

***The New Securities Transfer Act, 2005***

**The Coming Revolution in the Law of Securities Transfers**

**By**

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**Ontario Bar Association  
2006 Institute of Continuing Legal Education**

**Business Law  
January 24, 2006**

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<sup>1</sup> I would like to acknowledge the assistance and insights of my partner Wayne Gray in preparing this paper. Any errors or omissions, of course, remain my own.

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On December 1, 2005, Bill 41, the *Securities Transfer Act, 2005* (the “STA”), received first reading in the Ontario legislature.<sup>3</sup> Although the event went largely unnoticed in the media, Bill 41 is nothing less than revolutionary. It will enact one of the most comprehensive packages of legislative reforms that Ontario commercial law has seen since the introduction of the *Personal Property Security Act*<sup>4</sup> (the “PPSA”). Like the PPSA, the STA is modeled on similar reforms under the U.S. *Uniform Commercial Code* (the “UCC”), and like the PPSA, the STA will rationalize and unify a body of commercial law that previously was a muddled patchwork of incomplete and confusing legislative and judge-made rules. As such, the STA will bring securities transfer law into the twenty-first century and mark nothing less than a fundamental paradigm shift in how Ontario law regards what once was the simple process of transferring or pledging a security.

This paper will provide an overview of the purpose and background of the STA, a discussion of why Ontario (and all of Canada) needs the reforms it will implement and finally a summary of some of the more novel and unfamiliar provisions that may impact everyday practice.

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<sup>2</sup> Of the Toronto office of McMillan Binch Mendelsohn LLP.

<sup>3</sup> Legislative Assembly of Ontario, Bill 41 2005, *An Act to create a comprehensive system of rules for the transfer of securities that is consistent with such rules across North America and to make consequential amendments to various Acts*. See [http://www.ontla.on.ca/documents/Bills/38\\_Parliament/Session2/b041\\_e.htm](http://www.ontla.on.ca/documents/Bills/38_Parliament/Session2/b041_e.htm).

<sup>4</sup> R.S.O. 1990, c. p. 10.

## Part I: Overview and Background

Modeled on the *Uniform Securities Transfer Act* (the “USTA”) prepared by the Canadian Securities Administrators USTA Task Force and approved in 2004 by the Uniform Law Conference of Canada,<sup>5</sup> the STA represents the culmination of over nine years of hard work and tireless lobbying by a group of lawyers and public servants led by Eric Spink (formerly, vice chair of the Alberta Securities Commission), and Max Paré of the Ontario Securities Commission.<sup>6</sup>

Implementation of the STA had the powerful support of the Ontario Legislature’s Standing Committee on Finance and Economic Affairs, the Five-Year Review Committee’s Final Report on the *Securities Act*, the Governor of the Bank of Canada, the Ontario Securities Commission, the Canadian Depository for Securities Limited (“CDS”), the Canadian Bankers Association, the Canadian Bar Association, the Ontario Bar Association, the International Swap Dealers Associations, the Toronto Opinion Group and others. The STA is also the centre-piece of Phase One of an ambitious multi-year program of commercial law reform announced last May by then Minister of Consumer and Business Services Jim Watson.<sup>7</sup> I understand that Bill 44 has been fast-tracked to ensure its speedy enactment.

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<sup>5</sup> Canadian Securities Administrators’ Uniform Securities Transfer Act Task Force, *Uniform Securities Transfer Act Approved at the Uniform Law Conference of Canada Annual Meeting, August 22-26, 2004*, available on the web at [http://www.ulcc.ca/en/us/Uniform\\_Securities\\_Transfer\\_Act\\_En.pdf](http://www.ulcc.ca/en/us/Uniform_Securities_Transfer_Act_En.pdf)

<sup>6</sup> For background on the USTA, particularly the drafting challenges facing drafters trying to adapt US legislation to very different Canadian drafting protocols, see Eric. T. Spink, “The Influence of UCC Article 8 on Canadian Securities Transfer Law: Is There Room for a Canadian Dialect in Global Commercial Language?”, Canadian Institute for the Administration of Justice, Publication LD 83, available on the web at <http://www.ciaj-icaj.ca/english/publications/LD83Spink.pdf>

<sup>7</sup> Keynote address to Ontario Bar Association program on Corporate-Commercial Law Reform, May 16, 2005.

To their credit, the legislative drafters of the STA have kept the original language and structure of the USTA largely intact (with a few notable exceptions discussed below), making only relatively modest changes in organization and wording to conform to Ontario drafting protocols. This restraint is in itself quite remarkable. Anyone familiar with the legislative drafting process will know that the draft bills contained in studies preceding major commercial legislation often bear little resemblance to the bill actually introduced by the government. Since conformity with both its U.S. source (Revised Article 8 of the UCC) and the counterpart legislation that it is hoped will be enacted in all the other provinces will be one key to the success of the STA, the fact that the USTA survived the legislative drafting process relatively unscathed bodes well for the future.

## **1. What and Where is the Current Law?**

Until the STA becomes law (possibly by late spring of 2006), transfers of investment securities will continue to be dealt with under Part VI of the *Business Corporations Act*<sup>8</sup> (the “OBCA”). Part VI applies to securities issued by any “body corporate” including, subject to conflict of laws rules, foreign bodies corporate. However, it does not generally extend to securities issued by non-corporate enterprises such as limited partnerships, real estate investment trusts or business income trusts. Nor, subject to an exception in section 85 of the OBCA that governs securities held through clearing agencies, does it extend to government securities or securities issued in the form of bills of exchange or promissory notes. The creation, perfection and enforcement of security interests in securities are governed by the PPSA.

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<sup>8</sup> R.S.O. 1990, c. B. 15.

## **2. What's Wrong with the Current Law and Why We Need the STA**

### *(a) The Tiered Holding System*

We need the STA mainly because the Canadian law governing transfers of securities has not kept pace with modern market practice in what is known as the “tiered holding system” or “indirect holding system.” Until the 1960’s, purchasers of stocks and bonds nearly always received physical certificates evidencing their securities. Although sometimes held by the broker in “street name”, securities were for the most part evidenced by certificates registered in the name of the beneficial owners. This simple and effective system is still widely used for private companies. Since under corporate law, securities are generally negotiable instruments<sup>9</sup>, a transfer of ownership or a pledge of a certificated security can usually be effected by simple physical delivery of an endorsed certificate. However, this paper-based “direct holding system” proved impractical for processing the huge volumes of trades that first flooded the North American public markets in the 1960’s and ’70’s.

As a result, most publicly-traded securities are held and traded through a complex network of intermediaries (such as clearing agencies, brokers and financial institutions), often stretching across multiple jurisdictions. In most cases, an issuer issues securities to a nominee of a clearing agency such as CDS in Canada or The Depository Trust Company (“DTC”) in the U.S. The clearing agency, in turn, holds the securities (usually in the form of “global” certificates) for its member-participants, which are generally banks, trust companies and securities dealers. An intermediary may hold securities for its own house account, for another intermediary or for the ultimate retail or institutional investor. If the securities are held for another intermediary, that intermediary may hold for itself, a retail or institutional investor or, in turn, another intermediary.

This system of indirect holdings through tiers of intermediaries has become the dominant pattern for holdings of publicly-traded securities. The significant advantage of the indirect holding system is that it facilitates the efficient transfer and pledge of securities through a computerized book-based system. No paper security certificates need be handled, stored for safekeeping or endorsed for transfer. Problems associated with the loss, damage or theft of security certificates are largely avoided.

The indirect holding system allows a tremendous volume of securities transactions to be settled through computerized book-entries on the records of the clearing agency and the various intermediaries in the system that would be impossible through a direct paper-based system. CDS holds about \$2.4 trillion worth of securities on deposit, handling over 62 million securities trades annually.<sup>10</sup> In the U.S., DTC holds about \$25 trillion worth of securities and processes about 225 million electronic book entries annually.<sup>11</sup>

*(b) Section 85 of the OBCA: An Imperfect Solution*

With limited exceptions, Part VI of the OBCA, like its companion provisions in the *Canada Business Corporations Act* (the “CBCA”) and other Canadian corporation legislation, presupposes a direct holding system where owners of securities have a direct relationship with the issuer and hold physical security certificates. As such, it assumes the possession and delivery of security certificates. As a result it is wholly inadequate to deal with the indirect and book-based settlement systems.

