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Modernizing Securities Transfer Rules in Federal Statutes

NATIONAL BUSINESS LAW SECTION
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TABLE OF CONTENTS

Modernizing Securities Transfer Rules in Federal Statutes

PREFACE ..... **i**

EXECUTIVE SUMMARY **1**

I INTRODUCTION **6**

1. Fundamental Goal of the STAs: Legal Certainty 6
2. Why These Issues Are Important 8

II TRANSFER PROVISIONS IN FEDERAL CORPORATE STATUTES (CONSULTATION PAPER, PART 3B) **9**

1. OPTION 1: COMPREHENSIVE STAND-ALONE FEDERAL STA (Why there should be no Federal Presence in Indirect Holding System) 9
2. OPTIONS 2 AND 3: WHY FEDERAL ROLE IN DIRECT HOLDING SYSTEM SHOULD BE ABANDONED, NOT UPDATED 20
3. RESPONSES TO ARGUMENTS AGAINST OPTION 2 (General Repeal of the Federal Securities Transfer Provisions) 27

III DBNA AND BEA (CONSULTATION PAPER PART 3D) **31**

1. Depository Bills and Notes Act 31
2. Bills of Exchange Act 32

IV IMPACT OF PROVINCIAL STAS ON FEDERALLY INCORPORATED ENTITIES (CONSULTATION PAPER PART 3A)..... 33

V INTERACTION OF PROVINCIAL STAS ON THE OVERALL LEGISLATIVE AND REGULATORY FRAMEWORK FOR FEDERALLY INCORPORATED ENTITIES (CONSULTATION PAPER PART 3C) 34

VI CONCLUSION..... 35

PREFACE

The Canadian Bar Association is a national association representing 37,000 jurists, including lawyers, notaries, law teachers and students across Canada. The Association's primary objectives include improvement in the law and in the administration of justice.

This submission was prepared by the National Business Section of the Canadian Bar Association, with assistance from the Legislation and Law Reform Directorate at the National Office. The submission has been reviewed by the Legislation and Law Reform Committee and approved as a public statement of the National Business Section of the Canadian Bar Association.

Modernizing Securities Transfer Rules in Federal Statutes

EXECUTIVE SUMMARY

The National Business Law Section of the Canadian Bar Association (the CBA Section) is pleased to comment on Finance Canada's June 2007 consultation paper, *Modernizing the Legal Framework for Financial Transactions: Reforming Federal Securities Transfer Rules*. In general, the CBA Section believes, that, with limited exceptions relating to the direct holding system for certain debt instruments, there is no need for any federal securities transfer legislation. Parliament should refrain from legislating further in this area and should vacate the field entirely. The new uniform *Securities Transfer Acts* (**STAs**) now in force in five provinces and soon to be law across the country are more than adequate to govern transfers of all securities — a matter of property law, not corporate law — regardless of the jurisdiction of the issuer. A federal STA would be at best unnecessary and duplicative and at worst a source of confusion, uncertainty and market inefficiencies. Repealing the existing securities transfer provisions in federal corporate legislation would leave no gaps that would not be filled by provincial and territorial STAs.[1]

Our comments focus principally on the issues in part 3B of the Consultation Paper, *Transfer Provisions in Federal Corporate Statutes*, since we believe that these issues are of most importance to Canada's capital markets.

Issue 3B: Transfer Provisions in Federal Corporate Statutes

Option 1 (a comprehensive federal STA) is not desirable because[2]:

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1 As in the Consultation Paper, reference to provinces in this submission also includes the territories, where appropriate.

