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

April 23, 2014

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

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RE: CSA Notice and Request for Comment on Proposed Amendments to National Instrument 45-106 Prospectus and Registration Exemptions Relating to the Short-term Debt Prospectus Exemption and Proposed Securitized Products Amendments (the "Notice")

FAIR Canada is pleased to offer comments on the Request for Comment by the Canadian Securities Administrators ("**CSA**") regarding the proposed amendments for the Short-Term Debt Prospectus Exemption and the Short-Term Securitized Products Prospectus Exemption set out in the Notice dated January 23, 2014.

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.

Introduction

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. While Canada suffered much less than other jurisdictions during the global financial crisis, it did not escape unscathed. The asset-backed commercial paper ("**ABCP**") crisis that occurred in Canada foreshadowed some of the financial crisis events that happened later and was similar in nature.[1] The ACBP crisis provided an illustration of what can go wrong with the creation and sale of complex financial products on an exempt basis and illustrated the dangers of conflicts of interest and the inappropriate use of ratings as a substitute for a real understanding of the product and its risk. Over 1,800 individual investors as well as institutional investors lost billions of dollars. The causes of the ABCP crisis and the flawed assumptions upon which ABCP was sold have been well-documented.[2] The ABCP crisis and the subsequent world financial crisis focused attention on many needed areas of regulatory reform.

FAIR Canada's Comments and Recommendations

1. Reform of Exempt Market– Wealth Should Not be Used as a Proxy for Sophistication: FAIR Canada believes that reforms are needed governing the sale of the sale of exempt

[1] Christie Ford, "Financial Innovation and Flexible Regulation: Destabilizing the Regulatory State", available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2403092.

[2] See John Chant, "The ABCP Crisis in Canada: The Implications for the Regulation of Financial Markets, A Research Study Prepared for the Expert Panel on Securities Regulation", available online at http://www.expertpanel.ca/documents/research-studies/The%20ABCP%20Crisis%20in%20Canada%20-%20Chant.English.pdf; Supra, note 1.

market products to retail investors, especially complex ones such as securitized products, so that the assumption upon which it is sold, namely that such investors are sophisticated and therefore do not need the disclosure the securities regulatory regime would otherwise provide, actually holds true. Wealth is not a valid or sufficient proxy for sophistication. This is especially true with respect to complex financial products that have proven to be difficult to understand, even by many of the registrants who sold them and credit rating agencies who rated them. The 2011 CSA Proposed Securitized Products Rules[3] ("**2011 CSA Proposal**") attempted to address this issue by, among other things, restricting the class of investors that are able to rely on prospectus exemptions to purchase securitized products and creating a list of "highly sophisticated" investors who would be eligible securitized product investors. Unfortunately, the current proposal abandons this approach.

2. Implement a Statutory Best Interest Standard to Protect Investors: FAIR Canada encourages the CSA to implement a statutory best interest standard for registered dealers and advisers, thereby requiring that clients be placed in exempt securities such as commercial paper, ABCP and securitized products only where such products are in the clients' best interests. This would significantly enhance investor protection.

3. Regulation Should not Be Based on Bank ABCP versus Non-Bank ABCP Types: FAIR Canada questions whether a clear distinction can be made between bank ABCP conduits and non-bank ABCP conduits as described in the Notice. According to the academic John Chant[4], some bank ABCP issues utilized the acquire-to-distribute model whereby bank sponsored conduits acquired assets in order to distribute them and did not solely utilize the originate-to-distribute model whereby the bank would have only placed assets in the trust that originated from the bank or its clients. Canadian banks also sponsored ABCP conduits, holding them off-balance sheet so as to avoid capital requirements. In addition, some banks provided essential liquidity support and credit enhancement to third-party (i.e. non-bank) ABCP conduits which made them viable.[5] FAIR Canada therefore cautions that regulatory approaches need to be cautious in identifying "types" of ABCP and regulating based upon such classifications when there is no bright line.

4. Regulatory Regime Should Anticipate Future Market Developments: FAIR Canada also cautions that the CSA should put into place a regulatory regime that will address future market developments and innovations, to the greatest extent possible, rather than only putting in place regulations for the market as it exists today. While currently, according to the CSA Notice, non-bank ABCP is not being issued and the size of the existing market is small, this may not remain the case. According to the IOSCO Final Report on Global

[3] (2011) 34 OSCB 3811

[4] Supra, note 2.

[5] Supra, note 2, at page 33.

Developments in Securitisation Regulation[6] (the "**IOSCO Final Report**"), the Canadian securitization market as at January 2012 was $93.9 billion. In 2011, new issuances returned to levels seen prior to the 2008 recession and the total volume of new asset backed securities and ABCP issuance throughout the year was $23.4 billion.[7] A recent article in The Economist noted that asset-backed securities, mortgage backed securities and collateralized loan obligations had a "bumper year" in 2013 and more growth is expected.[8]

5. In addition, while the majority of securitized products in Canada are now backed by government guarantees, it is far from ideal to have to depend upon the honouring of such guarantees and the use of taxpayers' money to do so, from an investor protection and public policy perspective.

