Regulatory Study, Review and Recommendations concerning the manufacture and distribution by IIROC member firms of Third-Party Asset-Backed Commercial Paper in Canada.

October 2008

IIROC OCRCVM

TABLE OF CONTENTS

ABBREVIATIONS USED IN THIS REPORT VI

GLOSSARY VIII

PREFACE XII

ROLE OF INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA (IIROC) XII

OVERVIEW OF THE REPORT XII

OBJECTIVE OF THE REPORT XIII

INTRODUCTION XV

RETAIL CLIENT POSITIONS AT IIROC DEALER MEMBERS XVI

IIROC RESPONSE TO THE ABCP LIQUIDITY CRISIS XVII

PART I REGULATORY STUDY 1

1. ABCP IN THE CANADIAN MONEY MARKET 1

MONEY MARKET INSTRUMENTS 2

PRICING OF MONEY MARKET INSTRUMENTS 2

2. WHAT IS ASSET-BACKED COMMERCIAL PAPER? 3

DESCRIPTION 3

ABCP RISKS 5

CREDIT ENHANCEMENT 6

LIQUIDITY SUPPORT 6

3. THIRD-PARTY ABCP PROGRAMMES 8

DEVELOPMENT OF THIRD-PARTY ABCP PROGRAMMES 8

GROWTH OF THE GLOBAL CREDIT DERIVATIVES MARKET 9

COLLATERALIZED DEBT OBLIGATIONS 10

SYNTHETIC AND HYBRID CDOS 11

FUNDED AND UNFUNDED CDOS 12

CDO CREDIT RATINGS 13

THIRD-PARTY ABCP PROGRAMMES AND LEVERAGED SUPER-SENIOR NOTES 15

EFFECTS OF THE USE OF CDOS BY THIRD-PARTY ABCP PROGRAMMES 17

4. CANADIAN STYLE LIQUIDITY AGREEMENTS 18

FEDERAL GUIDANCE ON LIQUIDITY FACILITIES 18

POSITION OF US RATING AGENCIES ON CANADIAN-STYLE LIQUIDITY AGREEMENTS 20

OSFI JUNE 2008 DRAFT ADVISORY 22

VARIATIONS IN GENERAL MARKET DISRUPTION CRITERIA USED IN LIQUIDITY AGREEMENTS 22

5. CREDIT RATINGS 25

THE CREDIT RATING PROCESS 25

CREDIT RATING SCALE 26

CONTINUOUS CREDIT RATING MONITORING 27

NOVEMBER 2006 DBRS ADVISORY 27

CHANGE OF REQUIREMENT FOR LIQUIDITY AGREEMENTS 27

6. ABCP CLEARING, SETTLEMENT AND CUSTODY 28

PROCESS 28

7. THIRD-PARTY ABCP SPONSORS 31

SIGNIFICANT AFFILIATION OR OWNERSHIP INTERESTS IN ABCP PROGRAMME SPONSORS 32

CONDUITS SPONSORED BY IIROC DEALER MEMBERS 34

8. DISTRIBUTORS OF THIRD-PARTY ABCP 34

9. MARKET PERFORMANCE OF THIRD-PARTY ABCP 36

THIRD-PARTY ABCP YIELD COMPARED TO BANK-SPONSORED ABCP YIELD 36

THIRD-PARTY ABCP YIELD COMPARED TO T-BILLS AND BANKERS' ACCEPTANCES 37

10. COMMERCIAL PAPER DISTRIBUTION RULES 38

PROSPECTUS EXEMPTION FOR COMMERCIAL PAPER 38

THE APPROVED CREDIT RATING 40

11. ABCP DISCLOSURE AND THE AVAILABILITY OF INFORMATION ABOUT ABCP 41

EXPOSURE TO U.S. SUB-PRIME 42

PART II COMPLIANCE SWEEP 44

1. HOLDINGS OF FROZEN THIRD-PARTY ABCP BY IIROC DEALER MEMBERS 45

NUMBER OF CONDUITS 45

INITIAL REQUEST FOR POSITION INFORMATION 45

DEALER MEMBER THIRD-PARTY ABCP HOLDINGS 46

TOTAL THIRD-PARTY ABCP FLOAT 46

FROZEN ABCP HELD BY IIROC DEALER MEMBERS 46

NUMBER OF IIROC DEALER MEMBERS INVOLVED IN THIRD-PARTY ABCP 47

HOLDINGS OF THIRD-PARTY ABCP 48

2. DEALER MEMBER SPONSORS OF THIRD-PARTY ABCP 48

OBJECTIVE AND FRAMEWORK OF THE MANUFACTURING COMPONENT 48

POPULATION AND PROCESS 49

BUSINESS RATIONALE 49

NEW BUSINESS AND PRODUCT IDENTIFICATION AND REVIEW PROCESSES 50

RISK MANAGEMENT OVERSIGHT 50

PRODUCT RESPONSIBILITY AND ACCOUNTABILITY 50

PRODUCT STRUCTURING 51

DISTRIBUTION OF DEALER MEMBER MANUFACTURED ABCP 51

COST AND COMPENSATION STRUCTURE 51

DISCLOSURE 52

3. DEALER MEMBERS WHO SOLD THIRD-PARTY ABCP 53

OBJECTIVE AND SCOPE 53

PROCESS, POPULATION AND HOLDINGS 53

PRODUCT DUE DILIGENCE 55

DISCLOSURE 56

TRAINING AND PRODUCT KNOWLEDGE 57

SUITABILITY 57

COMMISSION AND MARK-UPS 58

4. CURRENT PRODUCT DUE DILIGENCE PRACTICES 59

IDENTIFICATION OF PRODUCTS TO BE REVIEWED 59

PRODUCT FACTORS CONSIDERED IN THE DUE DILIGENCE PROCESS 61

STRUCTURE, PROCESS AND RESPONSIBILITY 62

RECORD KEEPING 63

COMMUNICATION OF PRODUCT DUE DILIGENCE RESULTS 63

5. MARGIN RULE COMPLIANCE 64

ABCP MARGIN RULES 66

6. CLIENT RELIEF PLANS 66

PART III FINDINGS & RECOMMENDATIONS 68

1. SUMMARY FINDINGS 69

GENERAL FINDINGS REGARDING THIRD-PARTY ABCP 69

DEALER MEMBER FINDINGS 70

2. IIROC STANDARDS 71

OBJECTIVES 71

SUITABILITY 72

PRODUCT KNOWLEDGE 72

SUPERVISION 73

MARKETING MATERIAL 73

MEETING THE SUITABILITY STANDARD 73

3. RECOMMENDATIONS 74

PRODUCT DUE DILIGENCE 74

PRODUCT TRANSPARENCY 75

CONFLICTS OF INTEREST 76

CREDIT RATINGS 76

4. GUIDANCE NOTICE 76

APPENDIX A: IIROC NOTICE ON NEW PRODUCTS 77

APPENDIX B: LIST OF CANADIAN THIRD-PARTY ABCP 84

APPENDIX C: DBRS LETTER RE CANADIAN ABCP-FUNDED STRUCTURED FINANCIAL ASSET-BACKED TRANSACTIONS 85

BIBLIOGRAPHY 87

ENDNOTES: 90

IIROC OCRCVM

ABBREVIATIONS USED IN THIS REPORT

ABCP	asset-backed commercial paper:
BA	bankers' acceptance
BBA	British Bankers Association
bps	basis points
CDOR	Canadian Dealer Offered Rate
CDS	credit default swap
CDS Ltd.	Canadian Depository for Securities Limited
CSA	Canadian Securities Administrators
CDO	collateralized debt obligation
CP	commercial paper
DBRS	Dominion Bond Rating Service
FINRA	Financial Industry Regulatory Authority
IDA	Investment Dealers Association of Canada
IIROC	Investment Industry Regulatory Organization of Canada
IM	Information memorandum
IOSCO	The International Organization of Securities Commissions
ISDA	The International Swaps and Derivatives Association, Inc.
NI	National Instrument

OSA	*Ontario Securities Act*
OSFI	Office of the Superintendent of Financial Institutions
SIFMA	Securities Industry and Financial Markets Association
SPE	special purpose entity
T-Bill	Government of Canada Treasury Bill

Glossary

ABCP conduit or trust	The trust created to hold the assets and issue securities of an ABCP programme.
affected ABCP trusts	The 20 Third-Party ABCP Trusts subject to the Pan-Canadian Restructuring Plan. For a listing, see Appendix B.
asset-backed commercial paper	Short-term debt instruments issued by legal trusts established to fund holdings of underlying financial assets.
attachment point	The percentage at which a collateral debt obligation begins to participate in default loss in the underlying asset portfolio.
bankers' acceptance	A guarantee by a bank to pay a specified sum on a future date to the bearer of a bank draft drawn by a customer of the bank.
basis point	One one-hundredth (1/100) of a percent.
Canadian Dealer Offered Rate	The average of all bankers' acceptance rates offered by the main banks operating in Canada, calculated and published daily by Thomson Reuters. It is the recognized benchmark index for bankers' acceptances with a term-to-maturity of one year or less, and is used as a reference rate in setting the floating interest rate in commercial agreements and as the settlement price for a number of derivatives including futures contracts and swaps.
Canadian Depository for Securities Limited	The central depository for securities in Canada. CDS facilitates the clearing and settlement process for Canadian exchange-traded and over-the-counter equity, debt and money market transactions.
Canadian Securities Administrators (CSA)	A forum for the 13 securities regulators of Canada's provinces and territories to coordinate and harmonize regulation of the Canadian capital markets.

Canadian-style liquidity agreement	A liquidity agreement in which the liquidity provider's obligation is triggered by a "general market disruption" in the ABCP market.
collateralized debt obligation	A structured security backed by a portfolio of debt securities. The pool can be made up of any type of debt such as bonds, loans and mortgages or synthetic financial assets.
commercial paper	Short-term unsecured promissory notes primarily issued by crown corporations, municipalities and publicly listed corporations to provide working capital, sold on the creditworthiness of the issuer.
conduit	See ABCP conduit or trust.
credit default swap	A derivative contract under which one party (the buyer) makes payments to another (the seller) in return for a promise of a payoff if a specified credit event occurs in respect of a specified entity or security (the "reference entity"). If the credit event occurs, settlement may be in cash or by a transaction in the reference entity. The effect is to transfer the credit risk from the buyer to the seller.
credit derivative	A generic term for any derivative contract used to transfer credit risk on a reference entity or reference obligor between a credit protection seller and a credit protection buyer.
credit enhancement	Various methods used to reduce the risk of loss to investors in ABCP caused by deterioration of the value of the assets held by the ABCP conduit.
detachment point	The percentage at which a tranche of a collateral debt obligation ceases to participate in default loss in the underlying asset portfolio.

global-style liquidity agreement	A liquidity agreement in which the liquidity provider's obligation is triggered by the ABCP conduit's inability to sell new ABCP to fund the redemption of outstanding ABCP coming due.
International Organization of Securities Commissions	The international association of securities regulators that serves as a cooperative forum for securities regulatory agencies and sets non-binding international standards for securities market regulation.
International Swaps and Derivatives Association, Inc.	An industry organization that sets standards and provides templates for over-the-counter derivatives and other relevant documentation.
leveraged super senior (LSS)	A leveraged form of Synthetic CDO for which the amount of credit protection sold is greater than the amount of collateral pledged by the credit protection seller and for which the risk of loss on the underlying credit is determined by one or more rating agencies to be lower than the risk of loss on AAA-rated security.
liquidity agreement	An agreement under which a financial institution establishes a liquidity facility for an ABCP programme which may be used to fund the repayment of ABCP on maturity if a specified trigger event prevents the programme from funding the repayment through the sale of new ABCP.
margin	The collateral a customer deposits with a dealer when borrowing from the dealer to buy securities.
National Instrument	A regulation adopted by all of Canada's provincial and territorial securities regulatory authorities
Office of the Superintendent of Financial Institutions	A Federal agency that regulates banks, trust companies, loan companies, cooperative credit associations, insurance companies and pension plans.

special purpose entity	An entity, often a trust, created to house assets or businesses so as to make them bankruptcy-remote from the sponsoring organization. The trusts used to structure ABCP programmes were special purpose entities.
sponsor	The manufacturer or management company that creates and administers an ABCP programme
structured financial asset	A combination of traditional asset classes and contingent claims such as derivatives, designed to replicate the income and risks of a traditional asset.
third-party asset-backed commercial paper	ABCP issued by conduits not sponsored or managed by a bank.

IIROC OCRCVM

PREFACE

Role of Investment Industry Regulatory Organization of Canada (IIROC)

IIROC is the national self-regulatory organization that oversees all investment dealers and trading activity on debt and equity marketplaces in Canada.

In order to understand the role played by IIROC investment dealer members in the manufacture and distribution of third-party asset-backed commercial paper (ABCP), it is also necessary to understand the evolution of ABCP, the differences between traditional bank-sponsored ABCP and third-party ABCP programmes, and the role played by other market participants including federally regulated financial institutions and credit rating agencies. We have therefore described the broader context of the third-party ABCP market, but emphasize that IIROC has regulatory responsibility for investment dealers only and the recommendations we make at the conclusion of our report are applicable only to IIROC members. This report should therefore be read in conjunction with reports issued by other regulators including the Canadian Securities Administrators (CSA) and the Office of the Superintendent of Financial Institutions (OSFI).

Individual firms have been identified in this report only to the extent that the information concerning those firms was publicly available.

Overview of the Report

This report is divided into three parts:

- A study of the development and regulation of the third-party ABCP market and the regulations governing it in the context of the money market in general, and leading up to the liquidity crisis in that market in August 2007;
- A report on compliance reviews conducted at IIROC Dealer Members involved in the third-party ABCP market to determine what controls and processes were in place and applied to the manufacture and sale of third-party ABCP;
- Findings and recommendations.

The compliance reviews focused on the period up to April 30 2007 in order to understand the market when it was functioning in a relatively normal fashion prior to the liquidity crisis.

The study and compliance review included the following steps:

- A review of academic papers and industry surveys on the evolution and growth of the global asset-backed securities and credit derivatives markets;
- A review of Canadian clearing, settlement and custody processes for debt securities, including commercial paper;
- Research into the evolution of exemptions for short-term commercial paper under provincial securities legislation;
- Gathering and review of publicly available information and disclosure documents on Canadian third-party ABCP programmes;
- Interviews with senior DBRS representatives to understand their ABCP programme credit rating review and approval process;
- Gathering of information from CDS Ltd. and dealer members on ABCP positions;
- Interviews of senior management of IIROC dealer members involved in the manufacture, distribution or custody of third-party ABCP including chief compliance officers, heads of institutional and wealth management divisions, and heads of fixed income and money market trading desks regarding trading processes, product due diligence, risk management, disclosure to customers, marketing materials and advisor training in relation to third-party ABCP; and
- Gathering of relevant policies, procedures, documents of the dealer members interviewed.

Objective of the Report

The goal of the reviews and this report is remedial and preventive – to identify and recommend improvements to the compliance programmes of IIROC dealer members and regulatory programmes of IIROC that will reduce the risk of a repeat of the kinds of difficulties

encountered by dealer members and their customers following the August 2007 third-party ABCP liquidity crisis.

Staff of the Financial and Operations Compliance and Business Conduct Compliance Departments of IIROC conducted the study and reviews.

INTRODUCTION

In June 2007 credit spreads in some of the world's major financial markets began to increase, resulting in a wave of significant rating downgrades by the major credit rating agencies. By August 2007 investors had become concerned about the sub-prime home mortgage market in the United States and the degree to which they might be exposed to potential losses through investments in mortgage-backed securities, including collateralized debt obligations (CDOs) and other securitized and structured finance instruments.

What occurred in the lead-up to August 2007 was succinctly described by Mr. Justice Blair in the August, 2008 judgment of the Ontario Court of Appeal[1]:

> The types of assets and asset interests acquired to "back" the ABCP Notes are varied and complex. They were generally long-term assets such as residential mortgages, credit card receivables, auto loans, cash collateralized debt obligations and derivative instruments such as credit default swaps. Their particular characteristics do not matter for the purpose of this appeal, but they shared a common feature that proved to be the Achilles heel of the ABCP market: because of their long-term nature there was an inherent timing mismatch between the cash they generated and the cash needed to repay maturing ABCP Notes.
>
> When uncertainty began to spread through the ABCP marketplace in the summer of 2007, investors stopped buying the ABCP product and existing Note holders ceased to roll over their maturing notes. There was no cash to redeem those notes. Although calls were made on the Liquidity Providers for payment, most of the Liquidity Providers declined to fund the redemption of the notes, arguing that the conditions for liquidity funding had not been met in the circumstances. Hence, the "liquidity crisis" in the ABCP market.
>
> The crisis was fuelled largely by a lack of transparency in the ABCP scheme. Investors could not tell what assets were backing their notes – partly because the ABCP Notes were often sold before or at the same time as the assets backing them were acquired; partly because of the sheer complexity of certain of the underlying assets; and partly because of assertions of confidentiality by those involved with the

> assets. As fears arising from the spreading U.S. sub-prime mortgage crisis mushroomed, investors became increasingly concerned that their ABCP Notes may be supported by those crumbling assets. For the reasons outlined above, however, they were unable to redeem their maturing ABCP Notes.

The liquidity crisis could have triggered a wholesale liquidation of the assets, at depressed prices. But it did not. During the week of August 13, 2007, the ABCP market in Canada froze – the result of a standstill arrangement orchestrated on the heels of the crisis by numerous market participants, including Asset Providers, Liquidity Providers, Note holders and other financial industry representatives. Under the standstill agreement – known as the Montréal Protocol – the parties committed to restructuring the ABCP market with a view, as much as possible, to preserving the value of the assets and of the notes.

The only ABCP programmes that averted a complete collapse were those that were bank-sponsored because the banks all provided liquidity for their programmes.

After the Montreal Accord, two of the 22 affected ABCP conduits were restructured and taken out of the Montreal Accord plan. The Ontario Superior Court of Justice has approved the restructuring plan and the approval has been upheld on appeal by the Ontario Court of Appeal.

Retail Client Positions at IIROC Dealer Members

At the time of the liquidity crisis 14 IIROC Dealer Members held positions in third-party ABCP for retail clients. Two of these had been transferred in from other IIROC Dealer Members and were subsequently returned to the dealer members from which they had been purchased.

The remaining dealers have implemented or committed to compensation plans for clients amounting to almost half a billion dollars, in some cases with a per-client dollar limit. Seven compensated clients almost immediately by taking over client positions with a total value of $319.7 million; three others have compensation plans totaling over $177 million that are dependent on completion of the restructuring. Some have also made special lending arrangements for corporate clients that had positions in third-party ABCP.

IIROC Response to the ABCP Liquidity Crisis

When the ABCP market froze, IIROC (then IDA) staff immediately obtained information on and monitored dealer member positions in third-party ABCP to ensure that the freeze did not cause any capital deficiencies, issued a reminder of IIROC rules on margin rates for commercial paper and debit instruments in default, and began the regulatory study that forms part of this report. In December 2007 staff began preparation of the compliance sweep programme. Interviews of dealer members and gathering of material continued through July 2008.

PART I

REGULATORY STUDY

1. ABCP IN THE CANADIAN MONEY MARKET

This section provides a brief overview of the function of the Canadian money market and how ABCP fit within it.

The Canadian money market is an integral part of the Canadian capital market, providing short-term funding and investment opportunities. The Bank of Canada's report entitled *"Financial System Review (FSR) - June 2008"* provides a breakdown of the structure and size of Canadian capital markets as at December 31, 2007[2].