2 In this submission, references to Options 1, 2 and 3 are to the options in part 3B of the Consultation Paper.

- Securities transfer law is not and should not be a matter of corporate law governed by the jurisdiction of the corporate issuer. It is commercial property law. Corporate law governs the respective rights and obligations of the issuer and the registered holder. In contrast, securities transfer law governs voluntary transfers of property interests in securities. Federal legislation that purports to govern securities transfer law would obscure this boundary.
- This clear boundary should be uniformly and consistently respected regardless of the jurisdiction under which the underlying issuer is incorporated. Provincial STAs do so; a federal STA would not.
- The constitutionality of a federal STA governing the indirect holding system is also in doubt. Canada's securities transfer system would labour under considerable uncertainty until the courts definitively ruled on the constitutionality of a federal STA (which might not happen for years, if ever). If after years of being in force, a federal STA were declared *ultra vires*, additional legal uncertainty would be created.
- A federal STA would lead to confusion, overlap and inconsistency. Provincial STAs comprehensively cover the transfer of securities issued by federal issuers (in both the direct and indirect systems). In the case of the indirect system, the conflict of laws rule under the provincial STAs depends on the intermediary's jurisdiction, which could not be federal law. For market participants, the jurisdiction of the underlying issuer is and should be irrelevant.
- A federal STA that purported to govern the indirect holding system would have to adopt the discredited look-through approach to determine whether the credit or debit to a securities account involves securities in which the underlying issuer is a federal issuer. This would greatly increase the complexity and difficulty of applying Canadian securities transfer laws, as well as making them inconsistent in their underlying principles with the comparable laws of Canada's most important trading partners, in particular, the United States.
- We believe that, with increased globalization of capital markets, growing acceptance of the principles enshrined in the *Hague Securities Convention*[3] and publicized evaluation of national and regional settlement systems by the Group of 30[4] ("G30"), the duplication and confusion caused by a

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[3] Hague Conference on Private International Law, Convention no. 36, Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the "**Hague Securities Convention**"). Canada, along with the United States, is one of more than 50 signatories to the Convention.

[4] The G30 has been described as "a private, non-profit, international body composed of very senior representatives of the private and public sectors and academia", its members including "governors and directors of central banks, major commercial banks, or financial services firms, and senior academics." See E.T. Spink and M.A. Paré, "The *Uniform Securities Transfer Act*: Globalized Commercial Law for Canada" (2004), 19 B.F.L.R. 321 at 332.

federal STA would hurt the competitiveness of Canada's overall securities settlement system.[5]

- Since there is no federal Personal Property Security statute (a "federal PPSA") (and there are no plans to enact one), federal transfer rules would always be significantly incomplete in that they could not cover security interests in shares and other securities, which are a significant portion of transfers in the capital markets. Only provincial law can deal with such security interests, including rules on attachment, perfection and priority.
- The lack of a federal PPSA regime would mean that federal law could apply only to absolute transfers and provincial PPSAs/STAs to transfers intended as security, such as pledges. This distinction is often difficult to make in practice, and the characterization may vary for different purposes. Having to characterize a transfer of a federal security as either an absolute transfer or a pledge in order to decide what law applies would lead to legal uncertainty and unnecessary complexity.
- In the indirect system, intermediaries generally do not know, and will not care, about the purpose of the debit against the transferor's securities account or credit in the transferee's account or whether it should be characterized as an outright transfer, a pledge or something else. Except where the intermediary is party to a control agreement, the intermediary is generally oblivious to whether the relationship between the transferor and transferee is that of seller and buyer or that of pledgor and secured party.

Option 2 (general repeal of federal securities transfer provisions) is preferable to Option 3 (update of existing – mostly direct – securities transfer provisions) because:

- Option 3 again would obscure the boundary between corporate law and securities transfer law.
- In effect, Option 3 contemplates the co-existence of federal and provincial direct transfer rules.
- The conflict of laws rules under provincial STAs governing transfers in the direct holding system depend exclusively on the issuer's jurisdiction, which, in most cases for federal issuers, will be the province or territory in which the corporation's registered office or head office is located (or another location, if permitted by federal law). Only the validity of the security and related corporate matters are and should be governed by the law of the issuer's jurisdiction of incorporation or formation.
- The co-existence of federal and provincial direct transfer rules would lead to confusion in the application of the conflict of laws rules in provincial STAs to federal issuers since these already cover securities of federal issuers and would require awkward carve outs.

