

Citation: 2013 BCSECCOM 525

Headnote

Multilateral Instrument 11-102 *Passport System* and National Policy 11-203 *Process for Exemptive Relief Applications in Multiple Jurisdictions* – National Instrument 81-102 *Mutual Funds* (NI 81-102) – s.19.1 - Specified derivatives relief - s. 2.7(1) and s. 2.7(4) - Custodian relief - s. 6.1(1)

Counterparty Credit Rating Requirement

A group of mutual funds seeks relief from the counterparty credit rating requirement in subsection 2.7(1) of NI 81-102 to permit the mutual funds to enter into certain swaps that are cleared through a clearing corporation - The mutual fund cannot meet the counterparty credit rating requirement in subsection 2.7(1); the mutual fund will enter into swaps that are cleared through a clearing corporation; the clearing corporation will be the counterparty to the trade

Counterparty Mark-to-Market Exposure Limit

A group of mutual funds seeks relief from the mark-to-market exposure restrictions in subsection 2.7(4) of NI 81-102 to permit the mutual funds to enter into certain swaps that are cleared through a clearing corporation - The mutual fund wants to clear swaps through a clearing corporation that is not an “acceptable clearing corporation” and that is not in Appendix A to NI 81-102; the mutual fund will only clear swaps through certain clearing corporations with adequate regulatory and capital requirements

Custodial Requirements – Deposit of Margin

A group of mutual funds seeks relief from the custodial requirements in subsection 6.1(1) of NI 81-102 to permit the mutual funds to deposit cash and portfolio assets with a dealer as margin for transactions involving cleared swaps - The mutual fund wants to deposit portfolio assets with a dealer as margin for cleared swaps; the portfolio assets will be deposited with a dealer meeting conditions in subsections 6.8(1) and 6.8(2) of NI 81-102

Applicable British Columbia Provisions

National Instrument 81-102 Mutual Funds – s.19.1, s. 2.7(1) and s. 2.7(4), and s. 6.1(1)

November 11, 2013

In the Matter of
the Securities Legislation of
British Columbia and Ontario
(the Jurisdictions)

and

In the Matter of
the Process for Exemptive Relief Applications in Multiple Jurisdictions

and

In the Matter of
HSBC Global Asset Management (Canada) Limited
(the Filer)

Decision

Background

¶ 1 The securities regulatory authority or regulator in each of the Jurisdictions (the Decision Maker) has received an application from the Filer for a decision under the securities legislation of the Jurisdictions (the Legislation), under section 19.1 of National Instrument 81-102 *Mutual Funds* (NI 81-102), exempting each Existing HSBC Fund (as defined below) and all current and future mutual funds managed by the Filer that enter into Swaps (as defined below) in the future (each, a Future HSBC Fund and, together with the Existing HSBC Funds, each, a HSBC Fund and, collectively, the HSBC Funds):

- (a) from the requirement in subsection 2.7(1) of NI 81-102 that a mutual fund must not purchase an option or a debt-like security or enter into a swap or a forward contract unless, at the time of the transaction, the option, debt-like security, swap or contract has a designated rating, or the equivalent debt of the counterparty, or of a person or company that has fully and unconditionally guaranteed the obligations of the counterparty in respect of the option, debt-like security, swap or contract, has a designated rating;
- (b) from the limitation in subsection 2.7(4) of NI 81-102 that 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 settles transactions made on a futures exchange listed in Appendix A to NI 81-102 shall not exceed, for a period of 30 days or more, 10 percent of the net asset value of the mutual fund; and
- (c) from the requirement in subsection 6.1(1) of NI 81-102 to hold all portfolio assets of a mutual fund under the custodianship of one custodian in order to permit each HSBC Fund to deposit cash and portfolio assets directly with a Futures Commission Merchant (as defined below) and indirectly with a Clearing Corporation (as defined below) as margin,

in each case, with respect to cleared Swaps (the Exemption Sought).