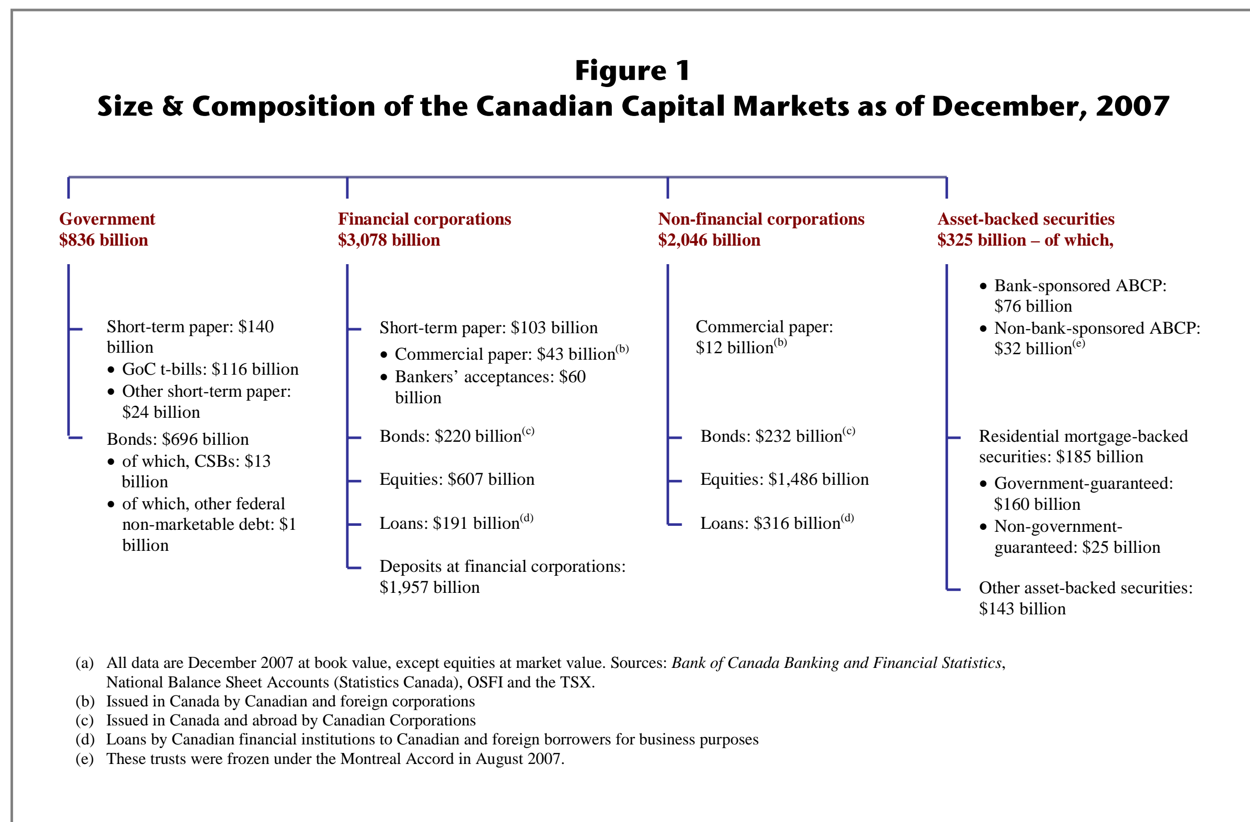


Figure 1
Size & Composition of the Canadian Capital Markets as of December, 2007

Money market instruments totaled $363 billion of the total capital market of $6.3 trillion. The total of $108 billion in ABCP represented 30% of outstanding money market instruments, comprised of $76 billion bank-sponsored ABCP (70% of ABCP; 21% of all short-term paper) and $32 billion third-party ABCP (30% of ABCP; 9% of all short-term paper).[3]

Money Market Instruments

The common types of money market instruments are as follows:

- Commercial paper—short-term unsecured promissory notes primarily issued by crown corporations, municipalities and publicly listed corporations to fund working capital and sold on the creditworthiness of the issuer. The maturity of commercial paper does not generally exceed 12 months and usually averages 30 days.

  As of December 31, 2007, the size of the market in Canada was $55 billion.

- Asset-backed commercial paper—unsecured debt obligations, typically with maturities of 30 to 180 days, issued by legal trust structures holding underlying assets such as credit card receivables, car leases and loans, and residential mortgages as collateral security.

  As of December 31, 2007, the size of the ABCP market was $108 billion, 70% bank-sponsored and 30% non-bank sponsored.

- Treasury Bills—short-term debt obligations of national governments, with maturities that do not generally exceed 12 months and usually average 30 days.

- Bankers' Acceptance—A bankers' acceptance is a guarantee by a bank to pay a specified sum of money to the bearer of a bank draft drawn by a third-party customer of the bank on a future date, typically one to six months. The bank guarantee makes the obligation an unconditional liability of the bank.

  As of December 31, 2007, the size of the market in Canada was $140 billion.

Pricing of Money Market Instruments

Pricing of short-term money market paper is based on a benchmark yield curve of risk-free short-term debt, such as the Government of Canada T-Bills[4]. The spread between the T-Bill yield and the quoted yield for an issuer's commercial paper is the market price of credit risk for non-government money market instruments.

The pricing of credit risk is integral to how money markets function and relies significantly on recognized credit rating services such as Moody's, Standard & Poor's, and Fitch (in the United

States) and Dominion Bond Rating Service (DBRS) (in Canada). If market participants cannot measure and price credit risk because of gaps in the timely delivery of market information concerning an issuer, demand slackens. This in turn widens bid-ask yield spreads and can lead to secondary market illiquidity in the issuer's paper[5].

2. WHAT IS ASSET-BACKED COMMERCIAL PAPER?

This section provides an overview of the structure of ABCP programmes and the features affecting their credit ratings. Section 5 contains a fuller description of the rating process.

Description

Traditional asset securitization programmes purchased consumer receivables from "originating" lenders such as banks and other deposit-taking institutions, finance companies, mortgage companies, leasing companies and credit card companies.

The asset securitization process begins with the segregation of financial assets into pools that are relatively homogeneous with respect to their cash-flow characteristics and risk profiles, including both credit and market risks. The financial assets or 'exposures to financial assets' are acquired by a special purpose entity[*], also referred to as a "conduit". The special purpose entity funds the purchase of the assets by selling securities collateralized by the pool of assets. The asset-backed securities are obligations of the special purpose entity, not the asset originator. The principal and interest on the securities are paid from the cash flows generated by the underlying assets.

Securitization requires the separation of the financial assets from the originator (i.e. a transferred title or "true sale") so that certain events related to the originator do not impair the special purpose entity's right to receive cash flow from the underlying financial assets. If an originator enters into bankruptcy, the obligors of the financial assets are still required to pay their obligations. Because the assets are structurally isolated from the originator and directly

[*] In Canada, almost all special purpose entities for ABCP programmes are trusts because that structure provides the separation needed to make them bankruptcy-remote from the sponsor and provides appropriate tax treatment.

secured by the pool assets, asset-backed securities are typically rated higher than the general debt of the originator.

For example, a bank[†] will start with a loan portfolio consisting of mortgages, car loans and credit card receivables on its balance sheet. The portfolio ties up capital to provide for the risk of loan defaults. To release this capital for other purposes, the bank can set up a conduit to buy the portfolio from the bank. Typically, assets sold to the programmes must meet minimum credit quality standards based on the sponsors' normal credit approval process. The conduit may also buy assets from other originators. Depending on the number of originators selling their receivables to a conduit, the ABCP conduit is referred to as either a *single originator* or *multiple originator* conduit.

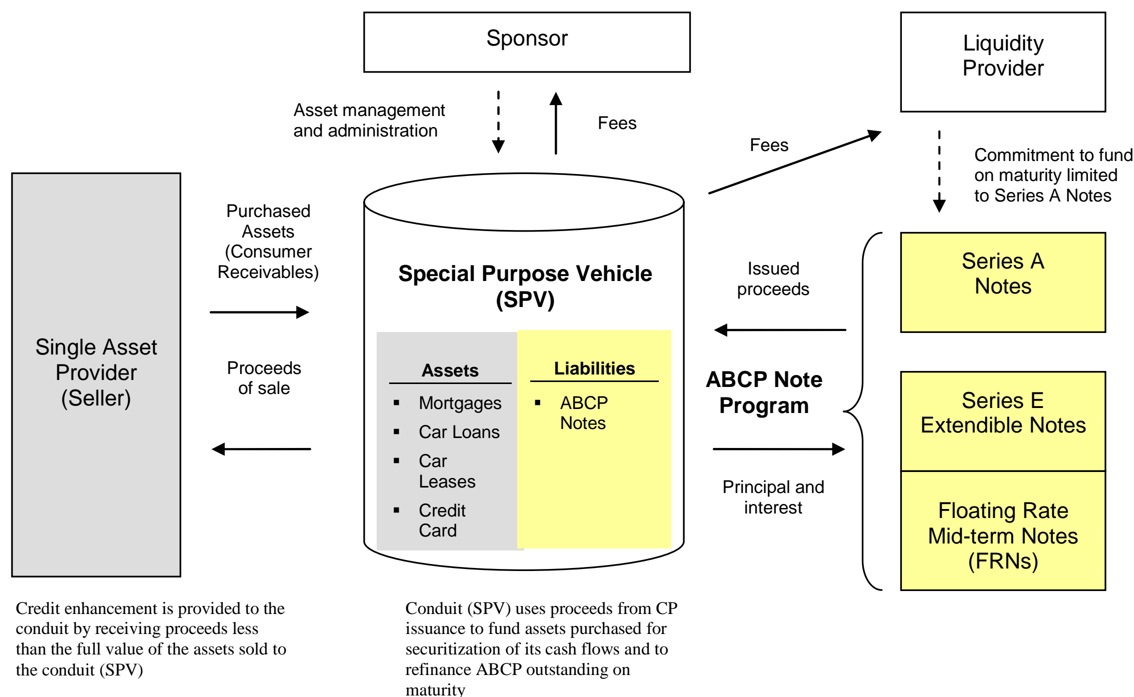
The conduit funds the cost of the portfolio by issuing securities collateralized by the portfolio. In the example above, the bank is the "sponsor" of the conduit and typically retains a financial stake in the conduit by providing credit enhancement, liquidity support, administrative services or any combination thereof. However, the sponsor no longer owns the portfolio, no longer bears the default risk associated with it and has therefore released its capital for other purposes.

The securities sold by a conduit may not be restricted to ABCP. They often include extendible and longer-term notes that are attractive to some institutional investors.

The following diagram shows the structure of a typical bank-sponsored single originator conduit, in which the bank sells a combination of mortgages, car loans and credit card receivables into a special purpose entity[6].

[†] Not all ABCP conduits are sponsored by banks. There are also large finance company issuers which set-up their own conduits and establish liquidity provider arrangements with various banks.

Figure 2
Structure of a single-originator ABCP program using traditional assets



Derived from: Information for Note holders, "*Proposed Restructuring of Canadian third-party Structured Asset-Backed Commercial Paper*", March 20, 2008, prepared by the Canadian Investors Committee for third-party Structured Asset-Backed Commercial Paper – Exhibit D- JPMorgan Report on Restructuring, page 86

ABCP Risks

The repayment of ABCP issued by a conduit depends primarily on the cash collections received from the conduit's asset portfolio and a conduit's ability to issue new ABCP. The main risks faced by ABCP investors are:

- Asset deterioration in the conduit's underlying portfolio;
- Timing mismatches between the cash flows of the underlying asset interests and the redemption of maturing commercial paper as described above;
- Inability to issue new commercial paper to fund redemption of maturing paper; and
- Risks associated with asset servicers.

To protect investors from these risks, ABCP programmes and the asset interests financed through them are structured with various protections, such as credit enhancement, liquidity support, and commercial paper stop-issuance and wind-down triggers.

Credit Enhancement

A credit enhancement is an arrangement provided by a conduit to cover losses associated with the pool of assets. It protects investors in the event that cash flows from the underlying assets are insufficient to pay the interest and principal due for the ABCP in a timely manner.

Credit enhancement improves the credit rating and therefore the pricing and marketability of ABCP. The conduit's sponsor determines the amount of enhancement, which varies with the credit quality and liquidity of the assets. Sponsors are aware of the rating methods used by rating agencies and have discussions with them about portfolio contents that enable a sponsor to judge the amount of credit enhancement necessary to achieve a desired rating.

The seller of assets usually provides the first-loss credit enhancement through over-collateralization, i.e. the amount paid to the seller is less than the full value of the assets sold to the conduit. The amount that is not funded by the sale of securities is the over-collateralization. The seller is at risk for that amount, which goes back to the seller once the notes are fully redeemed.

ABCP sponsors and credit rating agencies monitor asset quality closely for possible deterioration. The overriding intent of credit enhancement is to create a low cost, efficient funding source that has minimal exposure to risk. Strong portfolio surveillance is an integral part of risk mitigation by sponsors.

Liquidity Support

Liquidity support is intended to cover any inability of the conduit to fund the redemption of ABCP that is not associated with the credit risk or performance of the underlying portfolio.

The risks managed through liquidity support include:

- Timing mismatches between the maturities of ABCP and the receipt of the asset receivables.

- Shortfalls in collections caused by servicer defaults. The conduit must be able to redeem ABCP, even if a servicer's bankruptcy proceeding disrupts the cash collection process.
- Inability to fund an asset purchase to which the conduit is committed.
- Any inability on the part of the conduit to sell new ABCP to fund redemption of maturing ABCP.

Without liquidity protection the conduit would be unable to sell its paper to investors because they would be unwilling to bear the default risk.

Banks normally provide at least part of the liquidity support for their sponsored conduits. While the bank can provide either full or partial liquidity support, full liquidity support might be treated as a direct credit substitute because the bank continues to bear the entire risk. The conduit can also buy liquidity support from other banks or financial institutions.

In the United States, liquidity facilities exist on either a transaction-specific- or a programme-wide level. In either case, liquidity support can take the form of an agreement to lend funds to or purchase assets from the conduit when liquidity is required.

The rating of an ABCP note issued by a conduit is a function of the underlying asset pool and the rating of the conduit's liquidity provider. The obligation of the liquidity provider is to provide the funds that are relied on to repay the maturing ABCP in the event a liquidity draw becomes necessary. As a result, with limited exceptions, liquidity providers must have minimum credit ratings commensurate with the desired rating of the ABCP notes issued by a conduit.

Agreements governing liquidity facilities include defined circumstances, known as "funding outs," in which liquidity providers are relieved of their obligation to provide liquidity funding. For liquidity support facilities to be effective, funding outs must be specifically limited.

Liquidity support agreements used in Canada differed from those used in the United States and internationally. The differences, which contributed to the freeze in the ABCP market, will be described in Section 4.

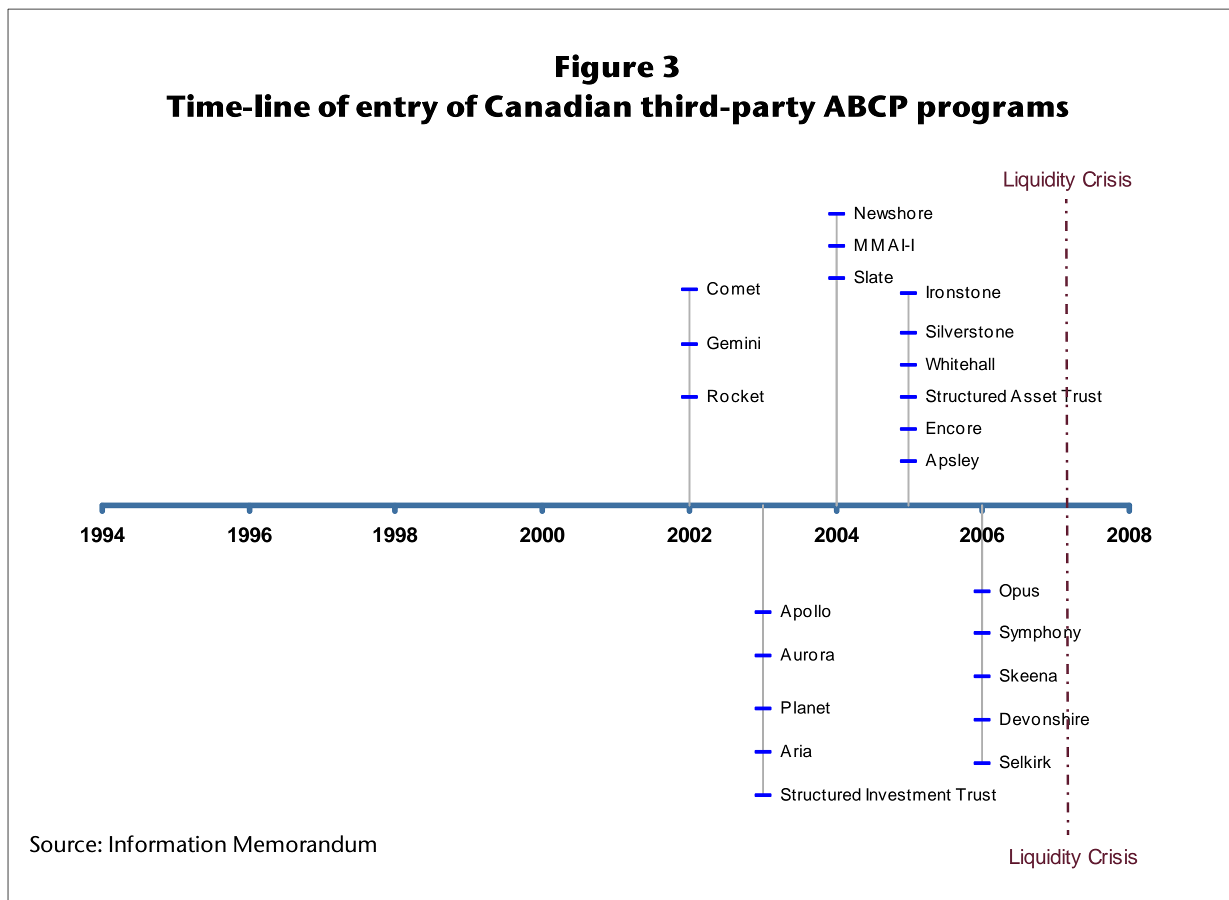
3. THIRD-PARTY ABCP PROGRAMMES

This section describes the development of third-party ABCP programmes and the differences between the asset composition of traditional and third-party ABCP programmes.

Development of Third-party ABCP Programmes

The following timeline chart, based on a review of all available Information Memoranda on Canadian third-party ABCP programmes, shows the entry date of the third-party ABCP programmes with paper outstanding in August 2007.

Figure 3
Time-line of entry of Canadian third-party ABCP programs



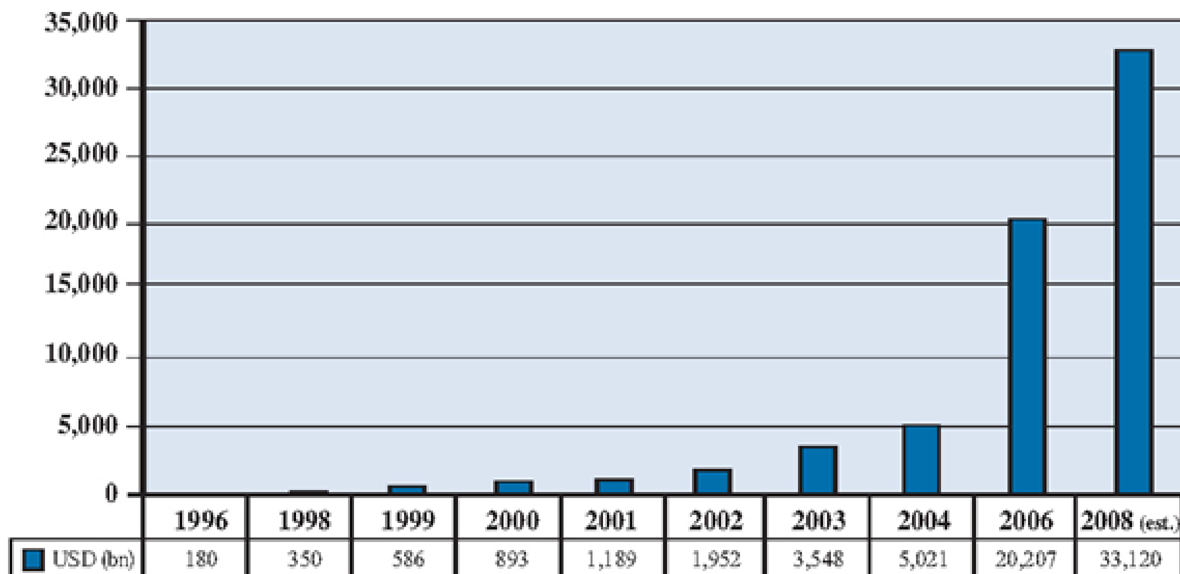
Source: Information Memorandum

Because third-party ABCP sponsors were not credit originators and did not generally have access to bank-originated assets (the banks having their own securitization programmes), they made extensive use of a new and rapidly growing class of assets that was available to them—credit derivatives. Coventree Inc. established the first third-party ABCP programmes—Comet, Gemini and Rocket—in 2002. Coventree pioneered the use of structured financial assets. DBRS applied its credit rating methodologies to an asset composition in which structured financial assets and credit derivatives became the new and predominant asset classes.

Growth of the Global Credit Derivatives Market

The growth of the third-party ABCP market was coincident with and enabled by rapid growth in the global credit derivatives market. As shown in the following chart, the global credit derivatives market grew more than tenfold from less than US $2 trillion to more than US $20 trillion between 2002, when the first third-party ABCP was issued, and 2006.

Chart 1
Growth of the Global Credit Derivatives Market



Source: British Bankers Association

In addition, the composition of the market changed through the rapid growth in synthetic collateralized debt obligations, as shown in the table below.

Table 1

Make-up of the Global Credit Derivatives Market

Type	2000	2002	2004	2006
Basket products	6.0%	6.0%	4.0%	1.8%
Credit linked notes	10.0%	8.0%	6.0%	3.1%
Credit spread options	5.0%	5.0%	2.0%	1.3%
Equity linked credit products	n/a	n/a	1.0%	0.4%
Full index trades	n/a	n/a	9.0%	30.1%
Single-name credit default swaps	38.0%	45.0%	51.0%	32.9%
Swaptions	n/a	n/a	1.0%	0.8%
Synthetic CDOs – full capital	n/a	n/a	6.0%	3.7%
Synthetic CDOs – partial capital	n/a	n/a	10.0%	12.6%
Tranched index trades	n/a	n/a	2.0%	7.6%
Others	41.0%	36.0%	8.0%	5.7%

Source: British Bankers Association

Collateralized Debt Obligations

A collateralized debt obligation (CDO) is a structured financial asset that separates the investor from direct ownership of assets such as bonds or loans. Instead, they give the investor exposure to the income and risks of part of a portfolio of fixed income assets, referred to as the "reference portfolio." The portfolio assets can contain any type of traditional credit assets, including bonds, mortgages or loans.

The reference portfolio may continue to be held by the debt originator, in which case the originator is using the CDOs to sell the risk and the buyer is providing it with risk protection.

The income and risks vary depending on the slice or tranche of the reference portfolio underlying the CDO and the specific points at which the CDO begins to take part in portfolio losses. The percentage loss in the reference portfolio at which a CDO begins to participate in default losses is called the attachment point; the point at which it ceases to participate in further default losses is the detachment point.

