

## CSA Notice

### **National Instrument 25-101 *Designated Rating Organizations***

#### **Related Policies and Consequential Amendments**

#### **1. Purpose of Notice**

We, the members of the Canadian Securities Administrators (**CSA**), are adopting National Instrument 25-101 *Designated Rating Organizations* (the **Instrument**), related policies and related consequential amendments. The Instrument will 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 adopting the materials included in the following annexes:

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

The Instrument, the consequential amendments and NP 11-205 are collectively referred to as the **Materials**.

Jurisdictions that are a party to Multilateral Instrument 11-102 *Passport System* (currently all jurisdictions except Ontario) are also publishing amendments to that instrument and companion policy that permit the use of the passport system for designation applications by CROs and exemptive relief applications by designated rating organizations. These related amendments are contained in Annexes G and H.

The Materials are also available on the websites of CSA members, including the following:

- [www.bcsc.bc.ca](http://www.bcsc.bc.ca)
- [www.albertasecurities.com](http://www.albertasecurities.com)

- [www.osc.gov.on.ca](http://www.osc.gov.on.ca)
- [www.lautorite.qc.ca](http://www.lautorite.qc.ca)
- [www.msc.gov.mb.ca](http://www.msc.gov.mb.ca)
- [www.nbsc-cvmnb.ca](http://www.nbsc-cvmnb.ca)
- [www.gov.ns.ca/nssc](http://www.gov.ns.ca/nssc)

In some jurisdictions, Ministerial approvals are required for the implementation of the Materials. Subject to obtaining all necessary approvals, the Materials will come into force on **April 20, 2012**.

## **2. Substance and Purpose of the Instrument**

CROs play a significant role in the credit markets, and ratings issued by CROs continue to be referred to within securities legislation. However, CROs are not currently subject to formal securities regulatory oversight in Canada. As a result, we think it is appropriate to develop a securities regulatory regime for CROs that is consistent with international standards and developments. The Instrument, together with the related legislative amendments (described below), are intended to implement an appropriate Canadian regulatory regime for CROs.

We initially published for comment the Instrument, related policies and consequential amendments on July 16, 2010 (the **2010 Proposal**). 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**). However, in the spirit of the IOSCO Code, the 2010 Proposal would have also permitted a designated rating organization to deviate from a provision or provisions of the IOSCO Code in certain circumstances; this was referred to as a “comply or explain” model.

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**). The EU Regulation contains some provisions that are also found in the IOSCO Code but that are now legally binding. A registration procedure has thus been introduced to enable the European Commission to monitor the activities of CROs. For recognizing the ratings issued by CROs outside of the European Union, the European Commission must make a decision confirming that the standards of regulation in a non-European country are “equivalent” to the EU Regulation.

In connection with the endorsement and certification provisions in articles 4 and 5 of the EU Regulation, staff of the European Security Markets Authority 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 in 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.

To be consistent with developing international standards and to facilitate a positive equivalency determination from the European Commission, we republished for comment the Instrument, related policies and consequential amendments on March 18, 2011 (the **2011 Proposal**). The 2011 Proposal departed from the “comply or explain” model and required designated rating organizations to establish, maintain and comply with a code of conduct that incorporates a list of provisions set out in Appendix A of the Instrument. These provisions are based substantially on the IOSCO Code and have been supplemented and modified to meet developing international standards and to clarify the conduct we expect of designated rating organizations.

Unless a designated credit rating organization obtains exemptive relief, its code of conduct would not be permitted to deviate from the provisions enumerated in the Instrument.

### **3. Summary of Key Changes Made to the Instrument**

We have made some revisions to the 2011 Proposal, including minor drafting changes made only for the purposes of clarification or in response to comments received. The paragraphs below describe the key changes made to the 2011 Proposal. As the changes are not considered material, we are not republishing the Instrument for a further comment period.