Under the Process for Exemptive Relief Applications in Multiple Jurisdictions (for a dual application):

- (a) the British Columbia Securities Commission is the principal regulator for this application;
- (b) the Filer has provided notice that subsection 4.7(1) of Multilateral Instrument 11-102 *Passport System* (MI 11-102) is intended to be relied upon in Alberta, Saskatchewan,

Manitoba, Québec, New Brunswick, Nova Scotia, Prince Edward Island, Newfoundland and Labrador, Northwest Territories, Yukon Territory and Nunavut; and

- (c) the decision is the decision of the principal regulator and evidences the decision of the securities regulatory authority or regulator in Ontario.

Interpretation

- ¶ 2 Terms defined in NI 81-102, National Instrument 14-101 *Definitions*, and MI 11-102 have the same meaning if used in this decision, unless otherwise defined. Capitalized terms used in this decision have the following meanings:

“CFTC” means the U.S. Commodity Futures Trading Commission;

“Clearing Corporation” means any of the Chicago Mercantile Exchange Inc., ICE Clear Credit LLC, LCH.Clearnet Limited and any other clearing organization that is permitted to operate in the jurisdiction of Canada where the HSBC Fund is located;

“Dodd-Frank” means the *Dodd-Frank Wall Street Reform and Consumer Protection Act*;

“Existing HSBC Funds” means any of HSBC Emerging Markets Debt Fund, HSBC U.S. Dollar Monthly Income Fund, HSBC Canadian Bond Fund, HSBC Canadian Bond Pooled Fund, HSBC Global Inflation Linked Bond Pooled Fund, HSBC U.S. High Yield Bond Pooled Fund and HSBC Canadian Balanced Fund;

“Futures Commission Merchant” means any futures commission merchant that is registered with the CFTC and is a member of a Clearing Corporation;

“OTC” means over-the-counter;

“Portfolio Advisor” means each of the Filer and each affiliate of the Filer and each third party portfolio manager retained from time to time by the Filer to sub-advise the investment portfolio of one or more HSBC Funds;

“Swaps” means the swaps that are, or will become, subject to a clearing determination issued by the CFTC, including fixed-to-floating interest rate swaps, basis swaps, forward rate agreements in U.S. dollars, the Euro, Pounds Sterling or the Japanese Yen, overnight index swaps in U.S. dollars, the Euro and Pounds Sterling and untranchured credit default swaps on certain North American indices (CDX.NA.IG and CDX.NA.HY) and European indices (iTraxx Europe, iTraxx Europe Crossover and iTraxx Europe HiVol) at various terms; and

“U.S. Person” has the meaning given to it by the CFTC.

Representations

- ¶ 3 This decision is based on the following facts represented by the Filer:

1. the Filer is, or will be, the investment fund manager of each HSBC Fund; the Filer is registered as an investment fund manager, a portfolio manager and an exempt market dealer in British Columbia, Ontario, Newfoundland and Labrador and Québec, as a portfolio manager and an exempt market dealer in each of Alberta, Saskatchewan, Manitoba, New Brunswick and Nova Scotia and as an exempt market dealer in the Northwest Territories; the head office of the Filer is in Vancouver, British Columbia;
2. the Filer is, or will be, the portfolio manager of the HSBC Funds; another Portfolio Advisor is, or will be, the sub-advisor to certain of the HSBC Funds;
3. each HSBC Fund is, or will be, a mutual fund created under the laws of British Columbia and is, or will be, subject to the provisions of NI 81-102;
4. neither the Filer nor the HSBC Funds are, or will be, in default of securities legislation in each jurisdiction of Canada;
5. the securities of each HSBC Fund are, or will be, qualified for distribution under a prospectus that was, or will be, prepared and filed in accordance with the securities legislation of the Jurisdictions; accordingly, each HSBC Fund is, or will be, a reporting issuer or the equivalent in each jurisdiction of Canada;
6. the investment objective and investment strategies of each HSBC Fund permit, or will permit, the HSBC Fund to enter into derivative transactions, including Swaps; the Portfolio Advisors for the Existing HSBC Funds consider Swaps to be an important investment tool that is available to them to properly manage the applicable Existing HSBC Fund's portfolio; each of the Existing HSBC Funds have entered into, or intend to enter into, foreign exchange swaps, interest rate swaps and credit default swaps on single names and indices;
7. Dodd-Frank requires that certain OTC derivatives be cleared through a Futures Commission Merchant at a clearing organization recognized by the CFTC; generally, where one party to a Swap is a U.S. Person and the other party to the Swap is a mutual fund, such as a HSBC Fund, that Swap must be cleared, absent an available exception, as of June 10, 2013; with respect to entities such as the HSBC Funds, the compliance date for the clearing of iTraxx CDS indices was July 25, 2013;
8. currently, the Existing HSBC Funds may enter into Swaps on an OTC basis with a number of Canadian, U.S. and other international counterparties; these OTC Swaps are entered into in compliance with the derivative provisions of NI 81-102;
9. in order to benefit from both the pricing benefits and reduced trading costs that a Portfolio Advisor may be able to achieve through its trade execution practices for its advised investments funds and other accounts and from the reduced costs associated with cleared OTC derivatives as compared to other OTC trades, the Filer wishes to have the HSBC Funds enter into Swaps cleared through one or more Clearing Corporations;

