ISDA Safe, Efficient Markets

July 15, 2014

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Dear Sirs/Mesdames:

Re: Statutory Review of the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*

This letter is provided in response to Industry Canada's invitation to make submissions in response to its discussion paper "Statutory Review of the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*" (the **Paper**).

The International Swaps and Derivatives Association (**ISDA**)[1] welcomes the opportunity to make submissions on the *Bankruptcy and Insolvency* Act (**BIA**) and the *Companies' Creditors Arrangement Act* (**CCAA**). ISDA's mandate is to make OTC

[1] ISDA has more than 800 member institutions from 64 countries. ISDA members comprise a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Canadian members of ISDA include not only financial institutions, but also pension entities and other end-users of derivatives.

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derivatives markets safe and efficient. Its pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. ISDA has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. One of the key areas of ISDA's work involves reducing counterparty credit risk and a key aspect of that is helping legislators to understand the importance that bankruptcy and insolvency laws play in reducing counterparty credit risk and, consequently, systemic risk in the financial system. ISDA welcomes the opportunity to provide input on those aspects of Canadian insolvency laws that affect derivatives markets and participants in those markets.

We have organized our submissions as follows: (A) matters that are raised in the Report by Dr. Janis Sarra entitled "Examining the Insolvency Toolkit: *Report of the Public Meetings on the Canadian Commercial Insolvency Law System*" July 2012 (the **Sarra Report**) that relate to derivatives, (B) matters that are raised in the Insolvency Institution of Canada's Task Force on Derivatives Report (**IIC Report**), and (C) additional matters of interest to ISDA members.

(A) Matters Addressed in the Sarra Report

1. Credit Default Swaps (CDS) and the Netting Safe-Harbour

The Paper refers to the Sarra Report's discussion of CDS Counterparties[2]. The Sarra Report presents, as an option, that credit default swaps and other credit derivatives (**CDS**) could be subject to a stay of proceedings under the CCAA, except with leave of the court on the basis of unfair prejudice. The court could then "exercise oversight of the clearing process in a measured way that assists with the risk management aspects of the products and slows the speculative market"[3].

[2] on pages 54 to 61 of the Sarra Report
[3] Sarra Report, page 58.

Unfortunately, this option appears to be based on a misunderstanding of how CDSs operate and the effect of the CCAA eligible financial contract (**EFC**) exemption from stay risk relating to termination, netting and dealing with collateral (**EFC Stay Exemption**) on them. Excluding CDSs from the definition of an EFC would not address the issues raised in the Sarra Report. To explain why that is the case, a brief simplified description of how a CDS works may be helpful.

A typical CDS would operate as follows (the capitalized terms used here are those set out in the ISDA Credit Derivatives Definitions). Bank A (as credit protection Buyer) and Bank B (as credit protection Seller) are parties to the CDS contract. The Reference Entity under the contract is the debtor entity and the Reference Obligations are debt securities issued by or loan obligations of the Reference Entity. The Reference Entity is <u>not</u> a party to the CDS. The CDS provides that, if there is a Credit Event with respect to the Reference Entity, including a Bankruptcy or Restructuring Event, Bank B must buy Obligations of the Reference Entity (which may be the Reference Obligation or other debt falling within the definition of a Deliverable Obligation) from Bank A (if physically settled) or pay a certain specified amount reflecting the loss of value of the Reference Obligation to Bank A (if cash settled). Bank A will have paid an upfront fixed payment or a series of fixed payments (similar to insurance premiums) for this protection. The types of credit derivatives discussed in the Sarra Report, and with respect to which concerns are raised, are those for which the insolvent party is the Reference Entity and its debt is the Reference Obligation.

The statutory or court ordered stay (to which the EFC Stay Exemption applies) prevents termination or acceleration of obligations under contracts between counterparties and the insolvent party. The stay would not apply to the type of CDS described in the Sarra Report because:

1. it is a contract between Bank A and Bank B to which the debtor (as Reference Entity) is not a party; and

2. the payment obligations under the CDS are not triggered by a "termination" of the contract or an "acceleration" of obligations ordinarily due on a later date (the trigger words used in the CCAA) – payment and delivery under the CDS is the ordinary course performance contemplated by and paid for under the terms of the contract.

There is no need to rely on an EFC Stay Exemption in this context, because the stay simply does not apply.

The Sarra Report appears to have misunderstood the relationship between the stay and the particular issues identified with respect to the effect of having credit protection buyers under CDS that are also holders of the Reference Obligations (and, consequently, creditors) involved in a proceeding. The two issues are not related.

Nor should a stay apply to prevent performance under a CDS between third parties (or indeed in respect of any arms' length contract between third parties). CDSs are used as a hedge against loss by holders of debt or are entered into by market participants to provide liquidity in the CDS market. As noted, the credit protection Buyers have paid for this protection. Credit insurance would serve the same purpose, as would a third party guarantee. There is no suggestion that a court would, should, or has jurisdiction to, prevent claims being made under these other types of third party credit protection contract.[4]

If there are procedural issues that arise because of the parallel settlement of CDS contracts during the restructuring process (e.g. protection Sellers becoming the new debt holders on settlement of the CDS), this should be dealt with by focusing on the particular procedural issues. Presumably it could be addressed by setting timely claims bar dates (as the Sarra Report also suggests), not fundamentally altering the contractually bargained for rights between third parties.

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[4] This is now also confirmed by section 11.04 of the CCAA. See also *Fairview Industries Ltd. (Re)* (1991), 11 C.B.R. (3d) 37 (N.S.S.C.) and *Keddy Motors Inns Ltd. (Re)* (1901), 107 N.S.R. (2d) 424 at ¶27 to the same effect.

A debtor company in a CCAA proceeding may be a party to a CDS and in that case the EFC safe-harbour would be relevant, but that CDS would not be with respect to the Reference Obligations of the debtor company. The Sarra Report does not identify any reason why a temporary stay (as suggested by one commentator[5]) would be any more beneficial to the restructuring in that situation than with respect to any other EFC.

Considerable market risk is eliminated by netting and collateral offset with respect to derivatives transactions, including credit derivatives products. The following 2012 mid-year data from the Bank for International Settlements (**BIS**) as well as from ISDA's own research illustrates the risk mitigation benefits of netting and collateral offset. The Gross Market Value, which is a BIS measure of credit exposure, is the market value of all outstanding contracts before netting or collateral offset. It shows the aggregate positive market values of all outstanding contracts to in-the-money counterparties.[6] Gross Credit Exposure applies the benefits of netting to the Gross Market Value. Gross Market Value of the OTC derivatives market in June 2012 was estimated by BIS to be 25.4 trillion US. Gross Credit Exposure however is 3.7 trillion US, which is only 14.3% of the Gross Market Value.[7] ISDA, through its margin surveys and other data sources, measures the effect of collateral on Gross Credit Exposure. In mid-year 2012, it was estimated that 71% of exposure was collateralized and that applying both netting and collateral, Gross Credit Exposure was reduced to 1.1trillion US, which reduces credit exposure to 4.3% of the Gross Market Value[8]. Using other methods of calculating the effect of collateral based on the amount of collateral in circulation and data obtained from the ISDA Margin Survey, the ISDA analysis estimates that netting and collateral reduce Gross Market Value by 92.5% (which is $1.9 trillion). Data from prior years is consistent

