CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

Notice and Request for Comment

Proposed National Instrument 25-101 *Designated Rating Organizations*, Related Policies and Consequential Amendments

1. Purpose of notice

We, the members of the Canadian Securities Administrators (the **CSA**), are publishing for comment revised versions of proposed National Instrument 25-101 *Designated Rating Organizations* (the Proposed Instrument), proposed policies and related consequential amendments. The Proposed Instrument would impose requirements on those credit rating agencies or organizations (CROs) that wish to have their credit ratings eligible for use in securities legislation.

Specifically, we are publishing revised versions of:

- the Proposed Instrument,
- Consequential amendments to National Instrument 41-101 *General Prospectus Requirements*,
- Consequential amendments to National Instrument 44-101 *Short Form Prospectus Distributions*,
- Consequential amendments to National Instrument 51-102 *Continuous Disclosure Obligations*, and
- National Policy 11-205 *Process for Designation of Credit Rating Organizations in Multiple Jurisdictions* (the Proposed NP 11-205).

The Proposed Instrument, the proposed consequential amendments and Proposed NP 11-205 are collectively referred to as the Proposed Materials.[1]

We initially published for comment the Proposed Instrument and related policies and consequential amendments on July 16, 2010 (the 2010 Proposal). We received nine comment letters. A summary of the comments we received and our responses to those comments are included in Annex A.

We are publishing the Proposed Materials with this Notice. Certain jurisdictions may also include additional local information in Annex G. In particular, those jurisdictions that are a party to Multilateral Instrument 11-102 *Passport System* (currently all jurisdictions except Ontario) are

[1] In jurisdictions other than Ontario, the Proposed Materials also include the proposed amendments to Multilateral Instrument 11-102 *The Passport System*, as well as Companion Policy 11-102CP to Multilateral Instrument 11-102 *The Passport System*, blacklined to show proposed changes to the current Companion Policy 11-102CP.

publishing for comment amendments to that instrument and its companion policy that permit the use of the passport system for designation applications by CROs and exemptive relief applications by designated rating organizations. As Ontario is not a party to Multilateral Instrument 11-102, these amendments will not be published for comment in Ontario.

2. Substance and purpose of the Proposed Instrument

CROs are not currently subject to formal securities regulatory oversight in Canada. However, the conduct of their business may have a significant impact upon credit markets. Further, ratings continue to be referred to within securities legislation. For both of these reasons, we think it is appropriate to develop a securities regulatory regime for CROs that is consistent with international standards and developments.

The Proposed Materials, together with the proposed legislative amendments (see below), are intended to implement an appropriate Canadian regulatory regime for CROs.

3. Summary of Key Changes Made to the Proposed Instrument

Mandatory Compliance with the IOSCO Code

The 2010 Proposal would have required that a designated rating organization establish, maintain and ensure compliance with a code of conduct that complies with each provision of the IOSCO *Code of Conduct Fundamentals for Credit Rating Agencies* (the IOSCO Code). Notwithstanding the foregoing, the 2010 Proposal would have permitted a designated rating organization to deviate from a provision or provisions of the IOSCO Code in certain circumstances. This is generally referred to as the "comply or explain" approach to the IOSCO Code. Indeed, the central concept of the IOSCO Code is the "comply or explain" feature.

The European Union has implemented a regulatory framework for CROs in the form of *Regulation (EC) No 1060/2009 on credit rating agencies* (the EU Regulation). In connection with the endorsement and certification provisions in articles 4 and 5 of the EU Regulation, staff of the Committee of European Securities Regulators (CESR)[2] have been assessing whether the proposed Canadian regulatory framework applicable to CROs is "equivalent" to the EU Regulation.

The failure to obtain an equivalency determination from the European Commission, and the consequent inability of a CRO that issues ratings out of Canada to rely on the endorsement or certification models in the EU Regulation, would have a negative impact on such CROs. The issuers that such CROs rate might also be negatively impacted to the extent those ratings are used for regulatory purposes in the European Union.

