TITLE: Musical Chairs: Who's Left Standing When the ABCP Music Stops?

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"[W]hen the rain falls, it don't fall on one man's house"
-Bob Marley

Introduction

1 At the time of writing, the global financial markets are in a free fall. An alarming number of sub-prime mortgage foreclosures generated a growing wave of uncertainty in the markets. The series of major corporate collapses started with Bear Stearns. In March 2008, the venerable investment bank reached an agreement with JPMorgan Chase to be acquired for only $2 per share (following a high of $160 per share within 12 months of the transaction). The deal closed on May 30, 2008[1]. Because Bear Stearns is one of the largest underwriters of mortgage-backed securities, the sale was only made possible with $30B of support from the U.S. government required to fund the over-extended brokerage's illiquid assets[2]. September 2008 marked the end of Wall St. investment banks Lehman Brothers and Merrill Lynch & Co as well. On September 15, 2008, Bank of America agreed to acquire the weakened Merrill Lynch for $50B[3]. Lehman Brothers was acquired out of Chapter 11 bankruptcy protection by Barclays Capital on September 22, 2008[4]. Earlier in September, the U.S. government took over failing mortgage finance giants Fannie Mae and Freddie Mac with a commitment to invest as much as $200B to maintain their solvency[5]. If that wasn't enough, the U.S. government effectively nationalized the world's largest insurance company, American International Group (AIG), as part of an $85B bailout to save it from collapse due to illiquidity induced by a downgrade to its credit rating[6]. To make matters worse, the largest savings and loan bank in the United States, Washington Mutual, was put into receivership on September 25, 2008[7]. Currently, the U.S. Congress is contemplating a massive additional $700B bailout to support its emaciated financial services sector.

2 Why does this matter? Only a couple years ago, when the economies of the world's industrialized countries were still strong and credit was readily available, none of the architects of asset-backed securities on Wall St. and Bay St. could have foreseen the severity of such a liquidity crisis. Concepts like a general market disruption and collateral call risk were the subject of remoteness discussions reserved for credit rating agencies, liquidity protection arrangements (and the related premiums) and legal opinions. It turns out that the risks were real and, furthermore, the credit swap market now carries substantial counterparty risk -- it is entirely possible, given the foregoing paragraph, that the party on the other end of a credit swap transaction may not be able to meet its obligations.

3 This paper cannot and does not try to examine the global economy. But, it would be a huge oversight to ignore what is going on right now in the United States. In Canada, we have our own experiences to draw upon. With the benefit of hindsight, it seems that the Canadian aspects of the credit crisis were just the tip of the iceberg. This paper reflects on what happened, why it happened, and what might be considered to prevent it from happening again.

The Unfolding Turmoil

4 In August 2007 the financial markets in many developed economies came under a seemingly sudden and severe strain. These economies included those of the United States, Canada, the United Kingdom, Switzerland, Australia and Japan. It has been very strongly argued that the unfolding turmoil is most accurately seen as the result of a lengthy period of aggressive risk-taking, the eye at the centre of this storm being the United States sub-prime mortgage market. It was a build-up of financial imbalances in good economic times that were exposed when the financial environment became less benign.[8]

5 The earliest warnings of the re-pricing of this risk that was so aggressively taken came in January of 2007. In the two years preceding this, defaults in the United States sub-prime market were on the rise and there was a fall in residential property prices in some areas. The spread on structured products with exposures to the sub-prime market widened as corporate spreads continued to shrink to all time lows. But this warning was partly reversed, and the uncertainties that were generated abated, with problems created by this episode expected to be limited to the sub-prime market.

6 In mid-June 2007, more signs of a serious re-pricing began to show. Several asset-backed securities backed by mortgage pools were downgraded by credit rating agencies and spreads began to rise sharply in response to two Bear Sterns hedge funds that experienced very heavy losses in a matter of weeks and were in danger of being shut down. But it was not until late July and early August that the turmoil truly reared its ugly head.[9]

7 A liquidity crunch began to build through confidence-shaking news. Asset-backed commercial paper (ABCP) conduits started to face roll-over difficulty as nervous investors started to pull back with concerns about asset quality. As demand for ABCP softened, dealers began increasing their inventory to absorb unplaced commercial paper. This was very troubling since ABCP conduits must tap the market on a daily basis for the purposes of refinancing maturing paper. As a result, new issuances were cancelled or put on hold. Again, in early August, further ABCP conduits exercised an option to extend the maturity dates on their notes for the first time ever. Write downs at financial institutions built-up beyond all expectations, and credit standards tightened further into sectors not directly affected by the turmoil. The situation in the United States housing market continued to worsen. The economic outlook darkened, with signs of a potentially serious deterioration in the United States economy.[10]

8 The situation was very succinctly summed up by the Bank for International Settlements in a paper that was released in March of 2008 where it was stated that,

9 The characterization of the dynamics of the financial turmoil is rather simple. The turmoil represented a sharp re-pricing of credit risk that, given the leverage built up in the system, led to and was exacerbated by, an evaporation of liquidity in many markets, including the interbank market. The re-pricing, which happened to have the US sub-prime market at its epicentre, followed a prolonged phase of broad-based and aggressive risk taking. It was amplified by the great opacity of new instruments, such as structured credits, and of the distribution of exposures across the system. This led to a crisis in the confidence of valuations, triggered by unexpected rating agency downgrades, and to a generalized distrust of counterparties, as market participants wondered about the size and character of their own exposures and those of others. The crisis in confidence in turn triggered an evaporation of market liquidity for the instruments concerned and of funding liquidity for the institutions suspected of being vulnerable to the market disruption.[11]

10 The years prior to the financial turmoil saw incredibly strong performance in the world economy, posting records in 2004, 2005 and 2006 for growth rates, all with inflation remaining stable. Private and official forecasts saw a mild slow down in growth rates with no change in inflation. Residential property prices had been rising rapidly, acting as a support for household spending.

11 Against a backdrop of historically low interest rates and exploding asset prices, the extension of credit, in the aggregate, expanded rapidly. The high level of asset prices kept leverage in check, while both corporate balance sheets and household budgeting did not appear to be under strain. Throughout this period, there were isolated bumps through different financial sectors, but in every case markets rebounded strongly.[12]

12 But in August 2007, a portion of the Canadian ABCP market not sponsored by large banks ceased to function completely, trapping the supposedly short-term and liquid investments of both corporations and the public. What was it about the Canadian ABCP market that caused it to lock up? The structure of this sector of the financial market and possible adjustments to be made are the subject of much discussion.

The Music Starts

13 The ABCP market had been functioning with relative stability in Canada for more than 17 years

[13]. Then, quite suddenly, the non-bank sponsored sector of the market in Canada broke down in August of 2007 -- only now is the end of the turmoil in sight.

14 It is essential that we come to understand the elements that combined to create a perfect storm in this sector of the financial market. It is even more essential that we endeavour to prepare our markets and systems so that a recurrence of such an event is as remote as possible. This however, raises many questions that have to be answered. By clarifying the nature of the ABCP market and the events surrounding its freeze, we can identify the relevant stakeholders and flaws in the structure of the ABCP market itself. The implication, from a legal point of view, is whether or not additional regulatory intervention is required.

15 When ABCP first appeared on the financial radar, it was fairly simple and linear in structure. The process began with an "Asset Originator", which is generally a business of some kind, a mortgage lending company for example. In the case of mortgage lending, the originator needs money to lend to potential mortgagors, so they obtain the money through bank loans and/or other investment capital.

16 Consider a simple scenario: (i) the bank lends, for example, $10 million to the originator at an interest rate of perhaps 6%; and (ii) the originator then issues loans to mortgagors from that $10 million at an interest rate of perhaps 8%. This leaves the originator with no money in the coffers, but mortgage payment entitlements from the mortgagors. The originator at this point is issuing no further loans as they do not have the liquidity to do so. Their cash flow consists of the payments made by the mortgagors at 8% interest, which the originator then would use to pay their $10 million bank loan at 6% interest. So their spread is fairly modest. The originator would rather continue to issue mortgages, but they may not have access to additional financing from banks or investor capital.