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[5] Sarra Report, top of page 59.
[6] Equivalent to the absolute value of the aggregate negative market values of those contracts to out-of the money counterparties.
[7] This is 0.6% of the notional principal amounts, but nNotional principal amounts do not reflect market value and therefore do not reflect credit exposure.
[8] Which is 0.2% of notional principal amount.

with these figures and reflects the continuing significant reduction in credit exposure due to increased levels of collateralization.[9]

Further, if there is a possibility of a stay under the CCAA, even if it is one that may be lifted by the court, the result will be that financial institutions providing these hedging products to clients cannot apply netting treatment for capital purposes, and this will directly and significantly affect liquidity in this market and the cost of these products to clients in an adverse manner. Unless there is certainty that contractual rights can be exercised (whether or not the party is solvent or insolvent), financial institutions cannot apply favourable capital treatment. Further, when it comes to the issue of termination, netting and collateral enforcement rights, it should not be a question of what is fair or prejudicial in a particular case before a court. The purpose of the statutory provisions is to reduce counterparty credit risk in derivatives markets generally and, consequently, systemic risk in those markets.

Therefore, we recommend against any modification of the EFC Stay Exemption as it applies to credit derivatives because such a modification would (a) be ineffective to accomplish anything with respect to voting transparency or incentives in insolvency proceedings involving the entities whose debt is the subject of the CDS (an issue which the Sarra Report appears to believe would be addressed by the change), (b) be financially damaging to counterparties who purchase these protection products, and (c) increase counterparty credit risk with respect to these products.

2. Flip Clauses and Derivatives

On page 59 of the Sarra Report there is a note that “flip clauses” have become very popular in derivatives contracts. It describes flip clauses as clauses that provide that the defaulting counterparty, even if in the money, is deprived of the benefit of such a contract. According to the Report, the “practical effect” is that the “bankrupt counterparty” is deprived of a valuable asset in the estate.

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[9] See ISDA OTC Derivatives Market Analysis Mid-Year 2012, Table 4.

This part of the Sarra Report appears to be confusing flip clauses with walk-away clauses. We address such clauses below in section (B)(3). We would point out that a "flip clause" does not deprive a "defaulting counterparty" of the benefit of the derivative contract. A "flip clause" is generally understood to be a clause in an inter-creditor agreement that changes the order in which payments are made in the payment waterfall depending on whether or not the debtor is in insolvency proceedings. These types of inter-creditor agreements arise in asset securitization transactions. In some cases the derivatives liabilities may move up the waterfall in the case of an insolvency of one of the other creditors in the waterfall (as opposed to the counterparty to the derivative) with the result that the creditor whose priority has "flipped" with the priority of the derivatives counterparty may not receive payment from the collateral that is supporting all of the obligations provided for in the waterfall. These clauses are not terms of the derivatives themselves. Nor are they generally "popular". They are used only in certain limited contexts, like structured finance transactions.

Flip clauses usually serve a valid commercial purpose (e.g. to meet the requirements of rating agencies[10]) and, where they do not, they may be challenged under the existing law. The U.K. Supreme Court addressed flip clauses of this type in *Belmont Park Investment Pty Limited v. BNY Corporate Trustee Services Limited*[11]and found that the clause in that case did not offend the anti-deprivation principle. A different result was arrived at in the U.S. proceedings[12], but that is because there is a very broad *ipso facto* clause in the U.S. *Bankruptcy Code* that does not allow for the more principled analysis the U.K. court applied. The anti-deprivation principle is a part of Canadian insolvency law and any contract that offends the principle can be challenged.[13]

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[10] The objective is to protect rated vehicles from the consequences of a counterparty insolvency.
[11] [2011] UKSC 38.
[12] *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Limited*, 422 B.R. 407 (Bankr. S.D.N.Y., 2010.
[13] A discussion of the case law and the anti-deprivation principle as it applies to these types of clauses can be found in "Financial Products and the Anti-Forfeiture Principle", by Margaret Grottenthaler and Elizabeth Pillon, in Journal of the Insolvency Institute of Canada / Insolvency Institute of Canada, ed.

3. Disclosure of CDS Positions in Proceedings

The Sarra Report notes that a number of presenters commented on the issues that arise where creditors that take part in the proceeding have less economic interest in the outcome because of the fact that they have purchased CDS protection. (We note again that none of the provisions in the BIA or CCAA dealing with EFCs are related to this particular issue.)

A creditor's real economic interest may be affected by a CDS, but it might also be affected by other types of contracts with a similar effect, such as guarantees, credit insurance and risk participation agreements. Creditors who purchase debt securities at a significant discount also have economic interests that are different than the original debtholder. If this issue is to be addressed in the legislation, then it should be addressed comprehensively and not so as to single out CDS transactions, as this could result in product arbitrage.

There are certainly reasons why a judge considering the fairness of a plan of arrangement should understand the economic interests of all creditors, those that voted against and those that voted in favour of the plan. However, any rule requiring disclosure of the credit protection arrangements benefiting any particular creditor should be carefully formulated so as to protect the confidential trading information of the parties to the credit protection arrangements.

(B) Matters Addressed in the IIC Report

1. Protect EFCs in Receivership

ISDA supports the recommendation of the IIC Report that the receivership provisions in the BIA be amended to ensure that a court does not have the power to impose a stay on the exercise of the right to terminate, net and deal with financial collateral for an EFC in the context of receivership proceedings. ISDA also supports

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Stephanie Ben-Ishai, Rod Wood and Max Mendelsohn (Toronto: Carswell, 2012), p. 139.

extended section 88 of the BIA to receiverships under Part XI of the BIA. Consistent treatment across all insolvency regimes is appropriate and important to derivatives markets. The Model Receivership Order used in Ontario provides some comfort to market participants dealing with Ontario counterparties, but does not provide the same level of certainty that exists under the BIA proposal and bankruptcy regimes.

2. Removal of the prohibition on disclaiming eligible financial contracts

In this section we address the recommendation in the Insolvency Institution of Canada's Task Force on Derivatives Report (**IIC Report**) that sections 32(9) of the CCAA and section 65.11(10)(a) of the BIA should be amended to provide that an EFC can be disclaimed (or resiliated) by the insolvent party, provided that the insolvent party cannot disclaim for 30 days from the commencement of the proceeding, at the end of the 30 day period the same regime for disclaimer as applies to other non-exempt contracts should apply and that the entire contractual relationship must be disclaimed so that there is no cherry picking of favourable transactions.

The agreement disclaimer provisions were codified in the CCAA and BIA in 2009 and since that date EFCs have been excluded from the disclaimer power, together with financing agreements under which the debtor is the borrower, collective agreements and real property leases.

