

By Email – businesslawpolicy@ontario.ca

December 12, 2016

Business Law Policy
Consumer and Business Policy Unit
Ministry of Government and Consumer
Services
6th Floor, 56 Wellesley Street West
Toronto ON M7A 1C1

Dear Sirs/Mesdames:

Re: Business Law Report 2016

The purpose of this letter is to communicate the support of the International Swaps and Derivatives Association, Inc. (**ISDA**)¹ for the recommendations in the Business Law Advisory Council Report to the Minister of Government and Consumer Services on priorities and recommendations for reform of Ontario's corporate and commercial legislation (the **Report**) as they relate to amendments to the *Personal Property Security Act* (**PPSA**).

Recommendation for Perfection by Control

ISDA strongly supports the recommendation to provide for the ability to perfect a security interest in cash by control and a first priority based on control. It is imperative that these amendments be introduced as soon as possible. Beginning in March 2017, new global, including Canadian, requirements for the posting of variation margin (margin to cover the marked to market exposures arising under derivatives contracts) will come into effect. Cash collateral in respect of variation margin is not subject to an additional haircut where the currency of the asset differs from the currency of the collateral. Under regulations with respect

¹ Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 66 countries. These members comprise a broad range of 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, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

to collateral for uncleared transactions², cash collateral in respect of variation margin is not subject to an additional haircut where the currency of the asset differs from the currency of the collateral. In contrast, non-cash variation margin exchanged in a currency other than the ones agreed in the relevant contract is subject to an additional haircut when the currency of the asset differs from the currency of the collateral. In addition, regulations mandating the clearing of standardized derivatives will soon be finalized. These developments will increase the demand for high quality, liquid collateral, including, most importantly, cash collateral. Cash collateral is the most available, most liquid and least expensive form of collateral to provide and receive. For operational reasons, cash collateral is also a preferred form of collateral as it can be transferred easily on a daily basis in amounts that precisely match the constantly changing credit exposure of the parties to each other.

The current Ontario regime, requiring perfection by registration and the uncertain priority it entails, have been an impediment to the acceptability of cash collateral, particularly Canadian dollar cash collateral, from Ontario-based counterparties. It is also an impediment to the further standardization of credit support agreements globally. A clear and certain law allowing perfection and priority based on obtaining control over deposit accounts or transfers of cash in credit support arrangements, as was proposed by the Ontario Bar Association Personal Property Security Law Subcommittee entitled *Perfecting Security Interests in Cash Collateral (OBA Proposal)*, will remove the impediments identified above. ISDA has been urging reform along these lines since it first wrote to the Minister in June of 2009, supported the OBA Proposal (as set out in our letter to the Ministry dated May 7, 2012) and continues to strongly support this approach.

ISDA also urges you to make an announcement as soon as possible with respect to the Ministry's intention to introduce the legislation. In the next few months, thousands of credit support documents will have to be entered into or amended to address variation margin for uncleared swaps. The need for specific Canadian law amendments to address the cash collateral issues³ complicates this already complicated process and adds a significant cost burden. A clear statement from the Ministry now that these amendments will be introduced in this legislative session may come in time to alleviate the need to make these amendments for counterparties located in Ontario.

Priority over the Section 30(7) Lien

ISDA also agrees strongly that a security interest in cash collateral perfected by control must have priority over any deemed trust under PPSA subsection 30(7) that might attach to the accounts in which cash collateral is held, whether those are accounts in the name of the debtor or accounts of the secured party into which the cash collateral is transferred. As the Report

² For example, OSFI Guideline E-22 - *Margin Requirements for Non-Centrally Cleared Derivatives*, s.4.2. By way of illustration, the standardized supervisory haircuts under these Guidelines provide that certain equities (including convertible bonds) listed on a recognized exchange used as collateral have a 25% haircut with a potential further 8% cross currency haircut where margin is exchanged in a currency other than the ones agreed to in the relevant contract, while cash collateral, has a 0% haircut.

³ Canadian law amendments provide for title transfer cash collateral arrangements, as opposed to an express security interest. This requires a significant set of amendments to the ISDA New York form of Credit Support Annex (which is the most widely used of the ISDA credit support documents in Canadian derivatives markets).

correctly points out, employer obligations for which a priority is provided by subsection 30(7) are typically unascertainable, so cannot be addressed in cash collateral arrangements by way of collateral cushions or effective monitoring. Given the decision of the Supreme Court of Canada in *Sun Indalex*, this special priority includes pension plan wind-up deficiencies with respect to single employer defined benefit pension plans. These deficiencies have the potential to be exceptionally large, potentially wiping out the value of the cash collateral. Variation margin for eligible financial contracts is carefully calculated to correlate to the exposure of the secured party to its counterparty. Priority liens of uncertain amount render it impossible to make the kinds of calculations required to effectively collateralize these types of arrangements or indeed comply with regulatory requirements.

The recommendation of the Report is to subordinate security interests in deposit accounts to the subsection 30(7) priority, except where the secured obligations arise under eligible financial contracts as defined in regulations to the *Bankruptcy and Insolvency Act* (Canada) (**BIA**). We are assuming that this will be drafted in such a way that it is simply a definitional cross-reference and it would not be necessary that the BIA actually be the statute that applies to the debtor. Debtors may in fact not be subject to the BIA (e.g. if they are banks or other financial institutions, railways, trusts (possibly), pension entities, foreign entities). It is to be hoped that the regulations to the BIA, *Winding-up and Restructuring Act*, *Canada Deposit Insurance Corporation Act* and *Companies' Creditors Arrangement Act* will continue to define an eligible financial contract in an identical fashion. We do note, however, that different federal ministries are responsible for this legislation. The most certain approach to drafting (which would not require further amendments in future) would be to define an eligible financial contract as one meeting the definition under any of these regulations.

Another potential issue arises from the possibility that a master agreement may apply to transactions or liabilities that may or may not be eligible financial contracts. The definition of eligible financial contract has certain elements that require the exercise of judgment and, with new or unusual products, it is not always clear if they would qualify as eligible financial contracts. The drafting should make it clear that the priority is not lost with respect to those obligations arising under a master agreement that arise from eligible financial contracts even if the collateral also secures obligations that do not arise from eligible financial contracts.

ISDA would be pleased to provide you with any further information that you believe would assist you in implementing the recommendations of the Report and moving forward with this important initiative.

Yours truly,



Katherine Darras
ISDA General Counsel