17 Up to this point, there is nothing different from what might normally happen in a typical arbitrage transaction. But here, the securitization process begins in earnest. In fact, very few companies could ever compete with the banks to make loans using this model since the banks could always undercut them on pricing when lending directly to individual customers. The ABCP structures allow the mortgagee in our example to cut out the banks as intermediaries and access the global debt markets directly.

18 A "Sponsor" is a party that sees an opportunity here and takes steps. The sponsor would create a "Special Purpose Vehicle" (SPV) or "Conduit" to carry out the plan. The SPV or conduit generally takes the form of a trust, but similar results can be achieved through the use of a corporation or a limited liability partnership. In Canada, these conduits almost always take the form of a trust to avoid corporate capital tax.

19 The SPV sets up an arrangement with the originator to purchase the mortgages outright with funds they have raised in the debt market. Great care is taken by the SPV to ensure that the transaction is structured in such a way that the obligations or assets are bankruptcy remote from the originator. In other words, they ensure that the transaction constitutes a true sale, and from this point any unfavourable events affecting the originator, such as bankruptcy, have no effect on the mortgagors. The mortgagors are still obligated to make payments on their mortgages directly to the SPV and remain beyond the reach of the originator's creditors.

20 The originator can use the sale proceeds to repay debt owed to the bank, fund new mortgage acquisitions or pay dividends to investors. The SPV issues interest bearing notes to investors at a rate of perhaps 4.5%. They may sell $10 million worth of notes, raising enough money to complete the purchase of the assets that will create the cash flow required to pay out investors holding maturing notes.

21 ABCP is a short-term debt instrument secured by the underlying assets that the SPV purchases. In the example above we considered the securitization of mortgages, but the ABCP conduits and the market in general are not limited to mortgages[14]. Originators can include major banking institutions, credit card companies, mortgage companies, finance companies, manufacturers and consumer debt owed to retailers. The debt obligations created by the various originators can vary as well encompassing, but not limited to, mortgages, auto and equipment leases and loans, trade receivables, and credit card receivables.

22 The SPVs also establish credit enhancement features for their ABCP notes that will be sold to investors. By separating the underlying assets from the originators and the risks inherent with any business, they can attain a credit rating for the notes that would exceed the rating that would be assigned to the general debt of the originator. To further raise the credit rating assigned to the notes, the SPV will use such forms of credit enhancement as cash reserves, excess spread, over-collateralization, subordinated debt, insurance, letters of credit and hedging[15].

23 Credit enhancement is very important to ABCP because of the way the credit rating system works. Generally, these SPVs or conduits are dealing with very large pools of assets that may contain thousands of debt obligations. It would be impractical and nearly impossible for a credit rating agency to investigate and rate each individual asset underlying the notes sold to investors. Instead, credit rating agencies rely on model-based rating criteria. The rating agency looks at the pool of assets as a whole taking factors like asset-type diversification and geographical locations to predict long-term patterns with more certainty. Based upon the conclusion reached by the rating agency as to the losses expected to be suffered over the life of the transaction, credit enhancement is added to the product to meet the criteria for the rating that is desired by the SPV and absorb any anticipated losses[16].

24 In addition to evaluating the quality of the financial assets underlying the notes sold to investors, the credit rating agency looks at the legal structure of the transactions taking place and the structure of the SPV. The rating agency wants to make sure that in the contracts that constitute the purchase of the underlying assets that bankruptcy remoteness is actually achieved.

25 The SPV will add both structural and credit enhancements until the desired credit rating for the series of notes is achieved. Investors in ABCP relied almost exclusively on ratings given by agencies in their choice of investment, because very limited disclosure was provided with respect to the assets or the originators except in ratings reports and sponsor reports.

26 The events of August 2007 caused a segment of the ABCP market to freeze up. But that segment was not limited to the basic kind of ABCP described above. The ABCP market in Canada can be divided into two broad categories, based on the type of sponsor that creates the ABCP conduit. The first is bank sponsored ABCP, and the second is non-bank sponsored ABCP[17]. The latter, oddly enough, includes the National Bank of Canada.

27 Both legally and financially, the sponsor of a given ABCP conduit should not matter. In a legal sense, the sponsor is separate from the SPV and acts only as its agent. If this were not the case, creditors of the SPV could pursue the sponsor in extreme circumstances, and the sponsor is certain to take the necessary precautions to prevent that.

28 Since the SPV is separate from the sponsor in a legal sense, they are separate in a financial sense. From a financial perspective, who the sponsor is should not make a difference. But, in reality, it made a huge difference in August 2007. More important than the identity of the sponsor was the identity of the backstop liquidity provider for the conduits. Typically, with bank-sponsored conduits, it was the same entity that gave the investors higher confidence that liquidity would be available if it was needed. The threat of illiquidity was addressed either through formal liquidity facilities, or, as had become apparent later, the bank itself refinancing maturing ABCP.

29 When the ABCP market began experiencing problems with rolling over their notes, that is paying out maturing notes and issuing new notes, the non-bank sponsored SPVs, now facing a liquidity crisis, attempted to draw on liquidity arrangements that had been set up before hand. From a Canadian perspective, there are two basic kinds of liquidity agreements that were used in the ABCP market at the time: (i) global-style liquidity agreements (only used by RBC), and (ii) the Canadian-style Market Disruption Event (MDE) agreements.

30 In the United States and all other markets, the style used in liquidity arrangements as mandated by rating agencies is the Global-style liquidity arrangement. Under this kind of agreement, the conditions that must be met for the liquidity provider to pay out are much less onerous. Each liquidity agreement is its own stand-alone contract; there is no regulation of this system. In a very basic sense, there is a bi-lateral contract between two parties, where one party promises to pay periodic fees, and the other party promises to provide liquidity when certain events take place. But each agreement is negotiated separately. Some common conditions include: (1) the SPV cannot currently be in "default", however that may be defined in the agreement; (2) prior to a specified date, the SPV must deliver notice to the liquidity provider that there is an intention to draw on the liquidity facility; (3) after issuing the requested liquidity, the value of the ABCP's underlying assets will not have a negative value; and (4) the money drawn by the SPV cannot exceed a predetermined amount[18].

31 The second kind of liquidity agreement is the MDE agreement, or Canadian-style agreement, as Canada is the only jurisdiction where this style of agreement is permitted. The prevailing view in Canada was that ABCP were highly-rated commercial obligations with a strong, stable history in the market. Therefore, it was thought that absent a large scale disruption to the financial market as a whole there would be no problems in the repayment of maturing ABCP notes and the issuance of new notes. There are generally two key conditions that have to be met for an SPV to draw on a liquidity agreement created in this style: (1) the credit rating agency must affirm the original rating given to the notes; and (2) the inability to issue new ABCP must stem from a general disruption to the Canadian ABCP market[19].

32 The phrase "market disruption event" comes from Guideline B-5 of the Bank Act where Canadian banks offering liquidity protection in the case of market disruption did not have to maintain capital in support of those obligations; whereas those offering global style liquidity protection were taking greater risk and therefore were required to maintain capital reserves. A market disruption event was considered to be a rare and temporary inability to issue new ABCP was not due to a lack of creditworthiness concerning either the issuer itself, or the assets underlying the securities[20].

33 Aside from capital reserve requirements there was no regulation of the Canadian-style liquidity agreements, and it became a reality that every Canadian agreement contained its own variation of what would constitute a market disruption event. Although widely understood and accepted by the market at the time, no one could have foreseen that the entire market would come to a grinding halt due in large part to the these incompatible definitions. It created a situation where the SPVs and liquidity providers would fundamentally disagree as to whether or not a market disruption event had even occurred at all. This became a very important fact once the turmoil of August 2007 took hold.

34 The erosion of investor confidence, due to the events taking place in the United States sub-prime mortgage market, translated into a fear of investing into debt instruments like ABCP. So the SPVs in Canada experienced an inability to issue new ABCP notes, and could not meet their obligations to holders of maturing ABCP notes. When this happened, the SPVs turned to their liquidity providers for relief. Whether or not a market disruption event had taken place was a point of contention between the parties, and most liquidity providers declined to provide funding[21].

