

Blakes Bulletin

Securities Regulation

Canadian Securities Administrators Propose Regulatory Regime for Credit Rating Organizations

ALFRED BUGGÉ AND ANOOP DOGRA

On July 16, 2010, the Canadian Securities Administrators (CSA) published for comment proposed National Instrument 25-101 – *Designated Rating Organizations* (the Proposed Instrument), related policies and consequential amendments (the Proposed Materials). The Proposed Materials seek to impose requirements, including the filing of an application to become a “designated rating organization” (DRO), upon credit rating agencies or organizations (CROs) that wish to have use of their credit ratings in documents such as a prospectus or an issuer’s annual information form pursuant to Canadian securities laws. Designation as a DRO will not be mandatory for any CRO; consequently, if a CRO does not wish to have its ratings eligible to be so used, the CRO need not seek to be designated in any Canadian jurisdiction.

The Proposed Materials state that nothing in the Proposed Materials is to be interpreted as regulating the content of a credit rating or the methodology a CRO uses to determine a credit rating.

BACKGROUND AND COMMENT PERIOD

CROs are not currently subject to formal securities regulatory oversight in Canada. In the notice that accompanies the Proposed Materials, the CSA

acknowledge that the conduct of business of CROs “may have a significant impact upon financial markets, and because ratings continue to be referred to within securities legislation, we think it is appropriate to develop a securities regulatory regime for CROs that is consistent with international standards and developments.”

The Proposed Materials are a result of a previous CSA initiative on October 6, 2008, in which the CSA published for comment a consultation paper entitled *Securities Regulatory Proposals Stemming from the 2007-2008 Credit Market Turmoil and its Effects on the ABCP Market in Canada*. In connection therewith, the CSA ABCP Working Group proposed to establish a regulatory framework applicable to CROs.

The deadline for comments is October 25, 2010.

THE PROPOSED INSTRUMENT

Designation as a “designated rating organization”

The central requirement of the Proposed Instrument is that, once designated, a DRO must establish, maintain and ensure compliance with a code of conduct that is on terms substantially the same as the IOSCO *Code of Conduct Fundamentals for Credit Rating Agencies* (the IOSCO Code).

CONT'D ON PAGE 2

Highlights

- The Canadian Securities Administrators propose for comment National Instrument 25-101 – *Designated Rating Organizations*, related policies and consequential amendments (the Proposed Materials)
- The Proposed Materials would impose requirements, including the filing of an application to become a “designated rating organization” (DRO) upon credit rating organizations (CROs) that wish to have use of their credit ratings in places where credit ratings are referred to in Canadian securities laws; designation as a DRO will not be mandatory for any CRO
- The Proposed Materials are not intended to regulate the content of a credit rating or the methodology a CRO uses to determine a credit rating
- A DRO must establish, maintain and ensure compliance with a code of conduct that is on terms substantially the same as the IOSCO *Code of Conduct Fundamentals for Credit Rating Agencies*
- Comment period expires on October 25, 2010

CONT'D FROM PAGE 1

Under the Proposed Instrument, a CRO can apply for designation as a DRO by filing an application containing prescribed information (Form 25-101F1). Form 25-101F1 requires the CRO to disclose comprehensive information including disclosure of: (i) the CRO's procedures and methodologies to determine credit ratings; (ii) the number of credit analysts and supervisors along with their required qualifications; (iii) the professional background of the compliance officer and whether he or she is employed full-time or part-time; (iv) unaudited revenues generated by the CRO from credit ratings, subscribers, and all other services and products offered by the CRO; and (v) a list of the largest users of credit rating services of the CRO by the amount of net revenue earned by the applicant attributable to the user during the most recently completed financial year. The Form must be accompanied by a copy of the CRO's code of conduct, a personal information form for each director and executive officer of the CRO as well as the compliance officer, a copy of the policies and procedures related to conflicts of interest and to prevent the misuse of material non-public information, and a copy of its audited financial statements.

The Proposed Instrument also requires a DRO to file a Form 25-101F1 on an annual basis.

