Canada – Credit Rating Action Plan

I: Banks

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
1. Reducing reliance on CRA ratings in laws and regulations (Principle I)			
Based on the findings from the stock-taking exercise, please describe the areas identified as needing change and those areas considered priorities, as well as the steps authorities intend to take to reduce reliance on CRA ratings in laws and regulations. In addition, authorities should describe the incentives put in place for market participants to develop their own independent credit assessment processes. Examples of incentives might include disclosure requirements relating to credit risk assessment practices or articulating clear supervisory expectations of the extent to which firms should perform their own due diligence before making lending decisions.			
Canada supports the overall goals of the FSB's initiative to reduce reliance on credit ratings and we have made material steps to implement these principles. The banking regulator, the Office of the Superintendent of Financial Institutions, has emphasised the need to reduce the mechanistic reliance on credit ratings. For banks that use the internal ratings based approach for determining risk-based capital requirements, the external rating is not typically an input into the internal rating that is derived through the institution's model. The external rating is often used as a comparison and benchmark for the internal rating. For banks and insurance companies using the standardized approach, there is greater reliance on external ratings as part of the credit risk assessment process.			

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
a) Remove references to CRA ratings in laws and regulations relating to banks.	OSFI / Department of Finance	There are no references to CRA ratings in banking laws and regulations. The Department of Finance is responsible for laws and regulations pertaining to banks, while OSFI publishes guidelines and advisories to advise banks of expectations related to capital, liquidity and other business practices. The guidelines, in particular, are generally consistent with BCBS standards and as those standards are revised to reduce mechanistic reliance on the use of external ratings, OSFI guidance can be expected to follow.	Guidance is normally revised within one year of international standards being agreed upon. Implementation dates are generally consistent with international implementation.
b) Develop alternative standards of credit assessment, where needed, for the purpose of replacing references to CRA ratings in laws and regulations relating to banks.	OSFI	OSFI is not directly involved in the development of ratings processes, but it does provide feedback on internal rating processes, where appropriate. Ten banks in Canada are using IRB approaches for credit risk-weighted asset values of $1,104 bn . Sixty-four of the banks and trust companies under OSFI's jurisdiction	n.a.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
		use the standardised approach. In total, 86% of total credit risk weights are done on an IRB approach, while 14% are done under the standardised approach.	
2. Reducing market reliance on CRA ratings (Principle II)			
a) Enhance supervisory processes and procedures to assess the adequacy of banks' own credit assessment processes and incentivise market participants to develop internal risk management capabilities.	OSFI	Through OSFI's review of policies and procedures (and supported by samples) related to an internal ratings process, OSFI will note and report findings to the institution. Moreover, from time to time, institutions will seek input on their proposed processes. OSFI will provide feedback, to the extent suitable, but does not endorse any vendors or approach without file-level testing.	n.a.
b) Require or incentivise market participants to disclose information about their internal credit risk assessment processes.	OSFI	None noted at this time.	n.a.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
3.2 Prudential supervision of banks (Principle III.2)			
a) Enhance supervisory oversight of banks to ensure they develop adequate internal credit assessment processes that avoid mechanistic reliance on CRA ratings (differentiating where appropriate between banks subject to the internal ratings-based (IRB), Standardised Approach of other capital regime).	OSFI	As noted above, OSFI is not directly involved in the development of ratings processes. OSFI conducts file reviews (on a sample basis) at selected regulated banks and insurance companies. This review includes an assessment of the credit risk analysis that was completed and the suitability of the internal rating that was assigned. If OSFI does not concur with the assigned rating based on the file, a downgrade is advised to the institution based on their internal rating scale.	n.a.
b) Revise CRA ratings in other prudential supervisory policies (e.g. relating to liquidity requirements) to reduce reliance on CRA ratings.	OSFI	See comment above related to consistency with BCBS international guidance.	n.a.

II: Central bank operations

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
3. Application of the basic principles to particular financial market activities (Principle III)			
Based on the findings from the stock-taking exercise, please describe the areas identified as needing changes, including which areas are considered priorities, and the steps authorities intend to take to reduce reliance on CRA ratings in central bank policies and operations.			
Canadian authorities have taken action to reduce reliance on CRA ratings in central bank operations, as indicated below.			
3.1 Central bank operations (Principle III.1)			
a) Reduce reliance on CRA ratings in central bank policies (such as investments, asset management frameworks, and conventional and unconventional operations), including the decision to accept or reject an instrument as collateral or for outright purchase and in determining haircuts.	Bank of Canada / Department of Finance	Funds Management: The Bank of Canada and the Department of Finance continue to undertake a range of work to eliminate mechanistic reliance on CRA ratings in the area of reserves management. In 2013, the Bank of Canada developed the capacity to perform credit assessments and has worked with the Department of Finance to establish a governance structure for a new framework under which internally assigned ratings will be used for the purposes of reserves management to set eligibility requirements and credit limits as part of the	Expected to be implemented by the end of 2014

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
		government's risk-management policy. The internal sovereign rating methodology to support this framework was developed for, and approved by, senior management at Finance and the Bank. Methodologies for other asset classes eligible for investment of FX reserves are being developed. Internal ratings will replace CRA ratings currently referred to in the Statement of Investment Policy for Canada's foreign exchange reserves. <u>SLF Collateral Policy:</u> Currently, for some types of security assessed for eligibility as collateral at the Bank's Standing Liquidity Facility (SLF) the second-highest CRA rating must meet a specified minimum. However, CRA ratings are not required for all eligible assets. There is no minimum credit rating requirement for securities issued or guaranteed by the Government of Canada, for securities issued by the United States Treasury, and for non-mortgage loan portfolios. Furthermore,	This review is expected to be substantially advanced by the end of 2014.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. “end-2014” or “one year after new international standards agreed”)
		regardless of credit rating, the Bank retains the right of refusal for any asset presented as collateral, allowing for other relevant factors to determine acceptability. Key challenges the Bank perceives in regards to further reducing reliance on CRA ratings in the SLF include the need to have sufficient transparency and predictability in terms of collateral eligibility, and issues surrounding possible implicit communication to the market of internal credit assessments and associated risks of exacerbating market stresses. The Bank is analyzing the implications of reducing the role of CRA ratings in determining the eligibility of assets for the SLF, and possibly the determination of haircuts, and is exploring viable complements and alternatives to CRA ratings. Included in this analysis are synergies that might be realized from work already done in the Bank's Foreign Reserve Management area and in relation to other	

