Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

255 Albert Street
Ottawa, Canada
K1A 0H2

255, rue Albert
Ottawa, Canada
K1A 0H2

Guidance Note

Subject: Investments by Federally Regulated Financial Institutions in Mutual Fund Entities

Date: December 1999

This note is intended to clarify the approval requirements for and the capital treatment of substantial investments made by federally regulated financial institutions (FRFIs) in mutual fund entities.

Approval Requirements for Substantial Investments in Mutual Fund Entities

Mutual funds can take either of two forms; a mutual fund corporation (a body corporate) or a mutual fund trust (an unincorporated entity). A mutual fund corporation is a permitted substantial investment for FRFIs. A FRFI wishing to acquire or increase a substantial investment in a mutual fund corporation is not required to obtain regulatory approval.

However, a FRFI wishing to acquire or increase a substantial investment in a mutual fund trust is required to obtain the approval of the Minister of Finance (under subsection 468(1.1) of the Bank Act, subsection 495(2.1) of the Insurance Companies Act or subsection 453(1.1) of the Trust and Loan Companies Act). This is due to the fact that mutual fund trusts are not bodies corporate, but conduct activities which are the same as or substantially similar to those of a mutual fund corporation.

Each time a FRFI proposes to acquire or increase a substantial investment in a mutual fund trust, it may apply for an approval under one of the above-referenced provisions. Any such applications should be forwarded to the Registration and Approvals Division where they will be processed as expeditiously as possible.

Alternatively, FRFIs can make substantial investments in mutual fund trusts using the temporary investment provisions found in its governing statute (through subsection 471(2) of the Bank Act, subsection 498(2) in the Insurance Companies Act, or subsection 456(2) of the Trust and Loan Companies Act). If the investment is made in this manner, the FRFI must, within two years, or such other period as may be specified by the Superintendent, do all things necessary to ensure that such temporary investment is no longer held.

In the normal course, OSFI would expect that a temporary investment would not be held for more than two years. However, should a period in excess of two years be required for the holding of a substantial investment in a mutual fund trust, OSFI would be prepared to consider such applications given that substantial investments in mutual fund corporations do not require regulatory approval.

Capital Treatment of Investments in Mutual Fund Entities

In accordance with Guideline A-1 Capital Adequacy Requirements, and Guideline on Minimum Continuing Capital and Surplus Requirement (referred herein collectively as the Capital Guidelines) banks, federally regulated trust and loan companies (T&Ls), and federally regulated life insurance companies must deduct several items from total capital. Among these items are investments in unconsolidated subsidiaries and unconsolidated corporations in which a bank , T&L or life insurance company has a substantial investment. The term "substantial investment" used in the Capital Guidelines is defined in section 10 of each of the Bank Act the Trust and Loan Companies Act and the Insurance Companies Act.

The reason for these deductions is to prevent the double leveraging of the capital of the FRFI (i.e., a first time on the assets of the consolidated balance sheet of the FRFI and a second time on the assets of the unconsolidated subsidiary or corporation). Double leveraging could also occur if the substantial investment was in an unincorporated entity that was capable of borrowing to leverage its equity.

Accordingly, the current wording of the Capital Guidelines shall be interpreted to include an unincorporated entity or a body corporate only where the entity or body corporate leverages its equity by borrowing in debt markets or otherwise leverages its investments.

For example, no deduction of capital need be made from a FRFI’s total capital where the FRFI makes a substantial investment in either a mutual fund trust or corporation as part of a structured transaction that passes through the unaltered returns (i.e., no guarantee of performance) on the substantial investment to another party.

- END -