

ISDA[®]

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BY EMAIL

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Leslie Byberg
Ontario Securities Commission
20 Queen Street West
P.O. Box 55, Suite 1903
Toronto, Ontario
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Dear Sirs/Mesdames:

Re: National Instrument 81-102

We understand that the Commission is considering housekeeping amendments to National Instrument 81-102. As you know, the International Swaps and Derivatives Association, Inc. has provided substantial comments on NI 81-102 in the past, most of which were concerned with issues that a mutual fund would face in interpreting the instrument and its application to OTC derivatives. At the time we made those comments, public mutual funds were only just beginning to use OTC derivatives as part of their investment and hedging strategies and ISDA hoped our comments would be helpful.

ISDA would like to offer only a few comments on particular aspects of NI 81-102 which we believe are causing issues for counterparties dealing with mutual funds and which are, therefore, affecting the ability of mutual funds themselves to efficiently and effectively contract with those counterparties.

Our comments relate to sections 2.6, as it applies to security interests over portfolio assets, and 6.8, the custodial provisions relating to Derivatives and Securities Lending, Repurchase and Reverse Repurchase Agreement.

Section 2.6

Section 2.6(a)(ii) requires that (i) any security interest be made in accordance with industry practice and (ii) relate only to obligations arising under “that particular specified derivatives transaction”. The industry practice is to take collateral not on a transaction by transaction basis, but on a pooled and net basis. If the fund has agreed to post collateral and has entered into a number of transactions with the counterparty, some of which are in the money for the fund and some not, then the industry standard method of dealing with collateral is to require the fund to post collateral for the amount of the counterparty’s aggregate exposure on the out of the money transactions less any exposure which the fund has to the counterparty on the in the money transactions (and subject to any agreed unsecured thresholds). As the aggregate mark to market values change collateral may be returned or additional collateral delivered, but over time the collateral may relate to a different transaction than it was originally posted for (to the extent that is even possible to determine which transaction it originally related to). It is not clear that this industry standard arrangement, while it relates only to specified derivatives transactions with the fund, would meet the requirement that the security interest relate only to “the particular specified derivatives transaction”.

Section 6.8

Section 6.8(3) allows the fund to deposit with its counterparty portfolio assets over which it has granted a security interest in connection with a particular specified transaction. We assume this allows a deposit of portfolio assets with a custodian or intermediary into the counterparty’s own securities account, but additional clarity on that point would be helpful. The security agreement must, according to section 6.8(4), require the counterparty to ensure that its records show that the mutual fund is the “beneficial owner of the portfolio assets”.

Mutual funds have been requiring counterparties to agree that they will hold the secured assets in accounts that indicate that the mutual fund is the “beneficial owner”. We believe that the concept of “beneficial ownership” is no longer apt in light of the adoption of the *Securities Transfer Act* in Ontario and other Canadian jurisdictions (the *STA*). The *STA* does not use the concept of beneficial ownership. While corporate statutes may still use that concept, it is under those statutes the ultimate entitlement holder of the

account to which a financial asset is credited that is by law the beneficial owner.¹ Where financial assets are deposited with a counterparty by deposit to a securities account in the name of the counterparty (even if labelled as a 'pledge account' or something similar), the entitlement holder (and consequently the beneficial owner at law) is the counterparty.

We believe that the more appropriate requirement in light of the change in law effected by the STA is that the counterparty be required to hold them in an account that is separate from its own proprietary trading accounts at its intermediary, and that the account name indicate that it is an account in which the secured party is holding segregated assets. The counterparty should be permitted to hold the assets in an account in which it holds other pledged assets or assets it holds as intermediary. To require the counterparty to open a separate account with its intermediary for every fund could impose unnecessary costs on the fund.

This requirement, while protecting the fund, will ensure that the counterparty is able to perfect its security interest by *control* by becoming, in STA terms, the entitlement holder of the financial asset. It is important to counterparties that they be able to perfect by control, because control gives a high level of certainty that the security interest has priority over other secured creditors. Also, becoming the entitlement holder provides protection against assertions of other types of adverse claims. This level of certainty is necessary for many counterparties in order for the transactions to qualify for certain desired capital treatment. Better capital treatment allows the counterparty to offer better terms to the fund.

A counterparty could also perfect by control by entering into a control agreement with the fund and a securities intermediary holding the financial assets. With a control agreement the fund would remain the entitlement holder of the assets with the intermediary and the intermediary would agree to comply with entitlement orders from the counterparty, typically upon receipt of a particular form of notice from the counterparty (a notice that under the security agreement it would be permitted to provide on default).

Funds often propose that the trustee or custodian of the fund assets enter into a control agreement with the counterparty on the basis that it is a securities intermediary and can agree to act as such for the counterparty. This, however, may not be legally effective if the mutual fund is a trust and the intermediary is the trustee of the fund. A control agreement must be with a third party intermediary. A control agreement with a trustee of a fund

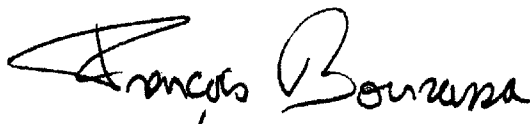
¹ Ontario *Business Corporations Act* section 1, definition of beneficial ownership.

might not meet the requirements for a tri-party control agreement. Funds often do not want to post collateral with another custodian because of the fees involved and the relationship they have with the existing trustee in terms of managing the trading relationships. As a result, the control agreement option is proving to be an impractical one in many cases.

Consequently, if a counterparty is to be able to perfect by control, the mutual fund must be permitted to allow the counterparty to hold the assets in its own securities account. As explained, something other than the concept of beneficial ownership is needed in that context as that concept is no longer relevant to the securities holding system under the STA. It does nothing for the fund to have a statement to this effect in account documentation, when it is legally meaningless. We believe that the fund can obtain the protection it needs in more effective ways.

Please do not hesitate to contact us if we can provide any assistance on the above.

Yours truly,

A handwritten signature in black ink that reads "Francois Bourassa". The signature is written in a cursive, slightly slanted style.

Ms. Francois Bourassa
Chair of the Canadian Legal and
Regulatory Affairs Committee, ISDA,
Senior Vice-President
Trading and Structured Products,
National Bank Financial Group

ISDA - Katherine Tew Darras