**Robert M. Scavone**
**Shahen A. Mirakian**
**Julie VanBerlo**
**McMillan Binch Mendelsohn LLP**

## Overview

Derivatives take two forms: (i) exchange-traded derivatives, which are traded on recognized exchanges, and (ii) over-the-counter (OTC) derivatives, which are privately negotiated contracts that may be transferred to a third party only under terms agreed to by the parties. The Canadian OTC derivatives market is substantially larger than the exchange-traded derivatives market.

Most OTC derivatives in Canada are documented using standard-form bilateral contracts developed by the International Swaps and Derivatives Association, Inc. (ISDA) including the 1992 ISDA Master Agreement and the 2002 ISDA Master Agreement. The ISDA Canada Steering Committee works actively with Canadian ISDA members to ensure that ISDA documentation remains effective for Canadian OTC derivatives market participants.

## New Securities Transfer Law Governing Collateralization

Until recently the use of securities such as government debt instruments as collateral for derivatives trades was hampered to some extent in Canada by the absence of clear and coherent legal rules governing the perfection of security interests in "book-entry" securities held through the indirect or tiered holding system and settled electronically through clearing agencies such as CDS Clearing and Depository Services Inc. (CDS). However, this situation has changed for the better with the recent enactment of uniform securities transfer legislation across Canada.

On January 1, 2007, a *Securities Transfer Act* (STA) came into force in both Ontario and Alberta and nearly identical legislation has since been proclaimed in Saskatchewan, British Columbia, and Newfoundland and Labrador. The other provinces and territories of Canada are expected to follow suit within the next year. Based on Revised Article 8 of the U.S. Uniform Commercial Code, first published in 1994, the STAs have radically reformed the prior inadequate and incomplete provincial law dealing with the transfer and pledging of securities, whether held directly as physical certificates or indirectly through a clearing agency.

The STA introduces a new form of property called a "security entitlement," which is the bundle of rights that the holder of a security or other financial assets through the indirect holding system (called the "entitlement holder") may assert against its "securities intermediary" (such as a broker, custodian or clearing agency) with respect to the underlying financial asset.

The STA and the companion amendments to provincial Personal Property Security Acts (PPSA) and Business Corporations Acts have replaced physical and "deemed" possession as a means of perfecting a security interest in investment property such as securities and security entitlements with the broader and functionally neutral concept of "control". For certificated securities, the secured party obtains control by taking delivery of endorsed security certificates or being registered as the owner. For a security entitlement, a secured party achieves control either by having the securities transferred to its account so as to become the entitlement holder or through a "control agreement" between the secured party and the securities intermediary, with the consent of the pledgor, whereby the securities intermediary agrees to take instructions or "entitlement orders" from the secured party regarding the underlying financial asset without further consent of the pledgor. Consistent with past market practice, most secured parties seem to prefer becoming the entitlement holder rather than using control agreements, which may be difficult to negotiate and could result in subordination to a prior secured party that entered into such an agreement first.

While control cannot perfect a security interest in cash collateral on deposit in a conventional bank account in Canada (as it can be in the US), control can perfect security interests in cash balances in securities accounts unless the parties agree otherwise. Accordingly, so long as each pledgor counterparty agrees to maintain cash collateral in a securities account subject to the control of the other counterparty, the parties can dispense with PPSA registrations or the use of the Ontario-law variant of the New York credit support annex developed by ISDA in Canada that replaces security interest in cash with a debtor creditor relationship giving rise to a right of set-off.

Of particular importance to multi-jurisdictional OTC derivatives transactions are the clear "conflict of laws" rules set out in the STAs and amended PPSAs that largely eliminate the existing uncertainty as to where a security interest in investment property must be perfected in order to ensure that the secured party has priority over competing claimants. Perfection through control is governed by the law of the "securities intermediary's jurisdiction", which in effect can be chosen by contract. (It generally depends on the jurisdiction designated in the agreement governing the securities account.)

To date the STAs have resulted in little change in derivatives documentation or practice. This may be the result of similar practices in the US and the fact that the legislation contains "translation" provisions that in effect permit the parties to continue to use the pre-STA parlance familiar to capital market participants and still achieve the same legal results as would have been achieved with the new STA terminology. The Canadian ISDA legal opinion regarding the enforceability of ISDA documentation and netting provisions in Canada was updated in January, 2007 to reflect the STAs of Ontario and Alberta, but very few changes were made to the

attached Ontario law amendments to the New York credit support annex.

