

# ISDA

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USTA Task Force of the Canadian Securities Administrators  
c/o Ontario Securities Commission  
Box 55  
Suite 1903 - 20 Queen Street West  
Toronto, Ontario M5H 3S8

Attention: **Mr. David Brown**,  
Executive Director, Uniform Securities Transfer Act Project  
**Mr. Maxime Paré**, Chair, CSA USTA Task Force  
Senior Legal Counsel, Market Regulation  
Capital Markets

Dear Sirs/Mesdames:

This letter is written to express the International Swaps and Derivatives Association's strong support for the *Uniform Securities Transfer Act* and consequential amendments to related legislation published for comment by the USTA Task Force of the Canadian Securities Administrators.

The International Swaps and Derivatives Association, Inc.<sup>1</sup> (**ISDA**) is the global trade association representing participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today numbers over 600 member institutions from 46 countries on six continents. ISDA's members include most of the world's major institutions who deal in and leading end-users of privately negotiated derivatives, as well as associated service providers and consultants. Privately negotiated derivatives play an important part in the Canadian financial and equity markets. The important part they play is already recognized in all federal insolvency legislation and also the *Payment, Clearing and Settlement Act*.

One of ISDA's key objectives is to promote legal certainty for cross-border financial transactions in or involving derivatives markets. ISDA and its members devote considerable resources to acquiring and updating legal opinions from a wide range of jurisdictions on netting, set-off and financial collateral arrangements and to promoting changes in laws to enhance the effectiveness of these types of

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<sup>1</sup> For further information on ISDA and its activities, please consult our website at <http://www.isda.org/>.

arrangements. ISDA also pays close attention to developments affecting the international regulatory environment for derivatives. Our Collateral Law Reform Group, which was founded in early 1999, has participated in every significant European and international financial law reform consultation affecting collateral arrangements since 1999.

It is therefore with great interest that ISDA members have reviewed the USTA, as well as the Task Force's August 1, 2003 consultation paper (the "Paper"). The issues addressed in these materials are of fundamental and pressing concern to the financial markets, including, of course, the market for privately negotiated derivative transactions.

As the Task Force clearly appreciates, the current Canadian legal regime, both federal and provincial, regarding the transfer of securities is out of step with modern securities transfer systems. The resulting legal uncertainty is adversely affecting the competitive position of Canadian participants and is adding significant costs for Canadians with respect to their participation in these important financial markets. As other countries modernize their laws Canadian participants will face further competitive disadvantages. It is critical that Canadian legislators act quickly to implement reform.

We would like to take this opportunity to make a few observations with respect to Canada's current regulatory regime and the USTA that are of particular relevance to the cross-border derivatives market.

### **Protecting Security and Other Interests in Securities**

We applaud the steps taken by the Task Force towards modernizing the law with respect to the protection for purchasers of securities, including secured creditors, against adverse claims in securities and in securities accounts. This is one of the most important changes sought to be introduced by the USTA, and, from ISDA's perspective, constitutes a significant enhancement of the legal certainty offered by Canada's personal property security regime.

Under the current system, there is a troubling lack of legal certainty with respect to determining what steps should be taken by a party seeking to obtain and protect a first priority interest in a security trading through a system involving clearing agencies and financial intermediaries. This uncertainty stems from the fact that the regulatory regime continues to reflect antiquated notions of possessory security interests and of financing statement-filing requirements that do not accommodate the modern realities of securities holding. Possession or control should be the only steps required to ensure a first priority interest in securities, distributions on securities and proceeds of securities.

Admittedly, some efforts at modernization have been made. For example, section 85 of the *Business Corporations Act* (Ontario) deems a participant to have possession of securities trading through the Canadian Depository for Securities Ltd. Other provincial PPSAs include similar provisions. However, these provisions fail to address certain important types of financial transactions. For example, where a Canadian counterparty pledges a security trading through a foreign book-based system, the current law in many provinces requires the secured party to protect its interest by registering a financing statement. This means of perfection does not ensure a first priority and it is, therefore, simply unacceptable to many market participants dealing with Canadian entities. In these circumstances, the Canadian participant will often incur the extra cost of dealing on an unsecured basis or providing a more expensive form of collateral, such as a letter of credit or cash.

In some circumstances absurd results arise from the application of outdated laws to modern systems. For example, if an entity located in Ontario posts a New Brunswick government security as collateral it may be necessary to comply with Quebec law by reason of the somewhat arbitrary factor that CDS holds the global certificate for those securities in its Quebec office. The need to rely on registration and the often absurd results are driven by (1) the lack of uniformity between the approaches in Canada and the United States, (2) uncertainty in the Canadian private international law rules and (3) an inadequate approach to the substantive issues regarding the means of protecting a purchaser of securities from adverse claims. Under the proposed USTA approach, each of these problems would be addressed. The modernized, relatively certain approach of the USTA will be far more appealing to international participants dealing with Canadians, and this is enforced by the substantial harmonization of the USTA with other jurisdictions' modernized legal standards in this area, particularly as set out in Revised Article 8 of the Uniform Commercial Code (**Rev. 8**).