35 This is when the identity of the sponsor of the ABCP conduit became extremely important. For the non-bank sponsored ABCP conduits, the sponsor was generally a business that existed to do nothing but create these investment vehicles, and they were therefore somewhat limited in their capital holdings. Meanwhile, bank sponsored ABCP conduits were created by large scale federally-regulated banks with massive amounts of liquidity available to them. When the market turmoil surfaced and the third-party liquidity providers denied that a market disruption event had taken place, the banks who were sponsors appear to have by-passed their own liquidity facilities and quietly purchased ABCP from their SPVs.[22].

36 This injection of liquidity by the banks obviously helped the bank sponsored ABCP meet their obligations to maturing ABCP, but it had very negative effects on the non-bank sponsored segment of the market. The bank sponsored ABCP market was able to continue functioning, while non-bank sponsored ABCP tried to argue to their liquidity providers that a market disruption event had taken place. The response of the liquidity providers was the point of view that there had been no general disruption of the Canadian ABCP market, as evidenced by the ability of bank sponsored ABCP to continue operations without formally drawing on liquidity facilities[23].

37 From a practical perspective, there was no way for any participant in the market in the early days to determine with any certainty what the extent of the disruption was, which conduits were able to issue paper, and who was buying that paper. The decisions to request and to honour a liquidity draw must be made in a matter of minutes on the day of the market disruption -- there is little time to gather much intelligence.

38 To explain how these circumstances resulted in a complete freeze of the non-bank ABCP market, there has to be an understanding of the increasingly complex structures that were being created by the non-bank ABCP sponsors.

From a Chord to a Symphony

39 Through a long period of general economic success, risk taking became more aggressive and investor confidence was high. This created a perfect environment to foster innovation. Non-bank ABCP sponsors pioneered the use of the Leveraged Super Senior (LSS) collateralized credit default swap structure for ABCP conduits. In this system, the structure still begins with a sponsor that creates an SPV to be the issuer of the ABCP (see Figure A below). The SPV sometimes creates a satellite trust to enter into the actual LSS transaction.

Figure A
Sample ABCP Transaction Structure

[Editor's note: Figure A, Sample ABCP Transaction Structure, could not be reproduced online. Please contact Quicklaw Customer Service at 1-800-387-0899 or service@lexisnexis.ca and request the following document: 9asp065.doc.]

40 In this innovation on the ABCP structure, the SPV's satellite trust does not acquire debt obligations but instead enters into a Credit Default Swap (CDS) with a highly rated counterparty, usually a swap dealer. Swap dealers facilitate the credit swap market by buying and selling credit protection.

41 The CDS is a contract between the satellite trust and the counterparty. The goal of the satellite trust is to earn premiums from the counterparty in return for the provision of credit protection. The goal of the counterparty is to acquire credit protection on a pool of reference assets. The goals of both parties are met through a derivative contract between the two parties.

42 Derivative contracts are used to trade almost any category of financial risk that one can conceive. They are referred to as derivatives because these contracts are valued based on the movements and price of the underlying assets[24]. The derivative contract will stipulate that in the case of a default within the asset or pool of assets, or some similarly defined event, a payment may be required by the SPV to the counterparty. The SPV does not want to make payments to the counterparty as this would cause a default on its own obligations issued to collateralize the CDS, but the probability of a default in a rated transaction occurring is incredibly remote.

43 The pool of reference assets is referred to as being "super senior", that is, the quality of the assets making up the pool is very high. In fact, the pool far exceeds the criteria set out by credit rating agencies to achieve an 'AAA' or top level rating. Central to understanding the actual risk associated with these structures, one must consider that the reference asset pools are tranched so that a CDS may only apply to losses in excess of a certain threshold. In other words, it is not the risk of default on the reference asset that is rated AAA, it is the risk of aggregate losses exceeding a threshold that is rated AAA.

44 Since the risk of aggregate losses exceeding a set threshold is remote, a pool of assets valued at $1 billion might only require $100 million of collateral. The SPV is able to leverage a smaller amount of collateral, $100 million, as adequate protection for the counterparty. The SPV is not providing protection on the entire pool of reference assets that is seeking credit protection.

45 The SPV pledges $100 million as collateral for $1 billion in credit protection for the counterparty, to be invested in highly-rated securities. In return for this credit protection, the counterparty pays out a premium to the SPV at intervals determined during the contract negotiations. The premium is generally determined in reference to the full amount of credit protection that is being provided by the SPV. So, even though the SPV has posted only $100 million of collateral, it receives a premium based on the full $1 billion of protection offered. It is easiest to quantify this premium in terms of basis points (bps) as that is how the financial sector identifies them. A premium being paid by the counterparty of perhaps 7 bps would be equal to a $700,000 premium for the credit protection (it is also possible to base the premium against the amount of the value of collateral -- in this case, 70 bps on $100 million).

46 On top of receiving a premium from the counterparty, the SPV receives a return on the collateral that was posted, generally equalling, or swapped to equal, the Canadian deposit offering rate (CDOR) which is simply the average of the rates offered by all the main banks in Canada on a specified date. So, in all, the SPV receives bankers' acceptance CDOR on their $100 million in collateral, plus 7 bps on the protected $1 billion pool of assets (or, $700,000 per annum).

47 The SPV raises the $100 million required for posting collateral through the issuing of ABCP notes to investors through a dealer. The premium paid by the counterparty and the CDOR on the collateral flow back to the SPV. In turn, the SPV pays a return on the ABCP of the CDOR on the collateral plus perhaps 15 bps (or, $150,000 per annum) back to the investors. The sponsor would receive a fee with the remaining 55 bps (or, $550,000 per annum).

48 That is essentially how the LSS transaction works. The remoteness of a default allows the SPV to leverage its capital to achieve a greater return safely. When the financial turmoil of 2007 took hold, it was not the quality of the credit default swaps that caused a problem, nor was it a default that caused the problem. A loss of investor confidence froze the ABCP market, while a re-pricing of risk in the debt market exposed investors to huge potential losses.

The Music Stops

49 With the onset of financial turmoil having the United States sub-prime market at its centre, investors in Canadian ABCP lost confidence in the SPVs they were previously investing in. While most investors were not aware of how the transactions underlying their ABCP functioned, they knew that assets underlying the value of the notes contained US sub-prime mortgages, which may have impaired value, notwithstanding rating agencies' assurances that the ABCP itself was sound.

50 There was an uncertainty in the investing public because of the lack of disclosure of how the ABCP market functioned. Even though sub-prime mortgages did exist in the reference pools of assets, the tranched nature of the CDS structure meant that the risk to investors in ABCP remained remote. Regardless of the actual risk exposure of the Canadian SPVs, investors stopped buying ABCP notes. Consequently, the lack of liquidity protection quickly became the biggest risk.

51 Compounding this problem, the turmoil in the market generally resulted in a re-pricing of risk generally. This re-pricing of risk allowed the credit swap counterparties to issue a margin call on the SPVs providing credit protection in leveraged transactions[25]. As the price of credit increased and a credit crunch began to loom in the market, the counterparties became exposed as the value of the credit protection began to exceed the total collateral posted. The counterparties demanded an increase in the collateral posted by the SPVs to perhaps $150 million for $1 billion in protection, but without a functioning ABCP market, the SPVs had no ability to raise additional funds.

52 The SPVs ended up in the middle of two market forces, and experienced extreme pressure. The investors on one side of the structure were no longer purchasing ABCP notes removing the liquidity from the system. In fact, many investors wanted to redeem their outstanding notes and remove themselves from the market entirely. On the other end of the structure, the CDS counterparties demanded that additional collateral be posted.

53 The SPVs could not redeem the notes of existing note holders because there was no market in which to issue new ABCP. Non-bank SPVs with no source of capital had two parties, one on either side of the transaction, demanding payment. However, the investment structure contemplates that redemption is only possible with proceeds of a new issuance or maturity of a deal. The ABCP market had operated so effectively for years that many participants glossed over the inherent risk of funding long assets with (rolling) short paper.

