FAIR | Canadian Foundation *for* Advancement *of* Investor Rights

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RE: Proposed Rules and Rule Amendments Relating to Securitized Products

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FAIR Canada is pleased to offer comments on the proposed rules and rule amendments relating to securitized products (the "Proposed Securitized Products Rules") prepared by the Canadian Securities Administrators (the "CSA") and contained in the Notice and Request for Comments published as (2011) 34 OSCB 3811 (the "Notice") published on March 25, 2011.

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

FAIR Canada Comments and Recommendations – Executive Summary:

1. FAIR Canada welcomes the Proposed Securitized Products Rules as a key step in restructuring the regulation of securities in Canada and a necessary response to the recent financial crisis.
2. FAIR Canada supports the introduction of the new rules that narrow the class of investors who can buy securitized products on a prospectus-exempt basis (the "Proposed Exempt Distribution Rules") and makes a number of recommendations to further improve these rules for the benefit of retail investors. Most importantly, we believe that securitized products should only be permitted to be sold to persons

meeting a minimum proficiency level of objective, active knowledge about the specific products they are purchasing and their attendant risks.

3. FAIR Canada strongly urges regulators to reform the entire exempt market on the same basis as in item 2 above. In addition, FAIR Canada recommends that the Northwestern exemption orders, which exempt individuals and firms from the dealer registration requirements of National Instrument 31-103, be revoked given the significant investor protection concerns that have arisen as a result.
4. FAIR Canada recommends that the CSA implement credit risk retention requirements for securitization transactions at or above the standards of the leading jurisdictions[1]. If such requirements are not imposed, there will be a significant increase in the risk that Canada may be used as a "dumping ground" for securitization.
5. FAIR Canada recommends that the CSA implement informational requirements related to assets, loans and payments at or above the level of detail required in the leading jurisdictions for the disclosure of securitized assets and payment structures. If such requirements are not imposed, there will be a significant increase in the risk that Canada may be used as a "dumping ground" for securitization transactions that do not meet international standards.
6. FAIR Canada provides responses in section 5 to some of the specific questions posed in the Notice. We will respond to the following specific questions raised by the CSA in the Notice: 1, 2, 3, 10, 12, 13, 18, 23, 27, 28, 30, 31, 32, 33, 37, 42, 43, 44, 46 and 47**.**

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1. FAIR Canada welcomes the Proposed Securitized Products Rules as a key step in restructuring the regulation of securities in Canada.

1.1. FAIR Canada views the Proposed Securitized Products Rules to be an essential part of the reform necessary for the system of securities regulation in Canada in response to the financial crisis.

1.2. Securitization was a major factor in the world financial crisis, particularly as it related to securitized subprime mortgages in the United States (collateralized debt obligations ("CDOs")) and securitized credit default instruments that used derivatives to amplify the risk already inherently present in the CDO market. Toxic assets have continued to mire many investors in difficulties.

1.3. The practical effect of the Proposed Securitized Products Rules is to create a more uniform and complete disclosure regime for securitization transactions. However, we are concerned that, as currently proposed, the enhanced disclosure obligations are not robust enough to prevent abuses of securitization, particularly use as a means of dumping assets. Without further

[1] Namely the United States (through "Reg AB II" adopted in April 2010) and the member countries of the European Union (through the EU Prospectus Directive) For the level of risk retention, Germany should be considered a leading jurisdiction (please refer to section 3.10 below).

refinements, the Proposed Securitized Products Rules would not even enable sophisticated investors to properly understand and account for the risks of an investment. Abuses of securitization would be most prevalent where the disclosure obligations do not mandate disclosure of (1) specific detail about securitized assets, and (2) the structured finance aspects of securitization transactions. We discuss such requirements in detail in section 4 below.

1.4. Furthermore, we view with some alarm the CSA's uncertainty about whether to adopt the leading jurisdictions' standard of risk retention for issuers in securitization transactions. This issue is discussed in section 3 below.

1.5. FAIR Canada would also encourage the CSA to consider the issues that have come to light regarding the exempt market, broadly speaking, as a result of the CSA's review and analysis of securitized products. We recommend that those issues be considered when the CSA reviews and reconsiders the regulation of the exempt market. We will discuss these issues in paragraphs 2.1, 2.15, 2.16, 5.11 to 5.13, and 5.18 below.

1.6. Finally, FAIR Canada provides some specific recommendations related to the Proposed Securitized Products Rules in section 5 below.

2. FAIR Canada supports the introduction of the Proposed Exempt Distribution Rules but urges regulators not to use wealth or income as a proxy for determining eligible securitized product investors or accredited investors.

2.1. FAIR Canada welcomes the introduction of the Proposed Exempt Distribution Rules that will restrict the classes of investors that are able to rely on prospectus exemptions to purchase securitized products. We also approve of the idea of creating a list of "highly sophisticated" investors who would be eligible securitized product investors under section 2.44. We have long considered the existing prospectus exemptions to be too broad; the presumptions inherent in the long-standing rules of investor sophistication are often not justified. It is important to ensure that the exempt market investor base is in fact sophisticated. The existing exemption encourages promoters of poor products to target investors with sufficient wealth and/or assets and such promoters are subject to a low level of scrutiny. This damages the reputation of the market and market integrity and is insufficient to ensure an acceptable level of investor protection. Mere ability to absorb losses, for example, should not be used as a criterion of investor sophistication. We have suggested amendments to the eligible securitized product investor definition below to address this.

