Headnote

Mutual Reliance Review System for Exemptive Relief Applications – s. 19.1 of National Instrument 81-102 *Mutual Funds* – exemption from section 2.7 (1)(a) of NI 81-102 to permit interest rate and credit derivative swaps and, for hedging purposes, currency swaps and forwards with a remaining term to maturity of greater than 3 years; exemption from section 2.8(1) of NI 81-102 to the extent that cash cover is required in respect of specified derivatives to permit the Funds to cover specified derivative positions with: certain bonds, debentures, notes or other evidences of indebtedness and securities of money market funds; and exemption from sections 2.8(1)(d) and (f)(i) NI 81-102 to permit the Funds when they open or maintain a long position in a standardized future or forward contract or when they enter into or maintain an interest rate swap position and during the periods when the Funds are entitled to receive payments under the swap, to use as cover, an option to sell an equivalent quantity of the underlying interest of the standardized future, forward or swap.

Applicable Legislative Provisions

National Instrument 81-102 *Mutual Funds,* ss. 2.7(1)(a), 2.8(1), 2.8(1)(d), 2.8(1)(f)(i) and 19.1

Citation: The Federation Des Caisses Desjardins Du Quebec**,** 2008 ABASC 55**Date:** 20080125

IN THE MATTER OF
THE SECURITIES LEGISLATION OF
BRITISH COLUMBIA, ALBERTA, SASKATCHEWAN, MANITOBA, ONTARIO,
QUEBEC, NEW BRUNSWICK, PRINCE EDWARD ISLAND, NOVA SCOTIA,
NEWFOUNDLAND AND LABRADOR, NORTHWEST TERRITORIES, YUKON
AND NUNAVUT
(the “Jurisdictions”)

AND

IN THE MATTER OF
THE MUTUAL RELIANCE REVIEW SYSTEM
FOR EXEMPTIVE RELIEF APPLICATIONS
(“MRRS”)

AND
IN THE MATTER OF
THE FÉDÉRATION DES CAISSES DESJARDINS DU QUÉBEC
(the “Filer”)

MRRS DECISION DOCUMENT

BACKGROUND

The local securities regulatory authority or regulator ("**Decision Maker**") in each of the Jurisdictions has received an application (the "**Application**") from the Filer on behalf of the mutual funds managed by the Filer together with all future mutual funds managed by the Filer, other than money market funds (each a "**Fund**" and together the "**Funds**") under section 19.1 of National Instrument 81-102 – *Mutual Funds* ("**NI 81-102**") for relief:

(a) from the requirement in section 2.7(1)(a) of NI 81-102 insofar as it requires a swap or forward contract to have a remaining term to maturity of 3 years or less (or 5 years or less in certain circumstances), to permit each of the Funds to enter into interest rate swaps, credit default swaps or, if the transaction is for hedging purposes, currency swaps or forwards that, in each case, have a remaining term to maturity of greater than 3 years,

(b) from the requirement in section 2.8(1) of NI 81-102 to the extent that cash cover is required in respect of specified derivatives, to permit each of the Funds to cover specified derivative positions with:

   (i) any bonds, debentures, notes or other evidences of indebtedness that are liquid (collectively, "**Fixed Income Securities**") provided they have a remaining term to maturity of 365 days or less and have an approved credit rating;

   (ii) floating rate evidences of indebtedness; or

   (iii) securities of one or more money market funds managed by the Filer to which NI 81-102 applies (collectively, "**Money Market Funds**"); and

(c) from the requirements in sections 2.8(1)(d) and (f)(i) of NI 81-102 to permit each of the Funds when it:

   (i) opens or maintains a long position in a debt-like security that has a component that is a long position in a forward contract or in a standardized future or forward contract; or

   (ii) enters into or maintains a swap position and during the periods when the Fund is entitled to receive payments under the swap,

   to use as cover a right or obligation to sell an equivalent quantity of the underlying interest of the standardized future, forward or swap;

(collectively, the "**Requested Relief**").

Under the MRRS :

(i) the principal regulator for the Application is the Autorité des marchés financiers; and

(ii) this MRRS decision document represents the decision of each of the Decision Makers.

INTERPRETATION

Defined terms contained in National Instrument 14-101 – *Definitions* and in NI 81-102 have the same meaning in this MRRS decision document unless they are otherwise defined in this decision.

REPRESENTATIONS

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

Background

1. The Funds are or will be mutual funds established under the laws of Québec. The Filer is a corporation incorporated under the laws of Québec and has its registered head office in Montréal, Québec. The Filer is or will be the manager of each of the Funds.