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
		domestic collateral policy changes, possible changes to existing eligibility policies, ways to include the non-mechanistic use of CRA ratings as inputs into internal assessments, and other alternative proxies for market and financial risk. <u>Receiver-General Cash Balance Auctions</u> The auctioning of these cash balances allows the government to earn a competitive market-driven rate of return on these balances. Recently announced changes to the terms of this program reflect evolving market practice and will serve to reduce the Government's exposure to counterparty credit risk. The most significant change is the elimination of uncollateralized exposure with counterparties which will effectively lower the Government's exposure to credit risk and significantly reduce mechanistic reliance on credit ratings.	This change will be in effect 1 April 2014.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
b) Adjust policies for imposing risk control measures (including haircuts) on financial instruments to align with the FSB Principles on CRA ratings.	Bank of Canada	As a risk control, the Bank currently imposes haircuts that incorporate price volatility and market liquidity considerations for all eligible collateral. The haircuts schedule for the SLF depends on the asset type, on the residual maturity, and on the second highest CRA rating for some assets classes. However, there is no differentiation in haircut levels based on credit ratings for securities issued or guaranteed by the Government of Canada or by a provincial government, for securities issued by the United States Treasury, and for non-mortgage loan portfolios. The haircut schedule, which is reviewed on an on-going basis to minimize credit, liquidity and market risks, is based on a long history of price data that includes a stress period (with the intent to have "through the cycle" haircuts). Other factors assessed include the specific features of the type of collateral pledged. For example, the Bank may use risk controls such as ensuring there is no optionality embedded	This review is expected to be substantially advanced by the end of 2014.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
		in securities, limiting the concentration of a private sector issuer's security in a given pledger's collateral portfolio, not accepting subordinated securities of an issuer and requiring in some cases minimum disclosure practices (e.g. in relation to eligible ABCP). An examination of policy options and potential implications for further reducing reliance on CRA ratings in determining the eligibility of assets for the SLF is on-going, and includes a review of the use of CRA ratings in the haircut policy.	
c) Develop the central bank's internal credit risk assessment capabilities and use of alternative measures of creditworthiness.	Bank of Canada / Department of Finance	As noted above, the Bank of Canada and the Department of Finance are implementing a new framework under which internally assigned ratings will be used for the purposes of reserves management.	Expected to be implemented by the end of 2014

III: Insurance/Reinsurance Companies[1]

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
1. Reducing reliance on CRA ratings in laws and regulations (Principle I)			
Based on the findings from the stock-taking exercise, please describe the areas identified as needing change and those areas considered priorities, as well as the steps authorities intend to take to reduce reliance on CRA ratings in laws and regulations. In addition, authorities should describe the incentives put in place for market participants to develop their own independent credit assessment processes. Examples of incentives might include disclosure requirements relating to credit risk assessment practices or articulating clear supervisory expectations of the extent to which firms should perform their own due diligence before making lending or investment decisions.			
OSFI has taken concrete steps to reduce the reliance on credit ratings for institutions subject to its oversight. *The Draft Own Risk Solvency Assessment (ORSA) Guideline was released in 2013 and states that, "Insurers should have enterprise-wide methodologies that enable them to assess the credit risk involved in individual and aggregate exposures." The Guideline further states, "The credit review assessment of capital adequacy should consider the limitations of an insurer's risk-rating systems and due diligence assessments and cover, as applicable, large exposures, risk concentrations, financial guarantees, counterparty, derivative counterparty and reinsurance arrangements."* *In addition, OSFI Guideline B-3 – Sound Reinsurance Practices and Procedures was issued in December 2010 and directly addresses and references the FSB's principles for reducing reliance on CRA ratings. More specifically, when performing due diligence on a current or prospective reinsurance counterparty, the Guideline strongly suggests that insurers perform their own analysis rather than relying on third-*			

[1] Answers in this section should relate to the prudential regulation of insurance companies and reinsurance companies. Laws and regulations relating to insurance companies in their capacity as institutional investors should be included in the section entitled "Investment Funds Management."

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
party assessments. The Guideline states, "In the evaluation of its current and prospective reinsurance counterparties, however, a federally regulated insurer should generally not rely solely on third parties, including rating agency assessments or broker analysis or recommendations. Prudent practice dictates that the federally regulated institution should, to an extent proportional to the importance of such counterparty, conduct its own due diligence on the financial strength and capabilities of all reinsurance counterparties."			
a) Remove references to CRA ratings in laws and regulations relating to insurance/reinsurance companies.	OSFI / Department of Finance	There are no references in this regard.	n.a.
b) Develop alternative standards of credit assessment, where needed, for the purpose of replacing references to CRA ratings in laws and regulations relating to insurance/reinsurance companies.	OSFI	OSFI is currently developing a models-based solvency framework for Canadian life insurance companies which will include the use of internal models to determine ratings.	Ongoing
2. Reducing market reliance on CRA ratings (Principle II)			
a) Enhance supervisory processes and procedures to assess the adequacy of insurers'/reinsurers' own credit assessment processes and incentivise market participants to develop internal risk management capabilities.	OSFI	Insurers use a combination of CRA ratings and their own internal analysis when assessing credit risk. OSFI encourages companies to not solely rely on the ratings of CRAs. OSFI wants to see that insurers	n.a.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
		have their own models to assess the credit-worthiness of the counterparty. OSFI conducts file reviews (on a sample basis) at selected regulated life insurance companies. This review includes an assessment of the credit risk analysis that was completed and the suitability of the internal rating that was assigned. If OSFI does not concur with the assigned rating based on the file, a downgrade is advised to the institution based on their internal rating scale. In addition, as mentioned above, OSFI is currently developing a models-based solvency framework for Canadian life insurance companies which will include the use of internal models to determine ratings.	

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. “end-2014” or “one year after new international standards agreed”)
b) Require or incentivise market participants to disclose information about their internal credit risk assessment processes.	OSFI	None noted at this time.	n.a.

