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British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut

c/o

The Secretary
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comments@osc.gov.on.ca

-and-

Me Anne-Marie Beaudoin
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Ladies and Gentlemen,

RE: CSA Notice and Request for Comment on the Modernization of Investment Fund Product Regulation – Alternative Funds

Thank you for the opportunity to comment on the Canadian Securities Administrators' ("**CSA**") Notice and Request for Comment on the Modernization of Investment Fund Product Regulation – Alternative Funds (the "**Proposed Amendments**").

This letter represents the general comments of certain members of the Financial Products & Services practice group at Stikeman Elliott LLP (and not those of the firm generally or any client of the firm) and is submitted without prejudice to any position taken or that may be taken by our firm on its own behalf or on behalf of any client.

While we expect that the consolidation of the rules applicable to publicly offered investment funds in a single instrument will bring added coherence and simplicity to investment fund regulation in Canada, we have concerns with some of the investment restrictions proposed for alternative funds and non-redeemable investment funds and the absence of any grandfathering provisions for existing funds.

We have provided our responses to some of the questions posed by the CSA below followed by commentary on specific aspects of the Proposed Amendments that are not addressed by the questions posed by the CSA.

A. Responses to CSA Questions

Question 1 – Under the Proposed Amendments, we are seeking to replace the term "commodity pool" with "alternative fund" in NI 81-102. We seek feedback on whether the term "alternative fund" best reflects the funds that are to be subject to the Proposed Amendments. If not, please propose other terms that may better reflect these types of funds. For example, would the term "non-conventional mutual fund" better reflect these types of funds?

In our view, an alternative fund should be able to select a redemption frequency of its choice (i.e., weekly, monthly, quarterly or no redemptions at all) based on its investment strategy, liquidity features and other investment, operational and market considerations.

In this regard, the CSA should ensure alignment of the NAV calculation requirements and redemption pricing under National Instrument 81-106 *Investment Fund Continuous Disclosure* ("**NI 81-106**"). Section 14.2(3) of NI 81-106 requires investment funds to calculate NAV at least weekly or daily. Sections 9.3 and 10.3 of National Instrument 81-102 *Investment Funds* ("**NI 81-102**") require that investment funds determine the issue price and the redemption price of investment securities at the NAV per security next determined after the receipt of the purchase or redemption order, respectively. These provisions in combination can result in, for example, an investment fund with a monthly redemption date redeeming investors at different NAVs per security per day. We encourage the CSA to remedy this incongruity. Alternative funds that do not have daily redemptions should have the flexibility to specify a redemption pricing date in a manner that is similar to the flexibility granted to exchange-traded mutual funds pursuant to section 10.3(2) of NI 81-102.

We do not believe that the proposed addition of section 10.3(5) provides sufficient flexibility.

Question 3 – We are proposing to raise the concentration limit for alternative funds to 20% of NAV at the time of purchase, meaning the limit must be observed only at the time of purchasing additional securities of an issuer. Should we also consider introducing an absolute upper limit or "hard cap" on concentration, which would require a fund to begin divesting its holdings of an issuer if the hard cap is breached, even passively, which is similar to the approach taken with illiquid assets under NI 81-102? Please explain why or why not.

Given the variety of potential strategies pursued by alternative funds, we would recommend that the CSA carefully consider whether conventional concentration limits would be appropriate. In particular, the CSA might consider whether timely and appropriate disclosure in the investment strategies and Management Discussion & Analysis of an alternative fund would be desirable instead of imposing a "hard cap" on concentration.

If the CSA imposes a "hard cap", a reasonable period of time should be allowed to facilitate divestment on a basis that would not adversely impact investment returns. The standard for divestment in the case of the illiquid assets restriction, being "as quickly as is commercially reasonable", is a helpful benchmark. In addition, timely exemptive relief from the concentration restriction should be readily available in appropriate circumstances.

Question 4 – We are not proposing to raise the illiquid asset limits for alternative funds under the Proposed Amendments. Are there strategies commonly used by alternative funds for which a higher illiquid asset investment threshold would be appropriate.

