MOODY'S
INVESTORS SERVICE

November 2, 2010

By Electronic Mail

To: British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers du Québec
Nova Scotia Securities Commission
New Brunswick Securities Commission
Office of the Attorney General, Prince Edward Island
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Government of Yukon
Registrar of Securities, Department of Justice, Government of the Northwest Territories
Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunavut

Re: Proposed National Instrument 25-101 – Designated Rating Organizations ("NI 25-101"), Related Polices and Consequential Amendments (collectively, the "Proposed Materials")

Moody's Investors Service ("**MIS**") appreciates the opportunity to provide comments to the Canadian Securities Administrators ("**CSA**") on the Proposed Materials. MIS does not object to the establishment of a regulatory framework for credit rating agencies ("**CRAs**") that is consistent with the limited role of CRAs as market commentators. Credit ratings provide a point of reference and common language of credit used by market professionals to compare credit risk across jurisdictions, sectors and industries, thereby facilitating the efficient flow of capital worldwide. We intend for our ratings to promote dialogue and debate among market professionals, who we expect to use our opinions as a supplement, rather than a replacement, for their own credit analysis. We believe that thoughtful action by authorities as well as market participants can play a critical role in reinforcing high quality ratings and improving market transparency without intruding on the substance of rating opinions or creating incentives for market participants to over-rely on ratings. Moreover, we support the CSA's efforts to promote international convergence in the oversight of CRAs, as reflected in the CSA's proposal to align the Canadian regulatory framework with the International Organization of Securities Commissions ("**IOSCO**") *Principles for Credit Rating Agencies* ("**IOSCO Principles**") and revised *Code of Conduct Fundamentals for Credit Rating Agencies* ("**IOSCO Code**").

MIS does not object in principle to most aspects of the Proposed Materials. We do, however, have the following areas of concern.

- **The scope of the Canadian regulatory framework for designated rating organizations** ("**DROs**") **should be clarified.** MIS recommends that proposed NI 25-101 be modified so that a CRA that applies to become a DRO can specify: (i) which entity or entities it is seeking to register as DROs subject to the Canadian supervisory framework; and (ii) which entity or entities within the CRA it

wishes to have treated as "rating affiliates" whose ratings will be considered to be ratings of the DRO for purposes of Canadian securities legislation.

- **DROs should be permitted to waive compliance with provisions in their codes of conduct when it is not unreasonable to do so.** There may be limited circumstances where a DRO would reasonably conclude that it should waive compliance with one or more provisions in its code of conduct, for example in order to comply with local laws or achieve another objective specified by the IOSCO Code or the DRO's code of conduct. If Section 7 of NI 25-101 is adopted as proposed, however, such a waiver will be prohibited. Among other things, this will make it more difficult, if not impossible, for a DRO to adopt a code of conduct that applies to its activities in multiple jurisdictions. The more country- or region-specific policies and procedures a CRA is required to adopt, the greater the risk that this patchwork of policies and procedures could result in ratings that are not comparable across jurisdictions, sectors and asset classes. This lack of ratings comparability would not serve the interests of investors or the broader market. To balance the CSA's interest in knowing that a DRO's code of conduct reflects expected practice with the need for a degree of flexibility in applying such a code, we recommend that Section 7 be amended to provide that a DRO shall not <u>unreasonably</u> waive compliance with provisions in its code of conduct.

- **The DRO compliance officer's monitoring, assessment and reporting functions should focus on the DRO's activities as a CRA and on its employees.** MIS is concerned that, if Section 11 of proposed NI 25-101 is adopted in its current form, DRO compliance officers will have to implement and oversee policies and procedures that have nothing to do with the DRO's business. This is because Section 11 will require the compliance officer to monitor compliance by the DRO and individuals acting on its behalf with all Canadian securities legislation, not just those provisions relating to the DRO's activities as a CRA. Moreover, the term "individuals acting on the DRO's behalf" could include non-employees such as lawyers, accountants, and financial advisers. It would be impracticable for compliance officers to be responsible for assessing the conduct of third parties and potentially could require the DRO to disclose confidential information to such non-employees in order to effectively monitor their conduct. Accordingly, we recommend that the compliance officer's monitoring, assessment and reporting functions focus on compliance by the DRO and its employees with the DRO's code of conduct and with provisions in securities legislation applicable to the DRO's activities as a CRA.

- **Prohibiting the issuance or maintenance of a rating in all cases where a prohibited conflict arises could be disruptive for market participants.** MIS agrees with the CSA that DROs should be prohibited from having any of the conflicts of interest listed in Section 8 of proposed NI 25-101. If one of the listed conflicts arises, we believe that the appropriate solution often would be for the DRO to refrain from assigning a credit rating or to withdraw an existing credit rating. In some circumstances, however, it may be possible for the DRO to address the situation in a way that eliminates the conflict or otherwise prevents the conflict from affecting the integrity of rating. Declining to assign a requested rating or withdrawing an existing rating could disrupt an offering of securities, affect institutional investors' ability to hold a previously rated security, or result in a breach of covenants in an issuer's contracts. We believe, therefore, that it would not be inappropriate for a DRO to assign or maintain a rating, notwithstanding the occurrence of a conflict of interest, provided that the DRO takes all necessary measures to prevent the conflict from affecting the integrity of the rating.

- **The CSA should not mandate disclosure of ratings by issuers.** MIS is concerned that the continuation of mandatory ratings disclosure requirements for issuers may cause investors to mistakenly perceive those ratings as "material information". This is likely to encourage market participants to over-rely on

ratings, instead of using them as just one of several inputs in their investment decision-making process. This outcome is inconsistent with the commitments made by Canadian and other authorities to take steps designed to reduce reliance on ratings.

- **The proposed rating fee disclosure requirements for issuers could undermine firewalls designed to promote analytical independence.** Consistent with the IOSCO Code, MIS has taken strong measures to insulate its rating analysts and rating committees from commercial influences. The CSA's proposal to require issuers to disclose information about rating fees, however, would expose MIS's rating analysts and committees to more commercial information than we believe would be appropriate in light of our efforts to separate rating activities from commercial considerations.

- **The existing safe harbour from expert liability for DROs should be retained.**[1] MIS believes that the safe harbour remains appropriate and should be retained because it allows CRAs to focus on producing a broad range of investor-oriented credit rating opinions, reduces the cost of capital market transactions, and facilitates the efficient allocation of capital. If the CSA repealed the Exemption while continuing to require issuers to disclose ratings in prospectuses, CRAs would have to choose among several undesirable options: (1) putting themselves out of business in Canada by declining to consent to the disclosure of their ratings (and therefore having issuers choose not to hire them to provide ratings); (2) potentially being put out of business due to exposure to massive, unquantifiable liability to issuers and the investing public; or (3) modifying their rating opinions and scope of coverage in a way that would make ratings much less useful to the market.

These concerns and some technical comments are set out in more detail in the attached annex to our comment letter. Once again, we appreciate the opportunity to comment on the Proposed Materials. We would be pleased to discuss our comments further with CSA members.