Timing for Disclaimer

ISDA members would not have any strong objection to allowing insolvent debtors to disclaim executory EFCs where an inability to disclaim would affect the ability to restructure provided a sufficiently long period of time is given to allow the solvent party to exercise its termination right in a controlled manner that effectively allows it to unwind its hedges of that position or enter into replacement transactions. For many contracts, the 60 day period provided for in the proposal of the IIC Report would be sufficient. However, for certain customized and longer term contracts, a 60 day period would not be sufficient. Nor is this issue addressed by allowing a party to ask the court for an extension if that would involve a public procedure and public disclosure of the terms of the transactions. Such disclosure would compromise the ability to unwind hedges or re-hedge. Derivatives markets are becoming more transparent as trade reporting obligations come into effect globally and in Canada also. But, even in that context, public disclosure is only of aggregated and anonymous data. If any such procedure is to be adopted, it will be important to ensure the confidentiality of the evidence presented on any motion to extend the time.

The transactions for which 60 days would be sufficient are also likely to be more standardized and, therefore, subject to clearing. As the IIC Report notes, the disclaimer should not apply to cleared transactions.

We believe that 90 days would be a more appropriate notice period. Please see the paragraph below in the discussion of walk-away clauses that advises on the proposed ISDA amendment to section 2(a)(iii). The U.K. Financial Services Authority has agreed that 90 days is an appropriate period of time for a party to determine whether to continue to perform or exercise its termination rights.

Disclaimer Should Not Apply to EFCs that are used for financing purposes

Certain EFCs are essentially financing transactions. These include margin loans, securities loans, commodity loans and repurchase transactions. There is no policy reason to treat them differently in terms of disclaimers (where the insolvent entity is the securities lender, seller under the repurchase agreement or borrower under the margin loan) than loans and other more traditional financing agreements that are exempt. Consequently, if the EFC disclaimer exemption is amended, it should remain fully in place for EFCs of this nature.

Consider Whether Removing the Exemption is Necessary or Particularly Beneficial

With respect to other EFCs, we question whether it is necessary to make this amendment. With respect to the necessity for the amendment, we note that the IIC Report points out that an insolvent business needs to be cleared of burdensome contracts, including EFCs, in order to effectively restructure. Certainly that is the purpose of the disclaimer power. However, the IIC Report provides no examples of situations where this problem has arisen in practice. The Sarra Report, in its discussion of disclaimer of agreements, did not refer to any particular issue being raised by those consulted with respect to the EFC disclaimer exemption. We question whether there is empirical, or even anecdotal, evidence to support that the existing exemption has materially interfered with the ability of an entity to restructure under the CCAA or BIA. We believe that this should be examined more closely before removing an exemption that serves a valid purpose.

We also believe that the IIC Task Force has misunderstood what the effect of disclaimer would be, with the result that it has overstated the benefits. The IIC Report suggests in several places that the disclaimer would allow the insolvent party to benefit from the "in-the-money" amount of the contract. This is simply not the case. The only basis upon which a party can benefit from the value of the transactions is by exercising a termination right under the terms of the contract. Parties cannot terminate at will. Termination rights are triggered by certain events, including events of default, including insolvency events of default. Termination under the contractual terms in turn allows the non-defaulting party to calculate the net termination payment pursuant to the terms of the contract, which may result in payment to the insolvent party if it is in-the-money. The insolvent party, as the defaulting party, does not have a termination right . Disclaimer does not confer that contractual right. While disclaimer may effectively result in termination of the contract, because it is not a termination under the terms of the contract itself, it does not trigger the close-out calculations that give rise to the net termination payment calculation. Disclaimer does give the solvent party a right to make a claim in the proceeding for its damages. If the solvent party suffers no damages (as it would if it was in-the-money to the insolvent party), it would not have a claim, but it would also not have any obligation to pay an amount equal to the benefit arising from disclaimer to the insolvent party. This could not be required for EFCs any more than it could be required for other contracts.

This issue was considered in the context of an ISDA master agreement in the Australian case, *Enron Australia Pty Limited v. TXU Electricity Limited*[14] and, as determined in that case, the court does not have the power to amend the terms of the contract. An insolvent party that wishes to receive the benefit of a contract, must affirm it, not disclaim it. Nor does the court have jurisdiction to rewrite the terms of the contract between the parties.

If indeed the non-insolvent party does exercise its contractual termination right, the insolvent party would receive a net termination payment if the transactions were in the money to the non-insolvent party on a net basis. Contrary to the impression left by the conclusions in the IIC Report, very few master agreements would allow the terminating party to not make that net termination payment. While there are provisions in the ISDA Master Agreement that allow a non-defaulting party to suspend certain performance obligations in the face of an uncured default,[15] the obligation to pay the net termination payment is not one of those suspended obligations. It is also possible to opt for a netting calculation that would not result in a payment to the defaulting party. This is what the industry refers to as a walk-away clause. These types of clauses are not common because capital rules applicable to banks would prevent the banks from netting for capital purposes if the agreements contained such a clause. We discuss these types of clauses in more detail below in our discussion of the IIC Report recommendations with respect to walk-away clauses. Suffice it to say at this point that they have nothing to do with whether an insolvent party could realize the value of the transactions by disclaimer.

Adding Disclaimer Power to Bankruptcy, Receivership and WURA Proceedings

The IIC Report also recommends adding the power to disclaim EFCs in the context of BIA bankruptcy, receivership proceedings under the BIA and to liquidation under the *Winding-up and Restructuring Act* (**WURA**). It is not clear

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[14] [2005] N.S.W.C.A. 12 (Feb. 11, 2005).

[15] For example, section 2(c)(iii) of the ISDA Master Agreement. It suspends payment obligations under the transactions while they remain in effect, not termination payments. We discuss the effect of these clauses in the discussion of walk-away clauses in section *.

whether the IIC Report is recommending that a codified disclaimer power in general be added with respect to these other proceedings or whether it is a disclaimer power restricted to EFCs that is recommended. We see no reason why the disclaimer power should be so restricted if that is indeed the recommendation.

Also, the IIC Report states that the purpose of disclaimer is to shed the entity of onerous contracts so as to facilitate the restructuring. Restructuring is not the goal of bankruptcies, certain receiverships or liquidations under the WURA, so careful consideration should be given to whether it would be appropriate to include the same type of general disclaimer provisions in those proceedings. Presumably it should be considered through a wider lens than simply looking, in isolation, at the question of whether the insolvency representative should be allowed to disclaim EFCs and with a full consideration of the adequacy of the existing law on disclaimer in the context of such proceedings.

If it is decided to remove the EFC disclaimer exemption, then it is important to make it clear that cherry-picking is not permitted (as the IIC Report also recommends).[16]

A trustee in bankruptcy does have a power to disclaim contracts and a court order could confer such power on a receiver or liquidator.[17] A trustee has a reasonable time to determine whether to affirm an executory contract (and hence become responsible for performing the remaining obligations of the bankrupt, if any,

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[16] Query whether that principle should apply more generally than just to EFCs.