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[5] *Id*., at 334.

- Determining whether and when federal or provincial law applied to such matters as proceeds from the sale of federal securities, the redemption of federal securities, the consideration received on the disposition of federal securities, dividends and interest would similarly add unnecessary legal uncertainty and complexity, aggravated by the limitation of federal law to absolute transfers, as distinct from security interests.
- While a federal STA could in theory be harmonized with the provincial STAs, the interplay between federal and provincial statutes would be highly complex and their points of intersection uncertain. As well, such legislation would have to be closely monitored to ensure their ongoing consistency. Even if this were possible, there would be no substantive benefits to the overall system to offset the additional complexity and legal costs that would be associated with maintaining and complying with two parallel regimes.
- There are would be no meaningful gaps or transitional problems with the adoption of Option 2.

Legislative simplicity favours general repeal of the federal securities transfer laws in accordance with Option 2, not a continuing federal role.

The argument that repeal of federal securities transfer laws would add to the regulatory burden for federal corporations wrongly conflates corporate governance and security transfer rules. As long as the boundaries between federal corporate governance laws and provincial securities transfer laws are well-defined and regulatory overlap is minimized, the separation of these functionally separate laws by implementing Option 2 will reduce, not add to, the regulatory burden.

Recommendation:

The CBA section recommends that the federal government adopt Option 2 (repeal of federal securities transfer provisions), subject to the comment below on the *Depository Bills and Notes Act.*

Issue 3D: Bills of Exchange Act and *Depository Bills and Notes Act*

The *Depository Bills and Notes Act*[6] should be confined to direct transfers of federal depository bills and notes to the clearing agency. As a housekeeping matter, the deemed

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[6] S.C. 1998, c.13 (the "**DBNA**").

possession provisions should be removed. The antiquated deemed possession regime embodied in the DBNA no longer reflects modern market practices or the structure of the indirect holding system and is unnecessary in light of the provincial STAs. These deal comprehensively with transfers of any financial asset credited to a securities account, which can include depository bills and notes. Perpetuating the deemed possession regime for depository bills and notes would foster anomalous inconsistencies with no offsetting benefit.

No changes to the *Bills of Exchange Act*[7] are needed or recommended because bills of exchange are exclusively within the federal legislative sphere and the BEA deals only with direct transfers.

Recommendation:

The CBA Section recommends repeal of the indirect transfer provisions of the DBNA and no changes to the BEA.

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7 R.S.C. 1985, c. B-4 (the "**BEA**").

I INTRODUCTION

The National Business Law Section of the Canadian Bar Association (the CBA Section) is pleased to comment on Finance Canada's June 2007 consultation paper, *Modernizing the Legal Framework for Financial Transactions: Reforming Federal Securities Transfer Rules*. Part of the mandate of the CBA Section is to make the technical expertise and experience of its members available to government as a resource when considering new legislation or reform of existing legislation. In providing this resource, the CBA Section offers a non-partisan view on matters of public import.[8]

Canadian lawyers represent many individuals and organizations, local, national and international, that are affected daily by the legal system governing the holding, transfer and pledge of securities in both the direct and indirect systems: issuers; investors; secured lenders; CDS Clearing and Depository Services Inc(CDS); registrars and transfer agents; and banks, trust companies, securities dealers and other intermediaries in the system.

Many of our clients faced the challenges of the system that existed prior to the enactment of provincial STAs. The CBA Section strongly endorsed implementing STAs to replace the antiquated, inadequate and often non existent law with uniform legislation that reflects modern market practices.[9]

1. Fundamental Goal of the STAs: Legal Certainty

The introduction to the Consultation Paper notes that a key element of an efficient securities settlement system is legal certainty. When considering whether Parliament has a role to play in securities transfer law, one should recall that the paramount goal of the provincial STAs was to create that legal certainty for existing market practices. Such certainty can best be

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[8] The CBA Section members forming the working group that prepared this submission are: Robert Scavone, Chair, Toronto; Jennifer Babe, Toronto; Ian Binnie, Toronto; John Cameron, Toronto; Michel Deschamps, Montreal; Michael Disney, Toronto; Wayne Gray, Toronto; and Eric Spink, Edmonton.