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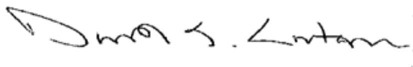
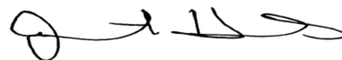
Sincerely,





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

Janet Holmes
Vice President, Regulatory Affairs (Americas)
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[1] Canadian securities legislation currently provides that issuers are exempt from the requirement to obtain a CRA's consent to include the CRA's credit rating in a prospectus. If this exemption is repealed, issuers will have to obtain the CRA's consent to disclose the CRA's rating in a prospectus. If the CRA consents to the inclusion of its rating in a prospectus, it will be subject to an "expert liability" standard. While the CSA is not proposing at this time to repeal this exemption, it has solicited comments on whether this exemption, and the resulting safe harbour from expert liability for CRAs, continue to be appropriate.

Annex

I. Scope of Canadian Regulatory Framework

Proposed NI 25-101 provides a framework for CRAs to apply to become DROs and for the supervision of DROs by Canadian securities regulators. It is unclear from the Proposed Materials, however: (i) which entity or entities within the CRA will be treated as subject to the Canadian supervisory framework; and (ii) which ratings produced by the CRA should be treated as "DRO ratings" under Canadian securities legislation.

For example, MIS is a globally active CRA consisting of various companies that are direct or indirect subsidiaries of Moody's Corporation ("**MCO**"). One of these subsidiaries, Moody's Canada Inc. ("**MIS Canada**"), has its headquarters in Toronto, Ontario. Canadian issuers that seek credit ratings from MIS typically sign rating applications with MIS Canada. MIS credit ratings for Canadian issuers, however, generally are not produced exclusively in Canada. While the lead analyst for a Canadian issuer is often based in Canada (and employed by MIS Canada), MIS's credit ratings are determined collectively by rating committees whose members may be based in different MIS offices around the world. Moreover, Canadian investors may invest in securities of non-Canadian issuers that have signed rating applications with other MIS entities. These investors likely would want the MIS ratings on those securities to be treated as "DRO credit ratings" under Canadian securities legislation.

MIS believes, therefore, that DRO status should attach to credit ratings assigned by any entity that the DRO elects to list as a "rating affiliate" in the CRA's filings with Canadian securities regulators. It would not be necessary or efficient, however, for all of these rating affiliates to be subject to the Canadian securities regulatory framework. We note that most of the entities that MIS would expect to designate as rating affiliates under the Canadian regulatory framework are, or are expected to become, subject to regulatory oversight in other jurisdictions. Canadian securities regulators would be able to work cooperatively with their counterparts in other jurisdictions if an issue arose with respect to a rating affiliate's activities that had some connection to Canadian securities markets. Accordingly, we recommend that proposed NI 25-101 be modified to provide that an applicant for DRO status may specify: (i) which entity or entities it is applying to register as DROs in Canada (and subject to the Canadian regulatory framework); and (ii) which entity or entities it wishes to have treated as "rating affiliates", whose ratings will be considered to be DRO ratings for purposes of Canadian securities legislation.

We support the CSA's proposal to permit an Nationally Recognized Statistical Rating Organizations ("**NRSRO**") to file its most recent Form NRSRO in lieu of Form 25-101F1 as part of its application to become a DRO and thereafter on an annual basis in satisfaction of its annual filing requirements under Section 13 of proposed NI 25-101. Offering this option could help reduce the regulatory burden for CRAs that are NRSROs and might encourage more NRSROs to seek DRO status in Canada. We recommend, however, that NI 25-101 be amended to provide that an NRSRO that files its Form NRSRO with Canadian securities regulators is permitted to specify, perhaps in a cover page attached to its filing:

- which entity or entities it is seeking to have designated as a DRO in Canada (if the filing is in connection with its application for DRO status);
- which entity or entities are designated as DROs in Canada (if it is complying with its annual reporting obligation); and
- in either case, which entity or entities it is electing to treat as "rating affiliates", whose ratings will be considered to be DRO ratings for Canadian securities regulatory purposes.

II. GLOBALLY CONSISTENT SUPERVISORY FRAMEWORK FOR CRAS IS ESSENTIAL

A. MIS Supports the CSA's Proposal to Base Its Regulatory Framework on a Requirement to "Comply or Explain" with the IOSCO Code

As discussed in our February 2009 comment letter regarding a potential regulatory framework for CRAs in Canada,[2] MIS supports and is committed to the success of the international regulatory architecture embodied in the IOSCO Principles and IOSCO Code. As you know, members of the G-20, including Canada, agreed in 2009 that any regulatory framework for CRAs that they introduced in their countries would be aligned with the IOSCO Code.[3] Consequently, we view it as a positive development that the CSA is proposing to base the Canadian regulatory framework for DROs primarily upon an obligation to "comply or explain" with the IOSCO Code.[4]

As we stated in our earlier submission, we believe that this flexible, principles-based regime enables all CRAs, regardless of size or business model, to adhere to the Canadian regime. This regulatory approach also can make it easier for CRAs that operate in multiple countries to implement globally consistent structures, policies and procedures for their rating operations. This in turn helps CRAs produce ratings that are comparable across jurisdictions, industries and asset classes. This global comparability in ratings is one of the key attributes of credit ratings, helping to make them an easily understood point of reference and, in effect, a common language for market participants to communicate with each other about credit. This common language of credit facilitates the efficient flow of capital worldwide.

B. Protecting the Independence of CRAs' Opinions and Methodologies is a Core IOSCO Principle

The IOSCO Principles state that "in offering informed, independent analyses and opinions" (emphasis added), CRAs contribute to achieving the core objectives of securities regulation, which are "protecting investors, ensuring that securities markets are fair, efficient and transparent, and reducing systemic risk." Stressing the importance of independence in the rating process, the IOSCO Principles provide in part that "CRA ratings decisions should be independent and free from political and economic pressures". The independence of CRA opinions is also highly valued by market participants.

Given the importance that authorities and market participants attach to independence in the rating process, MIS believes it is critical that the CSA adopt Section 2 of proposed NI 25-101, which states that "Nothing in this Instrument is to be interpreted as regulating the content of a credit rating or the methodology a credit rating organization uses to determine a credit rating." We believe that this provision goes a long way toward addressing the concern we previously had raised that the Canadian securities regulators' proposed enforcement powers could be used to regulate the substance of credit ratings or rating methodologies.[5]

Our concerns, however, have not been fully resolved. The CSA has indicated in Part 4 of the Proposed Materials that "changes to local securities regulation may include … confirmation that the securities regulatory authorities may not direct or regulate the content of credit ratings or methodologies used to determine ratings" (emphasis added). Similarly, Annex A of the Proposed Materials states that "securities regulatory authorities

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[2] See *Comment Letter re Response to CSA Consultation Paper 11-405 – Securities Regulatory Proposals Stemming from 2007-2008 Market Turmoil and Its Effect on the ABCP Market in Canada* (February 17, 2009).

[3] See G-20, *Declaration on Strengthening the Financial System* (at 6), April 2, 2009, available at http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf.

[4] See Part 3 of proposed NI 25-101.

[5] *Ibid.*, footnote 2 at 5-6.

will, in most cases, be prohibited from directing or regulating the content of credit ratings or the methodologies" (emphasis added). These statements suggest that, in some Canadian provinces or territories, legislation providing a framework for regulation of CRAs might not preclude regulators in those jurisdictions from exercising their powers in a way that could intrude upon the substance of rating opinions or methodologies.

