OSC Investor Advisory Panel
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October 25, 2010

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West, Box 1903
Toronto, ON M5H 3S8

Dear Mr. Stevenson,

Re: Proposed National Instrument 25-101

As members of the OSC's Investor Advisory Panel (IAP), please find below our submission regarding Proposed National Instrument 25-101 "Designated Rating Organizations" (the Proposed Instrument). In making this submission, we are responding to the Request for Comments published in (2010) 33 OSCB 6353.

Context for Submission

The IAP is an independent body appointed by the Ontario Securities Commission in August, 2010. We are charged with representing the views of investors and providing input on the Commission's policy initiatives, including proposed rules and policies, the annual Statement of Priorities, concept papers and specific issues. This submission emanates from our overarching objective – does the proposed instrument protect the investing public? We note that this submission is based on the expertise and judgment of the Panel members and, unlike future submissions that we will make, does not result from consultations with investors themselves.[1] We also note that one of our working principles in evaluating proposed rules and policies is that investors in Ontario should be as well protected as they are in other developed market systems.

Basic Role of CRAs

Credit rating agencies (CRAs) are ideally neutral entities, providing objective assessments of the quality of the security that they are rating. For investors, credit ratings are important because of the signal they send about the credit quality of an issuer and the resulting ability of investors to price the debt based on this signal.[2] The importance of CRAs thus rests in a well-functioning "reputation mechanism" which provides CRAs with optimal incentives for producing high-quality ratings.[3] A reputation mechanism that works well enables CRAs to maintain their value as long as they provide ratings of high-quality and integrity. If investors determine that ratings are of low quality or that the CRA is unobjective, they will stop valuing the ratings produced by the CRA which in turn will lose value.

However, CRAs are potentially susceptible to incentives that compromise their neutrality. In particular, because CRAs may want to maintain a relationship with the issuer that seeks the rating and pays their fees, they have an incentive to provide a rating

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1 The primary reason that we have not undertaken public consultation with regards to this submission is the proximity of the deadline for submission of comments vis a vis our formation as a Panel last month.

2 Ronald Gilson & Reinier Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 Virginia L.Rev.549 at 613-631.

3 John Patrick Hunt, "Credit Rating Agencies and the 'Worldwide Credit Crisis': the Limits of Reputation, the Insufficiency of Reform and A Proposal for Improvement" http://works.bepress.com/cgi/viewcontent.cgi?article=1000&context=john_hunt.

with which the issuer is satisfied.[4] This possibility can undermine CRAs' neutrality as arm's length agencies that offer objective assessments of the security's creditworthiness.[5] In terms of recent financial market developments, the monetary incentives for providing favourable ratings have grown with the market for securitized products, likely because corresponding expected revenue from these ratings stands to increase also.

Reasons for Reform

Credit Rating Agencies (CRAs) across the developed world played a significant role in the recent financial crisis. Some of the problems with CRAs included conflicts of interest that stemmed from an issuer pays business model which allowed issuers to shop for ratings and a failure among CRAs to adjust their models to reflect heightened risks or to consider plausible alternatives such as a widespread decline in real estate values. In the United States many bankrupt or near-bankrupt companies (e.g. AIG, Fannie Mae and Freddie Mac, Lehman Bros.) carried high investment grade ratings until it was too late to protect investors.

As in many other aspects of the global financial crisis, Canada suffered much less than others but our financial markets hardly escaped unscathed. The Asset Backed Commercial Paper (ABCP) crisis illustrated the dangers of conflicts of interest and of the

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4 See for general discussion Frank Partnoy, "How and Why Credit Rating Agencies are not Like Other Gatekeepers" in Yasuyuki Fuchita, & Robert E. Litan, eds., *Financial Gatekeepers: Can They Protect Investors?* (Washington DC: Brookings Institution Press, 2006), online: SSRN<http://ssrn.com/abstract=900257>. With regards to the current crisis, see Press Release, Securities and Exchange Commission, 2008-135, "SEC Examinations Find Shortcomings in Credit Rating Agencies' Practices and Disclosure to Investors" (8 July 2008), online SEC: <http://www.sec.gov/news/press/2008/2008-135.htm>.