Synthetic and Hybrid CDOs

A synthetic CDO uses credit default swaps to recreate the cash flows and default risks of a CDO based on cash asset holdings.

A credit default swap (CDS) is a credit derivative contract in which a protection buyer makes periodic payments to a protection seller in order to gain insurance against a default on the credit instruments of a third-party, called a "reference entity." The contract spells out the following:

- The reference entity, typically a government or corporation which usually, but not always, has outstanding debt obligations.
- The start and termination dates of the protection.
- The periodic payment.
- The type of "credit event" that will be deemed a default. Typical credit events include bankruptcy of the reference corporation, failure to make interest payments on outstanding debt and sometimes restructuring of the reference corporation.
- A "reference obligation," normally an unsubordinated debt instrument of the reference entity, or a description of the characteristics of an obligation, that will be the instrument delivered in the event of a default.
- The settlement method, which can be delivery of the reference obligation of the reference entity against payment at par, or cash settlement of the difference between the market price of the reference obligation and par.

Instead of cash assets like loans or debt securities, underlying a synthetic CDO is a portfolio of CDSs on a variety of reference entities, known as "names," in which the CDO conduit is the protection seller. The cash flow from the assets in a cash CDO is replaced with the periodic payments from the CDS protection buyers; the risk in the event of default is similar, although in a cash CDO the risk is limited to the actual assets held, while in the case of a CDS the "credit event" relates to the reference entity.

A hybrid CDO has a mixed portfolio: partly cash assets and party CDSs.

Funded and Unfunded CDOs

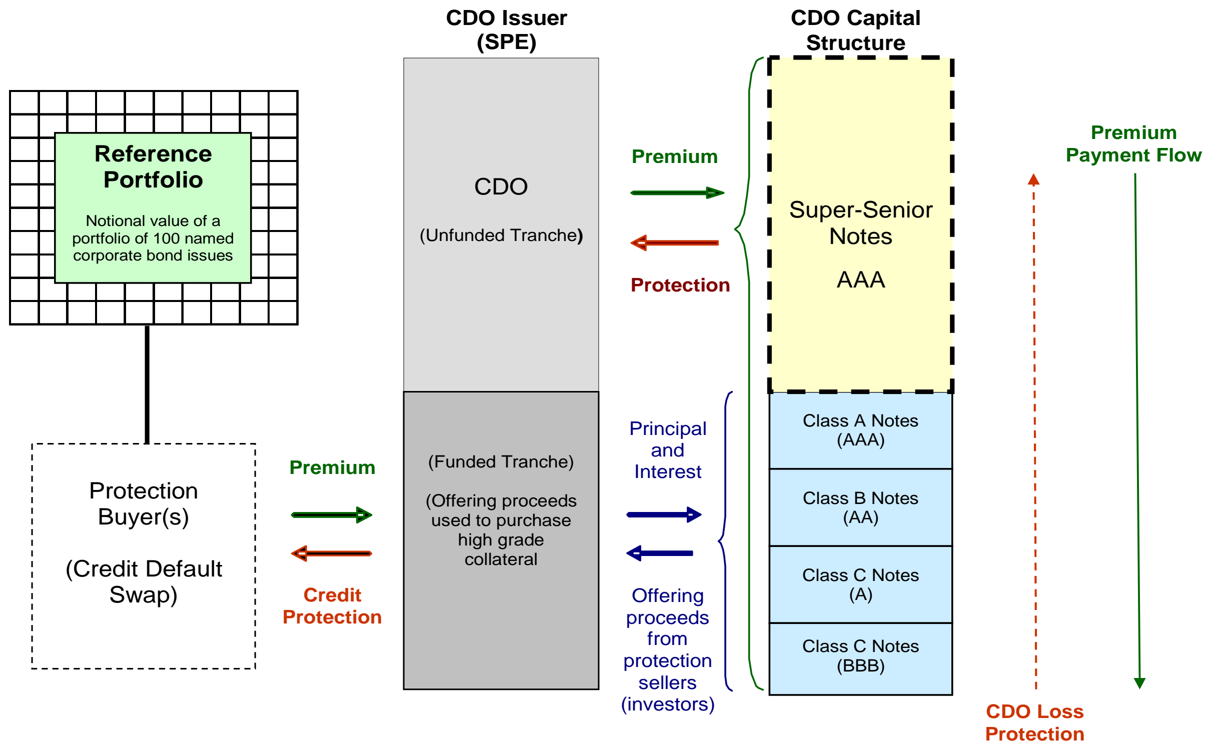
Synthetic CDOs can be funded, unfunded or partially funded.

Because a synthetic CDO does not have to acquire cash assets, it does not need the cash from note sales to fund purchases. It can be "fully funded," i.e. require full payment, acquiring sufficient funds to settle all possible credit events. However, for creditworthy purchasers it can simply accept the purchaser's agreement to pay when called upon to do so in order to settle defaults, or it can require the posting of partial collateral against the possibility of default settlements.

Many synthetic CDOs are partially funded. The junior tranches, which face the greatest risk of default losses, are fully funded. For a fully synthetic CDO, the CDO does not need the funds to pay for assets, so it invests them in highly liquid and highly rated debt securities, using the interest to add to the CDS premium payments in order to pay the interest on outstanding notes. The senior tranches, with the most remote risk of loss, are unfunded.

This unfunded senior-most tranche is commonly referred to as "super-senior" notes. The following shows the structure of a partially funded CDO with super senior notes:

Figure 4
Synthetic CDO Structure with Super-Senior Notes

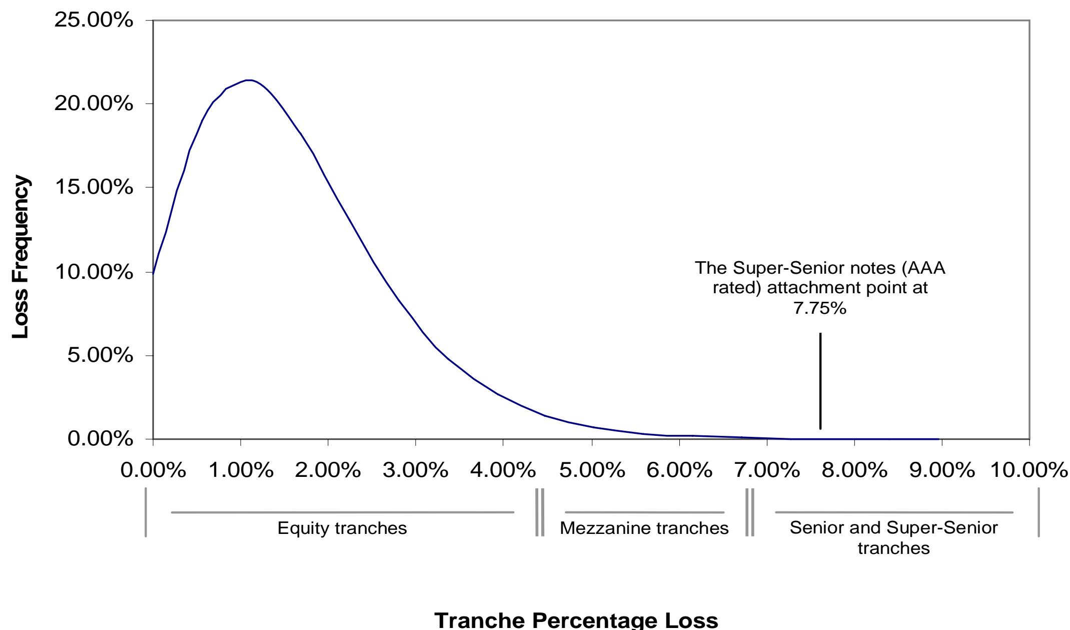


Derived from: DBRS Presentation to IDA entitled "Fundamentals of CDO" dated April 23, 2008 and Fabozzi, Frank and Mann, Steven, "The Handbook of Fixed Income Securities, Seventh Edition, 2005, page 703

CDO Credit Ratings

Credit rating agencies rate CDOs based on probability of the reference portfolio experiencing default loss beyond the attachment point and up to the detachment point. The credit rating approach for a CDO is different than for a traditional asset-backed security in which investors participate equally in the performance of the whole reference portfolio. For a CDO, the credit rating agency first determines the loss distribution profile based on the probability of default in the reference portfolio as a whole. Using models of the default correlation, default probability, and loss recovery rate for the assets in the reference portfolio, it generates a loss distribution profile, as illustrated below, showing the probability of default loss at each attachment point.

Figure 5
Example of a loss distribution profile of a CDO reference portfolio



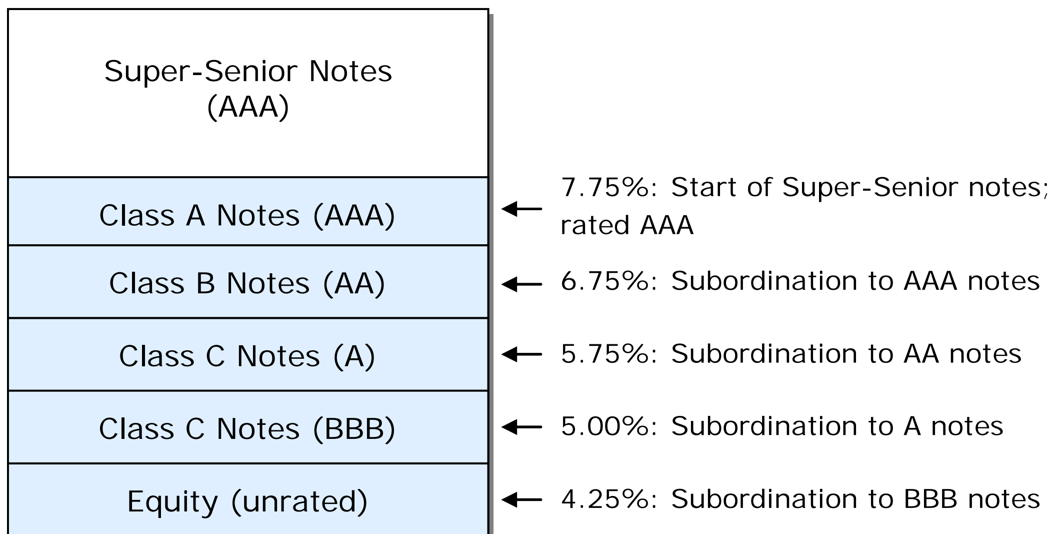
Derived from: DBRS Presentation to IDA entitled "Fundamentals of CDO" dated April 23, 2008

From this information, the credit rating agency determines attachment points that equate to the probability of loss for each CDO tranche note at which specific credit ratings apply. The lower the loss probability of the reference portfolio at each attachment point, the higher the credit rating for that specific tranche note. In the example shown above, the attachment point for the highest (AAA) credit rating is 6.75%. In other words, the credit rating agency model assesses the probability of default losses in the reference portfolio greater than 6.75% to be equivalent to a the default loss probability of a traditional debt instrument rated AAA. For super senior notes, the attachment point is 7.75%. As illustrated in the chart above, the beginning of the distribution curve tail at approximately 6.75% and onward represents the most remote probability of a credit loss.

The breakpoints from this distribution graph are then applied in establishing the CDO "tranches" to be sold to investors and assigning credit ratings for CDO note issued based on the tranche in which it participates.

The tranches based on the loss distribution profile shown above might be as shown below.

Figure 6
Example of ratings and attachment points of CDO tranches



Derived from: DBRS Presentation to IDA entitled "Fundamentals of CDO" dated April 23, 2008

Each slice of the collateralized debt obligation represents a tranche that allows investors to participate at different risk of loss levels. Losses first affect the equity tranche, next the mezzanine tranches, and finally the senior and super-senior tranches. Each tranche receives a periodic premium payment out of the income from the reference portfolio assets, with the junior tranches offering higher premiums to compensate for the increased rate of default risk.

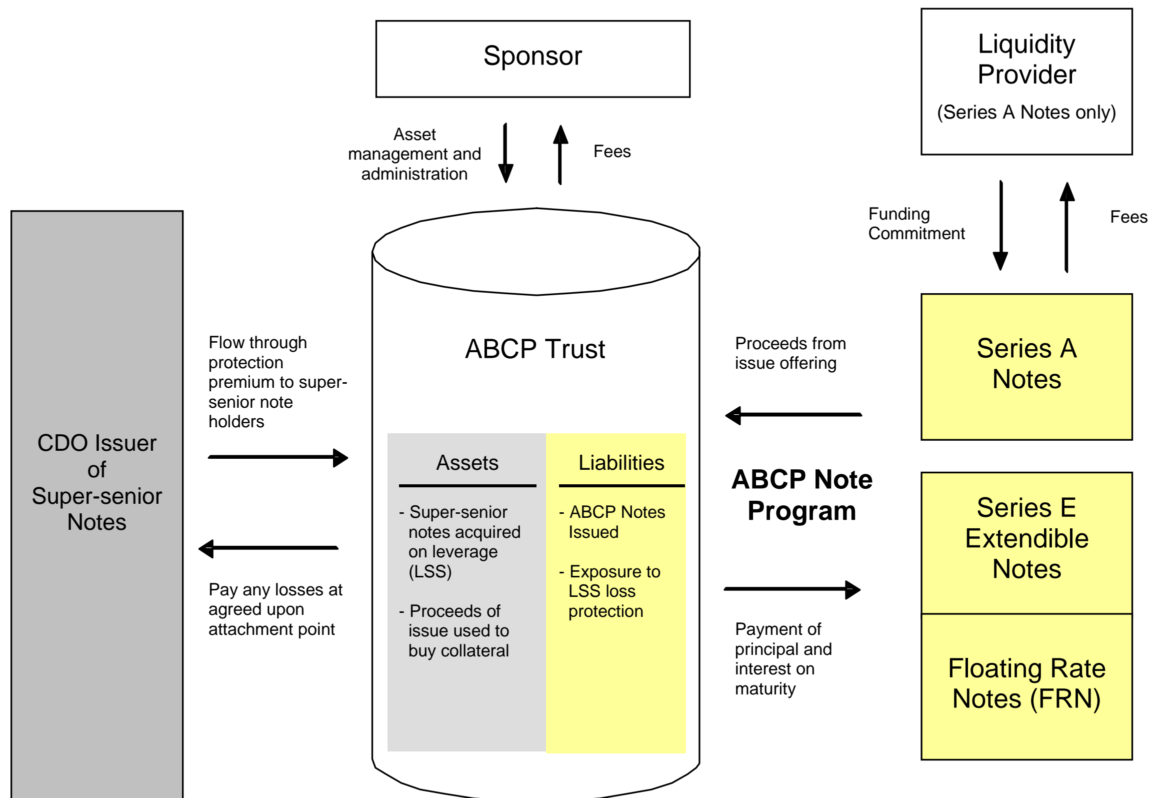
Third-party ABCP Programmes and Leveraged Super-senior Notes

Because they did not generally have enough access to the loan portfolios that bank-sponsored ABCP programmes could obtain from their sponsoring banks, third-party ABCP programmes used CDOs extensively. However, while super-senior notes have the highest credit rating and remotest exposure to default loss, making them highly useful in creating an ABCP programme that will achieve the desired credit rating, the premium on super-senior notes is also the smallest of all tranches, typically 6 to 8 basis points (bps).

Third-party ABCP programmes could enhance the yield by leveraging their exposure to super-senior notes. For example, $100 million in collateral deposit in an ABCP trust could be leveraged 10:1 (and sometimes as high as 40:1) to acquire exposure to $1 billion of super-senior notes. The use of leveraged super-senior-notes tranche enhanced the yield necessary to generate a positive spread between the income on ABCP assets and the interest paid to ABCP purchasers, i.e. it made ABCP programmes using super-senior notes more economically viable[7].

The following diagram illustrates the structuring of a conduit using leveraged super-senior notes as an asset class.

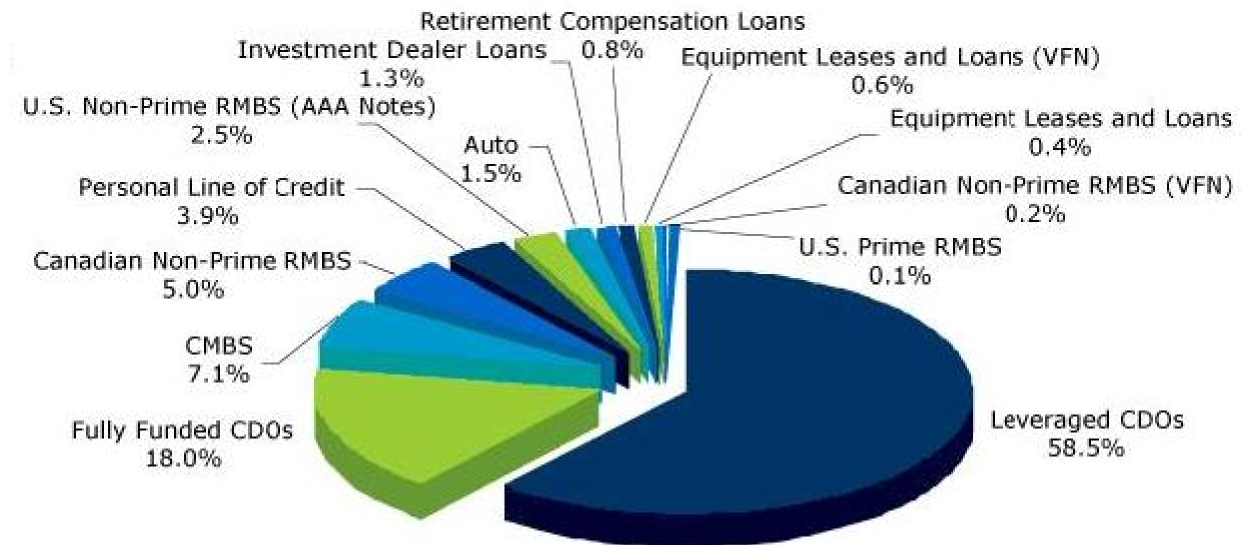
Figure 7
Structure of an ABCP program using super-senior notes



Derived from: Information for Note holders, "*Proposed Restructuring of Canadian third-party Structured Asset-Backed Commercial Paper*", March 20, 2008, prepared by the Canadian Investors Committee for third-party Structured Asset-Backed Commercial Paper – Exhibit D- JPMorgan Report on Restructuring, page 86

Leveraged CDOs became the single largest component of third-party ABCP assets. The following DBRS chart shows the aggregate composition of the affected ABCP trusts by asset class, demonstrating the extent of their use of CDOs, both leveraged and unleveraged:

Figure 8
Affected ABCP trusts by asset class



Source: Dominion Bond Rating Service "CDO Newsletter," Volume 2, Issue 14, December 18, 2007

Effects of the Use of CDOs by Third-party ABCP programmes

The credit risk characteristics between traditional ABCP programmes based on consumer receivables (credit card receivable, car loans and residential mortgages) and third-party ABCP programmes based on leveraged super senior notes are quite different. Traditional ABCP programmes have, as their name suggests, assets that generate a cash flow. Third-party ABCP programmes holding leveraged super senior notes have contingent liabilities. Leveraged super-senior notes were also subject to increases in collateral deposit in the event that the market value of the notes changed because of market conditions or default losses.

Although super senior notes having a statistically remote probability of default loss exposure, the modeling methods used by DBRS in rating them incorporate the probability of the protection buyer requiring the protection seller to post additional collateral. DBRS uses the

same credit rating scale for rating super senior CDOs as it uses for traditional short and long term debt, which investors understood and relied on.

The complexity of the structures behind third-party ABCP would make it difficult, even with the fullest knowledge of the programme assets, to understand the risks, particularly the sensitivity of portfolio to highly volatile conditions like the credit crisis flowing from the sub-prime mortgage problems. They also introduce risks into the structure that are difficult to assess, such as the counterparty risk of CDSs. While in normal situations that risk is low because only large and well-capitalized financial institutions participate in the CDS market, when the capital positions of even large financial institutions are being called into question such additional risks may inject further uncertainty.

However, as will be further described in Section 11, the actual level of transparency was low and the market did not differentiate between ABCP programmes based on traditional assets and those using structured financial assets and credit derivatives.

4. CANADIAN STYLE LIQUIDITY AGREEMENTS

This section describes the Canadian-style liquidity agreements used by third-party ABCP and their role in the August, 2007 liquidity crisis.

The general market disruption clause contained in almost all of the Canadian third-party ABCP programmes was a contributing factor that led to the liquidity crisis and investor standstill agreement on August 2007.

Federal Guidance on Liquidity Facilities

As described above, liquidity support is a key factor in the credit rating of a conduit. Banks are generally the main providers of liquidity support facilities. Because they entail taking on risk, liquidity support commitments have capital implications governed by bank capital rules set by the Office of the Superintendent of Financial Institutions (OSFI). Under federal law, OSFI oversees the prudential regulation of banks, federally regulated trust and loan companies, cooperative credit associations, life insurance companies and property and casualty companies. OSFI's jurisdiction also covers foreign bank branches operating in Canada[8].

Federally regulated financial institutions follow principles-based guidelines and advisories issued by OSFI. Of particular importance to the subject matter of this report are OSFI prudential rules relating to asset securitization limits and restrictions as set out in OSFI Guideline B-5 dated July 1994 and revised in November 2004, and an accompanying OSFI advisory dated January 2005.

