MOODY'S
INVESTORS SERVICE

May 17, 2011

By Electronic Mail

To: Members of the Canadian Securities Administrators ("CSA")

Re: Revised 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 CSA on the Proposed Materials published in March 2011. We do not object in principle to most aspects of the Proposed Materials. We do, however, have significant concerns in the following areas and have made recommendations to address them:

- the potential application of Canadian securities laws to non-Canadian, credit rating agency ("**CRA**") affiliates of designated credit rating organizations ("**DROs**");
- the regulatory mechanism that embeds in Canadian securities law a prescribed code of conduct that includes provisions deviating from, and/or going beyond, the International Organization of Securities Commissions ("**IOSCO**") Code of Conduct Fundamentals for Credit Rating Agencies ("**IOSCO Code**");
- the related prohibition on DROs waiving any provisions in their codes of conduct unless prior exemptive relief is obtained; and
- the proposed measures to address rating shopping.

We also have a few technical comments on matters such as the proposed governance requirements for DROs. Our substantive and technical comments and recommendations are set out in more detail below.

I. Potential Application of the Canadian Regulatory Framework to DRO Rating Affiliates outside Canada

In our November 2010 submission, MIS asked whether it was necessary or efficient for the Canadian regulatory framework to extend to non-Canadian CRA affiliates of DROs. We appreciate that CSA members will want to know whether the credit ratings of such entities meet appropriate standards for ratings quality, integrity and transparency since the DRO and/or Canadian market participants may wish to have these CRA affiliates' credit ratings treated as DRO ratings for Canadian securities regulatory purposes.

We continue to believe that the CSA could meet its regulatory objectives in this regard without requiring non-Canadian CRA affiliates of DROs to be subject to the Canadian regulatory framework. In our view, imposing such requirements on these entities, many of which already are or likely will become subject to regulatory oversight in other jurisdictions, will significantly increase the complexity

of their operations. We think that the associated increase in these entities' business and regulatory costs would be disproportionate to the regulatory objectives the CSA is seeking to achieve.

As an alternative measure, we recommend that the CSA distinguish between CRA affiliates located in Canada and those that are not. We believe that credit ratings determined by a non-Canadian CRA that the DRO identifies as a "rating affiliate" in its filings with the CSA should be treated as DRO ratings without such affiliates becoming subject to the Canadian regulatory framework. The CSA could impose certain ongoing terms and conditions on its designation of the DRO that would give CSA members comfort that such rating affiliates operate in accordance with internationally accepted standards for CRAs. For example, it could require an applicant for DRO status to indicate which of the rating affiliates it has listed in its application are subject to regulatory oversight in another jurisdiction and which of its affiliates have adopted a code of conduct based on the IOSCO Code. The CSA members considering the application would have the discretion to decide, on an affiliate-by-affiliate basis, whether or not accept the DRO's request to have these entities' ratings treated as DRO ratings.

II. Requirements Relating to DROs' Codes of Conduct

The Proposed Materials state that the CSA believes that the Committee of European Securities Regulators ("**CESR**") will not provide an equivalency recommendation to the European Commission if a jurisdiction relies upon the IOSCO Code's "comply or explain" regulatory model. Consequently, the CSA is proposing to require each DRO to have a code of conduct that incorporates the provisions set out in Appendix A to proposed NI 25-101. Appendix A contains provisions based on the IOSCO Code, as well as a number of other provisions ("**Supplementary Code Provisions**"), such as governance requirements. In addition, every DRO will be prohibited from waiving any provision in its code of conduct unless it obtains prior exemptive relief.

MIS believes that the CSA could meet its objective of having a regulatory framework that goes beyond a "comply or explain" approach to the IOSCO Code while giving DROs the necessary flexibility to: (1) harmonize their codes of conduct across multiple jurisdictions; and (2) waive provisions in their codes of conduct in compelling circumstances without having to obtain exemptive relief in advance. Our recommended approach is set out below.

First, to promote international convergence in regulatory standards for CRAs, we believe that the proposed code of conduct provisions in Appendix A should only supplement, not revise, IOSCO Code provisions. Accordingly, we recommend deletion of the provisions in Appendix A that have a counterpart in the IOSCO Code, so that only the Supplementary Code Provisions remain.

