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The Classification and Regulation of Credit Derivatives

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1. INTRODUCTION

Credit Derivatives (“CDs”) are a relatively new and increasingly essential financial tool in Canada. The worldwide CD market had blossomed from US\$40 billion in 1997¹ to US\$1.6 trillion in 2002.² Despite this meteoric growth, the exact nature of these products remains to be fully understood by market participants. Also, the appropriate regulatory regime – insurance, securities or banking – is uncertain.

The recent failures of Enron and Worldcom raised the spectre of banks buckling as a result of their enormous debt exposure to these companies. However, the banking system remained stable due, in large part, to the use of CDs. This fact did not go unnoticed by US Federal Reserve Chairman, Alan Greenspan, who applauded banks for their innovations in risk management.³ Also of note, Senator Phil Gramm commended an audience of derivatives professionals for “doing God’s work” by protecting the public’s interest with the use of innovative credit risk transfer products.⁴

While Chairman Greenspan and Senator Gramm were singing the praises of CDs, financial guru Warren Buffet warned the world of their destructive power. Many investors suffered losses as a consequence of banks transferring their credit risk to protection sellers. In some cases, the risk of these losses was not elucidated to investors. Moreover, there is a perception that financial institutions could inappropriately benefit from the asymmetry of information regarding transfers of credit risk. These issues, among others, raise the question: how are CDs regulated?

Before exploring the regulatory taxonomy, it is important for the reader to understand the fundamental mechanics of CDs. The discussion will then illustrate how CDs could be classified as insurance products, securities and banking instruments. The classification of a CD will

determine the applicable regulatory regime for the arrangement. Hence, regulatory issues will be discussed for each classification.

2. CD BASICS

A CD contract facilitates the transfer and repackaging of credit risk. CDs unbundle credit risk from the debt, essentially separating ownership of an asset from ownership of the risk.⁵ They are contracts based on a credit asset, where the asset itself is not transferred through the creation of the CD.

A credit asset is the extension of credit, usually tendered in the manner of a loan, lease or instalment credit. Financial institutions are the most common extenders of credit and are considered to “own” the debt extended. The credit asset is expected to provide a certain return to the extender of credit. Due to many potential risk factors – delinquency, default, prepayment, interest rate fluctuations, exchange rate movements and increased business risk – the expected return on the credit asset may not come to fruition.⁶

Until the creation of CDs, credit risk management consisted of purchase and sale strategies in the secondary market, purchasing insurance, letters of credit and guarantees.⁷ This meant that the debtor’s business risk remained exposed to the creditor because those strategies do not separate the management of credit risk from the other exogenous risks in the bundle. By de-linking credit risk, CDs permit credit exposures to be transferred out of a debt portfolio even when the debt itself could not be transferred.⁸

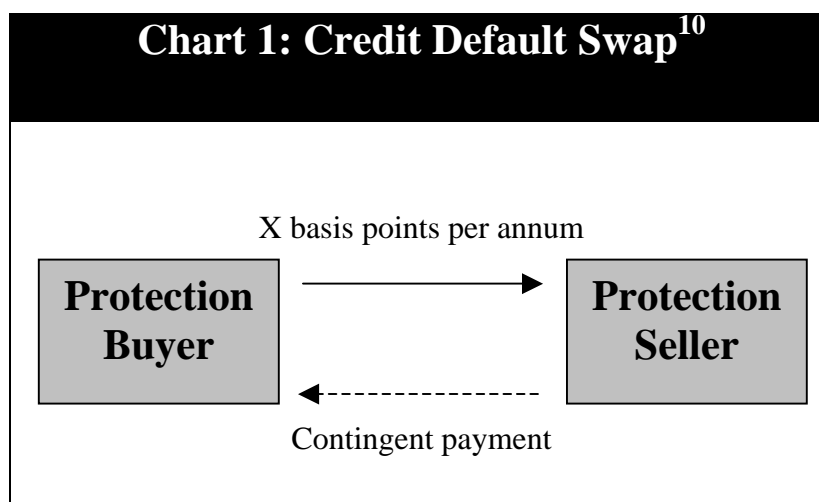
(a) Types of CDs

There are four main types of CDs:

- 1) Credit Default Swaps
- 2) Credit Options
- 3) Total Return Swaps
- 4) Credit-linked Notes

(i) Credit Default Swaps

The credit default swap, illustrated in Chart 1, is a contract where the protection buyer pays a periodic fee in exchange for a contingent payment by the protection seller upon the occurrence of a credit event. The definition of a credit event is negotiated between the parties and may involve such events as filing for bankruptcy protection, failure to meet payment obligations when due, repudiation, material adverse restructuring of debt, obligation acceleration or obligation default.⁹ Also, the periodic fee, contingent payment, and all other contract particulars are flexible and negotiable.



The solid arrow in Chart 1 indicates a periodic payment from the protection buyer to the protection seller based on X basis points of the notional value of the portfolio. The dashed arrow signifies that, if a credit event occurs, the contingent payment is made from the protection seller to the protection buyer.

The contingent payment is usually designed to mirror the expected loss as a result of the credit event.¹¹ The payment may be in the form of a cash settlement or physical delivery of specified obligations.

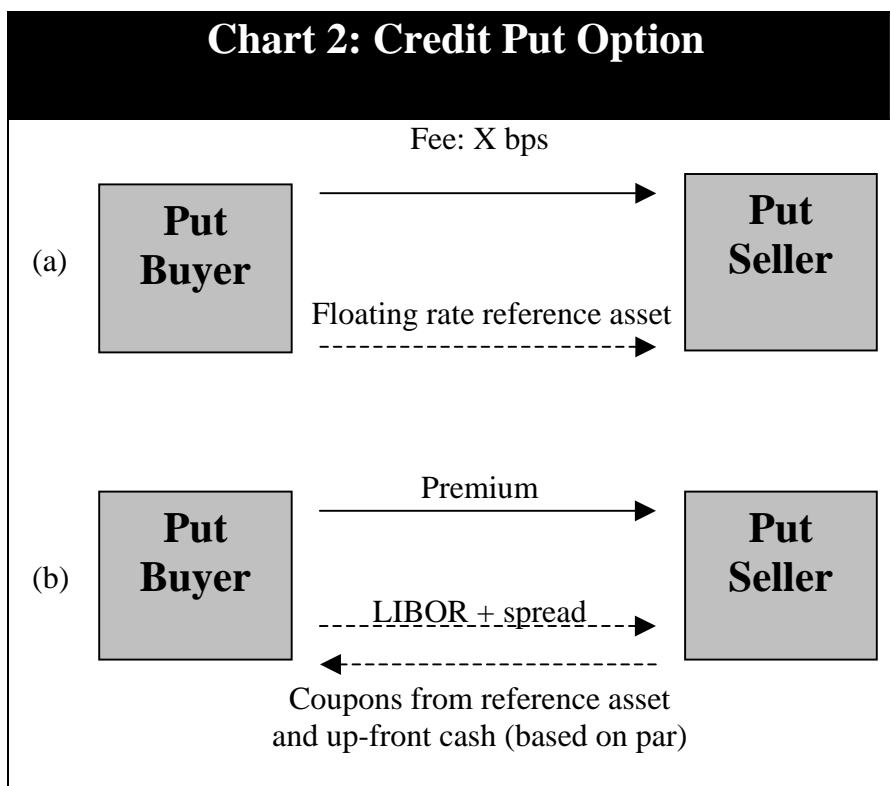
(ii) Credit Options

Credit options are either put or call options on:

