THE ASSOCIATION OF GLOBAL CUSTODIANS

May 3, 2000

VIA AIR COURIER

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Securities Commission
The Manitoba Securities Commission
Ontario Securities Commission
Office of the Administrator, New Brunswick
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland
Securities Registry, Government of the Northwest Territories
Registrar of Securities, Government of the Yukon Territory
Registrar of Securities, Government of Nunavut

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 800, Box 55
Toronto, Ontario M5H 3S8

Claude St. Pierre, Secretary
Commission des valeurs mobilières du Québec
800 Victoria Square
Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montreal, Québec H4Z 1G3

Re: Notice of Proposed Amendments to National Instrument 81-102 and Companion Policy 81-102CP

Ladies and Gentlemen:

The Association of Global Custodians ("Association") submits this letter in response to the Notice of Proposed Amendments to National Instrument 81-102 and Companion Policy 81-102CP, published by the Canadian Securities Administrators ("CSA") on January 28, 2000 ("January 28 Notice"). As we have noted in our prior submissions to the CSA on other matters, the Association is

an informal coalition of nine United States banks that act, directly or through affiliates, as global custodians or sub-custodians for the assets of major institutional investors, including Canadian mutual funds.[1] The Association recognizes that comments on the January 28 Notice were due by April 30, 2000, apologizes for its tardiness, and respectfully requests that the CSA nonetheless accept and consider the views set forth herein.

The purpose of the proposed amendments to NI 81-102 and CP 81-102CP is to permit Canadian mutual funds to engage in securities lending, and in repurchase and reverse repurchase transactions, in accordance with certain conditions and limitations. Since mutual funds and other institutional investors frequently appoint their custodians or subcustodians as lending agents, the members of the Association have an active interest in the terms and conditions under which fund securities lending and repurchase transactions may occur.

The Association has comments on five aspects of the proposals in the January 28 Notice. Our views are set forth below.

1/ The members of the Association are:

The Bank of New York
Boston Safe Deposit and Trust Company
Brown Brothers Harriman & Co.
The Chase Manhattan Bank
Citibank, N.A.
Deutsche Bank/Bankers Trust Company
Investors Bank & Trust Company
The Northern Trust Company
State Street Bank and Trust Company

One of the objectives of the Association is to encourage regulatory and legal policies that promote the efficient and effective provision of global custody services and the removal of barriers to transnational custody and investment. The Association seeks to accomplish these goals by, among other activities, participation in governmental and self-regulatory organization proceedings.

Definition of Qualified Securities

The proposed amendments to Section 1.1(b) of NI 81-102 contain a definition of the term "qualified security." This definition could be construed to exclude obligations issued or guaranteed by certain agencies and instrumentalities of the United States, such as the Federal Home Loan Mortgage Corporation (commonly known as "Freddie Mac") and the Federal National Mortgage Association (commonly known as "Fannie Mae"). This could occur because, with respect to U.S. obligations, the proposed definition of "qualified securities" is limited to debt issued or guaranteed by "the government of the United States of America." It is unclear whether this definition would encompass securities issued or guaranteed by a federal agency, but not backed by the full faith and credit of the United States.

U.S. agency securities are treated by the market as the functional equivalent of sovereign debt and are commonly utilized as collateral for repo obligations. These securities are also commonly utilized as collateral or as investment vehicles for cash collateral received in securities lending transactions. Accordingly, we recommend that the definition of "qualified securities" be expanded to expressly include rated obligations of agencies and instrumentalities of the United States.[2]

Other Limitations on Collateral

In addition to apparently precluding the use of U.S. agency securities as collateral, the proposed amendments could prevent Canadian funds and their borrowers from engaging in other practices that are common in the securities lending markets. In particular --

- The proposal would seemingly require that funds maintain a "matched book." This results from the fact

---

2/ If the change we recommend is not made, and if the definition of qualified securities is deemed to exclude agency obligations, a mutual fund could not accept such securities as collateral in a securities lending transaction and could not invest cash delivered to it as collateral or in a repo transaction in such securities. As noted above, precluding the use of U.S. agency securities for these purposes would be contrary to market practice and would impose a needless limitation on Canadian mutual funds.

that proposed Section 2.12(2)(a) provides that qualified securities purchased with cash collateral must have "a remaining term to maturity no longer than the term of the securities lending transaction." The effect of this provision may be to increase the risk profile of the collateral by encouraging lending agents to purchase term assets to match the term of the loan and by reducing their flexibility to manage the collateral pool in the manner that, in their professional judgment, minimizes risk.

