Derivatives Regulatory Reform and the Insolvency Safe Harbours

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The prevalence of derivatives in corporate finance challenges certain traditional notions of creditors and creditor priority. This paper seeks to advance two recommendations for reform to the insolvency and restructuring regime in response to these challenges. The safe harbour provisions for eligible financial contracts should be amended to align with the developing regime for derivatives regulation. Within insolvency proceedings, enhanced disclosure and increased discretion would assist courts in responding to actual exposure and incentives of stakeholder in light of the evolving corporate finance structure.
I. Introduction

Derivatives have become an essential financial and risk management tool for companies of all sizes, across a variety of sectors and around the world. Derivatives contracts, and the safe harbour provisions that protect the rights of parties to derivatives, have been the subject of debate and legislative uncertainty in Canada and the US. To a significant degree, derivatives and other structured financial products have become accepted tools in corporate finance, a development not adequately reflected in the current insolvency regime. Rather, the present regime reflects practices developed in response to capital structures based on classic notions of corporate finance. The use of derivatives and other structured financial products poses challenges to the notions of creditors and creditor priority within a restructuring proceeding. Application of the safe havens can impact creditor priority and the crystallization of obligations. The prevalence of structured financial products in corporate finances calls for a re-assessment of insolvency laws to better reflect current corporate capital structures. A re-assessment of the treatment of derivatives is a timely first step.

The mandatory five-year review of the Companies’ Creditors Arrangement Act ("CCAA") slated for 2012 offers an opportunity to review the insolvency safe harbour provisions for derivatives and other eligible financial contracts ("EFCs"). Stemming from commitments made by the G20 countries following the 2008-09 financial crisis, the Bank of Canada is engaged in enhancing the infrastructure and regulatory scheme for derivatives trading, including central clearing and exchange trading. Aligning the EFC safe harbour provisions with the Bank of Canada initiatives would streamline the overall regulatory regime for derivatives in Canada. In the insolvency context, alignment would allow for the restriction of safe harbour provisions, to contracts that are centrally-cleared or exchange-traded. In the broader context, the knock-on effect would be to strengthen the central-clearing and exchange-trading scheme as parties seek to ensure their derivatives contracts qualify for the safe harbour provisions. This paper seeks to build on previous discussions of derivatives in the insolvency context and move towards proposals for reform of the safe harbour provisions.


2 Companies’ Creditors Arrangement Act, RSC 1985, c C-36 [CCAA].
Along with aligning derivatives treatment, this paper recommends a requirement for stakeholders to disclose their economic stakes in an insolvent company. Enhanced disclosure, and an accompanying narrow discretion of the court to weight creditor voting on a proposed plan of arrangement or compromise, would strengthen the ability of courts to meet the needs of financially distressed companies in light of evolving corporate finance practices, while still fulfilling the policy objectives of the CCAA.

Professor Jacob Ziegel has characterized the approach of the Canadian government to insolvency law reform as “piecemeal,” resulting in “ambiguities, gaps and obsolete provisions” in the BIA and the CCAA. The discussion and recommendations herein, focussed on derivatives and safe harbour provisions, may appear to perpetuate this piecemeal approach. The paper seeks to mitigate this by tying these proposals to broader initiatives for derivatives regulation. However, this paper represents only one piece of a larger discussion surrounding fundamental challenges to the Canadian insolvency and restructuring regime posed by innovations in the capital markets and the evolution of corporate financial structure. A fuller discussion of the fundamental challenges posed by these developments is beyond the scope and size of this paper.

This paper proceeds as follows. Part II provides a background to the G20 commitments. Part III discusses derivatives in corporate finance. Part IV presents preliminary proposals for reform. Part V concludes.