2. The Funds are or will be reporting issuers under the securities laws of all of the provinces and territories of Canada and are or will be subject to the requirements of NI 81-102.

3. The existing Funds are not in default of any requirement of securities legislation in any Jurisdiction.

4. Many of the Funds may use specified derivatives under their investment strategies to replicate market indices in order to lower trading costs, to gain exposure to securities and financial markets instead of investing in the securities directly and to generate income. The Funds may also use derivative instruments to:

   (a) reduce risk by protecting the Funds against potential losses from changes in interest rates;

   (b) reduce the impact of currency fluctuations on the Funds' portfolio holdings; and

   (c) provide protection for the Funds' portfolios and reduce the overall volatility of returns.

   When specified derivatives are used for non-hedging purposes, the Funds are subject to the cash cover requirements of NI 81-102. Any Fund that is not currently permitted to commence the use of derivatives will only do so in accordance with section 2.11 of NI 81-102.

5. The use of derivatives by investors and portfolio managers has increased significantly in the last 20 to 30 years. The Filer is seeking an exemption from certain of the terms of NI 81-102 to permit the Funds to engage in derivative strategies that are consistent with industry practice.

6. The Filer believes that the Requested Relief is in the best interest of the Funds as it will save costs and potentially enhance the performance of the Funds. Further, the Requested Relief would not leave the Funds exposed to any material incremental

risk beyond the risk that the Filer, a Fund's portfolio advisor or portfolio sub-advisor is targeting and is consistent with the investment objectives and strategies of the applicable Funds. Without the Requested Relief, the Funds will not have the flexibility to enhance yield and to manage more effectively the exposures under specified derivatives.

Cash Cover

7. The purpose of the cash cover requirement in NI 81-102 is to prohibit a mutual fund from leveraging its assets when using certain specified derivatives and to ensure that the mutual fund is in a position to meet its obligations on the settlement date. This is evident from the definition of "cash cover", which is defined as certain specific portfolio assets of the mutual fund that have not been allocated for specific purposes and that are available to satisfy all or part of the obligations arising from a position in specified derivatives held by the mutual fund. Currently, the definition of "cash cover" includes six different categories of securities, including certain evidences of indebtedness (cash equivalents and commercial paper) that generally have a remaining term to maturity of 365 days or less and that have an approved credit rating or are issued or guaranteed by an entity with an approved credit rating (collectively, "**short-term debt**").

8. In addition to the securities currently included in the definition of cash cover, the Funds would also like to invest in Fixed Income Securities, floating rate evidences of indebtedness and/or securities of Money Market Funds for purposes of satisfying their cash cover requirements.

9. It is submitted that the proposed use of Fixed Income Securities, floating rate evidences of indebtedness and securities of Money Market Funds as cash cover for the Funds should be granted by the securities authorities for the reasons set out below.

Fixed Income Securities

10. While the money market instruments that are currently permitted as cash cover are highly liquid, these instruments typically generate very low yields relative to longer dated instruments and similar risk alternatives.

11. Other fixed income securities with remaining terms to maturity of less than 365 days and approved credit ratings are also highly liquid but provide the potential for higher yields. The definition of cash cover addresses regulatory concerns of interest rate risk and credit risk by limiting the terms of the instruments and requiring the instruments to have an approved credit rating. It is submitted that by permitting the Funds to use for cash cover purposes Fixed Income Securities with a remaining term to maturity of 365 days or less and an approved credit rating, the regulatory concerns are met, since the term and credit rating will be the same as other short-term debt instruments currently permitted to be used as cash cover.

Floating Rate Evidences of Indebtedness

12. Floating rate evidences of indebtedness, also known as floating rate notes ("**FRNs**"), are debt securities issued by the federal or provincial governments, the Crown or

other corporations and other entities with floating interest rates that reset periodically, usually every 30 to 90 days.

13. Although the term to maturity of FRNs can be more than 365 days, the Funds propose to limit their investment in FRNs used for cash cover purposes to those that have interest rates that reset at least every 185 days.

14. Allowing the Funds to use FRNs for cash cover purposes could increase the rate of return earned by each of the Fund's investors without reducing the credit quality of the instruments held as cash cover. It is submitted that the frequent interest rate resets mitigate the risk of investing in FRNs as cash cover. For the purposes of money market funds under NI 81-102 meeting the 90 days dollar-weighted average term to maturity, the term of a floating rate evidence of indebtedness is the period remaining to the date of the next rate setting. If a FRN resets every 365 days, then the interest rate risk of the FRN is about the same as a fixed rate instrument with a term to maturity of 365 days.