5 "Debt rating agencies didn't cause the Crash", *Vancouver Sun* (30 April 2010), online: Vancouver Sun < http://www.vancouversun.com/business/Debt+rating+agencies+didn+cause+crash/2969999/story.html>.

inappropriate use of ratings as a substitute for true risk analysis. This crisis cost both retail and institutional investors billions of dollars and in turn focused attention on appropriate areas for regulatory reform.

The lack of regulation relating to CRAs was undoubtedly an issue in Canadian financial markets as it was in global markets. Investors came to rely on the stamp of approval from a CRA rating, without direction or even warnings to conduct their own due diligence. In Canada, issuers of short-term debt were exempt from disclosure requirements if they had an "approved rating from an approved credit rating organization."[6] As a result of this exemption, CRAs (and particularly the Dominion Bond Rating Service) became the sole gatekeeper for distributions of ABCP.[7] Once a CRA provided a favourable rating,[8] ABCP could be distributed without other investor protection measures, such as disclosure regarding the securities, and the underlying assets, themselves.[9] If the ABCP or other securities were distributed under the accredited investor exemption, no disclosure was similarly required.[10] We are concerned about these exemptions and believe that the rules relating to the exempt market require re-

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[6] See *NI 45-106*, s. 2.35 which states, "The prospectus requirement does not apply to a distribution of a negotiable promissory note or commercial paper maturing not more than one year from the date of issue, if the note or commercial paper distributed…(b) has an approved credit rating from an approved credit rating organization." See also John Chant, "The ABCP Crisis in Canada: The Implications for the Regulation of Financial Markets", Report for the Expert Panel on Securities Regulation, online: Expert Panel on Securities Regulation <http://www.expertpanel.ca/eng/reports/research-studies/the-abcp-crisis-in-canada-chant.html> [Chant].

[7] See Chant, *ibid.* at 13.

[8] Dominion Bond Rating Service (DBRS) was the primary credit rating agency rating ABCP, generally rating Canadian ABCP at the highest rating possible – R-1 (High). See Investment Industry Regulatory Organization of Canada, "Regulatory Study, Review and Recommendations concerning the manufacture and distribution by IIROC member firms of Third-Party Asset-Backed Commercial Paper in Canada" (October 2008).

[9] See Chant, *supra* note 6 at 22.

[10] See Anita I. Anand, "Is Systemic Risk relevant to Securities Regulation?" (2010) 60 University of Toronto Law Journal 941 (forthcoming).

examination in light of the complexity of securities such as ABCP that can be distributed in private markets without any disclosure at all.

Objectives of Reform and Reform Alternatives

CRAs perform an important function for investors. Most retail and many institutional investors are not in a position to undertake detailed credit analysis of individual securities and to practically weigh the risk of default compared to similar instruments. CRAs have the resources and the history to perform that role in a cost-effective manner. A regulatory regime governing CRAs should seek to:

- reduce conflicts of interest by ensuring that issuers are unable to influence the content of ratings;
- enhance CRA accountability by increasing rating transparency so that investors know the major assumptions that guide the ratings;
- reduce investor reliance on ratings as the sole or major criterion for allowing purchase of securities;
- separate derivative, structured, and complex products from mainstream credit products given that new or complex products pose additional risks to investors; often the analysis lacks a historical base.[11]

With these objectives in mind, one approach would be to establish an independent body to mediate the relationship between the issuer and CRA which could be established

[11] See Consumer Federation of America, "The Role of Securities Regulation in Restoring the Flow of Sustainable Credit to Low- and Moderate- Income Consumers" White Paper by Barbara Roper (unpublished paper for the Ford Foundation).

by government or a government agency (such as the relevant securities commission).[12] However, we are not in favour of this approach because it would require the establishment of yet another regulatory body and may not address institutional and informational failures that can arise.