[9] Canada's pre-STA securities settlement laws were once described as a "legal *terra incognita*". See M. Disney and J. Holmes, "Securities Transfers in the Modern Market" in "The Future of Corporate Law – Issues and Perspectives", *Queen's Annual Business Law Symposium*, 1997, 121 at 144.

achieved with a single set of rules that applies to all securities transfers, regardless of the law governing the issuer.

The volume of transactions in the indirect holding system, as well as a participant's typical lack of information about the underlying securities, makes it impracticable for issuers, investors, secured parties, clearing agencies and other intermediaries and their legal advisers to determine which set of legal rules applies to a transaction involving particular underlying securities. Instead, those trading in the indirect holding system do so on the basis that the law governing the underlying issuer is, in substance, irrelevant. In the indirect system, parties transact not in the underlying securities themselves but in separate property interests known as "security entitlements". The indirect system works well because security entitlements can be created and extinguished with no change to the registered ownership of the underlying securities and without regard to such concepts as beneficial ownership and tracing or even the attributes of the underlying security. Instead, the creation of a security entitlement to an underlying security in favour of a purchaser can be compartmentalized or legally delinked from the extinguishment of the security entitlement to that "same" security as against the vendor.

The need for legal certainty in this area of law is particularly acute because of its international scope. Canada's securities marketplace is not an island but is closely integrated with the securities settlement systems of the United States, Europe, Japan and other countries. Several converging factors are tightening the competitiveness of securities settlement systems worldwide. First, there is the continued globalization and interlinking of capital markets themselves. Second, implementation of Revised Article 8 (Article 8) of the *Uniform Commercial Code* (the **UCC**) in all 50 US states, adoption of STAs (which are closely modelled on Article 8) by several Canadian provinces this year, and widespread adoption of the Hague Securities Convention in other leading capital markets jurisdictions are leading to increased party autonomy in the selection of the laws governing the underlying securities transaction in both the direct and indirect systems.[10] Third, the G30

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[10] Further, see Spink and Paré, *supra*, footnote 4.

has begun ranking national securities settlement systems and have listed the laws governing those systems as a factor in its scorecard.[11]

The quest for legal certainty in Canada's security settlement system is close to fruition, although not yet complete. The passage of STAs in Alberta[12] and Ontario[13] in 2006 and the subsequent adoption of STAs in British Columbia,[14] Newfoundland and Labrador[15] and Saskatchewan[16] were critical steps in reforming Canada's securities settlement infrastructure with uniform legislation. As the remaining provinces and territories proceed to adopt their own STAs,[17] the next logical step is for the federal government to vacate the field.

The CBA Section strongly believes that the need for legal certainty, simplicity and consistency will best be served by repealing existing federal legislation dealing with the transfer of securities in the indirect holding system (Option 2). We believe as well that federal securities transfer legislation would at best be unnecessary and duplicative and at worst would be a source of uncertainty and confusion that could undermine Canada's competitive position in world markets.[18]

2. Why These Issues Are Important

We cannot overstate the importance of the issues raised in the Consultation Paper to Canada's securities settlement infrastructure and to the reputation of that settlement system

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11 *Id*., at 332-4.

12 *Securities Transfer Act*, S.A. 2006, c.S-4.5, in effect January 1, 2007.

13 *Securities Transfer Act*, 2006, S.O. 2006, c.8 (the "Ontario STA"), also in effect January 1, 2007. All references in this submission to specific provisions of the STA are to the Ontario STA.

14 *Securities Transfer Act*, S.B.C. 2007, c. 10, in effect July 1, 2007.