- Letter of credit collateral does not appear to be authorized. The inability to accept letters of credit as collateral will reduce the lending opportunities available to mutual funds.[3]

- Proposed Section 2.12(3) could be interpreted to prohibit funds from returning to their borrowers any portion of non-cash collateral while the loan is outstanding, even when retention by the fund of the entire amount of the collateral is not needed to comply with the mark to market requirements and where standard industry documentation would give the borrowers the right to the return of such collateral.

These restrictions are inconsistent with industry practice and eliminating them would not therefore expose Canadian funds to unusual risks or compromise their safety. We recommend that, with respect to each of these points, the proposal be amended or clarified to remove the proposed limitation.

Collateralization Level

Item 7 of proposed Section 2.12(1) would require that the collateral for a securities loan and the loaned securities be marked to market each business day and that the market value of

---

3/ In the United States, Banking Circular 196 requires that a lending agent bank: (a) perform a credit analysis of each bank issuing letter of credit collateral (which analysis must be periodically updated), and (b) establish and adhere to concentration limits with respect to letter of credit issuers. We would suggest that, rather than precluding letter of credit collateral, NI 81-102 should similarly require agent banks to adhere to prudential standards.

the collateral held by the fund be adjusted so as to always be at least 102 percent of the market value of the loaned securities. In contrast, securities lending programs conducted on behalf of other types of institutional investors are typically managed to maintain a 100 percent collateralization minimum.[4]

4/ In the United States, 102 percent initial collateralization is typical in the case of a loan of domestic securities, while 105 percent initial collateralization is standard in the case of a loan of non-U.S. securities. However, the various U.S. financial regulatory bodies have concluded that 100 percent maintenance collateralization is adequate. For example --

- The Department of Labor, which authorizes securities lending by employee benefit plans that are subject to the Employee Retirement Income Security Act ("ERISA"), permits initial collateralization to be 100 percent (Condition No. 2) and requires mark to market adjustments only if collateral falls below 100 percent. See Prohibited Transaction Exemption 81-6 ("PTE 81-6"), Conditions No. 2 and No. 6. In addition, PTE 81-6 permits ERISA plans to accept letter of credit collateral and U.S. government agency collateral. Further, PTE 81-6 does not require a matched book.

- A supervisory policy statement issued by the Federal Financial Institutions Examination Council sets out "prudent controls" applicable to lending agent banks. This policy statement recognizes that "borrowers generally pledge and maintain collateral at a level equal to at least 100 percent of the value of the securities borrowed." See Comptroller Banking Circular No. 196. Like PTE 81-6, the policy statement does not require a matched book and acknowledges that "securities loans are collateralized by U.S. government or federal agency securities, cash or letters of credit."

- The Securities and Exchange Commission has accepted representations from regulated investment companies in connection with exemptive applications related to the marking of collateral that describe the securities lending market as requiring that "borrowers * * * post collateral at least equal to 100% of the market value of loaned securities plus accrued interest." See,

If the CSA imposes a requirement, such as the proposed 102 percent minimum, that is stricter than market practice, the likely result is that borrowers will be inhibited from dealing with Canadian mutual funds, and the shareholders of such funds will therefore not enjoy the economic benefits of securities lending. Obviously, borrowers prefer lenders with lower collateral requirements and avoid lenders with requirements that exceed those of other lending sources. Moreover, the proposed 102 percent collateralization requirement would make it substantially more difficult for an agent bank to manage a securities lending program for a Canadian mutual fund. For example, the collateral management systems of the banks that specialize in this field are not geared to a 102 percent collateralization requirement.[5]

