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Governments of:
British Columbia,
Saskatchewan,
Ontario,
New Brunswick,
Prince Edward Island, and
Canada

By Electronic Mail: commentonlegislation@ccmr-ocrmc.ca

**COMMENTS ON DRAFT PROVINCIAL CAPITAL MARKETS ACT (“DRAFT PCMA”)
AND DRAFT CAPITAL MARKETS STABILITY ACT (“DRAFT CMSA”) TO
IMPLEMENT A COOPERATIVE CAPITAL MARKETS REGULATORY SYSTEM IN
CANADA (“PROPOSED COOPERATIVE SYSTEM”)**

Moody's Canada Inc. (“Moody's”) wishes to thank the Governments of British Columbia, Saskatchewan, Ontario, New Brunswick, Prince Edward Island, and Canada (“Participating Jurisdictions”) for the opportunity to comment on the Draft PCMA, Draft CMSA, and Proposed Cooperative System.

Moody's supports the Participating Jurisdictions' efforts to regulate the Canadian capital markets in a manner that will foster efficiency and facilitate integration with the global capital markets. We also recognize **the Participating Jurisdictions' interest in regulating the Canadian capital markets** in a manner that will identify and manage systemic risk on a national basis. However, **Moody's is concerned** that the Draft CMSA mischaracterizes the role of credit rating organizations (CROs) by providing for the designation of CROs as systemically important. We are also concerned that the Draft CMSA and the Proposed Cooperative System contain elements that are extra-territorial in scope. We believe these elements could be refined to effectively address matters more specifically related to the Canadian capital markets.

We discuss these concerns in more detail in the attached Annex I.

Yours sincerely,

/s/ Hilary Parkes

Hilary Parkes

I. CROs should not be designated as systemically important

The proposal to authorize the **capital markets regulatory authority** (“**Authority**”) to designate CROs as systemically important raises two concerns related to the use of credit ratings. First, such a designation would exacerbate the risk of over-reliance on credit ratings. Second, the designation criteria are driven almost entirely by regulatory use and reliance on credit ratings.

A. The limited role of CROs is inconsistent with systemic importance

Moody’s is concerned that by introducing the systemically important designation for CROs in Canada, the Draft CMSA amplifies the role of CROs beyond their intended role in the Canadian capital markets. CROs occupy a narrow niche in the information industry. We provide forward-looking opinions and research about credit risk for use by market professionals. If market professionals choose to use our opinions, we expect them to use our opinions to augment, rather than replace, their own analysis. We intend for our ratings to promote dialogue and debate among market professionals, not end it.

Moody’s believes that by assigning or suggesting a larger role for CROs, the Draft CMSA may increase, rather than reduce, the vulnerabilities in the system. The Draft CMSA defines “systemic risk” as:

A threat to the stability or integrity of Canada’s financial system that originates in, is transmitted through or impairs capital markets and that has the potential to have an adverse effect on the Canadian economy.¹

The Draft CMSA defines the “integrity” of Canada’s financial system as “the structural integrity of all or any significant part of that system including”:

- (a) its continuous and orderly operation without disruption;*
- (b) its soundness, cohesion and resilience;*
- (c) the avoidance of its structural impairment; and*
- (d) the maintenance of public confidence in its structural integrity.²*

In determining whether a CRO should be designated as systemically important, the Draft CMSA expressly requires consideration of “the availability of substitutes for those credit ratings”. In our view, unless credit ratings are required by regulation, there are substitutes for credit ratings. Credit ratings are opinions about credit risk, and although they play an important role in the global capital markets, they are not without alternatives. Credit ratings are but one “tool in the toolbox”. They should be used by sophisticated market participants in combination with their own analysis and

¹ Section 3(1) of the Draft CMSA.

² Section 3(2) of the Draft CMSA.

other available measures of credit risk. If used appropriately and as intended, credit ratings could not operate to undermine the stability or the integrity of the Canadian capital markets.