#### *Application of the Instrument to DRO Affiliates Outside of Canada*

The 2011 Proposal clarified that CROs applying to be designated rating organizations (**DROs**) pursuant to the Instrument will have to ensure that the application for designation is made by the entity or entities that want to have their credit ratings used in Canada. A number of commenters have expressed concern that the 2011 Proposal could be read to constitute an attempt to apply the Canadian regime extra-territorially. Commenters also asked whether it is necessary or efficient for the Canadian regulatory regime to extend to non-Canadian CRO affiliates of DROs when a number of these affiliates are already, or likely will become, subject to regulatory oversight in other jurisdictions.

While we do not think that the 2011 Proposal would, at law, have resulted in extra-territorial application of the Instrument, we have nonetheless amended the Instrument so that it clearly applies on only a local level. This has primarily been achieved through the adoption of the definition of **DRO affiliate**. Section 1 of the Instrument now provides that a DRO affiliate is

*an affiliate of a designated rating organization that issues credit ratings in a foreign jurisdiction and that has been designated as a DRO affiliate under the terms of the designated rating organization’s designation.*

A DRO affiliate is not required to comply with all of the Instrument, although where appropriate, references to a DRO affiliate are included in the Instrument and the prescribed

code of conduct provisions in Appendix A to the Instrument.

The suitability of an affiliate to be designated as a “DRO affiliate” under a designation order of a CRO will be determined on a case-by-case basis at the time of designation. A CRO applying for a designation should provide the name of each affiliate proposed as a DRO affiliate, the jurisdiction of incorporation, or equivalent, and the address of the principal place of business of such affiliate.

In determining whether a CRO in a foreign jurisdiction should be designated as a DRO affiliate, we will consider the legal and supervisory framework of the foreign jurisdiction, including whether the CRO is authorized or registered in that foreign jurisdiction and whether the CRO is subject to effective supervision and enforcement. We may also consider the ability of the competent regulatory authority of the foreign jurisdiction to assess and monitor the compliance of the CRO established in the foreign jurisdiction.

Future consequential amendments (see below) will provide that a designated rating is a rating that is provided by either a designated rating organization or its DRO affiliate.

#### **4. Legislative Amendments**

To make the Instrument as a rule and 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 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, British Columbia, Manitoba, New Brunswick and Nova Scotia the enabling legislation is either already in force or awaiting proclamation. In Saskatchewan, the enabling legislation will be proclaimed later in the Spring.

#### **5. NP 11-205**

NP 11-205 contained in Annex F describes the process for the filing and review of an application to become a designated rating organization in more than one jurisdiction of Canada.

## 6. Consequential Amendments

We are also adopting related consequential amendments to the following:

- National Instrument 41-101 *General Prospectus Requirements*,
- National Instrument 44-101 *Short Form Prospectus Distributions*, and
- National Instrument 51-102 *Continuous Disclosure Obligations*.

These related consequential amendments are contained in Annexes C, D & E and will require issuers to more fully describe their relationship with CROs.

## 7. Future Consequential Amendments

Following the implementation of the 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”.

## 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 an 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 U.S. Securities and Exchange Commission (**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.

On November 15, 2011, the European Commission published for comment a draft amendment to the EU Regulation in relation to the civil liability of CROs towards investors. This amendment would render a CRO liable in circumstances where it infringes, whether intentionally or with gross negligence, the EU Regulation, thereby causing damage to an investor having relied on a credit rating of such CRO, provided the infringement in question affected the credit rating.

We will continue to monitor developments in the U.S. and other jurisdictions and will assess methods of increasing CRO accountability.

## **9. Written Comments**

The comment period for the 2011 Proposal expired on May 17, 2011 and we received submissions from four commenters. We have considered these comments and we thank all the commenters. A list of the four commenters and a summary of their comments, together with our responses, are contained in Annex A.

## **10. Local Notices**

Certain jurisdictions are publishing other information required by local securities legislation in Annex I.

## **11. Questions**

If you have any questions, please refer them to any of the following:

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