- a) the price of a floating rate note, bond or loan; or

- b) an asset swap package consisting of a “credit-risky” instrument with payment characteristics and a derivative contract that exchanges the cash flows for a floating rate cash flow stream.¹²

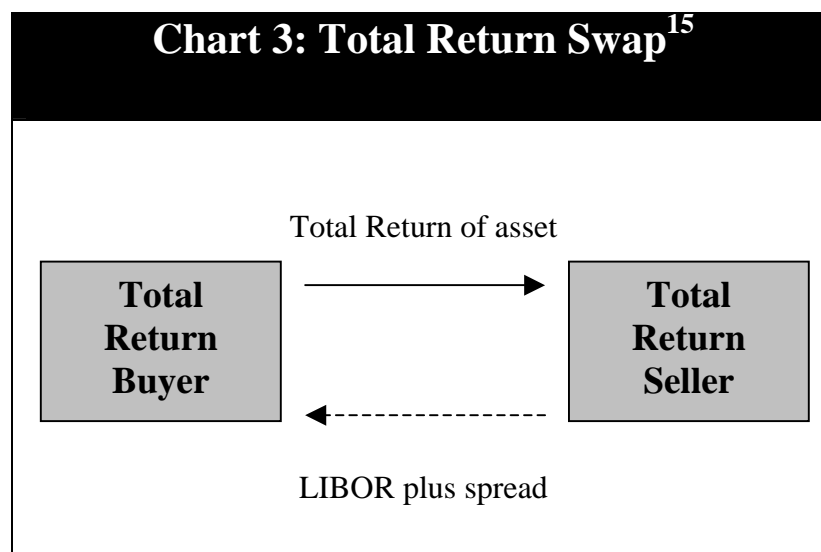
The simpler version of the credit option, exhibited in (a) of Chart 2, is where the purchaser of a credit put option grants the put buyer the right (but not the obligation) to sell a specified floating rate reference asset to the put seller at a pre-specified price (the strike price). The put buyer pays a fee for this right.



The more complex credit option is illustrated in (b) of Chart 2. The put buyer pays a premium to the put seller for the right to sell a reference asset and simultaneously enter into a swap where the put seller pays the put buyer coupons from the reference asset in exchange for 3 or 6 month LIBOR plus a strike spread. The put seller pays par up-front for the total package when the option is exercised.

(iii) Total Return Swaps

A total return swap is a swap involving the total return out of a credit asset in exchange for a predetermined return. The total return from a credit asset is determined from various factors, such as interest rate movements and exchange rate fluctuations.¹³ The protection seller guarantees a prefixed return to the originator who gives the entire collections from the credit asset to the protection seller. In other words, the protection buyer swaps the total return from a credit asset for a predetermined, prefixed return.¹⁴

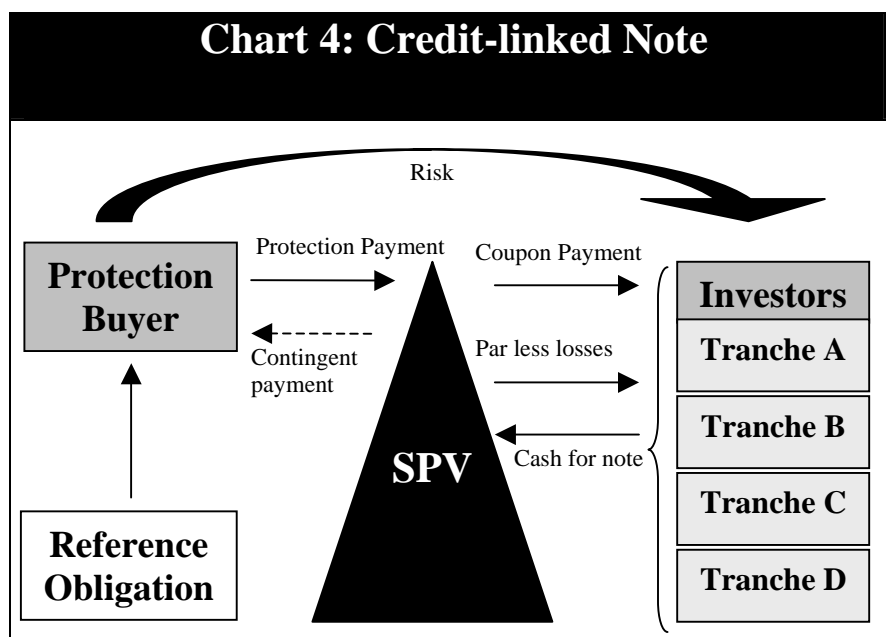


As shown in Chart 3, the total return payer is paid LIBOR plus a spread in exchange for the total return of the asset, which is the sum of the interest, fees and any change in value payment with respect to the reference obligation.

(iv) Credit-linked Notes

A credit-linked note is a securitized form of a CD. In these multifaceted structures, a protection buyer issues notes to investors. The notes may appear like a normal bond with regular coupon payments. The difference is that, upon a credit event, the investor suffers the loss in the form of foregone interest, reduced interest, or delayed payments. The losses generally would impact the principal repayment of the note.

As Chart 4 demonstrates, the structure of a credit-linked note looks similar to some securitization structures. The Special Purpose Vehicle (“SPV”) issues the note to investors, which it purchased from the protection buyer. Some of these structures are very complex and investors need to understand the true risks associated with this investment.



The investor assumes the risk for losses as a result of all credit risk factors; this will determine the principle repayment at the maturity of the note. Generally, the notes will have a waterfall effect, where the highest tranche will get paid first and has the highest credit rating (AAA rating), while the lowest tranche will have an equity rating and thus takes on the greatest risk. Since some structures are designed for a single investor, the waterfall effect would be irrelevant because, in those situations, the one investor takes on all the risk.

(b) The Risk of CDs

Derivatives can be used to hedge risk, to speculate, or even to “cook the books.” CDs create a paradox in the financial markets: market participants simultaneously fear credit risk and the use of the instruments to allay that fear.¹⁶ When asked what their top ten fears of the financial system were, 175 bankers, regulators, and corporate users answered “credit risk” as

their primary fear and “financial instruments designed to cope with credit risk” closely behind as the fourth leading fear.¹⁷

In an article written by Jim Jubek on MSN Money,¹⁸ Jubek discusses the risk for disaster at financial powerhouses like J.P. Morgan Chase, due to their position in the derivatives market. The article points out that most investors do not truly understand the risk of investing in these institutions because of these complex derivative arrangements. Most are not aware that, as protection sellers, they run the risk of paying out billions of dollars upon credit events.