Code of Conduct and the IOSCO Code

The Proposed Instrument requires a DRO to establish, maintain and ensure compliance with a code of conduct, which code must comply with the IOSCO Code. Consistent with the model of the IOSCO Code, a DRO will only be permitted to deviate from the specific requirements of the IOSCO Code if it explains the deviation and indicates how its code nonetheless achieves the objectives of the IOSCO Code (the so-called "comply or explain" requirement).

A DRO is required to file a copy of its code of conduct with the securities regulators and post a copy of it, together with any amendments, prominently on its website. The code of conduct must specify that a DRO must not waive provisions of its code of conduct.

The IOSCO Code provides that CROs should adopt and adhere to a code which includes provisions related to: (i) the quality and integrity of the rating process; (ii) the independence and avoidance of conflicts of interest by the CRO; and (iii) CRO responsibilities to the investing public and issuers.

Below are some highlights of the IOSCO Code:

- A CRO and its analysts should take steps to avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of an issuer or obligation.
- A CRO should adopt reasonable measures so that the information it uses in assigning a rating is of sufficient quality to support a credible rating. If the rating involves a type of financial product presenting limited historical data (such as an innovative financial vehicle), the CRO should make clear, in a prominent place, the limitations of the rating.
- A CRO 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. In cases where the complexity or structure of a new type of structured product or the lack of substantial information about its underlying assets raise doubts as to whether the CRO can determine a credible credit rating for the security, the CRO should refrain from issuing a credit rating.
- A CRO should ensure that adequate personnel and financial resources are allocated to monitoring and updating its ratings. Except for ratings that clearly indicate they do not entail ongoing surveillance, once a rating is published, the CRO should monitor on an ongoing basis and update the rating.
- Where a CRO makes its ratings available to the public, the CRO should publicly announce if it discontinues rating an issuer or obligation. Where a CRO's ratings are provided only to its subscribers, the CRO should announce to its subscribers if it discontinues rating an issuer or obligation. In both cases, continuing publications by the CRO of the discontinued rating should indicate the date the rating was last updated and the fact that the rating is no longer being updated.
- A CRO should prohibit its analysts from making proposals or recommendations regarding the design of structured finance products that a CRO rates.
- All CRO employees should report to the agency's compliance officer any illegal or unethical conduct or activities contrary to the CRO's code of conduct committed by any of its employees or affiliated entities.

CONT'D ON PAGE 3

CONT'D FROM PAGE 2

- The credit rating a CRO assigns to an issuer or security should not be affected by the existence of or potential for a business relationship between the CRO and the issuer, and their respective affiliates.
- A CRO should separate its credit rating business and CRO analysts from any other business of the CRO, including consulting businesses, that may present a conflict of interest.
- CROs should disclose in their rating announcements whether the issuer of a structured finance product has informed it that all relevant information about its product has been publicly disclosed or if the information remains non-public.
- A CRO analyst should not be compensated or evaluated based on the revenue generated by the CRO from issuers that the analysts rates or with which the analyst regularly interacts.
- A CRO should not have employees who are directly involved in the rating process initiate or participate in discussions regarding fees or payments with any entity they rate.
- A CRO should publicly disclose its policies for distributing ratings, reports and updates.
- A CRO should publish sufficient information about its procedures, methodologies and assumptions (including financial statement adjustments that deviate materially from those contained in the issuer's published financial statements and a description of the rating committee process, if applicable) so that outside parties can understand how a rating was arrived at by the CRO.
- A CRO should differentiate ratings of structured finance products from traditional corporate bond ratings, preferably through a different rating symbology, along with explanations of such distinction.
- A CRO, where possible, should publish sufficient information about the historical default rates of CRO rating categories and whether the default rates of these categories have changed over time, so that interested parties can understand the historical performance of each category and if and how rating categories have changed, and be able to draw quality comparisons among ratings given by different CROs. If the nature of the rating or other circumstances make a historical default rate inappropriate, statistically invalid, or

otherwise likely to mislead the users of the rating, the CRO should explain this. This information should include verifiable, quantifiable historical information about the performance of its rating opinions, organized and structured, and, where possible, standardized in such a way to assist investors in drawing performance comparisons between different CROs.