IV: Investment Funds Management

(including collective investment schemes, alternative investment schemes, occupational retirement schemes)

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
1. Reducing reliance on CRA ratings in laws and regulations (Principle I)			
Based on the findings from the stock-taking exercise, please describe the areas identified as needing change and those areas considered priorities, as well as the steps authorities intend to take to reduce reliance on CRA ratings in laws and regulations. In addition, authorities should describe the incentives put in place for market participants to develop their own independent credit assessment processes. Examples of incentives might include disclosure requirements relating to credit risk assessment practices.			
a) Remove references to CRA ratings in laws and regulations for investment funds management.	Canadian Securities Administrators (CSA) /OSFI/ Provincial Pension Regulators	There are very few references in the federal framework to credit ratings, and those that remain have been reviewed and it has been determined that they serve an appropriate policy purpose. Furthermore, at this time, CSA members do not propose to remove all references to credit ratings from Canada's provincial and territorial securities legislation and regulation. Please see the annex for additional discussion.	n.a.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
b) Develop alternative standards of credit assessment, where needed, for the purpose of replacing references to CRA ratings in laws and regulations for investment funds management.	CSA	CSA members have not developed any alternative standards of assessment for the purpose of replacing references to CRA ratings at this time. CSA members will continue to monitor international developments regarding appropriate alternative proxies to credit ratings.	n.a.
2. Reducing market reliance on CRA ratings (Principle II)			
a) Enhance supervisory processes and procedures to assess the adequacy of market participants' own credit assessment processes.	CSA/OSFI/ Provincial Pension Regulators	Regulators have broad authority to review the policies of market participants. At this time, CSA members have no specific supervisory processes and procedures to assess the adequacy of market participants' own credit assessment processes.	n.a.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
3. Application of the basic principles to particular financial market activities (Principle III.3)			
a) Establish, as appropriate, supervisory review of internal limits and investment policies of investment managers and institutional investors.			
a. Insurance companies (in their capacity as institutional investors)	OSFI	OSFI already conducts file reviews (on a sample basis) at selected regulated life insurance companies.	n.a.
b. Investment managers (i.e. managers of collective investment schemes).	CSA	The OSC already has the authority to conduct compliance examinations to inspect the business and conduct of registrants to determine if registrants are complying with securities legislation.	n.a.
c. Alternative investment managers (e.g. hedge funds, endowments).	CSA	As noted above, the OSC already has the authority to conduct compliance examinations to inspect the business and conduct of registrants, including hedge fund managers, to determine if registrants are complying with securities legislation.	n.a.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
d. Managers of occupational retirement schemes.	OSFI / Provincial Pension Regulators	Pension plan administrators are required to invest the assets of a pension fund in accordance with Regulations and in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund. Prudent investment practices require appropriate processes that include due diligence in selecting, reporting and monitoring investments. A plan administrator may therefore consider using credit ratings as part of their due diligence review. In addition, when using a letter of credit a plan administrator must obtain the letter of credit from an issuer that has an acceptable credit rating. Pension plan regulators have the authority to conduct compliance reviews.	n.a.
b) Require changes to internal limits and investment policies.			

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
a. Insurance companies (in their capacity as institutional investors)	OSFI	None noted at this time.	n.a.
b. Investment managers (i.e. managers of collective investment schemes).	CSA	Internal limits and investment policies are routinely reviewed as part of the compliance examination process for all portfolio managers.	n.a.
c. Alternative investment managers (e.g. hedge funds, endowments).	CSA	As noted above, internal limits and investment policies are routinely reviewed as part of the compliance examination process for all portfolio managers. This includes those that manage the portfolio of a hedge fund.	n.a.
d. Managers of occupational retirement schemes.	OSFI / Provincial Pension Regulators	None noted at this time.	n.a.
c) Incentivise compliance with the CRA Principles.			
a. Insurance companies (in their capacity as institutional investors)	OSFI	None noted at this time.	n.a.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
b. Investment managers (i.e. mangers of collective investment schemes).	CSA	None noted at this time.	n.a.
c. Alternative investment managers (e.g. hedge funds, endowments).	CSA	None noted at this time.	n.a.
d. Managers of occupational retirement schemes.	OSFI / Provincial Pension Regulators	None noted at this time.	n.a.
d) Strengthen supervisory oversight to assess whether investments managers and institutional investors have made changes to the role that CRA ratings play in investment mandates, thresholds and triggers.			
a. Insurance companies (in their capacity as institutional investors)	OSFI	None noted at this time.	n.a.
b. Investment managers (i.e. managers of collective investment schemes).	CSA	None noted at this time.	n.a.
c. Alternative investment managers (e.g. hedge funds, endowments).	CSA	None noted at this time.	n.a.
d. Managers of occupational retirement schemes.	OSFI / Provincial Pension Regulators	None noted at this time.	n.a.

V: Collateral Policies for Central Counterparties (CCPs)

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
Based on the findings from the stock-taking exercise, please describe the areas identified as needing change and those areas considered priorities, as well as the steps authorities intend to take to reduce reliance on CRA ratings in laws and regulations. In addition, authorities should describe the incentives put in place for market participants to develop their own independent credit assessment processes. Examples of incentives might include disclosure requirements relating to credit risk assessment practices or articulating clear supervisory expectations of the extent to which CCPs should perform their own due diligence.			
1. Reducing reliance on CRA ratings in laws and regulations (Principle I)			
a) Remove references to CRA ratings in laws and regulations relating to collateral policies for CCPs.	Bank of Canada	Where possible, references to CRA ratings will be removed. Under CDS Participant Rules 5.3.1, the collateral requirements for a Participant are consistent with that of the Bank of Canada's Standing Liquidity Facility (SLF), so that those types of securities eligible as collateral could be pledged to the Central Bank for liquidity purposes. As such, a review of CDS Participant Rule 5.3.1 will be initiated, pending changes to the Bank of Canada's SLF collateral policy.	The SLF review is expected to be substantially advanced by the end of 2014. The next review will follow upon completion of the SLF review.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
b) Develop alternative standards of credit assessment, where necessary, for the purpose of replacing references to CRA ratings in laws and regulations relating to collateral policies for CCPs.	Bank of Canada	As noted above, the Bank of Canada is examining policy options and potential implications for reducing reliance on CRAs for the Standing Liquidity Facility. A subsequent review of CDS participant rules will occur, pending any changes. This review will address both the removal of references where possible, and the development of alternative standards of credit assessment where necessary.	The SLF review is expected to be substantially advanced by the end of 2014. The next review will follow upon completion of the SLF review.
2. Reducing market reliance on CRA ratings (Principle II)			
a) Enhance supervisory processes and procedures to assess the adequacy of CCPs' own credit assessment processes.	Bank of Canada	None noted at this time.	n.a.
3. Application of the basic principles to particular financial market activities (Principle III)			
3.1 Central counterparties and private sector margin agreements (Principle III.4a)			
a) Conduct stress tests or estimate the procyclical effect, on the overall margin requirements for the CCP participants, of a sudden downgrade of	Bank of Canada	The CCPs have completed their self-assessment against the CPSS-IOSCO Principles and have highlighted	end-2014

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
the credit ratings of some widely used securities.		procyclicality as a gap that needs to be addressed. The FMIs plan to propose remedial actions to their regulators in 2014 in order to address procyclicality.	
b) Assess the reliance on credit ratings in the investment policy of the CCP.	Bank of Canada	Authorities are assessing the reliance on credit ratings in the investment policy as part of the Principles for Financial Market Infrastructures assessment.	On-going; expected completion by end-2014
c) Review private sector margin agreements to ensure compliance with the Principle.	Bank of Canada	CCP Supervisors do not have any role in reviewing bi-lateral margin agreements. Supervisors do review and approve CCP margin agreements.	n.a.
d) Require changes to private sector margin agreements.	Bank of Canada	As noted above, CCP Supervisors do not have any role in reviewing bi-lateral margin agreements, nor have any role in requiring changes therein.	n.a.
e) Incentivise compliance with the CRA Principles.	Bank of Canada	None noted at this time	n.a.

