with the disclosure element in the "comply or explain" provision of the IOSCO Code, so that market participants and regulators are equipped with sufficient information to draw their own conclusions about whether the approved credit rating organization has implemented the IOSCO Code to their satisfaction;[4]
- conduct supervisory reviews of approved credit rating organizations' practices and procedures, including reviews of the extent of such CRAs' implementation of the IOSCO Code and adherence to their own codes of conduct, policies and procedures;
- impose terms and conditions upon an approved credit rating organization's conduct of business or make changes to its practices and procedures, provided that such terms, conditions or requirements did not affect the substance of the approved credit rating organization's ratings or the substance of the methodologies and procedures by which it determines ratings;
- exercise enforcement powers in respect of any breach by a CRA of any securities laws of general application, such as laws relating to insider trading and tipping; and

[4] Such a power could be exercised if the approved credit rating organization did not provide any explanation of its deviation from the IOSCO Code or provided an explanation that the securities regulator considered to be insufficiently detailed.

- vary or revoke an approved credit rating organization's approved status, if the securities regulator concludes that the deviation or deviations from the IOSCO Code are material enough to warrant such action.

The exercise of these powers could, among other things, contribute to greater transparency about CRA activities and facilitate market discipline.

We note as well that, if the CSA decides that Canadian securities regulators should retain the power to decide whether or not to recognize a CRA as an approved credit rating organization (instead of providing in the legislation for the automatic recognition of certain CRAs as approved credit rating organizations), such regulators would be able to assess, in the first instance, whether or not a particular CRA's ratings possess the attributes, and whether or not the CRA employ the structures, practices and procedures, that render one or more classes of its ratings suitable for use in regulation.[5]

2. Committee Proposal 1 – Disclosure in Structured Finance Markets

As we discuss in more detail below, MIS generally supports efforts by the private sector and regulators aimed at increasing transparency in structured finance markets. We believe that the emphasis should be, as it is for other types of securities, on having the party wishing to access the securities markets assume responsibility for disseminating all information that is material to the investment decision, regardless of whether or not it has been provided to or used by a CRA. Accordingly, we urge the Committee not to adopt a requirement that all information provided by an issuer and used by CRA in determining or monitoring a credit rating for an asset-backed security be disclosed, either by the issuer or the CRA. We believe instead that: (1) securities regulators should determine and prescribe disclosure of the material information needed by investors to make informed decisions and/or facilitate transparent markets; and (2) issuers should bear responsibility for making the prescribed disclosures. We set out our arguments in more detail below.

2. 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?

A. Improve the Availability and Quality of Information Underlying Structured Finance Securities

MIS recommends that Canadian securities regulators consider introducing requirements to enhance the availability and quality of information underlying structured finance securities. Similar to the analysis of other types of securities, analyzing structured securities is a data-intensive process. The information needed to evaluate and monitor

[5] This approach to approval of credit rating organizations is consistent with the views we express in Section III.3 below that all users of ratings, whether they are market participants or regulators, should consider carefully whether ratings and CRAs: (i) address some or all of the risks that the user is seeking to measure and manage; and (ii) exhibit the attributes that meet the user's needs.

structured transactions is granular, often relating to the individual assets[6] in the structured pool and the legal features of the structure. Importantly, detailed and high quality data are essential inputs to the analytical methodologies, qualitative judgments and quantitative models that project cash flows from the assets and allocate those projected flows to the various tranches in the structured financing. Irrespective of the rigor of the methodological approach or the model used in the analysis, if the underlying data used are of inadequate quality or stale, the resulting analysis will in turn be similarly susceptible.

However, structured finance markets generally operate under a limited information disclosure model where CRAs ask for additional information to rate securities. Simply put, prospectus and ongoing disclosure rules do not require the dissemination of sufficient information about the structure or underlying assets of a securitization to afford reliable analysis based on publicly available sources. Consequently, unlike the corporate market, where investors and CRAs can each develop informed opinions based on publicly available information, in the structured finance market CRAs and investors currently have the same dilemma: both lack sufficient public information about structured securities to form opinions. The recommended solution: enhance and update the mandatory disclosure regime for structured instruments. Sufficient information about transaction structures and underlying asset pools should be provided by issuers and originators to the investing public so that they can make better-informed investment decisions.[7]

There are three reasons why this approach would be helpful. First, giving investors access to more information about structured securities allows them to conduct their own analysis and develop their own independent views about securitized products. Incidentally, such access also has the effect of enhancing investors' ability to assess the work of the CRAs.

