
# THE NOVEL EXEMPTIVE RELIEF CHRONICLES

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Ontario Securities Commission exemptive relief decision clarifies ability of investment fund managers to permit rehypothecation of portfolio assets.
**Categories:** Insights, Publications

**You Can't Always Get What You Want...But, Sometimes, You Get What You Need - OSC Decision Removes the "Hype" Surrounding Rehypothecation**

In this edition of "The Novel Exemptive Relief Chronicles" we review and analyze a significant recent exemptive relief decision[1] (the "**Decision**") which permits publicly offered mutual funds and alternative mutual funds to exceed the applicable collateral limits on the deposit of portfolio assets with a borrowing agent that is not the custodian or a sub-custodian of the fund as security in the context of short sale transactions. However, the Decision is far more noteworthy for statements provided by the Ontario Securities Commission (the "**OSC**") in the Decision document concerning the ability of a fund to allow for rehypothecation of portfolio assets. This landmark Decision effectively resolves a large amount of confusion that existed within the Canadian investment funds industry since 2015 regarding the ability of managers of mutual funds and alternative mututal funds to permit rehypothecation of portfolio assets in connection with short selling, derivative and cash borrowing transactions.

**Background**

*Collateral Restrictions for Short Sale Transactions*

Under National Instrument 81-102 – *Investment Funds* ("**NI 81-102**") alternative mutual funds are permitted to deposit portfolio assets having a value of up to 25% of the net asset value of the fund at the time of deposit (the "**Short Sale Collateral Limit**") with a borrowing agent that is not the custodian or a sub-custodian of the fund (typically, a prime broker) as security for short selling transactions. Conventional mutual funds are subject to a 10% Short Sale Collateral Limit.

*Rehypothecation of Portfolio Assets*

Primarily as a result of certain statements from OSC staff in the Investment Funds Practitioner (the "Practitioner")[2], there have been divergent views and a large amount of confusion throughout the Canadian investment funds industry over the past few years regarding whether or not fund managers could permit

lenders or borrowing agents to rehypothecate portfolio assets delivered to them as collateral. The level of confusion was exacerbated following the adoption of the alternative mutual fund amendments to NI 81-102 in January of this year permitting alternative mutual funds to borrow cash for investment purposes and to engage in a much greater degree of short selling and use of derivative instruments than conventional mutual funds. Although the statements of OSC staff in the Practitioner were restricted to the issue of permitting rehypothecation in the context of specified (OTC) derivative transactions, they were frequently interpreted by market participants as also applying in the context of cash borrowing transactions and short selling transactions under NI 81-102.

**The Requested Relief**

In its application (the "**Application**"), the filer (the "**Filer**") requested exemptive relief from the Short Sale Collateral Limits in subsections 6.8.1(a) and (b) of NI 81-102 (the "**Short Sale Collateral Limit Relief**"). In support of its request, the Filer argued that given the operational models of prime brokers which are premised on the ability of the prime broker to retain the proceeds of a short sale transaction as collateral to secure the obligations of the fund (whether or not such proceeds are held in cash or used by the fund to purchase additional securities), the Short Sale Collateral Limit effectively requires funds (in particular, alternative mutual funds which are permitted to sell short securities having an aggregate market value of up to 50% of the net asset value of the fund) to enter into arrangements with multiple prime brokers in order to short sell securities up to the limits provided in NI 81-102. These arrangements create both operational inefficiencies and increased costs of operations for the funds.

In its Application, the Filer also requested exemptive relief (the "**Rehypothecation Relief**") from the requirements of subsection 6.8(4) of NI 81-102 relating to the deposit of portfolio assets by a fund with its lender as security for cleared specified derivatives, OTC derivatives and cash borrowing transactions in order to permit an alternative mutual fund to allow the lender to rehypothecate (including lending, pledging, transferring and/or selling) the pledged portfolio assets. The Filer noted that the requirement in subsection 6.8(4) of NI 81-102 requiring the person or company holding the portfolio assets to ensure that its records show that the fund is the beneficial owner of the pledged portfolio assets operates to effectively prohibit a fund from allowing the rehypothecation of such assets.

In support of its request for the Rehypothecation Relief, the Filer argued that the operational and pricing models used by lenders (including prime brokers) are based on their ability to rehypothecate the portfolio assets of a fund deposited with the lender as collateral. If alternative mutual funds were unable to permit lenders to rehypothecate portfolio assets, the Filer argued that higher borrowing costs, expenses and trading ratios, as well as barriers to service from such lenders would result. The Filer also argued that treatment of portfolio assets pledged in favour of lenders/prime brokers is the same under applicable insolvency legislation

regardless of whether the lender/prime broker rehypothecated the portfolio assets or not.