According to commentators,¹⁹ “the world’s deep pocketed financial markets are challenging insurance-industry dominance as ultimate guarantor of business risk.”²⁰ And it is not just financial institutions that are using products like CDs to protect themselves from credit risk. Corporations across the world exposed to credit risk are using CDs to transfer this risk. Moreover, companies are specializing in buying this risk. These companies act in the same fashion as insurance companies but do so in the derivatives market. Freddie Mac, Fannie Mae, and J.P. Morgan Chase are examples of such companies. On Sept. 30, 2001, J.P. Morgan Chase was exposed to 49.4% of the net system-wide credit risk associated with derivatives in the US.²¹ In the bull markets this exposure meant huge returns to this behemoth financial institution. However, since Enron’s demise and the tech-bust, J.P. Morgan Chase was forced to pay out on many of its derivative contracts.

Warren Buffet has been quoted as saying that the derivatives market is a “time bomb” because of the lack of disclosure to investors and the public.²² CDs are structured with the intention of revealing all material facts to each party to increase the level of certainty at both ends. The lack of disclosure that Buffet and other leading financial gurus are concerned about involves the disclosure of these deals to investors and the public. The J.P. Morgan Chase situation is a good example of how investors failed to understand the true risk of its position in over-the-counter (“OTC”) derivatives.

There is an added fear that regulators will react too strongly to public pressure and place too stringent restrictions on CDs, and thus destroy this burgeoning market.

The anxiety of market participants is matched only by that of regulators. For example, a primary goal for securities regulators is to protect the public. Since the market is so deeply concerned about these financial tools, there is pressure on regulators to create more certainty. However, regulators cannot escape their other primary goal – to facilitate the efficiency of the capital markets. If regulation is too restrictive, it raises the risk of industry participants going to less restrictive markets and destroying the burgeoning domestic market.

To alleviate some of this risk, the International Swaps and Derivatives Association (“ISDA”) released the *2002 Credit Derivatives Definitions* (the “*Definitions*”). The *Definitions* was meant to refine and improve areas identified by market participants and add stability to the CD market.²³ Before the *Definitions* was released, the momentum of CD interest and sophistication was building at an exponential rate.²⁴ Now Canadian market participants and regulators must act to reduce local fears and regulatory uncertainty in order to keep our market growing.

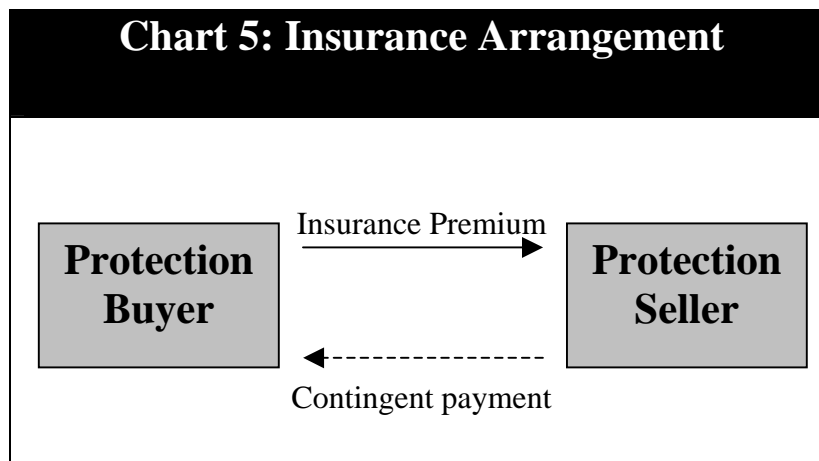
(c) **Classification of CDs**

CDs have attributes of insurance products, securities, and banking instruments. So, what are they? An online financial consultant offers an interesting analogy when asked “when is a credit derivative a hedge and when is it a trade.”²⁵ His answer: “When does your house provide shelter from the elements, and when does it provide an office for your business?”²⁶ Obviously, the home can have more than one classification – and so can CDs.

In fact, CDs could be structured to qualify as insurance, securities, and financial instruments. The classification of CDs matters because of regulatory separation of insurers, securities issuers, and banks.²⁷

3. CDS AS INSURANCE

The credit default swap is a clear example how CDs look like insurance for debtholders. By slightly altering Chart 1 in the previous section, Chart 5 illustrates that the credit default swap parallels an insurance transaction.



The concept of insurance is simple: a protection buyer pays a fee to a protection seller and receives nothing in return unless a contracted event occurs that lowers the value of the item being protected. This is typically the same purpose of credit default swaps. Moreover, the other types of CDs discussed in this paper are also forms of insurance for debtholders. Credit options, total return swaps, and credit-linked notes could act as a hedge for the debtholder with regard to credit risk.

(a) The Insurance “Test”

Even though CDs clearly have insurance attributes, can they legally be defined as insurance contracts? An analysis of the legal definition of insurance will help determine this. To qualify as an insurance contract, the transaction must have the following characteristics:

- i. a transaction where a person secures (usually for money) a benefit for herself on the happening of an uncertain event;²⁸
- ii. the benefit must be linked to an actual loss or detriment as a result of the uncertain event,²⁹ regarded as an insurable interest;³⁰ and
- iii. insurance contracts require good faith and disclosure of all material facts by both parties.³¹

Since credit default swaps and credit put options provide a benefit to protection buyers on the occurrence of a credit event, those CD arrangements should satisfy the first part of the

insurance test. Total return swaps and credit-linked notes are somewhat different because the benefit is secured whether or not the credit event actually happens. Nonetheless, many of these CDs are purchased to protect against the repercussions of an uncertain event, and as such may satisfy the first part of the test.

The second part of the insurance test states that the benefit received must be linked to an actual loss as a result of the uncertain event. While it may be true that a CD arrangement could be designed to satisfy this requirement, it is not essential. If the protection buyer does not own the reference asset, there is no insurable interest, and therefore, the CD would not be linked to an actual loss. This rule should also apply to situations where the protection buyer over-protects its position in the underlying asset. For example, protection buyers may seek protection from multiple protection sellers regarding the same reference obligation. Upon a credit event, the protection buyer would be allowed to make claims against each CD. Canadian insurance regulators limit multiple claims on the same property so a protection buyer does not profit from insurance in this manner.

The third and last part of the insurance test indicates that full disclosure of material facts by all parties is mandatory for insurance products. However, most commercial contracts are based on the premise of due diligence rather than voluntary disclosure. For insurance contracts, insurance companies have the comfort of knowing that courts will repudiate agreements that have less than complete disclosure. For commercial agreements, parties are forced to fend for themselves, to a large extent, in order to obtain the information necessary to decide whether or not to enter into the agreement and at what price.

(b) Are CDs Insurance?