15. Financial instruments that meet the current cash cover requirements have low credit risk. The current cash cover requirements provide that evidences of indebtedness of issuers, other than government agencies, must have approved credit ratings. As a result, if the issuer of FRNs is an entity other than a government agency, the FRNs used by the Funds for cash cover purposes will have an approved credit rating as required by NI 81-102.

16. Given the frequent interest rate resets, the nature of the issuer and the adequate liquidity of FRNs, the risk profile and the other characteristics of FRNs are similar to those of short-term debt, which constitute cash cover under NI 81-102.

Money Market Funds

17. Under NI 81-102, in order to qualify as money market funds, the Money Market Funds are restricted to investments that are, essentially, considered to be cash cover. These investments include floating rate evidences of indebtedness if their principal amounts continue to have a market value of approximately par at the time of each change in the rate to be paid to their holders.

18. If the direct investments of Money Market Funds would constitute cash cover under NI 81-102 (assuming that the relief allowing FRNs as cash cover is granted), then it is submitted that indirectly holding these investments through an investment in the securities of one or more Money Market Fund should also satisfy the cash cover requirements of NI 81-102.

19. It is therefore submitted that the securities of Money Market Funds should constitute cash cover for the Funds for purposes of NI 81-102.

Using Put Options or Short Positions as Cover for Long Positions in Futures, Forwards and Swaps

20. Sections 2.8(1)(d) and 2.8(1)(f)(i) of NI 81-102 do not permit covering a long position in a standardized future or forward contract or a position in a swap for a period when a Fund is entitled to receive payments under the swap, in whole or in part, with a

right or obligation to sell an equivalent quantity of the underlying interest of the future, forward or swap. In other words, these sections of NI 81-102 do not permit the use of put options or short future, forward or swap positions to cover long future, forward or swap positions.

21. Regulatory regimes in other countries recognize the hedging properties of options for all categories of derivatives, including long positions evidenced by standardized futures or forwards or in respect of swaps where a fund is entitled to receive payments from the counterparty, provided they are covered by an amount equal to the difference between the market price of a holding and the strike price of the option that was bought or sold to hedge it. NI 81-102 effectively imposes the requirement to overcollateralize, since the maximum liability to the fund under the scenario described is equal to the difference between the market value of the long and the exercise price of the option. Overcollateralization imposes a cost on the Funds.

22. Section 2.8(1)(c) of NI 81-102 permits a mutual fund to write a put option and cover it with buying a put option on an equivalent quantity of the underlying interest of the written put option. This position has risks that are similar to a long position in a future, forward or swap. Accordingly, it is submitted that the Funds should be permitted to cover a long position in a future, forward or swap with a put option or a short future, forward or swap position.

Extended Term to Maturity for Interest Rate Swaps, Credit Default Swaps and Currency Swaps or Forwards for Hedging Purposes

23. Section 2.7(1)(a) of NI 81-102 prohibits mutual funds from entering into a swap or forward contract with a term to maturity of greater than 3 years or greater than 5 years if the swap or contract provides the fund with a right to eliminate its exposure within 3 years. The Funds seek the ability to enter into interest rate swaps, credit default swaps or, if the transaction is for hedging purposes, currency swaps or forwards without a restriction as to the term of the swap or forward.

24. Fixed income investments have certain risks, including (but not limited to) interest rate risk, credit risk and currency risk. These risks can be controlled or mitigated through the use of over-the-counter (OTC) derivatives. Interest rate risk may be managed by interest rate swaps, credit risk can be managed by credit default swaps and currency risk can be managed by using currency swaps or forwards.

25. The term of a swap equals the maturity of its exposure, in contrast to other over-the-counter transactions, such as options and certain other types of forwards, where the contract term and maturity of the underlying security are not related. There is no restriction under NI 81-102, for example, on a forward with an underlying interest having a term of 10 years, whereas there is a restriction if the derivative is in the form of a swap.

26. Credit default swaps (CDS) have a similar risk profile to their reference entity (corporate or sovereign bonds) or, in the case of an index of credit default swaps (such as CDX) or a basket of reference entities, to an average of all the reference entities in the index or basket. The term of a credit default swap imparts credit risk similar to that of a bond of the reference entity with the same term. The Funds may not be able to achieve the same sensitivity to credit risk as their respective

benchmarks by using credit default swaps with a maximum term of 3 years (or 5 years in certain circumstances) because the relevant benchmark may have an average term that is longer. There is no term restriction in NI 81-102 when investing directly in the reference entities.