II. G20 Commitments

Following the 2008–09 financial crisis, the members of the G20 committed to overhauling the OTC derivatives market infrastructure. Specifically, the commitments involve increased standardization of OTC derivatives products, and include, for all standardized OTC derivative contracts: trading on exchanges or electronic platforms; central clearing by the end of 2012; reporting to trade repositories; and higher capital requirements where contracts not centrally-cleared. To this end, the Bank of Canada

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recently designated the Canadian Derivatives Clearing Service as subject to regulatory oversight\(^5\) under the *Payment and Clearing Settlement Act*.\(^6\)

Central clearing for derivatives involves novation, a process whereby the central clearing party (CCP) is interposed between the two parties, such that each party holds a contract with the CCP.\(^7\) Settlement payments and other obligations are notionally owed to the CCP; effectively, however, the CCP acts as a router for the payment of obligations from one counterparty to the other. Central clearing concentrates credit risk and other risks into one entity; in theory, a well-managed CCP can therefore reduce overall risk in the market.\(^8\) Central clearing is not without detractors,\(^9\) however a discussion on its merits is beyond the scope of this paper. In the insolvency context, a central clearing system for derivatives will allow for restriction of EFC safe harbours, and could improve the information available to the courts.

### III. Derivatives and the New Corporate Finance

#### A. Background

##### i. Derivatives

‘Derivatives’ are, in essence, financial instruments the value of which is based on an underlying asset, rate, or occurrence that does not form part of the derivatives contract. The parties to the contract agree to make payments (‘settlement payments’) at defined intervals (normally monthly) or at termination, based on changes in the value of the asset, movement of the rate (e.g. interest rate) or the (non-)occurrence of the event defined in contract. The underlying asset, rate or occurrence in the derivatives contract is termed the ‘reference entity’, and is typically independent of the parties to the contract.

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\(^8\) *Ibid.*

In Canada, ‘derivatives’ is used as a catch-all term, as illustrated by the broad and encompassing definition in the EFC Rules. Conversely, ‘swaps’ is used as the catch-all term in the US Bankruptcy Code, and in American academic commentary. This paper will follow the Canadian convention of using ‘derivatives’ as the catch-all term, encompassing swaps and other types of financial instruments.

ii. EFCs

‘Eligible Financial Contract’, or EFC, is the term used in insolvency legislation to refer a range of financial instruments. Exemption for derivatives and other financial contracts from the reach of insolvency legislation is limited to financial contracts which qualify as EFCs.

The Bankruptcy and Insolvency Act (“BIA”), the CCAA and the Winding-Up and Restructuring Act (“WURA”) define an EFC as “an agreement of a prescribed kind”. The list of prescribed agreements is set out in the Eligible Financial Contract General Rules attached to each Act. For the present purposes it suffices to note that most types of derivatives qualify as EFCs, including credit default swaps (CDS) and derivatives which trade on exchanges or in the over-the-counter (OTC) market.

iii. Safe Harbour Provisions and their Impact in an Insolvency

The treatment, or rather non-treatment, of EFCs in the Canadian insolvency context is provided for in the so-called “safe harbour” provisions in the BIA, CCAA and WURA. Essentially, the safe harbour provisions provide that in proceedings under those Acts, the rights and entitlements of parties under and to EFCs and related ‘financial collateral’ are not to be assigned, compromised, impaired or stayed. The policy reasons for exceptional treatment of EFCs can be generally summarized as a desire to provide market treatment of EFCs similar to that in other jurisdictions, implicitly recognizing the international nature of the derivatives market.

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12 Bankruptcy and Insolvency Act, RSC 1985, c B-3, s 2 [BIA].
13 CCAA, supra note 2 at 2.
14 Winding-up and Restructuring Act, RSC 1985, c W-11s 22.1 [WURA]
16 BIA, supra note 12, ss 65.1(7), 65.11(10), 66.34(7), 84.1(3), 84.2(7), and 254(4).
17 CCAA, supra note 2, ss 11.3, 32 and 34.
18 WURA, supra note 14, ss 100 and 101.
19 Chartrand, Sellers and McGregor, supra note 1 at 2.
20 Ibid at 3.
The standard governing contract for derivatives is the ISDA\textsuperscript{21} Master Agreement, which “serves as the contractual foundation for more than 90\% of over-the-counter derivatives transactions globally.”\textsuperscript{22} The interplay among the provisions of the ISDA Master Agreement, and the safe harbour provisions protect the rights of non-defaulting parties to a swap, and can significantly impact a restructuring or liquidation proceeding. Non-defaulting parties are prohibited from relying upon termination rights or receiving settlement payments due under existing derivatives contracts.\textsuperscript{23} The effects can include upsetting creditor priority, stripping cash out of the estate to make settlement payments, and delaying the crystallization of obligations due to unavailability of early termination.