A CD transaction could be classified as insurance if it is structured so that the protection seller would not make any payments unless the protection buyer actually holds the reference obligations or suffers a loss directly related to the reference obligations.³² In other words, the “insurable interest” component of the insurance test is crucial to determine if a CD would be insurance. Furthermore, in a non-insurance contract, the terms are generally *caveat emptor*, but in an insurance contract both parties are subject to a duty of utmost good faith.³³

CDs differ from insurance because the protection buyer is not required to ever own the reference obligation that is protected.³⁴ This would be analogous to a person buying fire insurance on his neighbour's home – that type of protection is not insurance, but rather, a wager. Wagers are unenforceable as insurance contracts because there is no “insurable interest.”³⁵

Does this mean that CD participants need to be concerned with Canadian gaming laws? Although some CDs have the characteristics of wagering agreements, they are unlikely to be viewed as wagering contracts since the contracts were entered into as commercial agreements aimed at hedging exposure to existing commercial arrangements.³⁶

Drafters of CD arrangements must be cognizant of the insurance test; otherwise, the CDs may be subject to stringent insurance regulation.

(c) **Insurance Regulation**

The *Insurance Companies Act (Canada)*³⁷ is the federal legislation for insurance companies and insurance products in Canada.³⁸ A CD arrangement will be subject to Canadian insurance regulation if it meets the aforementioned insurance test. Specifically, the CD could be subject to Canadian insurance law if the agreement is structured to replace traditional insurance, forces the protection buyer to own the reference asset, and prevents multiple claims on the same reference asset.

Any person who undertakes insurance in Ontario must be licensed by the Financial Services Commission of Ontario.³⁹ What then happens to the enforceability of CD contracts, classified as insurance, between unlicensed parties? The lack of jurisprudence on this issue leaves this question open; however, parties should be aware of the possibility that these agreements may be unenforceable. At the very least, non-insurer CD participants should speak with legal counsel to ensure that their agreements are sufficiently structured to avoid the classification as insurance contracts.

In any event, insurance companies may enter into CD transactions. Specifically, the *Insurance Act (Canada)*, *Ontario Corporation Act*,⁴⁰ and the *Canada Business Corporations Act*⁴¹ do not restrict licensed insurers from entering into OTC derivative contracts. In fact, in recent years, insurance companies have been active participants in the CD market. However,

these companies must be cautious in their use of CDs. Federally incorporated insurers are legislatively limited in their ability to provide financial services.⁴² Specifically, insurers have the power to enter into CD transactions as a market intermediary or for managing its portfolio.⁴³ Nonetheless, even if an insurer enters into a CD for another purpose, it could be argued that the contract is still enforceable because of a saving provision that states that no contract will be unenforceable simply because it contravenes the *Insurance Companies Act*.⁴⁴

Still, insurance companies are often ill-suited to take on credit risk through CDs.⁴⁵ Many are not equipped for the due diligence involved in many commercial contracts and they are not as equipped as banks at handling standard form policies; rather, they handle each claim on a risk-by-risk basis.⁴⁶

4. CDs AS SECURITIES

Ontario securities regulation only applies to investment activities in Ontario involving a trade in a “security.” So, what is a security?

According to the Ontario *Securities Act*⁴⁷ (“OSA”), a security includes “any document, instrument or writing commonly known as a security.”⁴⁸ Some financial products are “commonly known”⁴⁹ as securities, such as stocks and bonds. Derivative contracts sold to retail investors through a publicly traded market would undoubtedly be considered to be securities. However, an OTC derivative contract between two sophisticated financial institutions might not be considered a security.⁵⁰

A security also includes “any document constituting evidence of an option, subscription or other interest in or to a security.”⁵¹ It first appeared that cash-settled OTC derivatives would not fit this category. In *Procter and Gamble Co. v. Bankers Trust Co.*⁵² the Second District court of Appeals of Ohio held that the impugned transactions were not “options on securities” because the swap transactions “did not give either counterparty the right to exercise an option or to take possession of any security.”⁵³ This statement led some to conclude that only those OTC derivatives based on a security (i.e., marketable debt), where the debt must be physically settled, would constitute a security.⁵⁴ However, in *Caiola v. Citibank, N.A.*,⁵⁵ the Second Circuit Court of Appeals of New York held that cash-settled OTC options on stocks are securities. The Court concluded that the specific inclusion of “options on a security” as a security under section

3(a)(10) of the Securities Exchange Act of 1934 “applies to both exchange-traded as well as over-the-counter options and does not distinguish between physically-settled and cash-settled options.”⁵⁶ Furthermore, the Court concluded that “the right to take possession does not define an ‘option’ under section 3(a)(10), which covers options that can be physically delivered as well as those that cannot.”⁵⁷ Nonetheless, these cases have yet to be applied to “credit options” nor have they been considered by Canadian courts and securities regulators.

CDs are not enumerated in s.1(1) of the *OSA*, but may meet the criteria as securities if they qualify as “investment contracts.”⁵⁸ To determine if a CD is an investment contract, and thus subject to Ontario securities legislation, the investment contract test should be used.

(a) The Investment Contract Test⁵⁹

The leading Canadian case on investment contracts is *Pacific Coast Coin Exchange of Canada v. OSC*.⁶⁰ In this case, the Supreme Court of Canada proposed the following test for determining when an investment contract exists:

- i. there must be an investment of money that has been made with an intention for profit;
- ii. there must be a common enterprise; and
- iii. the efforts of the promoter must be undeniably significant to the success or failure of the enterprise.

Section 1.1 of the *OSA* states that the objectives of securities regulation in Ontario are to (a) protect investors from unfair, improper, or fraudulent practices; and (b) to foster fair and efficient capital markets and confidence in capital markets.

Securities regulators attempt a balance between these objectives. The inclusion of a particular CD arrangement under securities regulation will depend, to a great extent, on how these policy considerations play out. For example, in private arrangements involving sophisticated investors, securities regulators have little need to step in and regulate. Ontario regulators have shown, through legislation and policy statements, that many transactions

involving sophisticated investors (i.e., accredited investors and closely held issuers) will be exempt from prospectus and registration requirements.

However, due to the paucity of jurisprudence in Canada involving OTC derivatives, uncertainty will continue to plague this issue.⁶¹ Therefore, Ontario market participants enter into CD arrangements with the risk that they could be classified as securities and may not qualify for prospectus and registration exemptions. Careful attention to structuring CDs is necessary to avoid Ontario securities regulation. Nonetheless, because of the extreme breadth of the non-exhaustive enumerated definitions of a security, CD participants cannot completely protect themselves from the risk that their arrangements will be classified as securities by the Ontario Securities Commission (the “OSC”).

(b) Are CDs Investment Contracts?