VI: Securities Issuance (debt and equity, whether public issuance or private placement), including asset-backed securities and corporate debt

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
Based on the findings from the stock-taking exercise, please describe the areas identified as needing change and those areas considered priorities, as well as the steps authorities intend to take to reduce reliance on CRA ratings in laws and regulations. In addition, authorities should describe the incentives put in place for market participants to develop their own independent credit assessment processes. Examples of incentives might include disclosure requirements relating to credit risk assessment practices.			
Certain references to CRA ratings remain in the framework for Canadian securities issuances, as those are viewed as serving an appropriate policy purpose. *The adoption of National Instrument 25-101 (NI 25-101), described below, should provide market participants with greater confidence in the process used to generate ratings and the designated rating organization has appropriate policies and procedures in place to preserve the integrity of the ratings. It should also provide greater transparency as the details of issued ratings and the potential for conflicts of interest.* *Credit rating organizations that wish to have their credit ratings eligible for use in securities legislation must apply to the appropriate Securities Regulator to be considered as a "designated rating organization" (DRO). Entities that apply are obliged to submit application documents containing all the information that the securities regulator deems necessary and to demonstrate they meet the regulatory requirements. The regulatory requirements for DROs are set out in NI 25-101. These requirements include provisions that are based substantially on the IOSCO CRA Code.*			
1. Reducing reliance on CRA ratings in laws and regulations (Principle I)			
a) Remove references to CRA ratings in laws and regulations related to securities issuance.	CSA	At this time, CSA jurisdictions are not proposing to remove all references to	n.a.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
		credit ratings from securities legislation. Those which remain have been reviewed and it has been determined that they serve an appropriate policy purpose. Additional discussion can be found in the annex.	
b) Develop alternative standards of credit assessment, where necessary, for the purpose of replacing references to CRA ratings in laws and regulations relating to securities issuance.	CSA	The CSA has not developed any alternative standards of assessment for the purpose of replacing references to CRA ratings at this time. It will continue to monitor international developments regarding appropriate alternative proxies to credit ratings.	n.a.
2. Reducing market reliance on CRA ratings (Principle II)			
a) Enhance supervisory processes and procedures to assess the adequacy of market participants own credit assessment processes.	CSA	At this time, the CSA has not developed any supervisory processes and procedures to review credit assessment processes of reporting issuers. It will continue to monitor international developments in this regard.	n.a.

Action to be taken	Responsible national authority	High-level description of approach to be taken, and necessary or contributory factors to assist implementation (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
3. Application of the basic principles to particular financial market activities (Principle III)			
3.1 Central counterparties and private sector margin agreements (Principle III.5a)			
a) Review the role of credit rating in disclosures by issuers of securities.	CSA	None noted at this time.	n.a.
b) Reduce the role of credit ratings in disclosures by issuers of securities (list the steps to take).	CSA	None noted at this time.	n.a.

VII: Securities Firms (broker-dealers)

Action to be taken	Responsible national authority	Milestones to be met (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
Based on the findings from the stock-taking exercise, please describe the areas identified as needing change and those areas considered priorities, as well as the steps authorities intend to take to reduce reliance on CRA ratings in laws and regulations. In addition, authorities should describe the incentives put in place for market participants to develop their own independent credit assessment processes.			
Certain references to CRA ratings remain in the framework for Canadian for securities firms, as those are viewed as serving an appropriate policy purpose.			
1. Reducing reliance on CRA ratings in laws and regulations (Principle I)			
a) Remove references to CRA ratings in laws and regulations relating to securities firms.	CSA	At this time, CSA jurisdictions do not propose to remove all references to credit ratings from securities legislation. Those which remain have been reviewed and it has been determined that they serve an appropriate policy purpose. Additional discussion can be found in the annex.	n.a.
b) Develop alternative standards of credit assessment, where necessary, for the purpose of replacing references to CRA ratings in laws and regulations relating to securities firms.	CSA	The CSA has not developed any alternative standards of assessment for the purpose of replacing references to CRA ratings at this time. It will continue to monitor international developments regarding	n.a.

Action to be taken	Responsible national authority	Milestones to be met (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
		appropriate alternative proxies to credit ratings. However, there should be no apparent incentives for such reliance that follows as a result of the requirements in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103). NI 31-103 requires registered firms to establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to manage the risks associated with their business in accordance with prudent business practices. This general requirement is set out in paragraph 11.1(b) of NI 31-103 and applies to registered firms, including firms that are registered as a dealer, portfolio manager or investment fund manager. This general requirement **may** serve to encourage these market participants to make their own credit	

Action to be taken	Responsible national authority	Milestones to be met (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
		assessments, and not rely solely or mechanistically on CRA ratings, where to do so would be in accordance with prudent business practice.	
2. Reducing market reliance on CRA ratings (Principle II)			
a) Enhance supervisory processes and procedures to assess the adequacy of securities firms' own credit assessment processes.	CSA	As outlined above, NI 31-103 requires registered firms to establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to manage the risks associated with their business in accordance with prudent business practices. As part of the compliance oversight process, OSC staff conducts compliance reviews to assess registrants' compliance with securities laws and to test their systems of internal controls and processes. Subsection 13.3(1) of NI 31-103 requires registrants to take reasonable steps to	n.a.