The safe harbour provisions in insolvency law for derivatives and other EFCs continue to attract the attention of academics and practitioners, with a number of Canadian and American commentators calling for their narrowing or repeal.\textsuperscript{24} While a full discussion of this debate is beyond the scope of this article, the critiques suggest that the appropriateness of the safe harbour provisions is very much a live question as the 2012 CCAA review approaches.

B. Use of Derivatives

Derivatives have become an essential financial and risk management tool for companies of all sizes, across a variety of sectors and around the world. According to the Bank for International Settlement,\textsuperscript{25} the global OTC derivatives market grew by 780\%, from $80 trillion USD notional amounts outstanding\textsuperscript{26}

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\textsuperscript{21} The International Swaps and Derivatives Association (ISDA) comprises more than 830 members spanning 59 countries on 6 continents. ISDA seeks to promote the understanding and treatment of derivatives as a risk management tool, through engagement with policymakers and legislators around the world. ISDA works to reduce counterparty risk credit risk, increase transparency and improve the operational infrastructure of the derivatives industry through standardizing terminology and documentation for derivative contracts. “About ISDA”, online: International Swaps and Derivatives Association (ISDA) <http://www.isda.org>.

\textsuperscript{22} \textit{Lomas v JFB Firth Rixson}, [2010] EWHC 3372 Ch, [2011] 2 BCLC 120. See also International Swaps and Derivatives Association, Amicus Curiae Brief to the United States Bankruptcy Court of the Southern District of New York, \textit{In re Lehman Brothers Holdings Inc}, File 08-13555 (HMP), 17 June 2009.

\textsuperscript{23} See Chartrand, Sellers and McGregor, \textit{supra} note 1.


\textsuperscript{26} Notional amount outstanding means the total amount referenced in the derivative contract. This is to be distinguished from a second important metric, the gross market value of the derivative contracts themselves.
in 1998 to more than $707 trillion at June 2011.\textsuperscript{27} Interest rate contracts have consistently represented the greatest proportion of the total OTC derivatives market, accounting for more than 62\% in each reporting year. Foreign exchange ("FX") contracts consistently rank second in total notional amounts outstanding, however their proportion of the total decreased steadily from 22\% to 8\% at June 2009, climbing back to 9.6\% at June 2011. CDS, equity and commodities derivatives are also important components of the derivatives market. Canada represents approximately 2\% of the notional amount outstanding in the global OTC derivatives market,\textsuperscript{28} commensurate with several other G-20 countries.\textsuperscript{29} The Bank of Canada estimates that 80\% of all Canadian OTC derivatives market activity involves at least one side of the transaction being recorded in a foreign jurisdiction.\textsuperscript{30} FX contracts have maintained their importance in the Canadian OTC market, at 23\% of the Canadian total in 2010,\textsuperscript{31} compared to 9.6\% globally. A 2009 survey of Fortune Global 500 companies found that 94\% of the companies used derivatives.\textsuperscript{32} Examining 2008 annual reports, the survey found variances in the types of derivatives used by major companies in different industries. The use of commodity, equity and credit derivatives was concentrated among specific industries,\textsuperscript{33} demonstrating, according to ISDA, the use of derivatives as “an integral risk management tool among the world’s leading companies”.\textsuperscript{34} The rapid expansion of the global OTC derivatives market since the mid-1990s supports the conception of derivatives as risk management tools.\textsuperscript{35}

Not all accounts, however, paint the use of derivatives as only a risk-management tool. Using data from a 1998 study, Géczy, Minton and Schrand found that many firms use derivatives to take active, speculative positions.\textsuperscript{36} Speculative activity creates the potential for over-exposure to swings in derivatives contract values, and increased volatility in settlement payment obligations. The result may be to increase the likelihood of insolvency. Whether used as instruments for risk-management or for speculation, the safe