### Regulating Trades in Derivatives

In Canada, the regulation of exchange-traded derivatives is the responsibility of the provinces and falls within the jurisdiction of provincial securities commissions. In Ontario, the *Commodity Futures Act* (CFA) regulates all commodity futures contracts trading on commodity exchanges. The CFA also provides for the registration of traders in commodity futures contracts. Ontario is currently in the process of updating the CFA and other derivatives regulation. The CFA is undergoing review by an Advisory Committee that released its Interim Report on June 9, 2006. A final report dated January 2007 was released on March 28, 2007.

The final report makes recommendations to alter the current regulatory regime. The committee's recommendations consider firstly what changes are needed to modernize the CFA and its regulation of exchange-traded commodity futures contracts (CF contracts) and options on commodity futures contracts with respect to exchanges carrying on business in Ontario; secondly, what the legislative regime, if any, should be for OTC derivatives in Ontario; and thirdly, registration issues relevant to either intermediation of CF contract trading or retail OTC derivative contract trading.

In relation to modernizing the CFA, the committee recommends that the CFA be repealed and replaced with new legislation that is separate from the OSA and that the new legislation adopt a "core principles" approach to the regulation of exchanges and potentially other trading systems, clearing organizations, other self-regulatory organizations and participants.

In relation to OTC derivatives, the committee notes that, for the most part, OTC derivatives are risk management products and financial products. Securities regulators have little interest in regulating these financial or commercial markets, and participants in those markets see no need to be regulated. The committee also cautions that contracts for the actual sale and delivery of commodities or risk management products offered by financial institutions can be inadvertently swept into the regulatory scheme unless the scope of the regulation is carefully considered and defined and that certain markets which might overlap with a regime that covers OTC derivatives are already regulated by regulators who have special expertise. In contrast, in relation to OTC derivatives offered to retail investors, the committee believes that there is a legitimate role for a securities regulator and for disclosure and intermediary registration requirements.

On August 10, 2007, the Autorité des marchés financiers (AMF), the Québec financial markets regulator, published for comment a proposed framework for the regulation of derivatives in Québec. This proposed framework was based upon the findings in the AMF's May 2006 discussion paper on the regulation of Québec derivatives markets and the comments received from market participants regarding that discussion paper.

The proposed framework includes the text of proposed derivatives legislation, regulation and policy statements. The use of policy statements is meant to create a principles-based approach to regulation of derivatives and provide market participants with information on how the AMF intends to apply the proposed legislation and regulation.

The proposed framework is intended to regulate both exchange traded and OTC derivatives. Defining derivatives broadly, the proposed legislation carves out a number of instruments including, among others, conventional convertible securities, asset-backed securities, conventional and special warrants, strip bonds, options granted under a compensation plan and "institutional financial contracts" (IFC). IFCs are certain instruments, entered into by a Canadian bank or financial institution or subsidiary other than a securities or derivatives dealer, such as deposits, bankers' acceptances, letters of credit, credit card debit accounts, loan participations and insurance contracts.

Under the proposed legislation, registration requirements will be imposed on parties who deal in or advise others in respect of OTC and exchange-traded derivatives. The proposed legislation also sets out requirements for the public offering of OTC and exchange-traded derivatives, including the requirement to obtain a qualification from the AMF, which involves providing the AMF and the client detailed information about the derivative that is being offered. These requirements are not applicable to OTC derivatives entered into by a Canadian bank, Canadian financial institution, a wholly-owned subsidiary of a Canadian bank or financial institution, a registered derivatives dealer or an adviser acting as principal or on behalf of an "accredited client" or an "accredited client".

Also included in the proposed legislation is a list of sophisticated parties that qualify as "accredited clients", including various categories of financial institutions, persons with over $5 million in assets and "hedgers". "Hedgers" are defined as persons who are exposed to risks related to their activities which they seek to hedge by engaging in derivatives transactions negatively correlated with those risks.

The proposed legislation also regulates various parties active in the exchange-traded derivatives markets such as exchanges, clearing houses, regulation services providers and self-regulatory organizations.

### Bankruptcy Reform

#### A. Insolvency amendments exempt collateral for "eligible financial contracts" from stays

Recent amendments to federal Canadian insolvency legislation now make it clear that a counterparty to one of a long list of specified derivatives contracts will not

be stayed from realizing on its collateral during insolvency proceedings involving the other counterparty and cannot have its security interest subordinated, bringing Canada in line with the US. On June 22, 2007, most of Part 9 of the *Budget Implementation Act, 2007* came into force, amending the *Bankruptcy and Insolvency Act* (BIA), the *Canada Deposit Insurance Corporation Act*, the *Companies' Creditors Arrangement Act* (CCAA), the *Payment Clearing and Settlement Act* and the *Winding-up and Restructuring Act* (together, the "Acts") to provide protection against stays on dealing with or realizing on "financial collateral" taken for obligations under "eligible financial contracts". Each of the Acts now provides for a definition of "financial collateral" and "title transfer credit support agreement".

