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Submission of the International Swaps and Derivatives Association

Review of Bill C-12 to the Senate Standing Committee on Banking Trade and Commerce

February 26, 2008

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Review of Bill C-12 (formerly Bill C-62)
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Introduction

1. The International Swaps and Derivatives Association, ISDA, represents participants in the privately negotiated derivatives industry, and is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 815 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

2. ISDA is strongly supportive of the amendments that were made to both the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act* by S.C. 2005, c. 47 and the amendments to it in Bill C-12 (now S.C. 2007, c.36).

3. ISDA has prepared this written submission in order to comment and provide further information which the Committee may find of assistance in considering certain submissions and comments made by representatives of the Insolvency Institute of Canada.

4. In particular, ISDA would like to comment on one matter, namely the exemption for eligible financial contracts to the statutory power of the debtor to disclaim contracts in a BIA proposal or CCAA proceeding.

Disclaimer of Contracts

The Statutory Provisions

5. The amendments made to the BIA and CCAA by S.C. 2005, c.47 (as modified by Bill C-12) codified the power of a debtor company to disclaim contracts.[1] A number of types of contracts are exempt from this power, including certain leases, collective agreements and financing agreements where the debtor is the borrower. Eligible financial contracts are also included in the exemption.[2]

Testimony Before the Committee

6. The Committee has heard testimony from representatives of the Insolvency Institution of Canada (IIC) that this exemption for eligible financial contracts is a potential impediment to restructurings. We refer to the testimony of Mr. Patrick McCarthy. The concern raised is that a debtor company must in some cases be able to rid itself of an onerous forward contract or other derivatives contract in order to effectively restructure its business. It was suggested in the evidence that the exemption for eligible financial contracts was a possible oversight.

Policy Reasons for the Exemption

7. The eligible financial contracts exemption was not an oversight. Nor was it intended to prevent debtor companies from compromising liabilities under eligible financial contracts. Mr. McCarthy states in his testimony that the obligations under eligible financial contracts may be post-filing obligations not capable of being compromised. We had believed that they likely would be pre-filing obligations that could be compromised. While obligations under these types of contracts are contingent, they are existing, albeit future

[1] BIA, s.65.11(1); CCAA, s.32(1).
[2] BIA, s.65.11(10); CCAA, s.32(9).

liabilities. As noted in the testimony, however, the provisions of the BIA and CCAA as to the types of claims that can be compromised are not clear in their application to future contingent liabilities.

8. In any event, it is unlikely that financial markets participants would object to permitting the debtor to have a right of disclaimer. However, this cannot be accomplished simply by removing the exemption for eligible financial contracts from the disclaimer power, because to do so would undermine the policy of the eligible financial contracts exemptions for termination, netting and collateral enforcement. As the Committee is aware, the exemptions for termination, netting and collateral enforcement have been recently amended to meet international standards, so as to enhance Canada's competitive position in the important global securities financing and derivatives markets. It is important not to undermine the progress that has been made.

9. One reason that removing the exemption would not be appropriate is that the non-insolvent party to the eligible financial contract must have a sufficient time to decide whether or not to exercise its right to terminate the transactions. These types of contracts change values frequently and the value of the claim by or against the parties can vary on a daily basis. Calculations of loss are made by terminating as of a specific date and determining the market values or losses as of that date. The non-insolvent party makes the calculations, including in many cases obtaining market quotations from third parties. Depending on the type of transaction and the terms of the transaction it could take days or weeks to determine the appropriate close out timing. If the insolvent party could disclaim (as of the date of its choosing), it would undermine the non-insolvent party's right to

terminate as of the date of its choosing and the close-out netting provisions of most standard netting agreements. This is, in fact, the policy basis for the eligible financial contracts exemption to the disclaimer power.

10. Consequently, if there is to be any modification of the disclaimer power with respect to eligible financial contracts it must respect the right of the non-insolvent party to determine the timing of the termination of the transactions. This could be accomplished by restricting the right to disclaim with respect to eligible financial contracts to situations where the non-insolvent party has had a reasonable time to determine whether it will exercise its right to terminate and only if the non-insolvent party has not exercised its right to terminate within that time. This proposal was recommended by the Canadian Association of Insolvency and Restructuring Professionals in its December, 2007 submission to the Committee.

> To mitigate the impact of the termination of the EFC on the counterparty, the Association recommends an amendment to Bill C-12 to allow the counterparty to elect the termination date of the EFC for the purpose of calculating the net termination value and therefore the provable claim in the proceeding. The election of the EFC termination date by the counterparty would be supplemental to other rights the counterparty to the EFC may possess, including a set-off right.

11. Any power to disclaim must also clearly provide that the insolvent party cannot choose to disclaim certain transactions with the non-insolvent party while leaving others in place if the transactions are subject to a master agreement or other set-off arrangement. This “cherry-picking” of transactions would undermine the netting arrangements between the parties. Where a master agreement (or master agreement with respect to more than one master agreement) is in place, the master agreement and all

individual transactions under it form a single agreement. It should be made clear that if the insolvent party is entitled to disclaim it must disclaim all transactions subject to a master agreement.

12. In summary, there are important policy reasons supporting the exemption for eligible financial contracts from the power of the insolvent party to disclaim contracts. Amendments to the existing exemption to allow a more circumscribed exemption would not necessarily undermine those policy reasons, but they must be carefully crafted to ensure that they do not undermine the protected rights of termination and netting of transactions and do not permit cherry picking by the insolvent party.

Yours truly,

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