54 At this point, the non-bank SPVs attempted to draw on the liquidity protection agreements they had negotiated. From the view of the SPV, this was the kind of situation that was contemplated in the Canadian-style market disruption agreements. They saw the turmoil as a general disruption to the Canadian ABCP market, and according to the rating agencies there was no problem with the creditworthiness of the underlying assets. But the major banks in Canada which had become sponsors of ABCP conduits began injecting liquidity into them regardless of legal obligation under liquidity agreements or their status as sponsors. This allowed the bank sponsored portion of the ABCP market to continue operating[26].

55 The ABCP market in Canada at the time was comprised of approximately $176 billion of commercial paper. Approximately $33 billion of that total comprised the segment of the market that was non-bank sponsored[27]. Since a majority of the ABCP market appeared to function, many liquidity providers of the non-bank sponsored ABCP conduits took the position that the Canadian ABCP market had not experienced a general disruption. If the conditions precedent to providing liquidity were not met, liquidity providers denied the obligation to fund. As a result, the requests of the ABCP conduits were refused.

56 Thus, with both streams of possible liquidity for the SPVs interrupted simultaneously, the non-bank ABCP market ground to a complete halt on August 13th and 14th, 2007.

A Rush to Put the Orchestra Back Together

57 Immediately after the events of August 14th, 2007 a meeting was convened in Montreal to develop an interim solution to the freeze which would avoid further losses by the ABCP conduits in respect of their notes, or agreements concerning the assets which supported the ABCP. The cross-default provisions in LSS deals would trigger massive mark-to-market losses for investors in non-bank ABCP conduits.

58 On August 15th, 2007 there was a meeting attended by representatives of asset providers, liquidity providers, certain ABCP investors and other participants in the market. A proposal was developed which came to be known as the Montreal Accord. The accord outlined a plan for all parties to work together in good faith to achieve a restructuring of the outstanding ABCP notes by converting them into longer-term floating rate notes. The accord also recommended a 60 day standstill to allow for the focus of all parties to rest on the restructuring of the ABCP[28].

59 The purpose of the Montreal Accord was four-fold. It was intended to: (1) convert the outstanding ABCP notes to floating rate notes that would mature simultaneous with or after the assets backing the notes; (2) existing liquidity agreements would be cancelled as they would no longer be required, and requests for liquidity already issued would be cancelled; (3) establish a structure whereby the new notes would pay out interest monthly or quarterly, whatever would match the repayment schedules of the underlying assets; and (4) create new stability by retooling margin call provisions[29].

60 An Investors Committee was created and meetings were held throughout September, 2007. The committee represented a total of approximately 66.25% of the outstanding ABCP. Throughout September the committee addressed such issues as access to confidential information, the need for liquidity and transparency, as well as extraordinary resolutions under each of the 42 affected ABCP conduits to enforce the Montreal Accord's standstill and proposals for restructuring. The committee attained the 66.66% approval rating required to have the resolutions adopted by the conduits. The standstill period was set to last until no later than March 14, 2008[30].

61 As the Investors Committee grew to a greater understanding of the functioning of the ABCP conduits and the underlying assets, they began to address the possibility of pooling certain assets to mitigate the need for additional margin funding. Sponsors, who understood the complex structure from the beginning, were left out of this process.

62 By mid-November of 2007, there were as many as ten proposals tabled for the restructuring. On November 26, 2007 a consensus was reached to support one proposal.

63 In mid-December, the process closed in on a restructuring agreement with the asset providers, the ABCP sponsors and the margin funding lenders. The more final features of the restructuring plan were revealed, namely that the plan would create two "master" conduits which investors could choose from depending on their willingness and ability to insure themselves from future margin calls[31].

64 At this point, the Investor Committee sought out an asset manager and administrator to look after the restructured ABCP and replace the sponsors. Out of a pool of over thirty applicants, a company called BlackRock was selected[32].

65 In February 2008 a conditional agreement was reached with several federally-regulated Canadian banks including Bank of Montreal, CIBC, Royal Bank of Canada and Scotiabank. The conditional agreement was a limited commitment on the part of the bank to provide margin funding for investors who could not provide their own[33].

66 During this period, preparations were being made in creating the requisite materials for the upcoming hearing under the Companies Creditors Arrangement Act (CCAA) which would seek court approval of the proposed restructuring agreement. At this point, a third and final "master" conduit was proposed to segregate the traditional (non-leveraged and ineligible) assets underlying ABCP[34].

67 The Investors Committee decided to file under the CCAA as they concluded that the CCAA forum would provide the timeliest way of achieving the restructuring as well as providing an opportunity for all of the holders of outstanding ABCP to consider the restructuring plan[35].

Writing New Music

68 The plan as agreed on by the Investors Committee identified three kinds of assets underlying the outstanding ABCP. First, assets that were solely traditional, second, assets that were LSS assets or a combination of LSS and traditional assets referred to as hybrid assets and third, assets with exposures in whole or in part to the United States sub-prime mortgage market. With this division in mind, three master conduits were established to pool the assets (see Figure B below).

Figure B
Diagram of Restructuring Plan

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69 Master Asset Vehicles (MAVs) 1 and 2 were to be constituted of a proportional splitting of LSS assets and hybrid assets in order to allow for cross-collateralization of the underlying LSS transactions in each pool. By cross-collateralizing, and including a larger amount of traditional assets in each pool, this would decrease the risk of future margin calls[36].

70 MAV 3 was to be a pool consisting only of exclusively traditional assets that were backing ABCP conduits. Where holders of outstanding ABCP were holders of ABCP backed only by traditional assets, they would be issued notes from this pool of only traditional assets. The interest paid on these notes was to be derived from the net returns generated by the pool of assets, and the maturity date would be set to match the maturity of the underlying assets[37].

71 Investors that held outstanding notes from ABCP conduits backed by either LSS assets or hybrid assets would be able to elect participation in either MAV 1 or MAV 2 depending on their ability and willingness to self-insure against future margin calls.

72 Investors who elected to participate in MAV 1 would be required to fund their own share of the margin funding facility as set out in the agreement. Those that elected to participate in MAV 1 would be required to commit to fund an amount in the range of 50-55% of the total amount of their holdings in the LSS or hybrid ABCP conduit. Those note holders that did not elect to participate in any of the new conduits was deemed to have elected to participate in the MAV 2 conduit[38].

73 In the MAV 2 structure, a third-party margin funding facility would be established and no additional commitment would be required of the note holders. The LSS assets and hybrid assets in the aggregate were to be split proportionally between MAV 1 and MAV 2 to reflect the elections of participation in either conduit, and the holdings of the electees in the previous ABCP conduits[39].

74 Where a note holder's outstanding ABCP was backed by ineligible assets (assets with exposures to the United States sub-prime mortgage market), the notes would be included in the appropriate MAV but kept segregated from the general pool of assets. The notes issued to the holder of the notes backed by ineligible assets would generate a return based on the individual ineligible assets with a maturity matching that of the ineligible asset.

75 Overall, this plan was chosen because it provided ten basic benefits[40]. First, this plan provided value preservation. By preventing liquidation of the underlying assets at decreased market prices, losses are avoided.

76 Second, the plan provides for the equitable treatment of all note holders. Under the CCAA proceedings, every note holder of affected ABCP would have a voice, regardless of the size of their holding.

77 Third, the plan creates an enhanced structure for the management of the underlying assets. Separating the assets into distinct classes such as traditional, LSS, hybrid and ineligible allows the structure to take advantage of the strengths of each class without the note holders being affected by the weaknesses of other asset classes.

78 Fourth, the plan prevents defaults in payment on maturing notes. By restructuring the notes to have a term matching the maturities of the assets, with payments being made as the obligors of the underlying assets make their payments defaults are avoided.

79 Fifth, the plan anticipates the possibility of margin calls on CDS exposures and creates margin funding facilities for just such an occurrence. An approximate total of $13.6 billion was made available for the possibility of margin call triggers being reached.

80 Sixth and seventh, the plan reduces the chance of margin calls being issued by (i) pooling the LSS assets, and (ii) using a spread-loss trigger to define the margin call trigger. Spread-loss triggers are generally seen as preferable as they are based on observable metrics. Additionally, the pooling of assets and trigger type allow the levels required for a margin call to be much higher.