Based on our discussions with CESR staff, we understand that CESR staff will not provide an equivalency recommendation to the European Commission if a jurisdiction's regulatory framework relies on the IOSCO Code's "comply or explain" model.

[2] The function of assessing the equivalency of other jurisdictions' regulatory framework has since been transferred to the European Security Markets Authority.

In order to be consistent with developing international standards and following discussions with CESR staff, we are proposing to require designated rating organizations to establish, maintain and comply with a code of conduct that incorporates a list of provisions set out in Appendix A to the Proposed Instrument, which is included as Annex B to this notice and request for comment. These provisions are based substantially on the IOSCO Code and have been supplemented and modified, as described below, to meet developing international standards and to clarify the conduct we expect of designated rating organizations.

As a result, we are proposing that, unless a designated rating organization obtains exemptive relief, its code of conduct would not be permitted to deviate from the provisions enumerated in Appendix A to the Proposed Instrument.

Additional Provisions to be Included in a Code of Conduct

In addition to the international trend towards mandating compliance with the IOSCO Code, many regulatory authorities are imposing additional requirements on CROs. In order to be consistent with international standards, we are proposing that a designated rating organization be required to include in its code of conduct additional provisions relating to the following matters:

- **Governance.** A designated rating organization would be required to include in its code of conduct the following provisions:
    - the designated rating organization must have a board of directors with at least half, but not fewer than two, independent members;
    - the compensation of the independent members of the board of directors must not be linked to the business performance of the designated rating organization, and must be arranged so as to preserve the independence of their judgment;
    - the designated rating organization must design sound administrative and accounting procedures, internal control mechanisms, procedures for risk assessment, and control and safeguard arrangements for information processing systems. The designated organization must also monitor and evaluate such procedures, mechanisms and systems;
    - the designated rating organization must not outsource functions if doing so materially impairs the quality of the designated rating organization's internal controls or the ability of the securities regulatory authority to perform compliance reviews of the designated rating organization.
- **Ratings Reports.** In addition to the disclosure in ratings reports provided for in the IOSCO Code, a designated rating organization's code of conduct would have to include provisions requiring the following additional disclosure in each ratings report:

- the meaning of each rating category and the definition of default or recovery, and the time horizon the designated rating organization used when making a rating decision;

- any attributes and limitations of the credit rating;

- all significant sources that were used to prepare the credit rating and whether the credit rating was disclosed to the rated entity before being issued and amended following such disclosure.

In each ratings report in respect of a securitized product, a designated rating organization's code of conduct would require the following additional disclosure:

- all information about loss and cash-flow analysis it has performed or is relying upon and an indication of any expected change in the credit rating;

- the degree to which the designated rating organization analyzes how sensitive a rating of a securitized product is to changes in the designated rating organization's underlying rating assumptions;

- the level of assessment the designated rating organization has performed concerning the due diligence processes carried out at the level of underlying financial instruments or other assets of securitized products and whether the designated rating organization has undertaken any assessment of such due diligence processes or whether it has relied on a third-party assessment and how the outcome of such assessment impacts the credit rating.

Compliance Officer

We also revised the proposed requirements applicable to compliance officers. Specifically, compliance officers would be prohibited from participating in the development of credit ratings, or methodologies or models used in developing credit ratings. Compliance officers also would be prohibited from participating in the establishment of compensation for most employees of the designated rating organization. Finally, the compensation of the compliance officer would have to be independent of the financial performance of the designated rating organization and structured so as to preserve the independence of the compliance officer's judgment.

Personal Information Forms

We have removed the originally proposed requirement that directors and officers of a designated rating organization or a CRO applying to be designated submit personal information forms.