\textsuperscript{27} Statistics, Bank for International Settlements (BIS). The figures in this section are compiled from BIS reports on OTC derivatives market activity, released semi-annually in May and November, and available online: BIS <http://www.bis.org>.  
\textsuperscript{28} Wilkins and Woodman, supra note 4 at 35.  
\textsuperscript{29} Ibid at 36.  
\textsuperscript{30} Ibid.  
\textsuperscript{33} Ibid.  
\textsuperscript{34} Eraj Shirvani, ISDA Chairman and Head of Fixed Income for EMEA at Credit Suisse, in ibid, para 6.  
\textsuperscript{35} Note Ludger Hentschel and SP Kothari, “Are Corporations Reducing of Taking Risks with Derivatives?” (March 2001) Journal of Financial and Quantitative Analysis 93, who find no statistically significant risk or volatility increases or reductions due to the use of derivatives.  
harbour provisions carve out derivatives contracts from the jurisdiction of courts in insolvency proceedings.

C. Credit Derivatives

CDS are a type of credit derivative that has garnered substantial attention from academics, particularly in relation to the negative incentives for creditors using CDS in the context of a financially distressed company. ‘Credit derivatives’\textsuperscript{37} encompasses a variety of instruments, the common purpose of which is to create a tradable contract the value of which is based on the likelihood of default by the referenced entity. ‘Default’ is defined in the contract, and would normally include the insolvency of the referenced entity and the filing of insolvency proceedings.

Professor Sarra describes the shifting of incentives among creditors that can result from CDS in the insolvency context.\textsuperscript{38} Sarra notes, \textit{inter alia}, that CDS allow a creditor to reduce its economic exposure to the debtor, even to the point of negative exposure. With reduced economic interest, the creditor may be unwilling to engage in the restructuring process; where the creditor is a primary lender, they may be unwilling to advance further credit or exit financing to advance the prospects and future viability of the company emerging from the restructuring. More significantly, CDS can provide a negative incentive to over-hedged creditors, to refuse to renegotiate credit facilities or impede restructuring plans and thereby benefit financially from a failed restructuring.

D. Summary

The prevalent use of derivatives and their risk management potential suggest an opportunity to facilitate the beneficial use of derivatives, while erecting certain safeguards to limit potentially harmful impacts on the restructuring and insolvency regime.

IV. Policy Recommendations

This section presents preliminary policy recommendations, to bring the Canadian restructuring regime in line with current corporate finance structure and the evolving regulatory regime for derivatives.

A. Limiting Access to Safe Harbours for EFCs


\textsuperscript{38} This section relies on Janis Sarra, “Manoeuvring through the Insolvency Maze – Shifting Stakeholder Identities and Implications for CCAA Restructurings” (2011) 27 BFLR 155 at 165–66 [Sarra].
To circumscribe the impact of the safe harbour provisions and strengthen the central clearing and exchange trading systems, the safe harbour provisions should be limited to derivatives contracts that are centrally-cleared or exchange-traded. This restriction would be most easily effected through an amendment to that effect in the EFC Rules.

The safe harbour provisions are an important facilitative element in the development of the derivatives market. Absent the safe harbours, parties would be required to assess, and price, the risk of counterparty default. The preservation of close-out and netting rights by the safe harbour provisions, exempting these rights from stay in an insolvency proceeding, mitigates the impact of a potential default, reducing the price of the risk and thus of the derivatives contract.

Only EFCs qualify for the safe harbours. Including a requirement in the EFC definition that contracts be centrally-cleared or exchange-traded would enable the restricting of the safe harbours to only derivatives that meet the new regulatory requirements. Qualification as an EFC will provide an incentive for parties to derivatives to structure their trading activities within the rubric of the central clearing system, in order to take advantage of the safe harbour protections.

This approach might discourage innovation in the derivatives market, as new types of contracts that are not centrally-cleared or exchange-traded would not benefit from the safe harbours. This could be a concern where sophisticated entities custom-tailor derivatives to meet their own hedging needs. However, the objectives of aligning derivatives rules are to increase transparency and decrease potential negative impacts in insolvencies; parties sophisticated enough to custom-tailor derivatives should be sophisticated enough to account for, and price, counterparty default risk among them.39

In recognition of the negative incentives involved in CDS and other credit derivatives, access to the safe harbour provisions for these contracts should be further restricted, in addition to the requirement of central clearing or exchange trading. For each creditor, access to the safe harbour provisions should be available for credit derivatives only up to 100% of the value of the insolvent’s debt held by that creditor. While this would not fully resolve the issue of negative incentives, restricted access to the safe harbours may discourage speculative CDS activity.