[17] Property of the bankrupt vests in the trustee in bankruptcy automatically (BIA, s.71(2)), including the benefit of executory contracts of the bankrupt. Disclaimer means that the trustee can elect within a reasonable period of time that certain assets do not form part of the estate in bankruptcy. In the context of an executory contract this means that the trustee elects not to perform the bankrupt's obligations under the contract and hence will not earn any potential benefit of the contract. It is a repudiatory breach by the bankrupt and, because the non-bankrupt party has no method to enforce actual performance, essentially it would exercise its common law or contractual right to terminate the contract and make a claim in the estate for its damages (if any) arising from the breach. Unless the trustee wants to keep the contract alive so as to realize on it (by assignment) for the benefit of the estate, it will disclaim. *Thomson Knitting Co., Re* (1924), 56 O.L.R. 625; *Creditel of Canada Ltd. v. Terrace Corp. (Construction)* (1983), 50 C.B.R. (N.S.) 87 at 89-90 (Alta. C.A.); *Minnie Pearl of Canada Ltd., Re* (1971), 15 C.B.R. (N.S.) 57 (B.C.S.C.); *Enron Australia Pty Limited v. TXU Electricity Limited,* [2005] N.S.W.C.A. 12 (Feb. 11, 2005).

in order to earn the benefits of it) or to disclaim it.[18] There is currently no exemption for EFCs (or any other type of contract for that matter) from that power. Since a power to disclaim contracts, including EFCs, already exists in these proceedings it is unnecessary to amend the legislation to provide especially for the disclaimer of EFCs. However, if the proposal is to make the disclaimer power explicit in bankruptcy proceedings, then we would recommend that careful consideration be given to the different purpose that disclaimer plays in a liquidation proceeding.

An amendment to ensure that the insolvency representative cannot cherry pick transactions under a master agreement in exercising a disclaimer right would be a useful codification of the existing case law in these contexts. Presumably, there would be no reason to restrict this protection to EFCs.

3. Removal of the prohibition on assigning eligible financial contracts

Under the BIA (both bankruptcy and proposal proceedings) and the CCAA, with the court's approval, the insolvency representative may assign rights and obligations under executory contracts of the insolvent party to any person approved by the court and who agrees to the assignment.[19] The court must be satisfied that the assignee can perform the obligations and that it is appropriate to assign the contracts. This power does not apply to certain types of contracts, including EFCs. It also does not apply to contracts that are unassignable by their nature, although the meaning of this limitation is unclear[20] The IIC Report recommends removing the exemption for uncleared EFCs, subject to a condition that there be no cherry-picking.

Factors to Consider for BIA and CCAA

In considering whether to propose an amendment to the EFC exemption to the prohibition on assignment or what amendment to make, we urge Industry Canada to consider the following.

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[18] If the contract provides for termination, however, a trustee's affirmation is subject to the termination provisions.

[19] BIA, s. 84.1(3)(b) and s.66; CCAA s.11.3(2)(b).

[20] The power has been invoked to assign contracts that include prohibitions or limits on assignment for example.

First, EFCs typically provide that they are not assignable without the consent of the parties. They are also typically governed by New York or English law. It is unclear that a Canadian bankruptcy court could have jurisdiction to invalidate an assignment limitation in a foreign-law governed contract. The effect of assignment limitations is a matter for the governing law of the agreement. We believe that any potential assignee of the foreign law governed contracts would be wary of relying on an order made in the context of a Canadian proceeding that purported to have the effect of changing the contractual terms in this way and that there would be a need to seek the consent of the non-insolvent counterparty in any event.

Second, EFCs are in some ways unlike other agreements in that it is not only the ability of a party to perform that is important, but also what type of entity that counterparty is and where it is located. Capital treatment depends on enforceability of termination, netting and collateral enforcement rights, and those rights are affected by the relevant insolvency laws and counterparty type, among other factors. The transactions will reflect pricing that takes efficient capital treatment into account (among other things) and the capital burden of taking on a new counterparty located in a jurisdiction may render the contract unprofitable. The provision does currently require the court to consider whether it is "appropriate" to transfer the contract to the proposed new party. It is to be hoped that the court would take into account factors affecting the non-assigning party. It would be useful to clarify (presumably for all contracts) that any increased burden of performance to the non-assigning party can be taken into account.

Third, it must be clear that the assignment power does not in any way interfere with the right to terminate, even after the date of the assignment, if the assignment occurs before the end of a period sufficient to allow termination rights to be effectively exercised. In other words, all of the same time periods as would apply to disclaimers should apply in this context without exception.[21]

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[21] The IIC Paper suggests 30 days, but it should at least be the same period (60 days) as applies to disclaimer, for the same reasons.

Fourth, it is not sufficient in the case of EFCs to simply provide that there cannot be any cherry-picking. EFCs are often related to other agreements entered into with the debtor that are not EFCs and it makes very little sense to separate them. For example, it would make little sense to assign an interest rate swap that hedges obligations under a particular loan without assigning the loan. A forward agreement may be associated with a financing agreement also. There are many examples. If the parties do not have certainty at the outset that these related agreements will remain in the same entity, then this may negatively affect the availability of these hedging products or their pricing. The IIC Report does recommend that all contracts associated with an EFC be required to be assigned as well and we agree with this approach if it is decided to recommend an amendment to the EFC assignment exemption.

Factors to Consider for Insurance Companies

The IIC Report makes particular note of the need to assign hedging transactions in the context of a sale of an insurance company and to be able to do so without delay.

The issue of allowing insurance companies to assign contracts within shortened time periods is a much more complex issue than presented in the IIC Report.

First, the assignment of contracts in the case of insurance companies would not be subject to the BIA or CCAA as insurance companies are liquidated under the WURA. The WURA does not have a similar provision to that in the BIA and CCAA that allows assignment, so it is unclear what type of provision is being recommended by the IIC Report in this context.

Secondly, if there is a stay on the exercise of termination rights in conjunction with this assignment power (which seems to be the IIC Report's recommendation), then this will essentially preclude reliance by counterparties of Canadian insurance companies on the EFC Stay Exemption under the WURA. This will result in increased capital costs and potentially limit the range of counterparties willing to transact with Canadian insurers. We believe that consultation with the insurance industry and with the insurance regulators is needed before introducing a change that would have such a potentially negative effect on the Canadian insurance industry.

There is of course precedent for a financial institution resolution regime potentially staying termination rights under EFCs in the *Canada Deposit Insurance Corporation Act*'s receivership regime with respect to insured deposit taking institutions. However, that regime involves very specific time periods and parameters for stays, is only allowed in the context of incorporation of a bridge institution and is conditional, essentially, on a government of Canada backstop (through its agent CDIC) for the obligations of the bridge institution to which the contracts are assigned or the insolvent institution if they are not. This regime has been developed to be consistent with international initiatives involving bank regulatory authorities and central banks. Negative capital effects are avoided largely because the Government of Canada stands behind the bridge institution. To propose that insurance companies should be able to transfer their EFCs to a purchaser of the business that is not a government backed bridge institution and that a stay on termination should be permitted in that context would essentially render Canada a jurisdiction that is not netting positive for insurance companies. In the context of a revised comprehensive regime for insurance company resolution, conditional stays of the same nature as apply to Canadian banks may be acceptable. However, any insolvency regime applicable to systemically important financial institutions, must be addressed by the Office of the Superintendent of Financial Institutions, the Department of Finance and the Bank of Canada and should be consistent with the international approaches that are in development and in which Canada is participating.[22]

[22] See for example the Consultative Document of the Financial Stability Board entitled *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* dated August 13, 2013 which considers the features of a resolution regime for systemically important financial institutions. The Bank of Canada, the Office of the Superintendent of Financial Institutions and the Department of Finance are members of the Financial Stability Board.

