Some are 'road kill,' says Urquhart

By KEN MARK

The long, winding journey that was the asset-backed commercial paper negotiation is over. In January, court approval of a restructuring plan ended a 17-month ordeal for disgruntled investors, unlocking $32 billion in assets frozen since August 2007.

The clear winners are the 1,780 retail investors holding less than $1 million each in ABCP.

"By midday Jan. 30, about 1,440 Canaccord investors had their accounts credited with amounts equal to the par value of their original notes and their share of the restructuring costs," says Scott Davidson, Toronto-based managing director, global head of marketing and communications for Canaccord Capital Inc.

"A week earlier, they received the full amount of their accrued interest. The total payout is between $120 million and $140 million."

The other retail investors were made whole by a similar plan from Credential Financial Inc.

Not so lucky are the 36 individuals — rather than corporate investors — holding more than $1 million in ABCP. They face the worst of both worlds. They will not be receiving any payments from sellers, nor can they sue them for liability, because as part of their participation in the Companies' Creditors Arrangement Act restructuring plan, they waived such rights.

"They are collateral road kill," says Diane Urquhart, Mississauga-based independent financial analyst. "Many of them are older investors who were counting on their ABCP investments to fund their retirement. As individuals, not corporations, they are paying for legal costs out of their own pockets without much chance of getting any of that money back."

Urquhart estimates that the group is holding about $350 million in toxic assets.

Despite the liability waiver, there still remains a possible remedy for the 36 individuals and other investors. It comes in the form of augmentation or top-up payments from government regulators such as the Ontario Securities Commission (OSC) and self-regulatory industry groups specifically, the Investment Industry Regulatory Organization of Canada (IIROC) for investment brokers and dealers.

"Some of these investors have approached us to push forward with the regulators to seek a class-wide or mass order rather than individual suits related to specific ABCP-related business practices that contravene OSC and IIROC regulations," says Toronto lawyer, Henry Juroviesky.

According to Urquhart, the regulators are empowered to act in the public interest when their regulations have been breached. The actions of the OSC and IIROC are duplicative — they can work together or separately and independently on the same case using similar but not identical processes. These include holding internal disciplinary hearings before an adjudicator (such quasi-judicial actions closely resemble Institute of Chartered Accountants of Ontario professional misconduct hearings).

After the hearing, if adjudicators decide that the regulator's rules have been breached based on the regulator's in-house investigation staff reports and the investors' lawyers presentations, they can set the terms and conditions of the augmentation payments.

Or regulators can issue a letter to both sides seeking a voluntary settlement. If they agree, a hearing becomes unnecessary. The regulator then decides how the settlement funds will be distributed. Such actions are not considered civil litigation, so they are not subject to the ban on third-party liability suits.

However, a perhaps more relevant legal issue is the ABCP restructuring plan, which contains a clause preventing regulators from taking such actions. Juroviesky claims that this ban is beyond the powers of CCAA legislation. Ultimately, a court will have to decide its admissibility.

URQUHART

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The key financial element of the restructuring plan involved repackaging the original ABCP assets into new notes and returning them to the investors.

Now the third investor group consisting of corporate note holders large and small has to decide what to do with their repurposed notes. Several Quebec-based investors such as the Caisse Populaire, with $13.2 billion, hold the majority of the value of ABCP paper.

Since many of them have deep pockets and long-term investment horizons, they are expected hold on to the notes until maturity. For many of the underlying assets that could be as late as 2017.

In the meantime, other corporate investors may decide to sell the repackaged notes into the secondary market. In late December, DBRS conferred a single-A rating on the ABCP notes, down from a provisional AA rating in April 2008.

"Many things have changed since our earlier ratings," says James Feehely, a DBRS spokesperson. "One of them is the structural element. There has been a considerable widening of the spread between the value of the underlying assets and the credit default swaps (CDSs) held by counterparties. The spread indicates the level of market risk.

"There is also increased funding risk. That occurs when a note holder need to pledge additional funds to support the underlying asset value when it falls below pre-set spread loss triggers, by meeting the counter party's request for additional collateral."

However, the DBRS rating may not be enough to calm jittery investors. "The single A rating is likely to be dismissed," says Daryl Ching, Toronto-based vice-president, Canadian Hedge Watch. "In the past, such a rating was considered to provide a 95 per cent comfort level with only a five per cent risk of possible default.

"Many market observers now believe the model is broken. During the summer, the prevailing view was that most underlying assets would fetch par if held to maturity. Then things got worse. Some investors are expecting more Lehman-Brothers bankruptcy-type events to happen."

Another millstone weighing down the market is the 18-month moratorium on collateral calls. It was a condition required by the federal, Ontario, Quebec and Alberta governments for establishing a $3.5 billion super-senior standby line of credit in late December.

This 11th hour commitment was crucial to finalizing the CCAA restructuring plan since it satisfied the foreign banks' need for a further financial backstop to ensure their continued participation. Without it, the reconstruction plan would have failed.

However, the 'cooling off' period could increase market uncertainty. "During the moratorium, only vulture buyers making stink-bids will be active," says Urquhart.

"Investors need to be able to predict what an unfettered market will look like in the 19th month, i.e., what the credit default swap price will be at that time. If value of underlying asset slips below the pre-set trigger point, the holder needs to make collateral payments to the counterparty to continue holding the CDS contract. Such risks will not attract buy-and-hold investors."

With the ink barely dry on the ABCP restructuring plan, serious discussions are already emerging about how to prevent the fire next time. At the top of the list is the proposal to establish a single national securities regulator. But views differ on how such a regulator could have averted the ABCP debacle.

"A single regulator in place prepared to deal with complex investments that posed problems of market liquidity and systemic risk could have prevented ABCP," says Tom Hockin, chair of the Expert Panel on Securities Regulation.

But lawyer Purdy Crawford, who essentially devised and oversaw the restructuring plan, holds a contrary view. Asset-back commercial paper "was an unprecedented problem involving exempt securities markets," he says.

"As a firm believer in a single national securities regulator, I still think having one in place would not have made a damn bit of difference."

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