ISDA®

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June 8, 2009

Consumer & Business Services
Ministry of Government Services
77 Wellesley Street West
Ferguson Block, 6th Floor
Toronto, ON M7A 1N3

Attention: Mr. Allen Doppelt, Senior Counsel, Legal Services Branch

Land Titles and Personal Properties Registry
Service Alberta
3rd floor, John E Brownlee Building
10365 - 97 Street
Edmonton, AB T5J 3W7

Attention: Mr. Doug Morrison, Executive Director

Dear Sirs/Mesdames:

Re: Proposal for Amendments to the Treatment of Deposit Accounts under the PPSA

Purpose of this Letter

This letter is a request on behalf of ISDA's Canadian and non-Canadian members that the Ontario and Alberta governments consider amendments to the *Personal Property Security Act* for security arrangements collateralized by deposit accounts.

The International Swaps and Derivatives Association Inc., which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has over 825 member institutions from 57 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. ISDA members include the Canadian chartered banks and other major financial institutions, as well as many other Canadian financial and commodities market participants. ISDA members deal with many Canadian entities that are not themselves ISDA members, but which are nevertheless important players in derivatives and securities lending markets. Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business.

ISDA members have a particular interest in reducing risk around cash collateral arrangements. Cash is received and delivered as credit support for the mark to market exposure on derivatives and securities financing transactions (eg securities loans, securities repurchase agreements, margin loans) at very significant levels. Often both parties are required to post collateral to each other as exposures change during the course of the contractual relationship. This can mean transfers of large amounts of cash collateral on a regular basis, and in many cases on a DAILY basis as the mark to market value of transactions changes. Some significant market participants will accept only cash collateral. While exact statistics are not available for Canada, the ISDA collateral survey for December 2008 indicated that 72% of the collateral posted worldwide at that time to support over-the-counter derivatives transactions was in the form of cash. One Canadian institution reports that it received and delivered in the past six months over $7 billion in cash. The importance of cash collateral in the financial markets makes it imperative to create legal certainty regarding the effectiveness of measures to perfect security interests in cash collateral.

The enactment of the *Securities Transfer Act* and the companion amendments to the PPSA and Ontario *Business Corporations Act* have provided an immense benefit to market participants in reducing risk surrounding the posting of securities collateral for derivatives and securities financing transactions. Canadian market participants would benefit significantly if the same level of legal certainty and efficiency with respect to the posting of cash collateral could be achieved. In this letter we set out what our membership has identified as issues under the PPSA that are impeding collateral relationships with Canadian market participants and

proposals for your consideration as to how these issues could be addressed in the PPSAs.

Description of Typical Security Arrangements for Cash

The types of cash collateral arrangements our members typically have involve the transfer by wire or other means of funds in various currencies into specified bank accounts in Canada or other countries. In other words, participants are not usually dealing with security interests over the general operating account of a debtor with its bank. Funds are transferred typically to specific accounts, which may be a general operating account in the name of the secured party or a separate account in which the secured party holds cash collateral from numerous counterparties or cash collateral from a particular collateral provider. The collateral arrangements vary in terms of documentation. Some involve an absolute title transfer approach without an intention to create a security interest. Others, however, are traditional pledge/security interest agreements. For example, ISDA's form of Credit Support Annex governed by New York law, which is widely used in the Canadian market, creates a security interest in the posted collateral.

The "collateral" is the asset created by the deposit, which is a debt obligation of the deposit institution. Although this deposit account is in the name of the secured party, the secured party still has only been granted a security interest in the transferred funds and, therefore, has only a security interest in the deposit account. For example, Canadian Bank A may deliver cash to US Dealer B by depositing Canadian funds in US Dealer B's account with Canadian custodial Bank C, in which case the collateral is the rights with respect to the account at Bank C. Because the collateral is an "intangible" in PPSA terms, the governing law for validity, perfection and priority is the place where the debtor is located, the only means of perfection possible is registration of a financing statement, and priority as against other consensual secured creditors is determined by order of registration.

Uncertainties and Inefficiencies in the Treatment of Cash Collateral

No Assurance of Priority

If secured creditors must rely on registration to perfect their security interest they cannot be assured of a first priority to the cash collateral even if the deposit account is held in their own name. If they are willing to incur the not insubstantial costs involved in conducting searches and obtaining subordination agreements, waivers or estoppels from prior registrants they could obtain some comfort that they have priority over other consensual PPSA governed secured creditors. However, many of the entities that participate in derivatives and securities financing markets are large financial institutions and corporations and they can have many registrations against them. It is rarely practical to conduct this type of process. Even if they did, this does not assure protection against other non-consensual secured creditors (such as deemed trust claimants) or other adverse claimants.