**B. Disclosure and Discretion**

Increased transparency is a primary objective underlying the regulatory reforms to the derivatives market, and informs the proposal to align the safe harbours with these reforms. Increased transparency

39 For a discussion of pricing of counterparty risk, see Arora, Gandhi and Longstaff, supra note 9.
40 Wilkins and Woodman, supra note 4 at 35.
in the insolvency context would also be improved by a requirement for full disclosure by stakeholders of economic stakes in a restructuring proceeding.

Professor Sarra has suggested that disclosure of all economic stakes should be required within insolvency proceedings, in both bankruptcy and restructuring.\textsuperscript{41} This would build on US Bankruptcy Code Practice Rule 2019\textsuperscript{42} for disclosure by groups, committees and entities representing or consisting of creditors. Rule 2019 was targeted at determining the economic stakes held by distressed debt investors, but appears to remain unclear in its requirements and triggers.\textsuperscript{43}

In the Canadian insolvency context, disclosure of economic stakes by stakeholders in a proceeding would increase transparency and assist courts in properly assessing the exposure and incentives of each stakeholder. In order for courts to make effective use of the full disclosure of economic stakes, judges should be granted a narrow discretion to weight or exclude votes on a proposed plan of arrangement or compromise by creditors speculating on the success or failure of the restructuring. Over-hedged creditors with negative exposure through CDS are an obvious example, however speculation in either direction should be dampened. Proposed plans should be approved or refused on the merit of the plan, and not on pure speculation, wherever possible.

To improve buy-in, creditors could apply to have disclosures kept confidential by the court, as the information should be used only in determining whether to discount or exclude the votes of a particular creditor. Disclosure would be required of any creditor or equity holder of the debtor, holding or beneficially holding, including through derivatives, a stake exceeding a specified dollar amount or percentage of the total debt or equity in a class.

Granting courts a narrow discretion to weight the votes of speculating creditors could help to align the policy objectives of restructuring – continuing viable businesses while safeguarding the interests of certain stakeholders – with the developing corporate finance reality, and assist in mitigating the issue of shifting stakeholder identities associated with structured financial products and distressed debt investing.

Alternative approaches include adopting a duty on stakeholders in an insolvency to act in ‘good faith’. A recent development designed to help preserve the integrity of the US bankruptcy system,\textsuperscript{44} a duty to act in

\footnotesize{\textsuperscript{41} Sarra, \textit{supra} note 38 at 166.  
\textsuperscript{44} Sarra, \textit{supra} note 38 at 177.}
good faith would also require disclosure of economic stakes.\textsuperscript{45} However, full disclosure plus discretion to
discount or exclude votes of speculating creditors would be more easily administered by the courts than
would the creation of a new standard of conduct.

V. Conclusion

The prevalence of derivatives in corporate finance challenges traditional notions of creditor and creditor
priority. This paper has sought to advance two recommendations for reform to the insolvency and
restructuring regime in response to these challenges.

Aligning the EFC safe harbour provisions with the regulatory objectives and scheme for derivatives being
developed under the G-20 initiative would streamline the overall regulatory regime for derivatives in
Canada, strengthening the central clearing infrastructure and mitigating the potential negative impacts of
derivatives in an insolvency. Required disclosure by stakeholders of economic stakes in insolvency
proceedings, coupled with narrow discretion for courts to re-weight or exclude voting by speculating
creditors, would assist courts in appropriately responding to the exposures and incentives of stakeholders.

The skeletal structure of the CCAA and the discretion granted to courts thereunder have been lauded by
the SCC as flexible in responding to complex restructurings.\textsuperscript{46} Updating the corporate finance
underpinnings of the CCAA would improve its responsiveness to the stakeholder dynamics present within
restructuring proceedings today.

\textsuperscript{45} Ibid.

\textsuperscript{46} \textit{Re Ted LeRoy Trucking Ltd}, 2010 SCC 60 at para 14, \textit{(sub nom Century Services Inc v Canada (AG))} [2010] 3
SCR 379, 326 DLR (4th) 577.