

The Uniform Securities Transfer Act (USTA)

A. Why we need it.

1. What is the USTA proposal?

The USTA proposal will modernize Canadian commercial law rules governing the property rights that exist whenever securities are bought, sold, or used as collateral.

These rules apply to Canadian securities market transactions which are valued in the hundreds of billions of dollars per day. They are critically important to the safety and efficiency of the Canadian securities settlement system, and to the global competitiveness of Canadian market participants. Yet the role of these commercial law rules in our securities market is generally not well understood and the current rules have been neglected to the point where they no longer adequately serve our needs.

Existing Canadian commercial law governing the transfer and pledge of securities is based on the traditional concepts of delivery and possession of certificates. In practice, certificates are rarely used for settlement (if they exist at all). Modern securities settlement systems are built around central securities depositories like CDS, DTCC, and Euroclear, and rely almost entirely upon *book-entry settlement*.

Today, settlement activity is concentrated with fewer and larger entities. The global total value of securities held through intermediaries was recently estimated at 50 trillion euros. Cross-border trading has grown dramatically (increasing a hundred-fold in the U.S. since 1980).¹ This increasing integration of global markets has also increased the potential for systemic risk—i.e. for disruptions in one settlement system to affect other systems.

The USTA proposal will provide these main benefits:

- modernize our commercial law to support current (and anticipated) securities holding and settlement practices,
- reduce systemic and legal risk, and
- remove competitive disadvantages now faced by Canadian securities markets and intermediaries (especially in comparison with the U.S.).

2. International focus on risk reduction

In the past few years, the risks associated with global securities settlement systems, and the law supporting those systems, have come under closer scrutiny than ever before. This scrutiny has produced a number of recommendations and initiatives from several international sources, all of which confirm the importance of the USTA proposal for Canada.

- 1) In 2001, IOSCO issued its report *Recommendations for securities settlement systems*.² That report makes 19 recommendations, described as minimum standards for securities settlement systems. Recommendation #1 is that systems “should have a well founded, clear and transparent legal basis”.

¹ From 1980-2001, U.S. activity in foreign securities grew from \$53 billion to over \$5 trillion, and foreign activity in U.S. securities grew from \$198 billion to \$20 trillion. Source: G30 Report, Figure 1.1, p. 17.

² The report was jointly issued by the IOSCO Technical Committee and the Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries.

- 2) In 2003, the Group of Thirty³ published a study: *Global Clearing and Settlement—A Plan of Action*. That report builds upon the IOSCO recommendations but goes further, recommending “best practices” and placing greater emphasis on cross-border issues. This report contains 20 recommendations, two of which focus upon advancing legal certainty relating to securities settlement systems.
- 3) The 2003 report of the Giovannini Group observed that insufficiencies in the legal framework were still among the most serious obstacles to the integration of the European Union financial market, and advocated harmonization in this area.

The USTA proposal addresses the commercial law component of the IOSCO and G30 recommendations. It is worth emphasizing this narrow scope of the USTA proposal. It includes the USTA itself—a separate statute dealing with transfers of securities having the same scope as Article 8 of the U.S. Uniform Commercial Code—plus consequential amendments to the PPSAs similar to Article 9 of the UCC.

Although this commercial law is extremely important and may be seen as the foundation of securities settlement systems, most of the recommendations in the IOSCO and G30 reports go beyond commercial law to address the larger legal and operational framework of securities settlement systems. Except for the commercial law component, the Canadian settlement system is remarkably sophisticated, efficient and innovative. The narrow scope of the USTA makes it deliberately neutral towards the larger legal and operational framework, although having a clear and certain commercial law foundation does facilitate improvements in other areas. For example, the USTA facilitates and underpins:

- more effective, better co-ordinated regulation of intermediaries,
 - reform of other law (e.g. the Bankruptcy and Insolvency Act, corporate and trust statutes), and
 - operational improvements (like the current industry initiative to achieve Straight Through Processing (STP)—estimated to save the Canadian securities industry \$140 million annually).
- 4) In December 2002, Canada and more than 50 other countries signed the Hague Convention⁴ addressing choice-of-law rules for securities held with an intermediary. Upon ratification, the Convention will determine which jurisdiction’s commercial law applies in any cross-border situation. The Convention spotlights the legal risks peculiar to each jurisdiction. This increases the likelihood that global market participants, as a function of normal risk analysis and risk management, will shun jurisdictions with particular legal risks. Not surprisingly, the prospect of the Hague Convention has spurred efforts to reform national laws to reduce such risk.

³ The G30 describes itself as “a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia”. Its members include governors and directors of central banks, major commercial banks, or financial services firms, and senior academics.

⁴ The full title is: Hague Conference on Private International Law—*Convention On The Law Applicable To Certain Rights In Respect Of Securities Held With An Intermediary*.

- 5) In 2002, a project to reform national laws in this area was undertaken by UNIDROIT, an organization of 59 member states (including Canada) dedicated to modernizing and harmonizing international commercial law. UNIDROIT published a position paper in August 2003 and hopes to present a draft Convention and other material by early 2007.

