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Mr. Paul Halucha
Director-General, Marketplace Framework Policy Branch
Industry Canada
235 Queen Street, 10th Floor, East Tower
Ottawa, Ontario K1A 0H5

RE: Statutory Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act

Dear Mr Halucha:

Thank you for permitting the Canadian Derivatives Clearing Corporation ("CDCC"), the Canadian Depository for Securities Ltd. ("CDS") and Natural Gas Exchange Inc. ("NGX") (collectively, the "TMX FMIs") to submit their views in response to Industry Canada's Statutory Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act after the stated deadline. TMX Group is of the view that insolvency law has a significant impact on the economy and that the reliability and predictability of the insolvency regime plays an important role in maintaining stable markets. TMX Group would like to comment specifically on eligible financial contracts ("EFCs") and how they are dealt with in the context of insolvency and restructuring proceedings. We also wish to make a few suggestions relating to the Report issued by Insolvency Institute of Canada's Task Force on Derivatives ("IIC Report"). We have had the opportunity to review the International Swaps and Derivatives Association (ISDA) comments made in regard of the consultation and would like to mention that we fully support ISDA's submissions.

TMX Group

Pursuant to the *Payment Clearing and Settlement Act* ("PCSA"), the Bank of Canada has designated CDCC and CDS as FMIs of systemic importance. The TMX FMIs are subsidiaries of TMX Group Limited ("TMX Group"). TMX Group's key subsidiaries operate cash and derivative markets for multiple asset classes including equities, fixed income and energy. Toronto Stock Exchange, TSX Venture Exchange, TMX Select, Alpha Exchange, CDS, CDCC, Montréal Exchange, Natural Gas Exchange, Boston Options

Exchange, Shorcan, Shorcan Energy Brokers, Equicom and other TMX Group companies provide listing markets, trading markets, clearing facilities, data products and other services to the global financial community. TMX Group is headquartered in Toronto and operates offices across Canada (Montreal, Calgary and Vancouver), in key U.S. markets (New York, Houston, Boston and Chicago) as well as in London, Beijing and Sydney.

I- Balancing Policy Considerations

Insolvency legislation including the Bankruptcy and Insolvency Act[1] ("BIA") and the Companies' Creditors Arrangement Act[2] ("CCAA") provide for a legislative framework governing the reorganization or restructuring of an insolvent party, the liquidation of its assets and its bankruptcy. Maintaining an orderly process for the distribution of proceeds and ensuring fair and equitable treatment of creditors and debtors are important policy considerations. The emphasis on improving the resilience of financial institutions and increasing derivatives market transparency and stability has greatly shaped the regulatory reform which is currently unfolding. Consistent with Canada's G-20 commitments for the harmonization of international securities legislation, the regulations developed by the provincial securities authorities and the Canadian Securities Administrators ("CSA") expressly endorse the *Principles for financial market infrastructures* published by CPSS-IOSCO in April 2012 (the "PFMIs" or "Principles")[3]. These Principles aim at fostering sound risk management standards for Financial Market Infrastructures (FMIs). More specifically, as part of the Bank of Canada designation, both CDS and CDCC are required to align their risk management practices with the PFMIs.

II- Set-off and Close-Out Netting

The PFMIs provide for 24 principles of general application, many of which indirectly address the treatment of EFCs in the context of insolvency. Specifically, Principle 1 – Legal Basis, Principle 4- Credit Risk, Principle 13- Default Management and Principle 14- Segregation and Portability point out the significant contribution of set-off and close-out netting rights in risk mitigation.

To ensure consistency in the terms used therein, the term set-off, netting or compensation should simply be understood as the "discharge of reciprocal obligations to the extent of the smaller obligation"[4]. It is, generally speaking, a form of payment provided, for example, under the Civil Code (1672 *C.c.Q*). Traditionally, the concept of set-off applies only to parties with mutual debts of the same kind that are already due and payable, and that are legally distinct.