Whether or not a CD arrangement passes the investment contract test depends on the structure of each arrangement. Generally speaking, an OTC derivative will not be considered a security if the arrangement is:

- i. entered into between sophisticated people capable of assessing the risks associated with the investment;
- ii. tailored to the specific requirements of the parties;
- iii. not assignable;
- iv. not fungible;
- v. in need of credit analysis or takes into account the relative performance risk of the counter-party;
- vi. entered into on a one-on-one basis; and
- vii. not marketed to the public.⁶²

Credit default swaps and credit options do not have the usual attributes of a regulated security. They can usually be structured to satisfy the above criteria to avoid securities

regulation. Certain total return swaps and credit-linked notes are more problematic, especially when these products involve an issue to the public.

(c) Securities Regulation

The OSC is Ontario's regulatory body for securities. It enforces the *OSA* and publishes rules and policies related to securities issues. Although there are no provisions in the *OSA* (nor are there any specific OSC rulings and policies) that deal specifically with CDs, certain securities regulation may apply.

(i) OTC Derivatives Regulation

OSC Rule and Companion Policy 91-504⁶³ ("Rule 91-504") was released on September 8, 2000 to deal with the regulation of OTC derivatives. Rule 91-504 was highly criticized by the Canadian Bankers' Association (the "CBA") and ISDA and was later rejected by the Ontario Minister of Finance. Rule 91-504 would have brought all OTC derivatives under the *OSA*.⁶⁴ The CBA and ISDA argued that Rule 91-504 would drive OTC derivative transactions out of Ontario because of perceived complexities and burdensome legal costs for market participants to comply with the rule. ISDA suggested that the development and use of CDs in Ontario would be negatively impacted. CD transactions would likely move offshore, given that the OTC derivative market is entirely portable and no other major jurisdiction had similar regulatory requirements. The CBA believed that "regulatory arbitrage" was a realistic consequence of Rule 91-504.⁶⁵

The OSC claimed that the rule was intended to intervene as little as possible in the OTC derivatives market. Nonetheless, the Minister of Finance returned the proposed rule to the OSC for reconsideration. The Minister suggested that the rule should be limited to classes of transactions and parties that would benefit from regulation rather than encompass all OTC derivatives.⁶⁶

Although Rule 91-504 remains legislatively dead, many CD participants still rely on the broad exemptions under this rule to avoid prospectus and registration requirements.

(ii) Insider Trading

There is a concern that banks could exploit their asymmetry of information in CD transaction negotiations.⁶⁷ As a natural consequence of their lending relationships with debtors,

financial institutions often receive material nonpublic information regarding the debtors' affairs. In theory, the trading side of the banks could receive material nonpublic information from the lending side of the bank. In response to this concern, the Joint Market Practices Forum (the "Joint Forum")⁶⁸ recently published a document providing recommendations for the handling of material non-public information by CD participants, including:⁶⁹

- i. market participants should create a formal policy and procedure statement for the handling of nonpublic material information;
- ii. there should be a functional and physical separation of departments; and
- iii. implement a "restricted list" of securities that cannot be traded and a "watch list" for securities that are subject to close scrutiny by the firm's compliance group.⁷⁰

Under the *OSA*, anyone in a "special relationship"⁷¹ with a reporting issuer with knowledge of a "material fact"⁷² or "material change"⁷³ is prohibited from trading in securities of that reporting issuer.⁷⁴ Of course, the applicability of this regulation is limited to trading in securities. Since it may not be clear whether a particular CD arrangement is a security, the applicability of Ontario's insider trading rules for CD transactions remains uncertain.

(iii) Insider Reporting Requirements

On February 28, 2003, the Canadian Securities Administrators ("CSA") released the proposed rule, *Multilateral Instrument 55-103, Insider Reporting For Certain Derivative Transactions* (Equity Monetization) ("MI 55-103"). Although the purpose of MI 55-103 is to ensure that certain derivative-based transactions fall under insider reporting requirements, the broad language of the proposed rule would have required insiders to report their CD transactions.⁷⁵ However, in response to comments by market participants, the CSA included an exemption for CD transactions involving corporations to the final rule released November 28, 2003. MI 55-103 came into effect on February 27, 2004.

According to MI 55-103, an insider must file an insider report using the prescribed form within ten days of entering into any agreement, arrangement, or transaction that changes an insider's "economic exposure" to a reporting issuer or changes the insider's "economic interest in a security" of the reporting issuer.⁷⁶

Equity monetization products allow an investor to receive cash in an amount similar to that of proceeds of disposing all or some of the economic risk of a security. These products allow for the removal of economic risk without transferring legal and beneficial ownership of the securities.⁷⁷ Therefore, individuals who are insiders that enter into CD arrangements that affects the insiders' economic exposure or economic interest in a security of a reporting issuer would be forced to report the transaction.

“Economic exposure,” in relation to a reporting issuer, is defined in MI 55-103 as the extent to which the economic or financial interests of a person or company are aligned with the trading price of securities of the reporting issuer or the economic or financial interests of the reporting issuer. “Economic interest in a security” means (a) a right to receive or the opportunity to participate in a reward, benefit, or return from a particular security, or (b) exposure to a loss or a risk of loss in respect to the security.

5. CDs AS BANKING INSTRUMENTS

(a) Different Uses of CDs

Although bank failures are rare, they have often occurred from excessive credit exposure to certain borrowers or groups of borrowers.⁷⁸ Therefore, the development of the CD market could improve the stability and efficiency of the financial system as a whole if used as a hedge against their exposure to credit risk. Conversely, the use of long-term OTC derivatives by financial institutions as speculative positions could cause instability to Canada's financial system.

(i) Hedging with CDs

According to David Rule, a senior officer at the Bank of England, the “credit risk transfer” market has the potential to “contribute to a more efficient allocation of credit risk in the economy.”⁷⁹ Through hedging with CDs, banks can reduce concentrations of exposure and they are able to diversify risks beyond their customer base. In addition, CDs add liquidity to the market, which improves the pricing of loans and other credit exposure.⁸⁰ So, the use of CDs by banks to hedge current loan positions could add stability to the financial markets through the reduction of bank exposures to undesirable risk, such as default risk and prepayment risk.

CDs provide certain advantages to financial institutions that other established credit risk transfer instruments cannot offer. For example, securitization products allow banks to sell portfolios of various types of loans (e.g., mortgages, credit card, and automobile). However, securitizations do not allow banks to manage credit risk separately from funding. Also, for CD transactions, the credit risk purchaser generally provides funds *ex post* only upon the occurrence of a credit event, while securitizations generally provide funds *ex ante*.⁸¹

Furthermore, CDs allow banks to unbundle debt instruments into their basic elements, where credit risk is sold to buyers interested in diversifying their credit risk portfolio. At the same time, banks can exit out of unwanted risk areas and keep desired positions by creating CD contracts. Specifically, banks can retain debt positions without the credit risk associated with particular debt.

(ii) Creating Leverage with CDs

Some CDs can be used to create leveraged positions.⁸² For example, in a total rate of return swap, one party is obligated to pay the other amounts equal to the return on a reference credit in exchange for periodic payments equal to cost of funds of the reference credit. What happens here is that one party transfers all the credit risk (i.e., potential losses and gains) to another party.