81 Eighth, the plan allows for better credit ratings given to the notes. Absent the implementation of the restructuring, the market conditions are such that the operations of the ABCP conduits would suffer, resulting in a likely downgrade of the ratings given to their notes.

82 Ninth, the restructuring plan greatly enhances transparency by creating an environment where the asset providers and ABCP conduits have agreed to share all of their confidential information with the note holders. By creating an environment of transparency it is expected to increase liquidity and investor confidence.

83 Finally, the restructuring plan creates improved liquidity. The sheer size of the asset pools, combined with credit enhancement, a high credit rating, margin funding facilities, higher margin call triggers, greater transparency and improved diversification of assets should promote a market for the for the notes of these plans.

84 Overall, the plan looked like a viable solution given the circumstances. There was only one major stumbling block left to the implementation of the plan. The participation of the major Canadian banks was required for the liquidity and margin funding facilities to implement the restructuring of the ABCP notes. But the commitment of the major banks at this point was conditional upon the inclusion of a release clause in the plan.

85 The release that the banks wanted included stipulated that the ABCP conduits, the ABCP sponsors, the satellite trust parties, the administrative agents, BlackRock, the financial services agent, the asset providers, the issuer trustees, the original issuer trustees, the existing indenture trustee, the new indenture trustee, the Canadian banks, the liquidity providers, asset originators, ABCP dealers, issuing and paying agents, the note holders, the rating agency, the applicants, all of their respective affiliates, present and former officers, directors, employees, auditors, financial advisors and legal counsel would receive fully effective and comprehensive releases with respect to all matters concerning or otherwise related to the ABCP market in Canada. Additionally there was to be limited liability for all parties involved with the plan, to the extent that they would have not be liable or obligated to any person for their role in the restructuring, any act or omission on their part in connection with the observed standstill, the CCAA proceedings, the restructuring plan or any property under the plan[41].

86 The release demanded by the participating parties was completely comprehensive, potentially even relieving liability for fraud. Some note holders were very troubled by the scope of the release and had objections that they wanted heard. On May 12th and 13th 2008 a hearing was held before Mr. Justice Colin Campbell to hear the objections of note holders as they related to the release.

87 On May 16th 2008, Mr. Justice Campbell rendered his decision[42] that insufficient information was presented to persuade him either way that a release broad enough to encompass fraud was allowed by the CCAA, or that the release was fair and reasonable[43]. He did conclude however that claims for negligence simply had to be covered by the release for the plan for restructuring to be able to continue.

88 In a June 5th, 2008 decision by Mr. Justice Campbell[44], it was concluded that the need for the release to encompass a release from liability for fraud had been made out[45]. The only exception was claims for certain types of fraud, beyond the ordinary[46].

89 Subsequent to the June decision by Mr. Justice Campbell, the Ontario Court of Appeal (ONCA) dismissed an appeal commenced by holders of third-party, non-bank ABCP thereby supporting the lower court's decision to approve and sanction the plan as being fair and reasonable[47]. On Friday, September 19, 2008, the Supreme Court of Canada dismissed the applications for leave to appeal the decision of the ONCA.

Starting the Music Again

90 The restructuring plan has now been approved through the CCAA process and all appeals have been exhausted. The Ontario Court of Appeal affirmed the trial decision that the restructuring plan was fair and reasonable, and that the third party release would be permitted by the CCAA where those releases are reasonably connected to the proposed restructuring[48]. Leave to appeal to the Supreme Court of Canada was refused on September 18, 2008[49]. The standstill has hopefully come to a conclusion and the individual investors will soon begin to recoup their investments. But this is not the end; it is simply a resolution to what may be a symptom of deeper problems in the systems surrounding this segment of the market. Questions will linger for years.

91 There are many issues to be addressed, and no single publication or regulation could encompass everything that went wrong in the ABCP market. Various aspects of the matter must be deconstructed and reviewed in detail to prevent such an event from ever happening again.

Rough Justice via the CCAA?

92 The restructuring plan that was conceived and approved by the Investors Committee was approved by a majority of the investors as being a good course of action. The Investors Committee decided that they would proceed under the CCAA process due to its flexibility, seeking court approval of the plan. Many questions have surfaced as to whether or not the CCAA forum was the most appropriate in these circumstances. To consider this possibility, there has to be at least a certain minimal understanding of the Act and its purpose.

93 The CCAA has its origins during the great depression, a time of great financial turmoil. It is remedial legislation, and therefore allows for a more liberal interpretation. At its beginning, it was identified by the Supreme Court of Canada as remedial legislation that allowed the judiciary to deal with insolvency in a way that otherwise may not be valid prior to beginning bankruptcy proceedings[50]. But the Act itself is very vague in terms of what actual authority the judiciary has to make orders, and according to Mr. Justice Campbell, it has now been accepted as allowing for great flexibility on the part of the judiciary in enabling the business community to restructure insolvent organizations through majority vote[51].

94 The great example of the flexibility afforded the judiciary in CCAA proceedings is the issue of the objections by some note holders to the release clause included in the restructuring plan. Under the CCAA, the judiciary is explicitly given the power to release directors of insolvent entities, but nothing is said of the scores of third-parties that are released in the ABCP restructuring plan. Mr. Justice Campbell came to agree with the decision in Canadian Airlines Corp. (Re)[52] where it was held that the Act may not specifically authorize the release of third-parties, but neither does the Act prohibit such releases[53]. The view was adopted in conjunction with a previous decision of Blair J. where it was held that the philosophy of the CCAA was underscored by the two concepts of fairness and reasonableness; fairness being the ultimate expression of the court's equitable jurisdiction, and reasonableness providing objectivity for the process[54].

95 Thus Mr. Justice Campbell concluded that the comprehensive releases in the restructuring were necessary to the effective implementation of the plan, and therefore exercised his discretion to allow the releases to remain, even covering most allegations of fraud.

96 Perhaps a more interesting issue in the specific case of the ABCP crisis is that of the true fairness of the CCAA proceedings given the participants in the market. Under the CCAA votes, every note holder is entitled to a vote, either in approval of or rejection of the plan to resolve the situation. All note holders are treated equally, regardless of who they are and the size of the stake that they hold. In the ABCP market, there were many retail investors with relatively small amounts of money invested into the conduits. There were also very large corporate investors with massive amounts of money invested as compared to the everyday retail investors. Under the vote the retail investor's vote is exactly as valuable as the vote of the corporation. The question is whether or not this allowed for a truly fair and representative cross-section of the opinion of the investors.

97 Financially the corporations likely represent a much larger portion of the investment into the ABCP market, yet they still receive just one vote each in the CCAA process. Mr. Justice Campbell addresses the idea that the plan will not be universally looked upon as favourable. He notes that no plan of the size and complexity of this one can ever satisfy everyone affected, but the size of the majority is evidence of the overall fairness. He stresses that a plan to resolve a crisis of this magnitude cannot be expected to work perfect equity among all stakeholders[55], so the function of the judiciary is to determine whether or not the plan is as fair as can reasonably be expected within the scope of the CCAA. It should be noted that only note holders got a vote as part of the CCAA process -- all other creditors are participating voluntarily and could fail to come to terms.

98 Irrespective of the difference in quantum of investment, the retail investors involved in the market and their interests have to be considered just as those of larger, institutional investors. It may very well be that, given the circumstances, the restructuring plan and the CCAA proceedings were as fair as can reasonably be expected to all parties involved.

Lulled into a False Sense of Security

99 The discussion of investors of different financial calibers leads somewhat into another issue highlighted by the ABCP crisis. The financial capabilities of an investor can be one way to gauge the savvy or understanding of capital markets and their function. Where ABCP is concerned, it is likely that the vast majority of investors do not understand how the market functions. The understanding of many investors is likely limited to an understanding that money goes into the ABCP conduit, something happens in a "black box" and the invested capital plus a modest gain returns to the investor. The ABCP that was invested in was rated by a reputable credit rating agency and achieved high ratings, so therefore to the eyes of the average investor, it was safe. Given that there was no disclosure, one has to wonder whether knowledge would have changed investor behaviour.