We encourage the CSA to use this consultation as an opportunity to consider whether the term "illiquid asset" can be updated to reflect current market realities. NI 81-102 defines "illiquid assets" by reference to whether a portfolio asset can be "readily disposed of through market facilities on which public quotations in common use are widely available at an amount that at least approximates the amount at which the portfolio asset is valued in calculating the net asset value per security of the mutual fund". The definition is difficult to apply in practice because it uses several terms that may be subject to differing interpretations. Furthermore, other factors may be determinative in identifying non-illiquid assets. If the portfolio asset may be disposed of on an arm's length basis outside of a public market and without delay, such portfolio asset should not necessarily be deemed to be an illiquid asset. In this regard, the United States Securities and Exchange Commission's ("**SEC**") approach to defining "illiquid assets" is instructive. Under SEC Rule 22e-4, an "illiquid investment" is defined as:

> any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment

The primary advantage of this definition is that it is flexible because it does not rely on the characteristics of the market or the quotation to determine whether it is an illiquid asset. The definition is only tied to whether the fund has a reasonable expectation that the asset can be disposed of within seven days without a significant impact on market value. We submit that the ability to dispose of a security within a period of seven calendar days is also an appropriate interval for mutual funds under NI 81-102, particularly in light of the restrictions on the percentage of illiquid securities can be held by mutual funds. For example, in its September 2014 whitepaper "*ViewPoint* – Fund Structures as Systemic Risk Mitigants", BlackRock Inc. advises that "40 Act Funds are permitted to wire proceeds within seven days after receiving a redemption order. However, funds typically meet redemption requests within a shorter time frame and would not avail themselves to the seven day redemption period other than in extraordinary circumstances."[1] We do not see why the experience in Canada would be different. For this reason, we do not believe that a liquidity test based on a seven-day interval would be inconsistent with the requirement under section 10.4 of NI 81-102 for a mutual fund to pay redemption proceeds within three business days after the relevant date set forth in section 10.4(1)(a) or (b).

We would encourage the CSA to consider adopting an SEC-type definition modified to meet any policy objectives specific to the Canadian market. We expect that a revised definition of "illiquid asset" coupled with Companion Policy guidance and specified exclusions would be easier to apply.

Question 5 – Should we consider how frequently an alternative fund accepts redemptions in considering an appropriate illiquid asset limit? If so, please be specific. We also seek feedback regarding whether any specific measures to mitigate the liquidity risk should be considered in those cases.

Question 7 – Although non-redeemable investment funds typically have a feature allowing securities to be redeemable at NAV once a year, we also seek feedback on whether a different limit on illiquid assets should apply in circumstances where a non-redeemable investment fund does not allow securities to be redeemed at NAV.

Liquidity requirements are much less relevant for alternative funds and non-redeemable investment funds that have minimal, or no, redemption rights. Accordingly, we encourage the CSA to reconsider its proposal to introduce an investment limit in illiquid assets for all non-redeemable investment funds and for all alternative funds, even where they have limited, or no, redemption features.

The requirement that an investment fund maintain a certain proportion of liquid assets is important where the investment fund has regular and potentially significant cash obligations, such as a daily redemption feature or margin calls by derivative counterparties. Non-redeemable investment funds and alternative funds that have limited, or no, redemption rights are not subject to significant liquidity requirements and should not have a limit on illiquid assets. This view is consistent with the views expressed by the International Organizations for Securities Commissions:

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[1] See https://www.blackrock.com/corporate/en-fi/literature/whitepaper/viewpoint-fund-structures-as-systemic-risk-mitigants-september-2014.pdf.

> The responsible entity should set appropriate liquidity thresholds which are proportionate to the redemption obligations and liabilities of the CIS.
>
> The responsible entity should set appropriate internal definitions and thresholds for the CIS's liquidity, which are in line with the principle of fair treatment of investors and the CIS's investment strategy. The thresholds should act as a signal to the responsible entity to carry out more extensive in-depth, quantitative and/or qualitative liquidity analysis as part of the risk management process (with the intention that the responsible entity would then take appropriate remedial steps if the analysis revealed vulnerabilities).
>
> For example, a daily dealing CIS would be expected to have stricter liquidity requirements than a CIS sold on the basis that investors would not be expected to redeem before a set period expired; or a CIS that invested predominantly in real estate but promised frequent redemption rights to its investors might consider it appropriate to hold a relatively large stock of more liquid assets (which could be related to real estate) as well, because of the expected length of time it would take to dispose of physical properties in order to meet redemption requests.
>
> A responsible entity could place stricter internal thresholds on liquidity than its local regulatory requirements.[2]

Limiting the ability of an investment fund to invest in illiquid assets without accounting for the fund's terms, conditions and policies can result in investors bearing unnecessary costs in the form of reduced returns.