Action to be taken	Responsible national authority	Milestones to be met (e.g. changes in international standards)	Milestones and expected completion date (e.g. “end-2014” or “one year after new international standards agreed”)
		ensure that a proposed trade is suitable for a client before making a recommendation or accepting instructions from the client. To meet this suitability obligation, registrants should have in-depth knowledge of all securities that they buy and sell for, or recommend to, their clients. This is often referred to as the “know your product” obligation. During the course of compliance field reviews, staff examine the due diligence process performed by registrants on the securities they are researching for investment decision making purposes. To assess the registrant firm’s research and investment decision making process, OSC staff will look at the steps that the registrant takes in their research, including if the registrant firm’s representatives meet with management of the issuer, review the issuer’s financial statements and other filings, use third party research and reports,	

Action to be taken	Responsible national authority	Milestones to be met (e.g. changes in international standards)	Milestones and expected completion date (e.g. "end-2014" or "one year after new international standards agreed")
		participate in analysts' conference calls or perform their own internal valuations of issuers. CSA members expect registrants to conduct an adequate level of due diligence, and not rely solely on CRA ratings, in order to fulfil their "know your product" obligation. Without a proper understanding of the structure, features and risks of a security, the registrant does not have an adequate process to assess suitability on behalf of their clients.	

Annex – Additional Information on Canadian Securities Legislation and Capital Markets

A. Overview

Certain references to credit ratings remain in Canada's provincial and territorial securities legislation.

In connection with the enactment of National Instrument 25-101 *Designated Rating Organizations* (NI 25-101) in 2012, staff of the Canadian Securities Administrators (CSA) reviewed all references to credit ratings and credit rating organizations in Canada's provincial and territorial securities legislation. CSA staff confirmed that each reference served an appropriate policy purpose.

We understand the policy rationale for eliminating mechanistic reliance on credit ratings and are monitoring approaches taken by other international securities regulators in this area. We understand removing ratings references is one approach which may achieve this policy objective, however, the CSA does not proposed to remove all references at this time.

As set out in more detail below, the credit rating references in Canada's provincial and territorial securities legislation serve an appropriate policy purpose and do not necessarily create mechanistic reliance (or, in the alternative, do not create undue or problematic reliance). These include providing disclosure to investors, creating eligibility criteria for market participants to engage in certain activities, such as a corporate issuer offering certain debt securities without a prospectus, and creating thresholds for defining permitted investments for market participants, such as mutual funds.

In some instances, removing these references would require an alternative proxy. The CSA notes the need for international consistency in developing alternative risk assessment capabilities and processes before proposing legislative amendments. We are monitoring approaches taken by other international securities regulators and will consider whether those approaches could inform future proposals to maintain, modify or delete references to credit ratings in Canada's provincial and territorial securities legislation. As part of this work, we are actively involved in two IOSCO Committees (described below) which are considering initiatives to reduce reliance on credit ratings.

B. Issuers of securities other than investment funds

This section reviews certain references to credit ratings in legislation governing issuers of securities (other than investment funds) and attempts to explain why those references serve an appropriate policy purpose – rather than mechanistic or problematic reliance on credit ratings. A chart setting out all such references can be provided on request.

Disclosure about credit ratings required in a prospectus

If an issuer has asked for and received a credit rating, the prospectus rules require the issuer to disclose information about the credit rating.

- The purpose of these rules is not to require a credit rating, but rather to require an issuer to disclose any credit rating the issuer has asked for and received, and to require the issuer to provide complementary information regarding its dealings with the ratings industry.
- We think this information is useful to investors and is also aimed to discourage "rating shopping" practices.
- We take the view that until a suitable alternative to credit ratings is established, credit ratings constitute an element of information that should be part of the "full, true and plain" disclosure in a prospectus.
- Likewise, any change in an already disclosed rating may trigger the filing by the issuer of a material change report, in application of general continuous disclosure requirements under securities legislation.

Eligibility to file a short form prospectus or a shelf prospectus

In Canada, the "short form prospectus" regime and the "shelf prospectus" regime allow certain issuers to have relatively quick access to the capital markets by filing an abbreviated form of prospectus, rather than a much longer prospectus that would otherwise be required.

- In order to file a short form prospectus or a shelf prospectus, an issuer must meet certain eligibility criteria. The purpose of the eligibility criteria is to restrict access to the short form/shelf prospectus system to "qualified issuers" that meet certain minimum standards.
- One criterion is for the issuer to have its equity securities listed on a recognized stock exchange.
- However, there are a number of issuers in Canada that do not have their equity securities listed on a stock exchange (e.g., issuers that only offer preferred shares, debt securities or asset backed securities to the public). As a result, the rules provide for alternative criteria if the issuer has a "designated rating" from a designated rating organization. The references to designated ratings serve a "gate-keeping" function, rather than problematic reliance on credit ratings.
- We do not propose to remove the credit rating references at this time because there has not been an alternative risk assessment proxy that would justify amendments. In proposing alternatives to credit ratings, the challenge is seeking generally to neither narrow nor broaden the scope of issuers that would qualify for the benefits conferred in the existing rules.

Existing prospectus exemption for short-term debt and proposed amendments

In Canada, a prospectus exemption is available for certain offerings of short-term debt.

- The current short-term debt prospectus exemption (Short-Term Debt Prospectus Exemption) requires that the debt have a "designated rating" from a designated rating organization. The exemption is used for offerings of commercial paper (CP) in Canada.
- The rationale for not requiring a prospectus under the short-term debt exemption is that the security is considered of sufficiently high credit quality by virtue of its short term to maturity and its credit rating at or above a certain threshold.
- The references to designated ratings serve a gate-keeping function, rather than problematic reliance on credit ratings. Issuers that do not meet the designated rating thresholds are not eligible to use the short term debt exemption and would only be

able to issue short term debt under a prospectus or pursuant to another prospectus exemption (e.g., accredited investor).
- In early 2014, we will be publishing for comment proposed amendments to the exemption that reflect our regulatory experience, especially our experience since the 2007-2008 credit market turmoil.

The proposed amendments will:

- Change the requirements that short-term debt securities must satisfy in order to be distributed under the Short-Term Debt Prospectus Exemption.
- Make the Short-Term Debt Prospectus Exemption unavailable for securitized products such as asset-backed commercial paper (ABCP).
- Introduce a new prospectus exemption for short-term securitized products that would only be available for conventional or traditional ABCP (the Short-Term Securitized Products Prospectus Exemption).

Short-Term Debt Prospectus Exemption

The amendments to the Short-Term Debt Prospectus Exemption will:

- Modify the credit ratings required to distribute CP.
- Remove the regulatory disincentive for some CP issuers to obtain an additional rating.
- Provide consistent treatment of CP issuers with similar credit risk.
- Maintain the current credit quality of CP distributed under the Short-Term Debt Prospectus Exemption.