> "A close-out netting mechanism comes into operation either by means of a declaration by one of the parties when a pre-defined event occurs, in particular default or insolvency of its counterparty, or it is triggered automatically when such an event occurs. The mechanism extends to a number, often hundreds, of outstanding transactions between the parties that are contractually included in a netting provision. Once the close-out netting mechanism is triggered, whether automatically or by means of a declaration by one party, generally all transactions that are covered by the close-out netting provision are terminated and a value is

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[1] RSC 1985, c B-3.
[2] RSC 1985, c C-36.
[3] The PFMI Report is available on the Bank for International Settlements' website (www.bis.org) and the IOSCO website (www.iosco.org). See CSA Staff Notice 24-310 http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20140717_24-310_update-proposed-rule-24310-clearing-agency-reqs.htm
[4] Wood, Philip, Law and Practice of International Finance, University Edition, 2010 at section 14-03.

determined for each under a pre-defined valuation mechanism, which may also take into account, inter alia, the identity and credit standing of the party responsible for this determination and any existing credit support and other material terms of the parties' agreement. The sum value of all such transactions is then aggregated, resulting in a single net payment obligation. The net obligation remains the only obligation to be settled and is generally due immediately after being determined even though no debts may have been due and payable under the transactions covered by the close-out netting provision prior to the operation of the close-out netting mechanism."[5]

Close-out netting ensures that EFCs remain outside of the normal bankruptcy procedure.

Predictability and legal certainty of the legal treatment of EFCs is, in the TMX Group's view, desirable for Canada's economic stability. TMX Group CCP participants utilise its clearing services with a full expectation that close-out netting will be applied where pre-defined trigger events occur, as set forth in the relevant CCP's rules. CCP participant clients and other market participants also rely on this expectation. Furthermore, a remote possibility for a counterparty to become liable for a gross settlement amount as a result of a challenge in court of a set-off provision for instance, could have enormous impact on the market. For a clearing agency, whose main purpose is to clear transactions and as a result act as a central counterparty ("CCP"), it would be chaotic. The strength of the legal framework governing set-off and close-out netting rights for FMIs has been at the center of the Bank of International Settlement discussion as evidenced by the Financial Stability Board and IOSCO and CPSS publications[6].

Close-out rights ensure a CCP's ability to close-out the defaulting clearing member positions. This takes place as part as the process known as the default management procedure which is governed by very detailed rules. The development and implementation of a clear default management procedure is a key element of the PFMIs. The default management grants a discretionary power to the CCP to either close-out positions or, where certain conditions are met, transfer, or port, them to another clearing member. This process is extremely time-sensitive and the CCP's ability to implement it smoothly is crucial in preventing risk contagion. In time of market instability, a solvent party facing an insolvent party must be entitled to manage its EFC portfolio in consideration of the market conditions prevailing at the time and to close-out outstanding positions. The intervention of a court at any step of this process would jeopardize the ability of the solvent counterparty to get through this period of crisis and appropriately re-hedge its portfolio. Any change to the insolvency regime in Canada should only aim at strengthening the legal certainty of EFCs and the financial collateral in the context of insolvency procedures. For a CCP, a court intervention would derail, in the TMX Group's view, the default management procedure and could greatly increase systemic risk. We respectfully submit that the proposal that EFCs be part of the normal bankruptcy regime is contrary to Canada's commitment to the G-20 to enact and enforce PFMIs.

Section 8(1)(b) of the PCSA overrides any statute that would invalidate the obligation of a participant of a clearing house or CCP to net payment or close-out. Designated clearing and settlement system

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[5] Unidroit, Principles on the Operation of Close-out Netting Provisions, http://www.unidroit.org/en/instruments/capital-markets/netting .