Active Investor Knowledge of Complex Investment Product Required

2.2. FAIR Canada recently stated, in response to the draft Ontario Securities Commission 2011-2012 Statement of Priorities, that "[r]etail investors should not be sold... a complex product, unless the intermediary is satisfied, based on objective evidence, that the investors actually understand the product and its associated risks and costs." This should be the central principle in the regulation of complex investment products, including securitized products. A new model of retail investor protection for complex financial products is needed: the burden should be on the parties who sell complex financial products to ensure that their clients and investors i) actually understand the products being sold and their associated costs and ii) understand the implications of the disclosure documents provided. Where investors are not able to understand

the nature of the product, its attendant risks and costs, or the implications of the purchase and sale of such a product, the product should not be permitted to be sold to them.

2.3. In other words, FAIR Canada advocates for the replacement of the current system, which provides for a standard of informational disclosure with exceptions for investors who are presumed to be sophisticated. **We propose that there be a standard of active investor knowledge of the investment products in question**. For example, investors cannot be presumed to understand the implications of multilayered risk in securitized products. Such a model would mean that originators and dealers of complex products would need to reach out to investors and clients and actually build their knowledge and understanding of the products in question in order to sell them such products. Only this approach can actually protect the interests of investors in a marketplace of sophisticated, structured products and ensure that clients' best interests are put first by dealers and advisors.

"Eligible Securitized Product Investors" Needs to Be Narrowed Further

2.4. Currently, securitized products may be sold to persons who are accredited investors or to others under an offering memorandum. Accredited investors include a large pool of investors, including individuals with $1,000,000 in financial assets, or an income over $200,000 (or whose income combined with their spouse's income is over $300,000) and corporations with assets over $5,000,000. The Proposed Exempt Distribution Rules narrow these categories for securitized products, which are to be sold only under an information memorandum and only to "eligible securitized product investors", a restricted subcategory of accredited investors which includes many institutional investors but also many high net worth individuals (having assets over $5,000,000) and companies with substantial balance sheets (having assets over $25,000,000). The proposed definition of eligible securitized product investor also includes registered dealers and advisers, regulated pension funds, municipalities, and even registered charities that receive advice from registered advisers.

2.5. An information memorandum, as required by the new rules, may potentially deliver much information that is useful to a prospective investor in a securitized product. However, there is no assurance whatsoever that the eligible securitized product investors who receive the information memorandum will be able to understand it or decipher what it means.

2.6. **The new definition of an "eligible securitized product investor" leaves the category open to many investors that might not otherwise appropriately be considered sophisticated in financial matters, particularly high net worth individuals and companies with sizable balance sheets. Wealth is not an appropriate criterion to substitute for knowledge, experience or sophistication** and exempting individuals or other persons on such a basis is inappropriate where there are no other institutional or regulatory constraints. Wealth is not a reasonable proxy for sophistication.

2.7. We agree with the CSA that a person who acquires securities under the minimum amount investment exemption (2.10 of National Instrument 45-106) should not be an "eligible securitized product investor" nor be exempt from prospectus delivery requirements as a result. Presumptions of sophistication cannot be made in situations where investment amounts are large. Merely investing a large amount of money is not, under any circumstances, a criterion of investor sophistication.

2.8. **In light of the fact that the ability to absorb losses is not a reasonable proxy for investor sophistication, FAIR Canada recommends that paragraph (n) and paragraph (p) of the proposed amended definition of "eligible securitized product investor" in section 1.1 of National Instrument 45-106 be deleted.** We believe that the only retail investor category that would be appropriate under this definition would be an investor who has met an appropriate test of active knowledge.

2.9. FAIR Canada is also concerned that many of the non-individual categories within the definition of "eligible securitized product investor" will similarly lack the necessary sophistication to assess the risks and benefits of structured securitized products. Regulated pension plans may be very small and administered by individuals who do not have extensive investment expertise. Many municipalities lack the knowledge and expertise to properly assess structured securitization products.[2] Many advisers may not be considered to be sophisticated regarding securitization matters, a matter we will return to in paragraph 5.26 below. This has implications for the advisers themselves, but also for charities, which are eligible securitized product investors if they are advised by any registered adviser (or an "eligibility adviser"). FAIR Canada recommends that paragraphs (d), (e), (f), (i), (k), and (m) of the proposed definition of "eligible securitized product investor" in section 1.1 of National Instrument 45-106 be amended to include active knowledge and proficiency requirements.

Certification and Liability Constraints Required to Operationalize Active Knowledge Standard

2.10. **FAIR Canada suggests a standard of active knowledge for eligible securitized product investors, with appropriate liability constraints, to ensure that dealers and issuers are only permitted to sell securitized products to retail investors who have active knowledge.** In our view, such a system has two primary advantages. First, it ensures equal treatment of investors irrespective of their financial means. Second, it ensures that dealers, advisers and issuers have an incentive to take an active role in educating their investors about the products that are being sold to them, which will have the salutary effect of improving the knowledge of other investors.

