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In this Issue:

[Ontario's Securities Transfer Act, 2006: New Rules for Securities as Collateral](#)

[Business Judgment Rule and Share Retractions: *Itak International Corp. v CPI Plastics Group Limited*](#)

[Frozen Donuts: The Importance of a Legal Audit When Transforming Production and Manufacturing Processes](#)

[The Accidental Franchise](#)

[Section Executive 2006-2007](#)

Ontario's *Securities Transfer Act, 2006*: New Rules for Securities as Collateral

*John Cameron**

The new *Securities Transfer Act, 2006* (Ontario) (the STA) has been proclaimed to come into force on January 1, 2007. It creates a complex set of rules relating to the transfer of securities that govern the rights and obligations of issuers of securities, securities intermediaries, investors and secured parties. Despite this complexity, the STA and related amendments to the *Personal Property Security Act* (Ontario) (the PPSA), which also come into force on January 1, 2007, will greatly facilitate the use of securities as collateral.

This article provides a brief summary of the important rules.¹ To understand these rules, the reader must bear in mind that securities are held in North America under two systems: the direct holding system and the indirect holding system. The direct holding system applies where a direct relationship exists between an issuer and an investor. For example, the direct holding system applies to the relationship between a private company and its shareholders. The indirect holding system applies to the indirect relationship between an issuer and an investor, where the securities are held through a securities intermediary such as CDS Clearing and Depository Services Inc. (CDS),² a bank or trust company acting as custodian, or a securities dealer. The indirect holding system depends in part on the direct holding system because for every security held in the indirect

holding system, a direct relationship exists between an issuer and a person registered as the owner of a security or holding a bearer security, such as CDS.

The most common types of secured lending transactions that lawyers in private practice deal with occur under the direct holding system. For example, when a corporate borrower pledges the shares of its subsidiaries to secure a credit facility, and delivers the duly endorsed share certificates to the lender at closing, the direct holding system applies. While the terminology used in the PPSA will change slightly, the substance of the relevant rules applicable to secured transactions in the direct holding system remains largely unchanged by the STA. The most significant changes arise in the context of the indirect holding system, where secured parties will have a new ability to perfect their security interest by way of a "control agreement" between the securities intermediary, the secured party and the debtor (i.e., the investor).

The STA, together with the related PPSA amendments, contains an enormous amount of detail, including many subtle nuances. Simplifying greatly, I summarize the most important rules in practice below. For the purposes of this summary, I use the words "investor" and "debtor" interchangeably, depending on the context.

Methods of Perfection

Apart from some special rules, there are three methods to perfect a security interest under the new rules:

1. **Registration:** A secured party can continue to perfect its security interest by registering a financing statement against the debtor, whether securities are held in the direct or indirect holding system.
2. **Control:** “Control” is the best method to perfect a security interest, whether securities are held in the direct or indirect holding system. In essence, “control” means that the secured party has the ability to transfer the investment property without further action by the debtor.
3. **Possession:** A secured party can continue to perfect a security interest in a certificated security in registered form by obtaining possession of that security. With an appropriate endorsement, the secured creditor obtains “control” of that security.

Control in the Direct System

In the direct system, a security can be certificated or uncertificated. The method to obtain control varies depending whether the security is certificated or uncertificated:

1. **Certificated Securities:** For a bearer security, a secured party obtains control by receiving the certificate. For a registered security, a secured party obtains control by receiving the certificate, together with (i) an appropriate endorsement, or (ii) arranging for the issuer to register the security in the name of the secured party. These steps correspond to the steps that would be taken under current law for the secured party to acquire the status of a “good faith purchaser” of a certificated security.
2. **Uncertificated Securities:** If the security is not evidenced by a certificate, control is obtained by (i) arranging for the issuer to register the security in the name of the secured party,

(ii) obtaining a control agreement from the issuer, or (iii) someone else having control for the benefit of the secured party. Most mutual fund securities are issued in uncertificated form. Until the new laws come into force, the only way to perfect a security interest in an uncertificated mutual fund unit is by registration of a financing statement under the PPSA. The new rules will introduce a new method of perfection – that is, by a secured party obtaining a control agreement from the issuer of the mutual fund security.

Control Agreement in the Direct System

In the direct holding system, a control agreement is an agreement between the issuer of an uncertificated security, the secured party and the debtor, under which the issuer agrees to comply with instructions from the secured party without the debtor’s further consent. A control agreement need not give exclusive control to a secured party. A debtor can retain the right to give instructions, and other secured parties can obtain (or may already have) a concurrent right to give instructions.

Securities Accounts in the Indirect System

Under the indirect system, a securities intermediary (such as CDS, a bank or trust company acting as custodian or a securities dealer) holds securities and other “financial assets” in a securities account for the benefit of its customer (e.g., an investor). In addition to securities, financial assets held in a securities account can include virtually any form of property if the securities intermediary and the customer agree that it is to be treated as a financial asset for the purposes of the STA. “Financial assets” also include any credit balance in the securities account unless the securities intermediary and the customer otherwise agree.

