

Business Beat

BUSINESS LAW SECTION / SECTION DU DROIT DES AFFAIRES

A Primer on the *Uniform Securities Transfer Act*

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1. Why Practitioners Need to Know About the USTA

While the *Uniform Securities Transfer Act* (USTA) is not yet law, corporate-commercial and banking practitioners would do well to familiarize themselves with the USTA and understand what it will mean to their daily practices. Although the date of arrival of the USTA, and the companion changes to the *Personal Property Security Act* (PPSA) and the *Business Corporations Act* (OBCA), is not yet known, arrive it will and, with any luck, sooner than many may think. Draft legislation has been prepared.¹ As part of the public hearings held on August 18 and 19, 2004 on the Five-Year Review Committee's Final Report² reviewing the *Securities Act*, the Ontario Legislature's Standing Committee on Finance and Economic Affairs received powerful endorsements for early implementation of the USTA from the Ontario Securities Commission (OSC), The Canadian Depository for Securities Limited (CDS), the Canadian Bankers Association, the Ontario Bar Association³ (OBA), the Toronto Opinion Group⁴ (TOROG) and others.⁵

Early familiarization with the USTA will be an advantage. Its technical complexity demands a steep learning curve.

2. What is the Current Law?

Currently, transfers of investment securities are dealt with in Part VI of the OBCA, which is certainly the least known part of the statute. It is also the Part most in need of wholesale revision. Unlike most of the OBCA, Part VI goes beyond securities issued by an OBCA "corporation". Part VI applies to securities issued by any "body corporate" including, subject to conflict-of-laws rules, foreign bodies corporate. However, with one exception in s. 85, it does not generally extend to securities issued by non-corporate enterprises such as limited partnerships, real estate investment trusts or income trusts. Nor, subject to that same exception, 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.

3. What is Wrong with the Current Law?

Part VI of the OBCA, like its companion provisions in the *Canada Business Corporations Act* (CBCA) and other Canadian corporation legislation, is modeled on an old, largely antiquated concept of securities holding. With limited



exceptions, Part VI only contemplates a direct holding system where owners of securities have a direct relationship with the issuer and hold physical security certificates.

While the direct holding system still dominates the private company market, publicly-traded securities are now generally held and traded through a complex network of intermediaries, 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 (some 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 eliminated.

The indirect holding system therefore 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 trillion worth of securities on deposit. The gross value of securities that are traded on the records of CDS on an average day ranges from \$100 - \$150 billion.⁶ In the U.S., DTC holds about \$25 trillion worth of securities and processes about \$100 trillion in settlement obligations annually.⁷

However, the current law in Canada does not recognize the reality of the indirect holding system. Nor does it treat in a coherent way the nature of property rights within that system.

Part VI of the OBCA, with the exception of s. 85, was designed only for the direct holding system.

As such, it assumes the possession and delivery of security certificates and is wholly inadequate to deal with the indirect and book-based settlement systems. Section 85 creates an awkward fiction of "constructive" delivery and possession of indirectly held securities that does not accurately reflect market practice, nor does it adequately address the tiers of intermediaries below the direct participants of CDS. Moreover, while the PPSA permits perfection of security interests in securities by "possession", this concept only works imperfectly with the indirect holding system, and there is serious uncertainty regarding where a "book-based security" is "situated" for the purpose of applying the conflict-of-laws rules.

The structural problems with the prevailing legal edifice are compounded due to the volume of cross-border transactions, the lack of inter-jurisdictional uniformity and the difficulties of determining the applicable law governing even a simple retail securities transfer. Operationally, the indirect holding and book-based system is highly efficient compared with the direct holding system. But legally, its foundations are surprisingly shaky and in some respects non-existent.

4. Background to the Reform 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 1993 report of the Alberta Law Reform Institute on *Transfers of Investments Securities*.⁸ The U.S. source is revised Article 8 of the *Uniform Commercial Code* (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 has worked well.

Revised Article 8 is now serving as the model for the Canadian legislative proposals in this field. 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, there is a major structural difference between revised Article 8 and the USTA. 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 is not contained in a single statute like the UCC but instead resides piecemeal in separate PPSAs and in various corporate and other

statutes at the provincial and federal level⁹ which currently address, in patchwork fashion, transfers of securities in corporate issuers. Implementation of the USTA will, therefore, also involve companion changes to the PPSA and the OBCA. 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 loans.

As a result of the USTA regime, most of OBCA Part VI's direct holding system rules will disappear and resurface in substantially similar form in a separate, stand-alone USTA statute. What would be left of Part VI would deal primarily with the issuance of share certificates of an OBCA corporation as a 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.

5. What Implementation of the USTA Will Mean

The USTA is commercial property-transfer law, which governs the transfer and holding of securities and interests in securities. It 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. In contrast, the USTA 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 the capital markets require.

The USTA only deals with the settlement side of a transaction involving the purchase or sale of 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 USTA does not deal with the payment side of the transaction.

The USTA and the companion changes to the OBCA and PPSA will radically reform, even revolutionize, the law applicable to the transfer and pledge of securities in Ontario. If the work of the USTA Task Force is successful, implementation of the USTA will result in 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.

In short, the USTA 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. The adoption of the USTA will further the goal of post-transaction finality, increasing the reliance that can be placed on settled securities transactions. It will facilitate the market for loans collateralized by a portfolio of investment securities including everything from cross-border transactions to consumer-level secured loans. It will enable lawyers to provide transaction opinions with confidence, a task that the current confused state of the law makes all but impossible.