OSFI does not oversee the firms that created the non-bank ABCP. These firms are not subject to OSFI B-5. OSFI has advised us that Guideline B-5 does not apply to the offshore banks that negotiated the bulk of the liquidity lines to non-bank ABCP conduits. They further advised us that most of the banks that these non-bank entities were dealing with were offshore foreign banks not regulated by OSFI.[9]

A federally regulated financial institution may perform one or more functions in an asset securitization transaction.

OSFI does not mandate that financial institutions use particular types of liquidity guarantees; rather its guidelines establish requirements for holding bank capital, and those requirements are based on the risk to the bank.

Under OSFI Guideline B-5 dated November 1994, a bank providing a liquidity facility to any single special purpose entity could treat the undrawn portion of the facility as an ordinary lending commitment (i.e., a 0% loan equivalent if under one year maturity and 50% loan equivalent if over one year maturity) for the calculation of its exposure to the special purpose entity if either (i) the facility benefited from a significant subordinated enhancement or (ii) at least 25 % of the facility was syndicated to an independent third party with the benefit of first loss protection from a third party. Otherwise, the unfunded commitment would be either an enhancement (100% loan equivalent) or a first loss facility (deduction from capital). The OSFI guideline referred to liquidity facilities as intended for a "market disruption" without elaborating further on the term.

The practice for third-party ABCP conduits in Canada was to obtain liquidity support that could only be drawn on the occurrence of a "general market disruption." This came to be known as "Canadian-style liquidity".

By contrast, in the United States it was the common practice for a liquidity facility to cover any mismatch in asset and liability term regardless of market disruption or credit deterioration of the underlying assets. This is commonly referred to as global-style liquidity support.

OSFI advised us that most Canadian banks typically only had in place general market disruption lines for their ABCP conduits in Canada. At least one large Canadian bank changed that practice some time ago and established only global style lines to its Canadian conduits. All the major Canadian banks had in place only global style lines for their conduits in the United States, since US investors insisted on global style lines as well as two ratings.

As of August 2007, 79% of the third-party ABCP programmes had liquidity agreements with “general market disruption” provisions[10]. Some liquidity providers honored these agreements, others did not.

Position of US Rating Agencies on Canadian-style Liquidity Agreements

US rating agencies took the position that timely payment was not guaranteed if the rollover protection was not specific to the issuer’s programme. Standard & Poor’s[11] pointed to circumstances in which liquidity problems could have arisen even in the absence of either a general market disruption or a deterioration in the quality of the ABCP assets. Moody’s cited the September 11, 2001 attacks on New York City, noting that Canadian liquidity lines were so restrictive that they could not be invoked[12].

In a report dated August 1, 2002 entitled “Leap of Faith: Canadian ABCP Often Lacks Liquidity Backup” Standard & Poor’s commented on Canadian-style liquidity agreements as follows:

> A peculiar feature of the Canadian ABCP market is that the conduit structures do not typically incorporate widely available backup liquidity facilities. This approach might currently reduce the costs borne by the conduit sponsors or issuers by allowing them to provide a very limited form of liquidity…
>
> Without liquidity lines, there are other imaginable ways that a conduit could try to manage through a refinancing problem, such as asset sales, the sale of commercial paper to another conduit managed by the same bank, or reliance on general support from the sponsoring bank. Each of these avenues requires a leap of faith

> that liquidity relief will actually be available, which is insufficient as a primary response to liquidity risk for a conduit to achieve an investment-grade CP rating.[13]

The comment highlights that Canadian-style liquidity lines might have attracted a lower cost or fee relative to global-style agreements, which implies that the commitment by liquidity providers under Canadian-style agreements was limited. ABCP sponsors could benefit from lower cost and increased positive spread in their programmes by choosing a Canadian-style liquidity agreement over a global style agreement, provided they could obtain the desired credit rating while doing so.

In an article entitled "Developments and Issues in the Canadian Market for ABCP" in its "Financial System Review 2003," the Bank of Canada made reference to the Canadian liquidity agreement issue. It noted that 95% of Canadian ABCP carried an R-1(high) credit rating from the DBRS[14] and described DBRS' position on Canadian-style/global-style liquidity issue as follows:

> DBRS argued that Canadian ABCP is already fully protected against timing mismatches and credit-deterioration problems, via the programme's credit enhancements and operational practices. It would be redundant to add US style supplemental credit-risk protection to the liquidity facility.[15]

DBRS continued to give most Canadian ABCP its highest rating – R-1(High). The Bank of Canada concluded: "Although ABCP poses potential legal and liquidity risks that are inherent in the securitization process, the Canadian investment community seems comfortable with them."[16]

In November 2004, after a consultation process, OSFI released a revised Guideline B-5. The Guideline contained the following definition of general market disruption:

> A disruption in the Canadian commercial paper market resulting in the inability of Canadian commercial paper issuers, including the Special Purpose Entity, to issue any commercial paper, and where the inability does not result from a diminution in the creditworthiness of the Special Purpose Entity or any originator or from deterioration in the performance of the assets of the Special Purpose Entity.

This definition did not alter the decisions of the U.S. rating agencies to refrain from rating Canadian ABCP.

OSFI June 2008 Draft Advisory

On June 19, 2008, OSFI issued a draft advisory setting out its new expectations for banks' securitization activities. Specifically, the following requirements were established[*]:

- The zero percent credit conversion factor for general market disruption liquidity facilities is eliminated, and will be subject to the same capital treatment as global style liquidity facilities. This better reflects the actual risk assumed by Canadian Federally Regulated Entities, and is in line with pending changes to Basel II capital rules;
- Clarification of the sponsorship roles that Federally Regulated Entities play with respect to a securitization vehicle. This includes ongoing disclosure regarding vehicle sponsorship, and an assessment of the impact of those sponsorship roles on potential reputational risk; and
- Effective September 15, 2008, two external credit ratings will be required to apply ratings-related risk weights to most securitization exposures. The advisory reminds Federally Regulated Entities that external credit ratings are only one indication of the quality of the exposures, and should not be the sole factor in investment decisions.

Variations in General Market Disruption Criteria Used in Liquidity Agreements

Neither the liquidity agreements nor the identities of liquidity providers of third-party ABCP programmes are publicly available. However, we were able to obtain and review the general market disruption clauses found in liquidity agreements used by ABCP programmes sponsored by two IIROC dealer members, Dundee Securities Corporation (Dundee) and National Bank Financial Inc. (NBF) that were available to DBRS, liquidity providers and the conduit. They show variations between both agreements for different conduits sponsored by the same dealer member and agreements with different liquidity providers covering the same ABCP programme.

For example, an agreement between NBF-sponsored MMAI-I Trust and a foreign bank provider defined the term as follows:

> Market Disruption Event shall mean a general disruption in the Canadian ABCP market which is not limited to, or focused on, a single Canadian ABCP issuer resulting in the inability of [named conduit] to issue Class A Series Notes in amounts sufficient to fund the repayment of all principal and interest, if any, on the Class A Series A Notes that are maturing or due, and held by third parties (the "CP Redemption Amount") which inability of [named conduit] to issue Class A Series A Notes to repay Class A Series A Notes maturing or due is neither the result of a diminution in the creditworthiness of [named conduit] or a deterioration in the performance of the assets of [named conduit] and shall be evidenced by the giving of an effective Market Disruption Notice.

An agreement between another NBF-sponsored conduit, Ironstone Trust and a Canadian bank liquidity provider, included the following definition:

> Market Disruption means a disruption in the Canadian commercial paper market resulting in the inability of Canadian commercial paper issuers, including the Borrower, to issue any commercial paper, and where the inability does not result from a diminution in the creditworthiness of the Borrower or any Originator or from a deterioration in the performance of the assets of the Borrower.

The former refers to a general disruption, the latter only to a disruption; the former says that disruption cannot be limited to a single ABCP issuer, the latter uses the broad term "Canadian commercial paper issuers."

As an illustration of differences between liquidity agreements entered into by the same conduit with different liquidity providers, Skeena Capital Trust, sponsored by Dundee, had liquidity agreements that contained the following definitions:

1. With a Canadian bank:

> Market Disruption means, on any date, a general disruption in the Canadian ABCP market which is not limited to a single Canadian ABCP paper conduit resulting in the inability of the Borrower to issue ABCP in an amount equal to

the amount owing in respect of ABCP maturing on such date which inability is neither the result of a diminution in the creditworthiness of the Borrower nor a deterioration in the performance of the assets of the Borrower, which shall be definitively confirmed by the Rating Agency of the current rating assigned by it on such date.

2. with a foreign bank:

   Market Disruption Event means, on any date, a general market disruption in the Canadian ABCP market which is not limited to Conduits of a single sponsor as definitely confirmed in accordance with Section (2)(b)(ii) of the related Advance Notice and which results in the inability of the Borrower to issue commercial paper in an amount equal to the amount owing in respect of commercial paper maturing on such date, which inability is neither the result of a diminution in the creditworthiness of the Borrower nor a deterioration in the performance of the assets of the Borrower as the same shall be definitively confirmed by a confirmation on such date from DBRS of a rating of R-1(high) on the Series A Notes.

3. with another foreign bank:

   Market Disruption Event means, on any date, a general market disruption in the Canadian ABCP market resulting in the inability of Canadian ABCP issuers, including the Trust, to issue ABCP, where such inability does not result from a diminution in the creditworthiness of the Trust or from a deterioration in the performance of the assets of the Trust, which shall be definitively confirmed by a confirmation from DBRS of the current ratings assigned by it to the Series A Notes outstanding on such date.

The first and second are like the first quoted MMAI-I agreement in referring to a disruption affecting more than a single entity. The third provision has the more general language of the second quoted MMAI-I agreement.

5. CREDIT RATINGS

This section describes the role played by credit ratings in ABCP and the process used to determine them. While outside the purview of this report, there have been a number of reports on credit rating agencies prompted by the credit crisis listed in the Bibliography. The list of agencies that have issued reports includes the Bank of Canada, Canadian Securities Administrators, the United States Securities and Exchange Commission, and the International Organization of Securities Commissions.

Credit rating agencies play an influential role in financial markets by acting as information intermediaries specializing in the appraisal of the creditworthiness of corporations that issue debt. They have become central to financial markets because the credit ratings they issue are relied upon as a means of mitigating information asymmetries that exist between issuers and investors. Concurrently, they have gained considerable influence over market participants because their assessments of creditworthiness have come to be viewed as authoritative.

Three of the largest credit rating agencies operating on a global scale are based in the United States: Moody's, Standard & Poor's, and Fitch. They also operate in Canada; however, DBRS provides rating services for 99% of all corporate commercial paper issuers in Canada and 98.6% of the asset-backed securities market. DBRS was also the only credit rating agency for Canadian third-party ABCP programmes[17]. The remainder of this section will therefore deal solely with DBRS processes as applied to Canadian third-party ABCP.

In Canada, DBRS is not subject to formal regulation. Its staff nonetheless met voluntarily with IIROC staff, provided written material on its process, answered questions regarding both the rating process in general and ABCP in particular, and was otherwise helpful in the preparation of this report.

The Credit Rating Process

For structured finance products, securities are typically issued by a special purpose entity to fund the purchase of the underlying transactions. To properly assess these structures, the rating process is divided into two stages: the review of the special purpose entity structure and the review of the specific transaction to be funded through the special purpose entity structure.

At a broad level, the review and approval of the special purpose entity structure involves the following steps:[18]

- Initial meeting between DBRS and the sponsor to discuss the structure of the special purpose entity,
- Issuance of an engagement letter to formalize and confirm the terms of the engagement,
- Gathering information on the sponsor in order to evaluate its financial and operational capabilities,
- Review of the legal structure,
- Drafting the rating report, that focuses on the structural features, the roles performed by various parties and structural mitigants such as rating triggers on sellers, servicers and credit enhancers,
- Determination of the rating by the Rating Committee, and
- Review of the press release and draft rating report by the sponsor for factual inaccuracies and to ensure they do not contain confidential information.

Generally, each purchase of assets by an ABCP is reviewed by Rating Committee. For an ABCP purchase, DBRS will typically issue a confirmation letter for the conduit's rating.

The review of the specific transactions to be funded through the special purpose entity structure consists of certain standard elements including management contact, specific information requirements and documentation review, review of the seller, determination of credit enhancement and Rating Committee review.

Because of confidentiality agreements with sponsors of the third-party ABCP programmes, and other confidentiality restrictions, DBRS could not make public detailed information about the underlying asset composition and its related performance.

Credit Rating Scale

DBRS uses different scales for rating long-term and short-term obligations, although the basic approach to rating long-term and short-term paper is similar.

The separate scale for short-term paper reflects the greater importance of liquidity considerations arising from the mismatch between the longer maturity of the underlying assets and the shorter maturity of the liabilities. Liquidity is a consideration in long-term ratings as

well, but its importance is magnified in the case of short-term paper. Sponsors support the ratings through liquidity support facilities and credit enhancements as described in Part 2, as well as through monitoring the conduit's assets.

For short-term paper, R-1(high) is DBRS highest credit quality rating. In the case of ABCP, the ratings apply to the notes issued by the conduit, not the individual portfolios that generate the cash flows. R-1(high) maps to three credit ratings for long-term paper: AAA, AAH and occasionally AA.[19]

Continuous Credit Rating Monitoring

Each sponsor is generally required to provide DBRS with a monthly report, which provides an overview of the performance of each purchase made by the special purpose entity structure and the overall portfolio within that structure, and to provide prompt notification to DBRS of any covenant trigger and a proposed course of action to remedy the situation.

The DBRS Surveillance Group generally reviews the monthly report from the sponsor, provides, as necessary, notice to the analyst covering the rating of a breach of any covenant, and records any such breach and any deteriorating transactions on the 'watch list' for further monthly reviews.[20]

November 2006 DBRS Advisory

In November, 2006 DBRS issued an advisory addressed to "various market participants." The advisory noted the rapid growth and concentration in ABCP use of structured financial assets and market conditions making the returns to protection sellers less attractive than previously. DBRS announced in the advisory that programmes using such assets should expect more restrictive approvals of future transactions. It also noted that existing programmes were credit enhanced over minimum thresholds for each rating category. (See Appendix C)

Change of Requirement for Liquidity Agreements

In January 2007 DBRS changed its CDO rating criteria for arbitrage-type structured financial asset transactions to require, among other things, global-style liquidity agreements. However, the change did not apply to existing third-party ABCP programmes, they were applied only to new ABCP programmes.

6. ABCP CLEARING, SETTLEMENT AND CUSTODY

This section describes the clearing, settlement and custodial arrangements that facilitated the distribution of ABCP.

Process

A key component for widespread distribution of any financial instrument is its distribution channel – the processes for issuance, clearing and settlement of trades, and custody of the security. Those processes must be efficient and effective for a security to be widely held.

A central depository system is an electronic book-entry system that records and maintains securities and registers their transfer, enabling ownership to be changed without physical movements of securities or execution of transfer deeds. The ownership transfer is effected as the securities move from one account to another.

In Canada, the central depository for securities is the Canadian Depository for Securities Limited (CDS Ltd.). CDS Ltd. facilitates the clearing and settlement process of Canadian exchange-traded and over-the-counter equity, debt and money market securities that meet its criteria, including ABCP.

For an issuer to have its securities cleared and settled within CDS, the issuer must qualify as a CDS participant or enter into an arrangement with a CDS participant. If the latter, the issuer engages the services of a CDS participant or participants for two critical roles: issuing and paying agent and distribution agent.

Because ABCP programmes were structured as trusts rather than corporations, other parties were involved in the issuance and distribution process. A trust is not a separate legal entity under Canadian law. A trust is a relationship created with respect to property that belongs to the beneficiaries of the trust. The following roles are integral to the structure and distribution of the ABCP programme of a conduit:

- Indenture Trustee

  The indenture trustee acts as the agent of the note-holders. The indenture trustee is responsible for receiving payments from third parties and remitting payments to the note-holders.

- Issuing Trustee

  The title of the trust's property is vested in the issuing trustee, who acts as principal in carrying out the trust's activities. Generally, the issuing trustee appoints agents to carry on the trust's activities. The issuing trustee, however, retains ultimate power to exercise control over the trust and its property.

- Administrative Agent

  The administrative agent conducts the day-to-day operations. Duties of the administrative agent generally relate to the issuance, sale and repayment of the ABCP notes. Often the administrative agent is the sponsor or an affiliate of the sponsor. In some cases, it is an independent third-party. For the conduits manufactured by IIROC dealer members, either the dealer member itself or the parent-bank of the dealer member acted as the administrative agent.

- Issuing and Paying Agent

  The issuing and paying agent is responsible for the settlement and record keeping pertaining to the issuance and repayment of the ABCP notes. Payments are made through CDS. Generally, this function is performed by a bank or trust company.

- Primary Distribution Agent

  All ABCP programmes appoint one or more primary distribution agents to coordinate the actual sale of the ABCP notes. The primary distribution agent works closely with the administrative agent to determine the face or principal amount, maturities, interest or discount rates and denominations of the ABCP notes to be issued. A limited pool of banks and IIROC dealer members were primary distribution agents for ABCP.

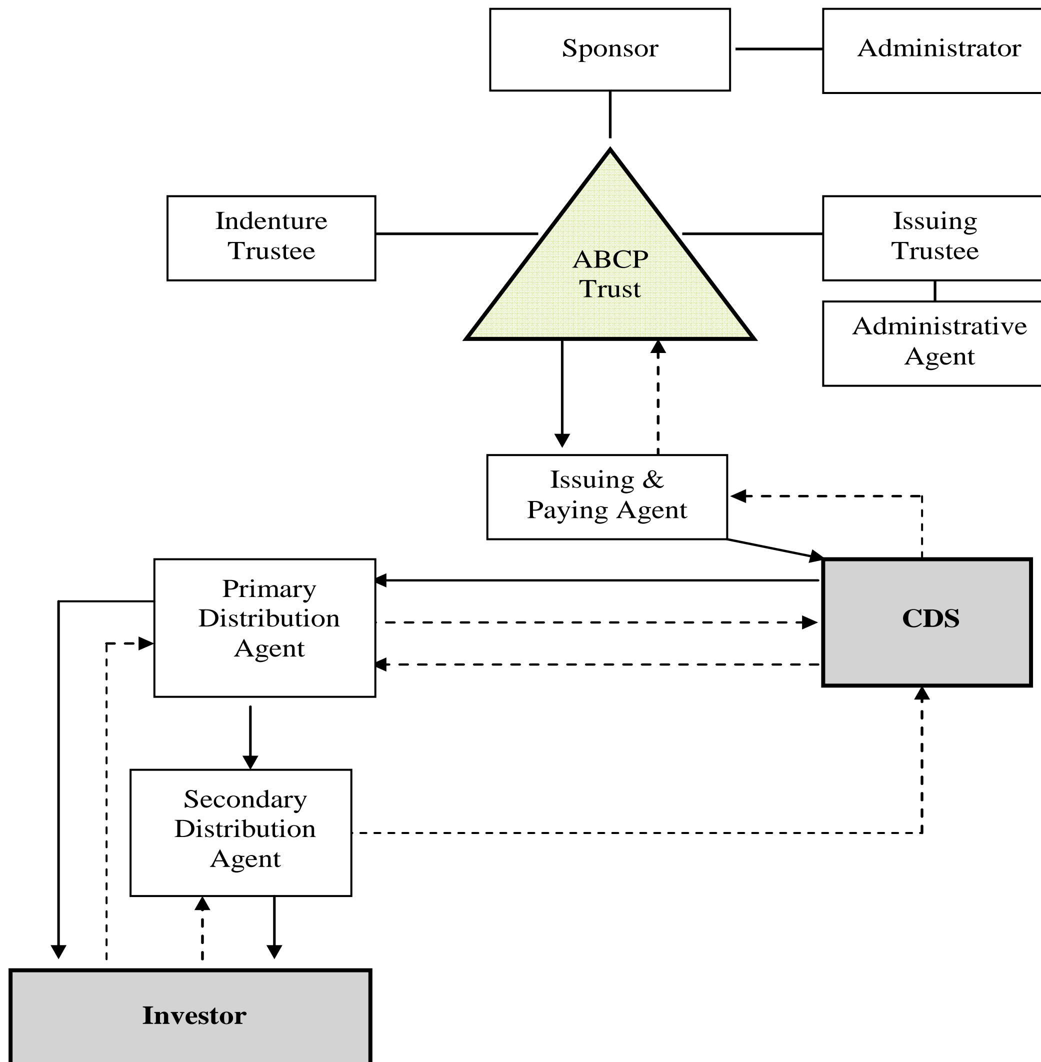
- Secondary Distribution Agent

  A primary distribution agent can sell directly to a client or to a counterparty. The counter-party, also a CDS participant, can sell to a client or hold the ABCP notes as part of its inventory for investment purposes or for future resale to a client. A small group of IIROC dealer members acted as secondary distribution agents.

The compliance sweep section of this report discusses the activities of IIROC dealer members as manufacturer or distribution agent of third-party ABCP.

The following diagram shows the roles of these parties in the ABCP distribution channel:

Figure 9
ABCP distribution and administration structure



The eligibility for CDS book-based processing increased the distribution efficiency of Canadian Third-Party ABCP to retail investors.

7. THIRD-PARTY ABCP SPONSORS

This section describes the sponsors of the third-party ABCP conduits and their ownership.