The lack of certainty with respect to priority is a particularly acute problem in the derivatives and securities financing areas, because without it market participants cannot take the collateral fully into account in determining their risk exposure for capital or credit purposes. International bank capital rules, for example, would require that the value of the collateral be significantly discounted if there is not sufficient certainty as to priority.

Also, institutions set their policies based on their assessment of legal risk for counterparties generally in the particular jurisdiction. Even if in individual cases a secured creditor may be able to easily obtain priority based on the registration, the fact that there will be situations where they cannot get assurance as to priority based on perfection by registration, essentially results in setting a policy not to take a security interest in cash collateral from Canadian counterparties.

No Clear Right to Use Collateral

Also, the rights that a secured party has with respect to investment property under s.17.1 of the PPSA are not extended to this form of collateral as it is not "investment property". Consequently, it is unclear whether a secured creditor that actually receives cash collateral, even into its own account, could be permitted to use

it. This distinction between cash and other fungible property does not make much sense from a policy perspective. Collateral providers obtain significantly better terms if the secured party is permitted to use the collateral. This applies not only to securities, but also to cash.

Realization Rights as Against Cash are Unclear

In addition, in terms of realization rights, there is no provision in the PPSA that clearly allows a secured party to simply apply the amount of the cash collateral against the debt, although that is obviously the only sensible course of action when the funds are already being held by the secured party. Doing this could technically be a foreclosure on this collateral. It makes little sense to require the processes for foreclosure to apply to deposit accounts.

Work Arounds Are Not Complete Solutions

Market participants taking cash from Canadian parties to secure derivatives and other financial transactions have for these reasons been avoiding arrangements that create a security interest. For example, under the ISDA form of Credit Support Annex governed by New York law amendments are often made with respect to cash so that no security interest is granted in the cash. Instead cash is transferred absolutely to the secured creditor and a debtor/creditor relationship is created. The amount of the debt can then be set-off against amounts owing under the secured obligation. This set-off arrangement is likely not subject to the PPSA as no security interest is created in any property of the debtor. This arrangement would also allow use of the cash collateral by the transferee and set-off of the amount against the obligations of the debtor.

So given this work around, why do we recommend amendments?

There are a number of reasons, some policy-based and some practical.

First, for regulatory or operational reasons not all debtors are able to provide cash collateral by way of an absolute transfer. For credit reasons, not all debtors want to. Mutual funds and pension funds are examples. So the work around is not always available.

Second, putting in place the required amendments adds substantially to the cost of putting collateral arrangements in place. We have heard from some of our Canadian members that negotiating the amendments to the credit support documents to deal with cash is a key impediment to putting collateral arrangements in place.

Third, there is some risk that, notwithstanding the form of these arrangements, a court would nevertheless characterize them as creating security interests. This possibility, however small, results in many market participants refusing cash collateral from Canadian entities and requiring either securities or letters of credit, which may for a particular entity be a more expensive form of collateral to provide.

Fourth, unlike the case with securities collateral, there is no additional protection as there is in the STA from adverse claims, leaving open the possibility of claims by other lien holders and other non-PPSA interests.

Holders of securities collateral and other investment property now have far more certain and inalienable rights to their collateral than a holder of cash collateral. An entitlement holder of securities has first priority and cannot be subject to proceedings from adverse claimants. As a policy matter, given the fungible nature of both types of property and the importance of finality in the transfer of cash as well as securities, it really does not make sense to treat them so significantly differently.

If the cash was being held in a securities account, it would be classed as investment property and the security interest in it could be perfected by control. It would also have the benefit of the entitlement holder protections from adverse claims that are in the STA. Yet if the same intermediary holds client cash in a cash account separate from the securities trading account, the secured party could lose priority since the cash account is not necessarily a "securities account". For example, in many brokerage arrangements, the client is required to deposit cash to a cash account with the broker to cover margin loans. The broker is perfected by control with respect to cash or securities credited to the client's securities trading account, but arguably not with respect to cash credited to the client's cash account. Requiring

changes to standard form agreements for accounts with Canadians or changing practices regarding the operations of accounts can, practically speaking, impede the development of relationships with Canadian clients. In certain jurisdictions intermediaries are not permitted by regulation or operational constraints to maintain cash in a client's securities account so the separate cash account is a requirement.

It is not only collateral takers that are disadvantaged by the current regime. The collateral provider loses many of the benefits of the PPSA when arrangements are put in place to avoid the creation of security interests and, therefore, the applicability of the PPSA. For example, if an absolute transfer approach is adopted in order to deal with the priority issues, it means by definition that the provider of the cash is taking on the credit risk of the collateral taker and giving up the protections inherent in a retaining at least a right of redemption. With securities on the other hand, there is flexibility to assure the collateral taker has first priority, while allowing the collateral provider to limit the use the collateral taker can make of the collateral and to retain entitlement to the collateral.

