



Securities regulatory response to asset backed commercial paper and credit market turmoil

On October 6, 2008, the Canadian Securities Administrators (CSA) issued a bulletin announcing the publication of a consultation paper (the Paper) entitled "*Securities Regulatory Proposals in Response to the 2007-08 Credit Market Turmoil and its Effect on the ABCP Market in Canada*". In this consultation paper, the CSA first considers the causes of what it labels the "Market Turmoil" and then makes seven proposals to deal with the issues related to Asset Backed Commercial Papers (ABCPs).

The CSA identifies several causes to the current Market Turmoil including the U.S. subprime mortgage crisis and the securitisation of such mortgages. Subprime mortgages are mortgages extended to high risk borrowers with lower income and little credit history. A combination of lower lending standards, interest rate adjustments on adjustable rate mortgages and a softening of U.S. house prices led to a significant increase in the default and foreclosure rates for subprime mortgages. Investment banks in the U.S. packaged many of these subprime mortgages into pools securing mortgage-backed securities that were sold to investors. This securitisation is viewed by the CSA as the vector that "*spread the contagion*" throughout global credit markets (usually through ABCP) which allowed the risks related to those mortgages to be spread from the originator of the loans to many (retail) investors.

Securities Regulatory Proposals

1. Institute a "regulatory framework" for approved credit rating agencies - The CSA proposes to establish a regulatory framework requiring CRAs to adhere to the "comply or explain" provisions of the Code of Conduct Fundamentals for Credit Rating Agencies (the Code of Conduct) of the International Organisation of Securities Commissions (IOSCO). The CSA also intends to consider the need to require that CRAs disclose, with a reasonably broad dissemination, all the information provided by an issuer to the CRAs and used to establish and monitor a rating. The framework would define "*approved credit rating agencies*" to include Nationally Recognized Statistical Rating Organizations (NRSROs) recognized by the U.S. Securities and Exchange Commission (SEC). Securities regulators would have the authority to impose terms and conditions on CRAs, which would have to provide all information required by the regulators and make changes to their practices as ordered by the regulators.

2. Amend the short term debt exemption under section 2.35 of Regulation 45-106 Prospectus and Registration Exemptions (45-106) - The CSA proposes that the exemption remain unchanged for short term debt that is not asset backed short-term debt.

However, prospectus exempt distributions of ABCP and similar asset-backed short-term debt would be made only in reliance on other existing exemptions, such as the accredited investor exemption or the \$150,000 minimum amount investment exemption in 45-106.

3. Revise the appropriateness of the income and net financial asset thresholds in the accredited investor definition, and the \$150,000 exemption found in 45-106 - Though accredited investors are generally presumed to be able to make investment decisions without the disclosure required in a prospectus and to withstand the risk of loss from an investment, the CSA believes that the current levels at which the income and net financial asset thresholds are set under the accredited investor definition do not suggest that such investors have the ability to withstand that risk. The CSA is therefore concerned that the current income and net financial asset thresholds for qualifying as an accredited investor may no longer be appropriate. Similarly, the CSA questions whether the rationale underlying the \$150,000 exemption continues to be justifiable. The CSA has also indicated its will more generally review the rationale for the registration and prospectus exemptions in the current exempt market regime and whether disclosure should be required in the exempt market.

The CSA also proposes to monitor accounting initiatives to promote enhanced disclosure of off-balance sheet entities of issuers, as well as initiative to determine how to simplify and improve standards for financial reporting of financial instruments in connection with fair-value accounting.

4. Reduce reliance on credit ratings - Canadian securities legislation includes references to credit ratings, generally to permit a different and lighter regulatory treatment based on the credit rating. For each national instrument or policy with such references, the CSA is considering whether to maintain, eliminate or modify the reference and whether an alternative proxy to credit ratings is appropriate. One proxy could include to restrict availability of the guaranteed debt exemption to debt securities issued or guaranteed by governments of countries whose risk of default in payment is comparable to that of Canadian governments. Another proxy would be to amend the definition of "*designated credit support securities*" (in Regulation 51-102 - *Continuous Disclosure Obligations*) for purpose of disclosure exemptions for certain credit support issuers, to replace the credit rating reference by a requirement that the relative credit risk be determined and disclosed by the issuer.

5. Address the role of intermediaries that are registrants with respect to ABCPs - The CSA intends to evaluate whether investment advisers and dealers have satisfied their know-your-client and suitability obligations in selling ABCP and clarify and/or enhance the know-your-client and suitability obligations of registrants and the manner in which they are implemented.

6. Review the definitions of “related issuer” and “connected issuer” in proposed National Instrument 31-103 – Registration Requirements (NI 31-103) - The CSA wishes to ensure that these definitions capture issuers of ABCP and similar products since some dealers or advisers may have had potential conflicts of interest because of their roles in both manufacturing and selling these products. Currently, those definitions are based on the relevant entities holding a specified percentage of voting rights. However, most issuers of ABCP are not structured as corporations, which means that the conflicts provisions in NI 31-103 requiring to identify and respond to all conflicts of interests and provide disclosure thereon may not apply to them.

7. Review criteria applicable to mutual funds under Regulation 81-102 - Mutual Funds - In Particular the CSA wants to review if the 10% concentration restriction for money market funds is still appropriate or should be reduced to 5% and if the restrictions on the type of investments for money market funds should be extended to exclude ABCPs. The CSA further proposes reconsidering the types of assets that are eligible for cash cover or as a qualified security, including ABCP and to remove the option for investment funds to aggregate disclosure of short-term instruments in their statement of investment portfolio.

This update is intended to provide general comment only and should not be relied upon as legal advice.

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