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<sup>9</sup> See eg CBCA s. 48(3).

<sup>10</sup> CDS home page: [www.cds.ca/cdshome.nsf](http://www.cds.ca/cdshome.nsf).

<sup>11</sup> Depository Trust and Clearing Corporation home page: [www.dtcc.com](http://www.dtcc.com).

As a stopgap measure, section 85 of the OBCA was enacted in 1986 to create the fiction of “constructive” delivery and possession of indirectly held securities. The idea behind section 85 is that once the “appropriate entry” is made in the records of the applicable clearing agency (which today means CDS)<sup>12</sup> recording the transfer of a position in a security held through CDS, the book entry has the same legal effect as the physical delivery of an endorsed security certificate. However, while better than nothing, section 85 is at best an imperfect solution because it does not accurately reflect market practice or the complex web of intermediaries below the direct participants in CDS. Its application to beneficial owners of book-based securities that are not “participants” in CDS is also not entirely clear and it raises a host of interpretive issues.

For example, delivery is a key concept with respect to transfers and pledges of securities: it is delivery that determines whether the seller has satisfied its contractual obligation and whether the pledgee has taken possession of the security to perfect a security interest. Yet it is not at all clear how one determines exactly when delivery of a book-based security occurs. Section 78(1)(g) of the OBCA provides that “delivery” of a security shown in the records of a clearing agency occurs when, among other things, an “appropriate entry” is made in the records of the clearing agency and the client’s broker in its records “identifies a specific security in the broker’s possession as belonging to the purchaser”. No one knows how to determine whether a given entry in CDS’s ledger is “appropriate”: the very concept is circular if “appropriateness” is measured by whether it achieves the intended legal effect of section 85. In my experience CDS will confirm in writing that its records show the transfer of a given position from Participant A to

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<sup>12</sup> “Clearing agency” is defined as a person designated as a recognized Clearing Agency by the Ontario Securities Commission (OBCA s. 53(1)). CDS is the only clearing agency now in existence that has been so recognized.

Participant B on a given date. But no one at CDS can confirm that the entry was “appropriate”, and it is very difficult to obtain confirmation in real time that the trade was executed. Moreover, since trades through CDS are settled on a net basis between participants, there is no “appropriate entry” that records an “intra client” transfer of a position from the account of Client A of Broker X to that of Client B of Broker X. Brokers will likely give you a blank stare if you ask them to confirm that a “specific security” in their possession belongs to a specific purchaser. They may give you a copy of a trade ticket showing that a specific trade has been executed for the account of a particular client in a particular issue, identified by a CUSIP or FINS number. But does this satisfy section 78(1)(g)(ii)? No one knows. As a result, any lawyer asked to give a “good faith purchaser opinion” with respect to a book-based security will almost invariably qualify it with assumptions that the “appropriate entry” has been made and that the broker has identified the “specific security”, rendering the opinion well-nigh useless.

(c) *Conflict of Laws Issues*

Even more seriously, the confused state of the conflict of laws principles as to what substantive law governs perfection of a possessory security interest in a book-based security makes it painfully difficult to determine with any certainty where and how to perfect such a security interest. Section 5(1) of the PPSA tells us that the validity, perfection and effect of perfection of a possessory security interest in a security is governed by the law of the jurisdiction where the security is “situated at the time the security interest attaches”. Section 22(d) of the PPSA provides that possession perfects a security interest in securities. Section 85(5) of the OBCA provides that a participant is deemed to have possession of a security deposited with a clearing agency for the purposes of the PPSA. However, there is little guidance as to where a “book-based security” is “situated” for the purpose of applying these rules. Is it the location of the

global certificate held by CDS or its agent (since this is the only tangible evidence of the security)? The location of the records of the issuer? The head office of the clearing agency? The location of the relevant broker (because s. 85(5) deems the participant to have possession of a security deposited with a clearing agency)? Even if the correct answer is the location of the global certificate, this is at best an awkward solution that can produce results at odds with the legitimate expectations of the parties. If CDS is in physical possession of the global certificate, it may be located in a vault in a province that does not have the equivalent of section 85 of the OBCA. Increasingly, global certificates are deposited with CDS on a “hold in custody” basis, which means the issuer retains them on behalf of CDS, making their physical location even less predictable. In any event, the secured party may have no practicable means of determining where the global certificate is located, which makes choosing a jurisdiction for perfection an expensive and dangerous guessing game.

(d) *Transaction and Opinion Issues*

Operationally, the indirect holding and book-based system is highly efficient compared with the direct holding system. Yet, in the absence of the STA, its foundations are surprisingly shaky and in some respects non-existent from a legal standpoint. As a result, even seemingly straightforward secured transactions involving indirectly held securities may entail unexpected delay, expense and legal uncertainty. Lenders are often reluctant to accept book-based securities as collateral without requiring a PPSA registration (instead of relying on constructive possession), along with the usual searches and subordinations of possible prior secured parties and sometimes will insist on delivery of definitive physical certificates, all of which can be time consuming and expensive. Counterparties to complex cross-border structured transactions using collateralized derivatives cannot confidently accept even government securities held through the

tiered holding system as collateral without fear that they might be subject to a prior security interest or sold free and clear to a third party. Negotiating legal opinions for even domestic transactions using such collateral can be costly and contentious.

For example, a transaction that I worked on last December involved a pledge of Government of Canada securities by an Alberta resident issuer of mortgage backed securities to an Ontario custodian that held the securities in an account with a bank-owned investment dealer. One would think that this purely domestic transaction involving two common-law provinces, each with similar PPSAs and similar business corporations acts, would present few difficulties. In fact it took three days of somewhat rancorous haggling among three major law firms to settle the opinion.

Our firm was acting for the custodian and we were required to request a good faith purchaser opinion from debtor's counsel with respect to the securities. As with nearly all Government of Canada securities, these were issued as a global certificate lodged with CDS. The opining law firm refused to give a good faith purchaser opinion because, while the "constructive possession" regime of section 85 of the OBCA did extend to government issuers, it was not clear that one could rely on the good faith purchaser exception with respect to government securities settled through CDS. The expanded definition of "issuer" in section 85 that includes governments does not expressly apply to section 69 of the OBCA, which defines good faith purchasers for the purpose of the PPSA. The Alberta *Business Corporations Act*<sup>13</sup> does not have the equivalent of section 85 of the OBCA, so "possession" of a book-entry security is not a meaningful concept under Alberta law. However, the lender still had little or no comfort that its security could not be

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<sup>13</sup> R.S.A. 2000, c. B-9.

defeated by a subsequent good faith purchaser for value without notice. There was also much debate about whether, given that CDS was, technically, the agent for both the broker for both the pledgor and the pledgee, it was possible even to perfect the security interest through deemed possession because section 22 of the PPSA does not permit pledged collateral to be held by the debtor or an “agent of the debtor”.

There was much discussion of characterization in conflict of laws, whether the securities were even “securities” at all under Alberta law, which law governed perfection, where a book-entry security is located for conflicts purposes and so on. All of this made for fascinating discussions of abstruse legal points, but at a cost of several thousand dollars in legal fees. Just explaining these esoteric concerns took many hours of expensive and torturous e-mails and telephone calls and many more to resolve them. And at the end of the day the opinion was so highly qualified and convoluted as to be nearly unintelligible to anyone but lawyers well versed in the issues. It’s difficult to justify this sort of negotiation and expense to a client, who will inevitably mutter something about lawyers charging by the word and angels dancing on the head of a pin. A client questioning a huge legal bill will not be mollified by hearing that another \$6,000 had to be spent because no one really knows where a book-entry security is located.