Another suggestion has been to impose liability for CRAs that fail to comply with rules relating conflicts of interests and disclosure.[13] A liability regime akin to that in place for prospectus disclosure is one option, with CRAs having to provide full, true and plain disclosure of all material facts contained in the rating. CRAs may be willing to bear the cost of potential liability, however, and the underlying issues relating to reputation and conflict of interest may be left unresolved. The question is how can CRAs be made accountable for the ratings they deliver?

The CSA Proposal and the IOSCO Code of Conduct

Under the Proposed Instrument, CRAs would need to apply to become designated rating organizations (DROs).[14] Once the application to become a DRO is granted, the DRO would be able to have its credit ratings utilized for various purposes covered by

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[12] This is essentially an "issuer pays" model which allows completion to flourish but with a centralized clearing platform through which all debt to be rated flows. The model, of course, turns on a well-functioning regulator (or central clearing platform). Barbara Kiviat, "A bolder approach to credit-rating agency reform", *Time Blog* (18 September 2009), online: Time.com. <http://curiouscapitalist.blogs.time.com/2009/09/18/a-bolder-approach-to-credit-rating-agency-reform/>. This proposal derives from Matthew Richardson and Lawrence White, "The Rating Agencies: Is Regulation the Answer?", online: NYU <http://whitepapers.stern.nyu.edu/summaries/ch03.html>.

[13] See Hunt who supports the imposition of liability on CRAs, *supra* note 3.

[14] Proposed National Instrument 25-101 "Designated Rating Organizations". See also CSA Consultation Paper 11-405 "Securities Regulatory Proposals Stemming from the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada" which proposes implementing a code of conduct for CRAs as has been developed by IOSCO; reforming the short-term debt exemption and making it unavailable for certain types of securities including ABCP; and, reducing the reliance on CRAs in securities legislation

securities regulation.[15] Furthermore, DROs would be required to develop and enforce a code of conduct that follows the IOSCO Code under a "comply or explain" regime. A DRO must comply with the IOSCO Code of Conduct, or explain their failure to do so. DROs would be required to: manage conflicts of interest and the inappropriate use of information, appoint a compliance officer and annually file a report relating to these activities. Once designated, DROs become subject to potential enforcement actions and compliance reviews.

The 2008 revised IOSCO Code of Conduct for Credit Rating Agencies seeks to heighten CRA accountability.[16] Some of the provisions in the revised Code include:

- CRAs should adopt, implement and enforce written procedures to ensure that the opinions they disseminate are based on a thorough analysis of all information known to the CRA that is relevant to its analysis according to its published rating methodology (para 1.1);
- CRAs should use rating methodologies that are rigorous, systematic, and, where possible, result in ratings that can be subjected to objective (para 1.2);
- CRAs should use people who, individually or collectively, have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied (para 1.4);

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15 For example, issuances of debt securities under the short-form prospectus rules will require a credit rating from a DRO. See Canadian Securities Administrators, "Canadian Securities Regulators Propose Regulatory Regime for Credit Rating Organizations." July 16, 2010 online: CSA http://www.securitiesadministrators.ca/aboutcsa.aspx?id=915.

16 The Technical Committee of the International Organization of Securities Commission, Code of Conduct Fundamentals for Credit Rating Agencies (revised May 2008) online at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf [IOSCO Code of Conduct or IOSCO Code]. The cited paragraphs are not verbatim.

- ratings should reflect all information known, and believed to be relevant, to the CRA, consistent with its published methodology (para 1.4);
- CRAs should assess whether existing methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially (para 1.7-3);
- CRAs should refrain from issuing a rating where the complexity or structure of a new type of structured product or the lack of robust data about the assets underlying the structured product raise serious questions as to whether the CRA can determine a credible credit rating for the security (para 1.7-3); and
- The determination of a credit rating should be influenced only by factors relevant to the credit assessment (para 2.3).