The first party has created a leveraged position through the total return swap. This is advantageous for financial institutions that are looking to diversify their risk position. Basically, banks can diversify risk without entering into new credit agreements with customers. Instead, they diversify through the creation of CD agreements with other financial institutions.⁸³

(iii) Speculating with CDs

In some situations financial institutions have engaged in the use of CDs as speculative agreements. In that event, banks are either buying or selling protection without a position in the underlying debt.

In these situations, banks take on additional risk through the creation of the CD. Arguably, this type of banking is not in the best interests of deposit holders due to the speculative nature of the transaction. However, if the CD transaction adds reasonable risk diversification, in

context with the bank's entire portfolio, the investment may be sound and to the benefit of investors. Nonetheless, since banking regulation is primarily concerned with the protection of deposit holders' deposits, activities that put these deposits at risk could be subject to stringent regulation.

(b) Are CDs Banking Instruments?

The test to determine whether or not CDs are banking instruments is far less complex than the insurance test or securities test. All that needs to be determined is whether or not a Canadian financial institution is a participant to the CD contract.

Simply put, if the transaction does not involve a Canadian bank, it is not a banking instrument and will not be subject to Canadian banking regulations. If the CD involves a Canadian financial institution, the contract will be subject to Canadian banking regulations.

(c) Banking Regulation

The regulatory body for the Canadian banking industry is the Office of the Superintendent of Financial Institutions ("OSFI"). In 2001, OSFI published its policies regarding CD contracts involving Canadian banks.⁸⁴

The purpose of bank regulation is to ensure that financial institutions use CD products for the benefit or protection of depositors. Since banks may use CDs to increase risk exposure and put deposits at risk, OSFI stepped in and set guidelines for the appropriate treatment and usage of CD instruments.

In OSFI's *Guideline*, total rate of return swaps, credit default swaps, and credit-linked notes are all eligible for capital relief. No other CD product was identified as eligible under the *Guideline*. There are two main criteria that determine the capital recognition given to the transfer of credit risk:

- i. the effectiveness of the risk transfer; and
- ii. the permanence of the transfer.⁸⁵

The *Guideline* states that an effective risk transfer can only be achieved if the CD: (a) protects against deterioration in value or credit loss in the event of default on the asset held on the institution's balance sheet; and (b) is explicit, irrevocable, unconditional, and legally enforceable.⁸⁶

Moreover, the *Guideline* states that a CD must have: (a) a minimum term for recognizing any hedging effect; and (b) be subject to a capital charge for the unhedged forward credit risk arising from maturity mismatches in order to achieve a prudent level of permanence to the transfer of credit risk.⁸⁷

Why is any of this important? Under OSFI's current capital adequacy framework for deposit-taking institutions, the risk weight applied to a loan in the banking book can be reduced either by obtaining eligible collateral or by acquiring a qualifying guarantee. The *Guideline* sets out conditions for applying guarantee treatment to particular CDs in the banking book.

Under this treatment, a bank that sells protection through a CD is called the guarantor and becomes exposed to the credit risk of the reference asset. This exposure is treated as if the bank was providing a guarantee on the reference asset and has a negative impact on the banking book of the guarantor because of the increased exposure to credit risk.

A financial institution that receives the guarantee (i.e., the protection buyer) may reduce the risk weight of the underlying asset to that of the guarantor (i.e., the protection seller) if the transfer of risk is effective and achieves an adequate level of permanence.⁸⁸

When engaging in CD arrangements, OSFI expects financial institutions to abide by the "sound" risk management factors listed in OSFI *Guideline B-7 – Derivatives Best Practices*.⁸⁹ This document outlines issues OSFI expects bank management and directors to consider when using derivatives as part of its investment and financing profile. For example, management and directors should periodically review the bank's policies and procedures that:

- i. delineate lines of responsibility for managing risk;
- ii. set in place adequate systems for measuring risk;
- iii. create appropriately structured limits on risk taking;

- iv. establish effective independent internal controls; and
- v. describe comprehensive and timely risk monitoring and reporting.⁹⁰

The document also offers guidance for banks in the measurement of market risk, credit risk and liquidity risk.

5. INTERNATIONAL ORGANIZATIONS

Several international organizations play a pivotal role in the regulation of OTC derivatives indirectly, through their various publications, research, and industry involvement.

(i) ISDA

ISDA is recognized as the leading international body for derivative products. ISDA Master Agreements are ingrained into the fabric of the derivatives market worldwide. According to its mission statement, ISDA's primary purpose is to encourage the prudent and efficient development of the privately negotiated derivatives business by:

- a) promoting practices conducive to the efficient conduct of the business, including the development and maintenance of derivatives documentation;
- b) promoting the development of sound risk management practices;
- c) fostering high standards of commercial conduct;
- d) advancing international public understanding of the business;
- e) educating members and others on legislative regulatory, legal, documentation, accounting, tax, operational, technological and other issues affecting them; and
- f) creating a forum for the analysis and discussion of, and representing the common interest of its members on, these issues and developments.⁹¹

Adherence to ISDA policies is voluntary among the contracting parties; however, there is an understanding among the financial markets that ISDA continuously stays on top of all

derivative issues and attempts to incorporate these issues into policy and advice for structuring agreements. Hence, most derivative deals utilize ISDA Master Agreements and Definitions.

(ii) Bank for International Settlements

The Bank for International Settlements (the “BIS”) is another international organization that offers regulatory advice to banks and bank regulators. In its January 2003 web publication, *Credit Risk Transfer*, the BIS considers the development of the CD market to be “welcomed as increasing market efficiency, enabling better diversification of portfolios and providing a wider range of techniques for risk management.”⁹²

However, the BIS is concerned with some aspects of CD transactions: (1) that credit risk transfers (“CRTs”) are not disclosed sufficiently to the public; (2) that the plethora of aggregate data at the company level is matched with a dearth of data of how the CRT market is growing as a whole; and (3) that the market is overly reliant on the risk assessment techniques of rating agencies, who, as a result, play a critical role in the CRT market. Other issues of concern raised by BIS include regulation, accounting standards, contract design, and risk management.

The BIS hosts several committees, including the Basel Committee on Banking Supervision (“Basel”). Basel is a very influential international committee regarding the regulation of CDs. However, Basel does not have any international supervisory authority nor are its recommendations legally enforceable. Nonetheless, Basel offers standards and guidelines for best practices for banks across the world. In fact, many regulatory regimes have incorporated Basel recommendations into local banking legislation.

Basel has been influential in the international banking standards for regulating CDs.⁹³ In Basel’s *Principles*, the committee proposes common standards for prudent management of credit risk by banks. The paper proposes that banks:

- a) establish an appropriate credit risk environment for supervising and approving CD activities;
- b) operate under a sound credit granting process;

- c) maintain an appropriate credit administrations, measurement, and monitoring process; and
- d) ensure adequate controls over credit risk and establish a system of independent, ongoing credit reviews.⁹⁴

Basel has been influential in setting international regulation. For example, the U.S. Federal Reserve has implemented provisions from the Basel Capital Accord, which requires banks to hold capital to support their on-and-off-balance sheet risk exposures.