The publication notice for the amendments to the Short-Term Debt Prospectus Exemption will note that:

- We considered whether the use of credit ratings in the Short-Term Debt Prospectus Exemption serves appropriate investor protection and market efficiency functions.
- We concluded that it was appropriate to continue to use credit ratings to establish parameters for the credit quality of CP that can be issued on a prospectus-exempt basis.
- We did not identify specific alternatives or additional conditions to credit ratings that would materially enhance investor protection or financial stability in the CP market.

In contrast, we identified significant issues with how non-bank ABCP was rated and the reliance placed on intermediaries and investors on those ratings. These issues are being addressed by the proposed Short-Term Securitized Products Prospectus Exemption and related amendments.

Short-Term Securitized Products Prospectus Exemption

The new proposed Short-Term Securitized Products Prospectus Exemption:

- Will require additional disclosure by conduits.
- Will require credit ratings from at least two DROs.

Furthermore,

- Each credit rating must be at or above a prescribed minimum level, which is higher than the minimum level that we propose for CP.
- The exemption will be unavailable for a short-term securitized product if any of its credit ratings are under review by the relevant DRO and it would be reasonable for the conduit to expect that the review would result in the credit rating being withdrawn or downgraded below the prescribed minimum level.
- In order to enhance investor protection and reduce reliance on credit ratings, the exemption will be conditional on a number of liquidity support requirements.
- A conduit relying on the exemption would have to contractually agree that its asset pool would consist only of traditional asset classes such as bonds, leases, mortgages and receivables.

C. Investment funds

This section reviews certain references to credit ratings in legislation governing investment fund issuers and attempts to explain why those references serve an appropriate policy purpose – rather than mechanistic or problematic reliance on credit ratings. A chart setting out all such references can be provided on request.

In Canada, publicly offered investment funds are categorized into two types: (i) mutual funds and (ii) non-redeemable investment funds (e.g., closed-end funds sold through an initial public offering). While there are certain rules that apply to all investment funds, including prospectus and continuous disclosure rules, only mutual funds are currently subject to product regulation. The product regulation rule includes restrictions and practices on the classes of assets and investment strategies a mutual fund may invest in or employ.

By August 2014, we will be publishing amendments that will extend the application of the investment fund product rule to non-redeemable investment funds. However, some of the investment restrictions and practices discussed below will continue to apply only to mutual funds.

Eligibility for mutual funds to enter certain types of transactions

Several of the investment restrictions and practices contain eligibility criteria that must be met before a mutual fund may enter into certain types of transactions, such as short selling or a permitted derivative. As described further below, these criteria may include a reference to a "designated rating". These references, however, generally serve a "gate-keeping" function rather than allowing the fund to take certain actions based on a mechanistic reliance on credit ratings.

Cash requirements

If a mutual fund wishes to engage in limited short selling of securities, transactions in specified derivatives for non-hedging purposes, or securities lending, repurchase and reverse repurchase transactions, the mutual fund must comply with certain conditions.

These conditions include requiring the mutual fund to hold a certain amount of cash during the time the mutual fund is engaged in the transaction.

- For example, if a mutual fund wishes to short sell securities or use specified derivatives for non-hedging purposes, the mutual fund is required to hold "cash cover" that would permit the mutual fund to satisfy its obligations arising from the position in specified derivatives or from the short sale of securities.
- If a mutual fund wishes to enter into a securities lending transaction as lender, the borrower must deliver collateral in the form of cash or "qualified securities" to the mutual fund. Similarly, if a mutual fund wishes to enter into a repurchase transaction, an equivalent amount of cash must be delivered to the mutual fund for the sold securities until such time that the securities are repurchased.
- In order to satisfy these cash requirements, a specified group of assets that have attributes as near as possible to cash (i.e., assets with high liquidity and low credit risk) may be used instead of cash. Certain of the specified assets, such as short-term debt, require a "designated rating". The purpose of the credit rating requirement is to minimize the credit and liquidity risk of those assets.
- We do not propose to remove these credit rating references at this time because there has not been an alternative risk assessment proxy that would justify amendments. Given that the reference to a "designated rating" is not the only criterion determining whether a certain asset is sufficiently liquid for cash purposes, the "designated rating" serves as an additional, not stand-alone, tool for assessing the credit quality of the asset.

Transactions in specified derivatives

If a mutual fund wishes to use transactions in specified derivatives for both hedging and non-hedging purposes, the mutual fund must comply with certain conditions in addition to the need to hold prescribed assets as cash cover for derivative positions.

- In the case of over-the-counter (OTC) derivative transactions, the OTC derivative and the counterparty for the OTC derivative transaction must have a "designated rating" at the time of the transaction. Further, if the credit rating falls below the level of the "designated rating" while the derivative is held by the mutual fund, the mutual fund is required to take reasonable steps to close out its position in that derivative in an orderly and timely fashion.
- We do not propose to remove this credit rating reference at this time because there has not been an alternative risk assessment proxy that would justify amendments. These "designated rating" references are not the only criteria intended to ensure that the risks of a derivatives transaction will be sufficiently managed, and serve as additional risk assessment tools. There are other requirements such as the requirement that non-hedging derivatives positions not exceed a certain percentage of a mutual fund's net assets.
- Although we do not propose to remove this credit rating reference at this time, we do consider applications for exemptive relief where the credit rating requirements have not been met. This permits us to consider how other factors, other than the use of credit ratings, can mitigate the risks associated with OTC derivative transactions.

Eligibility for mutual funds to qualify as money market funds

If a mutual fund wishes to describe or market itself as a "money market fund," the mutual fund is subject to certain investment criteria, including that the mutual fund's assets must entirely be invested in permitted asset classes.

- These permitted asset classes include cash, cash equivalents, and other short-term debt securities such as floating rate notes that meet prescribed requirements.
- Certain of the requirements for those assets, such as short-term debt securities, reference "designated ratings." The credit rating requirement is used to impose a "floor" on the credit quality of issuers that qualify for investment by a money market fund.
- We do not propose to remove this credit rating reference at this time because there has not been an alternative risk assessment proxy that would justify amendments.
- In addition to limiting the classes of assets a money market fund may hold, money market funds must comply with several other requirements to support liquidity of the funds. Irrespective of the use of credit ratings, a mutual fund is expected to determine that each asset is appropriate in order to meet the mutual fund's investment objectives and strategies.

Eligibility for mutual funds to invest a substantial amount in foreign government bonds

Mutual funds are subject to a concentration restriction and are generally prohibited from purchasing a security of an issuer if, immediately after the purchase, more than 10% of the net assets of the mutual fund would be invested in securities of that issuer.