Security Entitlements in the Indirect System

An investor acquires a “security entitlement” when a securities intermediary indicates by book entry that a financial asset has been credited to that investor’s securities account. A “security entitlement” consists of a bundle of property and contract rights created

under Part VI of the STA. A security entitlement is not bought or sold. Instead, when an investor sells a security or other financial asset in the indirect system, the securities intermediary extinguishes the investor's security entitlement, and (if the related security or financial asset remains in the indirect system after the sale – as would normally be the case), a new security entitlement is created in favour of the purchaser.

Control in the Indirect System

A secured party obtains control of a security entitlement by (i) arranging for the securities intermediary to record the secured party as the entitlement holder, (ii) obtaining a control agreement from the securities intermediary, or (iii) someone else having control for the benefit of the secured party.

Control Agreement in the Indirect System

In the indirect holding system, a control agreement is an agreement between the securities intermediary, the secured party and the debtor, under which the securities intermediary agrees that it will comply with instructions from the secured party without further consent of the debtor. A control agreement need not give exclusive control to the secured party. A debtor can retain rights to give instructions, and other secured parties can obtain (or may already have) a concurrent right to give instructions.

Key Priority Rules

The key PPSA priority rules are as follows:

1. **Control Trumps Non-control:** A security interest perfected by control has priority over another security interest perfected otherwise than by control.
2. **Two Security Interests Perfected by Control:** If two or more security interests are perfected by control, they rank by priority in time to obtain control.
3. **Securities Intermediary Priority:** Despite the above rules, in the indirect holding system, a securities intermediary with a security interest in a security entitlement that it created has priority over other secured parties unless the intermediary otherwise agrees.

“Protected Purchasers”

In the direct holding system, a “protected purchaser” acquires priority over any adverse claim to a security by giving value without notice of any adverse claim to the security and obtaining control of the security. In the indirect holding system, there is no single corresponding rule; instead, there are a series of complex cut-off rules and legal principles.

Conflict of Law Rules

There are four main conflict of laws rules.

1. **Perfection by Registration of Financing Statement:** Perfection of a security interest by registration of a financing statement must take place in the debtor's location, which is defined in same manner as under the current PPSA – looking to the debtor's chief executive office if it has more than one place of business.
2. **Certificated Securities in Direct Holding System:** Apart from the rule for place of perfection by registration, the rules for the validity, perfection and priority of a security interest in certificated securities point to the location of the certificate.
3. **Uncertificated Securities in Direct Holding System:** Apart from the rule for place of perfection by registration, the rules for the validity, perfection and priority of a security interest in uncertificated securities point to the issuer's jurisdiction. The issuer's jurisdiction is determined according to (i) the location of the registered office or head office of a federally incorporated non-Crown issuer, and (ii) the jurisdiction of incorporation or organization for other non-Crown issuers. An issuer has the flexibility to choose its own jurisdiction outside its jurisdiction of incorporation or organization. Uncertificated securities issued by the Crown will normally be held through the indirect holding system, so the conflict of laws rules for security entitlements will govern the validity, perfection and priority of security interests in security entitlements relating to most securities issued by the Crown.

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4. **Security Entitlements:** Apart from the rule for the place of perfection by registration, the rules for the validity, perfection and priority of a security interest in a security entitlement point to the securities intermediary's jurisdiction, which can be (and invariably will be) determined by contract between the securities intermediary and the security entitlement holder.

Where Will Litigation Occur?

Even with the new conflict of laws rules, a secured party must always ask, "Where is litigation likely to occur if the debtor does not repay?" The secured party should make sure that all steps have been taken in those jurisdictions to protect the secured party, in addition to the jurisdiction dictated by the STA.

Transitional Rules

The transitional rules offer a four-month period within which to make sure that previously perfected security interests under current law remain perfected under new law. If a security interest was perfected under the current rules, in most (if not all) cases, the circumstances relating to that perfection will likely be sufficient to perfect the security interest under the new rules. For example, if a secured party relied on the old rules for deemed possession of a security held in CDS, the facts will invariably establish that the secured party (or a person acting on its behalf) has control of the related security entitlement under the new rules.

The STA and related PPSA amendments are complex; but despite that complexity, the law is evolving in a fashion that recognizes market practices in the securities industry and that provides greater certainty to all market participants. Virtually identical legislation has already been enacted in Alberta, and is expected to come into force on January 1, 2007. Saskatchewan has introduced a similar bill. Quebec is working on draft legislation, which is expected to be introduced some time next year. British Columbia has drafted a similar bill, which is expected to be introduced early in the new year. These developments are welcome additions to Canada's business laws, which all participants in the securities industry hope will be adopted in virtually identical form across Canada.

This summary is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss with you the issues raised by this summary in the context of your particular circumstances.

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¹ A more detailed description of the relevant rules is available in a paper published jointly by the Ontario Bar Association and The Law Society of Upper Canada: Cameron, "The New *Securities Transfer Act*, 2006: New Rules for Perfection and Priority", November 20, 2006.

² CDS Clearing and Depository Services Inc. is the successor to The Canadian Depository for Securities Limited, under a corporate restructuring completed in November 2006.