We believe that such a result would be inconsistent with the IOSCO Principle that emphasizes the importance of CRAs' independence. We also note that, if the regulatory framework for CRAs adopted in Canada does not clearly protect the independence of CRAs, there is a risk that European authorities will decline to find that the Canadian regime is "equivalent" for purposes of the European Regulation on Credit Rating Agencies.[6] A finding that the Canadian regime is not equivalent could mean that credit ratings developed by a DRO in Canada, *e.g.*, for Canadian issuers, would not be eligible for endorsement by the Canadian DRO's European affiliates. This in turn could mean that those ratings might be ineligible for use in Europe.

For these reasons, we recommend that the CSA retain Section 2 of proposed NI 25-101. In addition, while we recognize that the CSA is not in a position to direct the content of legislation in Canada, CSA members may be in a position to provide technical advice to the relevant policymakers about the importance of having legislation that protects the independence of CRAs.

C. DROs Should Be Permitted to Waive Provisions in Their Codes If It Is Not Unreasonable to Do So

We agree with the CSA that a DRO's code of conduct should reflect expected conduct within the organization. We believe, however, that, as drafted, the prohibition in Section 7 of proposed NI 25-101 on DROs waiving provisions in their codes of conduct is too restrictive.

In our view, proposed Section 7 does not reflect the reality that there may be limited circumstances where a CRA concludes that it is reasonable to waive compliance with one or more provisions in its code of conduct, for example so that it can achieve another objective specified in the IOSCO Code or the CRA's code or comply with local laws. For example, consistent with the IOSCO Code, provision 1.9 of the MIS Code of Professional Conduct ("**MIS Code**") states that MIS will organize its rating committees to promote continuity and avoid bias in the rating process. Provision 1.11 of the MIS Code states that, where practicable, MIS will use separate analytical teams, each with the requisite level of experience and resources, to assign credit ratings and for subsequent monitoring of structured finance instruments. A situation could arise where, in order to constitute a rating committee whose members have sufficient experience to consider changing a structured finance rating and who were not involved in determining the initial rating, it is appropriate to invite only people who had not previously participated in a rating committee relating to the structured finance instrument in question. In such circumstances, MIS might conclude that it is appropriate to waive the requirement for "continuity" in the rating process in order to achieve the objectives specified in provision 1.9 of the MIS Code. This example illustrates that that, sometimes, a CRA must waive compliance with all or part of one or more provisions in its code of conduct in order to achieve another objective reflected in the IOSCO Code that, in the circumstances, is more important.

Moreover, certain provisions in the IOSCO Code contain internally competing objectives. For example, taking the objective of "promoting continuity in the rating process" to an extreme could mean that rating committees for a particular issuer or obligation always would contain the same individuals. However, provision 1.9 of the MIS Code, which is consistent with the comparable provision in the IOSCO Code, also calls for MIS to organize its rating committees to avoid bias. MIS believes that it is beneficial for there to be some

[6] See provisions 17-18 of Regulation (EC) No 1060/2009 of the European Parliament and the Council of 16 September 2009 on Credit Rating Agencies ("**EU Regulation**").

change over time in the composition of rating committees. A strict interpretation of the "no waiver" rule in proposed NI 25-101, however, might lead a DRO to conclude that it could not strike a balance between the two objectives in provision 1.9 without risking a finding that it had breached Section 7 of NI 25-101.

As noted above, CRAs also sometimes have to balance the requirements of local laws with provisions in their codes of conduct. For example, provision 3.20 of the MIS Code states that MIS employees will not disclose any non-public information about credit ratings or possible future credit rating actions, except to the issuer or its designated agents. In Argentina, however, a representative of the Comisión Nacional de Valores is authorized to attend (and frequently does attend) rating committee meetings in the capacity of an observer. In such circumstances, MIS, in effect, waives strict compliance with provision 3.20 of the MIS Code so that it can comply with applicable local laws and provision 1.13 of the MIS Code (which states that MIS and its employees will comply with local laws).

For the reasons discussed above, if Section 7 of proposed NI 25-101 is adopted in its current form, MIS might not be able to adopt and adhere to a globally applicable code of conduct. MIS seeks to implement globally applicable policies and procedures wherever feasible because this facilitates a globally consistent approach to our credit analysis of issuers, which helps achieve ratings comparability across jurisdictions, sectors and asset classes. This is becoming more difficult, however, because MIS and a number of other CRAs are operating in a global regulatory environment that is becoming increasingly fragmented as various countries introduce regulatory frameworks that vary in their details. While, to date, there have been few operational conflicts between regimes (*i.e.*, situations where one country prohibits what another country requires), we believe that such conflicts are increasingly likely.

Even where there is no direct conflict between the rules and regulations of two jurisdictions, Section 7 could have the effect of allowing one jurisdiction to set regulatory standards for all others. For example, a CRA may operate in a jurisdiction that requires the CRA to include in its code of conduct a number of provisions in addition to those specified in the IOSCO Code. If the CRA incorporates those provisions into its global code of conduct, then Section 7 of NI 25-101 will have the effect of rendering those provisions binding at all times upon the CRA in all jurisdictions where it operates.

In the alternative, CRAs could adopt and implement unique codes of conduct for each jurisdiction in which it operates. MIS, for example, currently maintains a presence in 26 countries and could generate 26 separate codes of conduct. In the process, MIS would expend significant time and expense while also further exacerbating the global fragmentation of standards for CRAs and perhaps jeopardizing its ability to produce globally comparable ratings. MIS believes that this approach would be inconsistent with efforts by G-20 members and IOSCO to have CRAs operate in accordance with a globally harmonized framework of standards.

While MIS is concerned about the rigidity that proposed Section 7 would introduce into CRAs' operating environments, we are not opposed to the concept of the CSA restricting to some extent DROs' ability to waive adherence to provisions in their codes of conduct. We believe our concerns could be addressed by a simple amendment to proposed Section 7 so that it states that "A DRO shall not <u>unreasonably</u> waive compliance with provisions in its code of conduct". As part of the supervisory process, CSA members would be in a position to assess how DROs adhered to their codes of conduct in Canada and ask for information as to the reasons why waivers, if any were, granted.

We also recommend that DROs not be required to include a statement about waivers in their codes of conduct because this would add a requirement that is not specified in the IOSCO Code. As we commented earlier, MIS is concerned about the increasing fragmentation of the regulatory framework for CRAs. There are a number of instances in which national regulators are requiring CRAs to add provisions to their codes of

conduct that are not called for in the IOSCO Code. We believe it would be helpful if the CSA could set an example for other regulators and refrain from requiring DROs to include provisions in their codes of conduct that are not called for in the IOSCO Code. Moreover, the CSA's regulatory objectives can be achieved without requiring DROs to include a statement about waivers in their codes of conduct because Section 7 of proposed NI 25-101 will directly restrict their ability to waive provisions of their codes.