4. Walk-away clauses

The Paper notes that the IIC Report recommends that "walk-away" clauses, "which permit a solvent counterparty to refuse to make net termination payments owing to the insolvent party in the event of an insolvency, should be rendered ineffective".

As is noted above in Section (B)(1), once a net termination payment is calculated and if the net calculation payment is in the insolvent party's favour, it will typically be owing to the insolvent party (subject to further rights of set-off). The parties could agree to elect a calculation method that would not allow the insolvent party to receive the net termination payment if it was the defaulting party. If so, the calculation would not apply only in the case of an insolvency of the in-the-money party. It would also apply in the case of any type of termination event and regardless of which party is the party exercising the termination right. In any event, as noted above, these clauses are **rarely** used because financial institutions do not receive favourable capital treatment if the agreement contains such a calculation method with respect to either party to it. Since banks are the predominant market participants and capital efficiency is very important to its business, very few netting master agreements contain this provision. Our submission would be that there is no compelling policy reason to render such provisions ineffective. In those few cases where they are used, the court can consider whether they breach the anti-deprivation principle that applies in any bankruptcy or insolvency proceeding. A legislative solution is not needed.

They are used largely in situation where they make commercial sense in the context of the particular transactions. For example, there may be two related transactions (and one may be an EFC and the other not) with opposite and equal future obligations so that terminating both in the context of insolvency or otherwise provides the parties with exactly the benefits of the contracts that were intended.

Given the cases referred to in footnote 20 of the IIC Report, we believe the Task Force may be confusing what the industry refers to as a walk-away clause, with a provision such as section 2(a)(iii) of the ISDA Master Agreement. This provision does not have any direct connection to payment of any net termination amount. Section 2(a)(iii) (and clauses like it in other agreements) allow a party to suspend its on-going performance obligations during a period when there is a continuing uncured event of default (including bankruptcy events of default) with respect to its counterparty. It does not suspend the obligations of the defaulting party, but any payment obligation it has will be net of any payment obligation of the non-defaulting party due on the same date.[23] Nor does it extinguish the obligations of the non-defaulting party. They revive once the default is cured. The purpose of a clause such as Section 2(a)(iii) was explained by the English Court of Appeal[24] as protecting the non-defaulting party from the additional credit risk involved in performing its own obligations whilst the defaulting counterparty remains unable to meet its own. Otherwise the non-defaulting party would have to perform its obligations and risk, receiving only a dividend in the liquidation of the defaulting party. The ISDA clause has a valid commercial purpose and the English Court of Appeal found that it did not offend the anti-deprivation principle.[25]

The result was different in the U.S. proceedings under the Bankruptcy Code involving Lehman Brothers because of the different statutory regime governing *ipso facto* clauses.[26] However, the result of that case was not that the non-defaulting party had to make a net termination payment to Lehman. Rather, it simply had to perform until it decided whether it would exercise its termination right.

ISDA is aware that, in the context of insolvency proceedings, it may not be possible to cure a default and the result may be that performance is permanently suspended even after the date when all transactions subject to the master agreement have matured. There may be situations where the non-defaulting counterparty does

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[23] As determined in *Pioneer Freight Futures C. Ltd. v. TMT Asia Ltd.*[2011] EWHC 778 (Comm.) affirmed in *Lehman Brothers Special Financing Inc. v. Carlton Communications Ltd.* [2011] EWHC 718 (Ch.), appeal dismissed [2012] EWCA Civ. 419 (C.A.).

[24] In *Lehman Brothers Special Financing Inc. v. Carlton Communications Ltd.* [2011] EWHC 718 (Ch.), appeal dismissed [2012] EWCA Civ. 419 (C.A.).

[25] Ibid. at para. 87.

[26] See *In re Lehman Brothers Holdings Inc.* Case No. 08-13555 (JMP) (Bankr. SDNY, Sept. 15, 2009) ("*Metavante*"). Metavante appealed the ruling and the case was settled in March 2010.

not have any incentive to make a decision about whether it will or will not exercise its termination rights. The UK Treasury called on ISDA to amend Section 2(a)(iii) of the 1992 and 2002 versions of the ISDA Master Agreement by inserting a time limit on its operation. It did this primarily at the urging of the administrators of Lehman Brothers International (Europe) ISDA formed a working group of members to consider the issue and began a dialogue with the UK Treasury, the Bank of England and the Financial Services Authority (FSA), with the FSA taking the lead for the authorities. That dialogue has continued, with the Financial Conduct Authority (the **FCA**) taking the lead from 1 April 2013., An amendment to its standard form of master agreement which will give the defaulting party the option following a default to require the non-defaulting party to begin performing within a negotiated number of days(with 90 days being the maximum number which the FCA agreed to accept), of receiving notice from the defaulting party. Within that period the non-defaulting party will have to decide whether to terminate (in which case the net termination amount calculations will be made) or to perform. This amendment was published by ISDA in June 2014.[27] We believe this amendment will address any concerns about the effect of Section 2(a)(iii) in the context of liquidation or restructuring proceedings. To the extent a legislative response is still considered necessary, we would recommend that it be consistent with this provision, which has been worked out in consultation with the FSA.

5. Financial collateral

The IIC Report makes two recommendations with respect to the stay exemption for dealings with financial collateral and the statutory provision that prevents a court in a BIA or CCAA proceeding from making any order that subordinates the priority of financial collateral for an EFC.

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[27] A copy of the amendment and the explanatory document can be found in the ISDA bookstore as a free download.

The first recommendation is that the law should be clarified to create certainty that financial collateral will rank ahead of statutory priorities and lien claims, whether the solvent party is relying on a title transfer arrangement, a security interest or rights of set-off. We agree with this recommendation. Such statutory super-priorities do not exist with respect to financial collateral arrangements[28] for derivatives and other financial contracts in countries that have implemented the European Collateral Directive or under U.S. law. The existence of these types of potential priorities has created an incentive for collateral receivers to hold collateral from Canadians outside of Canada and disadvantages Canadian collateral receivers who have less flexibility to do so.

The second recommendation is to narrow the definition of financial collateral to the financial assets currently listed in the statutes, but only if they are "posted with, pledged to or specifically assigned to the solvent counterparty or under the control of an entity other than the insolvency counterparties or its related entities or that are subject to set-off or netting rights with the solvent counterparty, or where title to the assets has been transferred by the insolvency debtor pursuant to a title transfer credit support agreement". The reason expressed for putting in this limitation is the potential for problems that arise in proceedings where the same general security agreement secures both the general loan and the EFCs related to that loan (such as interest rate swaps or currency contracts). Certain types of assets subject to the general security agreement could constitute financial assets. The concern is expressed that this could impede obtaining interim financing in the proceeding.