Under the STA, this sort of opinion battle would simply not occur. Assuming Alberta enacts the same legislation, the analysis would be simple and straightforward. With limited exceptions the STA applies to security entitlements to government securities.<sup>14</sup> Any question about what law governed perfection of the security interest would be easily resolved by reference to the jurisdiction of the securities intermediary, which is determined by the clearcut rules in section

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<sup>14</sup> Under STA s. 8 the STA applies to the provincial and federal Crown, and the definition of “issuer” depends on the definition of “person”, which includes “governments”.

45(2). Perfection of the security interest could be effected by registration or “control”. Control would be preferable because of the enhanced rights given to a “protected purchaser”.<sup>15</sup> Control could be effected through a control agreement or by having the pledgee become the entitlement holder. Metaphysical debates about the location of collateral that has no physical existence would become an interesting footnote in legal history because location of the collateral would no longer be a relevant in the analysis. Under the STA life might be less interesting for lawyers, but it will be less expensive for clients.

### **3. Background to the STA Initiative**

The immediate source for the current initiative to reform the law of securities transfers and pledges is two-fold. The Canadian source is the Alberta Law Reform Institute Report on *Transfers of Investments Securities* published in 1993. The U.S. source is revised Article 8 of the UCC, approved, in 1994 by the American Law Institute and the National Conference of Commissioners on Uniform State Laws, the co-sponsors of the UCC. Revised Article 8 is in force in all 50 states and is recognized by experts as the leading statute of its kind in the world.

Revised Article 8 served as the ultimate model for the USTA, on which the Ontario STA is largely based. Drawing on U.S. sources for Canadian law in this area is not unusual: the current law is largely modelled on the pre-1962 version of UCC Article 8. However, for historical reasons there is a major structural difference between revised Article 8 and the STA. In the U.S., revised Article 8 is part of the UCC, which also includes Article 9 on personal property security law. In Canada, however, the legislation governing transfers and pledges of securities does not reside in a single statute but instead is split between separate PPSAs, various corporate and other

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<sup>15</sup> STA s. 70 and s. 28.1 of the PPSA as amended by the STA.

statutes at the provincial and federal level and the common law, which currently address, in patchwork fashion, transfers of securities in corporate issuers. Implementation of the STA, therefore, also necessitates companion changes to the PPSA, the OBCA and the Ontario *Execution Act*<sup>16</sup>. Amendments to the PPSA are needed to ensure that the two statutes together will coherently and comprehensively state the law governing the use of securities as collateral for secured transactions.

#### **4. Overview of the STA**

The STA is commercial property-transfer law, which governs the transfer and holding of securities and interests in securities. A useful analogy is to think of the STA as performing the same legal function for transfers of securities that the *Sale of Goods Act*<sup>17</sup> (Ontario) performs for the transfer of tangible goods. The STA is not securities regulatory law, which governs such matters as registration and prospectus requirements, exemptions from these requirements, continuous disclosure, insider trading rules, take-over bids, *etc.* that are intended to protect investors in the capital markets. Instead it is “facilitative” or “framework” legislation that sets out the legal rules that market participants agree will govern transfers of securities. Adopting such facilitative legislation promotes the legal certainty that capital markets require.

The STA deals only with the settlement side of a transaction involving the purchase or sale of government corporate or non-corporate securities or the pledge of such securities as collateral for a secured loan. It applies to securities whether they are publicly traded or not. The STA does not deal with the payment side of the transaction.

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<sup>16</sup> R.S.O. 1990, c. E. 24.

<sup>17</sup> R.S.O. 1990, c. S. 1.

The STA and the companion changes to the OBCA, the PPSA and the *Execution Act* will revolutionize the law applicable to the transfer and pledge of securities in Ontario. If other Canadian provinces and territories follow Ontario's lead, implementation of the STA will result in near word-for-word uniformity across the common-law jurisdictions in Canada and as close-to-uniformity as possible in Québec, having regard to Québec's unique *Civil Code* requirements. I understand that Ontario has delayed implementation of the STA precisely so that the other provinces and territories can consider the Ontario legislation and concurrently implement a near-uniform statute in their own jurisdictions.

In short, the STA will provide a modern legal foundation to support existing market practices. Uniformity will decrease the relevancy of conflict of laws issues involving securities transfers and pledges. Adoption of the STA furthers the goal of post-transaction finality, increasing the reliance that can be placed on settled securities transactions. It will facilitate the market for loans and other transactions collateralized by portfolios of investment securities, including everything from complex cross-border structured products to consumer-level secured loans. It will provide lawyers with the basis to provide transaction opinions with confidence with few of the convoluted qualifications that are now required, enabling transactions to proceed that were hitherto all but impossible under the current confused state of the law.

## **5. The USTA “Official Comment”**

A very useful adjunct to the ULCC approved version of the USTA is the official “Comment” that accompanies each legislative provision. The Comments are based largely on the Official Comments and Prefatory Note to Revised Article 8 of the UCC published by the American Law Institute and the National Commissioners on Uniform State Laws, which are quoted with the permission of the Permanent Editorial Board for the UCC under a temporary license. The

Comments contain a wealth of explanatory material and illustrative examples of how the provisions work in practice. Not surprisingly, the STA itself makes no reference to the Comments, perhaps because there is no precedent in Canadian legislation for giving official sanction to an extended interpretive gloss on that legislation provided by third parties.

Nevertheless, the Comment will be an invaluable resource for self-study of the STA, and Ontario courts will no doubt turn to it for guidance in interpreting many of the legislative provisions that have no counterpart in the existing law.<sup>18</sup>

## **Part II: What's New in the STA**

The STA introduces a number of new and often unfamiliar concepts and sets out clear rules to replace ones that are obscure or inconsistent under the existing law. The most dramatic changes involve securities held through the indirect holding system.

### **1. What's Old: Certificated and Uncertificated Securities**

In general, little will change under the STA with respect to the law governing transfers and pledges of directly held securities. Most of the provisions that now reside in Part VI of the OBCA governing the direct holding system will resurface in substantially similar form in the STA.<sup>19</sup> Transplanting these provisions from the corporate statute makes sense because they really form part of personal property law, not corporate law. The remnants of Part VI left in the OBCA will deal primarily with the issuance of share certificates of an OBCA corporation as a

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<sup>18</sup> For a discussion of how the Comments might be applied as an interpretive aid, see E. Spink, note 6, above, at p. 18-22. Mr. Spink has informed me that several jurisdictions, including Ontario, have expressed a desire to table the Comment during the legislative process so that, once the STA is in force, the Comment can be referred to as an interpretive aid.

<sup>19</sup> STA sections 29-40, and Parts III, IV and V are in substance very similar to the corresponding provisions in Part VI of the OBCA.

matter of corporate law, endorsements on share certificates and rules as to the transmission of securities on death, bankruptcy or other changes in the legal status of the holder.

One apparent exception is the change from “good faith purchaser” to “protected purchaser” as the term describing a purchaser (which also includes a pledgee) that acquires a security free and clear of adverse claims.<sup>20</sup> Unlike a good faith purchaser, a protected purchaser need not be acting in good faith to qualify as such. However, arguably this requirement is now redundant because section 4(1) provides that every contract to which the STA applies and every duty imposed by the Act imposes an obligation of good faith in its performance or enforcement.

What constitutes notice of an adverse claim is set out in detail in sections 18 and 19. In addition, an entitlement holder may not bring a legal action against the purchaser of a financial asset in respect of the entitlement holder’s property interest in the asset if the purchaser has given value, obtained control or possession of the asset and “does not act in collusion with the securities intermediary’s obligations under section 98”.<sup>21</sup> A more onerous standard than “bad faith” or actual notice, “in collusion” means “in concert, by conspiratorial arrangement or by agreement for the purpose of violating a person’s rights in respect of a financial asset”<sup>22</sup> and “collusion requires active participation in the wrongdoing of the transferor; and ... knowledge that the transfer is wrongful is a necessary but not necessarily conclusive condition of the collusion test.”<sup>23</sup>

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<sup>20</sup> STA s. 70.

