



SOCIAL INVESTMENT ORGANIZATION

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Ontario Securities Commission
Autorité des marchés financiers

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Suite 1900, Box 55
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Anne-Marie Beaudoin
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**Re: Comments on Regulatory proposals related to the ABCP market in Canada – CSA
Consultation Paper 11 – 405**

Dear Sirs/Madames:

I am writing on behalf of the members of the Social Investment Organization, the national association for socially responsible investment. Our members include about 40 investment funds, financial institutions, investment consultants, asset managers, credit unions, and institutional investors, as well as more than 100 investment advisors across Canada. Our members serve more than a million Canadian depositors and investors. I am writing in response to your request for comment on your regulatory proposals related to the asset-backed commercial paper (ABCP) market in Canada as set out in Consultation Paper 11 – 405.

We commend your initiative to review the regulatory issues surrounding the massive market failure of ABCP in Canada. In brief, we believe that the root cause of this market failure was a lack of transparency and disclosure by the issuers of ABCP in Canada, particularly with regard to the non-financial aspects of the underlying assets. This led to an inadequate understanding of the risks of this security, which resulted in massive over subscription, even by very sophisticated institutional investors. The regulatory responses to this crisis must address the fundamental issue of lack of transparency and disclosure.

Analysis of the ABCP market failure

As you explain in your consultation paper, the root cause of the credit turmoil was the sub-prime mortgage crisis in the US. Many observers have pointed out that the broad securitization of sub-prime mortgage loans led to the crisis in confidence in the credit markets, with the subsequent collapse in value in collateralized debt obligations, credit default swaps and other structured finance products, such as ABCP.

However, some observers, such as Innovest Strategic Value Advisors, did identify weaknesses in this market based on an environmental, social and governance (ESG) analysis. The ESG analysis conducted by Innovest in a review of bank credit markets in 2006 found that rising home ownership combined with lower real wages was putting the sub-prime mortgage markets at grave risk. (*The Subprime Meltdown and SRI: Engage, Avoid, Predict*, Social Funds.com <http://www.sri-adviser.com/article.mpl?sfArticleId=2366>)

Many socially responsible investors, particularly religious investors with a mission to address community poverty, engaged with sub-prime mortgage lenders on the issue with the aim of encouraging them to change their unethical, or “predatory” lending practices in poor communities.

In hindsight, these non-financial, or ESG risks, posed significant threats to the safety of the credit markets. So we have to ask ourselves the question of why these risks were not properly identified by the market and priced into mortgage-backed securities, and other structured finance products such as ABCP?

Unethical lending practices were the norm by many of these companies, and these practices were identified in shareholder proposals for many years by religious and SRI investors. When analyzed, it became apparent that these unethical lending practices were not sustainable. In fact, these practices proved to be unsustainable. The exorbitant penalties and interest rates on sub-prime mortgages combined to create such a burden in low income communities across the US that large numbers of homeowners walked away from their mortgages, creating a cascade effect that collapsed the sub-prime mortgage market, along with real estate values and other credit markets.

Yet these risks were not disclosed either in the mortgage-backed securities that were sold directly in the US market, nor as part of the bundle of asset backed commercial paper in Canada. This created a “market fog” around the asset-backed securities market in Canada and the US that contributed to their enormous and disastrous popularity.

We believe that if these risks had been properly disclosed, and the information disseminated into the market, many analysts and investors would have shown greater reluctance to purchase ABCP. This would have reduced liquidity for these instruments, thereby mitigating the impact of their subsequent collapse. While we recognize that collateralized debt obligations related to sub-prime mortgages represented only a small percentage of the total underlying assets of the ABCP market in Canada, the lack of transparency in asset-backed commercial paper created uncertainty about exposure to the sub-prime market, contributing to the subsequent collapse of ABCP in Canada.

With this background, it is clear that lack of transparency and disclosure of the financial and non-financial risks of ABCP was a key contributor to the collapse of the ABCP market in Canada.

Proposed regulatory responses in Consultation Paper 11 -405

Turning now to the regulatory deficiencies that contributed to this market failure, we believe that the proposed CSA policies in *Consultation Paper 11 – 405* are inadequate in many respects.