Second, while MIS is committed to implementing the IOSCO Code to the greatest extent practicable, we believe that its provisions should not be converted into securities law as provided for in the Proposed Materials. Some of the IOSCO Code's provisions are ambiguous or impose obligations whose scope is unclear.[1] This ambiguity does not present significant difficulties when the obligation is

[1] For example, provision 4.9 of the Appendix, which is based on provision 3.5c of the IOSCO Code, states in part that "A designated rating organization must assist investors in developing a greater understanding of what a credit rating is, and the limits to which credit ratings can be put…." How will compliance with this requirement be measured? Will it be measured by what a DRO does, by what an unidentified and potentially unlimited class of investors understands, or by how much their understanding improves? A

to "comply or explain" with a principles-based document. The situation is very different when the flexibility is stripped out and the prescribed code becomes part of securities law. There also are circumstances where competing objectives in the IOSCO Code must be balanced,[2] or where a provision in an IOSCO-based code of conduct could conflict with a requirement of local law.[3] In some circumstances, it may be possible to obtain exemptive relief in advance to resolve these potential conflicts. We believe there will be other situations, however, when there will be insufficient time to obtain exemptive relief but it will be in the public interest for a DRO to waive a provision in its code of conduct so that it can, for example, disclose on a timely basis significant, new information to the market about an issuer or obligation.

For these reasons, we recommend that the CSA reclassify the requirement for a DRO to have a code of conduct as an ongoing "term and condition" of designation. Specifically, proposed NI 25-101 could provide that it will be a "term and condition" that an applicant for DRO status adopt and maintain one or more codes of conduct that collectively, in the opinion of the relevant Canadian regulators, are substantially similar to the IOSCO Code and the Supplementary Code Provisions. This approach is similar to the regulatory approach taken in Australia, where having a suitable code of conduct based on the IOSCO Code was made a licensing condition.

In addition, for greater certainty, we recommend that NI 25-101 specify that a DRO's breach of its code of conduct does not, in itself, constitute a breach of securities law. Instead, a DRO's breach of its code of conduct would be a factor that CSA members could consider in deciding whether or not to suspend, revoke or impose further terms and conditions upon the designation of a CRA as a DRO.[4] The Monetary Authority of Singapore has taken a similar approach.

Third, we recommend that the CSA revise section 9 of NI 25-101 to permit a DRO to waive one or more provisions in its code of conduct in the following, limited circumstances, provided that it creates and maintains a written record documenting the reasons for the waiver:

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provision like this in the form of a requirement of securities law poses significant legal, regulatory and reputational risks for DROs. The same uncertainty also presents risks for the regulators responsible for enforcing the provision.

2 Provision 4.11 will require a DRO to inform the issuer of the critical information and principal considerations upon which a rating will be based, afford the issuer an opportunity to clarify likely factual misperceptions or other matters the DRO would wish to be made aware of to produce an accurate rating, and duly evaluate the response before it issues or revises the rating. This provision is similar to provision 3.7 of the IOSCO Code, except that the IOSCO Code qualifies this obligation by stating that it is something the CRA "should" do where it is "feasible and appropriate". There will be situations where it is impossible or not feasible for a DRO to comply with provision 4.11 of Appendix A. For example, an issuer's operations might have been impaired by a disaster, so that its management cannot be reached or are focused on addressing the damage. Alternatively, there may be credit market developments that are so significant and rapidly evolving that the DRO believes it is in the public interest for it to update the market immediately by disseminating a revised rating opinion for a single issuer or large group of issuers. The DRO will be mindful of its obligations under other provisions in Appendix A to revise its ratings promptly when circumstances warrant it and publish its ratings on a timely basis. In such circumstances, a DRO could have to choose which code provision to breach, since it will not have time to obtain exemptive relief.

3 For example, provision 4.20 of Appendix A states that DRO employees must 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 securities regulatory authority is authorized to attend (and frequently does attend) rating committees as an observer. Provision 2.15 of Appendix A requires the DRO and its rating employees to comply with all applicable laws. The requirements of Argentine law and provision 2.15, therefore, appear to conflict with provision 4.20.

4 We note that even if a breach or waiver by a DRO of a provision in its code of conduct is not characterized as a violation of securities law, CSA members nevertheless would have the power to exercise any enforcement powers granted to them that do not depend on a finding that there has been a breach of securities law.

- The DRO believes in good faith that it is necessary to waive one or more provisions in its code of conduct in order to comply with one or more other provisions in its codes of conduct and/or applicable laws; or
- The DRO believes in good faith that: (1) such a waiver is necessary so that it can make information publicly available about an issuer, security or obligation; and (2) there is insufficient time to obtain exemptive relief.

III. Measures to Discourage Rating Shopping

MIS supports the CSA's efforts to address rating shopping. We believe, however, that the disclosure requirement in provision 4.6 of Appendix A will not effectively address the rating shopping problem or provide meaningful information to the market.