In providing for the designation of CROs as systemically important, the Draft CMSA links CROs and credit ratings to the structural integrity of the Canadian capital markets, and would signal a degree of reliance and dependence that is misaligned with a CROs' limited role of assigning credit ratings.

B. The mechanistic use of credit ratings should be reduced

The role credit ratings play in the capital markets has been scrutinized over the past few years. That ratings are useful, and have fulfilled a market need, is widely accepted.

*“CRAs play an important role and their ratings can appropriately be used as an input to firms’ own judgement as part of internal credit assessment processes. They can provide economies of scale in analysing credit on behalf of smaller and less sophisticated investors, and can be used as an external comparator by all investors in their own internal assessments”.*³

In this respect, three important principles are generally accepted. First, because the mechanical use of ratings in regulation could have a detrimental effect on the markets – such as leading to herding behaviour by regulated entities – regulators should reduce instances of hardwiring ratings into oversight regimes. Second, ratings should not be perceived or treated as a “substitute”⁴ for market participants’ own assessment of credit or other risks. Finally, policymakers could inadvertently encourage broader market reliance on CRO ratings through the overall “design” of regulatory regimes.⁵

We note that under the current regime, a credit rating from a designated CRO is a precondition for a number of types of market activity, including, for example, an issuer being able to rely on certain prospectus exemptions, being able to file a short-form prospectus to qualify the distribution of certain types of securities, and for mutual funds, being able to enter into certain types of derivative transactions. Moody’s supports efforts to reduce reliance on credit ratings in regulation⁶, and we encourage initiatives that are in line with the Financial Stability Board’s (“FSB”) principles to reduce reliance on credit ratings in standards, laws, and regulations.⁷ The Draft

³ Financial Stability Board, Principles on Reducing Reliance on CRA Ratings, 27 October 2010, pg 2.

⁴ *“While references to CRA ratings in internal limits, credit policies and mandates can sometimes play a useful role as broad benchmarks for transparency of credit policies, they should not substitute for investment managers’ own independent credit judgments and that should be clear to the market and customers”.* *Id.*

⁵ *Id.*

⁶ *See e.g.*, MIS Special Comment Sovereign Ratings and Regulation: The Problem of Intervention (15 April 2013); MIS Special Comment The Role of Ratings in the Financial System (8 May 2012); MIS Response to the European Commission Public Consultation on Credit Rating Agencies (7 January 2011); MIS Comment Letter on the Banking Regulators’ Request for Comment re Alternatives to the Use of External Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies (25 October 2010); MIS Comment Letter on SEC’s Proposals Regarding References to Ratings of NRSROs (5 September 2008); and MIS Special Comment “Ratings in Regulation” (June 1995).

⁷ *See* Financial Stability Board, Principles on Reducing Reliance on CRA Ratings, 27 October 2010.

CMSA, however, relies on regulatory use of credit ratings as its starting point. We believe that the Participating Jurisdictions should examine ways to reduce regulatory use of credit ratings, rather than endorse such use in the Draft CMSA.

II. Elements of the Draft CMSA are extra-territorial in scope

Moody's understands that one of the purposes of the Draft CMSA is to protect the stability and integrity of Canada's financial system through the management of systemic risk related to capital markets. We believe, however, that this objective can be achieved without extra-territorial oversight over CROs. Section 23 of the Draft CMSA seems to contemplate that the Authority would have jurisdiction over any CRO it determines to be systemically important regardless of where that CRO is located or registered to do business. In addition, Section 38(1) of the Draft CMSA provides the Chief Regulator with broad powers to conduct investigations⁸ and searches⁹ for the purpose of inquiring into any matter related to **compliance with a foreign jurisdiction's capital markets** legislation. In addition, Sections 9 and 10 of the Draft CMSA provide the Authority and Chief Regulator with expansive data collection powers for the purpose of monitoring activity in the capital markets and detecting, indentifying and mitigating systemic risk in the capital markets.