<sup>21</sup> STA s. 97(7).

<sup>22</sup> STA s. 1(1).

<sup>23</sup> USTA Comment, p. 13.

One important innovation in Bill 44 will give OBCA corporations the option to “dematerialize” all of their securities by issuing them exclusively in uncertificated form.<sup>24</sup> Dematerialization means that the board of a corporation can opt not to issue any paper certificates at all. The evidence of ownership would be the share register of the issuer. This option has long been available in most U.S. states but never previously available for shares in Canadian corporations.

## **2. The “Security Entitlement”: A Core Concept**

### *(a) Nature of the Security Entitlement*

The novel core concept introduced by the STA, and also used in the companion changes to the PPSA, is statutory recognition of a new *sui generis* property interest known as the “security entitlement”. The security entitlement is essentially a description of the rights and property interests at the heart of the indirect holding system that is more rational and functionally accurate than the unwieldy fiction of constructive possession embodied in section 85 of the OBCA. Rather than pretend that the “beneficial owner” of a book-based security has direct rights against the issuer (which the issuer generally has no statutory duty to acknowledge), the security entitlement concept instead recognizes that in the tiered holding system, the property interest of a beneficial owner in the underlying “financial asset” in essence consists of a bundle of rights that may be exercised only against the “securities intermediary” that holds the underlying securities or other financial assets.

“Security entitlement” is defined functionally as “the rights and property interest of an entitlement holder with respect to a financial asset that are specified in Part VI”. In other words, a security entitlement is the sum total of the rights that an “entitlement holder” has with respect

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<sup>24</sup> OBCA s. 54(1), as amended by STA s. 111.

to the underlying financial assets by virtue of Part VI. “Financial asset” is a broad term that includes:

- (a) a security,
- (b) an obligation of a person that,
  - (i) is, or is of a type, dealt in or traded on financial markets, or
  - (ii) is recognized in any other market or area in which it is issued or dealt in as a medium for investment,
- (c) a share, participation or other interest in a person, or in property or an enterprise of a person, that,
  - (i) is, or is of a type, dealt in or traded on financial markets, or
  - (ii) is recognized in any other market or area in which it is issued or dealt in as a medium for investment,
- (d) any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under this Act, or
- (e) a credit balance in a securities account, unless the securities intermediary has expressly agreed with the person for whom the account is maintained that the credit balance is not to be treated as a financial asset under this Act.

Two interesting features of the definition are clauses (d) and (e), which permit the parties to opt in or out of the STA with respect to particular assets. For example, a client might ask her broker to treat gold bullion or swap contracts as financial assets, which would give the client the benefit of the insolvency provisions of the STA if the broker goes bankrupt. Despite its name, therefore, a security entitlement could extend beyond securities in the narrow sense. (It might more accurately be termed a “financial asset entitlement”, but “security entitlement” presumably was an awkward enough mouthful without adding more syllables.)

The fundamental characteristic of the security entitlement is that the entitlement holder's interest may be asserted only against the entitlement holder's own intermediary (for example, a client against his broker or the broker against the clearing agency).<sup>25</sup> One acquires a security entitlement only when it is created by the securities intermediary and one disposes of it when the entitlement is extinguished.

Section 95 sets out the two main methods by which a person acquires a security entitlement: (a) if the securities intermediary indicates by book entry that the financial asset has been credited to the person's securities account, or (b) if the securities intermediary receives a financial asset from the person and credits it to that person's account. There is no concept of a direct transfer of a security entitlement from one holder to another. Instead, the security entitlement of the transferor is extinguished and a new security entitlement in favour of the transferee is created. A transfer of the underlying financial asset could also result in the extinguishment of the transferor's security entitlement and the creation of a new one in favour of the transferee. Thus when a securities trade is settled by book-entries to the securities accounts maintained by the clearing agency and other intermediaries involved, the corresponding debit and credit entries to such securities accounts extinguish one property right (the transferor's security entitlement) and create another (the transferee's securities entitlement).

Likewise, an entitlement holder's property interest with respect to an underlying financial asset may not be asserted against a purchaser of the asset unless the securities intermediary is

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<sup>25</sup> See STA s. 95(3).

bankrupt, does not have sufficient assets to satisfy all entitlements, and has breached its statutory obligations, and the purchaser is not “protected” under s. 97(7).<sup>26</sup>

One advantage of this concept is that it eliminates problems associated with attempts to trace the underlying assets through the indirect holding system. One disadvantage (which may be more theoretical than real) is that it severs any connection between the entitlement holder and the issuer of the financial asset.

*(b) The Property Interest of an Entitlement Holder*

The nature of the property interest of an entitlement holder with respect to the underlying financial asset may be a matter of some concern if one regards the security entitlement as simply a bundle of contractual rights against the securities intermediary. At least one U.S. commentator has argued that that the security entitlement concept may disadvantage retail investors by exposing them to the insolvency risk of their brokers by forcing them to exchange a property interest for an unsecured contractual claim against the defaulting broker.<sup>27</sup> However, it is important to keep in mind that while entitlement holders do not have a direct right of action against the issuer of the financial asset, they do have a true property interest in the asset and not just a right of action against the securities intermediary. Section 97 makes this clear. Subsection (1) provides that to the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not the property of the securities intermediary and are not subject to claims of creditors of the

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<sup>26</sup> See discussion associated with note 21 above.

<sup>27</sup> For a critique of Revised Article 8 along these lines see Francis J. Facciolo, “Father Knows Best: Revised Article 8 and the Individual Investor”, 27 Florida State Univ. Law. Rev. 615.

securities intermediary, except as otherwise provided in section 105. Subsection (2) provides that the entitlement holder has a “proportionate interest” in all interests in the underlying financial asset, without regard to timing.

(c) *Position of Entitlement Holders on Broker Insolvencies*

The position of entitlement holders *vis à vis* a broker’s secured creditors and trustee in bankruptcy is admittedly not as strong as it would be if they held the financial assets directly, but arguably they are no worse than holders of beneficial interests in securities held by their brokers in “street form” or in a CDS account. As the Comment points out, applicable insolvency law rather than then STA will govern how financial assets held by an insolvent broker are distributed:

“Although this section describes the property interest of entitlement holders in the assets held by the intermediary, it does not necessarily determine how property held by a failed intermediary will be distributed in [bankruptcy or] insolvency proceedings. If the intermediary fails and its affairs are being administered in an [bankruptcy or] insolvency proceeding, the applicable [bankruptcy or] insolvency law governs how the various parties having claims against the firm are treated. For example, the distributional rules...under [Part XII of the Bankruptcy and Insolvency Act, entitled ‘Securities Firm Bankruptcies’] provide that [the ‘customer pool fund’] is distributed pro rata among all customers in proportion to [their ‘net equity’], rather than dividing the property on an issue by issue basis. For intermediaries that are not subject to the [Bankruptcy and Insolvency Act], other insolvency law would determine what distributional rule is applied.”<sup>28</sup>

If the securities intermediary has insufficient financial assets to satisfy both the entitlement holders and the securities’ intermediary’s creditors, section 105 determines priorities. If the other creditors do not have “control” over the financial asset, then the entitlement holders have

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<sup>28</sup> USTA, p. 203, Comment on USTA s. 108. Brackets in original.

priority. However, creditors who have control over a financial asset have priority over entitlement holders with respect to the financial asset. For example, if a broker has a line of credit with a bank secured by a general security agreement that includes particular securities as part of the collateral, but the security interest has been perfected only by registration rather than “control”, then entitlement holders having securities entitlements to those securities would have priority. However, if the bank held a pledge of those securities that has been perfected by control (either through a control agreement, discussed in more detail below, or by the bank becoming the entitlement holder) then the bank would take priority.

