INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÉRES

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June 26, 2006

The Honourable Maxime Bernier
Minister of Industry
Industry Canada
235 Queen Street
Ottawa, Ontario
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Dear Mr. Minister:

Re: Urgent Need to Amend the *Bankruptcy and Insolvency Act* (BIA) and *Companies' Creditors Arrangement Act* (CCAA)

The Investment Industry Association of Canada (IIAC)[1] commends progress being made by Industry Canada to reform the *Bankruptcy and Insolvency Act* (BIA) and *Companies' Creditors Arrangement Act* (CCAA) and urges you to ensure that this reform remains a priority for the legislative agenda this year. However, the 2005 amendments in the former government's Bill C-55, *An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts*[2], contained misdrafting and did not bring +Canada to current international standards as embodied in U.S. legislation and European Union directives. We are also requesting Finance Canada to make, where appropriate, equivalent amendments to the *Winding-up and Restructuring Act* (WURA), *Payment Clearing and Settlement Act* (PCSA) and *CDIC Act* (CDICA) to ensure that amendments in those laws parallel, where appropriate, changes that we believe are required to the BIA and CCAA. We know that you and the Minister of Finance understand the critical role that Canada's investment industry plays in the economy of this country. The attached paper, therefore:

1. Identifies the problems in current legislation and Bill C-55
2. Sets out what changes are required and why
3. Describes what Canadian capital markets and our economy have at stake if revisions are not made
4. Confirms why debtors are not disadvantaged by the proposed amendments

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[1] On April 1, 2006, the Investment Dealers Association of Canada (IDA) legally divided into a self-regulatory organization (SRO) and IIAC – the industry association. The Association represents the position of the Canadian investment industry on regulatory and public policy issues. Its mandate is to promote efficient, fair and competitive capital markets for Canada while helping its member firms succeed in the industry.

[2] While given final reading on November 25, 2005, Bill C-55 has not been proclaimed.

5. Lists recent changes in other countries' laws that (1) attest to these countries' view that debtors are not disadvantaged and (2) put Canadian firms at a disadvantage if Canada does not match the laws
6. Summarizes other recommendations *(the Investment Industry Association of Canada has separately made comments on registered retirement savings plan (RRSP) creditor-proofing and related issues; these are not repeated here).*

We would like the opportunity to meet on the critical issue of insolvency reform to address any concerns that you may have, understand your views and clarify timing from a legislative agenda perspective.

Yours truly,

CC:
Industry Canada: Éric Dagenais, Matthew Dooley
Finance Canada: Robert Wright, Deputy Minister; Mark Carney, Associate Deputy Minister; Timothy Bishop; Michele Legault-Dooley
Office of the Superintendent of Financial Institutions: Nicholas Le Pan; Brad Shinn; Robert Hanna; Julie Dickson; Greg Cooper
Stikeman Elliott LLP: Margaret Grottenthaler
ISDA: Robert Pickel; Katherine Tew Darras
The Financial Markets Lawyers Group: Diane Vizera
Canadian Bankers Association: Warren Law; Sandy Stephens
Ontario Securities Commission: Randee Pavalow
Bank of Canada: Ross MacKinnon, Rob Ogrodnick
The Canadian Depository for Securities Limited: Toomas Marley
The Bond Market Association: Robert Toomey

Bill C-55, *Bankruptcy and Insolvency Act* (BIA), *Companies' Creditors Arrangement Act* (CCAA), *Winding-Up and Restructuring Act* (WURA) and the *Payment Clearing and Settlement Act* (PCSA): Investment Industry Association of Canada (IIAC) Concerns and Recommendations *June 2006*

1. Problems in current legislation and proposed Bill C-55

There is an acknowledged drafting error, addressed below, in Bill C-55, *An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts*. Reform is also needed to the *Bankruptcy and Insolvency Act* (BIA), *Companies' Creditors Arrangement Act* (CCAA), *Winding-up and Restructuring Act* (WURA) and the *Payment Clearing and Settlement Act* (PCSA) and changes to them must be consistent. Moreover, the situation in the financial industry is complicated by recent provisions in the Basel Committee on Banking Supervision's *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (November 2005), which accord financial institutions capital relief for collateral held for derivatives and securities lending transactions if – *if* – in the event of their counterparty's insolvency, they have the right to exercise their rights "in a timely manner" (paragraph 123, attachment to *Revised Draft Capital Adequacy Requirements (CAR) – Guideline A-1 and Guideline A*, Office of the Superintendent of Financial Institutions (OSFI)). Institutions in Canada and globally are subject to the Basel requirements, which OSFI helped develop and is responsible for implementing. The above combine to create a number of problem areas:

i. ***Inability to enforce security in insolvency proceedings:*** Current law provides that Canadian entities are subject to court-ordered or automatic stays on the enforcement of collateral during bankruptcy or restructuring proceedings. The lack of an exemption for collateral provided for securities financing and derivatives transactions is a serious issue.