D. Technical Comments on Part 3 of NI 25-101

1. DRO Cannot "Ensure" Compliance

Section 5 of proposed NI 25-101 would require a DRO to establish, maintain and ensure compliance with a code of conduct. We agree that a DRO should establish and maintain a code of conduct designed to achieve the objectives of the IOSCO Code. A regulated entity, however, cannot guarantee 100% adherence with its code of conduct. This is particularly the case for a code that, as is required by the IOSCO Code, incorporates subjective standards.[7] We believe that a more appropriate requirement would be for Section 5 of proposed NI 25-101 to specify that a DRO shall "establish and maintain policies and procedures reasonably designed to achieve compliance with a code of conduct." This language is consistent with Section 9 of proposed NI 25-101 concerning the management of conflicts of interest.

2. Explanation of Deviations from Code Does Not Belong in the Code Itself

If Section 5 of proposed NI 25-101 is adopted as drafted, a DRO would have to explain <u>in its code of conduct</u> any deviations from the IOSCO Code and why its code nevertheless achieves the objectives of the IOSCO Code. The IOSCO Code itself, however, calls for this type of disclosure to be set out in the CRA's annual report on implementation of the IOSCO Code. We agree with IOSCO that the more appropriate place for such disclosures is the CRA's annual report, rather than in the code itself. Moreover, we note that Section 5 of proposed NI 25-101 will require every DRO to adopt a code of conduct that either complies with each provision in the IOSCO Code, including the provision on publishing an annual report on implementation of the IOSCO Code, or to explain any deviations. If a DRO chooses not to include a provision in its code of conduct requiring such an annual report, Canadian securities regulators could order a DRO to do so. Therefore, we recommend that Subsection 5(3) of proposed NI 25-101 be amended to provide that prescribed disclosures regarding the CRA's deviations from the IOSCO Code shall be included either in the CRA's code of conduct or in the annual report called for in the IOSCO Code.

III. Compliance Officer's Obligations

MIS does not object in principle to Section 11 of proposed NI 25-101, which requires a DRO to have a compliance officer, requires that he or she perform certain monitoring and assessment functions, and requires that he or she report certain instances of non-compliance with securities legislation[8] and the DRO's code of conduct to the DRO's board of directors. We believe, however, that these proposed responsibilities for the DRO are over-broad in certain respects, as we discuss in more detail below.

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[7] For example, provision 1.4 of the revised IOSCO Code states that "ratings should reflect all information known, and <u>believed to be relevant</u>, to the CRA" (emphasis added).

[8] We understand that the term "securities legislation" has the meaning given to it in Section 1.1 of National Instrument 14-101 and encompasses the Securities Act and related regulations and rules in force in the relevant province or territory in Canada.

A. Compliance Officer's Monitoring, Assessment and Reporting Functions Should Extend Only to Securities Legislation Applicable to the DRO's Activities as a CRA

Proposed Section 11, if adopted, would require the DRO's compliance officer to monitor and assess compliance by the DRO and individuals acting on its behalf with the DRO's code of conduct and securities legislation. He or she also would have to report certain instances of non-compliance by the DRO or individuals acting on its behalf with the DRO's code of conduct or securities legislation.

The role of DROs under Canadian securities legislation is very limited. A DRO will not act as an issuer, underwriter, adviser or investor. As drafted, however, Section 11 will require the DRO's compliance officer to monitor and assess compliance with aspects of Canadian securities legislation that do not apply specifically to CRA activities. This means that he or she will have to:

- establish, maintain, review and modify as necessary policies and procedures designed to define and prohibit a DRO and persons acting on its behalf from engaging in activities that have nothing to do with its business as a DRO and that it is not even authorized to pursue;
- monitor and assess the effectiveness of such policies and procedures at deterring the DRO and persons acting on its behalf from engaging in these prohibited activities (which have nothing to do with its business as a DRO); and
- report to the DRO's board on instances of non-compliance with policies having nothing to do with the DRO's business.

We believe that imposing such obligations on the compliance officer would not appreciably advance the regulatory objectives of investor protection or promotion of fair and efficient capital markets. Consequently, we believe that the business costs associated with imposing such requirements would be disproportionate to the significance of the regulatory objectives sought to be achieved. Accordingly, we recommend that the CSA amend Section 11 of proposed NI 25-101 to clarify the DRO compliance officer's obligations to monitor and assess compliance, and report on non-compliance, extend only to the DRO's code of conduct and to the provisions in Canadian securities legislation that apply to the DRO's activities as a CRA.

B. Compliance Officer's Monitoring, Assessment and Reporting Functions Should Extend Only to the DRO and Its Employees

If Section 11 of proposed NI 25-101 is adopted in its current form, the monitoring, assessment and reporting functions of the DRO's compliance officer might be interpreted as extending to non-employees who are not affiliated with the DRO but may nevertheless act on the DRO's behalf in certain matters. For example, Section 11 could be interpreted as extending to the lawyers, accountants, consultants, technology services providers, real estate brokers and financial advisers who act on the DRO's behalf from time to time. Such individuals might engage in activities to which securities legislation applies but that have nothing to do with their conduct on behalf of the DRO. Requiring the DRO to monitor and assess compliance by such individuals with the DRO's code and securities legislation would be inappropriate because the compliance officer would not be able to exert control over the full range of such individuals' activities to which securities legislation might apply.

Moreover, if Section 11 is adopted as proposed, it is foreseeable that the DRO's compliance officer might have to disclose confidential information (*e.g.*, lists of rating engagements) to such individuals in order to obtain the relevant information from them so that he or she can monitor their compliance with the DRO's code of conduct or with securities legislation. It would be inappropriate (and possibly illegal in some circumstances) to disclose this information to persons outside the DRO.

We also believe it is unnecessary to extend the compliance officer's monitoring and assessment obligations beyond the DRO and its employees because the IOSCO Code and NI 25-101 require the DRO to implement, and the DRO and its employees to comply with, measures reasonably designed to prevent various types of inappropriate or illegal conduct that might involve third parties. For example, the IOSCO Code provides that:

- CRAs should use confidential information only for purposes related to their credit rating business;
- CRA employees should take all reasonable measures to protect all property and records belonging to or in possession of the CRA from fraud, theft or misuse;
- CRA employees should not disclose any confidential information about credit ratings or possible future credit rating actions, except to the issuer or its designated agents; and
- CRAs should identify and either eliminate or manage and disclose actual or potential conflicts of interest.

Likewise, if adopted as proposed, Section 10 of NI 25-101 will require the DRO to have policies and procedures reasonably designed to prevent the inappropriate dissemination within or outside the DRO of material, non-public information and pending rating actions. The compliance officer's monitoring and assessment of compliance by the DRO and its employees with provisions like these in proposed NI 25-101 as well as the relevant provisions of the IOSCO Code, will help reduce the risk that third parties who act on the DRO's behalf will be in a position to act in a manner that compromises the integrity of Canadian capital markets as a result of their relationship with the DRO. Accordingly, we recommend that Subsection 11(1) of proposed NI 25-101 be amended as follows:

> "A designated rating organization must have a compliance officer that monitors and assesses compliance by the designated rating organization and its employees~~, and~~ ~~individuals acting on its behalf~~ with the organization's code of conduct and with the provisions in securities legislation applicable to the activities of designated rating organizations as credit rating organizations."