*(d) Entitlement Holders Have Rights Equivalent to Direct Holders*

Although entitlement holders do not have a direct property interest in the underlying securities, they generally enjoy rights that are equivalent to those of direct ownership. For example, an entitlement holder, through her intermediary, will receive interest and dividend payments and will be entitled to exercise voting and other rights and dispose of or pledge her interest by giving appropriate directions or “entitlement orders” to the securities intermediary.<sup>29</sup> An entitlement holder also has the right to direct her intermediary to change a security entitlement into another available form of holding, such as a registered holding on the books of the issuer with a security certificate in the holder’s name.<sup>30</sup> Existing provincial securities regulations will presumably continue to govern other responsibilities of securities intermediaries with respect to communications between issuers and entitlement holders.<sup>31</sup>

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<sup>29</sup> See STA ss. 99, 100.

<sup>30</sup> STA s. 100.

<sup>31</sup> For example National Instrument 54-101, “Communication with Beneficial Owners of Securities of a Reporting Issuer”. It is assumed that an entitlement holder would be regarded as a “beneficial owner” of the financial asset with respect to which the security entitlement is held. In time, we can expect NI 54-101 to be amended to clarify any ambiguity in its application to security entitlements and to adopt USTA terminology and property law concepts.

*(e) Translating the New Terminology*

Although the STA uses a new legal concept and changes the substantive legal analysis for many securities transactions, the STA should produce the same functional outcomes as the current law, but with more clarity and certainty. As is the case now, issuers will generally be unaware of the details of transactions involving their securities in the indirect holding system. Nor will market participants need to change the way they refer to securities transactions: section 17 of the STA provides in effect that references to the acquisition and transfer of a security through the indirect holding system will be deemed to refer to the appropriate transactions involving security entitlements. Under subsections 17(1) and (2), a person acquires a security or financial asset or an interest therein if the person acquires a security entitlement to the security or financial asset. Subsection 17(4) provides as follows:

(4) Unless the context of another statute, law, regulation, rule or agreement shows that a different meaning is intended, a person who is required by that statute, law, regulation, rule or agreement to transfer, deliver, present, surrender, exchange or otherwise put in the possession of another person a security or other financial asset satisfies that requirement by causing the other person to acquire an interest in the security or other financial asset as set out in subsection (1) or (2).

The combined effect of these sections is that little if any changes will need to be made to the terminology used in existing documentation for the purchase, sale and pledging of securities. Share purchase and subscription agreements can still refer to the underlying securities in respect of which the purchaser will acquire a security entitlement. Forwards requiring delivery of a specified financial asset need not be translated into security entitlement terminology to be legally effective.

More because of the inherent cautiousness and conservatism of institutional lenders than any real need, one exception may be security agreements, such as share pledges and general security agreements, granting security interests in the debtor's securities. The amendments to section 11(2) of the PPSA regarding attachment<sup>32</sup> specify as one of the indicia of attachment that the debtor has signed a security agreement that contains "a description of collateral that is a security entitlement, securities account or futures account, if it describes the collateral by any of those terms or as investment property *or if it describes the underlying financial asset or futures contract*". Given this wording, the customary grant of a security interest in all present or after acquired "securities" held by the debtor from time to time would appear to be sufficient to grant a security interest in security entitlements to those securities or the relevant securities accounts. There will therefore probably be no legal need to amend existing collateral descriptions. However, on a going forward basis for new transactions, one would expect that out of an abundance of caution secured lenders will want to add "security entitlements", "securities accounts", "financial assets" and "investment property" as defined in the STA and PPSA to the list of assets charged by a security agreement to ensure that the omission could not be construed as evidencing an intention to exclude those assets.

### **3. "Control" and Pledging Investment Property**

#### *(a) The Concept of Control*

Another key concept in the STA is "control". Control is the functional equivalent of possession in the case of certificated securities, but under the STA control is not limited to physical possession. Control replaces the awkward fiction of deemed possession in section 85 of the

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<sup>32</sup> STA s. 129.

OBCA in the case of indirectly held securities with a more flexible and functionally neutral concept. As the USTA Comment explains:

“The concept of ‘control’ plays a key role in various provisions dealing with the rights of purchasers including secured parties. See [s. 81<sup>33</sup> (protected purchasers); s. 108(7)<sup>34</sup> (purchasers from securities intermediaries); s. 115<sup>35</sup> (purchasers of security entitlements from entitlement holders); proposed OPPSA s. 22.1(1) . . . . (perfection of security interests); proposed OPPSA s. 28.1 . . . .(priorities among conflicting security interests)].”

“Obtaining ‘control’ means that the purchaser has taken whatever steps are necessary, given the manner in which the securities are held, to place itself in a position where it can have the securities sold, without further action by the owner.”

It should be noted that the term “purchaser” is much broader than “buyer” and includes a pledgee and other voluntary transferees.<sup>36</sup> Sections 23-28 deal with the manner in which a purchaser can obtain control.

*(b) Perfection of Security Interests by Control*

The chief practical consequence of the new concept of control will flow from the fact that, under the PPSA as amended by the STA, a security interest in “investment property” (which includes securities and security entitlements) may be perfected either by registration of a financing statement or by obtaining control.<sup>37</sup> “Control” with respect to each type of investment property is defined in section 1(2) by reference the relevant provisions of the STA. As is now the case with perfection by possession, control will be the preferable method because, with respect to the

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<sup>33</sup> STA s. 70.

<sup>34</sup> STA s. 97(7).

<sup>35</sup> STA s. 104.

<sup>36</sup> “Purchaser” means a “person who takes by purchase”; and “purchase” is defined as “a taking by sale, discount, negotiation, mortgage, hypothec, pledge, security interest, issue or reissue, gift or any other voluntary transaction that creates an interest in property”.

same collateral, a secured party having control over the investment property will take priority over one that does not have control.<sup>38</sup> In addition, by obtaining control secured parties that give value can become “protected purchasers” who will take priority over earlier security interests, even if perfected by registration.<sup>39</sup> With respect to security interests in security entitlements, perfection through control will be straightforward and legally certain, as is not the case now with security interests in securities held through a clearing agency.

One exception to the new control regime is in section 22(2) of the PPSA, which provides that a secured party may perfect a security interest in a certificated security by taking delivery of the certificated security under section 68 of the STA. Presumably this is meant to reflect existing market practice whereby pledges of certificated securities (and perfection of the security interest by possession) can be effected by simply delivering the security certificate, without endorsement. In contrast, “control” of a certificated security by a purchaser requires in addition to delivery, that the certificate be endorsed to the purchaser or in blank or registered in the name of the purchaser.<sup>40</sup>

Note that perfection of a security interest in a securities account also perfects a security interest in the security entitlements carried in the securities account.<sup>41</sup> Accordingly a broker or lender will be now able to perfect a security interest in all of a customer’s securities credited to a trading account by perfecting a security interest in the account. While since 1989 it has been possible to perfect a security interest in a securities account holding book-based securities by registration of

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<sup>37</sup> PPSA s. 22.1(1), as amended by STA s. 134.

<sup>38</sup> PPSA s. 30.1(2), as amended by STA s. 138.

<sup>39</sup> PPSA s. 28.1(2), as amended by s. 137.

<sup>40</sup> STA s. 23(2).

financing statement,<sup>42</sup> there was no practical method to do so by constructive possession without having positions in each security transferred to a collateral or pledge account held with the clearing agency. The same legal effect can now be achieved by obtaining control over the securities account through a control agreement.

(c) *Control in the Direct Holding System*

Sections 23 and 24 govern control in the direct holding system. With certificated securities, not much has changed: control is obtained in the case of a bearer security by delivery<sup>43</sup> of the certificate and in the case of a registered certificate either by delivery of an endorsed security certificate or registration of the security certificate in the name of the purchaser.<sup>44</sup>

With uncertificated securities, the rules are more complex. (An uncertificated security is simply a security not represented by a certificate.<sup>45</sup> It is not the same as what are now commonly referred to as a “book-based security” or “book-entry security”, which is a security (either certificated or uncertificated) held through a securities intermediary and would correspond roughly to a security entitlement.) A purchaser has control of an uncertificated security (a) if the uncertificated security is delivered to the purchaser or (b) the issuer has agreed that the issuer will comply with instructions that are originated by the purchaser without the further consent of the registered owner.<sup>46</sup> “Delivery” of an uncertificated security to a purchaser occurs when the

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<sup>41</sup> PPSA s. 19.1(1), as amended by STA s. 131.