2.11. An active knowledge standard would provide that securitized products could be sold to a retail investor, under an information memorandum, provided that the purchaser had active knowledge of the product being sold and its attendant risks. Active knowledge should be independently certified, or certified by dealers who are members of a self regulatory organization ("SRO"), backed by a compensation fund and subject to a strict liability standard. It may be appropriate to allow for certification of the eligible securitized product investor for a given time period rather than on a per transaction basis. We believe the requirement to obtain certification in order to invest in securitized products will encourage investors to actively seek information, and will stress the importance of understanding a product before investing in it.

2.12. Currently, FAIR Canada perceives a significant problem with the exempt securities market in that the interests of dealers, advisers and issuers and the interests of accredited investors are not

[2] An example of municipal governments suffering significant losses due to direct investments in securitized products happened in late 2007 and early 2008 when six Norwegian municipalities suffered "particularly large losses... due to leveraged investment in structured products in the U.S." (Council of European Municipalities and Regions, "The Economic and Financial Crisis: Impact on local and regional authorities", available online at http://www.ccre.org/docs/Economic_and_Financial_Crisis_(CEMR_2009).pdf). Those municipalities had apparently invested in structured notes based on a municipal bond arbitrage fund, both created by Citigroup to take funds off its balance sheet and marketed as low risk.

well-aligned. Dealers, advisers and issuers do not have a significant incentive to educate investors on what they are being sold, since educating clients would incur a cost with no real benefit to dealers, advisers or issuers. We believe that an active knowledge standard will align interests because dealers, advisers and issuers will have an incentive to enlarge the pool of exempt-market accredited investors (in this case, eligible securitized product investors) by educating investors on how to evaluate such products and it will afford unsophisticated investors with more protection.

2.13. It is important to emphasize that the objective, active knowledge test should apply not only to individuals but also to any other entities seeking to qualify under the "eligible securitized products investor" definition. However, we would not object if the tests (other than the test for individuals) permitted investment by persons who are actively advised by a registered adviser with regard to each trade, subject to paragraphs 2.14 and 2.15 below.

2.14. An objective knowledge test should also be imposed on dealers and advisers before they are permitted to advise clients regarding securitized products. See our discussion below at paragraph 5.26. A similar restriction should apply to dealers and advisers (including eligibility advisers) that are advising charities or any other person with respect to securitized products.

Better Oversight of Exempt Market Required

2.15. OSC Staff Notice 33-735 *Sale of Exempt Securities to Non-Accredited Investors* (published as (2011) 34 OSCB 5424) indicates that the OSC is concerned that dealers and issuers are selling exempt securities to individual investors who do not meet the accredited investor criteria, and are failing to collect the necessary Know Your Client information that would allow them to assess those criteria. FAIR Canada urges securities regulators to continue to be vigilant in order to ensure that the existing eligibility criteria are being complied with. Given that dealers and issuers are ignoring the limits in respect of existing eligibility criteria, we recommend that there be closer oversight (perhaps through better systems or increased resources) of the current criteria for the exempt market generally and in assessing the application of the new tests set out in the definition of "eligible securitized product investor", including the proposed active knowledge test FAIR Canada has recommended. The exempt market needs effective oversight in order for investors to be appropriately protected.

FAIR Canada Supports Review of Prospectus Exemptions for the Exempt Market and Not Simply in Respect of Securitized Products

2.16. FAIR Canada welcomes the CSA's assertion that it is "reviewing the prospectus exemptions more broadly, particularly the accredited investor exemption and the minimum investment amount exemption." All of our criticism of the accredited investor exemption and the corollary criticisms of the minimum investment amount apply generally and not only to the securitized products market.

2.17. In addition, FAIR Canada recommends that the Northwestern exemption orders, which exempt individuals and firms from the dealer registration requirements of National Instrument 31-103, be revoked given the significant investor protection concerns that have arisen as a result.[3] At

[3] See CSA Staff Notice 31-312 dated August 7, 2009 at http://www.albertasecurities.com/securitiesLaw/Regulatory%20Instruments/3/31-103/3270183-v3-CSA_Staff_Notice_31-312.pdf. David Baines, Business Reporter at the Vancouver Sun has recent several articles about David Michaels who has preyed on seniors in the Exempt Market in British Columbia. See

present, anyone (even someone found to be dishonest or lacking integrity) is able to sell high-risk exempt market products to the investing public including vulnerable groups such as seniors. Individuals should be required to register as Exempt Market Dealers as was originally contemplated by the Client Relationship Model.

3. FAIR Canada recommends that the CSA implement credit risk retention requirements for securitization transactions at or above the standard of leading jurisdictions. If such requirements are not imposed, there will be a significant increase in the risk that Canada may be used as a "dumping ground" for securitization.

3.1. Both the United States (through the *Dodd-Frank Wall Street Reform and Consumer Protection Act* "*Dodd-Frank Act*") and the member countries of the European Union (through Article 122a of EU Capital Requirements Directive 2009/111/EC, "Article 122a") have already adopted rules requiring "skin in the game" credit risk retention in securitization transactions. FAIR Canada agrees with this approach as it allows a better alignment of economic interests in the securitization process and is a necessary response to the recent financial crisis.