C. Compliance Officer's Duty to Report Non-Compliance Should Be Refined

We are not opposed to a requirement specifying that, in certain circumstances, the DRO's compliance officer must report to the DRO's board of directors instances of non-compliance with the DRO's code of conduct or provisions in securities legislation applicable to the DRO's activities as a CRA. We believe, however, that the reporting obligation in proposed Subsection 11(2) of NI 25-101 should be revised as follows.

First, an obligation to report possible instances of non-compliance "as soon as possible" might be counter-productive. This standard of urgency might not permit the compliance officer to gather and fully assess the circumstances surrounding the potential instance of non-compliance, the potential significance of that non-compliance, and the appropriate remedies to address the non-compliance. Moreover, as a practical matter, an "as soon as possible" standard could require the compliance officer to convene meetings of the DRO's board with little or no notice and at days and times that could make it difficult for the board members to organize their schedules to participate effectively in the meeting. We would not object, however, to a requirement that the compliance officer report to the DRO board on a timely basis after he or she has had an opportunity to assess the relevant information regarding the non-compliance or potential non-compliance and reach a conclusion about the significance of the incident or incidents.

Of course, there may be times when, due to the nature or breadth of the non-compliance or potential non-compliance, the compliance officer may determine to report to the DRO board on an *ad hoc*, "as soon as

possible" basis. The decision to do so before the compliance officer has fully investigated the incident should be left to his or her professional judgment.

Second, MIS believes it is inappropriate to require a DRO's compliance officer to consider whether or not the non-compliance (or possible non-compliance) creates a risk of harm to the DRO's "client" or to the "client's investors". It is unclear what the CSA means by the term "client" but we imagine that this term might be intended to refer to the entities or persons who pay DROs for credit ratings. In the rating process, MIS maintains independence in its relationships with issuers, investors and other persons who use ratings and accordingly, we have no "clients" as such. Users of credit ratings and authorities value the independence of CRA opinions and accordingly, labelling the persons who pay for credit ratings as DROs' "clients" inaccurately fosters the impression that DROs owe duties of loyalty to the persons who pay for ratings. Consequently, we recommend that paragraph (a) of Subsection 11(2) be struck out altogether.

Third, we believe that the test in paragraph (b) of Subsection 11(2) of NI 25-101 (*i.e.*, that the compliance officer report non-compliance where it creates, in the opinion of a reasonable person, "a risk of harm to the capital markets") is too vague and therefore would be difficult for a DRO to implement unless the CSA provides guidance. We also believe that "a risk of harm" is too low a threshold for reporting purposes. We believe a more appropriate test would be "a material risk of harm".

Fourth, as discussed in parts III(A) and (B) above, we believe that the compliance officer's monitoring, assessment and reporting functions should extend only to the DRO and its employees in respect of the DRO's code of conduct and provisions in securities legislation specifically applicable the DRO's activities as a CRO.

In light of these comments, we recommend that Subsection 11(2) of NI 25-101 be revised as follows:

> "~~The compliance officer must report to the board of directors of the designated rating organization (or the equivalent) as soon as possible if~~ If the compliance officer of a designated rating organization becomes aware of any circumstances indicating that the designated rating organization, or any ~~individual acting on its behalf~~ employee of the designated rating organization, may be in non-compliance with the organization's code of conduct or provisions in securities legislation applicable to the activities of designated rating organizations as credit rating organizations and:
>
> ~~(a) the non-compliance creates, in the opinion of a reasonable person, a risk of harm to the client or the client's investors,~~
>
> (b) the non-compliance creates, in the opinion of a reasonable person, a material risk of harm to ~~the~~ Canadian capital markets, or
>
> (c) the non-compliance is part of a pattern of non-compliance,
>
> the compliance officer must report to the board of directors of the designated rating organization (or equivalent) on a timely basis after he or she has had a reasonable opportunity to assess the relevant information and reach a conclusion about the significance of the non-compliance."

IV. Prohibited Conflicts of Interest

Section 8 of Proposed NI 25-101 states that a DRO must not issue or maintain a credit rating if one of the conflicts of interest listed in Subsections 8(a)-(f) exists. MIS agrees with the CSA that these conflicts of interest should be prohibited. We also believe that if one of the prohibited conflicts arises, the appropriate solution often will be for the DRO to refrain from assigning a rating (or to withdraw an existing rating).

There may be circumstances, however, where it is possible for the DRO to address the situation in a way that eliminates the conflict or otherwise prevents the conflict from affecting the integrity of the rating process. For example, MIS has policies that prohibit an analyst who participates in determining a credit rating from negotiating, discussing or arranging the fee paid for that rating. Among other things, a separate department within MIS handles all matters relating to rating fees and MIS informs issuers that analysts cannot participate in discussions about fees and that issuers should not disclose information about fees to analysts. It is conceivable, however, that an issuer could attempt to engage an analyst in a discussion or communication about fees. If Section 8 is adopted as proposed, MIS might conclude that the communications in question would require MIS to refrain from assigning a credit rating that was in the process of being developed with that analyst's input or would require MIS to withdraw an existing rating that the analyst in question had participated in monitoring or determining. Absent the strict prohibition in Section 8, however, MIS might conclude that it could resolve the conflict and preserve the integrity of the rating process without having to refrain from assigning the rating (or withdrawing an existing rating). For example, MIS might conclude that, provided that the analyst had not communicated any information about the fee to other persons involved in determining or monitoring the rating, it could reassign the analyst so that he or she did not participate for a specified period of time in determining or monitoring the rating in question.

Declining to assign a rating that an issuer has requested or withdrawing an existing rating can have adverse consequences for issuers and investors. For example, the timetable for a proposed offering of securities could be disrupted, causing an issuer to lose an opportunity to raise funds at an attractive price. Withdrawal of a rating could affect institutional investors' ability to hold a previously rated security or result in a breach of covenants in an issuer's contracts. While MIS believes that the paramount concern for a DRO should be maintaining the integrity of the rating process, if it is possible for the DRO to achieve this outcome without declining to assign a rating (or without having to withdraw a rating), then we believe the DRO should be permitted to do so. Of course, as noted above, if the DRO believes that a breach of Section 8 cannot be addressed in a manner that preserves the integrity of the rating process, then the DRO would be expected to decline to assign the rating or to withdraw an existing rating.

Moreover, permitting a DRO to assign or maintain a rating where the integrity of the rating process is preserved does not mean that there would be no consequences for a DRO where the conflict of interest arises due to faulty conduct on its part. A breach of Section 8 may nevertheless provide a basis for supervisory action to be taken or for sanctions to be imposed if such a result is warranted in the circumstances.

Accordingly, MIS recommends that Section 8 be amended so that the introductory clause states that "A designated rating organization is prohibited from having the following conflicts of interest with respect to the issuance or maintenance of credit ratings". This language is consistent with comparable provisions in applicable U.S. securities laws. The CSA also might wish to consider stating in Companion Policy 25-101CP that a DRO would not be expected to refrain from assigning or maintaining a credit rating in a situation where one of the prohibited conflicts had arisen if the DRO took all appropriate measures to eliminate the conflict or otherwise prevent the conflict from affecting the integrity of the rating process for the relevant ratings.