6. SUMMARY

CDs are an efficient and dangerous risk-management market tool. They are efficient because they help unbundle the risks associated with debt and add liquidity to the capital markets. They are dangerous because, if used for speculating purposes or to conceal future liabilities from the financial statements, they could add risk to the stability of the entities involved.

The structure of CD arrangements could be critical to determine the regulatory regime they fall under. CDs have insurance characteristics but are not generally considered insurance products because they usually lack an “insurable interest” – the protection buyer may not own the reference asset – and the protection buyer may profit from multiple CDs on the same reference asset.

CDs may be considered securities if CD arrangements meet the investment contract test. Also, there is some uncertainty whether CDs would qualify as an “option, subscription or other interest in or to a security.” If a CD were to qualify as a security: (1) insider trading rules may apply to the arrangements; (2) all CD arrangements that are equity monetizations would be subject to regulation under MI 55-103. Under this instrument, insiders must file an insider report within ten days of entering into an agreement that alters the insider’s economic exposure to a reporting issuer or changes the insider’s economic interest in a security of the reporting issuer; and (3) registration and prospectus rules would apply. In any event, many CD participants rely on the broad prospectus and registration exemptions pronounced by the OSC. For example, even

though Rule 91-504 is legislatively dead, it clearly states the OSC position regarding the availability of extensive exemptions for OTC derivatives.

Whenever a Canadian financial institution is involved in a CD arrangement, banking regulations will be involved. OSFI is interested in the classification of CD arrangements. Where the deal parallels exposure to debt, the transaction must be listed in the banking book. When the deal is more of a security, and debt is not exposed, the transaction will appear in the trading book. This classification is important to banks because it will determine the availability of capital.

Currently, the regulatory environment in Canada for CD transactions is neither too restrictive nor too passive. Insurance regulation may apply to certain CD arrangements, in order to protect both the insured and the insurer, if the CD arrangement resembles traditional insurance. Securities regulation could be applicable to CD contracts that qualify as securities, with the aim of protecting the public. Lastly, banking regulation may apply to CD agreements that involve financial institutions so as to ensure that deposit-holders funds are not at risk. The structure of each CD will determine its regulatory classification, while the level of regulatory interference may depend on the need to protect the interests of insurance participants, investors, and deposit-holders.

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¹ P. Usman Ali, "Unbundling Credit Risk: The Nature and Regulation of Credit Derivatives" *Journal of Banking & Finance Law and Practice*. (June 2000) Vol. 11 at 73.

² See International Swaps and Derivatives Association, Inc. [hereinafter ISDA], “Year In Review: A Retrospective of ISDA’s Activities 2002” (date unavailable), online: <<http://www.isda.org/index.html>>.

³ See S. Reier, “Derivatives Get Their Due”, International Herald Tribune (January 23, 2003), online: <<http://www.iht.com/articles/84253.html>>.

⁴ Senator Gramm made these comments in his Keynote Address at the International Swaps and Derivatives 19th Annual General Meeting at the Fairmont Hotel in Chicago on April 1, 2004.

⁵ See B. Specht, “Credit Default Swaps: An Overview” (September 2002), online: <<http://www.gtnews.com//article/4716.pdf?CFID=963179&CFTOKEN=79684177>>.

⁶ See V. Kothari, *Credit Derivatives: A Primer*. (date unavailable), online: <<http://www.credit-deriv.com/creprime.htm>>.

⁷ See J.P. Morgan, “The J.P. Morgan Guide to Credit Derivatives” (1999), 15 B.F.L.R. 297.

⁸ *Ibid.*, at ch. 1.

⁹ Since 1991, the ISDA allowed most credit swaps to be contracted under the umbrella of an ISDA Master Agreement. The intention of the Master Agreement is to standardize terms to provide greater clarity to participants and to point out all non-standardized components of the agreement, when standardization is not appropriate. See *Highlights on the New 1999 ISDA Credit Derivatives Definitions* for more information (the definitions have been updated in the 2003 ISDA Credit Derivatives Definitions).

¹⁰ *Supra* note 7 at ch. 2.

¹¹ *Ibid.*, at ch. 2.

¹² *Ibid.*, at ch. 2.

¹³ Kothari, *supra* note 6.

¹⁴ *Ibid.*

¹⁵ J.P. Morgan, *supra* note 7 at ch. 2.

¹⁶ J. Evans, “Credit risk and its management raise a Paradox”, *Euromoney* (March 2002).

¹⁷ Based on a survey published in February 2001 by the Centre for the Study of Financial Innovation.

¹⁸ J. Jubek, “Jubek’s Journal” (October 2002), online:
<<http://moneycentral.msn.com/content/P31234.asp>>.

¹⁹ Frank Vetrano is a senior financial advisor at Freddie Mac’s corporate finance department. Bill Lyons is the National Director of capital products in Freddie Mac’s investor and dealer services division.

²⁰ Vetrano and Lyons, “Credit Derivatives: Hedging Closer to Happiness”, *SMM* (December 1999) vol 2, no. 2 at 15.

²¹ See J. Grant, “Flawed Giants”, *Forbes.com* (February 2002).

²² See Fleckenstein, “Contrarian Chronicles”. *MSN Money* (March 2003), online:
<<http://moneycentral.msn.com/content/P43149.asp>>.

²³ ISDA, “2001: The year that tested the credit swap contract”, *ISDA update 2002* at 16.

²⁴ A. Yeung, “Credit Derivatives: The Art of Splitting Credit Risk”, *Banking & Finance Law Review* (date unavailable).

²⁵ Margrabe Group’s Derivatives ‘Zine web site, online:
<<http://www.margrabe.com/CreditDerivatives.html>>.

²⁶ *Ibid.*

²⁷ Hameed, “Insurance of Credit Derivatives”, *Asia Insurance Review* (June 2000) at 68.

²⁸ *Prudential Insurance v. IRC*, [1904] 2 KB 658.

²⁹ *Lucena v. Crawford*, (1806) 2 B & PNR 269.

³⁰ *Fugi Finance Corp. v. Fitna Life*, [1994] 4 All ER 1025.

³¹ *Carter v. Boehm* (1766) 3 Burr.

³² B Shinn, “Regulatory Developments”, *Credit Derivatives & CDO Symposium* (March 2003) at Tab 8.

³³ Financial Services Authority, *Cross-Sector Risk Transfers* (May 2002) at Annex B p.1.

³⁴ *Insurance*, *supra* note 27 at 68.

³⁵ *Ibid.*, at 68.

³⁶ *Ibid.*, at 68.

³⁷ S.C. 1991, c.47.

³⁸ In Ontario, the *Insurance Act* R.S.O. 1990, c. I.8 is the legislative authority.

³⁹ *Insurance Act*, s. 40(1),(2).

⁴⁰ R.S.O. 1990, c. C.38.