100 One aspect of the distribution of the notes that has yet to receive significant scrutiny is whether or not the sophisticated investment advisors, trustees and asset managers of large funds discharged their fiduciary duties when they purchased ABCP? Did anyone take the time to understand what they were buying? What did they think they were buying and how was it communicated to them?

Who is accountable?

101 Also of great concern to many parties either invested in the ABCP market or observing with keen interest the market following the turmoil is transparency. Transparency relates directly to the role of the credit rating agencies in the market. Rating agencies in Canada, such as DBRS, issued ratings on the notes issued by the ABCP conduits, but parts of the processes involved have spawned some questions about the effectiveness of the evaluations in communicating the information desired by involved parties.

102 When an issuer wants to have their ABCP rated by an agency, the issuer seeks out the rating agency and pays for the agency to evaluate the product and assign a credit rating. The concern here is that the system creates a conflict of interest or at the very least compromises the credit judgment of the rating agencies.

103 If the customer of the rating agency is the issuer, and if the rating agency wants to cultivate a profitable business, there would be a natural tendency towards pleasing your paying customer. The idea is that the rating agency is better served by looking towards the interests of the issuer in an effort to encourage repeat business. As an example of how important these customers are to the rating agencies, Moody's reported that 44% of their 2006 revenue came from rating structured finance.

104 If the function of the rating agency is to review securities and provide ratings based on their findings to potential investors, why are the issuers the primary customers of the ratings agencies? The section of the market relying on the rating agencies most heavily are the potential investors. Retail investors are generally not sophisticated enough to assess the evaluative models of the rating agencies, and do not understand the financial products well enough to make these evaluations on their own. This can create a situation where the investors are vulnerable to errors on the part of the rating agencies.

105 Credit rating agencies are almost completely unregulated[56]. In Canada there is no federal regulatory scheme or body, and there are no provincial regulatory bodies to oversee their activities and business practices. The closest thing to a regulatory scheme for credit rating agencies is a code of conduct that has been published by the International Organization of Securities Commissions (IOSCO) which credit rating agencies are not required to follow. While they are not required to follow IOSCO's code of conduct, all major and most minor credit rating agencies have adopted it. There is a desire, especially following the turmoil of 2007, by credit rating agencies to re-establish investor confidence in the quality and impartiality of their ratings. There are developments, opposed by the rating agencies, to shift the market paradigm to such a degree that the issuers are no longer paying for credit ratings, but that potential investors would become the primary paying customers of the agencies. There is currently no mechanism in place for investors to hire (or even choose) a rating agency.

106 As financial models become more and more complex, there is a greater and greater need for transparency and disclosure. But unfortunately, the provision of greater disclosure would likely result in little practical difference in the market. The likelihood of understanding massive disclosure documents (like a prospectus) is miniscule for the vast majority of involved parties. And, the impracticality of generating such documents for 30 and 60 day instruments should not be overlooked. The confidence of investors has been shaken badly and if the opacity of the market continues in the future, nothing will change. Perhaps the commercial paper system has simply become too complicated.

107 It seems that the Securities Commissions of Canada are in the best position to regulate or monitor the activity of credit rating agencies. The mandate of the securities commissions includes the provision of protection to investors. It is only reasonable to assume that the protection can be extended to include protection from credit ratings, which investors do not truly understand, and rely on too much.

108 But what kind of supervision can security commissions provide? It is yet to be established that the rating agencies did anything wrong. Some rating agencies refused to rate the commercial paper at all, while the rating agencies giving evaluations were adamant that their ratings were not investment evaluation tools. So the question remains, do regulators need to police rating agencies? Or, do people simply hear what they want to hear? Case in point: Canadian investors seemed to ignore the warnings of Moody's and Standard & Poor's.

109 Where ABCP is concerned, transparency and disclosure can only accomplish so much. When the derivatives products being examined and rated by the agencies are so incredibly complex in nature, the average, or even above average investor will still not understand the systems of either the financial structure or the analytical models utilized by the rating agencies. Part of the loss of confidence in rating agencies can be attributed to the unreasonable reliance by investors on the ratings given to structured finance notes. The rating given by the agency is meant only as an opinion as to the likelihood that the issuer will be able to meet its contractual or financial obligations as they become due. There is no recommendation to sell or buy a given security. Yet the opaque and complex nature of the structured finance instruments being rated has resulted in over reliance on ratings as an investment recommendation by uninformed investors and even those employed in the financial sector.

Should We Restrict Who Gets to Play the Game?

110 If we consider some of the elements that combined to create a terrible situation in the ABCP market, one possible adjustment that could be made to regulation becomes apparent.

111 We have created an ABCP market with two distinct demographics investing in it: (1) the small scale retail investors, even though sponsors did not originally intend this commercial paper for retail investment; and (2) large scale or corporate investors. Amongst these investors there are two levels of investment sophistication: those that do understand ABCP, and those that do not. It is unclear how much knowledge the sponsors had of the amount of ABCP that was being sold to retail investors. In theory, the dealers their financial advisors should understand the products they are selling and the clients' appetite for risk.

112 It stands to reason that the vast majority of the smaller scale retail investors belong to the group of investors that do not understand how the ABCP market functions. They, or their financial advisors, believed that a short-term investment in ABCP would be safe. This belief would generally be attributed to the short-term nature of the security along with the extremely high credit ratings assigned. Since they are smaller scale investors, they generally cannot afford a total loss of their investment in the event of a situation similar to those of August 2007. There were many, many more small scale investors involved in the non-bank ABCP market, and when the market froze their combined voices were very loud despite their relatively small investments.

113 In the restructuring efforts that followed the market freeze the small retail investors outnumbered the large corporate and institutional investors in votes, if not in investment dollars. Small scale investors who cannot afford to lose the money that they have already invested would be more likely to agree to anything that would get their money, or at least a percentage out again. Smaller investors, as they cannot afford to lose their investment, generally would not be inclined to undertake extremely expensive litigation regarding the matter, and therefore are generally not opposed to relieving the banks et al. of any liability.

114 Large corporate investors who may be able to handle the financial situation with more ease, and may be more inclined to pursue litigation regarding the market freeze and any losses they experience as a result. However, their desire to pursue litigation may be quashed by the majority of small scale investors who want to recoup some of their losses immediately.

115 Where a market is susceptible, because of its nature and structure, to events similar to that of the ABCP market, and there are distinct demographics within the investors with interests that may be at odds with one another, it may be prudent to restrict access to the market to some degree. If restriction in some form were a positive reform by consensus, how would that restriction function, and who would be responsible for carrying it out?

Current Game Master

116 In the ABCP market as was established, there are two distinct sectors, the bank sponsored sector and the non-bank sponsored sector. The non-bank sector of the market was the one destroyed by the turmoil of August 2007 resulting in a freeze of the market. The bank sponsored market escaped a freeze because the Canadian chartered banks had the requisite capital available to keep their own paper trading.

117 The bank sponsored sector of the ABCP market is somewhat under the regulation of the Office of the Superintendent of Financial Institutions of Canada (OSFI). The regulation of OSFI is felt in this segment of the market through their jurisdiction over the domestic banking industry in Canada. Conversely, the non-bank ABCP market is virtually free from any regulation whatsoever. They exist outside the statutory definition of the power of OSFI.

118 OSFI's jurisdiction is defined in the Office of the Superintendent of Financial Institutions Act[57] where it is stipulated that OSFI shall strive to protect the rights and interests of depositors, policyholders and creditors of financial institutions, having due regard to the need to allow financial institutions to compete effectively and take reasonable risks[58]. Financial institution in the Act is defined[59] as a bank within the meaning of section 2 of the Bank Act[60], and therefore as listed in Schedules I and II of the Bank Act. Since the jurisdiction of OSFI only extends, for the purposes of the ABCP market, as far as the listed Canadian banks, the non-bank sponsors of ABCP are not subject to regulation by OSFI.