- Staff guidance sets out circumstances in which an exemption would be granted for international bond funds. Generally, a mutual fund would be permitted to invest up to 20% or 35% of its net assets in foreign government debt securities if those securities meet a specified credit rating level.
- In addition to meeting the minimum credit rating requirement, the investment in foreign bonds must meet other criteria, including that the securities are traded on a mature and liquid market.
- Given that the requirement is only set out in staff guidance and not in the rules, staff have an opportunity to review each application for exemptive relief and consider whether there is overreliance on credit ratings. In each case, staff would ensure there are other mitigating factors for the liquidity risks associated with holding concentrated amounts of one issuer.

Eligibility for mutual funds to make purchases from a related underwriter

Under the conflicts of interest rules, a mutual fund is generally prohibited from purchasing securities during a distribution period if a related dealer is an underwriter for that distribution.

- An exemption is provided from this rule for an investment in a class of debt securities of an issuer if certain conditions are met. One of the conditions provides that the debt security has been given a "designated rating."
- This credit rating requirement is used as a mitigating factor for the potential conflict of interest that arises when a mutual fund purchases securities under an offering underwritten by a related dealer, in particular, to address concerns that dealers may "dump" otherwise lower-quality or undesirable debt securities on its related mutual funds in order to ensure a successful offering. It is not the key criterion used to address the potential conflict of interest, and only serves as an additional safeguard so that assets sold to the mutual fund may be of a minimum quality.
- Although we do not propose to remove this credit rating reference at this time, we have granted exemptive relief in several instances from the related dealer prohibition where the credit rating requirement has not been met. In order to enhance investor

protection and reduce reliance on credit ratings in those cases, the exemption was conditional on other factors that would mitigate conflict of interest concerns.

Disclosure about credit ratings required in financial statements

If an investment fund holds positions in derivatives, the investment fund is required to disclose in its financial statements several details about those derivatives positions, including if a rating of a counterparty has fallen below the designated rating level.

- The purpose of this rule is to require an investment fund to include complete information about the fund's positions in derivatives. Since a counterparty's credit rating is one of the factors considered prior to an investment fund entering into a derivatives position, we think whether the credit rating of the counterparty has fallen is useful information for investors.
- We take the view that until a suitable alternative to credit ratings is established in connection with an investment fund's transactions in specified derivatives, credit ratings constitute relevant information that should be required in the financial statements of an investment fund.

Relevant work by IOSCO Committee on Investment Management (Committee 5)

Note that the OSC is represented on the IOSCO Committee on Investment Management (Committee 5). The Committee has a designated small group that is currently working on a project to develop a set of recommendations and best practices for reducing reliance on credit ratings in the asset management industry. Canada is represented in the small group by the Autorité des marchés financiers, Québec (the AMF). The members of the small group consulted with their local investment fund industry with a view to identifying best practices for:

- the identification of eligible securities for investment funds;
- the eligibility of receivable collateral, investment fund guarantors and counterparties; and
- information made available to investors through public disclosure.

The small group is also analysing the areas where the use of credit ratings is still quite common and determining whether there are satisfactory alternatives available.

We are continuing to monitor international developments and participating in IOSCO's work in this area. In the future, any resulting recommendations and best practices from IOSCO will be used to inform future proposals to maintain, modify or delete references to credit ratings in Canada's provincial and territorial securities legislation governing investment funds.

D. Dealers, advisers and other market intermediaries

This section reviews certain references to credit ratings in legislation governing dealers, advisers and investment fund managers (collectively, **registrants**). There are very few references to credit ratings in the legislation applicable to registrants, and the references that exist serve an appropriate policy purpose. CSA members have not yet developed any

alternative standards of assessment for the purpose of replacing the references to credit ratings at this time. CSA members will continue to monitor international developments regarding appropriate alternative proxies to credit ratings. Accordingly, there are no current plans to remove these references to credit ratings.

National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) came into force on September 28, 2009 and introduced a new national registration regime that is harmonized, streamlined and modernized. NI 31-103 requires registered firms to establish, maintain and apply policies and procedures that establish a system of controls and supervision sufficient to manage the risks associated with their business in accordance with prudent business practices.

This general requirement applies to all firms that are registered as a dealer, portfolio manager or investment fund manager. This general requirement should serve to encourage these market participants to make their own credit assessments, and not rely solely or mechanistically on credit ratings, where to do so would be in accordance with prudent business practice. Specific references to credit ratings in NI 31-103 are discussed below:

Registration exemptions under NI 31-103

i) Existing exemption for trades in specified debt

Credit ratings are used in this instance to provide an objective measure of which types of trades are exempt from the requirement to register as a dealer. The dealer registration requirement does not apply in respect of a trade in a debt security issued by or guaranteed by a government of a foreign jurisdiction if the debt security has a designated rating from a designated rating organization.

In this case, reference to credit ratings serves a gate-keeping function, limiting the nature of trades that can be made without dealer registration. We do not believe this creates a mechanistic or problematic reliance on credit ratings. We do not propose to remove the reference to credit ratings from this exemption at this time as no other suitable measures or proxies have been identified to replace the use of credit ratings in this context. In order to maintain transparency and consistency in the application of the exemption, it would not be appropriate for market participants to use internal risk assessment models.

ii) Proposed exemption for trades in short-term debt

On December 5, 2013, the CSA published for comment certain amendments to NI 31-103 with the comment period ending on March 5, 2014. The proposed amendments include a new exemption from the dealer registration requirement to allow specified financial institutions to trade short-term debt instruments that have a designated rating with

permitted clients (as defined). The exemption is available in all jurisdictions of Canada, except Ontario. In Ontario, there are alternate exemptions that may be available for trading in short-term debt instruments, including the exemptions in section 35.1 of the *Securities Act* (Ontario) and section 4.1 of the Ontario Securities Commission Rule 45-501 *Ontario Prospectus and Registration Exemptions*.

The proposed amendments will:

- codify blanket orders that have been issued across the CSA in respect of short- term debt trades by specified financial institutions
- provide consistent treatment to the specified financial institutions by including a condition that the short-term debt instruments have a minimum rating from a designated rating organization or its designated rating organization affiliate
- limit the use of the exemption to trades with permitted clients who generally have sufficient investment knowledge or resources to obtain expert advice and accordingly, may not need or wish to have the same level of protection as other investors

The proposed short-term debt exemption from dealer registration retains the condition that the securities traded under this exemption have prescribed credit ratings. However, prior to the adoption of the exemption, this condition may be amended or removed based on the outcome of work in this area by other CSA committees. Specifically, there is a similar exemption from the prospectus requirement for short-term debt and, as described above under Part B – *Issuers of securities other than investment funds*, proposed amendments to such exemption are anticipated to be published in early 2014. At this time, it is not clear the impact that these proposed amendments will have on the form of proposed registration exemption for short-term debt.

