

**BILL S-40: AN ACT TO AMEND THE PAYMENT
CLEARING AND SETTLEMENT ACT**

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LEGISLATIVE HISTORY OF BILL S-40

HOUSE OF COMMONS

Bill Stage	Date
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First Reading:	20 March 2002
Second Reading:	19 April 2002
Committee Report:	2 May 2002
Report Stage:	9 May 2002
Third Reading:	9 May 2002

SENATE

Bill Stage	Date
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First Reading:	5 March 2002
Second Reading:	12 March 2002
Committee Report:	14 March 2002
Report Stage:	
Third Reading:	19 March 2002

Royal Assent: 4 June 2002

Statutes of Canada 2002, c.14

N.B. Any substantive changes in this Legislative Summary which have been made since the preceding issue are indicated in **bold print**.

Legislative history by Peter Niemczak

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BILL S-40: AN ACT TO AMEND THE PAYMENT
CLEARING AND SETTLEMENT ACT*

INTRODUCTION

Bill S-40, An Act to amend the Payment Clearing and Settlement Act, was introduced in the Senate on 5 March 2002 by the Leader of the Government in the Senate. The stated purpose of the bill is to protect the netting⁽¹⁾ agreements of a securities and derivatives clearing house (hereafter, a clearing house) and to permit a clearing house to realize the collateral⁽²⁾ of a member in the event of the member's bankruptcy or insolvency. The *Payment Clearing and Settlement Act* would be amended by adding proposed section 13.1.

DISCUSSION

Securities and derivatives clearing houses are centralized facilities for the clearing and settlement of securities or derivatives,⁽³⁾ acting as an intermediary/guarantor to all payment and delivery obligations cleared and settled through it. They provide access to capital and a means to channel savings into investments, and minimize and hedge risks in the financial and agricultural sectors.

* Notice: For clarity of exposition, the legislative proposals set out in the Bill described in this Legislative Summary are stated as if they had already been adopted or were in force. It is important to note, however, that bills may be amended during their consideration by the House of Commons and Senate, and have no force or effect unless and until they are passed by both Houses of Parliament, receive Royal Assent, and come into force.

- (1) For example, "netting" means that if a member of a securities and derivatives clearing house had bought a security for \$10,000 and sold a security for \$9,000, then that member's net obligation to the clearing house is \$1,000. Netting reduces the net payment and delivery obligations of clearing house members.
- (2) In this context, "collateral" generally means an asset, whether a cash deposit or the transfer or pledge of a security provided to a clearing house. Collateral would be posted with the clearing house and would fully or partially offset a member's payment or delivery obligations to the clearing house.
- (3) In essence, the clearing house endeavours to ensure that the buyer pays the amount that he or she has agreed to pay, and that the seller receives payment for the securities or derivatives he or she has agreed to sell.

Canada has four exchanges for securities and derivatives trades that clear and settle through three clearing houses. The four exchanges are: the Toronto Stock Exchange for senior equities, the Montreal Exchange for all non-commodities derivatives trading, the Canadian Venture Exchange in Calgary for junior equities, and the Winnipeg Commodity Exchange (WCE) for commodity derivatives. The three clearing houses are: the Canadian Derivatives Clearing Corporation, the Canadian Depository for Securities and the WCE Clearing Corporation. They are a critical element in the efficient and timely clearing and settlement of securities and derivatives transactions.

These clearing houses experience the risk that a member may default before a transaction is completed and settled, which would result in financial loss to the clearing house and, ultimately, its members. Although this risk can be reduced by requiring members to post collateral and to net their obligations with the clearing house, some risk remains. Importantly, the risk is greater in Canada than in other countries, including the United States and other G7 countries, with the result that more trading could occur outside of Canada should dealers decide that they face greater risk in dealing with a clearing house here than in another country.

In the United States, bankruptcy and insolvency legislation generally exempts securities clearing houses from court-ordered stays and allows them to net the obligations of members and realize their members' collateral. In Europe, the Settlement Finality Directive requires European Union member states to ensure that security settlement systems can net obligations; it also ensures that netting is legally enforceable and binding on third parties. Moreover, the Directive allows security to be realized expeditiously in any winding-up procedure, which means that collateral security is insulated from the effects of insolvency and can be realized for the benefit of claimants.

In Canada, however, current Canadian bankruptcy and insolvency laws⁽⁴⁾ do not protect netting agreements with clearing houses to the same extent as in other countries; nor do they prevent court-ordered stays on the ability of clearing houses to realize collateral in the event of a member's bankruptcy or insolvency.

Also of note is the Bank for International Settlements, an international organization that fosters co-operation among central banks and other agencies in pursuit of

(4) These include the *Bankruptcy and Insolvency Act*, the *Companies' Creditors Arrangement Act* and the *Winding-up and Restructuring Act*.

monetary and financial stability. In November 2001, it and the International Organization of Securities Commissions made recommendations about security settlement systems, including clearing houses. A key recommendation concerned a well-founded legal basis for security settlement systems to ensure that their rules and procedures can be enforced with a high degree of certainty, including the enforceability of transactions, netting arrangements, and the liquidation of assets pledged or transferred as collateral.

In order to ensure competitiveness with clearing houses in other countries (especially the United States), the amendments proposed in Bill S-40 would:

- protect the netting agreements of clearing houses in the case of bankruptcy or insolvency of one of its members; and
- prevent court-ordered stays on clearing houses which delay them from realizing the collateral of a bankrupt or insolvent member.

Without a competitive legal regime for clearing houses, Canadian securities and derivatives transactions could continue to migrate to the United States (as well as to other countries).

CLAUSE-BY-CLAUSE ANALYSIS

Proposed section 13.1(1) would protect the netting agreements of a clearing house in the case of bankruptcy or insolvency of one of its members (proposed section 13.1(1)(a)). It would also prevent court-ordered stays on clearing houses that delay the realization of the collateral of a bankrupt or insolvent member (proposed section 13.1(1)(b)).

In particular, nothing in any bankruptcy or insolvency law (Canadian or foreign) or court order (Canadian or foreign) made in respect of the administration of a reorganization, arrangement or receivership involving insolvency would:

- prevent a clearing house from terminating any netting agreement to which it is a party and determining a net termination value or net settlement amount consistent with the provisions of the agreement (the party entitled to an amount would become a creditor of the party owing the amount); or
- prevent a clearing house from acting in accordance with its rules that provide the basis on which payment and delivery obligations are calculated, netted and settled; or

- interfere with the rights or remedies of a clearing house in respect of collateral granted to it to secure the performance of the obligations of a member.

Proposed section 13.1(2) would provide the Minister of Finance with the authority to designate other clearing houses (that is, clearing houses other than the three identified above) provided:

- he or she is of the opinion that it is in the public interest to do so; and
- the entity provides clearing and settlement services to its clearing members in respect of transactions that involve securities or derivatives.

Finally, proposed section 13.1(3) would define the following terms: clearing member; net termination value; netting agreement; and securities and derivatives clearing house. A “clearing member” would be a person who uses the services of a clearing house, while “net termination value” would be the net amount obtained after setting off, or otherwise netting, the obligations between a clearing house and a clearing member in accordance with the netting agreement.

Included in the interpretation of “netting agreement” would be an agreement that provides for the netting, or setting off, of present or future obligations to make payments or deliveries against present or future rights to receive payments or make deliveries. This term could also mean an agreement between them that is an eligible financial contract within the meaning of section 22.1 of the *Winding-up and Restructuring Act*. Finally, “securities and derivatives clearing house” would be the three clearing houses identified earlier, in addition to any entity designated by the Minister of Finance in accordance with proposed section 13.1(2).