Under the Proposed Instrument, designated CRAs must either comply with these and other provisions of the IOSCO Code of Conduct or explain their failure to do so. We believe that the IOSCO Code, while a step in the right direction, does not go far enough to protect the needs of investors. It does not demand full, complete disclosure about who is paying for ratings. Nor does it contain any punishments for those who fail to comply. Like SROs, the industry would be left to police itself. By contrast, in the U.S., the SEC is required under the Dodd Frank Wall Street Reform and Protection Act to establish an Office of Credit Ratings to oversee CRAs.[17] Unless regulators here demonstrate that monitoring CRA activity is a priority, we fear that CRAs will continue to populate an

[17] See for information purposes, the SEC website at: http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml.

industry that is lightly supervised and that is able to determine its own standards including related compliance with those standards.

Recommendation

The Panel is of the view that because of the regulatory oversight that would exist, the Proposed Instrument will likely be an improvement on the complete absence of regulation relating to CRAs. Indeed, the regulation would be similar to laws relating to self-regulatory organizations (SROs) under which SROs apply for “recognition”. If granted, recognition renders the SRO subject to regulatory oversight. We therefore adopt a cautiously positive view of this regulatory initiative bearing in mind the specific concerns expressed below.

The main drawback of the Proposed Instrument is that securities regulators would not oversee the content or methodology of ratings (even though unjustifiably high ratings were at the heart of the ABCP crisis). Even with a compliance officer in place and an annual report filed with securities regulators, investors could continue to lack full and accurate information regarding the securities they are purchasing. The Panel is of the view that the IOSCO Code of Conduct, while a step in the right direction, does not go far enough to protect the needs of investors. The Code provides a framework for objective analysis to support credit ratings but stops short of promoting publication of the methodology used. It does not demand full, complete disclosure about who is paying for ratings. Nor does it contain any punishments for those who fail to comply. The Proposed

Instrument would allow CRAs to continue to operate under light supervision, determining their own disclosure standards.

Several submissions to regulators from the CRA industry emphasized the importance of Canada not deviating from the IOSCO principles, to avoid a situation where costs in this country could rise to non-economic levels that would discourage the agencies from providing ratings. While this is an important consideration, we believe that as in other jurisdictions, there is room for national standards to protect investors. We note in this vein that the IOSCO Code is not intended to constitute an exhaustive set of principles.[18] The overwhelming reliance by investors on ratings, and the "gatekeeper" function of CRAs as bodies that facilitate access to capital markets for issuers, turns ratings into a public good that must be closely supervised by regulators.

Our overarching concern is the investor practice of purchasing a security on blind faith based solely on a positive rating from a CRA. A combination of disclosure and investor education should be aimed at increasing investor awareness regarding CRAs. Such information concerns should be built into the ratings process; investors should be able to know the considerations that were taken into account in arriving at a CRA's rating. CRAs should be compelled to expound on the information that gives rise to the rating when completing their ratings. A comply or explain regime does not ensure that such information will in fact be provided.

[18] IOSCO states that, "the measures set forth in the Code Fundamentals are not intended to be all-inclusive: CRAs and regulators should consider whether or not additional measures may be necessary to properly implement the Principles in a specific jurisdiction…" See IOSCO Code, *supra* note 16 at 2.

In addition, ratings provided must be objective and CRAs must understand that their ratings may be subject to Commission review, not simply Commission oversight as a DRO with associated compliance reviews. Therefore, it is our view that regulators should implement a system to review ratings themselves, designating specific members of the commission to review ratings and related disclosure at least periodically.

We recognize that these recommendations go further than the Proposed Instrument. However, it is our position that the internal procedures recommended in the Proposed Instrument, and the proposed comply or explain regime which centres around the IOSCO Code, do not necessarily ensure that investors will be better protected from inaccurate or faulty ratings.

Thank you for the opportunity to comment on the Proposed Instrument. We look forward to hearing from you.

Yours very truly,

Anita Anand

Chair, Investor Advisory Panel on behalf of it members:

Nancy Averill
Paul Bates
Stan Buell
Lincoln Caylor
Steve Garmaise
Michael Wissell