Calculation of excess working capital

Credit ratings are used in setting the supervisory minimum capital requirements. They are used to calculate the measure of market risk to be attributed to specific types of securities of a registrant firm in the calculation of its excess working capital in the Form 31-103F1 *Calculation of Excess Working Capital* (**Form 31-103F1**).

The calculation of market risk involves applying a margin rate, or a "haircut", to the value of the firm's securities to reflect the market risk of the securities that are included in the firm's excess working capital.

When calculating working capital, credit ratings are used in very limited circumstances. Specifically, they are used in calculating the margin rate applied to bonds, debentures, treasury bills and other securities of or guaranteed by a foreign government (other than the US or the UK).

At this time, no other suitable measures have been identified to replace the use of credit ratings in this context. We have concerns with registrant firms using internal risk assessment models when assessing compliance with supervisory minimum capital requirements as there is no way to ensure consistency across market participants in how credit risk is evaluated. This would result in a lack of consistency across registered firms in how excess working capital is calculated.

Further, there is greater opportunity for there to be an upward bias in the credit assessment if a registrant is relying on internal risk and credit models to evaluate its securities (i.e. firms may be incentivized to apply lower margin rates on the securities for a more positive outcome in terms of their capital position). This could result in registrant firms maintaining less

regulatory capital than would otherwise be required if a more objective measure of credit risk was used in the excess working capital calculation.

For the time being, we believe that the use of credit ratings in this very limited circumstance is appropriate as it sets out a minimum threshold that should be applied consistently across all registrants. In this context, without an alternative risk assessment proxy, a more principles-based approach would undermine the objective of the minimum regulatory capital requirement.

Form 33-109F6 Firm Registration – Excess working capital calculation

A firm applying for registration as an adviser, dealer or investment fund manager must submit a calculation of its excess working capital using the Form 31-103F1. The references to a credit rating are the same as those described above, as is the rationale for maintaining such references for the time being.

IOSCO initiatives on credit ratings

Staff from the Ontario Securities Commission and l'Autorité des marchés financiers (Québec) are members of IOSCO Standing Committee 3 on market intermediaries (**SC3**). SC3 is in the process of finalizing a new mandate entitled "Sound practices at intermediaries regarding alternatives to the use of credit ratings to assess creditworthiness". The mandate will be sent to the IOSCO board in January for approval. SC3's work on this mandate will be led by staff of the Securities and Exchange Commission in the US.

The purpose and scope of the project (as set out in the November 18 draft mandate) is:

- To gain an updated understanding of where member jurisdictions currently stand in connection with the reduction on reliance on credit ratings for market intermediaries in line with the October 2010 principles issued by the Financial Stability Board (**FSB**). SC3 will leverage off previous IOSCO and FSB surveys in obtaining this information in order to reduce duplication of work.
- To identify through a new survey to large intermediaries in IOSCO member jurisdictions current practices at large intermediaries with respect to standards, procedures and methodologies they use to assess the creditworthiness of investment products and counterparties as alternatives to the mechanistic reliance on credit ratings. The survey will also seek to determine how, if at all, these firms use credit ratings in private contracts. However, the mandate will not examine, evaluate or opine on capital requirements. It is also expected that SC3 will conduct up to two roundtables with large intermediary industry representatives to elicit their views on alternatives to the use of credit ratings. On this basis, SC3 will work to develop a set of sound practices that can inform on-going and future regulatory reforms. In identifying such sound practices, SC3 will also leverage off the information gathered from its review of both the FSB peer review process and the Joint Forum project to help ensure consistent approaches. (As per the November 18 draft SC3 mandate, the Joint Forum is currently engaged in a project to update its 2011 Report on *Risk Management Practices and Regulatory Capital* and its 2006 follow-up Report, *Regulatory and Market Differences: Issues and Observations*, in order to understand the current issues and practices across the securities, banking, and insurance sectors with regard to the management of credit risk. Of particular relevance to SC3's project

mandate, the Joint Forum's broader evaluation of credit risk management practices will include an analysis of the private use of credit ratings.)

This proposed timeline for the mandate takes into account the draft action plans expected to be submitted by national authorities to the FSB in late 2013. In addition, SC3 expects to complete its work in advance of any final report by the FSB concerning alternative approaches to the over-reliance on credit ratings, which the FSB is expected to finalize in 2016. In this way, the FSB will be able to take into consideration IOSCO's findings on sound practices. Finally, SC3 will consult with SC5 regarding its on-going project to possibly identify sound practices with regard to the investment management industry, in order to ensure consistent recommendations.

E. Marketplaces and clearing agencies

This section reviews the reference to credit ratings in legislation covering dealers, inter-dealer bond brokers, marketplaces and clearing agencies.

Transparency requirements for marketplaces, inter-dealer bond brokers and dealers trading in corporate debt securities

- One of our regulatory objectives is to achieve a level of transparency of the trading activity in the fixed income market that provides market participants with sufficient information, without negatively impacting the liquidity of this market.
- To achieve transparency in the corporate debt market, our rules require marketplaces, inter-dealer bond brokers and dealers that trade corporate debt securities to provide order and trade information for certain corporate debt securities to an information processor, which is an entity that consolidates and displays publicly the data reported to it.
- The corporate debt securities for which this information is provided are selected by the information processor. The information that the marketplaces, inter-dealer bond brokers and dealers are required to report includes the volume traded, subject to certain volume caps. The volume caps are $2 million for investment grade corporate debt securities (i.e. they are reported as $2 million +) and $200,000 for non-investment grade corporate debt securities (i.e. they are reported as $200,000+). Investment grade corporate debt securities are securities rated by a listed rating organization at or above certain rating categories and non-investment grade corporate debt securities are the rest.
- The volume caps help ensure that our policy objective is met – that is, that an adequate level of transparency is achieved while protecting sensitive information, such as the full size of a trade, that, if disclosed, may negatively impact the liquidity of that corporate bond and those trading in it.
- We do not propose to remove the references to the rating categories that distinguish between investment-grade and non-investment grade securities at this time. We believe that they are useful, and currently, the only indicator of a bond's risk of default and allow us to delineate the bonds with a lower risk of default, for which more information may be made transparent without impacting the bond and its liquidity from the rest.