"Financial collateral" is defined as collateral such as cash or cash equivalents, securities and futures that secures obligations under an eligible financial contract or "title transfer credit support agreement". This latter term means an agreement (such as the English form of ISDA Credit Support Annex) where title to property is provided "for the purpose of securing the payment or performance of an obligation" in respect of an eligible financial contract.

Each of the Acts is amended to permit parties to an eligible financial contract to terminate the contract, and net or set off an amount payable under or in connection with the contract or any dealing with financial collateral including (i) the sale or foreclosure or, in the Province of Québec, the surrender of financial collateral, and (ii) the setting off (or compensation, in Québec) of financial collateral or the application of the proceeds or value of financial collateral.

The BIA and CCAA are also amended to prevent an order being made that would subordinate financial collateral. Also, the BIA now provides in Section 95(2.1) that no presumption of a preference under Section 95(2) arises in respect of "(a) a margin deposit made by a clearing member with a clearing house or (b) a transfer, charge or payment made in connection with financial collateral and in accordance with the provisions of an eligible financial contract".

These are all welcome changes to Canada's insolvency legislation which address a number of concerns raised by ISDA and others, reducing risk for Canadian derivatives market participants and improving Canada's competitiveness in the global derivatives market.

### B. Proposed regulation implementing a new definition of Eligible Financial Contracts

To better reflect the variety of derivatives products and better respond to rapid changes in the derivatives markets, "eligible financial contract" will now be defined by regulation rather than in the legislation itself. The new regulation, which came into effect November 17, 2007, provides a new definition of "eligible financial contract" for use with each of the Acts that adds several classes of derivatives (for example, those linked to credit, bandwidth, freight, emission rights and real property indices) not included in the current definition and expressly includes credit support agreements for other eligible financial contracts. Expanding the scope of the definition and moving to the regulation are both significant and welcome improvements in the clarity of Canadian law in this area. Since regulations may be amended more easily than legislation, changes to the definition can now be implemented more quickly to respond to derivatives market developments.

## Recent Cases of Importance

Two recent cases of note, one in Canada and one in England, involved freight forwarding swap agreements with North American Steamships Ltd. ("NASL") and decided important issues relating to insolvency proceedings, both domestic and cross border.

In *Re North America Steamships Ltd.* (2007 BCSC 267, released February 28, 2007), the BC Supreme Court considered two applications for declarations on the following questions: (a) is it necessary for a trustee in bankruptcy to affirm an in-the-money swap agreement in order to benefit from it; and (b) if it does so, will the trustee in bankruptcy be personally liable for the obligations of the bankrupt under the swap agreement or will its liability be limited to the assets in the bankruptcy estate?

The case involved two forward swap agreements (the "Swap Agreements") documented under ISDA Master Agreements entered into respectively between NASL, as Buyer, and each of AWB Geneva S.A. and Pioneer Metal Logistics, B.V.I. If the counterparties had terminated their respective ISDA Master Agreements by reason of the bankruptcy of NASL, they would have had to pay termination payments of about US$18.3 million to NASL. Understandably the counterparties had not terminated these agreements but were instead withholding payments in reliance on section 2(iii) of the ISDA Master Agreements, which provides that obligations under the agreement are subject to the condition precedent that no Event of Default has occurred and is continuing.

Mr. Justice Tysoe held that NASL's trustee had to affirm the Swap Agreements to benefit from them: a trustee in bankruptcy must either affirm or disclaim contracts entered into by the bankrupt because the other contracting party is entitled to know which alternative the trustee is choosing irrespective of whether that other party is entitled to terminate the contract as a result of the bankruptcy, if there is a prospect that the bankrupt may have to perform obligations under the contract before its termination. However, the court also held that the affirmation would not make the trustee personally liable in respect of NASL's obligations under the Swap Agreements as long as the trustee affirmed the Swap Agreements on

behalf of the bankruptcy estate and not in its personal capacity. Under Section 31(4) of the BIA, all "debts incurred and credit received in carrying on the business of a bankrupt… [are] debts incurred and credit received by the estate of the bankrupt", unless the creditor shows that the liability lies with the trustee personally. The Court declined to decide whether upon the trustee affirming the Swap Agreements, its liability thereunder would be limited to the realizable value of the property of NASL, less the trustee's fees and disbursements because no argument had been made with respect to the priority of the trustee's fees and disbursements.