Securities financing transactions, such as repurchase (repo) and reverse repo transactions, securities lending and borrowing and margin lending, are always collateralized. Collateral is an integral part of these financing transactions and is also often part of netting mechanisms under master agreements. In fact, most transactions would not take place without the collateral given requirements for financial institutions to protect themselves from risks in the interests of their investors and savers. Cross-border securities lending and repo markets trading are estimated at more than $50 billion daily and in the trillions of dollars annually.

Derivatives transactions, such as forwards, swaps and equity options, are often collateralized as a way to access larger credit lines from, and a greater pool of, counterparties; derivatives exchanges also depend on both security interest and title transfer collateral arrangements.

Who enters into repos, securities lending, derivative and similar transactions affected by the noted legislation? Typical borrowers of securities include investment dealers, banks, insurance companies, hedge funds and individuals. They borrow to:

- Cover "fails to receive" where clients have sold securities but have not yet delivered them
- Facilitate hedging strategies to mitigate market risk
- Manage their balance sheet and funding sources
- Establish short positions
- Take advantage of arbitrage opportunities.

Typical securities lenders include custodians lending securities on behalf of their clients, third-party lenders, pension funds, investment funds, mutual funds and investment dealers. They lend securities for different reasons, including access to low-risk opportunities to increase the return on their holdings and to raise cash. Pension funds, including the largest civil service ones in the country and the Canada Pension Plan Board itself, rely on derivatives and securities lending.

The Bank of Canada participates in the securities lending market to support monetary policy. The Canadian government and its crown corporations are sometimes major participants in the derivatives and securities financing markets.

ii. ***Questions regarding the enforceability of netting and termination:*** Bill C-55 adds an automatic stay on the termination of agreements under the CCAA and a provision allowing a court to make any order it considers appropriate. While an exemption for "Eligible Financial Contracts" remains, it is unclear whether it applies in the case of an automatic or court-ordered stay. We understand that Industry Canada is aware of the mistake and has committed to fix it through amending legislation. Care should be taken to ensure that Bill C-55 is not proclaimed until the necessary amendment can also be proclaimed.

iii. ***Fraudulent preference amendments:*** Current Canadian insolvency laws create further uncertainty, by international standards, in terms of how these laws apply to substitutes and top-ups of collateral. Collateral is provided on a mark-to-market basis, meaning that as the value of a security or contract fluctuates, new collateral to top up or substitute for the existing collateral sometimes must be delivered and this may be presumed to be preferential or fraudulent solely due to the fact that the transfers may take place after or before an insolvency proceeding starts. Although this charge would typically be successfully refuted, it will not be possible to provide legal comfort when the transaction is entered into.

2. Changes required and why

There are three types of changes required. Each area of primary change and the implications if changes are not effected are noted below:

i. ***Provide necessary collateral protections***

As current law provides that Canadian entities are subject to court-ordered or automatic stays on the enforcement of collateral during bankruptcy or restructuring proceedings, Canadian entities cannot take advantage of the maximum benefits from providing collateral because of stay risks that their counterparties may face in realizing on the collateral. The new Basel requirements referenced above provide that institutions will only be entitled to capital relief with respect to the collateral they hold if the legal mechanism by which the collateral is pledged or transferred ensures that the bank has the right to liquidate and take possession in a timely manner. The current law will prevent this form of capital relief to those taking collateral from Canadian counterparties.

Also, while a title transfer or security interest collateral arrangement may be documented under various master agreements and brought into the netting mechanism in these agreements, the collateral arrangement itself is not an eligible financial contract, meaning that there is also not sufficient certainty that the statutory protections apply to the collateral aspects of the transactions under these laws.

The consequences if there is no such right? Without capital relief, Canadian institutions will be seriously impaired in terms of their ability to participate in these important financial markets. For collateral to qualify for capital relief, firms need to obtain an unqualified or almost unqualified legal opinion that there is no automatic or court-ordered stay. If capital relief is not available or not fully available, firms will either not enter into the transactions or will require other significant concessions, such as higher compensation. Canadian institutions could very well not deal with

domestic parties in the securities lending markets and will have to seriously restrict dealings in derivatives.

ii. ***Update netting protections related to the enforceability of netting and termination:***
The protections in the BIA, WURA, CDICA and the PCSA for eligible financial contracts protect the right to terminate transactions and to net transaction exposures. The definition of "eligible financial contract" has not kept pace with market developments. Some very important categories of transaction, such as equity and credit derivatives, are not expressly covered by the definition.