No examples are given of situations where this potential problem has occurred. One reason why this likely has not been (and will not be) a practical issue is because the decisions taken with respect to collateral realization in loan facilities involving hedge counterparties are taken by the agent lender on the instruction of the majority lenders, with hedge counterparties (unless they are also lenders) often

[28] Fixed charge security and rights of set-off would have precedence over preferential claims of this nature in other jurisdictions.

not taking part in that decision. Hedge counterparties do not have any rights to take such actions on their own initiative. Unless an agent lender was holding separate collateral for the swaps, it is hard to imagine that the it would consider that it was not bound by a stay order on the basis that the collateral also secured related swaps, and harder still to imagine that a court could not deal with this issue appropriately in the context of the proceeding.

If it was a simple matter of drafting a description of the types of collateral arrangements that should constitute financial collateral and those that should not, then dealing with a potential and theoretical problem might be justified. However, it is not as simple as that. The words used by the IIC Report are vague and inappropriate for certain types of collateral. The words "post" and "pledge" have no clear accepted legal meaning. What it means to "specifically" assign is also not clear[29] and is not terminology used for assets other than intangibles. "Control" is a concept that is known to Canadian law for certain types of assets, such as securities (although not cash), and under U.S. law, but is not a concept used in many other jurisdictions. Also, it may easily be the case that collateral is held in a third party institution that is related to the debtor, such as a bank holding collateral that secures the obligations of a broker-dealer subsidiary. An insolvent entity related to a securities intermediary or custodian would not be an unusual scenario. Further, for fund entities, the assets may remain in control of the fund's custodian, and the security interest perfected by registration, due to regulatory restrictions on how assets for funds must be held. The result of introducing such uncertainty would be to drive collateral receivers to insist on methods of collateralization that involve title transfer or delivery of collateral to them which is not necessarily the best type of collateral arrangement for the collateral providers.

6. Section 95(3) of the BIA

The IIC Report recommends that the definition of "clearing house", "clearing member" and "margin deposit" in Section 95(3) of the BIA be expanded to cover

[29] Does it mean fixed versus floating charge for example?

derivatives clearing houses clearing derivatives transactions. We support this recommendation.

(C) Additional ISDA Recommendations

1. Expanded Definition of Financial Collateral

We also recommend that the definition of "financial collateral" be expanded to include rights to amounts owing from clearing agencies to clearing intermediaries or clearing clients. The definition of financial collateral in the *Payment Clearing and Settlement Act* (**PCSA**) has been expanded to include "an assignment of a right to payment or delivery against a clearing house".[30]

In a principal to principal clearing model, for example, a clearing member enters into transactions with the clearing agency as principal and has back to back transactions with the client that match those cleared transactions. The clearing member may assign amounts owed to it by the clearing agency or rights to receive a return of property on close-out or in the event of the clearing member's own default to the clearing client to secure the clearing member's obligations to the clearing client under the related transactions. This assignment is integral to the process that transfers the clearing clients' positions to a back-up clearing member. If the clearing member was an entity subject to the BIA or CCAA, there would not be a clear right in the clearing client to enforce the assignment because the delivery obligation or receivable from the clearing agency is not "financial collateral".[31]

In an agency or what is known as the futures model of clearing, the clearing intermediary (futures commission merchant or other dealer) enters into transactions with the clearing agency as agent for the clearing client. That clearing intermediary will have an assignment of, or security interest in, any payment or property rights of the clearing client against the clearing agency and possibly in the cleared contracts. Clearing intermediaries essentially guarantee client obligations to the clearing

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[30] We do not recommend the exact wording of the PCSA. The "assignment" is not a class of collateral but a method of taking the security.
[31] It is related to the financial collateral that the clearing member provided.

agency and the clearing agency will always look to those clearing intermediaries first for performance if clients default. The clearing intermediary must have effective and immediately enforceable security to support its undertaking those obligations.

Classes of collateral can also be added by regulation under the existing provisions of the BIA and CCAA. To facilitate clearing of client transactions involving entities that are potentially subject to these statutes, we recommend that Industry Canada introduce this change through this regulation making power so that it can be implemented sooner than changes to the BIA and CCAA could.

2. Clarification of "Termination" Rights

The EFC Stay Exemption in the BIA and CCAA protects the solvent counterparty's right to terminate obligations under an EFC and to net exposures with respect to terminated transactions. With respect to uncleared over-the-counter derivatives, termination of outstanding transactions is the means of closing out. However, with respect to cleared OTC derivatives transactions cleared in an agency clearing model (and this is the case for futures as well), the means of liquidating the contracts is for the agent to enter into offsetting transactions or risk reducing transactions for the account of the insolvent party with the clearing agency. The difference in the price at which those offsetting transactions can be entered into and that in the original contracts will measure the gain or loss to the client on the cleared transactions. The performance obligations otherwise cancel each other out and are settled on that basis in the clearing system. This methodology is a means of ending the performance obligations on the original transaction. It is the standard method of close-out on futures markets and, given that futures and options on futures are EFCs, we believe the intention of the EFC Stay Exemption is that this method of close-out is protected also for OTC derivatives even though it involves entering into additional transactions in the course of the proceeding as agent of the debtor.[32]

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[32] We understand that under Canadian common law the agency relationship would be irrevocable on

It would create additional certainty if the BIA and CCAA (as well as the WURA and CDIC Act) recognized that this method of termination and liquidation of transactions is protected.

3. Section 244 of the BIA

Section 244 of the BIA requires that a secured creditor who intends to enforces security on all or substantially all of the property of an insolvent period where the property was acquired for or is used in relation to a business carried on by the insolvent person to provide 10 days advance notice before enforcing its security interest. Normally collateral for derivatives transactions does not constitute all or substantially all a counterparty's property. However, there are situations, particularly when dealing with investment funds or special purpose vehicles created for specialized structured transactions, where that might be the case. Further, a party does not necessarily know if the financial assets over which it has collateral might be all or substantially all of the counterparty's assets at a future time when it would be in a position to realize on its security. The requirement of a 10 day notice period would undermine the protections for dealings with financial collateral. It is just as important that they apply outside of insolvency proceedings.

4. Cleared Transactions

We recommend that Investment Canada review the provisions of Part XII of the BIA as they relate to securities firm bankruptcies in light of federal and provincial regulations with respect to central counterparty clearing of customer OTC derivatives transactions and protection and porting of client collateral in the context of cleared transactions in order to ensure that they are consistent. Securities firms may be clearing intermediaries for OTC derivatives and it is important to the ability of the clearing house to protect customers positions in the event of a clearing intermediary's bankruptcy that the any compromise or modification of the rights of

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the basis that it is coupled with an interest of the clearing intermediary and would, on that basis, survive the commencement of a bankruptcy proceeding.

those customers with respect to their intermediary in the context of such a proceeding does not undermine the default regimes of the clearing houses.

Industry Canada may also want to clarify what protections collateral providers have in terms of obtaining a return of collateral outside of the context of Part XII.