Question 8 – Should alternative funds and non-redeemable investment funds be permitted to borrow from entities other than those that meet the definition of a custodian for investment fund assets in Canada? Will this requirement unduly limit the access to borrowing for investment funds? If so, please explain why.

Alternative funds should be permitted to borrow from a broader pool of entities than those that meet the definition of a custodian for investment fund assets in Canada (e.g., qualified prime brokers regulated in the U.S., the U.K or other major markets) provided any such entity is subject to prudential supervision or other regulatory oversight in its home country jurisdiction. Access to a deeper and more diversified pool of lenders may help reduce the alternative fund's exposure to a more concentrated pool of qualified lenders and limit associated systemic risks while also assisting alternative funds in obtaining competitive market rates for loans in a foreign-denominated currency. Furthermore, in circumstances where collateral is not physically delivered, a fund bears no counterparty risk as borrower.

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[2] International Organizations for Securities Commissions, Principles of Liquidity Risk Management for Collective Investment Schemes, March 2013,
<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf>

Question 11 – We note that the proposed leverage calculation method has its limits and its applicability through different type of derivatives transactions may vary. We also acknowledge that the notional amount doesn't necessarily act as a measure of the potential risk exposure (e.g. interest rate swaps, credit default swaps) or is not a representative metric of the potential losses (e.g. short position on futures), from leverage transactions. Are there leverage measurement methods that we should consider, that may better reflect the amount of and potential risk to a fund from leverage? If so, please explain and please consider how such methods would provide investors with a better understanding of the amount of leverage used.

We endorse the positions reflected in the letter dated December 22, 2016 by the Alternative Investment Management Association. The use of gross notional amount of specified derivatives is not necessarily an appropriate portfolio leverage limit. The SEC described this measure, accurately in our view, as a "relatively blunt measurement".[3] In our view, any leverage definition for specified derivative exposure should include an element of netting of risk-mitigating instruments. Rather than being overly prescriptive, we encourage the CSA to continue the principles-based approach in NI 81-102 and exclude from the exposure limit calculation any exposure associated with derivatives transactions that may be used to hedge or cover other transactions.

Question 15 – We seek feedback from fund managers regarding any specific or unique challenges or expenses that may arise with implementing point of sale disclosure for non-exchange traded alternative funds compared to other mutual funds that have already implemented a point of sale disclosure regime.

Under the Proposed Amendments, non-redeemable investment funds will be one of the few investment funds that cannot transact based on a summary disclosure document once ETF Facts disclosure is implemented in September 2017. The policy reasons for excluding non-redeemable investment funds from point of sale disclosure obligations are unclear given the CSA's objective of harmonizing disclosure regimes.

B. Other Comments on the Proposed Amendments

1. *Grandfathering*

We respectfully submit that existing commodity pools and non-redeemable investment funds should be grandfathered from the investment restrictions in the Proposed Amendments that would be newly applicable. Furthermore, we encourage the CSA to inform the market as soon as possible of any grandfathering that will be permitted and the nature of such grandfathering in the interests of market efficiency. Grandfathered funds should be permitted to conduct their business and operations in compliance with their constating documents and the previously applicable rules.

Securityholders that have invested in non-redeemable investment funds prior to the enactment of the Proposed Amendments should not be forced to decide between either

[3] See "Use of Derivatives by Registered Investment Companies and Business Development Companies," Release No. IC-31933 (Dec. 11, 2015), available at: http://www.sec.gov/rules/proposed/2015/ic-31933.pdf.

maintaining their investment in a materially different investment product or redeeming or otherwise disposing of their interest in the investment product with potentially adverse tax consequences. Furthermore, there may be significant costs to existing funds that are required to change their operations or liquidate a position in their portfolio as a result of newly imposed regulatory requirements. This could have an adverse effect on investors.

2. *Derivatives Terminology and Rehypothecation*

NI 81-102 contains derivatives-related terminology that is vague and inconsistent with established terms used by market participants. We would encourage the CSA to address these concerns as part of this consultation. We adopt the comments made by the International Swaps and Derivatives Association ("**ISDA**") in this regard in its comment letter dated October 17, 2002 regarding Proposed Amendments to NI 81-102 and have attached the comment letter as Schedule "A" hereto for ease of reference.