In the Paper, the CSA proposes to implement a regulatory framework for credit rating agencies (CRAs), and to consider a disclosure regime to require CRAs to release information provided by an issuer that is used by a CRA in determining its credit ratings. Further, the CSA proposes to change the exemption requirements for ABCP and to consider changes to the income thresholds to tighten the availability of exempt ABCP.

We believe these proposals fail to address the true regulatory failure that contributed to the collapse of the ABCP market in Canada. As you state in your Paper, the lack of transparency and disclosure of underlying assets was a main cause of the credit turmoil.

As your Paper states: “Originators did not always disclose, and/or investors did not always demand, adequate information about the structure of, and assets underlying structured products including asset-backed securities such as ABCP and CDOs. This lack of transparency made it difficult for market participants to determine which products were backed by sub-prime mortgages and what the underlying asset mix was for any specific products. That contributed to the crisis of confidence and the flight to safety by investors.”

We believe that it is inappropriate – as your Paper recommends – that the onus for disclosure should be on the credit rating agencies, rather than on the issuers or originators themselves. The role of credit rating agencies is to assist investors in making a decision about a credit product, not to release all the relevant information on that product into the market. Whether a security is exempt or not, markets only operate efficiently if the issuers release all material information on their security through on a continuous disclosure basis.

The information used by credit rating agencies to assess issuers is not collected in a systematic way. Your proposal would encourage credit rating agencies to disclose everything at their disposal, placing a large volume of information and data into the market in a format that would be of limited use for systematic analysis and comparison by other analysts and investors.

Similarly, your proposals to tighten the availability of ABCP by restricting the exempt distribution of ABCP and possibly increasing income thresholds for exempt distribution to individuals also fail to address the true nature of the regulatory failure of the ABCP market.

While it is true that ABCP was sold to many unsuitable individuals who were not able to adequately assess the risks of their investment, the same can be said of many sophisticated investors such as corporations, pension funds and mutual funds. The widespread investment in ABCP by the institutional market, including some of the largest pension funds in the country, attests to the lack of market knowledge of these instruments. Therefore, the regulatory failure is not one of suitability, but rather market opaqueness in general. This opaqueness is due to the general lack of transparency and disclosure of the underlying assets of asset-backed securities, an opaqueness caused by the lack of a continuous disclosure requirement.

Further, the market fog surrounding ABCP was a direct result of the lack of transparency on environmental, social and governance issues. The underlying risk of sub-prime mortgages was an ESG risk, not a financial risk. In other words, the underlying risk of sub-prime mortgages was that they would be unsustainable over the long term by the masses of low-income people who should never have been enticed into purchasing such mortgages through unethical distribution practices. Yet the lack of a disclosure framework generally, and an ESG disclosure requirement specifically, prevented analysts and investors from incorporating such risks into their assessment of asset-backed securities, resulting in a disastrous over subscription to this market.

Recommendations

With this analysis, here are our recommendations:

1. That issuers or originators of ABCP should be reporting issuers, and that they should be subject to prospectus and continuous disclosure requirements. This will require a review of the reporting requirements for all complex products available in Canada to determine which products should be defined as reporting issuers, and which can remain in the exempt market.
2. That continuous disclosure requirements for ABCP should include material environmental, social and governance risks, as well as key performance indicators to enable analysts and investors to assess the non-financial aspects of such offerings. ESG policies and practices should be outlined in the annual information form and the management's discussion and analysis as part of the continuous disclosure requirements.
3. That credit rating agencies should be subject to a regulatory framework, but mandated disclosure of information from issuers to credit rating agencies should not be a part of this framework.

The Social Investment Organization would be pleased to work with the CSA in implementing these recommendations in coming months and years.

Conclusion

The widespread economic and social damage created by the collapse in credit markets must create a moment for regulatory reform on a comprehensive scale. We must recognize the regulatory failures that contributed to the market crisis, and pledge to address them so that the chances of such a market crisis from happening again are much reduced. We believe the route to such regulatory repair is through mandated transparency and disclosure so that markets can assess the true nature of the risks and opportunities presented by the increasingly complex array of investment products now available.

Sincerely,



Eugene Ellmen
Executive Director