10. in the absence of the Exemption Sought, each Portfolio Advisor will need to structure the Swaps entered into by the HSBC Funds so as to avoid the clearing requirements of the CFTC; the Filer respectfully submits that this would not be in the best interests of the HSBC Funds and their investors for a number of reasons, as set out below;
11. the Filer strongly believes that it is in the best interests of the HSBC Funds and their investors to be able to execute OTC derivatives with U.S. Persons, including U.S. swap dealers;
12. in its role as a fiduciary for the HSBC Funds, the Filer has determined that central clearing represents the best choice for the investors in the HSBC Funds to mitigate the legal, operational and back office risks faced by investors in the global swap markets;
13. a Portfolio Advisor may use the same trade execution practices for all of its advised funds and other accounts; however, if the HSBC Funds are not able to use cleared Swaps, then each affected Portfolio Advisor will have to create separate trade execution practices only for the HSBC Funds for these types of trades; this will increase the operational risk for the HSBC Funds and will prevent the HSBC Funds from benefitting from both the pricing benefits and reduced trading costs that a Portfolio Advisor may be able to achieve through a common practice for its advised funds and other accounts;
14. as a member of the G20 and a participant in the September 2009 commitment of G20 nations to improve transparency and mitigate risk in derivatives markets, Canada has expressly recognized the systemic benefits that clearing OTC derivatives offers to market participants, such as the HSBC Funds; and
15. the Exemption Sought is analogous to the treatment currently afforded under NI 81-102 to other types of derivatives that are cleared, such as clearing corporation options, options on futures and standardized futures.

Decision

- ¶ 4 Each of the Decision Makers is satisfied that the decision meets the test set out in the Legislation for the Decision Maker to make the decision.

The decision of the Decision Makers under the Legislation is that the Exemption Sought is granted provided that, in respect of the deposit of cash and portfolio assets as margin:

- (a) in Canada,
 - (i) the Futures Commission Merchant is a member of a SRO that is a participating member of CIPF; and
 - (ii) the amount of margin deposited and maintained with the Futures Commission Merchant does not, when aggregated with the amount of margin already held by the Futures Commission Merchant, exceed 10 percent of the net asset value of the HSBC Fund as at the time of deposit; and

(b) outside of Canada,

- (i) the Futures Commission Merchant is a member of a Clearing Corporation and, as a result, is subject to a regulatory audit;
- (ii) the Futures Commission Merchant has a net worth, determined from its most recent audited financial statements that have been made public or from other publicly available financial information, in excess of the equivalent of \$50 million; and
- (iii) the amount of margin deposited and maintained with the Futures Commission Merchant does not, when aggregated with the amount of margin already held by the Futures Commission Merchant, exceed 10 percent of the net asset value of the HSBC Fund as at the time of deposit.

This decision will terminate on the earlier of (i) the coming into force of any revisions to the provisions of NI 81-102 that address the clearing of OTC derivatives, and (ii) two years from the date of this decision.

Brent W. Aitken
Vice Chair
British Columbia Securities Commission