Problems Arising Out of Originate-to-Distribute Model

3.2. Risk retention requirements address one of the key shortcomings of the securitization market, one which the CSA points out in the Notice, namely the "originate-to-distribute" model that allowed the generation, distribution and amplification (through derivative transactions) of large numbers of securitized products whose underlying assets were of poor quality. This occurred notably in US mortgage-backed securities, which created systemic risk not only downstream from these securities for holders, but upstream as well (since poor quality assets were created in order to feed a demand for securitized products). Systemic risk spread quickly with disastrous results.

3.3. In addition to issues of systemic risk, the originate-to-distribute model poses unacceptable risks to investors in those particular securities. Simply put, even the most robust disclosure requirements will not be able to provide investors with sufficient knowledge to adequately judge a pool of assets that the originator considers unworthy of investing in. The fundamental issue of originate-to-distribute assets is the lack of incentive to originate quality assets. If assets are of poor quality, that is not only a risk to the market as a whole but to the investors unwise enough to buy the securities.

3.4. The originate-to-distribute model was distinctly harmful to world markets as a whole because it encouraged the amplification of moral risk throughout the securitization market, creating systemic risk not only because of securitization, but also because of the use of credit derivatives, collateralized debt and similar leveraging tools. The wide availability of such complex financial products makes it particularly important to 1) ensure that the market has access to accurate, detailed and complete information about such products, and 2) restrict the category of qualified purchasers to those individuals and entities who understand the nature of such products. We suggest that this could be accomplished through the use of an "active knowledge" standard for determining an eligible securitized product investor in section 2.

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http://www.vancouversun.com/Baines+Securities+Commission+says+will+review+rules+sale+exempt+securities/5063440/story.html.

3.5. The incentives that created the originate-to-distribute model have not disappeared. They are inherent in a free market which permits securities that employ complex financial products to distribute and market risk. Where originators are not required to keep skin in the game, the originate-to-distribute model will continue to be viable, especially if there are not sufficient informational controls in place to allow investors to monitor the performance of securitized assets (see section 4 below).

3.6. FAIR Canada is concerned that by failing to eliminate or curtail the originate-to-distribute model through risk retention requirements, Canada would become an attractive place to dump assets (via securitization) that have been originated only to sell. Both the United States and the European Union are implementing risk retention requirements that will make it difficult, if not impossible, to distribute assets on a purely originate-to-distribute basis in those jurisdictions. If Canada does not follow their lead and implement risk retention requirements, Canada will become a logical target for those seeking to securitize assets that were originated to dump on investors.

3.7. FAIR Canada cautions that the model adopted by the US under the *Dodd-Frank Act*, which provides for broad classes of exempt securitization transactions, is not sufficient to completely discourage the securitization of poor quality assets. So-called "bright line" tests, as the *Dodd-Frank Act* proposes for assets to be exempt from the risk retention requirements for securitization transactions, invariably fail as products are designed (and assets are originated) to skirt the rules. Such rules have the potential to fail catastrophically, especially where the market depends largely on originators policing themselves. FAIR Canada believes that risk retention regulations should aim to discourage the originate-to-distribute model; exemptions could make such regulations ineffective. Exemptions will be used by originators to attempt to avoid risk retention, opening up the potential for the same abuses that were fostered by the originate-to-distribute model. **FAIR Canada recommends adopting a regime similar to the European model under Article 122a, which is narrowly tailored and permits no exemptions from risk retention requirements based on tests that attempt to determine the quality of collateral or other factors.** If Canada allows for exemptions that the EU does not, it will risk becoming a destination of choice for those seeking to originate and distribute poor-quality assets that nonetheless achieve technical compliance with Canadian rules.

3.8. The desire for risk retention flexibility for originators and issuers is appreciated, but FAIR Canada believes strongly that any attempt to under-regulate in this area would make the Canadian market a potential target.

Types & Level of Risk Retention

3.9. FAIR Canada would like to address the CSA's question about the "appropriate types and levels" of risk retention. We note first that FAIR Canada believes, as discussed in paragraphs 3.2 to 3.8 above, that exemptions to risk retention requirements are not appropriate as they significantly increase systemic risk. Risk retention exemptions can become a regulatory hiding place where lower-quality products can be introduced; swaps, derivatives and other leveraging tools can then be employed to create larger pools of risk that can potentially have harmful systemic effects.

3.10. As to the appropriate levels of risk retention, we note that although Article 122a proposes only a five percent risk retention requirement, Germany has indicated that it will require a ten percent risk retention after 2014. Germany has taken this step in response to concerns that a five

percent risk retention requirement is insufficient to increase the level of protection for investors, since five percent has been commonly complied with in the market and certain asset classes may result in a five percent retention not being sufficient to align the interests of originators and investors. **FAIR Canada therefore recommends a requirement for ten percent risk retention.** The committees of the German Federal Diet that considered the risk retention minimums identified a five percent risk retention as already common (although certainly not universal) in securitization markets, even at the time of the 2007-2008 financial crisis. This appears to be the reason that they decided that five percent may not be sufficient to align the interests of originators and investors.