The seven sponsors of the 22 third-party ABCP conduits affected by the August, 2007 freeze were as follows:

Table 2

ABCP Program Sponsors

	Conduit	Sponsor
1	Apollo Trust	Coventree Inc.
2	Aurora Trust	Coventree Inc.
3	Comet Trust	Coventree Inc.
4	Gemini Trust	Coventree Inc.
5	Planet Trust	Coventree Inc.
6	Rocket Trust	Coventree Inc.
7	Slate Trust	Coventree Inc.
8	Structured Asset Trust	Nereus Financial Inc.
9	Structured Investment Trust III	Nereus Financial Inc.
10	Ironstone Trust	National Bank Financial Inc.
11	MMAI Trust	National Bank Financial Inc.
12	Silverstone Trust	National Bank Financial Inc.
13	Aria Trust	Newshore Financial Services Inc.
14	Encore Trust	Newshore Financial Services Inc.
15	Newshore Canadian Trust	Newshore Financial Services Inc.
16	Opus Trust	Newshore Financial Services Inc.
17	Symphony Trust	Newshore Financial Services Inc.

18	Apsley Trust	Metcalfe & Mansfield Capital Corp.
19	Devonshire Trust	Metcalfe & Mansfield Capital Corp.
20	Whitehall Trust	Metcalfe & Mansfield Capital Corp.
21	Selkirk Funding Trust	Securitus Capital Corp.
22	Skeena Capital Trust	Dundee Securities Corporation

The shaded conduits were sponsored by IIROC Dealer Members.

Of the $35 billion in third-party ABCP debt outstanding as of August, 2007, programmes sponsored by Coventree Inc (Coventree) and its subsidiary Nereus Financial Inc. accounted for $16 billion or 46%. IIROC Dealer Members sponsored $6 billion or 18% of the frozen ABCP debt: National Bank Financial Inc. (NBF) 12% and Dundee Securities Corporation (Dundee) 6%.

Significant Affiliation or Ownership Interests in ABCP programme sponsors

Coventree Inc.

Coventree was founded in 1998 as Coventree Capital Group Inc. As noted above, it pioneered third-party ABCP programmes starting in 2002.

Coventree went public in 2006. Prior to the initial public offering its largest shareholder was Caisse de dépôt et placement du Quebec (the Caisse). After the initial public offering the Caisse held a 9.99% equity ownership interest.

Coventree had a 75.5% interest in Nereus Financial Inc. (Nereus), another sponsor. In its November, 2006 prospectus Coventree also disclosed that it owned slightly less than 10% of another public company, Xceed Mortgage Corporation (Xceed), an originator of sub-prime mortgages in Canada. Xceed was established in 1997 and went public in 2004.

Dundee Securities Corporation (Dundee)

Dundee is an indirect wholly-owned subsidiary of DundeeWealth Inc., a publicly listed company and is an IIROC dealer member.

In September 2007, the Bank of Nova Scotia acquired a share ownership interest of 18.8% of DundeeWealth Inc.

Metcalfe & Mansfield Capital Corp. (Metcalfe)

Metcalfe is a subsidiary of the Quanto Financial Group (Quanto). Two of Quanto's principal shareholders are National Bank Financial and Deutsche Bank Canada. Deutsche Bank Securities Ltd, an IIROC Dealer Member, is an affiliate of Deutsche Bank Canada.

Quanto and Metcalfe were formed in May, 2006, at which time National Bank Financial Inc. (NBF) transferred its wholesale distribution arm, Opensky Capital, to Quanto and part of its structured finance and securitization business to Quanto and Metcalfe. According to a news release at that time, NBF was to retain a minority stake in Quanto, the other investors being a Montreal-based private equity firm – Redfern Equity Capital Partners Inc., and an unnamed European institutional investor.

National Bank Financial Inc.

NBF is a wholly owned subsidiary of National Bank of Canada, which also owns three other IIROC dealer members: National Bank Financial Ltd, NBCN Inc., and National Bank Direct Brokerage Inc.

Nereus Financial Inc. (Nereus)

Nereus is a spin-off of Coventree and is operated on a stand-alone basis. The 24.5% not owned by Coventree is held by current and former employees. For issuer disclosure, Nereus's financial statements are consolidated with those of Coventree.

Newshore Financial Services Inc. (Newshore)

Newshore is part of the Newshore Capital Group Inc. We were unable to obtain any publicly available information about this entity.

Securitus Capital Corp. (Securitus)

Securitus is a private company founded in 2006 and was the last entrant to the Canadian third-party ABCP market.

Maple Financial Group Inc. has a minority equity interest in Securitus and indirect controlling interests in two IIROC Dealer Members: Maple Securities Canada Limited and Maple Futures Corp. National Bank of Canada has a 24% indirect ownership in Maple Securities Canada Limited.

Conduits Sponsored by IIROC Dealer Members

As listed above, four conduits were sponsored by two IIROC dealer members: three by NBF and one by Dundee.

NBF Inc. was the first third-party ABCP sponsor to enter the market after Coventree. Dundee entered the market in mid-2006.

The following shows relevant facts about the ABCP programmes sponsored by IIROC dealer members:

Table 3

ABCP programmes sponsored by IIROC dealer members sponsors

Conduit	Float	Percentage of ABCP Float	Asset Composition
MMAI-I Trust	$1.4 billion	4%	100% fully-funded CDOs
Silverstone Trust	$2.0 billion	6%	100% leveraged CDOs
Ironstone Trust	$0.8 billion	2%	100% fully-funded CDOs
Skeena Capital Trust	$2.1 billion	6%	100% leveraged CDOs

8. DISTRIBUTORS OF THIRD-PARTY ABCP

Conduits did not directly issue or distribute their ABCP. They delegated the distribution or selling function to banks and investment dealers.

A conduit would enter into an agreement for a single distributor or group of distributors to sell the ABCP on best efforts basis for a fee.

There were 13 distribution agents disclosed for the 18 conduits about which we could obtain information memoranda[‡]: nine IIROC Dealer Members and four banks. Eight of the nine IIROC dealer members were affiliated with banks.

‡ See Section 11 on transparency

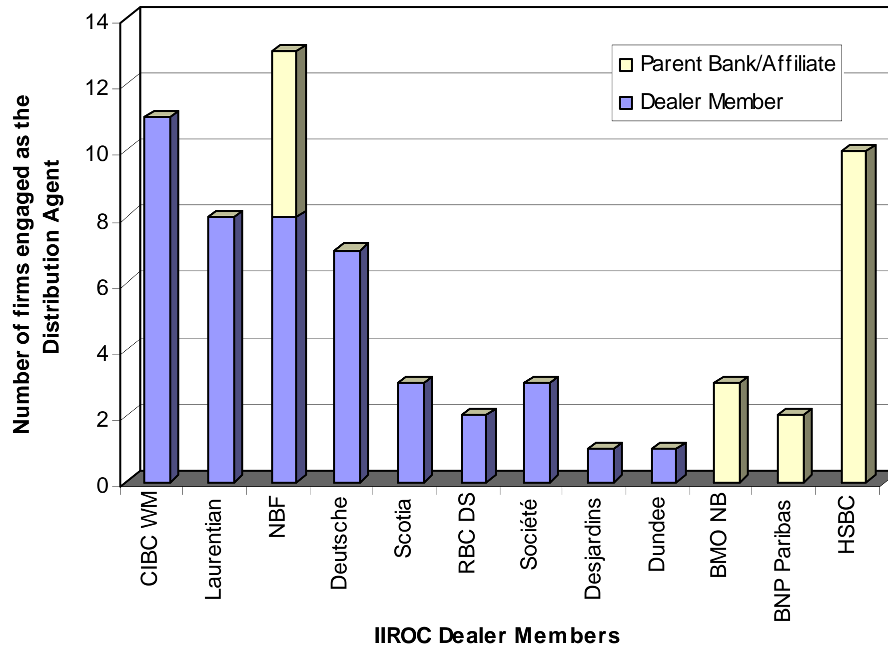
The distributors listed in the IMs were:

Table 4

Third-party ABCP primary distribution agents

Distributor	No.	Conduits
Dealer Members:		
CIBC World Markets Inc.[21] –	11	Apollo, Apsley, Comet, Gemini, Ironstone, Opus, Planet, Rocket, Silverstone, Symphony, Whitehall
Desjardins Securities Inc.	1	Apsley
Deutsche Bank Securities Ltd.	7	Apsley, MMAI, Opus, Silverstone, Skeena, Symphony, Whitehall
Dundee Securities Corporation	1	Skeena
Laurentian Bank Securities Inc.	8	Apollo, Apsley, Comet, Gemini, Planet, Rocket, Selkirk, Symphony
National Bank Financial Inc.	8	Apsley, Ironstone, MMAI, Opus, Silverstone, Skeena Symphony, Whitehall
RBC Dominion Securities Inc.	2	Apollo, Planet
Scotia Capital Inc.	3	Apollo, Planet, Skeena
Société Générale Securities Inc.	3	Apsley, Opus, Symphony
Banks:		
Bank of Montreal	3	Opus, Selkirk, Symphony
BNP Paribas (Canada)	2	MMAI, Silverstone
HSBC Bank Canada	10	Apollo, Apsley, Comet, Gemini, Opus, Planet, Rocket, Selkirk, Silverstone, Symphony
National Bank of Canada	5	Apollo, Comet, Gemini, Planet, Rocket

Chart 2
Primary Distribution Agents



Source: Information Memorandum

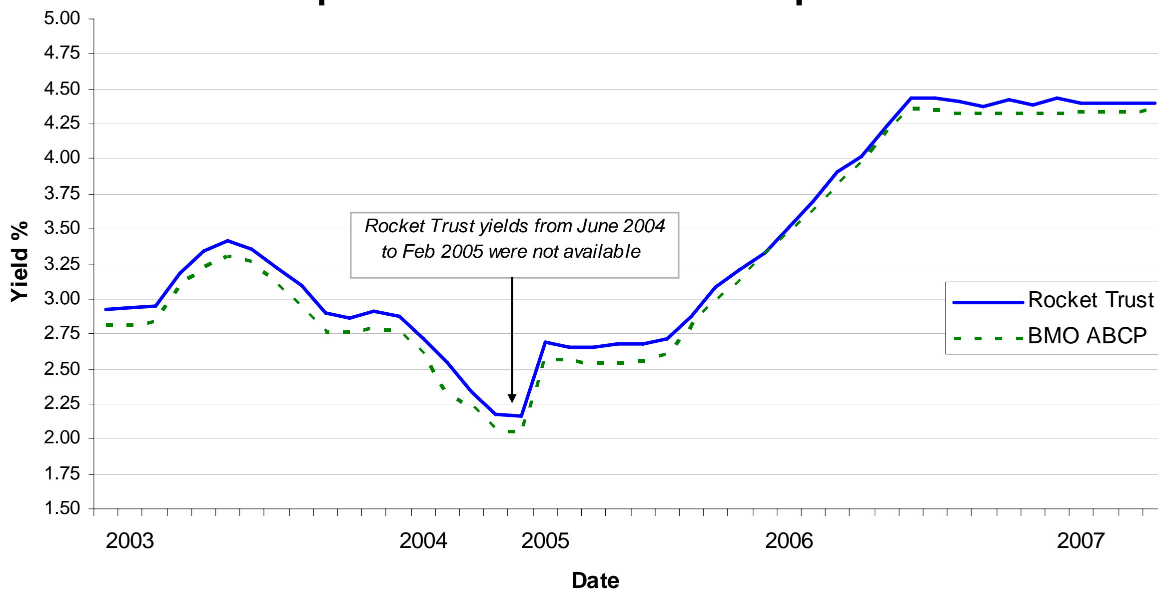
9. MARKET PERFORMANCE OF THIRD-PARTY ABCP

This section describes the performance of third-party ABCP in the market through comparisons of yields on representative issues and those on other money-market instruments.

Third-party ABCP Yield Compared to Bank-sponsored ABCP Yield

The following chart shows a comparison of the yield of Rocket Trust 30-day Series A Notes and 30-day Series A notes issued by the Bank of Montreal-sponsored ABCP trusts, both rated R-1(high), from December 2002 to April 2007.

Chart 3
Yield comparison - Rocket Trust and BMO - sponsored ABCP

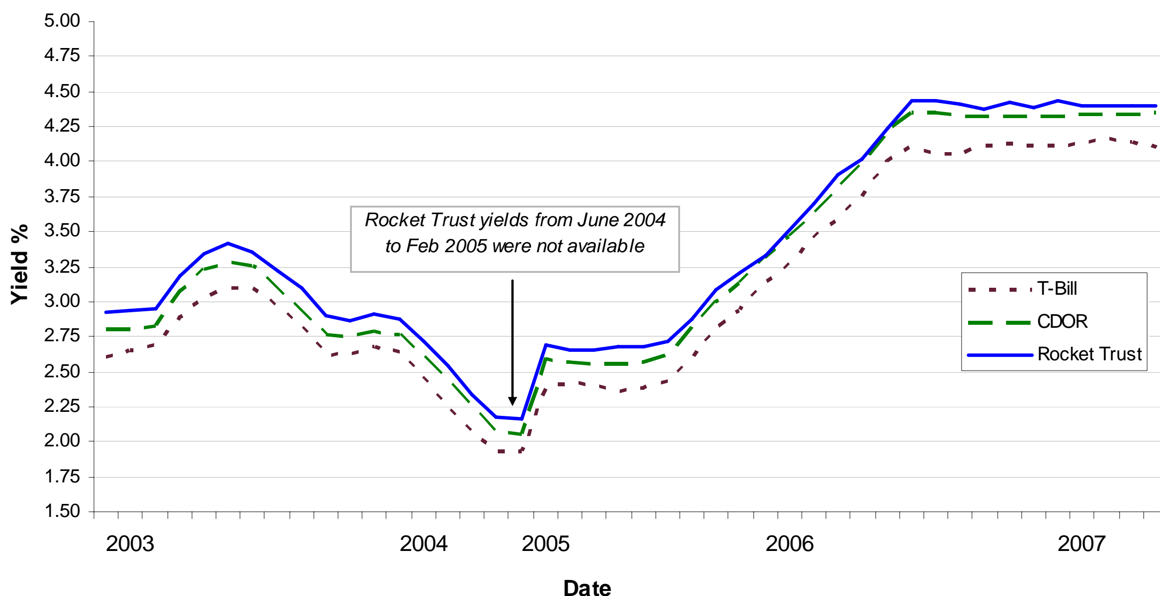


Yield data: Rocket Trust – RBC Dominion Securities Inc.
BMO ABCP – BMO Nesbitt Burns Inc.

There was initially a small spread, about 10 basis points but narrowing as time went on, suggesting that the market saw very little difference in risk between bank-sponsored ABCP and third-party ABCP.

Third-party ABCP Yield Compared to T-Bills and Bankers' Acceptances

The following chart compares the yields of Rocket Trust ABCP, T-Bills and the Canadian Dealer Offered Rate (CDOR), which is the average daily rate of bankers' acceptances.



Yield data: Rocket Trust – RBC Dominion Securities Inc.
BA and T-Bill Rates – Bank of Canada

The spread between third-party ABCP and CDOR narrowed over the period. Over the whole period, the yield on third-party ABCP was on average 25 bps higher than Canadian Dealer Offered Rate and 43 bps higher than the T-Bill yield.

10. Commercial Paper Distribution Rules

This section examines the securities regulations regarding distribution of commercial paper including ABCP.

Prospectus Exemption for Commercial Paper

The distribution of and trading in commercial paper in Canada is governed by provincial securities legislation. Under the *Securities Act* (Ontario) (OSA), commercial paper is generally subject to both prospectus and dealer registration, but is exempt from those requirements under certain conditions.

In 1963 the OSA was amended to add an exemption from registration and prospectus requirements for purchases above the minimum principal or denomination amount of $50,000[22].

The basis for the original exemption was that investors in commercial paper were thought not to need the protections that participation by a registrant and prospectus disclosure provide. Those that could afford the minimum purchase amount were considered to be sophisticated investors themselves or able to hire sophisticated advisors, and in large part the market was dominated by institutional investors. In addition, commercial paper was typically issued by companies that were listed on public stock exchanges and were therefore already subject to the disclosure standards under securities legislation and stock exchange rules.

In September, 2005 all Canadian securities regulatory authorities adopted National Instrument (NI) 45-106 to consolidate and harmonize the prospectus and registration exemptions contained in provincial statutes and regulations, including the commercial paper exemptions, into a single national rule.

The registration and prospectus exemptions for commercial paper are set out in section 2.35 of NI 45-105:

> 2.35 (1) The dealer registration requirement does not apply in respect of a trade in a negotiable promissory note or commercial paper maturing not more than one year from the date of issue, if the note or commercial paper traded
>
> (a) is not convertible or exchangeable into or accompanied by a right to purchase another security other than a security described in this section, and
>
> (b) has an approved credit rating from an approved credit rating organization.
>
> (2) The prospectus requirement does not apply to a distribution of a security in the circumstances referred to in subsection (1).

The requirement for commercial paper to have an "approved credit rating" from an "approved credit rating organization" was an alternative to the $50,000 minimum principal denomination requirement that had previously existed in some other provinces[23]. It was designed to limit the exemption to relatively low-risk securities.

The Approved Credit Rating

NI 45-106 adopts by reference the definitions of "approved credit rating" and "approved credit rating organization" in NI 81-102. They have been amended from time to time to reflect changes in the population of credit rating agencies in Canada, but the substance of the definitions has remained the same. Currently, DBRS, Fitch Ratings, Moody's Investors Service, and Standard & Poor's are all approved credit rating organizations.

The "approved credit ratings" are prescribed in NI 81-102 as follows:

Table 5

Approved Credit Ratings under NI 81-102

Approved Credit Rating Organization	Commercial Paper/Short Term Debt	Long Term Debt
Dominion Bond Rating Service Limited	R-1 (low)	A
Fitch Ratings	F1	A
Moody's Investors Service	P-1	A2
Standard & Poor's	A-1(Low)	A

The Information Memoranda for the 18 affected third-party ABCP issuers disclosed that all Series A notes issued and outstanding prior to August 2007 had received an "approved credit rating" by DBRS, an approved credit rating organization. All were rated R-1 (high) by DBRS.

The report recently issued by the CSA addresses the exemption and matters relating to credit rating agencies.

11. ABCP DISCLOSURE AND THE AVAILABILITY OF INFORMATION ABOUT ABCP

This section examines the disclosure requirements governing asset-backed securities and the availability of information regarding third-party ABCP.

To the extent that asset-backed securities are qualified for distribution by a prospectus, Canadian securities law mandates disclosures such as the composition of the pool of assets, income and losses from the pool, and collection experience of the pool.

The prospectus exemptions under which most asset-backed securities are issued do not trigger any prescribed disclosure to investors. Any disclosure provided to investors is on a voluntary basis in accordance with market demand and practice. Such disclosure can therefore vary significantly.

The SEDAR filing system (www.sedar.com) provides access to most documents and information filed under securities law by public companies and investment funds. There is no central public repository in Canada for information on securities issued pursuant to prospectus exemptions.[24]

Typically, voluntary disclosure consists of an information memorandum (IM) s. This document contains basic information regarding the issuer, sponsor, interest rate, date of repayment, dealers distributing the security and details of any guarantee of payments. It is typically prepared upon the inception of the programme, but may be updated from time to time.

We could locate the IMs of 18 of the 22 affected third-party ABCP programmes. A Canadian Web site had 15 of the IMs posted on a password-protected Web site accessible only to the bank's corporate and institutional clients. We also located two other IMs on the Internet, on the websites of the sponsors.[25]

While the information in the IMs varies, we found significant gaps:

- There is no detail as to the underlying asset class composition;
- The asset and liquidity providers are not disclosed in any of the IMs;
- The role of sponsor is not always clearly identified and disclosed;
- There is no consistent use of names for the various roles;

- The issuing and paying agent is not always disclosed;
- The distribution agents are not always identified.

For example, the following is an example of disclosure in the IM of a third-party ABCP regarding the asset composition of a conduit:

> The Trust is a special purpose entity established for the limited purposes of acquiring, purchasing or originating investments, directly or indirectly, in financial assets...
>
> Such Financial Assets may include, but are not limited to ... securitized pools of residential mortgage loans, commercial mortgage loans, trade receivables, consumer receivables, assignable corporate loans and bonds, securities backed by such assets or economic exposures to such assets obtained through financial contracts such as collateralized credit default swaps.

An article in the June 2003 *Bank of Canada Financial System Report* entitled "Developments and Issues in the Canadian Market for ABCP", noted as follows:

> The fact that securitization is a complicated process involving many participants would seem to argue for a high degree of disclosure. But the market is relatively opaque."[26]

Exposure to U.S. Sub-prime

The Pan-Canadian Investors Committee identified approximately $3 billion in third-party ABCP sub-prime assets, or less than 10% of the total assets[27].

One conduit sponsored by an IIROC Dealer Member was exposed to U.S. sub-prime mortgages.

The Information for Note holders prepared by the Pan-Canadian Investors Committee, stated that the underlying assets of Ironstone Trust were determined to be "... exclusively traditional assets that are also all ineligible assets ... The ABCP issued by Ironstone Trust has funded notes

issued by a CDO. The underlying reference portfolio of this CDO consists mainly of U.S. RMBS[§] and CMBS[**]." Almost all of the underlying assets of Ironstone Trust had U.S. sub-prime mortgage exposure.

Neither of the other two conduits sponsored by IIROC dealer members had exposure to US sub-prime mortgages.

[§] Residential mortgage-backed securities

[**] Commercial mortgage-backed securities

PART II

COMPLIANCE SWEEP

1. Holdings of frozen third-party ABCP by IIROC dealer members

In this section we review the holdings of third-party ABCP at IIROC dealer members.