The implications if it is not clear whether the exemption for "eligible financial contracts" applies in the case of an automatic or court-ordered stay? Law firms will be unable to provide an unqualified opinion on the enforceability of netting and termination in reorganization and bankruptcy proceedings in Canada, preventing Canadian and international banks from netting in the calculation of credit exposure to Canadian corporates for capital adequacy purposes (see below). This may lead to increased prices, cessation of certain business lines that Canadian borrowers or issuers require or movement of securities financing activities offshore. Reduced and/or higher cost access to derivatives, repos, securities lending and other securities financing markets will mean that governments at all levels, Canadian corporates and other businesses will be less able to manage risk in their portfolios and/or to earn extra returns.

iii. ***Consistently apply the relevant protections across the BIA, CCAA, WURA, PCSA and CDICA:***
It is critical that Industry Canada and Finance Canada work together not only to update the laws for which they are responsible, but also both to ensure consistency between and simplify Canadian insolvency laws and to bring them to international standards (see below). Also, Canada has signed the Hague Securities Convention (PRIMA Convention), an international multilateral treaty intended to remove, at a global scale, legal uncertainties for cross-border securities transactions and addressing these protections that support securities, including cross-border securities transactions, such as repos and swaps, is consistent with the general aims of the convention.

IIAC has reviewed the recommendations and draft wording put forward by the International Swaps and Derivatives Association (ISDA) over the past year and they address our members' concerns. While we have not yet considered the drafting in detail, we are confident that the work of ISDA, with its extensive expertise in the area of netting, termination and collateral in a wide range of countries, should be given serious consideration to ensure the ongoing high rating, integrity, liquidity and efficiency of Canadian capital markets and the future success of the investment industry.

3. What's at stake for Canadian capital markets and the Canadian economy if amendments are not made

Canada's economy benefits hugely – directly and indirectly – from both Canadian capital markets and the role of Canadian investment dealers and brokers in these markets. The securities industry channels savings to the most productive investments and helps Canadian businesses grow, manage risks and succeed in our now global environment. The industry helps governments with their financing and debt management needs. Canadians saving for retirement and other capital purchases also benefit from the capital markets industry. Finally, the securities industry employs 40,000 Canadians and pays substantial taxes to all levels of government.

Capital markets today truly know few borders (other than regulatory ones) as delivery has gone from physical certificates to electronic messages and Canadian firms can compete with the best in the world. Despite Canada's relatively small population, Canadian capital markets and the securities and broader financial services industry have developed a competitive advantage that enables Canadian firms to play a proportionally larger role in the global economy than the Canadian population suggests.

The success of Canada's securities and broader financial industry is based on certainty and trust. We cannot overstate the critical importance in an electronic world of certainty of the value of financial assets and associated transactions such as repos, securities lending and derivatives. The securities lending and derivatives markets depend on providing mark-to-market collateral, typically on a daily basis. In derivatives transactions, providing collateral opens up credit lines not only for bank customers, but also for the banks themselves. Securities lending markets, which can only operate on a fully collateralized basis, provide additional returns to investors.

Consistency of protections between the different pieces of legislation governing insolvency would also help Canadian and international parties not only be treated, but be seen to be treated, equitably and to better understand their rights.

4. Debtors are not disadvantaged by the proposed amendments

Changes that would impair (1) an affected company's ability to restructure in a restructuring proceeding such as a BIA proposal or under the CCAA or (2) the liquidation process are legitimate concerns. However, there is minimal to no concern that providing protections for eligible financial contracts, for example, will prevent the debtor from taking reasonable actions in either case. To the extent that the protection that we request be embodied in law is limited to financial collateral delivered into the ownership, control or possession of the collateral-taker:

- It neither relates to assets that are a requirement in the debtor's day-to-day operations to provide a good or service nor impedes the debtor who needs time to develop a restructuring plan.
- Collateral supporting securities financing and derivatives transactions has a market value that can be determined in a fast and straightforward way. Also, there are unlikely to be the priority disputes (particularly once each province has implemented its uniform *Securities Transfer Act*, currently under way), meaning no requirement to provide trustees or liquidators with time to value the collateral and understand competing priorities for the redemption of assets (in fact, there is every reason *not* to allow the cherrypicking by the trustee of what to redeem and what not to).

Canadian firms' and Canadians' ability to take advantage of global financial markets and mitigate the systemic and other risks in those markets must override any small residual risk for individual debtors.

5. Recent changes in other countries' legislation (1) that demonstrate their opinion that debtors are not unduly disadvantaged and (2) that are putting Canada at a disadvantage if Canada does not match these legal protections

Canada: Canada itself already recognizes in insolvency statutes the unique nature of securities financing, derivatives and similar types of transaction and the importance to global financial systems of not impeding the exercise of rights under them. The PCSA also extends the collateral protection to clearing organizations, recognizing the importance of the exercise of rights against collateral to futures and derivatives markets. Contractual termination and netting rights under contracts of this type ("eligible financial contracts") are specifically protected in all insolvency legislation (although the list in the legislation of eligible financial contracts needs to be updated). These protections allow for the management of systemic risk in global financial markets, which become more interconnected daily, and for the affected financial institutions to efficiently manage their capital. Canadian banks would not be able to net their exposures to counterparties and hence reduce their capital requirements without these express statutory protections. It is protections such as these that have enabled Canada to develop strong derivatives and securities financing markets. This said, the current protections only apply to rights to terminate and to net transaction values, and not to rights to realize on collateral.