### **Characterization Issues**

One of the major issues for participants in the international derivatives market seeking to transact business with Canadian counterparties is that the Canadian legal regime currently requires parties to consider characterization differences between transfers of securities and the taking of a security interest in securities. From a business perspective, modern securities trading practices draw no such distinctions. ISDA strongly favours the USTA's approach, which largely eliminates characterization differences between transfers of securities and the taking of security interests in securities.

**Rehypothecation Rights**

The Task Force has specifically requested comment in respect of OPPSA/APPSSA s. 17.1 on rehypothecation by a secured party with control of investment property. We have reviewed the two versions of s. 17.1 put forth in the Task Force's proposed amendments to the OPPSA and APPSSA. The Task Force approach would specifically permit the secured party to create a security interest in the collateral. The PPSA Working Group favors a more restrictive approach that would prohibit the creation of a security interest by the secured party where the effect would be to impair the debtor's right to redeem the collateral.

In ISDA's view neither approach goes far enough to reflect current practice. Market participants not only want to have the ability to confer on the secured party the right to create security interests in the pledged securities, but also the right to lend, sell or otherwise dispose of those securities in securities lending or repurchase transactions. We believe that conferring such rights, as well as a right to create security interests, may very well impair the debtor's right to redeem within the meaning of the current PPSAs and the Working Group's proposed version of section 17.1. Market participants benefit financially from being able to confer such rights on a secured party. The amendments should make it clear that it is not a breach of the PPSA to confer such rights on a secured party and that priority will not be affected when the secured party reacquires equivalent securities to those securities dealt with pursuant to these rights.

**Harmonization**

The objectives of USTA, namely to provide a sound legal foundation for securities holding and transfer practices, particularly the indirect holding system, and to harmonize with Rev. 8, are in close accord with ISDA's objective of promoting legal certainty for cross-border financial transactions. In this regard, ISDA strongly endorses many other aspects of the USTA in respect of which you have requested specific comment. The overarching policy of attaining uniform securities transfer laws in Canada is very important as the full benefits of modernization will not be achieved without it. The Crown and Crown corporations are also very important participants in these markets and so ISDA supports the application of USTA to the Crown. Also, without uniform and comprehensive choice of law provisions substantive law changes will not resolve legal uncertainty. All of these proposed reforms clearly enhance legal certainty, and reduce legal risk, for parties engaging in financial transactions with Canadian counterparties.

We note that the USTA has been deliberately drafted with a view to achieving substantial harmonization with Rev. 8. We agree with this approach, and your rationales underlying it, namely the

effectiveness and clarity of Rev. 8, and the confidence that participants in the global financial market have in Rev. 8.

### **Additional Matters**

In addition to the significant number of positive legal developments that would be introduced by the enactment of the USTA, we also wish to briefly discuss certain issues of concern to the international financial markets that the USTA currently does not address.

#### **Deposit Accounts**

We note that the proposed amendments to the PPSAs address monies deposited to a securities account, but do not address deposits with a bank or other financial institution. Under the current proposal, the control agreement approach will not apply to perfect a security interest in this type of asset. U.C.C. Revised Article 9 extends the control concept to deposit accounts. Participants in the derivatives markets commonly provide cash collateral in the form of deposit accounts. The current need to perfect a security interest by registration of a financing statement in the jurisdiction of the debtor's location, whether the deposit is in an institution in the province or not, is a significant impediment to Canadian's ability to collateralize their obligations by creating a security interest in this form of collateral. As with securities collateral, it should be clear that a secured party has the right to use the cash in its business if the parties agree, without losing priority.

ISDA strongly urges that the amendments extend the concept of perfection by control to deposit accounts. The failure to take this opportunity to extend that concept to deposit accounts simply means that current legal complexity and uncertainty regarding perfection of security interests in Canadian collateral will continue to be a concern where the proposed collateral is a deposit account.

#### **Concurrent Insolvency Law Reform**

The current lack of protections in Canadian insolvency legislation for collateral arrangements for derivatives transactions also creates legal uncertainty that adversely affects Canadian counterparties. Other jurisdictions around the globe have implemented or are implementing protections against stays on enforcement of collateral for financial arrangements such as derivatives, as well as protections against the application of fraudulent conveyance and creditor preference laws. Common collateral techniques such as providing collateral on a continuing mark to market basis, substitution of collateral and rehypothecation rights should also be protected by insolvency laws. Limiting the formalities required to

realize on securities collateral is also important to market participants. We appreciate that these types of reforms are outside of the scope of the USTA project, but we would emphasize that Canadian capital markets will remain uncertain ones for market participants unless insolvency laws also keep pace with global developments.

**Conclusion**

To reiterate, we believe that Canada's current regulatory regime significantly disadvantages both Canadians seeking to engage in cross-border financial transactions and non-Canadians who would, but for the uncertainty and risk resulting from the traditional approach of the current Canadian regime, deal more advantageously with Canadian counterparties. Ongoing international developments, such as revisions to the Basel Rules governing international banking, will require the ability to be increasingly precise in the assessment of risk. The current lack of certainty in the Canadian legal landscape will make it increasingly difficult for Canadian counterparties to fully and competitively participate in these markets both domestically and internationally. By harmonizing the Canadian regulatory environment with the world's most modernized regimes, the USTA represents a substantial, and critical, step towards minimizing the legal risk posed by the Canadian regulatory environment.

Yours truly,



Robert G. Pickel  
Executive Director and Chief Executive Officer