4. Proposed Legislative Amendments

To make the Proposed Instrument as a rule and to fully implement the regulatory regime it contemplates, certain amendments to local securities legislation are required. In addition to rule-making authority, changes to the local securities legislation may include:

- the power to designate a CRO under the legislation,
- the power to conduct compliance reviews[3] of a CRO, and to require a CRO to provide the securities regulatory authority with access to relevant books, information and documents,
- the power to make an order that a CRO submit to a review of its practices and procedures, where such an order is considered to be in the public interest, and
- confirmation that the securities regulatory authorities may not direct or regulate the content of credit ratings or the methodologies used to determine credit ratings.

In Québec, Ontario, Alberta and British Columbia, the enabling legislation is either already in force or awaiting proclamation.

5. Proposed Companion Policy and Consequential amendments

We are no longer proposing to publish a companion policy. As a result of changes we made to the 2010 Materials, much of the guidance in the proposed companion policy would be no longer applicable. As a result, a companion policy to the Proposed Instrument is not necessary.

The adoption of a Canadian regulatory regime for CROs also entails amendments to each of National Instrument 41-101 *General Prospectus Requirements*, National Instrument 44-101 *Short Form Prospectus Distributions*, and National Instrument 51-102 *Continuous Disclosure Obligations*. Under the Proposed Instrument, designated rating organizations will be obligated to disclose certain information regarding their credit rating activities. The purpose of the consequential amendments is to require issuers to disclose complementary information regarding their dealings with the ratings industry.

Instead of requiring that issuers disclose the amounts paid to a CRO for ratings and other services provided by the CRO, we are now proposing that issuers be required to disclose only whether they paid for the rating.

The text of the consequential amendments may be found in Annexes C through E.

[3] A specific compliance program will be developed after the Proposed Instrument is implemented and the first group of credit rating organizations have applied for designation.

6. Passport and Co-ordination of Review

Those jurisdictions that are a party to Multilateral Instrument 11-102 *Passport System* (all jurisdictions except Ontario, referred to as Passport Jurisdictions) are publishing for comment proposed amendments to that instrument and its companion policy to allow the passport system to be used for applications for designation by CROs and exemptive relief applications by designated rating organizations. In addition, all jurisdictions are publishing for comment Proposed NP 11-205, which provides CROs with guidance on the process for filing an application to become a designated rating organization in more than one jurisdiction of Canada.

We are proposing to add the Proposed Instrument to Appendix D of Multilateral Instrument 11-102, to permit the use of the passport system for applications for exemptive relief from the provisions of the Proposed Instrument. We have also proposed amendments to Companion Policy 11-102 CP *Passport System* to include guidance on the process for applications for designation.

The text of Proposed NP 11-205 may be found in Annex F. In the Passport Jurisdictions, the text of the proposed amendments to Multilateral Instrument 11-102 and Companion Policy 11-102 CP are in Annex G.

Except as described above, we are not proposing material changes to the versions of Multilateral Instrument 11-102 or Proposed NP 11-205 that were published with the 2010 Proposal.

7. Future Consequential Amendments

Following the adoption of the Proposed Instrument and the application for designation by interested CROs, we propose to make further consequential amendments to our rules to reflect the new regime. Among other things, these amendments will replace existing references to "approved rating organization" and "approved credit rating organization" with "designated rating organization". Similar changes will also be made to the term "approved rating".

These changes will be subject to a separate publication and comment process.

8. Civil Liability

Certain international jurisdictions have either adopted or are considering adopting changes to their securities legislation to impose greater civil liability upon CROs.

In the U.S., the *Dodd-Frank Wall Street Reform and Consumer Protection Act* repealed an exemption which exempted a "Nationally Recognized Statistical Rating Organization" (NRSRO) from having to provide a consent if its ratings were included in a registration statement.

Since the repeal of the U.S. exemption, we understand that NRSROs have refused to provide their consent to their ratings being included in a registration statement. In the case of Regulation AB, which requires ratings disclosure in a registration statement relating to an offering of asset-backed securities, the SEC has issued a "no-action" letter exempting asset-backed issuers from the disclosure requirement. As a result, the repeal of the exemption in the U.S. has not resulted in CROs being exposed to additional liability.