United States: The U.S., despite having the requisite protections in law for some time, has recently expanded the protections and clarified their scope, expressly providing statutory protections for financial collateral enforcement. Section 362(b)(17) of the U.S. *Bankruptcy Code* exempts those taking collateral for obligations under a "swap agreement" from the automatic stay and allows the

collateral-taker to use the collateral to satisfy amounts due from the bankrupt collateral-provider. The *Federal Deposit Insurance Act (FDIA)* and the *New York Banking Law* allow a party taking collateral to exercise any rights under any security agreement relating to any qualified financial contract in the event of proceedings under those Acts. The U.S. *Bankruptcy Code* and *FDIA* now include any security agreements or arrangements or other credit enhancements related to such agreements within the definitions of a repurchase agreement, swap agreement, securities contract, forward contract and commodity contract, clarifying that the security arrangements can be accelerated. Specifically, they:

- Include in the definition of "swap agreement" (i) total return, credit spread and credit swap, options, futures or forward agreements, (ii) equity index and equity swaps, options, futures or forward agreements, (iii) debt index or debt swaps, options, futures or forward agreements, and (iv) weather swaps, derivatives and options – while the previous definition of "swap agreement" contained language that was intended to encompass such market developments, the express enumeration added market certainty
- Expand the definition of "swap agreement" with an "any other similar agreement" basket, defining "any other similar agreement" to mean:
  "• any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that –
    I. is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap markets (including terms and conditions incorporated by reference therein); and
    II. is a forward, swap, future or option on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value."

Also, margin loans have been added to the list of protected contracts in the U.S. *Bankruptcy Code*.

European Union: The countries of the European Union have amended their laws to provide express protection for rights to realize on collateral for financial contracts under Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002.

6. Recommendations

Working with colleagues within Finance Canada, update Canadian insolvency law to international standards to:

i. Provide necessary collateral protections by:

- Making it clear that the special priorities provided for in Bill C-55, introduced by the last government, under the BIA and the CCAA, including the potential overriding of the first priority interest collateral by statutory claims (the wage arrears superpriority and pension claim priority under the BIA) and debtor-in-possession financing charges under the BIA and CCAA, which apply to all or any of a debtor's assets, do *not* take priority over financial collateral for eligible financial contracts such as repos (an issue for Industry Canada)
- Including title transfer collateral arrangements in the list of eligible financial contracts to ensure that they can be included in master agreements' termination and netting mechanisms (Industry Canada and Finance Canada)
- Exempting from automatic and court-ordered stays the exercise of rights (including sale, foreclosure and set-off) against financial collateral held by the party taking the collateral (cash, debt and equity securities of incorporated and unincorporated entities, negotiable instruments, letters of credit, claims or rights – for example, options, exchangeable features – with respect to any of the foregoing) related to eligible financial contracts (Industry Canada and Finance Canada)

- Removing unacceptable clawback risk under creditor preference legislation by expressly recognizing that the provision of top-up and substitute financial collateral is not voidable and does not lead to the assumption that the transaction is voidable because it takes place within specified pre-proceeding periods (Industry Canada and Finance Canada)

ii. Update netting protection, specifically:

- Expand the list of eligible financial contracts by regulation or legislative amendment to add items identified in the ISDA drafting recommendations, including margin loans, derivatives, title transfer collateral arrangements, etc. (Industry Canada and Finance Canada)
- Introduce a clearer basket clause, such as that in the U.S. *Bankruptcy Code*, to capture clearly developments in the fast-changing financial markets (Industry Canada and Finance Canada)
- Explicitly provide that rights under a master agreement are not affected if any particular transaction is not an eligible financial contract or the collateral arrangements also secure transactions that are not eligible financial contracts (Industry Canada and Finance Canada)
- Ensure that multibranch netting is fully effective in Canadian proceedings with respect to foreign branches of non-Canadian institutions (Finance Canada)
- Add mutual funds to the definition of "financial institution" in the PCSA (Finance Canada)

iii. Where there is no specific need for different protections and other provisions, consistently apply relevant protections across the BIA, CCAA, WURA, PCSA and CDICA (Industry Canada and Finance Canada)**.**

For a further elaboration of the views of the Investment Industry Association of Canada or to answer any questions, please contact Barbara Amsden, Director – Capital Markets, (416) 943-6249, bamsden@ida.ca.