

FOCUS ON CORPORATE COMMERCIAL LAW

New securities transfer act addresses challenges of the global capital market

By Robert M. Scavone

A hasty reader of May's Ontario budget might have missed the statement that later this year, "updated securities transfer legislation will be introduced to address the legal uncertainty that now exists and enhance the competitive position of Canada's capital markets and securities firms." This pledge may not have made front page headlines, but for corporate commercial lawyers, bankers, investment dealers and others with an interest in the health of Canada's capital markets, it should have been cause for celebration.

That's because the legislation referred to will be based on the Uniform Securities Transfer Act (USTA). The product of eight years of hard work by the Canadian Securities Administrators, the Uniform Law Conference of Canada and others, the USTA is model legislation that reflects the realities of the modern "tiered holding system" through which publicly traded securities have been held and settled for more than 20 years. The USTA will finally bring the law governing securities transfers into the 21st century.

This update is long overdue. The existing law is a muddled patchwork dating from a bygone era when every shareholder in a public company owned a paper share certificate. Today when you buy publicly traded securities, your evidence of ownership is rarely more than a trade ticket and a monthly statement. Trades are now settled electronically through "clearing agencies" such as The Canadian Depository for Securities Limited (CDS). If a physical certificate exists at all, it's "immobilized" in a vault and registered in the name of a CDS nominee. Positions are transferred and pledged on a net basis between participants in CDS (brokers and banks) on CDS's computer records. This complex multi-level "book-based" system can process huge volumes of trades (over 300 million a day through the TSX alone) in a way that would simply be impossible by moving around physical pieces of paper.

Yet the law in Ontario and most other provinces has not kept pace with these developments. While Ontario did make some attempts in the 1980s to update the Ontario Business Corporations Act (OBCA) and Personal Property Security Act (PPSA) to reflect electronic settlement, these were, at best, halfway measures. To address the fact that one can't possess an electronic ledger entry, section 85 of the OBCA created the awkward fiction of "constructive possession" for securities held through a clearing agency.

But serious flaws and gaps remained. Section 85 applies only to securities held through CDS. Existing conflicts of law rules based on the physical location of security certificates have no clear application to book-based or "dematerialized" securities. As a result, giving clean legal opinions on complex cross-border transactions using as collateral investments such as U.S. T-bills or foreign equities has proved almost impossible. It's often unclear exactly how or where, or even whether, a lender or swap counterparty can effectively perfect its security interest in such securities. That lack of legal certainty raises transaction costs and has probably caused many a capital market deal to go south -either figuratively or literally.

South of the border, all 50 states have now enacted Revised Article 8 of the Uniform Commercial Code (UCC), first published in 1994, which put the law of securities transfer on a sound conceptual footing. Revised Article 8 devised a new form of property called a "security entitlement" (SE) that

accurately describes the bundle of rights that an investor in a security actually has against the relevant "securities intermediary" (the broker or the clearing agency, for example), not the issuer. Instead of constructive possession, the legislation adopts the neutral concept of "control" as a way to perfect security interests in SEs. It sets out clear conflicts rules that leave no doubt about where to perfect those interests. Legal opinions in the U.S. on security in SEs are now clean and certain. As a result, Ontario has been labouring under a distinct competitive disadvantage relative to our neighbours to the south.

All this will change with the USTA and conforming amendments to the OBCA and PPSA. Based closely on Revised Article 8, the USTA will boost investor confidence by providing legal certainty, improve finality of settlement, encourage the use of securities as collateral, reduce transaction costs and litigation risks and facilitate cross-border trades.

Hopefully once Ontario leads the way, the rest of the provinces will follow suit with identical legislation that will harmonize Canadian law in this area with that of the U.S. Whether provincial lawmakers will have the political will to enact truly uniform legislation across the country remains to be seen. It's never been done before (witness the five or six flavours of the PPSA, not to mention Quebec) but it's vital to making the USTA work. In any event, with its promise to introduce the USTA next fall, Ontario has taken a big first step to meeting the challenges of a global capital market.

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