<sup>42</sup> A securities account would be either an “intangible” or an “account”.

<sup>43</sup> Section 68(1) sets out what constitutes “delivery” in the case of a certificated security: essentially it requires that either the purchaser, another person acting for the purchaser or the purchaser’s securities intermediary acquire possession of the security certificate.

<sup>44</sup> STA s. 23.

<sup>45</sup> STA s. 1(1).

<sup>46</sup> STA s. 24.

issuer registers the purchaser as the registered owner or another person becomes the registered owner on behalf of the purchaser or acknowledges that the person holds the uncertificated security for the purchaser.<sup>47</sup> The most radical change here is with respect to use of an agreement with the issuer to establish control. Functionally, such an agreement operates much the same way as a “control agreement” with a securities intermediary, discussed in more detail below.

Applying these rules to a conventional pledge of certificated shares in registered form by a private company to a bank lender, the lender’s practice would remain largely unchanged: as is the case today, to obtain control the lender would either take delivery of endorsed share certificates or have itself registered on the books of the company as the shareholder. As uncertificated securities become more common in the private company context, lending practice will no doubt evolve to accommodate agreements with the issuer as well as having the lender registered as the shareholder. One would expect that the latter will still be regarded as a superior method of obtaining control where the issuer is related to the pledgor (as in the case of an owner/manager of a small company pledging her shares to secure her obligations under a personal guarantee of the company’s indebtedness to the lender). If in breach by the company of its obligations under the control agreement, the company permits the shares to be transferred to a third party without notice of the lender’s adverse claim, as a “protected purchaser” the third party could defeat the lender’s security interest, leaving the lender with only an unsecured claim against the company.<sup>48</sup>

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<sup>47</sup> STA s. 68(2).

<sup>48</sup> See STA s. 70.

(d) *Control in the Indirect Holding System*

(i) *Methods of Obtaining Control*

A purchaser obtains control of a security entitlement in one of three ways: (a) by becoming the entitlement holder (for example, by having the pledgor's position in the underlying financial assets debited to the pledgor's account and credited to an account of the pledgee); (b) by entering into what is commonly referred to as a "control agreement" with the securities intermediary; or (c) by having a third party take control of the security entitlement on behalf of the purchaser or acknowledging that the person has such control.<sup>49</sup>

(ii) *Control Agreements*

Control by agreement with the securities intermediary may enable a major shift in current secured lending practices involving indirectly held securities. A purchaser may obtain control of a security entitlement through an agreement whereby the securities intermediary has agreed that it will comply with "entitlement orders" that are originated by the purchaser without the further consent of the entitlement holder.<sup>50</sup> An entitlement order is "a notice given to a securities intermediary directing the transfer or redemption of a financial asset to which the entitlement holder has a security entitlement".<sup>51</sup> As the market evolves, control agreements will no doubt become a common and relatively simple method whereby a secured party can perfect its security interest in a securities account or specific indirectly held securities – where it is impractical or undesirable for the secured party to become the entitlement holder.

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<sup>49</sup> STA s. 24.

<sup>50</sup> STA s. 25(1)(b).

<sup>51</sup> STA s. 1(1).

Note that control by agreement need not be exclusive to the purchaser: the entitlement holder can still retain the right to make substitutions for the security entitlement, originate entitlement orders or otherwise deal with the security entitlement.<sup>52</sup> Presumably the security or pledge agreement whereby the entitlement holder grants the security interest to the pledgee will set out the circumstances under which control passes exclusively to the pledgee, such as on the occurrence of an event of default permitting realization of the security, while permitting the entitlement holder to deal with the collateral to some extent prior to default and replace it with other collateral as agreed with the pledgee. Accordingly with respect to directly held securities, documentation and market practice need not change dramatically from the way share pledge agreements now commonly operate. As is the case now, the pledgor may be permitted to vote the pledged shares, receive dividends and interest and even replace the shares with securities of equivalent value. These practices can continue, if the relevant agreements so provide.

Control agreements cannot be forced on either owners of the investment property or third parties. The consent of the entitlement holder is required for such an agreement, the securities intermediary is not required to confirm its existence to a third party unless requested by the entitlement holder and a securities intermediary is not required to enter into such an agreement even if the entitlement holder so requests.<sup>53</sup> There are parallel provisions for uncertificated securities.<sup>54</sup> In practice economic and competitive pressures may render these protections somewhat illusory. If lenders routinely require the requisite control agreements by the pledgor as a condition precedent to funding, obtaining such consents may be little more than a formality

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<sup>52</sup> STA s. 25(2).

<sup>53</sup> STA s. 28.

<sup>54</sup> STA s. 27.

since they will likely be included in the relevant security documents and credit agreement. The extent to which investment dealers and other securities intermediaries will agree to be bound by control agreements to facilitate loans to their clients will likely be determined by evolving market practices and the securities intermediaries' ability to mitigate any risks associated with their role. A useful analogy is the "blocked account agreement" now widely used in Canada as a means of providing an asset-based lender or purchaser of receivables a measure of control over the cash generated by the pledged or purchased assets. In recent years deposit taking institutions have been prepared to enter into such agreements as an accommodation to their customers. But in my experience, negotiations of indemnity, set-off and waiver of liability provisions in such agreements have become increasingly difficult and contentious as liability concerns increase.

#### **4. New Conflict of Laws Rules in the STA and PPSA**

Due to the internationalization, volume and speed of securities transactions, one of the most important features of the STA and companion PPSA amendments will be to provide clear and certain conflict of laws rules. These rules determine which jurisdiction's laws apply to a transaction involving securities or security entitlements. Given the high degree of interconnectivity between Canadian and U.S. capital markets, it is crucial that the conflict of laws rules in Ontario be consistent with those applicable across the U.S.

##### *(a) Law Governing Validity*

Section 44 of the STA sets out what law governs the validity of a security. Essentially it is the law of the issuer's jurisdiction. For a federally incorporated corporation this is the law of Canada and the law of the province or territory in Canada in which the issuer has its registered or head office. For the federal Crown, it is the law of Canada and any other jurisdiction specified

by the issuer,<sup>55</sup> and for the provincial Crown the relevant province. In any other case, it is the jurisdiction under which the issuer is incorporated or otherwise organized. In each case the rules governing conflict of laws are excluded to prevent the “ping pong” problems raised by the doctrine of *renvoi*.

(b) *Securities Entitlements: Law of Securities Intermediary’s Jurisdiction*

Where the new conflicts rules in the STA and the conforming amendments to the PPSA will prove to be of greatest practical benefit will be with respect to securities entitlements. Section 45(1) provides that it is *the law of the securities intermediary’s jurisdiction* that governs the acquisition of a security entitlement from the securities intermediary, the rights and duties of the parties to the transaction and the rights of those who assert an adverse claim. New section 7.1(c) and 7.1(2)(c) of the PPSA<sup>56</sup> provide that the validity, perfection, the effect of perfection or of non-perfection and the priority of a security interest in investment property that is a security entitlement or securities account is also governed by the law of the securities intermediary’s jurisdiction.

These rules will render simple and straightforward the task of determining where to perfect a security interest in a security entitlement or securities account. First, unlike sections 5 and 7 of the PPSA, no distinction is made between whether the security interest is “possessory” or “non-possessory”. Second, instead of having to puzzle out where a security held through the indirect holding system is “situated” for conflicts purposes (now a nearly impossible task), one need only

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<sup>55</sup> This may be necessary if, once all the provinces enact a version of the USTA, the federal government vacates the field by removing those provisions of federal corporate legislation that overlap the USTA, such as Part VII of the CBCA.