Eligible Lending Agents

In many cases, it will be in the best interest of the mutual fund to utilize a lending agent that is actively engaged in securities lending on behalf of a large number of clients, both because of the experience that such an agent would bring and because of the number of borrowers participating in its program. However, proposed Section 2.15 creates arbitrary obstacles to the use of any bank other than the fund's custodian as a lending agent. Specifically, Subsection 2.15(4) would permit the fund's manager to appoint a subcustodian as lending agent only if the fund's custodian "does not satisfy the requirements of subsection (3)." Subsection (3), in turn, provides, in effect, that the custodian must be the fund's lending agent unless the fund's manager finds that the custodian cannot administer the lending program "in a competent and responsible manner."

---

e.g., Applicant's Representation No. 8, Investment Company Act Release No. 22336 (November 15, 1996). Representation No. 8 also states that securities loans are collateralized by U.S. government and federal agency securities, cash, and letters of credit; it makes no reference to maintenance of a matched book.

5/ The tendency to avoid Canadian funds would be exacerbated if NI 81-102 also imposes non-standard restrictions on the instruments that are eligible as collateral, such as by precluding the use of letters of credit or U.S. agency debt.

We would respectfully submit that a fund's manager should be permitted to make lending agent appointments based on its judgment of the appointments that would be in the best interests of the fund. Forcing the manager to appoint the custodian, except in the extraordinary case where the manager finds the custodian to be either incompetent or irresponsible to serve as its lending program agent, is not consistent with the protection of fund investors.

Treatment of Distributions

Section 3.6(4) of Companion Policy 81-102CP, as proposed to be amended, would require that a mutual fund's agreement with a borrower must provide that all distributions will be promptly paid to the fund. Distributions are, in turn, defined broadly to include all non-cash distributions. The breadth of that definition would encompass items that typically are not paid to a lender, but rather are either added to the existing loan (e.g., a stock split or a stock dividend) or are constituted as a new loan (e.g., warrants or rights to purchase shares).

* * * *

The changes the Association recommends to the proposals in the January 28 Notice would permit Canadian mutual funds to engage in securities lending on terms substantially equivalent to those applicable to other institutional investors. This, in turn, would expand fund lending opportunities and increase the potential returns from lending, but without compromising safety.

The Association appreciates the opportunity to comment on the proposed amendments. If there are questions concerning the Association's views, please feel free to contact the Association's counsel, Daniel L. Goelzer, Baker & McKenzie, 815 Connecticut Avenue, N.W., Washington, D.C. 20006 (telephone: 202/452-7013; fax: 202/452-7074; e-mail: daniel.l.goelzer @bakernet.com).

In accordance with the instructions in the January 28 Notice, we have enclosed a duplicate paper copy of this submission and a diskette on which the submission appears in MS Word 97 format. We have also forwarded copies of the submission

by e-mail to Messrs. Stevenson and St. Pierre and to each of the individuals included on the list at (2000) 23 OSCB(Supp.) 146.

Sincerely,

Association of Global Custodians

The Association of Global Custodians
By: Daniel L. Goelzer

cc (via e-mail only):

Noreen Bent
Senior Legal Counsel
British Columbia Securities Commission

Wayne Alford
Legal Counsel
Alberta Securities Commission

Dean Murrison
Deputy Director, Legal
Saskatchewan Securities Commission

Bob Bouchard
Director, Capital Markets and Chief Administrative Officer
The Manitoba Securities Commission

Rebecca Cowdery
Manager, Investment Funds
Capital Markets
Ontario Securities Commission

Pierre Martin
Legal Counsel, Service de la réglementation
Commission des valeurs mobiliéres du Québec

Renee Piette
Conseillere a la réglementation
Commission des valeurs mobiliéres du Québec

Members of the Association's
Ad Hoc Committee on Revisions to NI 81-102:

Simeon Amon
Vice President and Counsel
The Chase Manhattan Bank

Robert Lem
Principal and Counsel
Deutsche Bank/Bankers Trust Company

Simon Zornoza
Vice President and Counsel
State Street Bank and Trust Company