We also recommend that the guidance on rehypothecation of collateral for OTC derivatives provided by the OSC in the April 2016 edition of the Investment Funds Practitioner be clarified.

3. *Distribution Through Exempt Market Dealers*

We reiterate our remarks in our October 11, 2016 comment letter on Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("**NI 31-103**") and its Companion Policy, National Instrument 33-109 *Registration Information* and OSC Rule 33-506 *(Commodity Futures Act) Registration Information* dated July 7, 2016 (the "**EMD Amendments**") and note that, as currently proposed, the EMD Amendments would prohibit the sale by an exempt market dealer of prospectus-qualified mutual fund securities to qualified accredited investors, although the exempt market dealer could continue to sell, to the same class of investors, non-prospectus-qualified pooled funds (which are subject to less regulatory oversight) created for the same strategy. In addition, if the Proposed Amendments are adopted, exempt market dealers which currently offer alternative strategies in a pooled fund format to qualified accredited investors could not offer the same strategy in an NI 81-102-compliant prospectus-qualified format to the same class of investors. Significantly, these additional restrictions would come at a time when the CSA have already implemented robust exempt market reform and CRM2 amendments which exempt market dealers have had to work into their compliance programs in order to continue to service the exempt market for investment fund products.

The exempt market dealer category of registration is critical to the business model of independent manager-manufacturers of conventional mutual funds and would be equally critical to sponsors of NI 81-102-compliant alternative funds. If adopted, the EMD Amendments may deprive these managers of access to the institutional market, access which is vital to the design, development and evolution of new and competing demand-driven asset management solutions in a mutual fund format. Significantly, the dealer registration exemption in section 8.6 (Investment fund trades by adviser to managed account) of NI 31-103, as amended, would not address this gap since advisory arrangements

in the institutional market covering a manager-manufacturer's mutual fund product solutions are commonly entered into on a non-discretionary basis.

4. *Definition of "Designated Rating"*

We note that the credit ratings of major U.S. banks were downgraded in late 2015, among other reasons, on the prospect that the U.S. government would be less likely to provide support to its banking system. External market events such as this one may have the effect of materially reducing the pool of counterparties which meet the prescribed "designated rating" requirements under sections 2.7ff of NI 81-102, with the result that established ISDA arrangements have to be abruptly renegotiated with new counterparties and that NI 81-102-governed investment funds as a whole become exposed to a more concentrated pool of acceptable counterparties (e.g., Canadian banks only). We would recommend that the CSA consider articulating certain limited exceptions to the "designated rating" requirements in circumstances, such as this, where there is an industry-wide, rather than an institution-specific, ratings downgrade that may broadly disrupt a manager's existing counterparty arrangements because of the technical constraints of this definition.

* * *

We thank the Canadian Securities Administrators for the opportunity to comment on the Proposed Amendments and we would be pleased to discuss these issues further.

"Junaid Subhan"

Junaid Subhan
on my own behalf and on behalf of

Alix d'Anglejan-Chatillon
Jeffrey Elliott
Darin R. Renton
William Scott
Ramandeep Grewal
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SCHEDULE "A"

ISDA COMMENT LETTER RE: PROPOSED AMENDMENTS TO NI 81-102

ISDA

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October 17, 2002

By fax and email

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Dear Sirs/Mesdames:

Re: Proposed Amendments to National Instrument 81-102

The purpose of this letter is to comment on the proposed amendment to National Instrument 81-102 Mutual Funds and, in particular, on those aspects of NI 81-102 relating to swaps. The Canadian members of ISDA that are counterparties to transactions with mutual funds believe that the proposed amendments, while helpful, do not sufficiently correct or clarify the existing deficiencies in NI 81-102. It will remain difficult for mutual funds to satisfy themselves that they comply with the instrument and, therefore, that they are able to enter into swaps.

Canadian ISDA members would welcome an opportunity to assist in providing drafting suggestions or information about the swaps market that may assist you in

clarifying the language. While we hope it would be possible to accomplish the required changes in this round of amendments, we appreciate that it may not be and we would strongly encourage you to continue to evolve this instrument in terms of its application to swaps.

ISDA wishes to emphasize that it is not commenting on the basic principle of the instrument, i.e., that mutual funds should not use derivatives to provide leverage. The comments in this letter repeat many of the comments made in our letter to the Ontario Securities Commission dated July 24, 2000.