V. Proposed Ratings Disclosure Requirements for Issuers

In Annexes E-G of the Proposed Materials, the CSA has indicated that it intends to retain modified versions of existing ratings disclosure requirements for issuers that make distributions of securities or that are reporting issuers (the "**Disclosure Proposals**"). Historically, MIS has supported discontinuing or limiting the use of credit ratings in regulation, including mandatory ratings disclosure requirements for issuers, because we

believe that such requirements can contribute to over-reliance on ratings.[9] Consequently, we are concerned that the Disclosure Proposals could perpetuate and exacerbate incentives for market participants to over-rely on ratings. Moreover, the proposal to require issuers to disclose information about rating fees could jeopardize the independence of the rating process. We discuss these concerns in more detail below.

A. Limited Role of Ratings in Financial Markets

CRAs occupy a narrow niche in the information industry. We provide forward-looking opinions and research about credit risk for use by institutional, not retail, investors. Our ratings provide a point of reference that is easily understood by these market professionals. We intend for our ratings to promote dialogue and debate among these market professionals, who we expect to assess our opinions relative to their own credit judgments. Our opinions supplement, rather than replace, market participants' own credit analysis.

The fact that an issuer obtains a credit rating or discloses it in the context of an offering does not mean that the rating, standing alone, is material to an investment decision. A distinction should be drawn between risk factors (*e.g.*, credit risk), which should be disclosed by the issuer if material, and market commentators' opinions about that risk (*i.e.*, credit ratings). A rating may convey (in the investor's opinion) useful information, just as an equity analyst's report or a newspaper article about the issuer might, but this does not mean that the issuer should have to disclose such third party commentary in the prospectus.

B. Minimizing Ratings Disclosure Requirements Will De-emphasize Ratings

In the current environment, regulators have leveraged the market's use of ratings, for example by adopting ratings-based criteria in regulation and/or requiring issuers to disclose ratings. In our view, regulatory use of ratings weakens incentives for investors to conduct their own credit analysis and use ratings as just one of several inputs in their decision-making process.

The Financial Stability Board ("**FSB**") recently endorsed principles to reduce reliance on credit ratings.[10] Among other things, the principles call upon authorities to review whether ratings disclosure requirements provide unintended incentives for investors to rely excessively on ratings and, if appropriate, to remove or amend these requirements. MIS believes that the proposed Disclosure Proposals are inconsistent with these principles and authorities' efforts to reduce the risk of over-reliance on ratings. We also believe that requiring issuers to disclose ratings draws attention away from other, generally more important information. We are especially concerned that mandatory disclosure requirements may encourage many retail investors, who often are less sophisticated than institutional investors, to erroneously view the credit rating as their "one-stop shop" for information that is material to their investment decision. Disclosures by the issuer about the limitations of credit ratings are unlikely to discourage investors from over-emphasizing them.

We realize that it might seem counter-intuitive to advocate against mandatory disclosure of credit ratings, which some market participants find useful. Some people might argue that the fairness and efficiency of capital markets depend on transparency, and therefore more disclosure is always better. MIS supports efforts to provide investors with the full spectrum of information that investors might consider useful to their investment decision. These efforts include enhanced disclosure requirements in the structured finance market,

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[9] Recent MIS publications include the following, all of which are available on moodys.com: *Comment Letter re Joint Notice of Proposed Rulemaking on Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies* (Oct. 25, 2010); *Comment Letter re Proposed Amendments to Regulation AB* (Aug. 31, 2010); *Moody's Investors Service Comment Letter re Credit Ratings Disclosure* (Dec. 14, 2009); and *Comment Letter re References to Ratings of Nationally Recognized Statistical Rating Organizations* (Sept. 5, 2008).

[10] See FSB, Principle III.5.a in *Principles for Reducing Reliance on CRA Ratings* (October, 2010), available at www.financialstabilityboard.org/publications/r_101027.pdf

the continued dissemination of credit rating information through the internet, implementation by CRAs of the IOSCO Code's transparency recommendations, and disclosure by issuers of any known trends, demands, commitments, events or uncertainties that may affect their liquidity or results of operations.

Our objection, therefore, is not with disclosure of ratings *per se*. Our objection is to mandated disclosure of ratings by issuers, because such a disclosure requirement may cause investors to mistakenly perceive credit ratings as "material information". Moreover, while technically the Disclosure Proposals regulate issuers' conduct, in effect the CSA is prohibiting investors from purchasing rated securities unless the rating is disclosed in the prospectus. In our view, such a prohibition disempowers investors and creates incentives for them to over-rely on ratings. Given that credit ratings are widely and publicly available, we believe that the adverse consequences of mandating disclosure of ratings by issuers outweigh the potential advantages.

Consequently, we recommend that the CSA repeal all requirements for issuers and other non-CRA market participants to disclose ratings. We would not object, however, to a rule stating that, if an issuer elects to disclose a credit rating in a prospectus or continuous disclosure document, then the issuer also should disclose:

- the name of the CRA that assigned the rating and whether or not it is a DRO;
- the credit rating assigned;
- the identity of the person paying for the rating;
- the proportion of the aggregate fees received by the CRA and/or its rating affiliates from the issuer and/or its affiliates that constitute fees for non-rating services;[11]
- the website address where an interested person can obtain a description of the CRA's rating system, the credit rating and any available ratings history for the rating; and
- a statement that the rating is not a recommendation to buy, sell or hold securities and may be subject to revision at any time by the CRA.

We believe that issuers should not make the disclosures called for by paragraphs (c), (d), (e) and (f) of Subsection 7.9(1) of Form 44-101F1 (or similar requirements in other instruments) because of the risk that the information could be presented inaccurately or out of context. Among other things, such disclosures could require issuers to have an in-depth knowledge of the credit rating system of each CRA whose rating they use and/or create explanatory narratives for opinions that are not their own. Moreover, requiring the issuer to include such information in its documents could create the mistaken impression that CRAs are participants in the offering, rather than independent commentators.

C. Fee Disclosure Proposals Would Undermine Firewalls Designed to Promote Analytical Independence

Securities regulators have emphasized the importance of insulating rating analysts and rating committees from commercial influences. Therefore, consistent with the IOSCO Code, U.S. laws and Subsection 8(e) of proposed NI 25-101, MIS prohibits anyone who participates in determining or monitoring credit ratings, or developing or approving rating methodologies, from participating in discussions regarding the fees paid for that rating. In fact, MIS has established a separate team within MIS to handle discussions about fees and payment of fees for rating services, while Moody's Analytics ("**MA**")[12] sells MIS's credit ratings and

[11] See our discussion in Part V(C) below with respect to disclosure about rating fees.

[12] MCO owns two legally and operationally separate subsidiaries, MIS and MA. MIS is the CRA. MA brings together all of MCO's other commercial activities.

research to subscribers. These arrangements reflect our commitment to analytical independence. We have devoted significant time and resources to strengthening and maintaining these firewalls.

Our efforts to achieve and sustain analytical independence will be undermined, however, if the CSA requires issuers to disclose information related to fees paid for rating services and non-rating services in disclosure documents such as prospectuses and annual information forms ("**AIFs**"). If the Disclosure Proposals about rating fees are adopted, our analysts and rating committees will be exposed to more commercial information about rated issuers than we believe would be appropriate in light of our efforts to separate rating activities from commercial considerations. This exposure would undermine our efforts and those of regulators globally to shield analysts from such information in order to promote independence in the credit rating process.