3.11. Furthermore, given that risk retention is already common (although far from universal) in the securitization market, it seems that investors do want the additional security of extra risk retention by originators. For this reason, we encourage the CSA to further consider an increased limit.

3.12. Finally, FAIR Canada wishes to emphasize that all of these risk retention requirements will fail to guarantee their desired objective unless the exempt market rules are significantly tightened, as per our discussion in section 2 above.

4. FAIR Canada recommends that the CSA implement informational requirements related to assets, loans and payments at or above the level of detail required in the leading jurisdictions for the disclosure of securitized assets and payment structures. If such requirements are not imposed, there will be a significant increase in the risk that Canada may be used as a "dumping ground" for securitization transactions that do not meet international standards.

4.1. Both the United States (through "Reg AB II" adopted in April 2010) and the member countries of the European Union (through the EU Prospectus Directive) have already adopted rules requiring the disclosure of loan-level data in securitization transactions. FAIR Canada notes that loan-level data is rapidly becoming an international standard, which the CSA does not propose to require in the Proposed Securitized Products Rules.

4.2. Reg AB II also requires that issuers must make available computer programs that model a cash flow "waterfall", projecting cash flow and allocation of losses when data regarding pool assets are inputted. This information regarding pool assets might be projected or may be made available via the mandated disclosure of loan-level data under Reg AB II.

4.3. Both of these informational requirements are basic and fundamental to the proper monitoring and understanding of securitization transactions, particularly those issued in multilayer tranches. Without an accurate understanding of the mechanics of the "waterfall", a prospective investor is not able to properly assess the risk of a security; without loan-level data, securitization transactions are "black boxes" where performance monitoring becomes impossible.

4.4. Both (1) the absence of loan-level data and (2) insufficient or incomplete mathematical modelling (something the "waterfall" requirements are designed to supplement and address) have been blamed for the worst excesses of the pre-crisis securitization market. No amount of information, and no aid to proper and careful modelling, can guarantee against the abuse of

securitization to market toxic assets. However, they will be valuable tools that sophisticated investors can use to target (and shine light on) the worst abuses.

4.5. Absent a requirement to provide investors with such tools, Canada will become a preferred jurisdiction for the securitization of the worst-quality assets. An issuer concerned about the poor quality of its pool, and concerned that the assets it is securitizing are "brittle" in the event of a market downturn, will prefer to issue in the Canadian market where such tools are not required and where the "waterfall" will not disclose the downside risk. Furthermore, an issuer that was trying to "bury" underperforming or even toxic assets within its securitization asset pools would prefer to do so in Canada if loan-level or asset-level data was not required to be disclosed. Given that other jurisdictions (in particular, the EU and the US) are introducing requirements to disclose this data, Canada also needs to have such requirements. Otherwise, issuers will be able to hide bad assets in their securitization pools.

4.6. FAIR Canada considers the ability of investors to know exactly what they are investing in to be a fundamental principle of the Canadian securities market. Disclosing asset-level or loan-level data is fundamental to this core principle.

4.7. For the particular issue of asset-level or loan-level data, if the choice of a data template is a concern, the EU already has dealt with the question of an appropriate data template in a transnational context and therefore adoption of its data template (in broad outlines) may be appropriate.

5. FAIR Canada's responses to "Questions on the Proposed Securitized Products Rules".

5.1. FAIR Canada does not have comments on all of the "Questions on the Proposed Securitized Products Rules" on pages 3822-3828 of the Notice. We will therefore identify each question with its number where we have comments.

Question 1 *- We welcome any comments on the three principles we have taken into account in developing the Proposed Securitized Products Rules, which are set out under Substance and purpose of the Proposed Securitized Products Rules. Are these the right principles? Are there additional principles we should take into account and if so, what should these be?*

5.2. FAIR Canada agrees that the three principles the CSA has taken into account are important and has two additional comments. First, the avoidance of systemic risk through transparency should be emphasized as a particularly important guiding principle behind the regulation of securitization. As discussed above, in paragraph 3.2, systemic risk is amplified by the use of credit derivatives and similar leveraging tools. We understand that these tools are an accepted part of international financial markets, but they require the market to carefully and aggressively vet the assets of securitization vehicles. Therefore, it is crucial to the integrity and reputation of the market that the depth and quality of data about securitized products remains as high as possible.

5.3. Second, we draw attention to the fact that, contrary to the impression provided by the CSA, the lack of a subprime mortgage securitization bubble was not due to any particular success in the Canadian regulation of securitization; rather, it was due to particular features of the Canadian mortgage market. The lack of such a bubble should not be used as a "success story" to mitigate

the need for strong regulation of securitization transactions. Canada lacked the subprime mortgages to create a bubble; this is an accident of Canadian mortgage regulation, not a feature of the Canadian regulation of securitization.