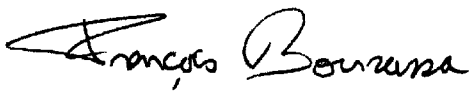
Solutions

The preferable solution would be to adopt similar provisions to those in Article 9 of the Uniform Commercial Code with respect to deposit accounts. These provisions allow for perfection by control either by becoming the customer with respect to the account or entering into an agreement with the deposit taking institution allowing the secured creditor to give directions as to payments from the account. This is a regime similar to that in place for securities entitlements and futures contracts. Pursuant to Article 9 perfection by control is the only method of perfection recognized. We recommend, however, that lenders retain the right to perfect by registration or to use other types of arrangements, such as lock-box arrangements, to protect their interests. Consequently, we believe that our recommendations will give cash collateral lenders maximum confidence with the minimal investigation commercial practice requires, without requiring any change in traditional bank lending processes or practices.

You might also be aware that the United Kingdom Law Reform Commission in its report entitled *Company Security Interests* (August 2005) recommended similar provisions be adopted under U.K. law for perfection of security interests in cash granted by companies. The earlier Consultation Report indicates that the concept of perfection by control for deposit accounts was widely accepted. It is to a certain extent also required by the European Union's Collateral Directive. (You can find a copy of the Commission's reports at http:// www.lawcom.gov.uk/ company_security.htm and the Collateral Directive at http:// ec.europa.eu/ internal_market/financial-markets/collateral/index_en.htm.)

We have attached draft provisions for your consideration. We would be pleased to meet with you to discuss any of the matters addressed in this letter. Please contact me directly or through ISDA's counsel in Canada, Margaret Grottenthaler of Stikeman Elliott LLP (mgrottenthaler@stikeman.com - 416-869-5686).

Yours truly,



Draft Provisions for Deposit Accounts

1. Add the following definitions to subsection 1(1):

"authentic record" means information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form that is:

(A) signed; or

(B) executed or which otherwise adopts a symbol, or is encrypted or similarly processed as a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record.

"deposit taking institution" means an organization that is engaged in the business of taking deposits and includes banks, savings banks, loan companies, savings and loan associations, treasury branches, credit unions, trust companies and other similar deposit taking institutions.

"deposit taking institution's customer" means a person identified in the records of the deposit taking institution as the person for whom the account is maintained;

"deposit account" means a demand, time, savings, passbook, or similar account maintained with a deposit taking institution that is not investment property or an instrument.

2. Amend subsection 1(2) to add a new subparagraph (f) and (g):

(f) a secured party has control of a deposit account if,

(i) the secured party is the deposit taking institution with which the deposit account is maintained;

(ii) the deposit taking institution's customer with respect to the account, secured party, and the deposit taking institution have agreed in an authenticated record that the deposit taking institution will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the deposit taking institution's customer; or

(iii) the secured party becomes the deposit taking institution's customer with respect to the deposit account.

(g) A secured party that has satisfied subsection (f) has control, even if the debtor retains the right to direct the disposition of funds from the deposit account.

3. Amend subparagraph 7.1(5)(a) to add the words "or a deposit account" after "investment property".

4. Amend subsection 7.1(7) to add the words "or a deposit account" after "investment property" and the words ", deposit taking institution's jurisdiction " after the words "securities intermediary's jurisdiction".

5. Add new subsections 7.1(8), 7.1(9) and 7.1(10):

(8) **Conflict of laws – validity of security interest in deposit accounts -** The validity of a security interest in a deposit account shall be governed by the law, at the time the security interest attaches, of the deposit taking institution's jurisdiction.

(9) **Conflict of laws- perfection and priority of security interest in deposit accounts-** Except as otherwise provided in subsection (5), perfection, the effect of perfection or of nonperfection and the priority of a security interest in a deposit account shall be governed by the law of the deposit taking institution's jurisdiction.

(10) **Determination of deposit taking institution's jurisdiction** – For purposes of this section, the following rules determine a deposit taking institution's jurisdiction:

1. If an agreement between the deposit taking institution and the deposit taking institution's customer governing the deposit account expressly provides that a particular jurisdiction is the deposit taking institution's jurisdiction for purposes of the law of that jurisdiction, this Act or any provisions of this Act, the jurisdiction expressly provided for in the agreement is the deposit taking institution's jurisdiction.

2. If paragraph 1 does not apply and an agreement between the deposit taking institution and deposit taking institution customer governing the deposit account expressly provides that the agreement shall be governed by the law of a particular jurisdiction, that jurisdiction is the deposit taking institution's jurisdiction.