<sup>56</sup> As amended by STA s. 126.

determine the “securities intermediary’s jurisdiction”. Section 45(2) sets out five simple “cascading” tests to make this determination: the securities intermediary’s jurisdiction is:

1. the jurisdiction expressly designated in the account agreement between the securities intermediary and its entitlement holder as the security intermediary’s jurisdiction;
2. if 1 does not apply, the jurisdiction designated in the governing law clause of the account agreement, if any;
3. if 1 or 2, does not apply, the jurisdiction of the office where securities account is maintained if specified in the account agreement;
4. if none of the preceding paragraphs applies, the jurisdiction in which the office identified in an account statement as the office serving the entitlement holder’s account is located; and
5. if none of the preceding paragraphs applies, the jurisdiction in which the chief executive office of the securities intermediary is located.

In practice, the account agreement can be expected to almost always expressly designate the jurisdiction, so that the analysis will begin and end at first test.

In addition, section 45(3) sets out a “black list” of matters that are *not* to be taken into account in determining the securities’ intermediary’s jurisdiction, even though each may have been used in the past to determine the *situs* of securities – the physical location of the certificates, the jurisdiction of the issuer or the location of the data processing or record keeping facilities.

Applying these tests will of course require some change in the due diligence required to determine where to perfect a security interest in securities, but it will greatly simplify the analysis. If a bank lender A wishes to take security over securities beneficially owned by borrower D and held in a brokerage account with investment dealer B, A will likely require, well in advance of closing, a certificate of the borrower attaching a copy of the account agreement between D and B, and if these are not determinative, a certificate from an officer of B setting out

the usual indicia for determining the location of the chief executive office. In most cases this additional step probably will not be necessary.

Once these new conflicts rules are in effect, it will no longer be necessary to include in legal opinions regarding perfection of security interests in securities the common qualification that no opinion is expressed as to the law governing perfection of the security interest, which obviously renders the opinion much less useful to the recipient. Once a security intermediary's jurisdiction has been determined to be Ontario, the opining lawyer can say with confidence that Ontario law governs perfection of security interests in security entitlements held by that securities intermediary's entitlement holders.

## **5. Priorities Under the Amended PPSA**

Under the PPSA as amended by the STA, because security interests in securities and other investment property can be perfected by control, new rules are necessary to govern the priority of competing security interests in the same investment property. These are clearly set out in section 30.1 of the PPSA.<sup>57</sup> The basic rules are as follows:

- (a) A security interest of a secured party having control has priority over that of a secured party not having control.<sup>58</sup>
- (b) A security interest in a certificated security in registered form perfected by delivery has priority over a security interest perfected otherwise than by control.<sup>59</sup>
- (c) Conflicting security interests of parties each of which has control rank according to priority in time:

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<sup>57</sup> As amended by section 138 of the STA.

<sup>58</sup> PPSA s. 30.1(2).

<sup>59</sup> STA s. 30.1(3).

- (i) if the collateral is a security, obtaining control;
- (ii) if the collateral is a security entitlement carried in a securities account
  - (1) the secured party's becoming the account holder;
  - (2) the date of the relevant control agreement; or
  - (3) if the secured party obtained control through a third party, the time on which priority would be based if the third party were the secured party.<sup>60</sup>

(It is not entirely clear from these rules how one would resolve a contest between Secured Party A, who obtained a control agreement on August 1, and Secured Party B, who became the account holder on September 1.<sup>61</sup> Does B win, or does one revert to the fallback rule in section 30(1) 3, which provides that where priority is determined between security interests perfected otherwise than registration, priority shall be determined by the order of perfection, in which case A would prevail?) The practical effect of these rules will likely be to encourage secured lenders to insist on perfection through control and exercise more vigilance over their debtors. Otherwise a security interest perfected by registration could be defeated by a later one perfected by control. Since priority could be obtained through an unregistered control agreement with the securities intermediary, a lender taking security in security entitlements would be well advised to insist on a certificate or representation from the securities intermediary that no competing control agreements exists.

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<sup>60</sup> PPSA s. 30.1(4).

<sup>61</sup> Presumably, in this hypothetical, Secured Party A's securities intermediary would have to deliver the underlying securities to Secured Party A, failing which, it would be liable in damages to Secured Party A. Secured Party B, as a protected customer, would acquire its interest in the securities registered in its name free of Secured Party A's adverse claims.

## 6. Other PPSA Amendments

### (a) *Rehypothecation*

One of the continuing issues under the PPSA is whether a secured party is permitted to use and even sell collateral in the form of securities. This “rehypothecation” issue frequently arises in the context of securities lending and “repo” agreements where market practice dictates that secured parties be permitted to sell the collateral to third parties free and clear of any adverse claim by the original owner. Section 17.1 will make it clear that, unless otherwise agreed, a secured party having control over investment property as collateral may create a security interest in the collateral and may sell, transfer, use or otherwise deal with the collateral in the manner and to the extent provided in the security agreement.<sup>62</sup> While this may be thought to give rise to opportunities to abuse, preventive control of securities intermediaries is a matter of securities regulatory law, not property transfer law.

### (b) *Transition*

Amended section 84 of the PPSA sets out the transitional rules governing perfection of security interests in securities. No further action will be required to continue perfection of the security interest if the security interest in the security was a perfected security interest immediately before this section comes into force and the action by which the security interest was perfected would suffice to perfect the security interest under the STA.<sup>63</sup> Accordingly security interests perfected by registration or physical possession of security certificates would remain perfected.

However, there is a grace period of four months after s. 84 comes into force for security interests perfected before the section comes into force but “the action by which the security interest was

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<sup>62</sup> PPSA s. 17.1(1)(c), (2).

perfected would not suffice to perfect the security interest” under the STA.<sup>64</sup> For example, if the STA comes into force on June 1, a security interest in a book-based security perfected by constructive possession under s. 85 of the OBCA on May 30 would remain perfected only until October 1 and would remain perfected only if the secured party obtained control of the security entitlement or securities account or registered a financing statement before October 1.

## 7. Other Noteworthy Provisions

### (a) *Paramountcy of Clearing House Rules*

Section 7(1) of the STA provides as follows:

A rule adopted by a clearing agency governing rights and obligations between the clearing agency and its participants or between participants in the clearing agency is effective even if the rule conflicts with this Act or the Personal Property Security Act and affects another person who does not consent to the rule.

I understand that during the consultation phase that preceded introduction of the STA this proposal aroused some controversy. It was argued that permitting the rules of a clearing agency (such as the Participant Rules of CDS) to prevail over legislation gave privileged status to a private party, and since the rules can affect third parties (such as creditors) that did not consent to them, they could even be construed as delegating legislative authority to the private sector. However, the rationale behind the rule (set out in s. 54 of the USTA), drawn from a parallel provision in Revised Article 8, is to promote systemic stability. This is explained at some length in the USTA Comment<sup>65</sup>:

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<sup>63</sup> PPSA s. 84(2), as amended by STA s. 141.

<sup>64</sup> PPSA s. 84(3).

<sup>65</sup> USTA, pp. 114-115.

The experience of the past few decades shows that securities holding and settlement practices may develop rapidly, and in unforeseeable directions. Accordingly, it is desirable that the rules of [the USTA] be adaptable both to ensure that commercial law can conform to changing practices and to ensure that commercial law does not operate as an obstacle to developments in securities practice. Even if practices were unchanging, it would not be possible in a general statute to specify in detail the rules needed to provide certainty in the operations of the clearance and settlement system.”

“The provisions of [the USTA] provide considerable flexibility in the specification of the details of the rights and obligations of participants in the securities holding system by agreement. See [sections 109-113<sup>66</sup> and s. 13(3)<sup>67</sup>]. Given the magnitude of the exposures involved in securities transactions, however, it may not be possible for the parties in developing practices to rely solely on private agreements, particularly with respect to matters that might affect others, such as creditors. For example, in order to be fully effective, rules of [clearing agencies] on the finality or reversibility of securities settlements must not only bind the participants in the [clearing agency] but also be effective against their creditors. . . . Section 54<sup>68</sup> provides that [clearing agency] rules are effective even if they indirectly affect third parties, such as creditors of a participant. This provision does not, however, permit rules to be adopted that would govern the rights and obligations of third parties other than as a consequence of rules that specify the rights and obligations of the [clearing agency] and its participants.