Section 2.8(1)(f)

Our focus is on section 2.8(1)(f), which is the section with respect to entering into or maintaining a swap position for purposes other than hedging.[1] The fund cannot enter into or maintain a swap unless certain coverage exists for its "long position" and its "short position". Our general comment is that these provisions employ concepts relevant to options that are not relevant to the swaps market and they are, consequently, difficult to understand and apply in that context. Our specific comments are as follows:

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[1] 2.8(1) A mutual fund shall not
(f) enter into, or maintain, a swap position unless
(i) for periods when the mutual fund would be entitled to receive payments under the swap, the mutual fund holds cash cover in an amount that, together with margin on account for the swap and the market value of the swap, is not less than, on a daily mark-to-market basis, the underlying market exposure of the swap; and
(ii) for periods when the mutual fund would be required to make payments under the swap, the mutual fund holds
(A) an equivalent quantity of the underlying interest of the swap,
(B) a right or obligation to acquire an equivalent quantity of the underlying interest of the swap and cash cover that, together with margin on account for the position, is not less than the aggregate amount of the obligations of the mutual fund under the swap, or
(C) a combination of the positions referred to in clauses (A) and (B) that is sufficient, without recourse to other assets of the mutual fund, to enable the mutual fund to satisfy its obligations under the swap.

"margin on account"

With respect to its long position (i.e. it obligation to receive delivery of the underlying interest - in the case of a physically settled swap presumably - or cash) the aggregate of the following three things must at least equal the underlying market exposure of the swap:

- cash cover held by the fund
- margin on account for the swap
- the market value of the long position of the swap

Is the reference to margin on account for the swap a reference to the collateral or margin that the mutual fund has delivered to the counterparty or is it a reference to collateral or margin which the counterparty has delivered to the mutual fund? Presumably the latter, but this should be clarified because we believe that in other parts of the section the same phrase is used to refer to margin provided by the mutual fund.

Also, what is meant by "margin"? In the derivatives area, there are very popular alternative means of collateralizing transactions that do not involve taking a security interest in the property delivered. It would be helpful to have a definition of "margin". In particular, it would be beneficial to have a definition that contemplates collateralization that is not in the form of a security interest. We would be happy to provide information as to what alternative forms of credit support are being used in the market.

Further, typically credit support is provided on a net basis, so that if the mutual fund has several transactions in place with a counterparty, some of which are in-the-money and some of which are out-of-the-money, the collateral is posted for the net exposure and covers all transactions. Presumably the removal of the word "particular" from the existing instrument is intended to permit the mutual fund to consider credit

support provided on such a basis as being "margin on account" for the swap. However, on what basis is the mutual fund to allocate the margin when it is provided on the basis of the net exposures under a group of swaps?

"market value of the long position of the swap"

There is no definition of "market value of the long position of a swap" in NI 81-102. In 13.5(3)[2] it states that the "value" of a swap is the gain or loss on the contract that would be realized if, on the date that valuation is made, the position in the swap were to be closed out. This is a calculation that nets the "short" and "long" positions. Presumably, this concept is not the one that is to be used in determining the market value of the "long position" of the swap. But, if not what is the market value?

Distinguishing between market value and underlying exposure makes sense in the context of options, but in the swaps context market value (if there is one) is really the same concept as exposure.

"underlying market exposure of the swap"

As noted above, the cash cover, the margin on account and the market value of the swap have to be at least equal to the "underlying market exposure of the swap", calculated on a daily mark-to-market basis.

"Underlying market exposure"[3] with respect to a swap means "the underlying market exposure, as calculated under paragraph (b) [of the definition of underlying

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[2] **Valuation of Specified Derivatives** – A mutual fund shall value specified derivatives transactions and positions in accordance with the following principles:

...

3. The value of a forward contract or swap shall be the gain or loss on the contract that would be realized if, on the date that valuation is made, the position in the forward contract or swap were to be closed out.

[3] Means, for a position of a mutual fund in

(a) an option, the quantity of the underlying interest of the option position multiplied by the market value of one unit of the underlying interest, multiplied, in turn, by the delta of the option,

(b) a standardized future or forward contract, the quantity of the underlying interest of the position multiplied by the current market value of one unit of the underlying interest; or

(c) a swap, the underlying market exposure, as calculated under paragraph (b), for the long position of the mutual fund in the swap.

market exposure] for the long position of the mutual fund in the swap." The underlying market exposure under paragraph (b) is the "quantity of the underlying interest of the position multiplied by the current market value of one unit of the underlying interest". "Long position"[4] for a swap means a position held by a mutual fund that "obliges the mutual fund to accept delivery of the underlying interest or receive cash".

