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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.

[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"

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[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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