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SECTION: Investment of Pension Funds

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- PBA, 1987 s. 23, 63\*, O. Reg. 708/87 s. 63, 72

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#### **Derivative Instruments – Investing With Options and Futures**

Questions have arisen from Administrators and investment managers, concerning the use of derivative instruments and whether they satisfy the compliance requirements of the PBA, 1987 and Regulation. These derivative instruments take the form of futures and options contracts. Under the old legislation, the *Pension Benefits Act*, 1980, the PCO imposed certain restrictions on Administrators in the use of futures and options; this was to ensure compliance with section 17 of the Regulation that dealt with allowable investments.

For instance, a fund could not write a call option for which it did not hold the underlying security (i.e. a naked call), nor could it sell a future unless it was directly related to the fund's underlying investments. Purchasing a put option for which no underlying security was held could only be achieved through the "basket clause" limitations of the Regulation, since the investment would not have satisfied the "legal list" standard of the *Canadian and British Insurance Companies Act*. This standard for the investment of pension fund assets has been discarded under the new legislation. The key points to note under the new legislation are :

- " the old rules and restrictions are replaced by the requirements of the PBA, 1987 and Regulation;
- " the prudent person provisions of the PBA, 1987, set the standard by which an Administrator or investment manager must reach decisions involving the use of derivatives and derivative strategies as set out under sections 23 and 63 of the PBA, 1987;
- " for purposes of complying with the prudence standard, the effect of using derivatives is judged in terms of the overall context of the investment portfolio. Subsection 63(2) of the Regulation dealing with the preparation of the Statement of Investment Policies and Goals ("SIP&G") refers to the concept of this portfolio context;
- " disclosure of the intended use of derivatives must be made in the SIP&G filed with the PCO, including the

types of derivative instruments and the categories of securities on which they are based, pursuant to clause 63(3)(e) of the Regulation; and

- " disclosure of derivative investments is required in the financial statements that are to be filed annually with the PCO in accordance with section 72 of the Regulation. Assets, liabilities and income resulting from transactions involving derivatives are to be disclosed in the Statement of Net Assets and the Statement of Changes in Net Assets. Additional disclosure at the individual investment level may be required in accordance with clause 72(13)(b) of the Regulation.

Mandatory disclosure is required under 72(13)(c) of the exposure of the fund to derivative investments, and it is recommended that disclosure be made of all outstanding futures and options at the statement date to satisfy this requirement.

It is advisable that the SIP&G disclose the strategies involving derivatives which the Administrator or investment manager will or can engage in, including the purpose behind such strategies. The staff will not prejudge, however, whether a particular strategy is prudent or not, or whether a plan is imprudent in not adopting the use of derivatives or derivative strategies. These are decisions for the Administrator to make in the light of the nature of plan liabilities, investment objectives of the fund, the prudence requirement of the PBA, 1987 and other factors that may be considered appropriate in the development of investment policy.

Commission staff currently are investigating the need for revising the disclosure requirements of the PBA, 1987 and Regulation with respect to derivatives, in both the SIP&G and the financial statements. The staff recognize that certain issues regarding appropriate reporting and documentation with respect to the use of derivatives are now being addressed by the investment industry, the results of which may have a bearing on the staff's recommended changes in disclosure.

Some PCO staff have participated in a project formed from within the investment industry to deal with these issues. The project includes among others, representatives from trust companies, brokerage firms, pension fund managers and consultants; this affords an opportunity for discussion between PCO staff and investment industry professionals on the new developments in this field. These issues have also been on the agenda of the Accounting and Auditing, and the Investment Advisory Committees.

Questions or comments regarding the above are invited and may be directed to Jules Huot, Senior Policy Analyst at 416-314-0613 or fax 416-314-0650.

\*PBA, R.S.O. 1990, s. 22 and 62