Starting with the definition of "long position", it is not clear when a mutual fund would have an obligation to accept delivery of the underlying interest or receive cash. Almost every cash settled swap can be said to require the mutual fund to receive cash at some point. Whether the fund will or will not actually receive cash will depend upon how the market is positioned on the payment dates and the maturity date. In the interim periods there is no obligation to receive cash or anything else. If this calculation is to be made on a "daily" basis, then what is the long position supposed to be?

It is also not clear what the "quantity of the underlying interest of the position" would be. If the swap is, for example, an interest rate swap, so that the underlying interest is an interest rate (e.g. 7%), then what is the "quantity" of the interest rate supposed to refer to? The parties do not deliver a rate. Also, what is the current market value of one unit of a rate of 7%? Take an equity index swap as another example. The underlying interest is the level of the index. Again, the concept of a "quantity" for such an intangible is unclear, as is the concept of such an index having a market value. Mutual funds can in theory make calculations that effectively convert into monetary terms their positions in such intangible underlying interests as rates. (Many rely on the counterparty to make that calculation for them where they are unable to do it themselves, which is often the case.) However, this is simply the mark to market value of the transaction. If this is what is intended, then it is not clear that the language used makes it clear that this is what the mutual fund is required to do.

[4] Means a position held by a mutual fund that, for
(e) a swap, obliges the mutual fund to accept delivery of the underlying interest or receive cash;

Is the instrument trying to say that when the mutual fund is in-the-money, it must calculate its exposure to its counterparty (as opposed to the counterparty's exposure to the mutual fund) on a daily basis? If so, is this not the same thing as saying that the mutual fund should calculate what its gain would be, if any, if the swap was terminated on the day the calculation was made? How does this concept differ from the "market value of the long position of the swap"? If it doesn't differ from the concept of market value of the long position of the swap, then wouldn't market value of the long position of the swap and underlying market exposure always be equal, rendering the formula meaningless? Since we assume that this was not what was intended, we are very unclear as to what underlying market exposure is supposed to measure.

"an equivalent quantity of the underlying interest of the swap"

With respect to its "short position" (i.e. the fund's own delivery obligation), the mutual fund must hold a combination of the underlying interest , a right to acquire the underlying interest and cash cover. In part (a) the instrument refers to "an equivalent quantity of the underlying interest of the short position of the swap". Many underlying interests are not things that can be held. If the underlying interest is an equity index, for example, the mutual fund cannot "hold" the index.

"a right or obligation to acquire an equivalent quantity of the underlying interest of the short position of the swap"

Also, as above, the underlying interests may not be things that can be acquired. The mutual fund may, however, have a right under another swap to receive payments based on the value of that index. Presumably, the mutual fund should be able to take that position into consideration as cover. The section, however, does not appear to allow this as it is not an acquisition of the underlying interest.

"margin on account for the position"

Again, is the reference to margin on account a reference to the collateral or margin that the mutual fund has delivered to the counterparty or is it a reference to collateral or margin that the counterparty has delivered to the mutual fund? Presumably, in this case it is margin that the counterparty holds for the obligations of the mutual fund.

"aggregate amount of the obligations of the mutual fund under the short position of the swap"

The cash cover, the margin on account and the right or obligation to acquire an equivalent quantity of the underlying interest must not be less than the "aggregate amount of the obligations of the mutual fund under the short position of the swap".

Until a payment period or maturity arrives, it may not be clear whether or not the mutual fund has any obligation or what the extent of it is. For example, if the mutual fund is making a payment based on the value of an index, it will not know what the value of the index is and, therefore, what the obligation is until the payment date arrives and even then it may only have to pay the difference between the index and some other variable, such as prime rate. How is the mutual fund supposed to aggregate amounts when it does not know what those amounts are or will be?

Section 2.7(4)[5]

This section provides that the "mark-to-market value of the exposure" of a mutual fund under its specified derivatives with any one counterparty cannot be more than 10% of the net assets of the fund for a period of 30 days or more.