15 *Securities Transfer Act*,, S.N.L. 2007, c. 13.01, in effect August 1, 2007.

16 *Securities Transfer Act*, S.S., c. S-42.3, in effect September 1, 2007. In this submission, "**STAs**" means the statutes referred to in footnotes 11 through 15.

17 There is no reason to think that the remaining provinces and territories can be far behind.

18 We do not hold ourselves out as economists and, therefore, are not qualified to predict the economic consequences of coexisting federal and provincial securities transfer rules. Nor do we wish to underestimate the resilience of our securities settlement system to inadequate laws. Until 2007, Canada's securities settlement system functioned despite the lack of the solid legal foundation that STAs now provide. However, as discussed above, several factors may be narrowing the competitive differential between national securities settlement systems and enhancing the ability of participants to avoid uncertain or cumbersome legal regimes.

in the global marketplace. Given the fluidity of securities transactions and the globalized nature of the industry, a weak, confusing, overly complex or uncertain legal infrastructure in Canada could well subject Canadian securities and Canadian securities transactions to a discount factor.[19] Participants in the indirect holding system can be expected to seek out those legal regimes that will offer the highest level of predictability and are most consistent with the legal models most familiar to them, such as Article 8 of the UCC. This predictability can best be achieved with a uniform body of provincial law that deals with transfers of securities in the indirect holding system without regard to the corporate law that may govern issuers of those securities. The provincial STAs will provide that uniformity and certainty; existing or proposed federal legislation in the same field will not.

II TRANSFER PROVISIONS IN FEDERAL CORPORATE STATUTES (Consultation Paper, Part 3B)

1. OPTION 1: COMPREHENSIVE STAND-ALONE FEDERAL STA (Why there should be no Federal Presence in Indirect Holding System)

Currently, Canadian corporate statutes, including the *Canada Business Corporations Act*,[20] apply only to the direct holding system (except for certain provisions in legislation governing federally regulated financial institutions, discussed briefly below). These statutes correctly ignore the indirect holding system. Indeed, apart from the DBNA and financial institutions legislation, current federal law does not extend to the indirect holding system at all. This is the correct approach.

(a) Boundary Between Corporate Law and Securities Transfer Law

The STAs correctly draw a clear line of demarcation between corporate law and securities transfer law. Corporate law governs the terms of the underlying security as between the issuer and the holder. In the case of equity securities, these terms would include the rights, privileges, restrictions and conditions attaching to the class or series of shares. It would also include all statutory rights and remedies given to shareholders in the applicable corporate

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[19] See qualification in footnote 18

[20] R.S.C. 1985, c. C-44 (the "**CBCA**").

statute. In the case of debt obligations, it would include all the contractual rights in the various instruments comprising the debt obligation and, depending on the nature of the debt obligation, may also involve some statutory rights and obligations such as those under the PPSAs or under the trust indenture and oppression provisions contained in the applicable corporate statute.

Corporate law, therefore, properly governs the respective rights and obligations of the issuer and the registered holder of securities in, or issued by, the corporation. However, a fundamental insight of the STA is that corporate law need not, and should not, deal with transfers of interests in securities. Eric Spink aptly refers to these as the "boundaries" between corporate law and securities transfer law.[21] In our view, these boundaries should be uniformly and consistently respected regardless of the jurisdiction under which the underlying issuer is incorporated or formed. Securities as intangible bundles of rights that can be traded or pledged ought not to be confused with the rights of the holder of those intangibles to enforce whatever remedies the holder may have against the issuer or the issuer's property.

This well recognized boundary between corporate and securities transfer laws should be no different for federally incorporated issuers than it is for any other issuers. Otherwise, uncertainty and consequent inefficiency will inevitably result. Issuers, investors and secured parties will not know what rules apply unless they first identify whether the underlying issuer is federally incorporated or is incorporated under provincial or foreign law. There is no need for this dual system or the uncertainties that it will engender. The provincial STAs already provide a regime that embraces federally incorporated issuers and treats them under one unified, consistent set of rules.