The Swap Agreements and the bankruptcy of NASL were considered again in AWB Geneva SA v. North America Steamships Ltd. [2007] EWHC 1167 by the English Commercial Court (May 17, 2007). The trustee had filed a petition under the CCAA seeking a stay of the counterparties' reliance on section 2(iii) of the ISDA Master Agreements. The trustee had also affirmed the Swap Agreements. At issue was (a) whether the Trustee could be enjoined from seeking an order under the CCAA that would stay the counterparties' reliance on section 2(iii), based on the English governing law and exclusive jurisdiction clauses of the ISDA Master Agreement; and (b) whether an action in England for a declaration as to the meaning and effectiveness of certain of the standard terms of the ISDA Master Agreement which are governed by English law should be stayed pending the Canadian CCAA proceedings.

Mr. Justice Field held that the exclusive jurisdiction clause of the ISDA Master Agreement applies where one of the parties is seeking a judicial determination on the rights or obligations of one or both of them under the contract. In applying to the Canadian court under the CCAA, the trustee was not seeking such a determination. The trustee's application was an application to a Canadian court to apply the free-standing statutory regime of the CCAA which sought relief in insolvency proceedings intended to prohibit the counterparties from relying on contractual rights they might otherwise be entitled to rely on. Accordingly the English Court refused the anti-suit injunction and stayed the English action for a declaration as to the meaning and effectiveness of certain standard terms of the ISDA Master Agreement.

On June 12 and 13, 2007, the English Court of Appeal heard application to appeal and denied permission to appeal against the refusal of the anti-suit injunction but granted the appeal against the stay of the English action for a declaration as to the meaning and effectiveness of certain standard terms of the ISDA Master Agreement. The trustee has confirmed that the parties settled and there were therefore no further hearings on the ISDA Master Agreement.n

**Robert M. Scavone,** *McMillan Binch Mendelsohn LLP*
Tel: (416) 865-7901 • Fax: (647) 722-6728 • E-mail: rob.scavone@mcmbm.com

Partner, Debt Products Group and Chair, Securitization Group. Practices business and financial services law with emphasis on securitization and structured finance. Advises major corporations, financial institutions, investment dealers and government agencies on secured loans, derivatives, securitization, personal property security and securities transfer law. Has developed asset-backed commercial paper programs for financial institutions. Acts for purchasers, sellers, agents, underwriters, issuers and providers of conventional and synthetic liquidity in private and public securitizations involving a wide variety of asset classes, including CDOs. Advised USTA Task Force and government agencies in developing new *Securities Transfer Act*. Co-author, *Annotated Securities Transfer Act*. Has spoken and published on cash collateral security, auditors' liability, guarantees, unanimous shareholder agreements, derivatives, securitization, legal drafting and securities transfer legislation. John's Hopkins University (BA), 1971; Yale University (M.Phil.), 1974; University of Toronto (LLB), 1985. Called to Ontario Bar 1987.

**Shahen A. Mirakian,** *McMillan Binch Mendelsohn LLP*
Tel: (416) 865-7238 • Fax: (416) 865-7048 • E-mail: shahen.mirakian@mcmbm.com

Partner in the firm's Banking and Finance Group. Practice focused on derivative products; hedge funds; retail structured products including structured notes; CDOs; and commercial lending. Completed a secondment providing legal support to the equity derivatives group of a leading Canadian bank. Represents array of counterparties including Canadian/foreign banks, over-the-counter derivatives dealers, public and private investment funds, corporations and high net worth individuals. Expertise in regulation of exchange-traded and over-the-counter derivative products pursuant to commodity futures, securities, insurance and banking rules. Member, CBA, Armenian Bar Association, Structured Products Association (New York), Toronto CFA Society. Active in ISDA Canada Legal and Regulatory Subcommittee. University of Toronto, BComm. – 1996 and LLB / MBA 2000. Ontario Bar 2002

**Julie Vanberlo,** *McMillan Binch Mendelsohn LLP*
Tel: (416) 865-7033 • Fax: (416) 865-7048 • E-mail: julie.vanberlo@mcmbm.com

Partner whose work covers all aspects of OTC and exchange traded derivatives, structured products and hedge funds. Other practice areas include business acquisitions, financial services regulation, e-trading and information technology. Former roles: VP and Senior Counsel UFJ International plc, London, England supporting the proprietary trading and client facing businesses; VP and Senior Counsel with Merrill Lynch, in London, England within its Europe, Middle East and Africa Equities Division supporting the Equity Derivatives trading and Prime Brokerage businesses; Associate, Clifford Chance in London, England – derivatives and regulatory practice group with secondments at Morgan Stanley fixed income derivatives desk and repo desk. Pacific & Western Group, London, Ontario as sole in-house counsel; member, Law Society of Upper Canada, Law Society of England and Wales, Securities and Investment Institute, Canadian Securities Institute. Graduated from University of Western Ontario, BA Hons. (Phil) – 1988, MA (Phil) – 1991 and LLB – 1990.