Question 2 *- ...Is it necessary or appropriate for us to make rules prescribing mandatory risk retention for securitized products in order to mitigate some of the risks associated with securitization? If so, what are the appropriate types and levels of risk retention for particular types of securitized products?*

5.4. Yes. We answer this question in section 3, above.

Question 3 *- The Dodd-Frank Act... prohibit[s] sponsors, underwriters or placement agents of securitized products, or affiliates of such entities, from engaging in any transaction that would involve or result in any material conflict of interest with respect to any investor in a sale of securitized products. The prohibition against such activity will apply for one year after the closing date of the sale and provides for certain exceptions that relate to risk-mitigating hedging activities intended to enhance liquidity. Should there be a similar prohibition in our rules? If so, what practical conflicts would this rule prevent that are seen in Canada today?*

5.5. It would be imprudent for the CSA to attempt to regulate only conflicts of interest that "are seen in Canada today". If investors are asked to wait until conflicts of interest arise before regulators step in, then the metaphorical doors will only ever be locked once the horse has bolted. The substance of these proposals in the US is to prevent conflicts of interest inherent in banks owning second or third liens against assets where they are also servicing the first liens on behalf of mortgage backed investors. It is not beyond the realm of possibility that such a conflict could arise in Canada in a different context, where a Canadian bank services a lien against property where the bank owns different types of claims against the property owner. The CSA should prohibit transactions that would involve or result in material conflicts of interest.

Question 10 *- Should the approved rating eligibility criterion for the short form and shelf prospectus systems be replaced with alternative criteria? In the alternative, if the approved rating eligibility criterion is maintained, should the issuer also satisfy one or more additional criteria...?*

5.6. FAIR Canada believes that retention of risk on a "vertical slice" (or more strict) basis should be a minimum standard criterion for the prospectus systems. As discussed above in section 3, FAIR Canada urges the CSA to consider stricter standards, including possibly raising the minimum risk retention requirements. FAIR Canada does not object to allowing issuers to retain a greater weight of riskier baskets or tranches, however we note that relative risk of baskets or tranches can be open to interpretation and the most foolproof method of ensuring appropriate criteria is to insist on the vertical slice method, with retention of a minimum amount of all tranches or baskets. Exceptions to the vertical-slice method could be made where: (1) an issuer retains a "horizontal" first-loss position of a certain minimum amount; or, (2) the issuer retains a so-called "L-shaped interest" where part of the retained interest is a vertical slice and the remainder is a first-loss portion; or, (3) the issuer maintains a cash reserve trust fund equivalent to the required residual interest.

Question 12 *- The SEC April 2010 Proposals require disclosure of asset- or loan-level data in some cases, and grouped asset disclosure in others (e.g. for credit card receivables). We are not proposing to require*

asset- or loan-level disclosure or grouped asset disclosure. Is this level of disclosure necessary and if so, what are appropriate standardized data points?

5.7. As discussed above in section 4, FAIR Canada is concerned that if detailed asset- or loan-level data is not required to be provided, as is mandated by new US and EU rules, then issuers and originators of the poorest quality securitization assets will naturally be attracted to Canada as a jurisdiction that allows them to avoid such disclosure. All other things being equal, the net result will be a migration of poor-quality assets to the Canadian market, which would not be in the interest of the capital market participants including investors

Question 13 *- The SEC April 2010 Proposals require that issuers provide a computer waterfall payment program to investors. We currently are not proposing to impose a similar requirement. Is this type of program necessary and if so, why?*

5.8. Please see our discussion above in section 4 and paragraph 5.6.

Question 18 *- The Proposed CD Rule requires reporting issuers that issue securitized products to make several new filings in addition to the filings required by NI 51-102... [S]hould reporting issuers be exempt in whole or in part from the requirements of NI 51-102 and related forms?... [D]o the costs associated with preparing and filing audited financial statements of the issuer outweigh the benefits to investors? We believe there may be circumstances where financial information about the issuer may be important to investors, such as information relating to derivative transactions to which the issuer is a party, or information relating to other liabilities of the issuer that may rank higher to or equally with the notes held by investors, and thereby reduce the potential recovery of investors in the case of an insolvency of the issuer. If we propose an exemption from the requirement to prepare and file audited financial statements, how should we address these concerns? What conditions should we include?*

5.9. In FAIR Canada's view, under no circumstances should issuers be permitted to avoid the filing of financial statements. It is fundamental to the system of securities regulation that issuers of securities disclose their financial health and situation to investors.

Question 23 - *Should the new documents that are required to be filed under the Proposed CD Rule be prescribed as core documents for secondary market civil liability?*

5.10. FAIR Canada considers each of these new documents to be analogous to existing core documents within current requirements and each are of critical importance in evaluating the ongoing performance of a securitized product.

Question 27 - *We are proposing a new Securitized Product Exemption which focuses on a specific product that has unique features and risks. Is this product-centred approach appropriate? Should we instead be focusing on reforming the exempt market as a whole?*

5.11. FAIR Canada is of the opinion that the CSA should be focusing on reforming the exempt market as a whole. All of our criticisms in section 2 above would apply equally to the exempt market as a whole, regardless of the additional complexity of securitized products and the additional risks their unique structure imposes.

Question 28 - *Should securitized products be allowed to be sold in the exempt market, or should they only be sold under a prospectus?*

5.12. Provided that the exempt market for securitized products is suitably restricted with an objective, active knowledge test, and adequate informational safeguards are in place, FAIR Canada considers it permissible and even desirable to sell securitized products in the exempt market. In the absence of our recommendations in sections 2, 3 and 4 FAIR Canada would consider it inappropriate to allow securitized products to be sold in the exempt market to the category of investors discussed in section 2 above.