Similarly, the Australian Securities and Investments Commission (ASIC) withdrew relief that allowed issuers of investment products to cite credit ratings without the consent of CROs. CROs have responded to ASIC's decision by refusing to consent, with the result that retail investors cannot access credit ratings in Australia.

In Canada, similar changes would involve revoking those provisions of securities legislation that provide a "carve-out" from the consent requirements for expertized portions of a prospectus or secondary market disclosure document. We are not at this time proposing such changes because we do not think that the benefits of subjecting designated rating organizations to "expert" liability in Canada would outweigh the potential costs. Unlike the U.S. and Australia, we require specified disclosure in prospectuses and annual information forms if a credit rating has been sought or if the issuer is aware that one has or will be issued. Accordingly, if securities legislation were to require that designated rating organizations provide their consent to disclosure of their ratings and designated rating organizations refused to provide such consents, uncertainty could be infused into offerings of rated securities in Canada.

We support consideration of all measures that could increase the accountability of CROs for their ratings decisions. We will continue to monitor developments in the U.S. and other jurisdictions and will assess methods of increasing CRO accountability.

9. Use of Ratings in European Union

As noted above, the proposed Canadian regulatory framework applicable to CROs is being assessed for equivalence with the EU Regulation. The EU Regulation is scheduled to be effective as of June 7, 2011. In the absence of an equivalency determination from the European Commission by such date or other accommodation, CROs that issue ratings out of Canada will not be able to rely on the endorsement or certification models in the EU Regulation until such time as an equivalency determination is achieved. We are currently anticipating that our proposed regulatory framework will be implemented no earlier than the fall of 2011. Accordingly, there may be a period during which CROs that issue ratings out of Canada will not be able to rely on the endorsement or certification models.

10. Request for Comments

We welcome your comments on the Proposed Materials. Please submit your comments in writing on or before May 17, 2011. If you are not sending your comments by email, please include a CD ROM containing the submissions.

Address your submission to the following CSA members:

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

Please deliver your comments only to the addresses that follow. Your comments will be forwarded to the remaining CSA members.

John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario
M5H 3S8
Fax: (416) 593-2318
Email: jstevenson@osc.gov.on.ca

M^{e} Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
Fax : 514-864-6381
E-mail: consultation-en-cours@lautorite.qc.ca

We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period. Comments will be posted to the OSC web-site at www.osc.gov.on.ca.

11. Questions
Please refer your questions to any of:

Michael Brown
Assistant Manager, Corporate Finance
Ontario Securities Commission
(416) 593-8266
mbrown@osc.gov.on.ca

Jeffrey Klam
Legal Counsel, Corporate Finance
Ontario Securities Commission
(416) 595-8932
jklam@osc.gov.on.ca

Maye Mouftah
Legal Counsel, Compliance & Registrant Regulation
Ontario Securities Commission
(416) 593-2358
mmouftah@osc.gov.on.ca

Lucie J. Roy
Senior Policy Adviser
Service de la réglementation
Surintendance aux marchés des valeurs
Autorité des marchés financiers
(514) 395-0337, ext 4464
lucie.roy@lautorite.qc.ca

Ashlyn D'Aoust
Legal Counsel, Corporate Finance
Alberta Securities Commission
(403) 355-4347
ashlyn.daoust@asc.ca

Denise Weeres
Senior Legal Counsel, Corporate Finance
Alberta Securities Commission
(403) 297-2930
denise.weeres@asc.ca

Christina Wolf
Chief Economist
British Columbia Securities Commission
(604) 899-6860
cwolf@bcsc.bc.ca

Nazma Lee
Senior Legal Counsel
Legal Services, Corporate Finance
British Columbia Securities Commission
(604) 899-6867
nlee@bcsc.bc.ca

March 18, 2011