⁴¹ R.S.C. 1985, c. C-44.

⁴² *Insurance Companies Act*, s.440.

⁴³ M. Grottenthaler & P. Henderson, *The Law of Financial Derivatives in Canada* (2003) Release 1 at 3.4.2.

⁴⁴ *Insurance Companies Act*, s.708.

⁴⁵ *supra* note 27 at 70.

⁴⁶ *Ibid.*, at 70.

⁴⁷ R.S.O. 1990, c. S.5.

⁴⁸ It is feasible to classify an OTC derivative as a security under ss.1(1)(a),(b),(d),(f),(n) and (p) of the *OSA*. This paper excludes discussion relating to ss.1(1)(b),(f) and (p) due to their lower relevance regarding CDs. See *OSA*, s.1(1) for the non-exhaustive list of what is classified as a security.

⁴⁹ In *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F. 2d 476 the U.S. Federal Court of Appeal judge stated that while “commonly known” was included in the legislation to ensure a broad and flexible interpretation of security, the common knowledge requirement referred not to the general public, but to the legal and financial communities. See Also *SEC v. C.M. Joiner Leasing Corp.* (1981), 320 U.S. 344, where the Court stated that “commonly known” is considered on the basis of the character the instrument is given in commerce by the terms of the offer, the plan of distribution and the economic inducements held out.

⁵⁰ *Supra* note 43 at 10.2.2(a).

⁵¹ *OSA*, s.1(1)(d).

⁵² 925 F Supp. 1270, 1996 [hereinafter *Procter*].

⁵³ *Ibid.*, at 1282.

⁵⁴ *Supra* note 43 at 10.2.2(a).

⁵⁵ 137 F.Supp.2d 362, 2002 [hereinafter *Caiola*].

⁵⁶ *Ibid.*, at 325.

⁵⁷ *Ibid.*, at 325.

⁵⁸ Securities regulators rarely apply the “commonly known” test or “options” test because they rely on investment contract cases to determine if an instrument is a security. See *supra*, note 43 at 10.2.2(a).

⁵⁹ The investment contract test is the culmination of two leading American judicial tests, the “Howey test”, established in *SEC v. W.J. Howey Co.* (1945) 328 U.S. 293 (U.S. S.C.) and the “risk capital test”, established in *Hawaii Commissioner of Securities v. Hawaii Market Centres Inc.* (1971) 485 P. 2d 105.

⁶⁰ [1978] 2 S.C.R. 112 [hereinafter *Pacific Coast*].

⁶¹ *Supra* note 43 at 10.2.3.

⁶² *Ibid.*, at 10.2.3.

⁶³ (2000), OSCR 91-504 and 91-504 CP. In November 1996, the OSC published the Proposed Rule and Companion Policy (1996), 19 OSCB 5929 for the regulation of OTC derivatives. In response to criticism of the Draft Policy, by the International Swap and Derivatives Association (“ISDA”) and the Canadian Bankers Association (“CBA”), on its potential damaging impact to the CD market in Canada, the OSC issued the Proposed Rule 91-504 (1998), 21 OSCB 7755 in December 1998 and released the final rule in September 2000.

⁶⁴ Even though a vast majority of these arrangements would then qualify for exemption. See Stikeman Elliott, “Minister of Finance asks OSC to reconsider proposed rule on OTC derivatives” *Derivatives Update* (December 2000), online: <<http://www.stikeman.com/newslett/DerDec00.pdf>>.

⁶⁵ See *supra* note 63.

⁶⁶ See *supra* note 64.

⁶⁷ H. Rosenberg, “Compromising Positions: Will credit derivatives encourage more lending, or will they harm the interests of borrowers?”, *CFO Magazine* (September 18, 2003) online: <<http://www.cfo.com/printarticle/0,5317,10534|C,00.html?f=options>>.

⁶⁸ The Joint Forum is comprised of four groups: ISDA, the Bond Market Association, the International Association of Credit Portfolio Managers, and the Loan Syndications and Trading Association. The Joint Forum was formed to address the common concerns of their members who transact in CDs and debt securities.

⁶⁹ Joint Forum, *Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants* (October 2003).

⁷⁰ *Ibid.*, at 5.

⁷¹ This includes a lender who becomes aware of a material fact or material change from an insider of the reporting issuer.

⁷² Under s.1(1) of the *OSA*, a material fact, when used in relation to securities issued or proposed to be issued, means a fact that would reasonably be expected to have a significant effect on the market price or value of the securities.

⁷³ Under s.1(1) of the *OSA*, a material change means, a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer, or a decision to implement a change made by the board of directors or other persons acting in a similar capacity or by senior management of the issuer who believe that confirmation of the decision by the board of directors or such other persons acting in a similar capacity is probable.

⁷⁴ *OSA*, s.76(1).

⁷⁵ See Comments Received 55-103 55-103CP - Insider Reporting for Certain Derivative Transactions (Equity Monetization) from C. Calder (CIBC) online: <http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_55-103_20030531_com_calder.pdf>.

⁷⁶ See “New Insider Reporting Obligations for Equity Monetizations”, *McMillan Binch LLP Derivatives Bulletin July 2003*.

⁷⁷ *Ibid.*, at p. 1.

⁷⁸ D. Rule, “The credit derivatives market: its development and possible implications for financial stability” *Financial Stability Review* (June 2001) at 117.

⁷⁹ *Ibid.*, at 117.

⁸⁰ *Ibid.*, at p.117.

⁸¹ *Ibid.*, at p.117.

⁸² See Yamane, “Using Credit Derivatives to achieve Leverage” (January 2000).

⁸³ O’Connell, “Securities Industry and Managed Investments”, *Company and Securities Law Journal* Volume 19 (August 2001) at 317.

⁸⁴ (2001), *Appendix to Guideline A – Capital Adequacy Requirements (CAR) – Parts I & II* [hereinafter *Guideline*].

⁸⁵ *Ibid.*, at p. 2.

⁸⁶ *Ibid.*

⁸⁷ *Ibid.*

⁸⁸ An adequate level of permanence is touched upon in the *Guideline's* section on Exceptional Circumstances. Specifically, a credit event must include items such as a failure to pay any amounts due according to the terms of the assets, filing for bankruptcy or protection from creditors, distressed restructuring, cross-default or cross-acceleration and a reduction in the amount of principal or premium payable.

⁸⁹ (1995) online: <<http://www.osfi-bsif.gc.ca/eng/documents/guidance/docs/b7e.pdf>>.

⁹⁰ *Ibid.*, at p. 3.

⁹¹ ISDA, "Mission" online: <<http://www.isda.org/index.html>>.

⁹² BIS, "Executive Summary" online: <<http://www.bis.org/publ/cgfs20.htm>>.

⁹³ See Basel Committee on Banking Supervision, *Principles for the Management of Credit Risk*. (July 1999) [hereinafter *Principles*].

⁹⁴ See Scheerer, "Credit Derivatives: A look at the American Regulatory Structure" (date unavailable).