[6] CPSS-IOSCO, Recovery of financial market infrastructures, Consultative report (August 2013), http://www.bis.org/publ/cpss109.pdf and Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011) http://www.financialstabilityboard.org/publications/r_111104cc.pdf .

such as CDCC, further enjoy a blanket protection of their settlement rules under 8.(1)(a) of PCSA. In addition, despite anything to the contrary under bankruptcy or insolvency law or pursuant to a court order made in respect of a reorganization, arrangement or receivership involving insolvency, a party to a netting agreement may terminate and determine a net termination value in accordance with the provisions of the agreement under sec. 13 of PCSA. Netting and close-out rights are therefore enforceable and protected by PCSA.

III- EFCs Safe Harbor

The current insolvency regime provides for a safe harbor for EFCs. EFCs are namely exempted from the termination prohibition and disclaimer regime, and netting provisions remain enforceable. The TMX Group supports this framework as it greatly enhances the confidence of investors and thus contributes to market stability.

Termination

Under sections 65.1 of the BIA and 34 of the CCAA, the termination of any contract by a solvent party, by reason only that the insolvent counterparty is insolvent or that a notice of intention/proposal has been issued, is prohibited. These provisions grant an exception for EFCs. Consistently, section 84.2 of the BIA and 34 CCAA provide that no person may terminate or amend or claim an accelerated payment or forfeiture of the term under any agreement, with a bankrupt individual by reason only of the individual's bankruptcy or insolvency. Again, both provide for an exception for EFCs.[7]

From a CCP's perspective, these tools are a key component of risk management. The combined objective of these exceptions is to ensure the enforceability of set-off or compensation and close-out netting rights which are the cornerstone of the derivatives markets. These tools greatly reduce the exposure of the counterparties to credit risks, hence limiting possible contagion or domino effects in the event of insolvency. It also serves at a higher level the greater purpose of reducing the cost of credit by reducing the cost of transactions. Indeed, without that legal certainty surrounding the enforceability of those rights, the collateral required would need to cover gross exposures. These tools which contribute to reducing systemic risk benefit the entire economy and should, in the TMX Group's view, be preferred over any individual right to restructuring. The BIA and CCAA provisions which currently expressly validate the close-out netting provisions of derivatives contracts, thus ensuring legal certainty in this field whether it involves an OTC transaction based on an ISDA or a centrally-cleared contract, are essential and should only be strengthened, not weakened. Consistent with this view of netting agreements, especially when related to EFCs subject to clearing, the section 13 of PCSA further confirms the prevalence of the close-out netting despite any other stipulation in insolvency or bankruptcy laws or under court order.

Disclaimer

The BIA and CCAA grant an insolvent party the ability to disclaim or resiliate a contract (other than a commercial lease) to which it is a party by applying to the court and providing a 30 days notice of its intention. Section 65.11 (10) and 32(9) CCAA however provide EFC counterparty with further legal certainty with respect to the validity of EFCs by preventing a debtor from disclaiming or resiliating an EFC to which it is a party. But for this exemption, a EFC counterparty would be left to challenge in court this disclaimer or resiliation. The court would then consider whether the disclaimer or resiliation would enhance the prospect of a viable proposal being made and or was likely cause

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[7] Sec 34(8) of the CCAA and sec. 84.2 (8) of the BIA.

significant hardship to a party to the agreement. These policy considerations aim at balancing the objective of securing a proposal while preventing a mere transfer of financial hardship on other party, and, in so doing, generating a systemic risk. Given the nature and value at stake in EFCs, allowing the disclaimer or resiliation of EFCs would certainly expose the solvent counterparty to great hardship. Thus, the possibility that EFCs would be subject to a court order as it may be the case for other contracts would create great uncertainty and in conditions of market instability and could give rise to system risk. Furthermore, in the unfolding of the bankruptcy, the role of a CCP is chiefly to manage the risks and ensure market stability. No other institution is in better position to gauge the myriad of factors at stake and ensure a smooth process. The involvement of the court in assessing each contract would slow down and potentially jeopardize the whole default management process which is highly time sensitive.