27. A currency swap or forward used for hedging purposes may or may not have a contract term and maturity that equals the maturity of the underlying interest. For example, if a Fund wants to hedge a 10-year bond that is denominated in U.S. dollars, under the current provisions of NI 81-102, the term of the currency swap or forward can be, at most, 5 years, even though the term of the underlying interest is 10 years. Ideally, to manage the currency risk, a fund has to enter into two consecutive 5-year currency swaps or forwards. However, the pricing for the currency swap or forward in respect of the second 5 year period is not known at the time the U.S. dollar bond is purchased. Consequently, the inability to enter into a 10-year currency swap or forward transaction indirectly introduces currency and pricing risk when a hedged 10-year position is the desired outcome. Accordingly, whenever the term of a bond is longer than 5 years, a fund may be exposed to additional risk. This constraint has become more relevant since there are no longer foreign investment restrictions under the *Income Tax Act* (Canada). It should also be noted that it is not market convention to have a transaction with a 5-year term (subject to a right to eliminate the exposure within 3 years) and, as a result, this off-market feature may subject a Fund to less efficient pricing.

28. The interest rate swap market, credit default swap market and currency swap and forward markets are very large and liquid.

29. The interest rate swap market is generally as liquid as government bonds and more liquid than corporate bonds. The Bank for International Settlements reported that the notional amount of interest rate swaps outstanding was U.S. $272 trillion as of June 30, 2007. In Canada, there were over U.S. $2.5 trillion of interest rate swaps outstanding as of June 30, 2007 greater than the sum of all outstanding federal and provincial debt.

30. Credit default swaps, on average, are highly liquid instruments. Single name CDS are slightly less liquid than the bonds of their reference entities, while CDS on CDX are generally more liquid than corporate or emerging market bonds. The Bank for International Settlements reported that the notional amount of credit default swaps outstanding was U.S. $42 trillion as of June 30, 2007. The International Swap and Derivatives Association's 2006 year-end market survey estimated the notional amount outstanding to be U.S. $34.4 trillion. Using either source, the credit default swap market has surpassed the size of the equity derivatives markets and is one of the fastest growing financial markets.

31. With respect to foreign exchange, the Bank for International Settlements reported that the notional amount of outright forwards and foreign exchange swaps outstanding was U.S. $24 trillion as at June 30, 2007. For comparative purposes, the S&P 500 had an estimated market capitalization of U.S. $13.4 trillion on September 30, 2007. The Bank for International Settlements also reported that the average daily turnover of OTC foreign exchange was U.S. $1,292 billion during April, 2004. The average daily turnover of outright forwards and foreign exchange swaps totalled U.S. $1,152 billion during such period. For comparative purposes, the daily

trading during November 2007 on the New York Stock Exchange was approximately U.S. $101 billion and on the Toronto Stock Exchange was approximately CAD $7.1 billion. Daily trading is many times larger for currencies and currency swaps and forwards than for well-known equity exchanges.

32. Because swaps and forward contracts are private agreements between two counterparties, a secondary market for these agreements would be a cumbersome process whereby one counterparty would have to find a new counterparty willing to take over its contract at a fair market price, get the original counterparty to approve the new counterparty and exchange a whole new set of documents. To avoid that process, market participants can unwind their positions in interest rate swaps and currency swaps or forwards by simply entering into an opposing swap or forward with an acceptable counterparty at market value. In this way, the original economic position of the initial swap or forward is offset. Parties may also agree to terminate the agreement at a fair market price prior to the maturity date of the agreement. Similarly, in the case of CDS, the counterparty can either enter into an off-setting hedge transaction or it can trade with another counterparty by assigning the swap to the other counterparty.

33. Credit risk exposure to a counterparty on an interest rate swap transaction or currency forward transaction is generally a small fraction of the underlying notional exposure equal to the cumulative price change since the inception of the swap or forward. Even this small risk is mitigated because the counterparty is required to have an approved credit rating as prescribed by NI 81-102.

34. Potential credit exposure to a counterparty in the case of a CDS on a CDX is equal to the notional exposure to any issuer in the index who has defaulted and, in the case of a single name CDS, is equal to the full notional exposure. As is the case with interest rate swaps, this exposure is mitigated because the counterparty is required to have an approved credit rating as prescribed by NI 81-102. Further, NI 81-102 also limits the credit exposure that is permitted in respect of any individual counterparty. Credit exposure may be further mitigated if a counterparty is required to provide collateral equal to the cumulative price in excess of a specified mark-to-market threshold.