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[21] E.T. Spink, "The Securities Transfer Act: Fitting New Concepts in Canadian Law" (2007), 45 Can. Bus. L. J., 167.

(b) Constitutional Uncertainty

Most of this submission responds to the proposed extension of federal jurisdiction into the indirect holding system by considering pragmatic rather than constitutional arguments. However, like Professor Benjamin Geva, who has written more fully on the constitutionality of a federal STA,[22] we have grave reservations about the constitutionality of an expanded federal regime to comprehensively govern the indirect holding system.

At the heart of the STAs is the newly created *sui generis* property interest known as the "security entitlement". The STAs involve personal property transfer law. The STAs do not involve regulatory law in any way. No STA creates a governmental agency to oversee transfers and pledges of security interests. Functionally, the STAs are analogous to provincial legislation governing the purchase and sale of goods. The STAs fit squarely within property and civil rights in the province and, therefore, fall within the exclusive provincial jurisdiction under s. 92(13) of the *Constitution Act, 1867*.[23]

We further agree with Professor Geva that there is no federal head of power that would support federal occupancy of the entire field. The federal incorporation power is currently used to legislate in relation to the direct holding system for federally incorporated issuers such as banks.[24] However, it is an entirely other matter to extend this beyond the direct holding system to the indirect holding system, involving security entitlements.

While federal power in relation to banking, bills of exchange, promissory notes, depository bills and notes and other federal debt would support federal legislation in relation to the direct transfer of these instruments, these are only specific categories of the entire universe of financial assets. Thus, the extension of federal power into the indirect holding system would, at most, be incomplete and necessitate application of the discredited "look-through"

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22 Benjamin Geva, "Legislative Power in Relation to Transfers of Securities: The Case for Provincial Jurisdiction in Canada" (2004), 19 B.F.L.R. 393.

23 (U.K.), 30 & 31 Vict. C. 3, reprinted in R.S.C. 1985, App. II, No. 5.

24 *Bank Act*, S.C. 1991, c. 46.

approach to jurisdiction discussed below.[25] It would necessarily exclude security entitlements involving securities of provincial and foreign issuers. Again, for the pragmatic reasons that we discuss in more detail below,[26] the bifurcation of the indirect holding system between security entitlements involving federal securities and all other securities is to be avoided in order to achieve legal certainty, consistency and efficiency.

Federal power in relation to the regulation of trade and commerce would not support federal rules governing the indirect holding system because, as Professor Geva correctly points out, many securities transfers do not involve interprovincial securities transactions. With respect to intraprovincial securities transactions, federal legislation would not involve a general regulatory scheme, the oversight of a regulatory agency or provincial incapacity to harmonize legislation.[27] Nor is such a scheme required. The provinces are quickly demonstrating that they have the capacity, and will, to enact STAs with a level of uniformity and synchronization previously unseen in this country.

In any case, if a federal STA were enacted, it might be many years (if ever) before the constitutionality of the legislation was tested before the courts. In the meantime, the constitutional uncertainty would only exacerbate the other uncertainties that federal legislation would bring; and if the federal legislation were ultimately declared *ultra vires*, the ensuing uncertainty would likely cause even greater legal uncertainty. The extension of federal power to the indirect holding system could thus destroy the legal certainty, efficiency and simplicity that the STAs were intended to bring.

(c) Integration with Provincial PPSAs

It is imperative that the law governing securities transfers be closely integrated with personal property security ("**PPS**") regimes which, in Canada, all exist at the provincial and territorial level. The Consultation Paper concedes that there is no plan for a federal personal property security regime. Any such regime would create overlap and resulting confusion

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25 See discussion in Part II 1.(f) below.