Question 30 – *The proposed Securitized Product Exemption in section 2.44 only permits certain "highly-sophisticated" investors (i.e., eligible securitized product investors) to buy securitized products on a prospectus-exempt basis. Other investors generally would only be able to buy securitized products that are distributed through a prospectus. Is this the right approach? If not, what approach should we take? In particular, should we permit other investors to purchase securitized products in the exempt market through a registrant subject to suitability obligations in respect of the purchaser? Would having a registrant involved adequately address our investor protection concerns? Please refer to Question 32 for additional related questions.*

5.13. Please see our discussion in section 2 above, and sections 5.26 and 5.27 below. Investors who are not "eligible securitized product investors" as further restricted by our comments in section 2 above should not be permitted to purchase securitized products in the exempt market through a registrant who is only subject to a suitability obligation.

Question 31 *- If our proposed approach to restrict access to securitized products to "highly-sophisticated" investors is appropriate, is the proposed list of eligible securitized product investors the right one? If not, how should it be modified?...*

5.14. As discussed in section 2 above, FAIR Canada considers it inappropriate to substitute the real or imputed ability to absorb losses as a proxy for investor sophistication. We believe that a standard of "active knowledge" should be used to identify "highly sophisticated" investors. At the very least, we would recommend that paragraphs (n) and (p) of the definition of "eligible securitized product investor" in proposed section 1.1 of proposed National Instrument 45-106 be deleted. Please see our discussion in section 2 of our comments for further discussion and details of FAIR Canada's proposals regarding the definition of "eligible securitized product investor".

Question 32 – *We continue to consider other possible prospectus exemptions for securitized products, along with appropriate conditions to such prospectus exemptions. We would appreciate your feedback on the following possible exemptions and conditions, and whether they should be in lieu of, or in addition to, the proposed Securitized Product Exemption:*

A. Enhanced accredited investor or minimum amount investment prospectus exemption

Should we maintain availability of the accredited investor and minimum investment amount prospectus exemptions? Should their continued availability require additional conditions and if so, what should those be? For example, should we require either or both of the following additional conditions:

(a) the issuer must provide an information memorandum and possibly ongoing disclosure; and

(b) the investor must buy the securitized product from a registrant?

5.15. FAIR Canada believes that the accredited investor prospectus exemption model needs to be reviewed and sets out its comments on the existing accredited investor prospectus exemption at section 2 above. We are opposed to a minimum investment amount prospectus exemption as also discussed in section 2 above. The additional conditions set out above would not address our concerns with the current model. In particular, we note that providing additional informational disclosure does not address our concern that accredited investors (as that category is currently defined) do not necessarily have the knowledge and expertise necessary to make sense of such informational disclosure. Where the problem is a lack of expertise, additional information does not assist in understanding.

B. Minimum amount investment prospectus exemption specifically for securitized products

Should we have a prospectus exemption that would permit an investor to purchase securitized products provided the minimum amount invested is relatively high? If so, what would be an appropriate minimum amount threshold?

5.16. FAIR Canada is adamantly opposed to any exemption from prospectus requirements on the basis of a minimum amount invested, on grounds similar to those discussed in section 2 above. Such an exemption may well do positive harm to markets.

C. Specified ABCP prospectus exemption

Should investors who are neither eligible securitized product investors nor accredited investors be permitted to invest in ABCP provided certain risk-mitigating conditions are met? If so, what conditions should we impose on these distributions? ...

5.17. In order to be exempted from the Proposed Securitized Products Rules, FAIR Canada believes that asset-backed commercial paper ("ABCP") would need to demonstrate that it is not susceptible to the problems that arose in the U.S. with the sub-prime mortgage securitization market that have precipitated the proposed rules. In our view, ABCP has not done so. ABCP conduits have a significant structural weakness that cannot be avoided; they issue short-term obligations against long-term assets[4] and are not structured with sufficient alignment of interests so as to insulate them from systemic risk. Such a market, in FAIR Canada's view, is not well-suited to an exemption from securities regulation regardless of any additional protections that are added to such securities.

Question 33 – *Should we provide for more limited access to securitized products than has been proposed?*

5.18. FAIR Canada believes that securitized products should only be permitted to be sold to persons meeting a minimum proficiency level of objective, active knowledge about the specific products they are purchasing and their attendant risks. FAIR Canada strongly urges regulators to reform the entire exempt market on the same basis. We believe that an "active knowledge" standard

[4] John Chant, "The ABCP Crisis in Canada: The Implications for the Regulation of Financial Markets" (online: <http://www.expertpanel.ca/documents/research-studies/The%20ABCP%20Crisis%20in%20Canada%20-%20Chant.English.pdf>).

will align interests because dealers, advisers and issuers will have an incentive to enlarge the pool of exempt-market accredited investors (in this case, eligible securitized product investors) by educating investors about such products. This will protect unsophisticated investors from highly complex products that they do not understand.

