



Pension Investment
Association of Canada

Association canadienne des
gestionnaires de caisses de retraite

November 24, 2014

Pension Policy Unit
Financial Services Commission of Ontario
5160 Yonge Street
Toronto ON M2N 6L9

Via E-mail: pensionconsultation@fscso.gov.on.ca

Re: Prudent Investment Practices for Derivatives

The Pension Investment Association of Canada (“PIAC”) has been the national voice for Canadian pension funds since 1977. Senior investment professionals employed by PIAC's member funds are responsible for the oversight and management of over \$1 trillion in assets on behalf of millions of Canadians. PIAC's mission is to promote sound investment practices and good governance for the benefit of pension plan sponsors and beneficiaries.

We are pleased to have this opportunity to respond to your request for comments in respect of the Investment Guidance Notes: Prudent Investment Practices for Derivatives (the “**Guidance Notes**”).

General Observations

As most of our members are users of derivatives in some capacity, PIAC welcomes reasonable guidance with respect to prudent investment practices related to derivatives. We appreciate the breadth and variety of the derivative themselves and the objectives associated with each of these instruments. Indeed, it may be imprudent for our members not to consider derivatives in managing their pension plans (e.g. LDI) while other strategies (e.g. leveraged strategies) can significantly increase risks to the plans. Although PIAC welcomes reasonable guidance with respect to prudent investment practices related to derivatives, we have some concerns with the present form of the Guidance Notes and offer our comments below.

Quantitative Limits

Consistent with many of our submissions on proposed regulations, legislation and industry guidelines, PIAC has presented the belief that general quantitative limits are not necessary

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and should not be relied upon to demonstrate the prudent person approach. In the Guideline Notes, FSCO has presented a 10% limit on the exposure or mark-to-market position of all contracts with a single counterparty or associated counterparties as a per cent of the fair value of the fund's investment assets (net of investment liabilities). This limit is repeated in the sections highlighting FSCO's expectations for risk mitigation (page 7) and risk monitoring (page 9) with the noteworthy addition of the following phrase: "...or such other limit as may be prudent in the circumstances".

PIAC would argue that this prudence should be the key criteria. In this case, it is the creditworthiness that should be key in determining a fund's allocation to a counterparty, with a lower percentage perhaps being prudent for lower-rated counterparties in certain types of derivatives (with the opposite true as well). Furthermore, the definition of the counterparty concentration limit percentage is broad and perhaps unclear referring to 'exposures or mark-to-market' and to the 'fund'. This creates confusion rather than clarity and possibly dilutes the effectiveness of the suggested quantitative limit. We note that individual plans are better suited to determine the appropriate transaction level with counterparties, and would urge FSCO to remove the 10% counterparty concentration limit from the Guidance Notes.

Harmonization

PIAC would suggest FSCO tackle directly the risk created within a derivatives transaction, rather than rely upon a 10% counterparty concentration limit. The risk created when the value of the underlying asset begins to fluctuate can be offset or eliminated by the mandatory exchange of collateral. As such, PIAC would suggest FSCO consider harmonizing their guidelines with those more broadly in the industry e.g. the BCBS/IOSCO principles related to margin for uncleared swaps.

SIPP and Documentation of Limits

PIAC does not disagree that limits, risk management practices and procedures for derivatives need to be in place to understand, measure, monitor and appropriately mitigate the risks associated with derivatives, or any investment within the pension fund. Requesting that these limits be placed in the SIPP will provide transparency on the types of derivatives and the extent they are used. However, the SIPP is meant to provide key policies and procedures setting out the strategies employed for the pension plan. It is broad due to its public nature. For many plans, given the complexity of strategies and derivative instruments, the policies and procedures should be presented, understood, and agreed to in much more granularity than what would be realistic to provide in a SIPP. For example, even simply describing the categories of derivatives can become cumbersome and the method of calculating the limits complex. It could be suggested by the Guidance Note that the approved limits, practices and procedures be documented in a technical and detailed manner outside of the SIPP, as appropriate for any plan.

Credit Assessments

PIAC would like to highlight that it agrees with the practice of pension plans conducting a comprehensive credit assessment in relation to each of its counterparties. However, the requirement to have this completed by an independent person should be a determination

may by the pension plan, based upon numerous characteristics, for example, the number of dedicated employees hired to perform such credit assessments.

Indirect Investment in Derivatives

PIAC would recommend that the Guidance Notes offer more tailored guidance with respect to indirect investment in derivatives. This would provide greater guidance to all market participants, including those market participants who access the derivatives market solely by indirect means. In addition, in section 7.0 the fourth bullet could be broadened to suggest that the administrator should understand the control environment and the review of procedures conducted by the pooled fund investment manager.

We thank you for the opportunity to share our thoughts with you, and would welcome an opportunity to meet with FSCO and discuss our comments and suggestions.

Yours truly,

A handwritten signature in black ink, appearing to read "Michael Keenan". The signature is fluid and cursive, with a small flourish at the end.

Michael Keenan
Chair