CROs are already subject to extensive regulatory oversight in other jurisdictions. In our view, the assertion of cross-border regulatory authority leads to duplicative and sometimes conflicting rules for both regulated entities and market participants. To avoid this dynamic, we believe the Participating Jurisdictions, through the Proposed Cooperative System, could cooperate with their counterparts in other jurisdictions if an issue arose with respect to a CRO operating outside the Proposed Cooperative System and the Participating Jurisdictions or a CRA operating within a Participating Jurisdiction that may not have complied with the capital markets legislation of another jurisdiction. In fact, mechanisms, including the IOSCO Supervisory College, already exist to facilitate cooperation and information sharing in the supervision of CROs, and the Draft CMSA and the Draft PCMA include powers enabling the Authority to cooperate with regulators in other jurisdictions.

⁸ Section 38(3) of the Draft CMSA permits an authorized person to:

- (a) summon the attendance, before the authorized person, of any person;
- (b) compel any person to give evidence on oath or otherwise; [and]
- (c) compel any person to produce records or other things or classes of records or things.

⁹ Section 38(7) of the Draft CMSA permits an authorized person to enter a place that they have reasonable grounds to believe contains any thing that is relevant to the inquiry and:

- (a) examine any thing in the place;
- (b) use any means of communication in the place or cause it to be used;
- (c) use, or cause to be used, any electronic device or other system in the place in order to examine data contained in, or available to, the device or system;
- (d) prepare a record, or cause one to be prepared, based on the data;
- (e) use, or cause to be used, any copying equipment at the place and make copies of any record; and
- (f) remove any thing from the place for examination or copying.

We therefore suggest that Section 23 of the Draft CMSA be revised to clarify that the application of the Draft CMSA and its authority to designate a CRO as systemically important is limited to entities operating in Canada:

23. (1) The Authority may, after consultation with the Chief Regulator, make an order designating a credit rating organization located in Canada as systemically important if, in **the Authority's opinion, the activities of the credit rating organization could pose a systemic risk related to the Canadian capital markets.**

(2) In making the order, the Authority must consider the following factors:

- (a) whether the credit ratings issued by the credit rating organization in Canada are used for regulation in Canada, including capital markets regulation;
- (b) the number of credit ratings issued in Canada by the credit rating organization and the value of securities to which those credit ratings apply;
- (c) the number and type of persons that rely on those credit ratings in Canada;
- (d) the Canadian markets that are affected by those credit ratings;
- (e) the availability of substitutes for those credit ratings; and
- (f) any other risk-related factors that the Authority considers appropriate.

We suggest that Section 38(1) of the Draft CMSA be revised as follows:

38. (1) The Chief Regulator may, by order, authorize a person to exercise, for the purpose of inquiring into any matter relating to compliance with this Act ~~or with a foreign jurisdiction's capital markets legislation~~, any of the powers set out in this section if the Chief Regulator is satisfied that the exercise of the powers is appropriate in the circumstances.

We also suggest that Sections 9 and 10 of the Draft CMSA be revised as follows:

9. The regulations may prescribe requirements in relation to the keeping of records and information and the provision of records and information to the Authority or a designated trade repository for the purposes of

- (a) monitoring activity in the Canadian capital markets or detecting, identifying or mitigating systemic risks related to the Canadian capital markets; or
- (b) conducting policy analysis related to the Authority's mandate and the purposes of this Act.

10. At the request of the Chief Regulator, a person must, at the time and in the form that the Chief Regulator specifies, provide him or her with the records and information that he or she requires for the purposes of

- (a) monitoring activity in the Canadian capital markets or detecting, identifying or mitigating systemic risks related to the Canadian capital markets; or
- (b) conducting policy analysis related to the Authority's mandate and the purposes of this Act.

We believe the proposed revised language will provide the Participating Jurisdictions with the authority necessary to protect the Canadian financial system and capital markets, while also enabling continued cooperation and consistency in the global regulatory oversight of CROs.