Second, embedding enhanced information requirements in prospectus disclosures intended for investors likely will improve the information quality about structures and assets. Issuer indifference to information quality is less likely to be a problem if the information is subject to securities law requirements for accuracy and completeness than if it is left to the demands of competing CRAs. The effect of alternative proposals to provide information only to CRAs is that structural conditions that induced rating shopping in the last credit cycle may induce "disclosure shopping" in the next. That is to say, the CRA or CRAs that demand the least information may have a competitive advantage over those that seek more information.

Third, if sufficient information is made available to investors, then it is necessarily also available to those CRAs not selected to rate a securitization. It is then possible for such CRAs to offer unsolicited ratings and research, which broadens the range of information available to investors.

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[6] The assets are the source of payment to the securities issued by the special purpose vehicle ("**SPV**") and it is therefore necessary to have credible and reliable information about the assets' characteristics. For example, in analyzing a mortgage-backed security, the following types of information may be useful to prospective investors for each loan in the structured pool: amount of the mortgage; location of the property; ratio of the loan amount to value of the property; ratio of the loan payment to the income of the borrower; and whether the property was the borrower's home or whether it was an investment. Examples of the type of information required on an ongoing basis to monitor a mortgage-backed security include performance measures such as loan delinquencies, foreclosures and losses.

[7] Consistent with our recommendations in this area, we support the Committee's proposal to restrict the availability of the exemptions for short-term debt so that they do not apply to short-term ABS.

B. Disclosure Requirements Tied to What CRAs Use Could Lead to Over-Reliance on CRAs

Requiring disclosure (by issuers or CRAs) of information provided to and used by CRAs to determine and monitor the rating for an asset-backed security is fundamentally inconsistent with the goal, articulated by the Committee and by policymakers globally[8], of reducing regulators' and market participants' over-reliance on credit ratings and CRAs. This is because such a disclosure requirement, if adopted, would establish CRAs as creators and enforcers of disclosure requirements in structured finance markets.

Historically, issuers and a limited number of other participants in offerings, such as underwriters, have been responsible for making complete and accurate disclosures to investors about the securities being offered according to standards that focus on the information's materiality and relevance to the investment decision-making process. If Canadian securities regulators adopt a disclosure requirement that turns on what has been provided to and used by a CRA, they would, in effect, delegate to CRAs the authority to establish the disclosure regime for structured finance offerings. In other words, CRAs, rather than the Canadian securities regulators, would determine what investors need to know and for which information issuers and underwriters could be held liable. CRAs also would be required to enforce these disclosure requirements by withholding credit ratings unless the prescribed information was disseminated.

Endowing any private market participant with this degree of delegated regulatory authority raises significant concerns. Moreover, establishing a disclosure regime based on what information CRAs use is particularly inappropriate because credit ratings address just one characteristic of debt securities – their creditworthiness. Credit ratings do not take into consideration other factors such as market prices, liquidity, or an investor's investment objectives and risk parameters. We believe that such a disclosure requirement would contribute to the misperception that the information that CRAs use in the credit rating process is sufficient for investment decision-making.

A disclosure requirement of this type also incorrectly presumes that the information requested by one CRA is sufficient to meet the requirements of any other CRA. Credit ratings cannot be commoditized in this fashion. Different CRAs use different methodologies, ask for different types and amounts of information and carry out their rating analysis with varying degrees of vigor. By contrast, such a disclosure requirement would contribute to the misperception that one CRA, or one CRA's rating, is equivalent to another CRA, or another CRA's rating. In so doing, such a requirement could discourage investors from carefully considering whether the information conveyed by a particular CRA's credit ratings is, in fact, useful for the investor's purposes.

C. Disclosure Regime May Lead to "Data Dumping"

This type of disclosure requirement also raises concerns about the unintended consequences of using a hard-to-apply disclosure standard focusing on the CRA's "use" of information to determine ratings or conduct surveillance. How will a CRA determine whether

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[8] See, *e.g.*, Financial Stability Forum, *Report on Enhancing Market and Institutional Resilience* (April 2008), at pp. 38-39.

it has “used” information that it has received? For example, will any review by a CRA analyst of information constitute “use”? We believe that, in practice, the difficulties (and related liability risk) associated with determining “use” on a case-by-case basis will result in CRAs deeming all information provided to them to have been “used”. This could lead to a disclosure regime characterized by “data dumping”, in stark contrast to the orderly and methodological presentation of relevant information required elsewhere under the securities laws. Accordingly, we recommend that, regardless of who is ultimately responsible for such disclosure, Canadian securities regulators should specify precisely which categories of information should be disclosed instead of relying on the overly broad and vague standard of “used by” a CRA.