6. Ensure Alignment of Incentives and Market Transparency Rather than Heavy Reliance on Credit Rating Agencies: FAIR Canada recommends that regulatory approaches put in place rules that ensure that incentives between securitizers and investors are aligned and that provide enough transparency to market participants to minimize the risk of harm posed to investors or the creation of systemic risk to the greatest extent possible, rather than rely on the type of ABCP sponsor/liquidity provider and the receipt of credit ratings. FAIR Canada is concerned that the proposed exemptions place too much reliance on credit rating agencies. Credit rating agencies played an important role in the ABCP crisis by failing to properly assess the product quality of ABCP. FAIR Canada shares the concern expressed by the CFA in their submission dated March 14, 2014 in respect of the Notice, that "enshrining credit ratings within legislation as the primary standard of reference of investment risk provides an enhanced air of legitimacy to credit raters' opinions. Investors can be misled into thinking that if a certain credit rating is considered "investment grade" by the regulators, then any security carrying that rating may be automatically accepted as an appropriate investment by investors as well."[9] FAIR Canada is of the view that, as credit rating agencies are paid by issuers they rate, the resulting conflicts of interest should inform the extent to which regulators and investors place reliance on such ratings and they should not be a major criterion for allowing the purchase of securities on an exempt basis. The adoption of the designated rating organization rule (adopted in 2012) does not overcome this concern.

7. Follow IOSCO's Recommendation to Require Risk Retention (skin in the game): FAIR Canada recommends that the CSA adopt Recommendation 1 of the IOSCO Final Report

[6] International Organization of Securities Commissions, Final Report on Global Developments in Securitisation Regulation (November 16, 2012).

[7] *Ibid*. at pages 13-14.

[8] January 11, 2014, The Economist, "Securitisation It's back: Once a cause of the financial world's problems, securitization is now part of the solution".

[9] Letter to CSA from the CFA dated March 14, 2014, available online at http://www.osc.gov.on.ca/en/com_20140314_45-106_canadian-advocacy-council.pdf.

and mandate retention of risk in securitization products. We refer the CSA to our earlier comments in our submission dated August 31, 2011.[10] The CSA relies on the fact that in Canada the originator of a pool of assets retains the risk of expected loss through such mechanisms such as over-collateralization, excess spread allocation to investors to offset losses, cash reserve accounts to cover debt service shortfalls and/or subordinated notes issued to originators. The CSA believes, as a result, that mandatory credit risk retention is not necessary. However, none of these measures are mandatory requirements and are at the discretion of the parties involved (the originator and the conduit, who may not be acting at arm's length in all cases). That such structures typically contain them is not the same as requiring credit support measures by regulation. FAIR Canada recommends that the CSA implement credit risk retention requirements for securitization transactions at or above the standards of other leading jurisdictions, such as the United States and the European Union.

8. Transparency and Detailed and Complete Information is Necessary: FAIR Canada is of the view that transparency is critically important to help prevent systemic risk from arising and that the market needs to have access to accurate, detailed and complete information about the securitized products. Many of the deficiencies (in liquidity requirements, in the transaction details, in the disclosure of the assets and their originators) were identified as issues long before the ABCP crisis ensued.[11] FAIR Canada believes the current proposals address the level of detail of information provided to investors through Form 45-106F8. However, we refer the CSA to our 2011 comments (in particular at section 4) that FAIR Canada believes that asset originators (from the bottom asset all the way up) should be fully disclosed and that the disclosure in Recommendation 5 of the IOSCO Final Report should be required so that investors have the necessary information to make an informed investment decision. Such disclosure would include providing investors with modeling tools that enable them to conduct cash flow analyses of a given securitization transaction throughout its life and requiring equal access to investors to all documents and data relevant to assess creditworthiness of a given securitization product that are provided to credit rating agencies, consistent with applicable privacy, confidentiality and other laws.

9. Earlier Comments by Stakeholders: FAIR Canada notes that the CSA indicates at page 1052 of the Notice that there was some support expressed for the 2011 CSA Proposal. It also states that "the majority of commenters expressed concerns that they were a disproportionate response to the risk posed by Canadian securitization activity." FAIR Canada cautions that retail investors lack the necessary expertise to comment on these proposals, while industry participants have far greater resources to comment. It is

[10] Available at <http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-Comments-re-Securitized-Products-Aug.-31-2011.pdf>.

[11] Paula Toovey and John Kiff, "Developments and Issues in the Canadian Market for Asset-Backed Commercial Paper, Financial System Review", available online at <http://www.bankofcanada.ca/wp-content/uploads/2012/02/fsr-0603-toovey.pdf>.

therefore inappropriate for the CSA to assess comments based on the number of commenters who are "for" versus "against" a set of proposals.

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 Neil Gross at 416-214-3408 (neil.gross@faircanada.ca) or Marian Passmore at 416-214-3441 (marian.passmore@faircanada.ca).

Sincerely,

Canadian Foundation for Advancement of Investor Rights