Canada is fortunate that the USTA project has been underway for some time, so we are in a position to act sooner than other countries. The USTA is compatible with the Hague Convention. The USTA Task Force has been asked to draft the provincial legislation implementing the Convention. The USTA proposal meets all the objectives identified for the UNIDROIT project and should be compatible with whatever UNIDROIT eventually recommends.

3. Harmonizing with U.S. law

The USTA is harmonized with Articles 8 and 9 of the U.S. Uniform Commercial Code—the leading working model in the world. Articles 8 and 9 have been uniformly enacted—practically word-for-word—by all 50 states. Most existing Canadian law is non-uniform and based on old versions of Article 8, which was revised in 1994. The Canadian and U.S. markets have always been highly integrated; over 25% of the trades reported over the past several years have been cross-border with the U.S.; and commercial practices are almost identical on both sides of the border.

Only a few slight modifications were necessary to adapt Articles 8 and 9 to the Canadian context and the remainder of the Canadian legal framework. By harmonizing with the leading working model, the USTA should be globally recognized as equally clear and reliable. Moreover, it increases the likelihood that, as other nations reform their law, all will be compatible with Canadian law.

The USTA uses the *security entitlement concept* to describe the key interest used in the indirect holding system. Thus, under the USTA a person who holds property through a securities intermediary will have a *security entitlement*—a defined package of rights and property interest—against that intermediary. The security entitlement is a rational concept that allows obligations to be compartmentalized between a particular entitlement holder and their intermediary. By avoiding the fictions of deemed delivery and possession in current law, it enables clear and certain conflict-of-law rules so that all market participants can know, in advance, exactly what law applies.

Conforming amendments to the PPSAs permit a security interest in investment property to be perfected by *control*. Again, by avoiding the fictions of deemed delivery and possession, this permits a rational system of perfection and certainty about what law applies.

4. Uniformity within Canada—a political challenge

The USTA changes to Canadian substantive law are not particularly controversial and are strongly supported by knowledgeable market participants. The major obstacles to implementing the USTA are political and peculiarly Canadian.

First, existing Canadian law is generally located in corporate statutes. This is an accident of history that largely explains why existing Canadian law has become so out-dated and non-uniform. Making the USTA a separate statute enables a single, uniform body of law to govern transfers of all securities in the marketplace, regardless of whether the issuer is a federal or provincial corporation, a trust, partnership, or the Crown. Users of the system place a high value on this kind of consolidation and simplification but it requires considerable political will to make this kind of change.

The second and more significant obstacle is that there is no history of this kind of word-for-word uniform commercial law in Canada. Nobody argues against the need for, or the benefits of, uniform commercial law but, unlike the U.S., Canada has no established mechanism for implementing such law uniformly. Overcoming this obstacle requires, again, considerable political will.

The USTA is supported by the Uniform Law Conference of Canada (ULCC) and is part of their Commercial Law Strategy, which was approved by all Ministers of Justice in 1999. Prior to publication of the USTA proposal, the securities industry expressed strong general support for the USTA proposal and for uniform implementation of the USTA across Canada. Viewed in the context of the Hague Convention, the IOSCO and G30 reports, the experience with UCC Article 8 and the UNDROIT project, it is difficult to imagine a stronger case for uniform implementation of the USTA across Canada.

The problem is that, although the implementation of the USTA would be a remarkable breakthrough for Canada, Canadian stakeholders have so far provided no comments on the USTA proposal or the need for uniform implementation. Stakeholders should not assume that, if they support the USTA, they need say nothing but merely wait for it to be implemented. In fact, clear expressions of support from stakeholders are needed because, without them, it is impossible to generate the political will to implement the USTA. The USTA is an arcane and mysterious subject for politicians—they will pay attention and take action only if Canadian market participants speak clearly about the urgent need for uniform implementation of the USTA.

B. Current status and implementation strategy

1. Current status of the USTA project

The deadline for receiving comments on the consultative USTA materials was December 15, 2003. However, the CSA task force is continuing to encourage stakeholders to provide comments, and intends to republish a revised version of the consultative USTA materials in both official languages in April 2004 for a further comment period of three months.

The CSA task force does not anticipate making any significant changes to the current materials. The only comment letter received so far by the CSA task force (from the *International Swaps and Derivatives Association* (ISDA), based in New York) strongly supports the USTA proposal. The republication of materials in both official languages is necessary because uniform implementation (and final approval of the USTA by the ULCC) requires it. However, now is the

optimal time for Canadian stakeholders to provide comments, including expressions of support. This will allow the CSA task force to address comments before it republishes the material in both languages. It will also greatly facilitate moving towards prompt, uniform implementation after republication.

The Canadian Capital Markets Association has targeted implementation of the USTA in 2005, to support the development of STP. The CSA task force requires immediate expressions of support from Canadian stakeholders in order to have a realistic chance of meeting that target.