Number of Conduits

Trading in the ABCP of 22 conduits froze in August 2007; however, the final restructuring plan included 20 affected programmes. One conduit, Skeena Capital Trust was separately restructured into White Knight Investment Trust. Another, Devonshire Trust is being restructured separately because of the inability of the Pan-Canadian restructuring group to negotiate an agreement with a credit default swap counterparty of the trust.

However, our analysis will examine all 22 conduits – and not just the 20 trusts remaining in the Pan-Canadian restructuring plan.

Initial Request for Position Information

When the third-party ABCP market froze in August 2007, we conducted a survey of the exposure of dealer members to third-party ABCP to ensure that the freeze did not have a significant impact on the capital of any dealer members.

In starting the survey, one of the greatest challenges was to identify the security. There appeared to be no standard for the 'security short name' used in the record-keeping systems used by dealer members. The security short name, as it appeared on the stock record, was dependent on the initial set-up, most likely performed by the issuing and paying agent.

It was not apparent from the short names that the securities were ABCP. In most cases, the letters "CP" formed part of the security's short name, but nothing distinguished it from other commercial paper or bank-sponsored ABCP.

The entries in dealer members' records did not clearly evidence that third-party ABCP was issued by trusts. The word "trust" was never part of the security name, nor was the sponsor of the conduit ever referred to in the security name. Furthermore, the records also did not clearly identify the class or series of the ABCP note. For example, it was not evident whether the security was Series A, which had the protection from a liquidity provider, or Series E extendible notes.

Dealer Member Third-party ABCP holdings

The reference point for our review was dealer member holdings of third-party ABCP as of April 30, 2007.

CDS Ltd. provided us with the holdings of third-party ABCP of IIROC dealer members who were CDS Ltd. participants. We then obtained from dealer members their security record and position details as of the same date, showing a breakdown of holdings by account and including both customer and inventory positions.

Some carrying brokers had bulk custody holdings for Type 3 and 4 introducing brokers, in which case we obtained the breakdown of holdings directly from the introducing broker.

Total Third-party ABCP Float

The dollar exposure to the third-party ABCP has been quoted by various sources to be anywhere from $32 billion to $35 billion. The amounts differ due to a number of factors, including foreign exchange conversion because some of the ABCP notes were denominated in US dollars and vary with conversion rates and because of the inclusion or exclusion of the two trusts that are no longer involved in the restructuring as noted above.

As at April 30, 2007, the outstanding amount of third-party ABCP that was later frozen was approximately $35 billion. Throughout this section, that figure is used as the base reference.

Frozen ABCP Held by IIROC Dealer Members

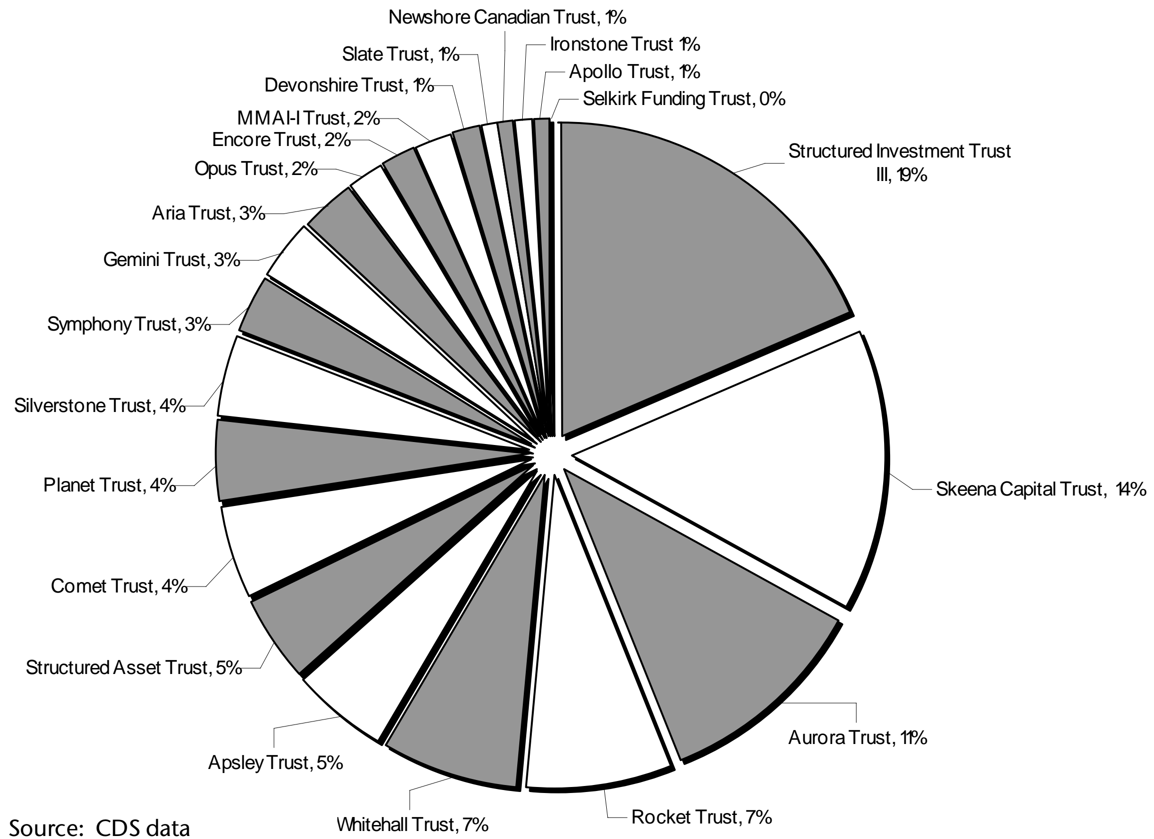
As at April 30, 2007, IIROC dealer members held $6.6 billion of third-party ABCP at CDS Ltd., approximately 19% of the float.

Goodmans LLP [the Investors Committee's legal advisor] and CDS Ltd. disclosed that only 50% of the entire frozen ABCP float was held within the CDS Ltd. book-based system; the remainder being held in certificated form by banks, trusts, mutual funds and institutions with their own physical or custody arrangements.

IIROC Dealer Members had exposure to all 22 conduits. The greatest exposure was to two conduits: Structured Investment Trust III (19%) and Skeena Capital Trust (14%).

The following chart shows the total exposure of Dealer Members to each of the 22 conduits:

Chart 5
Percentage of IIROC dealer member holdings by trust



Source: CDS data

Number of IIROC Dealer Members Involved in Third-party ABCP

Twenty-six dealer members were involved in the manufacture and/or distribution of third-party ABCP, 12% of the membership as of April 30, 2007.

- Two acted as a manufacturer/sponsor and distribution agent;
- Seven acted as primary distribution agents;
- Seventeen acted as secondary distributors.

Fourteen dealer members held positions for retail clients as at April 30, 2007.

Holdings of Third-party ABCP

Eight dealer members did not sell third-party ABCP to clients, institutional or retail. Some of these dealers purchased third-party ABCP for inventory, either as a temporary investment vehicle for excess cash or as part of arbitrage trading strategies; others only had positions held elsewhere, either as custodians, because client position had been transferred in or as carrying brokers.

Six dealer members sold third-party ABCP to institutional clients only. They held third-party ABCP in inventory to facilitate money-market trading operations with institutional clients.

The distribution of third-party ABCP to non-corporate retail customers was concentrated in a few dealer members.

- Thirteen firms sold third-party ABCP to non-corporate retail clients;
- The total amount of third-party ABCP held on behalf of retail clients by dealer members was $372 million, just over 1% of the total float;
- There were approximately 2,542 non-corporate retail client accounts at dealer members that held third-party ABCP. Ninety-five percent of these accounts were held at five dealer members, with one dealer member accounting for 63%.

2. DEALER MEMBER SPONSORS OF THIRD-PARTY ABCP

Objective and Framework of the Manufacturing Component

Our review of IIROC dealer members involved in the sponsorship of third-party ABCP covered the following areas:

- The business impetus for manufacturing third-party ABCP;
- Whether the manufacture of third-party ABCP was subjected to a product due diligence or new business approval process;
- The corporate governance, risk management oversight and approval process for third-party ABCP manufacture;

- The persons responsible and accountable for the structured finance and securitization activities;
- Whether information barriers were in place between the structured finance and securitization department and the fixed income department;
- The trust accounting information for the conduits manufactured;
- Whether the dealer member disclosed sufficient and appropriate information, including the different risks, to its clients and distribution agents;
- Whether the dealer member provided transparency by way of printed and/or web-accessible information to the general public;

Population and Process

The dealer members that acted as manufacturers were National Bank Financial Inc and Dundee Securities Corporation.

NBF was the sponsor of three conduits; Dundee of one conduit. The four conduits accounted for $6.3 billion (18%) of the $35 billion third-party ABCP float.

We obtained documentation from the dealer members, including liquidity agreements, DBRS credit rating confirmation, distribution agreements and trust accounting information, in order to obtain an understanding of the specifics of each conduit. We also interviewed representatives of the two dealer members.

Business Rationale

As previously noted, the market witnessed the exponential growth in the global credit derivatives market fueled in part by market demand for higher-yield money market instruments. Both dealer members saw satisfaction of the demand as a business opportunity.

In both cases the business strategy was driven by the parent but carried out by the dealer member.

New Business and Product Identification and Review Processes

Both dealer members identified the securitization activity as a new business line and built corporate governance oversight and risk management into the creation phase. However, this process was at the parent.

Neither dealer member considered third-party ABCP to be a new product. They viewed it as an accepted form of commercial paper and considered themselves to be new entrants to an established market. Although both confirmed that they have new product review committees, neither subjected their own sponsored ABCP to their new product review process.

As investment dealers, the manufacturers did not have any traditional assets to securitize but could structure the conduits to generate cash inflows from structured finance assets. One dealer member, despite being aware that the underlying assets were structured financial assets and credit derivatives, stated that it did not consider third-party ABCP to be a structured product.

Risk Management Oversight

Both dealer members have risk management oversight committees and formalized processes. The overall risk management is at the enterprise level, i.e. at the parent company, with dealer member representation in the process.

Both dealer members acquired personnel with specialized expertise in structured finance and securitization from outside of the firm, some from outside of Canada. At one dealer member an outside party was involved in the decision-making on structuring, design and execution of the programme.

Product Responsibility and Accountability

At the product level, risk monitoring was performed by the structured finance and securitization groups of both firms. At one firm it was done in collaboration with the outside party involved in the initial manufacturing process, as noted above.

Initially, one dealer member had in-house expertise. In 2005, the structured finance group left to form a separate company and took with them the intellectual property developed at the dealer member. For the operational continuance of the existing ABCP conduits, the dealer

member entered into a sub-contracting management service agreement with the new company. After an interim transition period to re-establish in-house expertise, it brought back the management and operation of the ABCP conduits.

Product Structuring

One of the objectives for the interviews conducted was to obtain an understanding of the product structure of the ABCP conduits manufactured by the IIROC Dealer Members.

Skeena Capital Trust, sponsored by Dundee was designed on a two-trust basis with a few selected counterparties. The top tier trust was the issuing trust for the ABCP programme. The second tier trust was created to track each leveraged super-senior transaction. The asset provider of the leveraged super-senior transaction was also the liquidity provider. Dundee, as the administrative agent, maintained a $5 million reserve account as a cushion to cover unanticipated operation expenses and increased funding costs.

For each leveraged super-senior transaction entered into by the conduit, a nine-page Deal Summary was prepared. This deal summary was the 'product structure due diligence' used as the basis for corporate approval of the transaction. It included: risks of the overall transaction, strengths and weaknesses, portfolio analysis, sensitivity analysis, credit default swap mechanics, ISDA schedule documentation, liquidity documentation and other technical analysis and information.

Distribution of Dealer Member Manufactured ABCP

Both dealer member manufacturers acted as primary distribution agents for their sponsored ABCP conduits. NBF also distributed other ABCP; Dundee distributed Skeena alone.

Dundee used four distribution agents including itself; NBF used five.

Cost and Compensation Structure

The financial accounting records of third-party ABCP trusts sponsored by IIROC dealer members showed that gross income derived from the net spread between the premium earned on CDOs plus interest earned on the collateral less the interest paid to the note holders. The

main expenses were fees paid to the distribution agents – typically 6.5 bps, liquidity fees paid to liquidity providers – a typically 10 bps, and administrative costs.

The average net spread between the gross income from trust assets and payouts to investors was approximately 42 bps; the average net spread after administration costs was 29 bps before any payout of management fees to the sponsor. The annual trust net income before management fees ranged from $800,000 to $7 million per conduit.

Disclosure

For both dealer members' manufacturers, the distribution agents and their internal sales forces had access to the IMs and the initial DBRS credit rating report.

NBF also made available, to distribution agents and institutional clients only, through a password-protected Web site, "Investor Reports" on all of its manufactured conduits.

The "Investor Report" contained updated critical information, including:

- The parties involved: issuer trustee, indenture trustee, paying agent, administrative agent, financial services agent, asset provider, liquidity provider, distribution agents.
- The credit ratings of the series and classes of ABCP notes.
- The credit rating of the asset provider.
- The credit rating of the liquidity provider.
- The underlying assets broken down by underlying exposure, asset category and current credit ratings.

Neither NBF nor Dundee provided the IMs to the general public on their Web sites, but both would provide a copy of an IM to a client upon request. They advised there were very few such requests; one noted that most were from institutional clients.

The IMs did not disclose the actual portfolio of assets of the conduit or the terms and conditions of and parties to liquidity agreements. Portfolio disclosure was a list of possible types of financial assets:

> Such Financial Assets may include, but are not limited to … securitized pools of residential mortgage loans, commercial mortgage loans, trade receivables,

consumer receivables, assignable corporate loans and bonds, securities backed by such assets or economic exposures to such assets obtained through financial contracts such as collateralized credit default swaps.

3. DEALER MEMBERS WHO SOLD THIRD-PARTY ABCP

Objective and Scope

The objectives of the compliance review of IIROC dealer members:

- To determine what product due diligence controls and processes were in place and how they were applied to third-party ABCP, including:
  - Product assessment processes for both new products and changes in current products;
  - Preparation and distribution internally and to clients of marketing material and other product information;
  - Training of supervisors, compliance staff and registered representatives regarding product features, risks and suitability issues;
  - Mark-ups and commissions and disclosure thereof
- To identify strengths and weaknesses in those controls and processes.
- To develop and provide regulatory guidance to the industry based on lessons learned.

Process, Population and Holdings

We reviewed 27 dealer members: 26 that held positions in third-party ABCPs as of April 30, 2007 and one that acquired a position between April 30 and August 30, 2007.

These dealers collectively held $6.6 billion of ABCP, as follows:

- $6.2 billion held in proprietary, institutional and corporate accounts;
- $372 million held in approximately 2,542 non-corporate retail accounts.

Of the 27 Dealer Members:

- Six had sold third party ABCP to institutional customers only;
- Nine had sold to retail clients only;
- Four had sold to both institutional and retail clients;
- Eight had sold to neither. The positions held on these Dealer Members' books included principal positions only, positions purchased elsewhere and held in a custodial role only, positions purchased elsewhere and transferred in, and positions held as a carrying broker for another registered firm.

Two are related companies that share processes. They have been treated as one for the purposes of the statistics given below.

We interviewed senior management, traders and compliance staff, depending on the firm's activity in third party ABCP. We also interviewed three salespeople who had sold to retail clients.

The dealer members who sold more widely to retail clients reported that the sales tended to be concentrated in one or a few offices and among a few salespeople. In some cases the dealer members observed that some salespeople were more yield-driven and some were more familiar with the product. For example, one branch manager interviewed reported that his office handles clients as a group, and one registered representative was a former bank manager who was familiar with the product through having sold ABCP to bank customers. He introduced it to the office.

We collected from each dealer member any relevant documents, with a focus on product review processes. We obtained:

- Product review policies and procedures;
- Compositions and mandates of product review committees;
- Sample product submissions and approved product lists;
- trade confirmations;
- Internal trade records;

- Quote sheets showing how ABCP were presented to registered representatives.

In interviewing firms that held only proprietary or custodial positions, we reviewed their product review processes and explored why they had not sold third party ABCP.

Product Due Diligence

We asked 21 firms that sold third party ABCP, including 12 that sold the product to retail clients whether they had product due diligence processes when they first sold third-party ABCP. We asked those who did not whether they implemented a product due diligence process between their first sale of third-party ABCP and April 30, 2007. The other six were carrying brokers or discount brokers which were not included in the sample because of the nature of their business. The results were:

- 13 had product due diligence processes when they first sold third-party ABCP, including 9 that sold to retail clients
- 3 implemented product due diligence processes between their first sale of third-party ABCP to clients and April 30, 2007, including 2 that sold to retail clients.

None of these firms had put third-party ABCP through their product due diligence processes. The reasons given were as follows:

- They did not view third-party ABCP as a new product and did not distinguish between bank-sponsored ABCP and third-party ABCP.
- Most dealer members relied exclusively on the DBRS rating of R-1(high).
- They viewed third-party ABCP as a fungible money market instrument that had obtained the highest possible credit rating, therefore no risk assessment or product review was required.
- Some dealer members indicated that they relied in part on their carrying broker having put third-party ABCP on the list of available securities, presuming that the carrying broker had done due diligence on the product.

The only product review processes applied to ABCP were at the parent banks of bank-owned dealers. The purpose of these reviews was largely to establish credit and trading limits as part

of the parent bank's financial risk control. Only one bank reviewed the product from a suitability perspective, and decided not to sell it. They stated that the decision was based on a belief that clients would not be able to understand it.

Several dealer members reported that while they did not put third-party ABCP through a product review process, had they done so they would have approved it in any event. One representative of a bank-owned dealer member reported that he thought the firm could have been criticized had it decided to place its clients in the bank's BAs because they were rated lower than third-party ABCP.

We asked several dealers with retail operations that did not sell third-party ABCP to retail clients why they refrained from doing so. The reasons given included:

- The probability that clients and many registered representatives would not understand the product, making time-consuming explanations necessary.
- The availability of alternatives, more attractive in some cases because they were simpler and well-known, in others because they bore the name of an affiliate of the dealer member.
- The lack of any profit on small transactions. Mark-ups generally did no more than cover transaction costs. This led some firms to discourage retail purchases through a variety of internal control mechanisms.

As dealer members did not subject third-party ABCP to their product due diligence processes in the first instance, there were no reassessments or follow-up procedures designed to identify changes in the product.

Disclosure

Seven dealers reported providing written information on ABCP conduits to institutional clients and two reported providing them to retail clients. The material provided included information memoranda and DBRS rating reports. Others indicated that written information was available to clients on request.

None of the firms interviewed reported preparing any marketing material for general distribution to clients or sales personnel. One dealer member sponsor sent its registered

representatives a link to the information memorandum and DBRS report on its sponsored conduit.

One dealer member made information available in its role as a sponsor and distributor of ABCP. It created an ABCP newsletter which it sent to its institutional customers, which was general in nature, discussing issues such as the economic outlook and interest rates. It was initially pushed out to customers holding third-party ABCP, who could then subscribe to later issues. It also prepared periodic reports on the conduits it had sponsored, providing information on asset composition that had more detail than was generally available for other conduits without providing information on specific holdings in the conduits. These reports were made available to institutional customers and to retail customers on request.

Training and Product Knowledge

No dealer members reported providing any training or special written material to registered representatives, supervisors or compliance staff regarding third-party ABCP. This was attributed to the general view that third-party ABCP was just one of several types of fungible money market instruments.

Neither retail representatives nor chief compliance officers interviewed were familiar with the nature of the liquidity guarantees and the differences between Canadian-style liquidity and global style liquidity guarantees. One commented that he thought that third-party ABCP was "backed by the banks," which he took to mean that they provided a liquidity guarantee but he did not know anything about the nature of the guarantee and relied on the credit rating.

There was a tendency among some of those interviewed to refer to third-party ABCP as being rated AAA rather than R-1 (high). One registered representative commented that he understood the difference between the ratings as relating to the term of the product but thought of them as the same and would use AAA because clients were more familiar with that rating.

Suitability

The dealer members interviewed reported that they did not consider suitability issues in providing third-party ABCP to retail clients because they viewed it as a fungible money market instrument with a high credit rating.

Several dealer members reported that most of their institutional customers were familiar with the product, obtained information memoranda and DBRS rating reports, and were aware of the differences between Canadian-style "market disruption" liquidity guarantees and global liquidity style guarantees. Under IIROC Rule 2700 (then IDA Policy 4) the dealer member does not have an obligation to determine the suitability of a particular recommendation to an institutional investor that is determined to be sophisticated and capable of independently evaluating the investment risk.

Commission and Mark-ups

Twenty-six IIROC dealer members distributed third-party ABCP to clients. Of these, five accounted for approximately 95% of the total retail client positions held in custody at CDS as of April 30, 2007.

From those five we collected information on:

- The commission payout structure to registered salespersons for short-term fixed income securities (i.e. Treasury Bills, Bankers Acceptances and ABCP).
- Based on a representative sample selection, details of purchase information by client (client account number, trade date, client purchase price, member's transfer price and commissions earned on third-party ABCP custody holdings).

There were three forms of compensation charged by dealer members:

- Mark-ups for acquisition cost going to the trading desk.
- Commissions going to the salespeople.
- Distribution fees.

The mark-ups on retail trades reported and seen in internal documents ranged from 10 bps to 45 bps. Introducing brokers reported that the amount of the mark-up that would go to them was included in the listings of available instruments provided by their carrying brokers.