**The Decision**

The OSC approved the Filer's request for the Short Sale Collateral Limit Relief to permit conventional mutual funds managed by the Filer to exceed the 10% Short Sale Collateral Limit and alternative mutual funds to exceed the 25% Short Sale Collateral Limit with a borrowing agent or prime broker. In practice, this means that a single borrowing agent that is not the custodian or a subcustodian of the fund can hold up to:

i. 25%, plus the aggregate market value of the proceeds from outstanding short sales of securities for an alternative mutual fund; and
ii. 10%, plus the aggregate market value of the proceeds from outstanding short sales of securities

as security for short sale transactions provided that the fund otherwise complies with the other requirements of section 6.8.1 of NI 81-102 relating to the required use of qualified dealers for short sale transactions both within and outside of Canada.

The Short Sale Collateral Limit Relief will be beneficial for any alternative mutual funds or conventional mutual funds that are seeking to minimize the number of counterparties used for short sale transactions. Funds with this type of exemptive relief will also be able to simplify their custodial arrangements. For example, with this relief, a fund could appoint either a traditional custodian or a qualified prime broker as its custodian under section 6.2 of NI 81-102 and then enter into a separate prime brokerage arrangement without the necessity of having that prime broker appointed as a sub-custodian of the fund. Finally, this type of exemptive relief may lead to fewer tri-partite arrangements, which are typically more costly and complicated to implement and manage, being utilized for both conventional mutual funds and alternative mutual funds.

Perhaps more important than the Short Sale Collateral Limit Relief approved in the Decision are the statements of the OSC contained in the document concerning the requested Rehypothecation Relief. Specifically, the OSC notes in the Decision that, following discussions with OSC staff, the Filer withdrew its request for Rehypothecation Relief based on representations from OSC staff that (a) notwithstanding statements previously made in the Practitioner, nothing in section 6.8 of NI 81-102, including subsections 6.8(3), 6.8(3.1) and 6.8(4) precludes a conventional mutual fund or an alternative mutual fund (as applicable) from permitting the portfolio assets deposited by it pursuant to any of the subsections of section 6.8 to be rehypothecated and (b) the use of the term "beneficial owner" in subsection 6.8(4) of NI 81-102 is meant to refer to the right of the fund to have returned to it portfolio assets of the same issue as the deposited assets, including the same class or series, if applicable and having the same current aggregate market value of the deposited assets at the time of such return.


The withdrawal of the request for Rehypothecation Relief and the statements attributed to OSC staff in the Decision effectively resolve any lingering confusion surrounding the topic of whether or not it is permissible for the manager of an alternative mutual fund or a conventional mutual fund to allow for rehypothecation of portfolio assets. In fact, by essentially revoking the statements of OSC staff contained in the Practitioner relating to rehypothecation in the context of OTC derivative transactions, the OSC has made it clear that there are no specific prohibitions in NI 81-102 on allowing for rehypothecation in connection with derivatives (including OTC derivatives), cash borrowing and short sale transactions by alternative mutual funds and conventional mutual funds.

We recommend that, in deciding on whether or not to permit rehypothecation in connection with a specific type of transaction, an investment fund manager should consider a number of factors as part of exercising its duty to act in the best interests of the investment fund. We would expect that these factors would include (but not be limited to): (i) the investment objectives of the applicable fund; (ii) the creditworthiness of the lender/borrowing agent/counterparty; (iii) the amount of the relative cost savings to the fund as a result of permitting rehypothecation vs. not allowing for rehypothecation when considered in the context of the potential risk of loss of the portfolio assets as a result of a default by the lender/borrowing agent/counterparty in delivering the rehypothecated assets back to the fund (and if this risk is greater than the general risk of the lender/borrowing agent/counterparty delivering back deposited assets that are not available for rehypothecation); (iv) any contractual safeguards that can be built into the arrangements with the lender/borrowing agent/counterparty to protect any rehypothecated portfolio assets; (v) any self-regulatory organization or statutory protections in place which may act to safeguard or assist in the recovery of rehypothecated portfolio assets; and (vi) any other relevant considerations. It is possible that OSC staff may publish additional guidance for investment fund managers regarding rehypothecation in the future.

Please contact a member of McMillan's Investment Funds and Asset Management Group if you have any questions with respect to the Decision or any of the above information.

by Michael Burns, Shahen Mirakian and Joseph Osborne (Articling Student)

[1] Re Fidelity Investments Canada ULC and Fidelity North American Directional Long Short Fund, August 16, 2019.[ps2id id='1' target='/]
[2] See Ontario Securities Commission Investment Funds Practitioner (April 2015), 38 OSCB 2952 at "Rehypothecation of Collateral for OTC Derivatives" and Ontario Securities Commission Investment Funds Practitioner (March 2018), 41 OSCB 2275 at "Update on Rehypothecation of Collateral for OTC Derivatives".[ps2id id='2' target='/]

**A Cautionary Note**