- For each rating, the CRO should disclose whether the issuer participated in the rating process.
- A CRO and its employees should use confidential information only for purposes related to its rating activities or any confidentiality agreement with the issuer.
- A CRO should not selectively disclose any non-public information about rating opinions except to the issuer or its designated agents nor engage in transactions in securities when they possess confidential information concerning the issuer of such security.

Additional Minimum Requirements

In addition to the central requirement to have a code of conduct, the Proposed Instrument imposes the following additional requirements on DROs:

1. Conflicts of Interest

The Proposed Instrument sets forth a list of circumstances in which the DRO must not issue or maintain a credit rating, including: (i) where the DRO, a credit analyst who worked on the credit rating or a person with approval authority for such rating owns securities or has ownership interest in the company that is subject to the credit rating; (ii) where the DRO made recommendations to the issuer, underwriter or sponsor of the securities about the assets, liabilities or activities of the issuer of the securities; (iii) where the fee paid for the rating was negotiated, discussed or arranged by a person within the DRO who is responsible for determining the credit rating or for approving methodologies used for determining credit ratings; or (iv) where the credit analyst who worked on the credit rating or a person with approval authority for such rating received gifts from the issuer, underwriter or sponsor of the securities being rated.

Additionally, the DRO must have policies in place to manage conflicts of interest that may arise in connection with the issuance of credit ratings.

CONT'D ON PAGE 4

CONT'D FROM PAGE 3

2. Policy on Material Non-Public Information

The Proposed Instrument requires a DRO to have policies to prevent: (i) the inappropriate dissemination of material non-public information; and (ii) transactions in securities by a person within the DRO when such person is aware of material non-public information, where such information has been obtained in connection with credit rating services.

3. Compliance Officer

The Proposed Instrument requires a DRO to have a compliance officer who monitors compliance by the DRO with its code of conduct and with securities laws and reports to the board of directors of the DRO as soon as possible any non-compliance with the foregoing where such non-compliance, in the opinion of a reasonable person, risks causing harm to its clients and their investors or to the capital markets.

4. Compliance Review

The Proposed Materials also indicate that local securities laws will eventually be amended to provide powers for securities regulatory authorities to conduct compliance reviews of a CRO and to issue orders to submit the latter to a review of its practices and procedures.

For further details, or if you have any questions concerning this bulletin, please contact [Alfred Bugge](mailto:alfred.bugge@blakes.com) at 514-982-4021 or alfred.bugge@blakes.com, [Anoop Dogra](mailto:anoop.dogra@blakes.com) at 416-863-3052 or anoop.dogra@blakes.com, or any other member of our [Securities Group](#).

SPECIFIC REQUEST FOR COMMENT

In addition to seeking general comments on the Proposed Materials, the CSA are inviting comments on some specific issues, including: (i) the proposed requirement to provide a completed personal information form for each director and executive officer of the applicant seeking to be designated as a DRO, as well as the compliance officer, and whether the costs of requiring a personal information form outweigh the benefits of these background checks; and (ii) whether CROs whose rating is referred to in a prospectus or other disclosure document should continue to be granted an exemption to file an "expert's consent" with securities regulators, which would result in the assumption of statutory liability for their opinion.

Go to blakes.com/english/subscribe.asp to subscribe to other Blakes Bulletins.

Blakes periodically provides materials on our services and developments in the law to interested persons. If you do not wish to receive further bulletins or other materials from Blakes, please click [here](#). For additional information on our privacy practices, please contact us at privacyofficer@blakes.com. *Blakes Bulletin* is intended for informational purposes only and does not create a lawyer-client relationship. The transmission of this information does not suggest Blakes or any of its lawyers are practising law of any jurisdiction other than Canada. The information provided in this bulletin is summary in nature and does not constitute legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For permission to reprint articles, please contact Blakes Marketing Department at 416-863-2403 or lynn.spencer@blakes.com. ©2010 Blake, Cassels & Graydon LLP.