6. Nature of "Security Entitlement" and Trades Involving Security Entitlements

The central concept introduced by the USTA, and 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 more rational description of the rights and property interest that is central to the indirect holding system.

A 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). This means that, when securities market transactions are normally 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 result not in the transfer of a single property right but rather in the extinguishment of one property right (the transferor's security entitlement) and the creation of another (the transferee's securities entitlement). One advantage of this concept is that it eliminates problems associated with attempts to trace the underlying assets through the indirect holding system.

Although entitlement holders do not have a direct property interest in the underlying securities, they generally enjoy rights that are equivalent to direct ownership. For example, an entitlement holder, through her intermediary, will receive interest and

dividend payments, receive notices, be entitled to exercise voting rights and be able to dispose of or pledge her interest. 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. It should be noted that direct registration is not available with some securities because they are issued in book-entry form only (e.g., especially government bonds and other non-corporate securities). While shares in OBCA and CBCA corporations must now be issued in registered form, and a registered shareholder is entitled to receive a share certificate, in some jurisdictions (e.g., most of the U.S. states) corporations are permitted to issue shares for which no certificate is ever made available.

Although the USTA uses a new legal concept and changes the substantive legal analysis for many securities transactions, the USTA should produce the same functional outcomes as current law, but with more clarity and certainty. For example, in the unlikely event that an intermediary becomes insolvent, customers of that intermediary will generally have the same rights as under current law. Similarly, 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: the USTA provides in effect that references to the transfer of a security through the indirect holding system will be deemed to refer to the appropriate transactions involving security entitlements.

7. Pledging Security Entitlements

As a combined result of the USTA and the changes to the PPSA, secured lending and other transactions collateralized by interests held through the indirect holding system would be conducted on a much firmer legal basis than at present. Here, the central concept is that the lender would perfect its security interest by obtaining "control" of the security entitlement. The lender obtains control by taking the steps necessary to enable it to sell the collateral without further involvement of the debtor. Control, therefore, would replace the existing concepts of actual or constructive possession. A lender would be able to obtain control of investment property in several different ways. First, in the case of securities represented by a definitive certificate, the lender

would obtain control as it would now, by physical possession of the security certificate. Second, in the case of security entitlements, the lender could either become the entitlement holder by having the security entitlement credited to the lender's account (by way of the debit and credit mechanism described above) or by obtaining a tri-partite account control agreement.¹⁰ Under an account control agreement, the debtor's intermediary would agree to act on entitlement orders received from the lender.

Perfection could still be effected through registration under the PPSA. However, priority rules would dictate that the secured party who obtains control has priority over a secured party who does not obtain control, making control the best available method of perfection, as is now the case with possession. "Cut-off" rules would also confer protected status on parties having control of securities entitlements.

8. Conclusion

Once the USTA becomes law, practitioners can expect to see many more transactions involving the disposition or creation of securities entitlements and transactions involving security entitlements as collateral. These transactions will displace transactions involving the underlying securities. As a result, Canadian lawyers will be able to speak the same language as their colleagues to the south when it comes to capital market transactions.

While there will be a period of transition before all of us become used to the new law, the USTA and the companion changes to the PPSA and OBCA will soon be seen for what they are: the closing of an enormous gap between existing market practices and the legal regime that underpins it. These represent changes that practitioners should embrace.

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Administrators (CSA) and Mr. Spink is a consultant to the OSC on the Task Force.

¹ The USTA Task Force published a revised Consultative Draft USTA with detailed comments, along with related PPSA and OBCA amendments and other materials, on May 28, 2004. The material is available in both English and French on the OSC website (see <http://www.osc.gov.on.ca>, under "Hot Topics"). A final version of the USTA was adopted as a uniform act by the Uniform Law Conference of Canada (ULCC) in Regina, Saskatchewan on August 26, 2004. The USTA has been developed by the USTA Task Force as a joint project with the ULCC.

² Five Year Review Committee - Final Report - Reviewing the Securities Act, March 21, 2003 (2003) 26 O.S.C.B. (Supp-2). The Five-Year Review Committee was appointed by the Ontario Ministry of Finance pursuant to the *Securities Act* (Ontario).

³ Mr. R. John Cameron spoke on behalf of the OBA.

⁴ Mr. Scavone spoke with the endorsement of TOROG.

⁵ While the Five-Year Review Committee's principal mandate was to review Ontario securities law, it made a powerful recommendation on the USTA, which is not securities regulatory law. See Recommendation 5 - Para. 2.3 - pages 48 to 50 of the Five-Year Review Committee's Final Report.

⁶ Eric T. Spink and Maxime A. Paré "The *Uniform Securities Transfer Act*: Globalized Commercial Law For Canada" (2004), 19 B.F.L.R. 321 at 327-8. Messrs. Spink and Paré cite the CDS website for these statistics.

⁷ *Ibid.*, at 328. Messrs. Spink and Paré cite the website of DTC's parent, Depository Trust & Clearing Corporation, for these statistics.

⁸ Alberta Law Reform Institute Report No. 67—*Transfers of Investment Securities*, June 1993.

⁹ This area of law at the federal level is found in the *CBCA, Bank Act, Trust and Loan Companies Act, Insurance Companies Act, Cooperative Credit Associations Act*, and *Depository Bills and Notes Act*.

¹⁰ The parties to an account control agreement consist of the lender, the debtor-customer and the intermediary.