Requiring every DRO to "disclose on an ongoing basis information about all securitized products submitted to it for its initial review or for a preliminary rating" might deter the most egregious forms of rating shopping by issuers. We are concerned, however, that this requirement might simply move rating shopping to an earlier point in the rating process. For example, instead of seeking preliminary ratings from a number of DROs and then selecting one or more ratings to use in connection with the offering, issuers will be more likely to avoid approaching DROs that are known to have more conservative methodologies. (This practice already occurs but the new disclosure requirement would reinforce the incentives to do so.) Issuers also will be less likely to engage in initial conversations with smaller or newer DROs, or DROs that are starting to build up a new practice area, because the issuer is less likely to be familiar with such CRAs' methodologies and rating procedures. This could adversely affect competition based on ratings quality in the DRO industry, *e.g.*, by making it harder for DROs to enter the market or expand their scope of coverage and/or making it harder for more conservative DROs to compete for business. Alternatively, issuers could simply present "hypotheticals" to DROs and claim that they did not submit a securitized product for initial review. Moreover, implementation of this requirement could leave market participants with the mistaken impression that no rating shopping has occurred.

Finally, we believe this measure could be interpreted as requiring DROs to disclose information about potential transactions before the issuer discloses the transaction. The provision could even be interpreted as requiring disclosure of potential transactions that are never implemented. We believe that such a disclosure requirement could discourage issuers from issuing rated structured finance products in Canada, thereby reducing the competitiveness and transparency of Canadian capital markets.

For these reasons, we recommend that provision 4.6 be deleted from Appendix A. In our view, the most effective way to address rating shopping is to enhance the mandatory disclosure regime for structured finance products. Greater transparency in this market would make it more difficult for issuers to shop for ratings because CRAs and other market observers will have access to the information needed to publish their own opinions. Similarly, investors will have access to greater information to assess the structured finance products and the quality of the opinions that CRAs and other market observers make available. We note that the CSA has requested comment on an enhanced disclosure

regime for asset-backed securities and we believe this initiative will be more effective at deterring rating shopping than provision 4.6 of Appendix A.

IV. Governance Provisions

MIS has two technical comments on the proposed governance provisions in Section D of Appendix A. First, Section D will require a DRO to have a board of directors that includes a prescribed number minimum number of members who meet specified independence criteria. To facilitate international convergence in regulatory requirements for CRAs, MIS recommends that Section D be revised to permit a DRO to satisfy these requirements either at the level of the DRO or its direct or indirect parent entity. This is the approach that has been taken in the United States, as reflected in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**").[5]

Second, we note that provision 2.21(c) of Appendix A states that a board member of a DRO will not be considered independent if he or she has a relationship with the DRO that, in the view of the DRO's board of directors, could reasonably be expected to interfere with the exercise of the director's independent judgment. MIS believes that an effective board of a DRO should include individuals with knowledge and experience relevant to a DRO's operations. Accordingly, many of the potential, leading candidates for appointment to a DRO's board are likely to be familiar with credit ratings and to be current or past users of credit ratings, either in a personal capacity or as representatives of entities that use credit ratings. MIS does not interpret provision 2.21(c) as precluding a DRO's board of directors from finding that an existing or potential board member who uses, or has used, the DRO's credit ratings, is independent. In our view, the board's assessment would be a fact-specific one taking into account the nature and extent of the individual's use of ratings as well as an assessment of whether such use could reasonably be expected to affect the individual's exercise of objective judgment as a board member. If our interpretation is incorrect, however, we believe it could be difficult for a DRO to recruit knowledgeable, experienced and independent board members.

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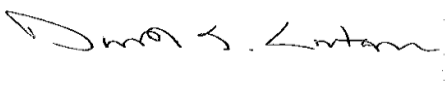
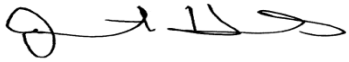
Once again, we appreciate the opportunity to comment on the Proposed Materials. We would be pleased to discuss our comments further with CSA members.

Sincerely,





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[5] The Dodd-Frank Act requires each Nationally Recognized Statistical Rating Organization ("**NRSRO**") to have a board of directors with independent directors and assigns to the board certain duties. It also provides that if an NRSRO is a subsidiary of a parent entity, the board of directors of the parent entity may satisfy the governance requirements by assigning to a committee of such board the duties prescribed in the Dodd-Frank Act if that committee meets the independence criteria set out in the legislation.