119 That is not to say however, that OSFI does not have a role to play in both the resolution of this current turmoil and prevention of future turmoil. When considering their regulation of Canadian banks, OSFI has been very clear in maintaining that their primary role is protecting the rights of depositors as banks hold the life savings of many Canadians[61]. Their role as far as contributing to public confidence in the financial system is concentrated in ensuring bank safety and soundness. With regard to those goals, OSFI has begun a review of their Guideline B-5 which requires Canadian banks to delineate their roles and responsibilities in the creation of ABCP conduits, as well as defining capital requirements for loans to those conduits[62].

120 Canadian banks do provide liquidity lines for ABCP conduits, and due in part to the reviews and contributions of OSFI all such lines carried by Canadian banks are global-style arrangements. As global-style arrangements have more certainty as to when liquidity lines may be drawn on, this allows for more certainty on the bank's point of view in projections. Global-style arrangements are also better for investors in the ABCP market, as they allow for a greater ability to draw on liquidity facilities. OSFI has also increased the capital charge banks must carry in relation to such arrangements from the 10% standard set in 2004 to the current standard of 20%[63]. The required capital reserves now reflect the implicit understanding that was always there in the domestic market -- banks would always fund.

121 Despite the indirect effects on ABCP conduits through their regulation of Canadian banks, OSFI maintains that it is not their role to regulate capital markets through their power to regulate banks. It is not the mandate of OSFI to advise investors on what to invest in or not invest in, or to advise unregulated players in capital markets how to carry out their business, nor do they tell Canadian banks to whom liquidity arrangements should be extended and on what conditions[64]. They purely seek to ensure the safety and soundness of financial institutions that make promises to pay depositors and policyholders.

122 But it can be argued that OSFI did not discharge their responsibility to ensure the soundness of the banking system. It can be argued that Guideline B-5 of the Bank Act helped to create the situation by allowing for liquidity arrangements based on a market disruption event to exist in the marketplace. The liquidity providers that refused to provide funding were foreign banks while

Canadian banks injected liquidity into their conduits - effectively ignoring their own market disruption agreements. Had the Canadian banks refused to fund their own conduits (as their contracts allowed) the entire commercial paper market would have stopped functioning. This would have created demonstrable support for the argument that a market disruption event had occurred and, consequently, forced all guarantors to fund.

123 Since the sponsors of ABCP conduits are not financial institutions as defined in the Bank Act they are not subject to OSFI's regulation. Since these sponsors do not have the responsibilities of Canadian banks, an extension of OSFI's mandate would prove fruitless as an attempt to mitigate future ABCP turmoil. Non-bank sponsors only exist to create conduits. They do not provide liquidity facilities to conduits, nor do they underwrite the notes of the conduits. As these sponsors do not have depositors to whom they owe a duty, nor do they provide liquidity to conduits, there is virtually nothing that OSFI regulation could change. The question then becomes, if OSFI is not equipped or poised to do anything about the ABCP market, is there another regulator that could or should fill that role?

The Perfect Conductor

124 There really are no problems with the ABCP sponsors that are not banks, they have done everything correctly as far as setting up the conduits properly, and creating bankruptcy remoteness as is required. The only questionable decision on the part of the sponsors was possibly the choice to pursue liquidity arrangements of the general market disruption style. But even that decision was defensible at the time as the cost of maintaining liquidity lines of this style were lower, which allowed the investment opportunity to be more attractive as the investors would receive a slightly higher return. In fact, the shortcomings of Canadian-style liquidity arrangements were widely known and discussed.

125 In the end it seems that the protection of the public, and the regulation of the ABCP market, must lie with the combined securities commissions of Canada.

126 ABCP, for all its complexity, is a just form of security and therefore within the jurisdiction of the securities commissions of Canada. In Canada, there is no federal oversight of capital markets and their products. Each province and territory has its own securities regulator that has jurisdiction within that province or territory. Since developments and innovations in capital markets take place in such a rapid way, the enabling legislation of the commissions gives the power to enact rules and policies that carry the force of law.

127 This system allowing each of the thirteen commissions to create their own rules and policies independent from the other jurisdictions of the country has been the subject of much criticism in the past. For a very long time the rules and policies in each province could be and were very different. To deal with these criticisms and the lack of cohesion in such a boundary spanning area, the securities commissions worked together to establish The Canadian Securities Administrators (CSA)[65] to serve as a central securities regulation body. At the CSA, rules and policies are developed by bringing the various commissions together with the result being a more harmonized regulatory system across the country. Once a rule or policy is developed, it is then enacted by each individual jurisdiction, possibly with small adjustments to tailor the policy to the needs of the jurisdiction, and thereby the securities regulation across the country becomes much more consistent.

128 There is already a central body established, so there is a forum for talks amongst the commissions to take place in addressing the changes that need to be made to their regulations. As there is already regulation concerning negotiable instruments such as ABCP, it is adjustments that must be made, not creation.

129 There are two basic requirements under Canadian securities law regardless of the jurisdiction. The first is registration. The second is the requirement to file a prospectus with the appropriate commissions.

130 Where a person or company wants to trade in a security or act as an advisor or underwriter, they must register with the requisite securities commission[66], unless there is an exemption available from the requirement to register. The commissions want to know who is functioning in their jurisdiction, in what capacity, and what would grant that person or company the specialty or expertise to function in that role. But, registration for certain kinds of securities is exempt. ABCP is one of the exempt forms of security. If the term of maturity on the ABCP is less than one year and the principal amount is not less than $50,000, the exemption from registration is granted[67].

131 When an entity wants to distribute a security to the public, in this case the ABCP conduits, they must file a prospectus with the applicable commission[68] unless there is an exemption available from this requirement. A prospectus is a very large, comprehensive disclosure document filed by the issuer of the security, and made available to investors who will then, in theory, know what is going on upon reading and understanding the document. In the case of ABCP, the commissions have established in their policies that when any commercial paper (corporate or structured) has a maturity date of less than one year from the date of issue and has an approved credit rating from an approved credit rating organization the prospectus requirement does not apply[69]. The commissions define "approved credit rating" in their policies as a rating that is either at or above the list of ratings given in the policy. The policies define "approved credit rating organization" as being any one of a list of agencies given in the policy, or their successors[70].

132 In Canada, there was only one credit rating agency assigning ratings to ABCP: DBRS Ltd. As DBRS is listed in the policy of the securities commissions as being an "approved credit rating organization", and the ratings assigned were of a high enough quality, the ABCP conduits were exempt from filing a prospectus when distributing their securities to investors. This means that there was absolutely no disclosure from the issuer of the ABCP to the eventual investors.

133 In the case of ABCP, the securities commissions relied completely on the assessments of the credit rating agency. This exemption from the prospectus requirement then creates an interesting dynamic in the ABCP market; no prospectus from the issuer means extremely limited disclosure about the security, this means that investors and advisors are virtually forced to rely on the assessments and ratings of credit rating agencies. Credit rating agencies insist that their ratings are not intended for use as recommendations on the securities, but where there is no disclosure by the issuer what other due diligence options are available to the investor?

134 Regardless of the problems as they stand today, the securities commissions have the authority and jurisdiction to adjust ABCP regulation in such a way that their goal of protecting investors could be achieved. It should be noted that many asset-backed securities with terms longer than one-year are issued without a prospectus using a private placement exemption. Requiring full, true and plain disclosure would destroy most of the commercial paper market due to prohibitive disclosure costs. It stands to reason that some compromise must be met in order to maintain an efficient market while protecting the investing public.

Amending the Sheet Music

135 To be fair to the securities commissions, the rules and policies relating to commercial paper was created years ago before the extreme innovation in the ABCP market. The regulation regarding commercial paper was conceived to deal with traditional "plain-vanilla" asset-backed securities, not the complex derivative based products that had surfaced in the last few years. While it can be argued that the commissions should have watched a niche market that traded tens of billions of dollars worth of securities on a monthly basis more closely, those are arguments to be made another day. The focus should be to effect regulatory changes and avoid a similar problem.