As an alternative, the CSA could require issuers to disclose the proportion of the aggregate fees received by a CRA and its rating affiliates[13] from the issuer and its affiliates that constitute fees for non-rating services. This information could help potential investors determine whether a CRA might be facing a potential conflict of interest because it, or its rating affiliates, receive a significant proportion of their fees for non-ratings services. Disclosure of this information would not undermine MIS's existing firewalls.

VI. Safe Harbour from "Expert Liability" Should Be Retained

Currently, Canadian securities legislation exempts an issuer that refers to a credit rating in a prospectus from the obligation to obtain and file with securities regulators the CRA's consent to such reference (the "**Exemption**").[14] Because of the Exemption, "approved rating organizations",[15] which provide ratings that issuers must disclose in prospectuses and AIFs, are not subject to "expert liability".

MIS believes that this Exemption and the resulting safe harbour from expert liability for DROs should be retained and extended to other CRAs. As discussed in more detail below, expert liability is inconsistent with the nature of credit ratings, which are forward-looking, probabilistic opinions determined in accordance with independently developed methodologies rather than industry standards. The Exemption and safe harbour allow CRAs to focus on providing diverse, nuanced and precise credit rating opinions for the use of investors. The Exemption and safe harbour also enable CRAs to strive for credit rating opinions that are stable and focused on long-term horizons as opposed to rating opinions that are micromanaged in response to momentary market disruptions. The safe harbour and Exemption also have lowered the cost of capital market transactions, facilitated efficient allocation of capital, and permitted broad rating coverage of issuers. In our view, eliminating the Exemption and safe harbour would reverse or dilute many of these positive developments. We have set out our reasoning in more detail below.

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[13] We recommend that the disclosures relate only to the proportion of fees received by the DRO and its rating affiliates in respect of non-rating services for the following reason. Some CRAs are part of corporate groups that include non-CRA entities that may provide a range of non-rating services and products to issuers and their affiliates in the ordinary course of business. For example, the three largest CRAs, including MIS, are affiliated with non-CRA entities that publish and distribute a wide variety of materials, ranging from materials that focus specifically on credit markets, to general interest newspapers and magazines, to school textbooks and *Seventeen* magazine. While it is unlikely that an issuer will be purchasing school textbooks or *Seventeen* magazine, requiring it to collect information about the proportion of fees paid for non-rating services that non-rating affiliates of the CRA provide to the issuer and its affiliates seems unnecessary, overly burdensome and irrelevant to the investment decision-making process.

[14] See, *e.g.*, Subsection 10.1(4) of *National Instrument 41-101 – General Prospectus Requirements*.

[15] Currently, Canadian securities legislation uses the term "approved rating organization". If the Proposed Materials are adopted, the term "approved rating organization" will be replaced with "designated rating organization" (or DRO). To simplify the discussion in this part of our comment letter, we will use the term DRO to refer both to approved rating organizations and DROs.

A. Expert Liability Is Inconsistent with the Nature of Credit Ratings

1. What Is a Credit Rating?

A credit rating is a current opinion of relative future credit risk. It is not a statement of fact – or even a prediction of fact. It cannot be proved as "right" or "wrong" when it is made. Only unknown future events can determine the opinion's predictive value. To illustrate this point, an analogy can be drawn between credit ratings and economists' recession forecasts. When economists make these predictions, the future must occur before it can be determined if the economist's forecast is accurate.

There is no exact science for credit ratings. If the future could be predicted with precision, CRAs would issue only two ratings: "will default" or "won't default". Instead, credit ratings are expressed on a nuanced rating scale. MIS's rating scale, for example, consists of 21 points, along with modifiers for reviews and outlooks.

Importantly, credit ratings are probabilistic, reflecting only the relative likelihood of default and loss in the event of default, not a guarantee of future performance. This means that, by definition, CRAs are predicting that a certain percentage of securities within each rating category – even in the highest rating categories – is expected to default. CRAs, however, do not predict which specific bonds within a category are expected to default. Rather, credit ratings communicate that the higher the rating category, the lower the expected frequency of default.

Nor can credit ratings be proved "correct" or "incorrect" simply by the occurrence or non-occurrence of the event upon which the rating opines. Subsequent default on a bond that was rated Aaa upon issuance does not "prove" that the original rating was wrong, any more than punctual payment of a bond initially rated Caa proves that the rating was flawed. After the fact, the historical usefulness of a rating *system* (as opposed to any individual rating opinion) can be measured by the degree to which ratings were correlated with actual default experience over time.

2. How Credit Ratings Differ from Other Opinions

Credit ratings are very different from the "expert" opinions that are typically subject to "expert liability". These fundamental differences relate to the very core of credit ratings and their unique role in the market. Because these differences are so fundamental, credit rating opinions are not suitable for parallel regulatory treatment and statutory liability.

First, credit ratings certify nothing the issuer discloses, nor do they validate the reasonableness of any estimates made by the issuer, unlike the reports or opinions provided by all other experts subject to expert liability under Canadian securities legislation. Instead, CRAs evaluate at arm's length the information provided by the issuer and others. It is this arm's length relationship between the CRA and the issuer that lends credibility to the credit rating itself.

Second, a credit rating is inherently and completely forward-looking, rather than backward-looking. For instance, auditors, engineers and lawyers look backwards, or at present facts, in order to certify the issuer's disclosures. By contrast, credit ratings are predictive opinions that apply well into the future, over the life of the debt.

To further illustrate this point, we note that while financial auditors conduct a largely backward-looking review in which they test and verify historical data, CRAs issue predictive opinions about inherently uncertain future outcomes – namely the relative probability of default and amount of loss, given default. Credit ratings would behave like audit opinions only if CRAs limited the nature of ratings to be simply current, point-in-time views of solvency. We do not believe that the CSA or market participants want CRA opinions to

be so limited. Similarly, when lawyers offer their opinion on the legality of a transaction or the tax consequences of a deal, they are expressing a view about a current situation based on a very particular set of instant facts and established legal principles, taking into account authoritative sources. That legal opinion is a statement analyzing current legal principles, not a prediction, for example, of future changes in law. The opinion, when given, can be deemed right or wrong.

Credit rating analysts cannot rely on solid precedents to guide their opinions: no such standards exist in the debt markets. While rating analysts may review historical data, those data do not have precedential value since what has happened in the past may not repeat itself. Nor is there any way of knowing when a rating opinion is expressed whether it will be prove to be "accurate" or "inaccurate".

The only experts whose function is in any way similar to that of a CRA on this point are actuaries, who predict future losses. The important difference with respect to the role of actuaries under securities legislation, however, is that they validate the estimates of internal actuaries. Since issuers are not required to make representations about the likelihood, relative to other issuers, that they will default on their obligations, there is nothing for a CRA to validate or prepare on their behalf. Moreover, actuaries are not held liable for failing to predict a future pandemic or the invention of a life-extending drug.