As for concerns that unregulated and unelected third party clearing agencies could in effect be making binding legislation, one should bear in mind that section 7(1) applies only to a clearing agency that has been recognized or exempted from recognition<sup>69</sup> under section 21.1 of the *Securities Act*<sup>70</sup> and that “clearing agency” itself is defined in such a way that some regulatory oversight is ensured: it must be recognized or otherwise regulated as a clearing agency or

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<sup>66</sup> STA ss. 98-102.

<sup>67</sup> STA s. 5.

<sup>68</sup> STA s. 7(1).

<sup>69</sup> STA s. 7(2).

<sup>70</sup> R.S.O. 1990, c. 5.5.

clearing house by a provincial securities regulator and must be either a securities and derivatives clearing house for the purposes of section 13.1 of the *Payment Clearing and Settlement Act*<sup>71</sup> or whose clearing and settlement system is designated under Part I of that Act, which latter requirements in effect involve regulation by the Bank of Canada.

*(b) Application to Government Securities*

Another set of somewhat controversial provisions in the STA are those exempting federal and provincial governments from the application of certain other provisions binding on issuers generally. During the consultation phase in the fall of 2005, the Ministry of Government Services solicited the views of a number of lawyers and stakeholders on these carve-outs, including the author and Wayne Gray.

Section 8 relates to application of the STA to the federal and provincial Crowns. Subsection (1) provides, unsurprisingly, that the Act applies to the Crown in right of Canada, the Crown in right of Ontario and the Crown in right of any other province of Canada, and any agencies of them. However, this is subject to subsections (2) and (3), which to some extent provide a separate regime for the Crown as issuer. Subsection (2) provides that nothing in the STA shall be construed as affecting any right, privilege or immunity, at common law, in equity or under any other Act, of the federal or provincial Crowns. Interestingly, this language is actually broader than the optional provision proposed in section 12(2) of the STA, whose scope is restricted to exempting the Crown from execution, injunctive relief or specific performance, which privileges are well established at common law. The more comprehensive language in the STA could conceivably give rise to some legal uncertainty with respect to the extent to which governments

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<sup>71</sup> R.S.O. 1985, c. P-●.

would be able to invoke such ill-defined common-law doctrines as Crown prerogative or Crown immunity.

Subsection 8(3) exempts government “legacy” securities from application of the STA: the Act does not apply to a government or any agency of it as an issuer in respect of a security issued before the section comes into force or to a security issued by a government or any agency of it before the section comes into force, except as otherwise expressly provided in the terms and conditions of the security. Aside from the uncertainty and possible perception of unfairness created by the government itself giving existing government securities the benefit of a regime possibly more favourable than for those issued by non-government issuers, this provision may be difficult to apply in practice to book-entry government securities now held through CDS given that the legislation that now governs such securities (such as section 85 of the OBCA) will have been repealed, leaving one to struggle with the even more inadequate common law. In addition, it seems unlikely that many government securities issued before the STA comes into force will expressly provide that the exemption does not apply.

Section 57 also creates a special regime for certificated government securities containing unauthorized signatures or other defects. With respect to the effect of unauthorized signatures, subsection (1) provides that an unauthorized signature placed on a security certificate before or in the course of issue is ineffective except that the signature is effective in favour of a purchaser for value of the certificated security if the purchaser is without notice of the lack of authority and the signing has been done by: (a) an authenticating trustee, registrar, transfer agent or other person entrusted by the issuer with the signing of the security certificate or of any similar security certificate or with the immediate preparation for signing of any of those security certificate; or (b) an employee of the issuer, or of any persons referred to in clause (a), entrusted

with responsible handling of the security certificate. However, subsection (3) provides that, with respect to certificated government securities, an unauthorized signature is valid in the hands of a purchaser without notice of the lack of authority only if “the signing has been done by an employee of the issuer entrusted with responsible handling of the security certificate”.

Conceivably, therefore, a certificated government bond signed by an unauthorized rogue employee of a custodian or transfer agent of the provincial government would be invalid even in the hands of a purchaser for value who had no way of knowing that the employee lacked such authority. Of course the likelihood of a rogue employee of an institutional transfer agent signing, say, an issue of Ontario savings bonds is probably small, and the likelihood of the Province denying liability even smaller; in addition, a forged certificate would be ineffective in any event since section 58 provides that except as provided in section 57 “lack of genuineness of a certificated security is a complete defence, even against a purchaser for value and without notice”. However, the special regime in section 57(3) does introduce an element of uncertainty and shifts the burden of due diligence onto purchasers who are probably in no position to discharge it.

Likewise subsection 57(4) places a similar burden on purchasers of otherwise defective government securities:

A security issued with a defect going to its validity is deemed to be valid if held by a purchaser for value and without notice of the defect and, in the case of such a security issued by a government or agency of it, if there has been substantial compliance with the legal requirements governing the issue.

It seems somewhat unfair to expect the purchaser of a government security without notice of a defect to determine whether “there has been substantial compliance with the legal requirements governing the issue” or accept the risk of invalidity if there has not. Does this mean that before I

purchase a provincial government bond I must obtain a legal opinion that it complies with the restrictions on debt issues under the *Financial Administration Act* and the relevant regulations and other “legal requirements”? This may be market practice with respect to some very large special-purpose government issues distributed by underwriters, such as municipal debentures, but surely a routine purchase of a treasury bill should not impose this burden. And what is “substantial compliance”? Again, interestingly enough, this provision is more generous to government issuers than its counterpart in the USTA: under section 66(4)(b) of the USTA a defective government security is valid in the hands of a purchaser without notice either if there has been substantial compliance with the legal requirements governing the issue or “the issuer has received a substantial consideration for the issue as a whole or for the particular security and a stated purpose of the issue is one for which the issuer has power to borrow money or issue the security.” Although still providing special safeguards to governments, this alternative would at least seem to strike a fairer balance between protecting the public purse and the reasonable expectations of purchasers who have no way to determine that an apparently valid government security, the proceeds of which end up in the consolidated revenue fund, actually has a fatal defect.

It remains to be seen whether this special treatment for government securities will survive the committee stage. If it does, other provinces could gain a competitive advantage over Ontario by not including these provisions in their version of the USTA. Ultimately, Ontario taxpayers may pay for these dubious advantages by paying an additional risk premium on Ontario debt obligations.

## 8. Execution Against Securities

The STA and conforming amendments to the *Execution Act* will clarify the means by which execution creditors can seize securities and security entitlements.<sup>72</sup> A certificated security may be seized only by actual seizure of the certificate, unless (a) it has been surrendered to the issuer, in which case notice can be given to the issuer, or (b) the certificate is in the possession of the secured party, in which case notice can be given to the secured party.<sup>73</sup> An interest in a security entitlement may be seized by the sheriff giving notice of the seizure to the relevant securities intermediary or to the secured party in whose name the security entitlement is maintained.<sup>74</sup> There are corresponding amendments to the *Execution Act* that set out in some detail provisions relating to seizure of investment property by a sheriff.<sup>75</sup>

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## Conclusion

Once the STA becomes law, transactions involving the disposition or creation of security entitlements and transactions involving security entitlements as collateral will operate on a much firmer legal basis than is now the case. As a result, Canadians will be able to speak the same language as their colleagues to the south when it comes to capital market transactions.

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<sup>72</sup> STA ss. 49-51 and amendments to the *Execution Act*.

<sup>73</sup> STA ss 48, 51.

<sup>74</sup> STA 50, 51.

<sup>75</sup> *Execution Act*. ss. 14, 15 and 16 as amended by STA s. 143.

The STA and the companion changes to the PPSA, OBCA and the *Execution Act* collectively represent the closing of an enormous gap between existing market practices and the legal regime that underpins it. These represent changes that clients and their counsel should embrace.