5. **Provincial Fraudulent Conveyance and Preference Laws**

Provincial fraudulent preference and fraudulent conveyance laws are still in effect, but they do not include the same protections for transfers of financial collateral for EFCs as are now in the WURA and the BIA. This undermines the effectiveness of the WURA and BIA provisions. It would be useful to clarify that the WURA and BIA provisions are paramount federal law in this respect in the context of insolvency and insolvency proceedings.

6. ***Canada Business Corporations Act* (CBCA) Plan of Arrangement Proceedings**

The Report invites input on the practice of CBCA arrangements involving insolvent business corporations.

Business corporations are subject to the BIA, CCAA and, in some cases, WURA and all of these statutes include the EFC Stay Exemption. However, if corporate arrangement provisions under statutes such as the CBCA[33] potentially permit stays and there is no clear principle whereby EFCs must be exempted from any such power, then this will prevent financial institutions from having the level of certainty required to apply netting treatment for capital purposes. Unless there is a high level of legal certainty that exposure to the counterparty is, in fact, the net exposure, additional capital must be held. This would directly result in increased costs for corporate counterparties potentially subject to this regime. The EFC Stay

[33] Canadian provincial corporate statutes generally include arrangement provisions similar to those in the CBCA and therefore the same problem arises in their regard.

Exemption in the BIA, CCAA and other statutes is in this way potentially undermined by the silence of the CBCA in this respect.

The Alberta court considered the issue of stay orders in the context of a CBCA plans of arrangement in *Enron Canada (Re)*[34] and it held that such orders should not be made with respect to EFCs. The applicant sought a stay of termination rights under what would have been classified as an "eligible financial contract" under the CCAA and other insolvency legislation. Parties to such contracts had contractual rights to terminate based on the US Chapter 11 filing of the applicant's parent corporation and/or other credit events affecting the parent corporation, which was the applicant's credit support provider. The applicant argued that it was solvent and that it could remain so if a stay was granted to give it time to renegotiate credit support arrangements with its counterparties. The court rejected the application on the basis that it was not appropriate to interfere with the contractual rights of the parties[35] and that the public policy against interfering with close-out and netting rights in the case of insolvent counterparties applied as well to solvent counterparties seeking to reorganize. The judge said:

> It is hard to conceive of solvent corporations pursuing plans of arrangement having rights to suspend, amend, or otherwise interfere with eligible financial contracts of the kind we are dealing with in this case, while similar latitude is statutorily denied to insolvent entities. Just as there is good reason for the statutory exemptions in the insolvency legislation, there is equally good reason to honour the underlying public policy considerations in cases involving solvent applicants.

However, in a similar later proceeding involving Abitibi-Consolidated Inc. a Quebec court took the unprecedented step of staying the termination of contracts with the applicant companies and made no exception for EFCs entered into with them. The *Enron Canada* case was not brought to the court's attention by the applicant. The court in the *Abitibi* proceeding made an interim order that looked

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[34] (2001), 31 C.B.R. (4th) 15 (Alta. Q.B.).
[35] Not just parties to EFCs

very much like an order a court would make in a CCAA proceeding. Included in the order was a temporary stay (until the hearing date for approval of the arrangement) against any person (not just the creditors directly subject to the arrangement, namely the bondholders and term lenders) accelerating or terminating any contract with any of the Abitibi entities. Unlike the orders granted under the CCAA, however, there was no exemption for EFCs between the Abitibi entities and their counterparties.

In its reasons associated with the order, the Quebec Superior Court does not deal with EFCs except to note that the orders requested that it "exclude from their application swap or derivative transactions or eligible financial contracts". However, the order itself did not exclude all eligible financial contracts from the stay. It only excluded eligible financial contracts with persons "other than the Abitibi parties". The intention here was seemingly to not interfere with the operation of credit default transactions having Abitibi as a reference entity or other eligible financial contracts between third parties where termination may have been triggered by an Abitibi default.[36] The issue in *Abitibi* became moot before parties could bring proceedings to set aside the order when the CBCA plan of arrangement was dropped in favour of a CCAA proceeding.

The very fact that the *Abitibi* order was made raises an issue for the exercise of termination rights under EFCs. The precedential value of the *Abitibi* order (made without any argument from affected parties) is not as great as the *Enron Canada* case in which interested parties were able to make submissions and which provides reasoning on the point. On the basis of the *Enron* case, market participants are currently able to conclude with sufficient certainty that close-out rights are enforceable. However, an Abitibi-like order to be made in another case, it would affect the ability of counsel to provide a robust opinion on the enforceability of termination and netting rights for transaction with Canadians corporate counterparties whose governing legislation provides for a plan of arrangement procedure. Making it clear through an amendment to the CBCA, or even through

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[36] And query whether the court could even have jurisdiction to make orders with respect to the contractual relationship between persons who are not parties to the proceeding.

guidance from the Director under the CBCA, that such orders are not to be made would solve the issue with respect to CBCA companies, but not provincially incorporated entities.

It would be helpful to have this addressed as a matter of law generally. For example, a generally stated principle, such as that in the PCSA (s.13)[37] that would apply to any arrangement proceeding, regardless of whether it is technically an insolvency proceeding and whether it is a federal or provincial proceeding. The PCSA currently applies where both parties are "financial institutions". Given that the same principle as is set out in section 13, as it applies to EFCs,[38] is also incorporated into the BIA, CCAA, and WURA, we suggest that the matter could be easily and effectively addressed by removing the requirement under the PCSA that both parties to the EFC be financial institutions. It would be sufficient if one party was a financial institution. The effect would be to override any law (provincial or federal) that interferes with such rights, as long as it fell within federal constitutional jurisdiction. Provincial laws that deal with restructuring insolvent corporations, or that potentially interfere in the operation of global derivatives markets and potentially lead to systemic risks, are presumably within the jurisdiction of the federal government. While we appreciate that the CBCA is within the responsibility of Industry Canada and the PCSA is not, we would ask that Industry Canada support this more comprehensive solution to this issue.

7. Entity Scope of WURA

The WURA currently applies to "trading companies", which is widely defined and could apply to any commercial corporation, other than a CBCA company.[39] ISDA members would support an amendment to the WURA that restricts its application to financial institutions. The differences between the WURA, on the one hand, and the BIA and CCAA on the other, particularly in areas such as

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[37] Section 13 applies "Despite anything in any law relating to bankruptcy or insolvency or any order of a court made in respect of a reorganization, arrangement or receivership involving insolvency".
[38] As opposed to the wider class of "netting agreements".
[39] The CBCA itself excludes CBCA companies from the scope of the WURA.

creditor preferences, transfers at an undervalue, disclaimer, and assignment of contracts, are material to participants in derivatives markets. While the substance of the law is acceptable, it appears unnecessary to have different statutes with the same purpose potentially applying to such entities and it gives rise to the possibility of statute-shopping.

We do believe that a separate tailored regime for financial institution insolvency proceedings is acceptable and preferable.