Question 37 *- We are not prescribing specific disclosure for the initial distribution of securitized products, other than short-term securitized products such as ABCP. Is this an appropriate approach? What impact would requiring an information memorandum for distributions of non short-term securitized products have on costs, timing and market access?*

5.19. FAIR Canada considers that, in general, specific, standardized disclosure improves market knowledge, improves the completeness and quality of disclosure, and that these factors improve the stability both of securitized products themselves and the financial system as a whole in times of stress.[5] We would therefore express a strong preference for mandated, specific, standardized form of disclosure because this would fit with the second stated general principle of these reforms - to facilitate transparency in the securitization market so that it can continue to function even in times of financial stress.

Question 42 – *We propose that there should be statutory civil rights of action against issuers, sponsors and underwriters for misrepresentations in an information memorandum provided in connection with a distribution of securitized products in the exempt market. Have we identified the appropriate parties whom an investor should be able to sue? If not, should any parties be added or removed?*

5.20. FAIR Canada agrees that investors should have rights to sue the issuer, the sponsor and each underwriter for damages if the information memorandum required by the Securitized Product Exemption contains a misrepresentation without the requirement that the investor prove reliance on the misrepresentation. The same rights of action should apply as for a prospectus or public offering.

5.21. FAIR Canada notes that under the current statutory regime for offering memoranda in Ontario, experts who provide their consent for their reports to be filed within the offering memorandum are not subject to the statutory civil rights regime. Although we recognize that it may be inappropriate for such experts to be subject to the regime for an information memorandum for securitized products when they are not so subject for an offering memorandum, we do consider this to be an area where the law could be usefully harmonized "upwards" in favour of greater protection for investors. The same reasoning applies to the directors of issuers and sellers, who are subject to the statutory liability regime for prospectuses but not for offering memoranda.

5.22. Finally, FAIR Canada would like to suggest one additional potential class that should be considered for addition to the statutory liability regime for securitized products. The issuers of securitized products are, typically, special purpose entities that are created solely for the purpose of issuing securities. They usually have no purpose outside the securitization transaction and indeed are often created solely to form a liability shield for a parent. As such,

[5] See Hendry, Lavoie and Wilkins, "Securitized Products, Disclosure, and the Reduction of Systemic Risk" Bank of Canada: Financial System Review, June 2010 at 57.and Financial Stability Board, "Improving Financial Regulation: Report of the FSB to G20 Leaders" September 25, 2009.

FAIR Canada recommends that the CSA consider extending the statutory liability regime to any promoter of the securitized product.

Question 43 *– Should there be statutory civil liability for misrepresentations in the continuous disclosure provided by an issuer of securitized product? If so, who should the investor be able to sue and why?*

5.23. FAIR Canada agrees that there should be statutory civil liability for misrepresentation in the continuous disclosure provided by an issuer of securitized product and believes that Ontario's secondary market liability regime is a useful model to guide the CSA.

Question 44 –*In certain jurisdictions, there are statutory provisions which also provide an investor with a right to withdraw from the purchase within two days of receiving a prescribed offering document. Should these rights of withdrawal apply to information memoranda used for the distribution of short-term securitized products? Should these rights of withdrawal apply to information memoranda used for the distribution of securitized products that are not short-term?*

5.24. FAIR Canada believes that investors should have the same withdrawal rights with respect to securitized product information memoranda as they do with a prospectus offering. FAIR Canada does not agree with only providing a "cooling off period" or a "cancellation right". In particular, FAIR Canada believes that investors should be put back into their pre-contract position and receive the full amount of the money that they have invested back (without penalty or charge) if they exercise their withdrawal right and not, a "cancellation right" or "cooling off period" which would only refund the lesser of (1) the amount invested and (2) its current value, upon cancellation.

Question 46 - *Are there any existing registration categories or registration exemptions that should be modified or made unavailable for the distribution and resale of securitized products in the exempt market?*

5.25. No. Please see paragraph 5.26 below, and paragraph 2.17 above. Securitized products should not be permitted to be sold subject to the Northwestern exemption orders

Question 47 - *In order to qualify for the proposed Securitized Product Exemption in section 2.44, registered firms and individuals will need to be able to identify which products are securitized products. Are there categories of registrants that will not have the appropriate proficiency to identify securitized products and understand their risks? For example, should exempt market dealers be restricted in any way from dealing in securitized products?*

5.26. FAIR Canada is as concerned with the potential inexperience and lack of proficiency or knowledge among registrants as it is with that among "eligible securitized product investors". As we have noted above, securitized products are complex and are often highly structured in a way that is difficult for the non-specialist to understand. As such, not all registrants can be expected to have familiarity with them. In terms of the investor market, we have proposed an objective, active knowledge standard that must be demonstrated before an investor is allowed to purchase securitized products. For registrants, we would similarly propose an active, objective knowledge standard before registrants are allowed to advise purchasers regarding securitized products. In addition, for registrants there should be the means to acquire knowledge of and proficiency with securitized products through education provided by their registering authority.

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-572-2282/ ermanno.pascutto@faircanada.ca or Marian Passmore at 416-572-2728/ marian.passmore@faircanada.ca.

Sincerely,

Canadian Foundation for Advancement of Investor Rights

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