3. If neither paragraph 1. nor paragraph 2. applies and an agreement between the deposit taking institution and the deposit taking institution's customer governing the deposit account expressly provides that the deposit account is maintained at an office in a particular jurisdiction, that jurisdiction is the deposit taking institution's jurisdiction.

4. If none of the preceding paragraphs applies, the deposit taking institution's jurisdiction is the jurisdiction in which the office

identified in an account statement as the office serving the deposit taking institution customer's account is located.

5. If none of the preceding paragraphs applies, the deposit taking institution's jurisdiction is the jurisdiction in which the chief executive office of the deposit taking institution is located.

6. Amend subsection 11(2) to add a new subparagraph (e):

(e) the collateral is a deposit account and the secured party has control under subsection 1(2) pursuant to the debtor's security agreement.

7. Amend section 17.1 to refer to deposit accounts in both subsections (1) and (2).

8. Add a new subsection 22.1(3)

(3) A security interest in a deposit account may be perfected by control of the collateral under subsection 1 (2).

(4) A security interest in a deposit account is perfected by control when the secured party obtains control and remains perfected by control only while the secured party retains control.

9. Add as new subsection 17.2:

17.2 **Exercise of deposit taking institution's rights of set-off and recoupment** – (1) (a) **Exercise of recoupment or set-off-** Except as otherwise provided in subsection (c), a deposit taking institution with which a deposit account is maintained may exercise any right of recoupment or set-off against a secured party that holds a security interest in the deposit account.

(b) **Recoupment or setoff not affected by security interest-** Except as otherwise provided in subsection (c), the application of this section to a security interest in a deposit account does not affect a right of recoupment or set-off of the secured party as to a deposit account maintained with the secured party.

(c) **When set-off ineffective-** The exercise by a deposit taking institution of a set-off against a deposit account is ineffective against a secured party that holds a security interest in the deposit account which is perfected by control, if the set-off is based on a claim against the debtor.

(2) **Deposit taking institution's rights and duties with respect to deposit account-**Except as otherwise provided in Section 17.2(1)(c), and unless the deposit taking institution otherwise agrees in an authenticated record, a deposit taking institution's rights and duties with respect to a deposit account

maintained with the deposit taking institution are not terminated, suspended, or modified by:

(a) the creation, attachment, or perfection of a security interest in the deposit account;

(b) the deposit taking institution's knowledge of the security interest; or

(c) the deposit taking institution's receipt of instructions from the secured party.

(3) **Deposit taking institution's right to refuse to enter into or disclose existence of control agreement-** This section does not require a deposit taking institution to enter into an agreement of the kind described in Section 1(2)(f)(ii) even if its customer so requests or directs. A deposit taking institution that has entered into such an agreement is not required to confirm the existence of the agreement to another person unless requested to do so by its customer.

10. Amend subsections 30.1(1), 30.1(2) and 30.1(8) to add the words "or deposit account" after the words "investment property".

11. Add a new subparagraph 30.1(4)(d):

(d) if the collateral is a deposit account carried with a deposit taking institution, the satisfaction of the requirement for control specified in subclause 1(2)(f)(ii) and (iii) with respect to deposit accounts carried or to be carried with the deposit taking institution.

12. Add the following new subsection 30.1(6.1):

(6.1) A security interest held by a deposit taking institution in a deposit account maintained with the deposit taking institution has priority over a conflicting security interest held by another secured party.

13. Replace subsection 30.1(7) with the following (underlying represents the changes to the current provision)

(7) **Interests granted by broker, intermediary <u>or deposit taking institution</u>-** Conflicting security interests granted by a broker, securities intermediary, futures intermediary <u>or deposit taking institution</u> which are perfected without control under subsection 1(2) rank equally.

14. Replace subsection 56(7) with the following (underlying represents the changes to the current provision):

> (7) **No outstanding secured obligation** – Where there is no outstanding security obligation and the secured party is not committed to make advances, incur obligation or otherwise give value, a security party having control of investment property or a deposit account under clause 25(1)(b) of the *Securities Transfer Act, 2006* or subclause 1(2)(d)(ii) of this Act shall, within 10 days after receipt of a written demand by the debtor, send to the securities intermediary, futures intermediary or deposit taking institution with which the security entitlement, futures contract or deposit account is maintained a written record that releases the securities intermediary, futures intermediary or deposit taking institution from any further obligation to comply with entitlements orders, directions or instructions originated by the secured party.

15. Amend subsection 61(1) to add the following subparagraphs (c) and (d):

(c) if it holds a security interest in a deposit account perfected by control under Section 1(2)(f)(i), may apply the balance of the deposit account to the obligation secured by the deposit account; and

(d) if it holds a security interest in a deposit account perfected by control under Section 1(2)(f)(ii) or (iii), may instruct the deposit taking institution to pay the balance of the deposit account to or for the benefit of the secured party.