Assignment

Finally, on application by the trustee and on notice to every party to an agreement, a court may make an order assigning the rights and obligations of a bankrupt under section 84.1 of the BIA and 11.3 of the CCAA. These provisions again provide for an exemption for EFCs. But for this exemption, the court would weigh the factors listed under subsection 84.1(4) of the BIA and 11.3(3) of the CCAA, namely whether the person to whom the rights and obligations are to be assigned is able to perform the obligations and judge on the appropriateness of such assignment. Allowing the assignment of EFCs by the insolvent clearing member or its court appointed officer would defeat the whole purpose of the default management procedure and directly contradicts the PFMIs principle 14 on portability which provides that "a CCP should have rules and procedures that enable the segregation and portability of positions of a participant's customers and the collateral provided to the CCP with respect to those positions."

The objective is to protect customer positions in the event of the default of a clearing member, including insolvency, and provide for an organized sequencing allowing the CCP to auction or allocate the defaulting clearing member's open positions at its discretion or transfer or port the customer positions[8]. Such procedure helps prevent the need to close-out positions and, as a result, minimizes market disruption[9]. Thus, the balancing process contemplated by the Court in assigning contracts is already built in to the default management procedure. The CCP, as part of the auction of the clearing member positions will assess whether the remaining clearing members with sufficient financial strength, may be allocated defaulting or insolvent clearing member's positions. The window of opportunity in which an auction or porting takes place is extremely time sensitive. In the context, there would be no benefit in transferring to the court such responsibilities as the CCP is in the best position to appropriately preserve market stability. The CCP will also benefit from the guidance of regulators during this process and in particular the Bank of Canada whose mandate is "to promote the economic and financial welfare of Canada"[10].

IV- Conclusion on the Recommendations of the Insolvency Institute of Canada

The IIC Report essentially proposes an improvement of EFCs counterparty priority over financial collateral to enhance protection against systemic risk while carving out from the EFC safe harbor, the protection afforded to EFCs against the debtor ability to disclaim or resiliate, and assign any contract. While concurring with the proposition to strengthen the priority over financial collateral and paying

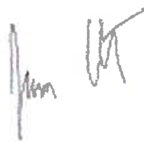
[8] See 3.13.1 and 3.13.2 PFMIs.
[9] See discussion under 3.14.3 PFMI.
[10] See the preamble of the Bank of Canada Act, R.S.C., 1985, c. B-2.

consideration to the argued policy reason supporting the IIC position, the TMX Group strongly disagrees with the proposal which would restrict EFCs protection. As duly exposed in its comments made pursuant to the Consultation on the Canada Business Corporation Act in May 2014, the TMX Group encourages a review of insolvency and close-out netting legislation to ensure that there is no resulting weakening of the benefits of close-out netting as a result of using the CBCA as an alternative to the BIA, CCAA. The TMX Group would like Industry Canada to ensure that any modification made to the BIA is consistent with the PCSA. And, to quote the UK Financial Stability Board's *Cooperation Guidance Between Recognised Bodies and Insolvency Practitioners to Assist management of member Default by Recognised Bodies*[11], the TMX Group believes that the BIA should be "crafted so as to ensure that the operation of the default rules of [CCP] takes precedence over insolvency procedures" which implies that trustee and courts should not "interfere or disrupt with the operation of the default rules or prevent settlement of transactions".

The TMX Group looks forward to further dialogue on the treatment of EFC in the context of insolvency proceedings. We hope that you will consider our concerns and suggestions and would be happy to discuss these at greater length with you, as needed.

Please feel free to contact us, if you have any questions regarding our comments.

Respectfully submitted,



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[11] Bank of England, UK Financial Stability Board, *Cooperation Guidance Between Recognised Bodies and Insolvency Practitioners to Assist management of member Default by Recognised Bodies*, at para. 6, (last accessed August 29, 2014): http://www.bankofengland.co.uk/financialstability/Documents/fmi/Insolvency%20practitioners.pdf.