We believe that this should be the mark-to-market value to the mutual fund of its specified derivatives, not the mark-to-market value of the exposure. The mark-to-market value *is* the exposure.

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[5] The mark-to-market value of the exposure of a mutual fund under its specified derivatives positions with any one counterparty other than an acceptable clearing corporation or a clearing corporation that clears and settles transactions made on a futures exchange listed in Appendix A, calculated in accordance with subsection (5), shall not exceed, for a period of 30 days or more, 10 percent of the net assets of the mutual fund.

In addition, the calculation of the mark-to-market value of the exposure of a mutual fund to a counterparty should be net of credit support provided by the counterparty.

Section 2.7(5)[6]

It is not clear how part (b) differs from part (a). The "aggregated" mark-to-market value" of the transactions appear to us to be the same as the "net" mark-to-market values.

Section 6.8(3)[7]

This provision states that a mutual fund may deposit with its counterparty portfolio assets over which it has granted a security interest in connection with a particular specified derivatives transaction.

We are assuming that the grant of a security interest in securities in connection with the mutual fund's net position with respect to a number of specified derivatives transactions would also be permitted. It would perhaps be clearer if this read "in connection with particular specified derivatives transactions".

Also, query whether the word "deposit" is accurate. If the credit support is in the form of securities trading through CDS, for example, the mutual fund does not deposit them with the counterparty, but simply arranges for them to be transferred to the counterparty's account or the counterparty's broker's account at CDS. The words "transfer to" would be preferable.

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[6] The mark-to-market value of specified derivatives positions of a mutual fund with any one counterparty shall be, for the purposes of subsection (4),

(a) if the mutual fund has an agreement with the counterparty that provides for netting or the right of set-off, the net mark-to-market value of the specified derivatives positions of the mutual fund; and

(b) in all other cases, the aggregated mark-to-market value of the specified derivative positions of the mutual fund.

[7] A mutual fund may deposit with its counterparty portfolio assets over which it has granted a security interest in connection with a particular specified derivatives transaction.

Further, it is not clear that this would permit a counterparty to transfer cash collateral for derivatives transactions. The transfer of the cash gives rise to a debtor/creditor relationship between the counterparty and the mutual fund. This obligation can then be set-off against the mutual fund's obligations under the derivatives transactions. The section should specifically provide that the mutual fund may transfer cash to its counterparty which it is providing as credit support in connection with particular specified derivatives transactions.

As noted above, parties often provide credit support by entering into alternative forms of credit arrangement that do not involve security interests. We would recommend that this provision be drafted with these alternative forms in mind.

Section 6.8(4)[8]

Where a person holds margin or collateral from a mutual fund, whether as counterparty or custodian, section 6.8(4) requires the records of the custodian or counterparty to show that the mutual fund is the beneficial owner of the portfolio assets.

How does this apply to cash collateral? The concept of ownership does not apply to cash collateral because it creates a debtor/creditor relationship. The records of the counterparty should show this amount as a receivable owing to the mutual fund. This would be consistent with 13.5(5)(a).

Also, with respect to securities collateral it should be made clear that the counterparty or custodian can hold the securities as part of a fungible bulk and through a clearing agency, such that it is clear that the portfolio assets that the counterparty or custodian is showing that the mutual fund "owns" are not necessarily the same securities as those delivered by the mutual fund. The use of the term "portfolio assets"

[8] The agreement by which portfolio assets of a mutual fund are deposited in accordance with this section shall require the person or company holding portfolio assets of the mutual fund so deposited to ensure that its records show that mutual fund is the beneficial owner of the portfolio assets.

creates some uncertainty in this respect. Also, the phrase "holding portfolio assets of the mutual fund so deposited" would be appropriately changed to "to whom the portfolio assets have been transferred".

As drafted section 6.8(4) would also preclude certain forms of alternative credit support arrangements, as mentioned above.

Section 1.1

"equivalent debt"

Section 2.7(1)(b) requires the "equivalent debt" of the counterparty to have an approved credit rating. "Equivalent debt" means an evidence of indebtedness of approximately the same term as, or a longer term than, the remaining term to maturity of the swap. In some cases the term to maturity of the swap is not an accurate determination of whether it is a short or long term obligation. We suggest that the sections simply refer to the approved credit rating of the person with respect to its debt obligations that are most closely aligned economically with the swap.

Yours truly,

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