All dealer members reported that commissions on retail trades were set, within guidelines, by the registered representative. They said that commissions were rarely charged; in a few cases commissions were set to cover the "ticket charge," the minimum charge necessary to cover

transaction costs. One dealer member reported a policy of a minimum 10 bps commission as that was deemed to be sufficient to cover transaction costs.

In commenting on mark-ups and commissions, all dealer members who sold to retail clients reported that third-party ABCP and money market trades in general were viewed as a loss-leader service to clients, enabling them to obtain additional yield on short-term cash positions.

Mark-ups to include any commission charges were included in the price of the transaction. No dealer members reported any disclosure on confirmations of the amount of the mark-up or commissions.

Dealer member syndicate distribution fees were based on the total distribution of the ABCP product. In a typical ABCP structure, dealer distribution fees were paid directly by the trust conduit and were not factored into any spread markup. The average fee across the board averaged to be 6.5 bps.

4. CURRENT PRODUCT DUE DILIGENCE PRACTICES

In the course of conducting interviews, we gathered information on product review and introduction processes in place at dealer members at the time of the interviews, including all those that sold third-party ABCP to clients and those that held positions purchased elsewhere. The goal was to understand current industry practices, identify sound practices and assess the need for the development of IIROC guidance in this area. We benchmarked the processes reviewed against guidance provided by the Securities Industry and Financial Markets Association (SIFMA) and the Financial Industry Regulatory Authority in the United States (FINRA).

Identification of Products to be Reviewed

We reviewed the processes of dealer members for criteria that start the review process for retail products. We found that, although most dealer members have a definition of what constitutes a new product, the definitions vary widely. The types of definitions included:

- Broad definitions covering any new product, service or instrument;

- Definitions based on process, such as a review of products to be added to order entry or back office systems on a case-by-case basis and products that would result in significant internal changes such as systems enhancements;
- Lists of types of new products that are subject to review;
- General criteria such as existing products that are new to the firm, registered representatives, a class of client or a geographic area.
- Involvement of regulatory issues such as the need to obtain regulatory approval, additional registration categories and whether the product qualifies under a particular regulation.

The definitions at some dealer members were inadequate in the following ways:

- They were too vague and general.
- They were limited to listings of a few types of products resulting in other types not being reviewed.
- They failed to include e-review of products where there was a material change to the nature of the product or its risks;
- They failed to include introduction of existing products to new types of customers.

The better processes included a broad range of criteria for identifying products for review, including:

- Products new to the dealer member;
- Existing products being introduced to a different type of customer or to be used in a different type of strategy.
- Specific types of products such as mutual funds or principal-protected notes that had not previously been sold by the dealer member.

- Products that could cause credit or reputational risk to the dealer member.

- Detection points such as additions to the dealer member's back-office systems or requirements for system changes.

Product Factors Considered in the Due Diligence Process

We reviewed the existing dealer product due diligence processes to ensure that they considered all of the key product characteristics and risks. Some failed to address important risk factors. We found the following:

- Reviews that focused solely on the adequacy of the new product's disclosure documentation.
- Failure to compare new products against less complex and lower risk alternatives, ignoring the overall investment merits.
- Failure to consider conflict of interest issues as part of the review process.
- Failure to consider the compensation structure of products.
- Failure to consider how the product will be marketed.

In addition to the basic characteristics, risks and suitability issues, better product due diligence processes also considered:

- Compensation issues, both total compensation and compensation to registered representatives. Several firms commented that they look for excessive compensation as a red flag in a new product.

- Conflicts of interest, including special review of products produced by the dealer members or its affiliates and appropriate disclosure.

- The public availability of sufficient information to properly assess the product.

- Financial risks to the firm including market risk and counter-party risk.

- Product marketing;

- Potential reputational risk.

Structure, Process and Responsibility

We reviewed existing dealer processes to determine what functional groups conducted the reviews, how the review was conducted and who was responsible for various aspects of the process. We found the following concerns:

- Some dealer members relied on processes at parents or affiliates in which they had limited involvement and did not independently assess the product risks to the dealer member and its clients. In some cases the dealer member was made aware of the results but not of the product details and risks that would assist it in conducting an independent review and supervision of subsequent marketing and trading activity.

- We observed that some bank groups that include dealer members have complex and fragmented processes for reviewing new products and businesses. They have separate risk management committees, new activity committees, credit risk committees and retail new product committees that all assess different elements of risk, most housed in the parent bank. The dealer member was represented on some of the committees and not on others, making it difficult or impossible to bring the results of the different assessments together into a coherent dealer member assessment.
- Most processes involve committees but some were unbalanced, involving only business managers or financial risk management personnel, not compliance personnel or others responsible for investor protection;
- Some processes had diffuse or unclear assignment of responsibility for bringing proposals forward and taking action on results.

The better product due diligence processes included:

- Assignment of specific responsibility for bringing products forward for review to business line leaders wanting to add the product to their product lines;

- Specific accountability through identifying an owner of the product due diligence process;
- Representation on the product due diligence committee of all departments having useful input on and an interest in the outcome of decisions, including compliance and supervision personnel;
- A clear decision-making process that identifies who must approve a product for sale. Some processes require unanimous sign-off by all members of the product due diligence committee; some accept a majority vote but make mandatory the approval of a particular department such as Compliance.

Record Keeping

We reviewed the record keeping procedures for recording the results of the product due diligence processes. Some showed the following weaknesses:

- Lack of evidence of the due diligence work conducted.
- Lack of information on the basis for decisions made in processes carried on outside the dealer member.
- Lack of records of conclusions regarding limitations on use of approved products.

The better processes included:

- Records of due diligence work done to assess the risks of products reviewed. These records could then serve as a basis for product education and marketing material;
- Specific records regarding product suitability issues considered in the process and the conclusions drawn.

Communication of Product Due Diligence Results

We reviewed existing product due diligence processes to determine how the results of the reviews were communicated to dealer member employees and clients. We found the following concerns:

- Some product due diligence processes did not include consideration of what should be communicated to supervisors and registered representatives to assist them in understanding the products reviewed and determining whether they were suitable for clients. The processes left it to the supervisors and registered representatives to educate themselves, having only the knowledge that the product had been approved
- Some did not identify important product characteristics that should be given to clients considering an investment.

Better processes included:

- A process for training registered representatives in the features and risks of new products;
- Processes to ensure that clients receive full explanations of product complexity and risks;
- Processes to ensure that registered representatives and clients are aware of lower risk alternatives.

5. MARGIN RULE COMPLIANCE

IIROC Rules 17.1, 100 and Form #1 set out the main elements of the Canadian securities industry's capital formula and margin rules. The capital formula is designed to measure the solvency of a firm based on the liquidity of balance sheet assets available to discharge its current liabilities. This calculation is also referred to as "net liquid" assets and is defined as being assets readily convertible into cash (or equivalents) minus liabilities. This calculated balance sheet amount is then adjusted by capital reserves which serve as a cushion for ongoing solvency of member firms. This also provides protection from possible future losses due to changes in the market value of assets leveraged by the firm. Leveraged assets may include inventory and client assets that were bought on margin.

The capital usage of a firm is primarily based on the quantification of a firm's liquidity risk. Although a lack of liquidity and a lack of equity are not the same, they can lead to the same result – bankruptcy. It is not uncommon for a business with financial statements reflecting

substantial equity to declare bankruptcy due to inability to meet liabilities as they became due. In most cases, this failure results from a business acquiring assets which may have long term value on a going concern basis but which cannot be readily converted to cash in order to discharge current obligations. The securities industry places a great deal of emphasis on liquidity because unlike other industries there is a continuous need for cash to meet both clearing obligations and clients' request for the return of their uninvested funds.

The revised capital formula was introduced in 1993 and has remained fundamentally unchanged. It is used to measure the liquidity risk of a securities firm and includes the computation of capital reserve requirements using strategy based margin rules to quantity the market risk for each particular type of security holding in inventory and customer margin accounts.

An alternative method of quantifying business risk in calculating capital requirements is the use of mathematical modeling. These include value-at-risk (VaR) models to compute capital requirements for market risks. The difference between VaR and strategy-based margin is that VaR determines the liquidation value for all products of the same issuer as one basket of risk. Whereas, strategy-based margin allows for the pairing of specific positions of the same issuer for margin offset purposes. In the case of overall portfolio market risk, VaR modeling further recognizes the risk reductions that can be achieved through portfolio diversification. This alternative approach to market risk quantification for large, diversified portfolios and exposure modeling to compute deductions for credit risk related to over-the-counter derivatives results in increased amounts of leverage.[28]

In Canada, IIROC dealer members can only use strategy-based margin offset rules, creating a difference in regulatory capital between dealer members and their bank parents which have adopted VaR modeling under the Basel Standard and OSFI bank capital guidelines. This has resulted in structured products such as collateralized debt obligations and credit default swaps being held on the books of the parent bank rather than the dealer member.

ABCP Margin Rules

IIROC margin rules include a specific category for money market instruments called "acceptable Canadian commercial, corporate finance company notes". It is given favourable margin treatment over other commercial bonds, debentures and notes, provided that the following minimum criteria are met:

- The issuer must be incorporated under Canadian law and have a net worth not less than $10 million; or
- The issue must be guaranteed by another company having a net worth of not less than $10 million or the issuer must have a binding agreement obligating a company having a net worth of not less than $25 million to pay to the issuer or a trustee for the note holders amounts sufficient to cover all of the indebtedness.

In addition, the product must be issued under either a prospectus or an information circular or memorandum, accompanied by specified information.

The legal structure of special purpose entities used for ABCP programmes does not meet the criteria for "acceptable commercial paper" because they are structured as trusts and not "companies incorporated in Canada". Furthermore, the information memoranda for the ABCP programmes do not provide all of the information required.

All firms applied the favourable margin rules as if the ABCP met the criteria for acceptable commercial paper. The regulatory capital consequence for this was not significant as all dealer members holding material inventory positions of third-party ABCP, notably the primary distributors, were bank-owned with more than sufficient regulatory capital to support the positions using the full margin rate. The client positions in third-party ABCP were not held on margin in any material amounts.

6. CLIENT RELIEF PLANS

All dealer members have either implemented or committed to client relief plans. The relief plans of three dealer members are contingent on completion of the restructuring under the Pan-Canadian Committee plan. The other dealer members provided the relief almost

immediately after the market seized up in August 2007. These dealer members or their parent companies repurchased the ABCP from their clients.

In total, 610 retail clients have already received $319,765,912 in relief from seven dealer members. Another 1,776 are to receive at $177,385,000 on completion of the restructuring, representing their full investment plus interest.

Some dealer members also made arrangements with some corporate clients that held third-party ABCP for alternative funding pending the restructuring. Some corporate clients remain exposed.

PART III

Findings

&

Recommendations

1. SUMMARY FINDINGS

Following is a highlight of the third-party ABCP Regulatory Study and Compliance Sweep findings:

General Findings regarding Third-party ABCP

1. The global credit derivatives market and Canadian third-party ABCP programmes grew rapidly and in parallel. Credit derivatives provided assets for third-party ABCP manufacturers to securitize, enabling them to compete for ABCP market share in a market previously dominated by bank-sponsored ABCP programmes using more traditional assets, but changing the contents of the underlying portfolios from assets to liabilities.
2. The expansion of ABCP programmes was also attributable to the simultaneous growth of liquid assets and reduction in some traditional short-term vehicles, such as treasury bills, as government borrowing was reduced.
3. Third-party ABCP was issued under the same securities laws exemptions that were intended for traditional commercial paper. These prospectus and registration exemptions were recently made uniform across Canada and require an "approved credit rating" from an "approved credit rating organization" in lieu of a minimum purchase amount.
4. Eligibility for book-based clearing, settlement and custody through CDS Ltd. increased distribution efficiency of Canadian third-party ABCP to retail investors at low transaction cost, enabling dealers who offered it to retail clients to cover transactions costs that left its yield advantage over other similarly rated money market instruments intact.
5. DBRS was the only credit rating agency service provider for third-party ABCP programmes in Canada. Because of confidentiality agreements with sponsors, there was no transparency as to the specific underlying assets, the quality and performance of the portfolio or the nature of the specifics of the liquidity agreements. Dealers and investors came to rely on the credit rating by DBRS and the knowledge that the programmes had liquidity support.
6. The market made no distinction between bank-sponsored programmes based on traditional assets and third-party ABCP programmes using structured financial products. There was no detailed public disclosure of asset class composition by conduit issuer to

differentiate the asset securitization strategy amongst ABCP conduits. Institutional investors had privileged access to information about the conduits sponsored by dealer members. Although DBRS used different methods to determine ratings for commercial paper programmes backed by traditional assets and programmes backed by structured financial assets, it used the same rating scale for both.

7. Third-party conduits had approximately the same yield as bank-sponsored ABCP. Over the period 2003 to 2007 both bank and non-bank programmes consistently yielded a few basis points (generally 20-30) more than bankers' acceptances.

8. The liquidity agreements backing third-party ABCP programmes were a matter of disagreement among credit rating agencies. The differences were known to sponsors.

9. The lack of transparency about the underlying assets contributed to the freeze in August 2007. No one could be sure whether the assets of any of the conduits had exposure to the collapsing U.S. sub-prime mortgage market or any of the parties that were taking substantial losses as a result of the collapse.

10. When the third-party ABCP market froze in August 2007 some liquidity providers agreed to provide liquidity; others did not.

Dealer Member Findings

1. Ninety-nine per cent of third-party ABCP distribution by dealer members was to institutional customers and inventory holdings.

2. Dealer members treated ABCP as a fungible money-market instrument offering a slightly higher yield but with little or no higher risk than other such instruments. They made no distinction between bank-sponsored and third-party ABCP.

3. Third-party ABCP found its way into the retail distribution chain in isolated pockets, through a few dealers and often, within them, through a few offices or registered representatives.

4. Dealer members and registered representatives gave little consideration to the attributes or risks of third-party ABCP. The critical factors in the acceptance of third-party ABCP by retail registered representatives (and their clients) were the credit rating and yield. In some cases, the exemption from prospectus and registration requirements under securities laws, the

appearance of the product on carrying dealer order screens or the low yield differential from other money-market products were sources of increased reliance by dealer members and registered representatives.

5. The dealers who sold third-party ABCP and other money market instruments to clients did so in order to have a full product offering. There was almost no commission charge on money market instruments including third-party ABCP, other than as necessary to cover transaction costs

6. The dealer member product introduction processes reviewed are generally inadequate in the following ways:

   - A few have no process.
   - Most dealer members do not have adequate criteria for determining what products should be reviewed.
   - Most dealer members do not consider reputational risk in assessing product offerings.
   - Bank-owned or affiliated dealer members tend to rely on the processes of their parent banks.
   - Most processes lack ongoing review or reassessment of approved products.
   - Most processes lack training for supervisors and registered representatives in the features and risks of new products.

2. IIROC STANDARDS

This section outlines the IIROC rules and standards relevant to dealings with customers.

Objectives

The objective of the IIROC rules described below is to ensure that dealer members and registered representatives meet their suitability obligation owed to clients and that securities are marketed to clients in an appropriate way. Dealer Members and registered representatives must have a sufficient understanding of the products being sold to their clients to be able to meet their obligations.

Suitability

IIROC Rule 1300 sets out the basic know-your-client and suitability requirements. It requires dealer members to use due diligence to learn the essential facts relative to every customer and every order and to ensure that any recommendation made to and any order accepted from a customer is suitable for the customer. The dealer member must judge suitability against know-your-client information based on factors including the customer's financial situation, investment knowledge, investment objectives and risk tolerance. It is important to note that the Rule addresses not only the need to understand the client's circumstances, but also the essential facts relative to each particular order.

Product Knowledge

The *Conduct and Practice Handbook for Securities Industry Professionals* (the "CPH") provides guidance as to what is expected of dealer members and registered representatives in discharging their suitability obligations[††]. To determine whether a trade is suitable for a client, registered representatives must know the risk/return attributes of the securities under consideration, in addition to knowing the relevant information about the client.

It states that for products that are complex in structure or lacking in transparency, the dealer member should complete a detailed evaluation of the security before approving the product for sale. In addition, the dealer member should perform an assessment of the availability and reliability of any marketing information from the issuer of the product. The CPH states that registered representatives should review this information before such products are recommended or sold. Registered representatives must consider the risk/return attributes of the product and all variables relating to the specific trade (purchase/sale, cash/margin) in order to properly evaluate the suitability of a proposed transaction.

[††] All IIROC approved persons permitted to deal with customers must pass an examination based on the CPH as part of their basic industry education. Rule 1500 also requires that all registered persons have access to an up-to-date version of the CPH.

Supervision

IRROC Rule 29.27 requires dealer members to establish and maintain systems to supervise the activities of each approved person of the dealer member. The dealer member must also have acceptable policies and procedures and sufficient personnel and resources to fully and properly enforce these policies and procedures.

Rule 2700 contains detailed requirements for the supervision of retail client account activity designed to ensure that recommendations to clients and trades for their accounts are suitable and that appropriate action is taken regarding any questionable activity.

Marketing Material

A dealer member's supervisory obligations include monitoring and approving materials used in the marketing of products. IIROC Rule 29.7 prohibits dealer members and approved persons from issuing to the public any advertisement, sales literature or correspondence in connection with the dealer member's or approved person's business which contains any untrue statement, omits a material fact, is otherwise false or misleading, or fails to fairly present the potential risks to the client.

Meeting the Suitability Standard

We expect Registered representatives to understand the products they sell. Supervisors must understand the products sold by those under their supervision. This means that dealer members must inform them of the salient characteristics of products that have gone through the product review process, the factors to be considered in making suitability determinations with regard to such products.

Structured products vary a great deal as to their terms, risk/reward profile, liquidity/availability of a secondary market, underlying asset, and a variety of other factors. It is important that registered representatives interacting with individual investors have an adequate understanding of structured products in general as well as an understanding of the characteristics of the individual structured products being offered.

Registered representatives should be able to explain clearly to their clients the product's features and risks, including the risks associated with the underlying assets, liquidity and market risk.

3. RECOMMENDATIONS

This study and the compliance sweep found that the majority of dealer members that acted in the distribution of third-party ABCP to retail investors did not understand the underlying asset composition, liquidity risks and distinct rating methodology used for the structured financial assets underlying the ABCP. Instead, they relied on the product classification as a money market instrument, the securities distribution exemption and credit rating.

The following recommendations address the responsibility of dealer members in the manufacture and distribution of products offered to their clients, including structured products.

Product Due Diligence

1. Dealer members must have a product due diligence process that takes into account the nature of the product and the target investors. The review should enable the dealer member to assess the risks to clients and to the firm, including reputational risk. It should also consider the investment merits of the product in relation to less complex and lower risk alternatives that are already available.

2. The product review process must have criteria for determining what products go through the process. It must include not only new products; other situations calling for product reviews include products that are new to the firm, that are being introduced to a new class of client or that have undergone a significant change.

3. It is not sufficient for a dealer member to accept a third-party manufacturer's assessment regarding appropriateness of products for individual investors, who are ultimately customers of the dealer member and not the manufacturer. Dealer members must conduct independent assessments of all such products.

4. The dealer member is responsible for the assessment. It can outsource processes, whether to contract experts, affiliated companies, or its carrying broker, but that does not relieve the dealer of its responsibility for the results. The dealer member has to both gain a sufficient understanding of the results to make its own decisions and understand what internal actions it needs to take as a result, such as development of marketing or

information material and training of registered persons. Dealer members that are affiliates of larger institutions are responsible for the process and cannot leave it up to the parent or a sister company. If the parent has multiple processes for assessing different kinds of risks, the dealer member must obtain sufficient information from each to inform its own product decisions.

5. Whether reviews are conducted entirely in house or are outsourced, dealer members must maintain full documentation of reviews and decisions taken regarding any products they are going to distribute.

6. Carrying brokers should identify to their introducing brokers product offerings that they or their affiliates manufacture. They should also make available any information requested by the introducers necessary to enable the introducers to make their own assessments of products offered to their clients.

Product Transparency

7. Dealer members who act as sponsors of structured product conduits must ensure that all material features of the product are disclosed in a way that enables potential investors to evaluate the investment, including the composition of the pool of assets, income and losses from the pool, and collection experience of the pool. Such materials should be adapted to, and reflective of, the knowledge and sophistication of investors in the target market, and where a product is eligible for sale to retail investors should take their needs into account.

8. Dealer members who manufacture exempt products using special purpose vehicles should make information about the ongoing operations of their conduits (such as asset composition by category, weightings, exposure and credit ratings, default experience and losses) available to all interested investors, not just institutions.

9. Dealer members who distribute these products must ensure that product features and risks are made available to clients.

Conflicts of Interest

10. Where a dealer member is a manufacturer and a distributor of proprietary structured products, it must have internal processes and controls to identify and mitigate potential conflicts of interest, including conflicts involving affiliates, parent companies and subsidiaries. The mitigation should generally include timely, adequate and clear disclosure to customers.
11. Products manufactured by a dealer member should be subject to at least the same, if not greater, product due diligence processes as other products for factors such as suitability for different types of customers, adequacy of disclosure from the customer's viewpoint and the need for training of supervisors and registered representatives.

Credit Ratings

12. Dealer members should have compensating controls where they rely heavily on credit rating agencies. The controls might include a thorough understanding of the meaning of ratings issued and the types of risk that they encompass, ratings from more than one agency, factoring in the additional risk entailed by having only one rating, and recognition that external credit ratings are but one factor in a product assessment.
13. Disclosure of the credit ratings should make clear their significance and limitations.