136 The first possible regulatory change regarding ABCP could be in relation to the exemption from the prospectus requirement. The exemption says that where ABCP has a maturity of less than one year and it carries an approved credit rating from an approved credit rating organization a prospectus is not required. But there is a condition on that exemption in the policy; it states that a security does not have satisfy the exemption where any approved credit rating organization has rated the instrument with a rating lower than the list of approved rating levels. In Canada, DBRS was the only approved credit rating organization assigning ratings to the ABCP instruments as other approved credit rating organizations refused to issue ratings. Both Moody's Investors Service Inc. (Moody's) and Standard & Poor's Corp. (S&P) refused to rate non-bank ABCP in Canada, with S&P stating that they would not rate a product with only market disruption liquidity facilities[71].

137 So it is obvious that S&P's, and likely Moody's, belief was that the structure of the non-bank ABCP in Canada was not satisfactory. And, if that is true, had they rated the product, they may not have achieved an approved credit rating as required by the regulations. Their outright refusal to rate the ABCP was not enough to fit within the condition to the prospectus requirement. Had they provided some rating below the approved level, the conduits would have been forced to either file a prospectus or alter their structure to include global-style liquidity assurances providing more protection for investors.

138 A simple change could be made to the condition attached to the prospectus exemption to include approved rating agencies that refuse to issue a rating based on structural concerns. In most other jurisdictions, there are multiple ratings issued for each ABCP instrument, yet only DBRS Ltd. rated non-bank ABCP in Canada. One possible solution would be to require at least two approved credit ratings from at two different approved credit rating organizations for the exemption to apply. An extension of this concept might be to also regulate the ratings agencies themselves since so much turns on their credit ratings. However, the securities commissions are not equipped to resolve methodology disputes between the rating agencies. There is some merit to this line of thinking but the subject matter is beyond the scope of this paper.

139 For ABCP, the prospectus requirement has the potential to be the most potent line of defence available to investors. The creation of a prospectus is a lengthy and expensive process that would require comprehensive financial data, legal counsel and a great amount of disclosure about the structure, function and management of the issuer. Since ABCP is meant to be a short-term investment by an issuer that expends as little money as possible, they seek to avoid filing a prospectus. By tightening the requirements to qualify for an exemption, we ensure that there is a minimum level of investor protection through basic features that must be present in the conduit for the exemption to apply. And, if the exemption does apply, there should be greater certainty associated with the credit ratings upon which the public bases its investment decisions.

140 A second change, and possibly the most effective, that regulators can make would be regarding who qualifies to invest in the ABCP market. This restriction on access could take on a variety of forms which will be examined.

141 It is established that thousands of small scale retail investors entered into the ABCP market not knowing how the market functions, and they were generally not in a position to lose their investment[72]. The most extreme form of restriction is obviously a total restriction of access to small scale investors. This could be achieved through the use of the accredited investor exemption. It would state that only "accredited investors" are eligible to purchase ABCP instruments, with "accredited investor" being a defined term in the policies of the Commissions.

142 An accredited investor, according to the Ontario Securities Commission (OSC), can take a variety of forms including Canadian financial institutions as defined in the Bank Act, the government or government agencies, investment funds, or individuals. For an individual to qualify as an accredited investor, they must meet one of three tests ascribed in the policy: (1) the total cash or securities held, not including property, either alone or with a spouse must equal or exceed $1 million; (2) the net yearly income of the individual must meet or exceed $200,000 or $300,000 when a spouse's income is included, there must have been that income level for each of the last two years with a reasonable expectation of similar earnings in the current year; or (3) the net assets, including property, of either an individual or together with a spouse must meet or exceed $5 million[73].

143 The accredited investor stipulation attached to ABCP would remove virtually all small scale retail investment from the ABCP market. Only individuals with exceptional earning potential and assets would even be eligible to participate in the market. These individuals would necessarily have a greater financial sophistication than their small scale counterparts, as well as access to a greater scope of financial advice. While the inclusion of the accredited investor threshold could be a very viable change that the securities commissions could make, it leaves a question lingering in the mind. Is the accredited investor requirement a high enough threshold?

144 Even accredited investors may not be in a position to truly understand the function of the market, and despite their financial success it is likely that they are not in a position to lose their investment completely. It may be that the threshold numbers for an accredited investor as far as the ABCP market is concerned must be even more restrictive. It seems that there are two possible ways to restrict access to the ABCP market further from this point.

145 One way would be to completely rewrite the accredited investor exemption into a sort of accredited ABCP investor threshold. What the required numbers would be would necessarily be the subject of much analysis and debate, but considering the nature and complexity of the ABCP market doubling all the figures in the accredited investor exemption does not seem unreasonable.

146 Another way that the ABCP market could be restricted without rewriting the accredited investor definition could be to create a double threshold to enter the market. So, in addition to being an accredited investor as defined by securities regulation, perhaps there would also be a minimum investment requirement. That is, the accredited investor may have the requisite asset value or cash flow, but the investment into the ABCP market must total at least $250,000 for example.

Will the Music End on a High Note?

147 In the end we are left with a terrible situation where a total collapse in consumer confidence led to suspicion of the Canadian ABCP market. Investors ceased to purchase ABCP notes, while there were near simultaneous margins calls on ABCP conduits. This created a state of illiquidity in the ABCP market causing the freeze, which has lasted over a year. The Investors Committee began hearings through the CCAA to have their restructuring plan for the ABCP market approved. The large number of small scale retail investors in the market outnumbered the large corporate players through the "equality" of the CCAA voting process. The restructuring plan was approved, inclusive of the comprehensive release from liability clauses.

148 The situation in the ABCP market highlighted issues in the operation of credit rating agencies, including potential conflicts of interest and transparency. The situation also highlighted issues in the ABCP market itself in terms of a lack of transparency which contributed to a loss in consumer confidence and resulted in undue reliance on the credit rating system. There was also an issue identified in the regulation of the non-bank sponsored ABCP market, in that there was none. The companies creating the ABCP conduits are not within the regulatory power of OSFI as they do not fall even close to within the definition of a financial institution as defined in the Bank Act. The power to regulate over these securities rested with the combined securities commissions of Canada, but their regulation was such that an exemption from regulation was easily achieved. Thus, by crossing all of their "T's" and dotting all of their "I's" the ABCP conduits were able to achieve a virtual blanket exemption for all of their securities distributions.

149 How can this kind of problem be solved? There may be a potential issue with the lack of transparency created by the ABCP conduits and their structures. But the nature and complexity of the ABCP market creates a situation where transparency is almost impossible to achieve, and practically speaking even if it were achieved, the vast majority of investors would not understand what was being disclosed to them. There is no point in exerting control over an area of regulation and pouring resources into changes that will have very little effect on the reality of the market.

150 So the solution must lie where changes can be made that will actually create a change in the marketplace. First, an adjustment in the function of credit rating agencies would be welcome, as change there could potentially eliminate these conflicts of interest and foster greater consumer confidence. Second, changes by the securities regulators could remove unreasonably low standards for exemptions in the ABCP market, and restrict access to the market to sophisticated investors such as corporations or individuals with truly extraordinary wealth. But then the question has to be asked as well, do regulators really need to do anything? Additional government regulation inevitably has the effect of addition costs to all parties concerned, and in this case, are the involved parties not already scrambling to rectify the situation and make adjustments to the methodologies that were used? It seems that, to a large degree at this point, the market has corrected itself without any additional regulation:

1. The non-bank sponsored ABCP market no longer exists in Canada;

2. All bank sponsored conduits have now adopted global-style liquidity (mandated by the credit rating agencies);

3. All bank sponsored conduits now have a Moody's or S&P rating in addition to a DBRS rating (investors demanded it); and

4. Dealers are reluctant to place ABCP with retail investors.

151 Whether or not additional regulation is needed must be examined carefully. The commercial paper market was created well over a decade ago in a much simpler form than what exists today. Even so, it was never intended as a market for the average investor to participate in. With the rapid innovation and complexity of today's derivatives market, how much more unsuitable is the market for the average investor? It appears that the first step in returning sanity and stability to a reeling market is restricting access to the market to remove those investors that were never meant to enter. But once again, with today's rapid innovation and complexity, where the market goes next is anyone's guess.

* * *

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Notes

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