Summary of Recommendations

Matters Addressed in the Sarra Report

1. **Credit Default Swaps.** No modifications should be made to the EFC Stay Exemption as it applies to CDS transactions or other credit derivatives on that basis that (a) the stay issue is unrelated to issues of voting transparency or incentives that appear to be the main issues of concern raised in the Sarra Report, (b) the court cannot and should not stay contracts between third parties that are unrelated to the insolvent entity, particularly credit protection contracts which those third parties have paid for or been paid for, and (c) doing so would increase counterparty credit risk given the significant volume of credit derivative transacting in global markets.

2. "**Flip clauses**". We believe the Sarra Report has misunderstood "flip-clauses". They are not terms of derivatives transactions, but other types of structured finance transactions, such as securitization. In any event, there is no need to legislatively address them as there is currently sufficient protection in the courts' power to restrict the performance of any contract that offends the anti-forfeiture principle.

3. **Disclosure of CDS Positions**.

   If the issue of real economic interest of creditors voting on a plan is to be addressed it should be done comprehensively, and not so as to single out CDS transactions, which are just one of several types of arrangements that can have this effect. Also, any rule requiring disclosure of the credit protection arrangements benefiting any particular creditor should be carefully formulated so as to protect the confidential trading information of the parties to the credit protection arrangements.

Matters Addressed in the IIC Report

1. **Extend EFC Protections to Receiverships under Part XI of the BIA**

ISDA supports extending the EFC exemptions to receivership proceedings and amending section 88 to extend protection against subordination of financial collateral to receivership proceedings.

2. **EFC Disclaimer Exemption.**

   a. Disclaimer of cleared contracts or EFCs that are financing contracts (securities loans, repurchase agreements and margin loans) should not be permitted.

   b. The current EFC disclaimer exemption serves an important purpose in providing the solvent party with time to carefully manage the close out process. Unless problems have arisen in practice for insolvent parties as a result of this exemption during the five years it has been in effect, which does not seem to have been the case, we would recommend maintaining the status quo.

   c. If modifications are to be made to the EFC disclaimer exemption with respect to uncleared EFCs, the additional notice period should be at least 90 days (not 60 days as proposed in the IIC Report) to provide the solvent counterparty with sufficient time to unwind or replace hedging arrangements and should permit a party to request an extended period.

d. Any proceeding dealing with issues of extensions of time for disclaimer should protect the confidentiality of the contractual terms in order to protect the solvent party's ability to unwind or replace hedges.

e. Exercise of a disclaimer power should not allow an insolvency representative or the debtor to disclaim unprofitable transactions and affirm profitable ones where they are subject to a single agreement, such as a master agreement.[40]

f. Removing or modifying the EFC disclaimer exemption is of more limited value than is suggested by the IIC Report. Disclaimer permits the insolvent party to be relieved of future performance obligations. It does not permit the insolvent party to realize the value of the contract where it was a profitable contract for the insolvent party.

g. There is no demonstrated need to add any provision allowing a trustee in bankruptcy, receiver or WURA liquidator to disclaim EFCs since they currently can exercise such a power with respect to any contract (with court approval in the case of receivers if the contract is material). If the law is to be codified, then it should be sensitive to the differences between liquidation and restructuring regimes and the different purpose disclaimer plays in each.

3. EFC Assignment Exemption

a. Industry Canada should consider whether removal of the EFC assignment exemption from the BIA and CCAA would provide any material benefit to insolvent parties since such contracts are, by their terms, non-assignable and, as a result, purchasers are unlikely to agree to novation without the consent of the solvent counterparty in

[40] Query whether this same principle should not apply to all contract types, not just EFCs.

any event notwithstanding a court order, particularly where the contract is not governed by a Canadian provincial law.

b. If an assignment power does apply to EFCs, then

   i. It should not interfere with the solvent party's right to terminate within a reasonable period of time (e.g. 90 days).

   ii. The assignee should be required to take all related transactions and transactions subject to the same single agreement and any collateral arrangements for the transactions.

c. The IIC Report recommendation to allow for a stay of termination rights under EFCs in the context of insurance company proceedings under the WURA will have a negative impact on the hedging activities of insurance companies.

4. Walk-away Clauses

We recommend against any legislative change to deal with "walk-away" clauses as there is no compelling policy reason to render such clauses ineffective, given the few cases in which such clauses are used. The court's power in connection with the anti-forfeiture principle are sufficient to deal with any situations where such clauses are used in a manner that inappropriate deprives an insolvent estate of assets

5. Financial Collateral

a. The BIA and CCAA should be amended to provide that financial collateral will rank ahead of statutory priorities and lien claims, whether the solvent party is relying on a title transfer arrangement, a security interest or rights of set-off.

b. We strongly recommend against the IIC Paper's recommendations to limit the financial collateral protections. The IIC Paper's recommended change does not appear to be addressing a practical problem that has already occurred and the suggested changes would introduce considerable uncertainty into the current legislative provision.

6. **Section 95(3) of the BIA**

   The definition of "clearing house", "clearing member" and "margin deposit" in Section 95(3) of the BIA should be expanded to cover derivatives clearing houses.

Additional ISDA Recommendations

1. **Expanded Definition of Financial Collateral**

   We recommend that the definition of "financial collateral" be expanded to include rights to amounts owing from clearing agencies to clearing intermediaries or clearing clients to ensure that (i) a clearing member subject to the BIA or CCAA has a clear right in the clearing client to enforce assigned amounts, and (ii) a clearing intermediary has effective and immediately enforceable security to support its undertaking those obligations. To facilitate clearing of client transactions involving entities that are potentially subject to these statutes, we recommend that Industry Canada add classes of collateral by regulation so that this change can be implemented sooner than changes to the BIA and CCAA could.

2. **Clarification of termination rights**

   Amendment of the BIA and CCAA (as well as the WURA and CDIC Act) to expressly recognize the standard method of termination and liquidation with respect to cleared OTC derivatives transactions cleared in an agency clearing model, namely entering into offsetting transactions.

3. **Section 244 of the BIA**

Exempt dealings with financial collateral for an EFC from the notice requirement in section 244 of the BIA.

4. **Cleared Transactions**

Consider whether amendments to the provisions of the BIA dealing with securities firm bankruptcies should be modified in light of regulatory developments related to central counterparty clearing of customer transactions in OTC derivatives. Consider whether protections for collateral providers to facilitate return of pledged collateral should be added, particularly in the context of clearing of transactions.

5. **Provincial Fraudulent Conveyance and Preference Laws**

Clarify that, in the context of insolvency and insolvency proceedings, the WURA and BIA provisions in respect of transfers of financial collateral for EFCs are paramount over provincial fraudulent preference and fraudulent conveyance laws.

6. **Corporate Plan of Arrangement Proceedings**

We recommend that it be clarified that a court order made in the context of a corporate plan of arrangement proceeding cannot interfere with close-out rights under EFCs. This could be accomplished with respect to both federal and provincial plan of arrangement procedures by removing the requirement under the PCSA that both parties to the EFC be financial institutions. It would be sufficient if one party was required to be a financial institution.

7. **Remove trading companies from WURA**

We recommend the removal of the current reference to “trading companies” in the WURA.

Yours truly,

Katherine Darras

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