4. GUIDANCE NOTICE

This regulatory review has demonstrated that dealer members need to understand the products they sell and identify the risks of those products. IIROC staff have prepared the guidance notice attached as Appendix A in order to clearly communicate our expectations for product due diligence.

IIROC will use the guidance in the attached notice to inform future compliance reviews and will determine, based on those reviews, whether further guidance is necessary.

APPENDIX A: IIROC NOTICE ON NEW PRODUCTS

IIROC NOTICE

Rules Notice
Guidance Note
Dealer Member Rules

Please distribute internally to:
Corporate Finance
Credit
Institutional
Internal Audit
Legal and Compliance
Operations
Registration
Regulatory Accounting
Research
Retail
Senior Management
Trading Desk
Training

Contact:

Louis Piergeti
Vice-President, Financial & Operations Compliance
416.865.3026
lpiergeti@iiroc.ca

Larry Boyce
Vice-President, Business Conduct Compliance
416.943.6903
lboyce@iiroc.ca

08-xxxx

, 2008

Best practices for product due diligence

This notice provides guidance on the introduction and supervision of new products.

The dealer's suitability obligation in recommendations to clients requires knowledge of the products sold to those clients. Even in the institutional setting, the dealer member must make a determination that that the assessment of new and different products falls within the client's expertise.

This guidance has benefited from a similar notice issued by the Financial Industry Regulatory Authority ("FINRA") in April 2005 and findings from a recent IIROC Compliance Sweep of all dealer members that acted in the manufacture or distribution of third-party asset-backed commercial paper.

Background

Investors and brokers are increasingly turning to alternatives to conventional equity and fixed-income investments in search of greater safety or higher returns. Products such as principal protected notes, asset-backed securities and other debt structured derivative products are complex or have unique features that may not be fully understood by the retail customers to whom they are offered, or even by the registered representatives who recommend them. Some appear to offer benefits to investors that are already available in the market in the form of less risky, less complicated, or less costly products, prompting concerns about suitability and potential conflicts of interest.

As gatekeepers to the securities industry, dealer members must take a proactive approach to reviewing and improving their procedures for introducing new products and monitoring those that are not new but have unique and complex features that may require monitoring. While suitability requirements and other sales practice obligations attach to the recommendation and sale of a product, adequate procedures for reviewing products before they are offered to the public can greatly enhance a firm's ability to detect and avoid conflicts, unsuitable recommendations, and other problems before violations occur.

Dealer members are responsible for meeting their regulatory obligations. They cannot simply rely on the work of others. If assessment of new products that will be sold through a dealer member is done by a parent company or affiliate, the dealer member should be represented in

the process and must ensure that it has sufficient documentation of the process and decision. It must also make its own determination on related matters such as suitability to its clients, marketing material and training of supervisors and registered representatives.

Written Procedures for Vetting New Products

As part of the obligation to have effective internal controls, all dealer members that sell new products must have formal written policies and procedures appropriate to their business to ensure that no new product is introduced to the marketplace before it has been thoroughly vetted from regulatory, risk management and business perspectives. At a minimum, those procedures must identify what constitutes a new product, and ensure that the right questions are asked and answered before one is offered for sale.

New Product Identification

It is critical for a dealer member to be able to determine what will go through the product due diligence process.

A dealer member needs to ensure that it can identify products requiring review through its supervisory processes and systems. For example, one control method is to review all products added to systems used to record client transactions to identify any types of products that should go through the due diligence process; another is to educate registered representatives and supervisors on the criteria for determining that a product has to be considered for review.

The following are sample criteria for products or transactions for institutional and retail clients:

Products to be offered to institutional clients

- The product is new to the Canadian marketplace or to the dealer member;
- The product design raises legal, funding, accounting, taxation, regulatory, compliance or appropriateness issues for the dealer member or its institutional clients not previously considered;
- The product design and/or the product disclosures make product pricing difficult due to unique or unverifiable valuation issues;

- The combined risk profile of the product is unique such that a new model is required to value the product and/or measure product risk, or revisions need to be made to an existing model;
- The product exposes the dealer member to market, liquidity or counterparty risk that is new or different in magnitude from that previously incurred;
- The product raises potential franchise and/or reputational risks;
- The product requires new trade processing capability, including settlement, delivery or custody, or exposes the dealer member to new settlement risks.

<u>Products to be offered to retail clients</u>

The same considerations as detailed above for an institutional client plus the following:

- The product has never previously been sold to the dealer member's retail clients;
- The product will be offered by registered representatives who have not previously sold it, to a new type of retail investor or within a new geographic region;
- Offering the product involves new or significantly changed sales practices, marketing strategies, fees or costs;
- Offering the product raises conflicts of interest that have not previously been identified and addressed;
- There has been a material modification to an existing product that is expected to present increased reputational, legal, market, investment or other risks; or
- Changes to an existing product materially change the time horizon, potential for loss, expected return or mark-to-market volatility of the product.

This list is not necessarily exhaustive of all factors that determine whether a product requires due diligence review. Dealer members should not simply assume that if something is similar to a product already in the marketplace, whether offered by the firm or by competitors, that little or no review is necessary.

Any material modification to a product marketed by a dealer member should be subject to the same level of review as a new product. It is also important that the standards for determining

what level of review is appropriate for any given product or modification of a product are clearly communicated and applied throughout the firm in a consistent manner.

IIROC believes that when dealer members are unsure as to whether a product warrants review, the best practice is to err on the side of caution.

Ask the right questions!

The fundamental goal of every due diligence process should be designed to ensure that the right questions are asked and satisfactorily answered. Asking the right questions is critical not only to determine whether the product should be offered at all, but also to identify important features that should be highlighted for marketing and training.

While the right questions will depend in part on the nature of the product, at a minimum every dealer member should ask and answer the following questions before a new product is offered for sale:

- For whom is the product intended? Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled? Conversely, to whom should the product not be offered?
- What investment need does the product fulfill? How does the product add to or improve the firm's current offerings? Can less costly, complex, or risky products achieve the objectives?
- What performance assumptions underlie the product, and how sound are they? What market or other factors influence the investor's return?
- How liquid is the product? Is there a secondary market for the product? What risks must be disclosed, and how will that disclosure be made?
- What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks?
- What costs and fees for the investor are associated with this product? Are they appropriate and transparent? How do they compare with comparable products offered by the firm or by competitors?
- How will the dealer member and its registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest

between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed?

- Does the product present any novel legal, tax, market investment, or credit risks?
- Will offering the product take advantage of a gray area of securities law or promote regulatory arbitrage?
- What is the complexity of the product in structure, function, and description? Does such complexity impair understanding and transparency of the product? Does such complexity impact suitability considerations and/or the training requirements associated with the product?
- How will the product be marketed? What promotional and sales materials will be used? What risks must be disclosed, and how will that disclosure be made? Will sales and marketing materials be considered by those responsible for the review?
- What are the qualifications of the people making determinations about a new product's assumptions, performance, and risk, and do such qualifications provide the expertise necessary to reach sound conclusions?
- Will the product necessitate the development or refinement of in-firm training programmes for registered representatives and their supervisors? If so, how and when will the training be provided?
- Do the dealer member's current systems support the product, or will new systems be required?

Best Practices

To help dealer members determine whether their current procedures for products due diligence are sound, IIROC considered new product practices reviewed during its compliance sweep of dealer members involved of the manufacture or distribution of third-party ABCP.

These recommended practices facilitate compliance with suitability obligations, mitigation of conflicts of interest, and planning for appropriate training and supervision. This notice is not a comprehensive roadmap for compliance and supervision, but rather highlights measures that some dealer members are using to ensure better compliance.

Dealer members should consider the information in this section in assessing their own procedures and in implementing improvements that are tailored to and work best for their firm. While a particular sound practice may work well for a large firm, the same approach may not be effective or economically feasible for a smaller firm. While dealer members must adopt procedures and controls that are effective given their size, structure, and operations, a firm may not fail to have relevant policies and procedures because of limitations related to its size, structure, or operations.

Dealer members should consider the following components of an effective product due diligence programme:

- A standardized process that requires a written "new product" proposal;
- A preliminary assessment of a proposed product or concept by compliance and/or legal personnel to determine, among other things, whether it is a new product or a material modification of an existing product, and the appropriate level of internal review;
- For new products or material modifications to existing products, detailed review by a committee or working group made up of representatives from all relevant sectors of the firm, including compliance, legal, finance, marketing, sales, and operations;
- A formal decision to approve, disapprove, or table the proposal by a new product committee or other decision-making group that includes members of the firm's senior management;
- An assessment of the extent of training in product features and risks necessary to ensure that registered representatives and supervisors can judge the suitability of recommendations and sales to clients and the development and implementation of the necessary training;
- If the product is approved, a determination of the appropriate level of and process for post-approval follow-up, including consideration of:
    - Monitoring of customer complaints and grievances related to the product;
    - Reassessment of training needs on a continuing basis;
    - Monitoring of compliance with restrictions placed on the sale of the product;
    - Periodic reassessment of the suitability of the product

APPENDIX B: LIST OF CANADIAN THIRD-PARTY ABCP

Conduits covered by the Montreal Proposal	Excluded	Affected Conduits under the Pan-Canadian Restructuring Plan
1 - Apollo Trust		1 - Apollo Trust
2 - Aurora Trust		2 - Aurora Trust
3 - Comet Trust		3 - Comet Trust
4 - Gemini Trust		4 - Gemini Trust
5 - Planet Trust		5 - Planet Trust
6 - Rocket Trust		6 - Rocket Trust
7 - Slate Trust		7 - Slate Trust
8 - Structured Asset Trust		8 - Structured Asset Trust
9 - Structured Investment Trust III		9 - Structured Investment Trust III
10 - Ironstone Trust		10 - Ironstone Trust
11 - MMAI Trust		11 - MMAI Trust
12 - Silverstone Trust		12 - Silverstone Trust
13 - Aria Trust		13 - Aria Trust
14 - Encore Trust		14 - Encore Trust
15 - Newshore Canadian Trust		15 - Newshore Canadian Trust
16 - Opus Trust		16 - Opus Trust
17 - Symphony Trust		17 - Symphony Trust
18 - Apsley Trust		18 - Apsley Trust
19 - Devonshire Trust	Devonshire Trust	
20 - Whitehall Trust		19 - Whitehall Trust
21 - Selkirk Funding Trust		20 - Selkirk Funding Trust
22 - Skeena Capital Trust	Skeena Capital Trust	

APPENDIX C: DBRS LETTER RE CANADIAN ABCP-FUNDED STRUCTURED FINANCIAL ASSET-BACKED TRANSACTIONS

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November 10, 2006

Sent by e-mail

To: various market participants,

Re: Canadian ABCP-funded Structured Financial Asset-backed transactions

As part of ongoing credit reviews of Canadian ABCP-funded transactions, DBRS has made the following observations:

1. The Canadian asset-backed commercial paper ("ABCP") market has experienced extraordinary growth (in excess of 50%) over the past two years. This growth has largely been attributed to the contemporaneous growth of Structured Financial Asset-backed ("SFA") transactions funded by ABCP. These types of transactions now comprise approximately 28% of all ABCP outstandings and approximately 20% of total ABS outstandings in the Canadian market;

2. Leveraged Super Senior ("LSS") CDO structures have been the most popular type of transaction selected for inclusion into Canadian ABCP conduits and the portion of LSS transactions funded by ABCP is now approximately 70%; and

3. Current conditions in the structured credit market provide for less attractive returns for credit protection sellers than before. Consequently, greater scrutiny has been required in reviewing newer transactions to ensure that no additional risks are incorporated into SFA transactions.

After considerable contemplation of the above points, together will a detailed review of existing SFA transactions, DBRS has concluded that:

1. Although the current volume of SFA transactions is sizable in relation to the overall ABS market, DBRS views the quality of current assets in its rated universe as very high and anticipates that future performance of these assets to be strong.

2. Should growth rates in SFA-backed transactions continue at the pace previously experienced, DBRS believes that certain concerns will arise with respect to:

   a. The continued and near exclusive use of LSS technology resulting in contingent funding obligations embedded in an increasingly larger portion of the market; and
   b. SFA transactions structured in the current environment potentially may incorporate economic and risk characteristics that are quite different from previously structured transactions.

Pursuant to the views expressed above, DBRS believes that a measured approach should be taken with respect to managing the future growth of SFA-backed transactions funded in the Canadian ABCP market. Consistent with past practice, market participants should only expect transactions that clear the minimum rating requirements by an ample margin to be approved by DBRS. However, consistent with DBRS's new approach to SFA transactions, market participants should also expect that the types of SFA transactions that will be approved going forward will be more restrictive than those approved in the past.

This mandate will be effective immediately. It is DBRS's expectation that no existing Canadian ABCP ratings will be affected, as all rated SFA transactions are currently enhanced beyond minimum thresholds for each rating category.

With regard to transactions currently under review by DBRS, such transactions will be reviewed on a case by case basis to determine whether the transaction in question can be approved.

All inquiries regarding this matter should be directed to Huston Loke.

Yours truly,

DOMINION BOND RATING SERVICE LIMITED

Huston Loke
Assistant Group Managing Director
416-597-3627

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ENDNOTES:

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[1] Re Metcalfe & Mansfield Alternative Investments II Corp., 2008 ONCA 587

[2] Bank of Canada Financial System Review – June 2008, page 10.

[3] The total third-party ABCP market was approximately $35 billion. The Bank of Canada Financial System Review – June 2008 reported only the ABCP of the 20 affected trusts that were subject to an investor standstill agreement under the Montreal Accord dated August 16, 2007. Two other trusts (Skeena Capital Trust and Devonshire Trust) representing another $2.8 billion were excluded in the Purdy Crawford Investor Committee Restructuring Proposal dated March 2008.

[4] The Government of Canada short-term TreasuryBill yield curve is determined through competitive tender auction by weekly Treasury-Bill sales in which the Bank of Canada, the chartered banks, and qualified investment dealers participate. Treasury Bills of 91-day and 182-day maturity are issued weekly with the occasional offering of a longer maturity of up to one year.

[5] The absence of publicly available information as to the detailed composition of the underlying assets of Canadian ABCP conduit programmes in August 2007 resulted in market participants unable to price credit risk.

[6] Illustration notes:

The Special Purpose Entity is set-up as a trust legal structure with issued equity of $10 for the primary purpose of being bankruptcy remote. The trust administrator of the Special Purpose Entity is normally the sponsor.

Assets are sold to the conduit at a discount to their fair value. This represents the credit enhancement needed to protect the conduit against asset value deterioration and attain a high credit rating for Class A notes issued with a term to maturity less than 270 days and typically less than 90 days. Class E notes are issued with extendible term up to a year at the option of the issuer and do not meet the criteria for exemption from registration or prospectus and can thereby only be sold to accredited investors.

The seller of the assets provides the conduit with credit enhancement through over-collateralization (a term used to mean discounted value) in which it assumes first-loss exposure by receiving proceeds less than the full value of the assets sold to the conduit. This difference represents the amount that **is not** funded by the Commercial Paper issued and goes back to the seller once the notes are fully paid off.

Liquidity Support is generally provided by a domestic or foreign bank that will commit to an amount equal to the par value of the Series A notes issued and outstanding. This is a liquidity provider of last resort under an emergency funding agreement. Liquidity support does not apply to Series E notes that are extendible at the option of the issuer or floating rate notes (FRN). FRN's are low-grade commercial paper. The investor assumes liquidity risk for any holdings of in Series E or FRN issued by the conduit.

To be exempt from provincial securities registration and prospectus requirement, ABCP Series A notes must meet a prescribed minimum credit rating by a recognized rating organization (such as R-1(low) by DBRS) and have a maturity less than 365 calendar days. As Series E notes and long-term FRN's do not qualify for exemption from securities registration and prospectus they are restricted to sale to accredited investors only.

[7] There are a number of factors that need to be taken into consideration and each LSS transaction varied in economics at the time it was entered into.

[8] Subsection 485(1) of the *Bank Act* (BA) and subsection 473(1) of the *Trust and Loan Companies Act* (TLCA) require banks and trust and loan companies to maintain adequate capital. Office of the Superintendent of Financial Institutions (OSFI) Guidelines are not made pursuant to subsection 485(1) of the BA or to subsection 473(1) of the TLCA. However, capital standards set out in Guidelines provide the framework within which the Superintendent assesses whether a bank or a trust or loan company maintains adequate capital pursuant to the acts.

For this purpose, the OSFI established two minimum standards for bank capital: assets to capital multiple, and risk-based capital ratio. The first test provides an overall measure of the adequacy of an institution's capital. The second measure focuses on risk faced by the institution. Notwithstanding that a bank or a trust or loan company may meet these standards, OSFI may direct a bank to increase its capital under subsection 485(3) of the BA, or a trust or loan company to increase its capital under subsection 473(3) of the TLCA.

[9] Backgrounder: OSFI's Role in the ABCP Market Issue – April 22, 2008, available at www.osfi-bsif.gc.ca.

[10] *Information for Noteholders: Proposed Restructuring of Canadian third-party Structured Asset-Backed Commercial Paper prepared by the Pan-Canadian Investors Committee on March 20, 2008 (page 52).*

[11] Bank of Canada Financial System Review – June 2003, page 43.

[12] Ibid. page 46.

[13] Ibid. page 2

[14] Bank of Canada Financial System Review – June 2003, page 45.

[15] Ibid. page 46.

[16] Ibid. page 46.

[17] DBRS PowerPoint presentation to IIROC compliance sweep team on April 23, 2008 on the fundamentals of Collaterilized Debt Obligations by Jamie Feehely, and Jirch Wong (page 3).

[18] www.dbrs.com for the Rating Process – Structured Finance

[19] www.dbrs.com for the Rating Scale: Commercial Paper and Short Term Debt and Rating Definitions & Other Rating Info: Short –Term and Long-Term Rating Relationships

[20] www.dbrs.com for the Rating Process – Structured Finance

[21] While CIBC World Markets Inc. was disclosed as being the distribution agent, it delegated its duties to its parent-bank.

[22] Peter J. Dey, *Exemptions under the Securities Act of Ontario*, at page 111 in: Special Lectures of the Law Society of Upper Canada, 1972, Corporate and Securities Law published commentary on the exemptions under the Ontario Securities Act and explained the rationale behind the $50,000 limit. He noted:

> The exemption is limited with respect to notes and commercial paper traded to individuals by a condition that each such note or commercial paper must have a denomination or principal amount of not less than $50,000. This restriction with respect to individuals was inserted by an amendment in 1963 to "restrain the activities of the so-called 'ten percenters' such as the Prudential Finance Corporation." The philosophy underlying the $50,000 figure appears similar to the philosophy underlying the $97,000 figure in section 19(3), i.e. an individual prepared to invest $50,000 in negotiable promissory notes or commercial paper must have some degree of sophistication.

[23] As at April 30, 2007, IIROC Dealer Members held $371 million par value of third-party ABCP securities in custody for retail customer accounts. This represented approximately 1% of the total $35 billion third-party ABCP market. IIROC regulatory analysis of the stock records obtained from 26 Dealer Members identified through CDS depository records showing third-party ABCP holdings identified 2,542 non-corporate named retail accounts. Of these accounts, 55% (or 1,389) had positions less than $50,000 and 74% held positions less than $150,000.

[24] Coventree is a publicly-listed company so that information on its business activities, financial position and operational results, as well as press releases about any material change, are available on the SEDAR system. However, it contains no specifics about any of the Coventree-sponsored ABCP.

[25] IIROC staff located 15 of the 22 third-ABCP conduit programme Information Memoranda on the CIBC World Markets web site - the bank (http:\www.cibcwm.com and the sub-link is

http://research.cibcwm.com/commercialpaper/private/cp_a.shtml). These documents were under the category - Canadian Research Services for Commercial Paper. The link to the documents was intended to be available only to CIBC World Markets Corporate and Institutional clients – by password protection requiring registration for access. Two other Information Memoranda were located on the web sites of the ABCP sponsor itself.

There were no other Information Memorandum documents located on the internet for 5 third-party ABCP programmes. This included 3 sponsored by Newshore Financial Services Inc. (Aria Trust, Encore Trust, Newshore Canadian Trust); 1 by National Bank Financial Inc. (MMAI Trust); and 1 by Metcalfe & Mansfield Capital Corp. (Devonshire Trust).

[26] Bank of Canada Financial Systems Review – June 2003, *"Developments and Issues in the Canadian Market for Asset-Backed Commercial Paper"* by Paula Toovey and John Kiff – page 47.

[27] Pan-Canadian Investors Committee press release: "Pan-Canadian Investors Committee Announces Restructuring Plan for Third-Party ABCP," December 23, 2007

[28] In 2004-5, the U.S Securities Exchange Commission (SEC) extended their supervision of certain broker-dealers (including Lehman Brothers, Bear Sterns, Merrill Lynch, Goldman Sachs, Morgan Stanley and JPMorgan) on a consolidated basis – referred to as Consolidated Supervised Entities (CSE). In this capacity, the SEC supervision extended beyond the registered broker-dealer to the unregulated affiliates of the broker-dealer and the holding company itself. Like any other consolidated supervisors overseeing internationally active institutions, the SEC permitted CSE's to compute capital adequacy measures consistent with the Basel Standard.

A US broker-dealer becomes a CSE by applying for an exemption to the SEC from the standard net capital rule, and the broker-dealer's ultimate holding company consenting to group-wide SEC supervision.

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