Third, credit ratings are independent opinions that are not determined in accordance with an industry "standard". In contrast, auditors, engineers, actuaries, valuation experts, and even lawyers apply a common set of professional standards *with the expectation of reaching common conclusions*. For instance, the goal of generally accepted accounting principles ("**GAAP**") is that different audit firms auditing the same company generally will reach the same conclusion about whether management's financial statements fairly present the company's financial condition. In other words, one does not expect much diversity of opinion among these experts, and neither the market nor regulators would applaud diverging opinions.

In contrast, multiple CRAs may well express different opinions on the same question (namely, the appropriate credit rating for a single debt issue). Importantly, this diversity of opinion is valued and sought out by market participants. A robust marketplace that values diversity encourages CRAs to compete based on the quality of their opinions and different methodologies.

Promoting the dissemination of diverse credit opinions, however, would be at odds with eliminating the Exemption and safe harbour. Without the safe harbour, CRAs would be punished for this diversity because, with the benefit of hindsight, some market participants mistakenly would conclude that certain CRAs reached the "wrong" opinion and should be held accountable under the law. This could undermine CRA independence and objectivity by motivating CRAs to reach a consensus view in order to avoid being the outlier CRA.

Fourth, credit ratings are nuanced in ways that expert opinions are not. For example, an audit firm offers one of two views: either the financial statements are presented in accordance with GAAP ("pass") or they are not ("fail"). Similarly, lawyers opine that something is legal or is not legal (or will have specified consequences under applicable laws).[16] Fairness opinions provide that something is fair or not fair for shareholders of the issuer. By contrast, CRAs opine on the relative probability of future default, and on expected losses in the case of such default, after considering a broad range of potential future events and circumstances. Unlike pass/fail, legal/not legal, fair/not fair opinions, credit ratings are expressed on a nuanced rating scale. MIS's rating scale, as previously discussed, consists of 21 points, along with modifiers for reviews and outlooks. In addition to credit ratings, MIS also publishes credit opinions that set out, among other things, the key elements underlying its rating.

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[16] Moreover, those legal opinions expressly indicate that they are not predictions of the future.

Finally, CRAs serve a role in the market that is more akin to securities analysts than "experts" traditionally subject to expert liability. Similar to securities analysts, CRAs serve as market commentators and issue reports based on their own models and powers of observation and analysis. This market commentary promotes market dialogue and debate, which in turn helps enhance the integrity of the debt markets and market participants' understanding of credit risk.

B. Eliminating the Exemption Would Have Significant Unintended Consequences

MIS believes that eliminating the Exemption and safe harbour could create a litigation environment that is incompatible with the CRA's current industry practice of publishing diverse, insightful and sophisticated credit rating opinions for the benefit of investors and the broader market. If the Exemption and safe harbour were eliminated, MIS anticipates a reduction in the amount of information available to investors and a corresponding decrease in activity in public, Canadian debt markets.

1. Interaction of Ratings Disclosure Requirements with Elimination of the Exemption

If the Exemption is repealed and the CSA retains the existing requirements for issuers to disclose ratings in prospectuses, DROs likely would be faced with the unattractive choice between exposure to the risk of expert liability and potentially going out of business in Canada. This dilemma would arise because issuers likely would require DROs to consent to the inclusion of their ratings in the prospectus as a precondition to hiring the DRO to provide a rating. Absent the DRO's consent, the rating would be of no use to the issuer. Therefore, the ratings disclosure regime for issuers combined with rescission of the Exemption might operate to deprive DROs of any genuine ability to withhold their consent.

2. Eliminating the Exemption Would Have a Chilling Effect on the Canadian Credit Market

Without the Exemption and safe harbour, DROs could be expected to assume a defensive litigation posture in anticipation of a potentially limitless class of unidentifiable plaintiffs with an indeterminate number of claims.[17] In light of these risks, DROs likely would withhold consent unless and until their legal exposure was clarified. Moreover, since issuers in Canada currently are required to disclose ratings in prospectuses in certain circumstances, the outcome could be a significant disruption of public debt markets in Canada.

Even if the legal exposure could be, and was, clarified for the broader market of issuers, DROs might continue to refrain from consenting to the disclosure by less stable issuers of ratings in prospectuses. This, in turn, could force a number of issuers to seek private funding for offerings that would otherwise be public and subject to the full slate of securities laws applicable to distributions. In effect, certain segments of the bond market could be driven offshore or into private markets, thereby reducing the depth and liquidity of Canadian credit markets.

3. Eliminating the Exemption and Safe Harbour Would Reduce the Amount of Information Available to Investors

If subjected to statutory liability, CRAs would be placed in the untenable position of issuing credit rating opinions without the ability to gauge the scope of their potential liability. To limit exposure to this undefined legal risk, CRAs likely would publish fewer credit rating opinions. In particular, CRAs would hesitate to rate issuers that raised creditworthiness concerns because those credit rating opinions might significantly increase a CRA's liability in the event of a default. Investors who have come to rely on a broad

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[17] Many CRAs, including MIS, make their ratings available to the public for free. Accordingly, a large and unknowable group of persons could assert that they relied on a rating in making a decision to buy, sell or hold a security, even though credit ratings are not and never have been intended to serve as investment recommendations.

range of credit ratings for a diverse pool of issuers would find themselves with fewer tools to make informed decisions about credit risk. The end result likely would be a diminished flow of information to investors, which appears contrary to the spirit behind the Proposed Materials.

Even assuming that CRAs continued to issue the same number of credit rating opinions, there is a significant risk that the substance of credit rating opinions would become "watered-down" and "market-reactive" in an effort to reduce litigation risks. CRAs have formulated their methodologies and applied their analytical skills with an eye towards candour and independence, and strive to provide the market with sophisticated market insight and robust analysis. If the Exemption were eliminated and CRAs consented to the inclusion of ratings in prospectuses, the CRAs likely would continue to formulate methodologies and apply their analytical skills, but with an eye toward litigation. Specifically, without the Exemption and safe harbour, there would be an incentive to publish "safe" credit rating opinions, and fewer of them. "Safe" credit rating opinions are opinions that offer little in the way of nuance, do not stray from mainstream analysis, refrain from controversial conclusions, and mechanically react to any hint of negative news regardless of the significance the CRA actually places on the news. CRAs also would be motivated to reach opinions similar to those of their competitors, in order to reduce the risk of being sued for being out of step with purported "industry standards". CRAs also would be motivated to heavily involve lawyers in preparing rating opinions to add appropriate disclaimers to protect against litigation. Rating opinions would be written by lawyers for lawyers instead of by credit analysts for investors.

4. Expert Liability Could Increase Incentives to Over-Rely on Ratings

We also believe that exposing CRAs to expert liability likely could increase incentives for investors to over-rely on credit ratings. Investors might be encouraged to believe that if a CRA is subject to strict liability for its rating, then the CRA must have considered all elements of risk for an investor. Credit ratings, however, address only credit risk and not other risks such as market value risk, liquidity risk or price volatility.

Investors also might erroneously view CRAs as, in effect, insurers of credit risk. Investors might be led to mistakenly believe that if they thought the rating was "wrong", they could seek a return on their investment through the court system. This in turn would discourage investors from making their own study and evaluation of the security. This outcome would be inconsistent with the efforts of regulators globally to reduce over-reliance on credit ratings.

Consequently, for all of the reasons set out above, MIS recommends that the Exemption and safe harbour be retained in Canadian securities laws.