D. Disclosure Regime Could Have a Chilling Effect

As we discuss in more detail in this section, a more likely, alternative scenario is that such a disclosure requirement would discourage issuers from providing information to CRAs and encourage them to shop for the CRA that demanded the least information. Presently, an MIS analyst can request, and typically receives, whatever information the analyst believes could be helpful in the analytical process. MIS analysts may also ask to speak to or meet with various individuals, including senior executives of issuers and arrangers, and may receive information through oral communications and/or onsite visits. Furthermore, some of the information that we receive from issuers and other participants in the structured finance transaction will have been provided to them by other parties.

If issuers and underwriters could be liable for information required to be made public under the disclosure requirement, we expect that they would become more reluctant to provide information to CRAs. Moreover, they might seek to discourage sponsors, depositors and trustees from providing non-public information to CRAs. This could result in CRAs providing less well-informed credit ratings.

The potentially adverse consequences of such a disclosure requirement cannot be overstated. First, the requirement could lead to less well-informed and more volatile credit ratings because of the chilling effect noted above. Second, the requirement is likely to encourage many issuers and underwriters to shop for the CRA that will demand the least information. Third, the rule could lead to issuers raising less capital through structured finance transactions, which could have adverse consequences for the liquidity and depth of capital markets for structured finance securities. This in turn could adversely affect the broader economy, *e.g.* by reducing the availability of mortgage financing. Fourth, some issuers that proceed with structured finance transactions may do so through unrated, private placements, particularly in buoyant markets with high transaction volumes, when investors often focus on deal speed and are willing to make decisions based on less information. While, ultimately, it is up to investors to decide whether or not to insist upon receiving information (including credit rating opinions) about securities, the likely net result of a disclosure requirement like the one the Committee is considering will be less, not more, transparency in public and private structured finance markets.

E. CRAs Should Not Be Liable for Conduct beyond Their Control

MIS is also concerned that CRAs would be subject to penalties or sanctions for actions taken, or not taken, by issuers and other participants in structured finance transactions since

CRAs cannot control third parties' behaviour. We believe that CRAs should not be subject to liability, especially regulatory sanctions, for the conduct of third parties since CRAs cannot control such parties' behaviour. We also believe that issuers, who control and/or own most of the relevant information and who benefit from access to securities markets, should bear responsibility for making any required disclosures and that it is the CSA's responsibility to set and enforce the appropriate disclosure standards.

3. The SEC's proposed disclosure requirement applies to a security or money market instrument issued by an asset pool or as any 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?

We note that the SEC has moved away from its original proposal and now is proposing that the information provided to and used by NRSROs would be disclosed only to other NRSROs under certain circumstances, rather than to the broader market.

As indicated above, MIS believes that the disclosure requirement should not turn on what has been provided to and used by a CRA. If the Committee and the CSA conclude that greater transparency in structured finance markets is appropriate, we believe that Canadian securities legislation should be amended to prescribe the types of information that should be disclosed by issuers.

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

As indicated above, MIS believes that the disclosure requirement should not turn on what has been provided to and used by a CRA. If, however, the CSA nevertheless decided to adopt such a requirement, we believe that approved credit rating organizations should be exempt from complying the disclosure requirement if the information already has been disclosed with respect to a specific security in accordance with the laws of another jurisdiction.

3. Committee Proposal 4 – Reducing Reliance on Ratings in Regulation

The Committee's fourth proposal considers whether to reduce reliance on credit ratings in Canadian securities legislation.

MIS recognizes that there are benefits from identifying and using objective, widely accepted standards for financial markets because this can facilitate efficient regulation. Credit ratings can be useful in this regard because they are easy-to-use, broadly disseminated, independent and reliably predictive opinions about relative creditworthiness. Nevertheless, we believe that widespread incorporation of ratings into regulation can affect the way ratings are used by regulated entities, the bases upon which issuers choose CRAs and the ways CRAs compete with each other. The appropriation of ratings for regulatory purposes also risks legislative or regulatory intrusion into the content of ratings, as the authorities' interest in comparable ratings can pressure CRAs to produce homogenous opinions and undermine their ability to provide diverse, independent opinions.

