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Securities Investments Permitted Under Regulation 75

The following article deals with several continuing issues facing those responsible for investing pension fund assets. Background was furnished by *The Canadian Depository for Securities Limited* ("CDS"). A certain mystique still surrounds the clearance and settlement of securities transactions even though more pension funds are investing in securities on a global scale.

Can pension plans hold securities in CDS?

Questions are arising as to the security of such investments and whether they are allowed under Regulation 75 of the *Pension Benefits Act*, 1987 (the "PBA).

Regulation 75 states that:

> "All investment and loans of a pension fund shall be held in the name of, or for the account of, the fund."

Before addressing the issue of the Regulation, it is worthwhile to define the clearing and settlement of securities. One of the best definitions comes from a U.S. Congress background paper:

> "...the processing aspect of trading on the world's stock, futures, and options exchanges, as well as the processing of trades which are done outside of any organized exchange. Generally speaking, "clearing and settlement" is what happens after the trade — everything from double-checking and confirming the terms of the transactions to paying for and delivering the traded financial instrument. "Clearing" is the process of confirming and matching (after the trade) the terms of the deal: how much is being bought and sold, at what price, on what date, from which seller, to which buyer. "Settlement" is the fulfilment — by each party to the trade — of the obligations of the trade. For example, in the equities markets, to the buyer, "settlement" means payment; to the seller, "settlement" means delivering the traded financial instrument (or transferring ownership) to the buyer."

Regulation 75 has put into question whether pension plan assets can be held in the "book entry" system of settlement. This system requires that securities be "deposited" with *The Canadian Depository for Securities Limited*. The depository then holds the records as to which participating brokerage firms, banks and trust companies own portions of each block of securities. The participants in turn hold records of how much they have purchased or hold and for which clients.

Therefore, under the book-based system, securities are held in the name or account of the brokerage house not the fund as required by the Regulation. The PCO has however taken the position that funds can invest in securities through the book entry system. This system provides speed, ease and increased accuracy in executing transactions and CDS serves merely as the holder or nominee in the system.

It is the understanding of the PCO at the present time that under various protection of securities regulations that federally regulated insurance, trust and loan companies are not allowed to deposit their own assets with CDS. However, this is under review.

Global trading and "book entry" in the 90s

With increased trading across national borders, Canada is moving towards the "book entry" system as a priority settlement method. For many classes of investors, such as pension funds, it is no longer possible to refer to their investments as domestic. This global investment activity has resulted in an effort by both the private and public sectors to reduce systemic risk in the markets in general.

Most actively traded and non-constrained equities are already eligible for deposit at CDS. Value on deposits exceeds $1 trillion. The greatest efficiency for the marketplace will come as all securities are made eligible and actually deposited. Work must still be done on the regulatory front to permit "book entry" holding of securities by some institutions, but it is clear that book entry clearance and settlement is the most efficient market strategy, both domestically and internationally.

To do this requires standardization and the linkage of clearing houses and depositories of many countries. In the absence of such standardization, these linkages could take a long time to develop. However, it will take the standardization of the clearing process worldwide to assure investors in global markets of minimal risk.

Equities settlement in Canada now is consistently three days after the trading date. However, the settlement period is not consistent on a global scale. The amount of time can vary from less than one day to more than a week.

Differences between "rolling" settlement and "periodic" settlement further complicate matters. Rolling settlement refers to regular trade settlement, a given number of days following a trade. Periodic settlement occurs in markets where all the trades made during a particular "accounting" period are collectively settled during a set settlement period. For example the United Kingdom settles transactions over a six day settlement period after a two week trading or "accounting period."

Even though there are specific factors in each market that determine the length of the settlement period, it is still possible to narrow the gaps if markets move towards a more uniform timetable for settlement of similar financial instruments.

PCO Staff Comment: This article was revised slightly to reflect current practice.