35. Permitting the Funds to enter into swaps and forwards that have terms beyond 3 years increases the possibility for the Funds to (i) increase returns, due to the fact that the opportunity set is expanded, and (ii) target exposures that might not otherwise be available in the cash bond markets or could not be achieved as efficiently in the cash bond markets. Further, the use of swaps and forwards with terms beyond 3 years enables the Funds to effect hedging transactions that help mitigate underlying investment risks associated with investing in fixed income investments.

The Filer's Derivative Policies and Practices

36. To the extent that the Funds use derivatives, the portfolio advisor and portfolio sub-advisors retained on behalf of the Funds are responsible for ensuring that derivatives are used in a manner that is consistent with the applicable investment objectives and restrictions of the Funds and that the derivatives comply with the requirements set out in NI 81-102. The Filer, the portfolio advisor and each portfolio sub-advisor have

their own policies and procedures relating to the use of derivatives. All derivative transactions for a Fund must be recorded on a real time basis and immediately reflected in the Fund's portfolio management records. Derivative positions are monitored daily to ensure that they comply with all regulatory requirements, including any cash cover requirement.

37. The prospectus and annual information form of the Funds discloses the policies and practices of the Filer regarding the use of derivatives and, upon renewal, will include disclosure of the nature of the exemptions granted in respect of the Funds.

DECISION

Each of the Decision Makers is satisfied that the test contained in the Legislation that provides the Decision Maker with the jurisdiction to make the decision has been met.

The decision of the Decision Makers under the Legislation is that the Requested Relief is granted provided that :

(i) the Fixed Income Securities have a remaining term to maturity of 365 days or less and have an "approved credit rating" as defined in NI 81-102;

(ii) the FRNs meet the following requirements:

(a) the floating interest rates of the FRNs reset no later than every 185 days;

(b) the FRNs are floating rate evidences of indebtedness with the principal amounts of the obligations that will continue to have a market value of approximately par at the time of each change in the rate to be paid to the holders of the evidences of indebtedness;

(c) if the FRNs are issued by a person or company other than a government or "permitted supranational agency" as defined in NI 81-102, the FRNs must have an "approved credit rating" as defined in NI 81-102;

(d) if the FRNs are issued by a government or permitted supranational agency, the FRNs have their principal and interest fully and unconditionally guaranteed by:

A) the government of Canada or the government of a jurisdiction in Canada; or

B) the government of the United States of America, the government of one of the states of the United States of America, the government of another sovereign state or a "permitted supranational agency" as defined in NI 81-102, if, in each case, the FRN has an "approved credit rating" as defined in NI 81-102; and

(e) the FRNs meet the definition of "conventional floating rate debt instrument" in section 1.1 of NI 81-102;

(iii) a Fund shall not open or maintain a long position in a debt-like security that has a component that is a long position in a forward contract, or in a standardized future or forward contract unless the Fund holds

(a) cash cover in an amount that, together with margin on account for the specified derivative and the market value of the specified derivative, is not less than, on a daily mark-to-market basis, the underlying market exposure of the specified derivative;

(b) a right or obligation to sell an equivalent quantity of the underlying interest of the future or forward contract, and cash cover that together with margin on account for the position, is not less than the amount, if any, by which the strike price of the future or forward contract exceeds the strike price of the right or obligation to sell the underlying interest; or

(c) a combination of the positions referred to in clauses (iii)(a) and (iii)(b) that is sufficient, without recourse to other assets of the Fund, to enable the Fund to acquire the underlying interest of the future or forward contract.

(iv) a Fund shall not enter into or maintain a swap position unless for periods when the Fund would be entitled to receive fixed payments under the swap, the Fund holds

(a) 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;

(b) a right or obligation to enter into an offsetting swap on an equivalent quantity and with an equivalent term and cash cover that together with margin on account for the position is not less than the aggregate amount, if any, of the obligations of the Fund under the swap less the obligations of the Fund under such offsetting swap; or

(c) a combination of the positions referred to in clauses (iv)(a) and (iv)(b) that is sufficient, without recourse to other assets of the Fund, to enable the Fund to satisfy its obligations under the swap.

(v) at the time of the next renewal and all subsequent renewals of the prospectus and annual information form each of the Funds relying upon this relief shall:

(a) disclose the nature of this relief in the annual information form of such Funds with a cross reference thereto in the prospectus of the Funds; and

(b) include a summary of the nature and terms of this relief in the prospectus of the Funds under the Investment Strategies section, or in the introduction to Part B of the prospectus with a cross reference thereto under the Investments Strategies section for the Funds.

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