Consequently, MIS historically has supported discontinuing the use of ratings in regulation. We continue to hold this view. We recognize, however, that in light of current market conditions, eliminating or reducing ratings-based criteria should be pursued very judiciously to avoid further disruption in already fragile financial markets. Accordingly, we encourage the Committee to analyze carefully the potential, direct and indirect impact of each of its recommendations on market participants and financial markets. MIS would welcome an appropriately a managed withdrawal of ratings-based criteria from Canadian securities legislation so that reliance on ratings is reduced without adversely affecting markets.

We support the healthy dialogue that the Committee has facilitated through the CRA Proposals and believe it will encourage all users of ratings, whether they are market participants or regulators, to consider carefully whether ratings: (i) address some or all of the risks that the user is seeking to measure and manage; and (ii) exhibit the attributes that meet the user's needs. In our view, this type of analysis should be conducted periodically, since new risks can emerge, the relative importance of risks can change, new assessment tools are developed and the needs of market participants and regulators can evolve.

Ultimately, ratings are simply one tool that is available to market participants and regulators. We do not believe, and never have recommended, that they should be used as anything but an opinion about credit risk. We expect that the Committee's reassessment of the use of ratings Canadian securities legislation will help reinforce this concept.

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Once again, we appreciate the opportunity to comment on the CRA Proposals. We would be pleased to discuss our comments further with the Committee.

Donald S. Carter
Managing Director
Moody's Canada Inc.

Janet Holmes
Vice President, Regulatory Affairs (Americas)
Moody's Investors Service

ANNEX: MIS'S ROLE IN FINANCIAL MARKETS AND HOW ARE CREDIT RATINGS ARE PRODUCED

1. MIS's Role in Financial Markets

MIS occupies an important but narrow niche in the information industry. Our role is to publish opinions about the relative creditworthiness of, among other things, bonds issued by corporations, banks and governmental entities, as well as pools of assets collected in securitized or "structured finance" obligations. By making these opinions broadly and publicly available, MIS helps to level the playing field by reducing information asymmetry between borrowers (debt issuers) and lenders (debt investors).

The heart of MIS's rating service is expressing opinions on the relative credit risk of long-term, fixed income debt instruments. Our opinions are expressed on a 21-category scale, ranging from Aaa to C.[9] In the most basic sense, all bonds perform in a binary manner: they either pay on time, or they default. If the future could be known, we would need only two ratings for bonds: "***Default***" or "***Won't Default***". Because the future cannot be known, credit analysis necessarily resides in the realm of opinion. Therefore, rather than being simple "default/won't default" statements, credit ratings are opinions about the risk of outcomes in the future with degrees of uncertainty. Moreover, MIS's opinions are about the <u>relative</u> credit risk of one MIS-rated bond versus other MIS-rated bonds. In other words, MIS's ratings provide a perspective on the relative rank ordering of credit risk, with the likelihood of loss increasing with each downward step on the rating scale. The lowest expected loss is at the Aaa level, with higher expected losses at the Aa level, yet higher expected losses at the single-A level, and so on.

It is essential for investors and others to understand the role of CRAs and what credit ratings can and cannot do. MIS has always been clear that credit ratings should be used primarily as a gauge of relative default probabilities and expected credit loss. MIS consistently has discouraged the market from using its ratings as indicators of price, measures of liquidity, or advice or recommendations to buy or sell securities – all of which are regularly influenced by factors unrelated to credit. MIS's ratings are not designed to address any risk other than credit risk and should not be assigned any other purpose.

2. Production of MIS's Credit Ratings: Organization of Analytical Staff

The organization and composition of our rating groups and analytical teams are key components of our efforts to produce high quality, independent and globally consistent credit ratings. Our credit analysis professionals are organized into three major rating groups: Fundamental (*e.g.* corporates and financial institutions), Public Finance (*e.g.* sovereign issuers) and Structured Finance. These major rating groups generally are subdivided into rating teams based on global industry or asset class.

Our organizational structure includes Managing Directors, ("**MDs**"), Credit Officers and other analysts. Senior MDs oversee the activities of global rating groups (such as the

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[9] MIS also assigns short-term credit ratings – primarily to issuers of commercial paper – on a different rating scale that ranks obligations Prime-1, Prime-2, Prime-3 or Not Prime.

global Financial Institutions group) or major business regions, such as Asia-Pacific. Group MDs generally manage large regional subdivisions within the global subdivisions (*e.g.*, the North American Corporate Finance Group) of the global rating groups. Rating teams that focus on a particular industry or asset class within a region generally are overseen by Team MDs. The Team MDs' responsibilities include managing rating assignments, overseeing the monitoring of outstanding credit ratings, chairing rating committees, reviewing written research and ensuring that credit policies are appropriately implemented within their respective teams.

Each major rating group has one or more Credit Officers, who oversee rating quality for the group, or a region or industry within the group. These Credit Officers are part of the global Credit Policy Group and report to MIS's Chief Credit Officer. They help ensure consistent application of our global rating methodologies and policies within and across rating groups, implement procedures for monitoring credit ratings, and support the development and implementation of new methodologies and analytical initiatives.

Analysts other than MDs and Credit Officers are primarily responsible for the credit analysis of specific issuers or obligations and typically are assigned to such issuers or obligations based on their relevant expertise or training. In this submission, we use the term "Assigned Analyst" to identify the person who is primarily responsible for taking a credit rating through the rating process and writing credit opinions, credit rating announcements and related credit research. As we discuss below, however, credit ratings are determined collectively by rating committees, not by any individual analyst.

3. Production of MIS's Credit Ratings: Credit Rating Process

One common misperception is that MIS's credit ratings are produced in the country in which the relevant Assigned Analyst resides or the country in which the issuing entity is based. This is not the case. As described in more detail below, ratings are determined collectively, by rating committees whose members may be based in different MIS offices around the world. Importantly, the credit rating produced reflects <u>MIS's</u> opinion, and not any individual analyst's opinion, based in any one country, of the relative creditworthiness of the issuer or obligation. Although rating criteria may differ from one sector (*e.g.*, corporate) to another (*e.g.*, structured finance), we use essentially the same rating process in all sectors throughout the world. Our ultimate goal is to provide high quality credit ratings that are comparable across sectors, regions and countries. Below is a summary of the key steps in the rating process.

- **Gathering Information:** The Assigned Analyst begins the credit analysis by assembling the relevant information. This information may come from the issuer in meetings or through other communications with the Assigned Analyst, as well as from public sources. It may be supplemented with information generated by MIS, including macro-economic and sector-specific or region-specific data.

- **Credit Analysis:** Once information has been gathered, the Assigned Analyst analyzes the issuer or obligation and formulates his or her view for the rating committee to consider. In doing so, the Assigned Analyst will apply relevant MIS methodologies, which generally are global in nature and likely will include consideration of both quantitative and qualitative factors.

- **The Rating Committee:** The rating committee is a critical mechanism in promoting the quality, consistency and integrity of our rating process. Rating committee composition varies based on the structure and complexity of the credit rating being assigned. Members are also selected based on expertise and diversity of perspective, and are encouraged to express dissenting or controversial views and discuss differences openly. Importantly, members can be from various MIS offices. The participation of analysts from different regions also helps to promote globally consistent application of methodologies and determination of ratings. The committee includes the Chair, who acts as the moderator; the Assigned Analyst, who presents his or her views and the analysis supporting them; and other participants, who may include support analysts, specialists (such as accounting specialists) and/or senior-level personnel with analytical responsibilities. Once a full discussion has taken place, the members then vote, with the most senior members voting last so as not to influence the votes of the junior members. The rating is determined by majority vote, with each member's vote carrying equal weight.

- **Dissemination of Credit Rating Announcements:** When a rating committee forms its opinion, we typically contact the issuer or its agent to inform them of the rating. The rating decision is not communicated to any other external party before it is published. Ratings are published simultaneously throughout the world on moodys.com. Moreover, to facilitate timely dissemination of its ratings, we use press and production teams throughout the world. For example, a credit rating announcement concerning a Canadian issuer and ready for release on Sunday afternoon could be issued by production staff in Australia.

- **Monitoring:** Once a credit rating is published, we monitor the rating on an ongoing basis and will modify it as appropriate to respond to changes in our view of the relative creditworthiness of the issuer or obligation. As part of this monitoring process, analysts may review public information as well as non-public information provided by the issuer or its agent. Analysts also use a range of tools to monitor and track rated issuers and obligations. These include comparisons of our ratings with other measures of credit risk, including measures derived from the market prices of bonds and credit default swaps, accounting ratio-implied ratings based on default prediction and rating prediction models (for corporate and sovereign issuers). We also use institutional monitoring processes overseen by our Credit Officers.

- **Research:** In addition to publishing credit ratings, MIS analysts produce credit research and data products. These products are only available through subscription and provide greater discussion of MIS's credit-relevant analysis.