26 See discussion in Part II 1.(c) through (h) below.

27 The test for the federal trade and commerce power adopted in *General Motors v. City National Leasing*, [1989] 1 S.C.R. 641 at 661, 58 D.L.R. (4th) 255.

and expense among secured parties, debtors and those who advise them. The same need to avoid duplication and confusion demands that the federal government not extend its reach into the indirect holding system, transfers in which involve creating security interests governed by PPS regimes.

Provincial PPS regimes (as amended by the STAs in the STA provinces) set out comprehensive, largely uniform provisions governing: (i) what laws apply to the creation and perfection of security interests in investment property such as securities; (ii) the basis for such application (location of certificates, jurisdiction of issuer of uncertificated securities, location of debtor and jurisdiction of the securities intermediary); (iii) the ways for a security interest to attach and be perfected; and (iv) the priorities of competing security interests in investment property. With the exception of security under the *Bank Act*[28] (which does not apply to securities), there is no equivalent federal system governing the attachment, perfection, effect of non-perfection and priority of security interests in personal property, and it is hard to see how a federal STA could be fully harmonized with provincial PPSAs.

(d) Transfer or Security Interest? Difficulty Differentiating on the Basis of the Nature of the Underlying Transaction

Even without a federal PPS regime, the coexistence of a federal STA alongside provincial counterparts would still give rise to confusion with respect to the creation of pledges or other security interests in investment property in the indirect holding system. Since there is no federal PPSA, provincial law would continue to apply to the creation of a security interests in security entitlements involving securities of a federal issuer while the federal STA could apply only to absolute transfers of those same securities. While this distinction may seem clear in theory, in practice it would be unworkable because the characterization of the transaction depends on the aggregate contractual arrangements between the parties and their respective intentions, not the legal structure of the transfer itself.

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[28] For example, see *Bank Act*, *supra*, footnote 24, s. 427.

For example, assume that party A acquires a security entitlement to a federal security to which party B formerly had a security entitlement. The security is debited from B's account and credited to A's account with an intermediary, I. This transaction could be either a security interest or an absolute transfer. If A and B agree that B has granted A a security interest in the security, A will have perfected that security interest by obtaining "control" of the security entitlement, thereby becoming the entitlement holder of the security. Characterized in this way, this would be a secured transaction governed by the applicable PPSA, for which there is no federal counterpart.

However, if A and B agree that B has sold the security to A, the transaction would be an absolute transfer governed by the federal STA, which would govern the creation of a security entitlement in favour of the buyer, A, to the securities and the cancellation of the security entitlement of the seller, B, to those securities, albeit on a net basis (meaning that, in most cases, there will be no direct matching of A's purchase to B's sale unless they happen to be the only traders in those securities on that trading day).

One of the difficulties is that, in most cases, the intermediary, I, does not know, and will not care, about the purpose of the credit to the transferee's account or the debit against the transferor's account. In any transaction, B could easily be a debtor and A could be a secured party requiring that B grant A control over the transferred assets through a control agreement with B's securities intermediary or by A's becoming the entitlement holder. Whether the transferor has the right to redeem the security entitlement is a matter between the transferor and the transferee. Except where the intermediary is party to a control agreement, it is generally oblivious to whether the relationship between the transferor and the transferee is that of a seller and buyer or of a debtor and secured party.

The fact that, in the tiered holding system, the matching of transferors and transferees of financial assets is on a net basis would further complicate matters. A particular intermediary in a system will be processing entitlement orders from buyers, sellers, pledgors and secured parties on an aggregate or net basis. If one portion of the net position is governed by federal transfer law and another portion by provincial PPS law, the legal analysis of the underlying transactions would be difficult, if not impossible. It is unclear whether bifurcating a single

net position in fungible securities evidenced only by electronic book entries into two notional sub-positions is even feasible.

In order to analyze the legal effect of transactions, the existence of a federal STA would require that one ascertain, first, whether particular security entitlements are in respect of securities of a federal issuer and, if so, second, whether the underlying transaction is in the nature of a purchase and sale or a pledge. This would introduce needless complexity, uncertainty and inefficiency into the legal analysis of transactions in the securities settlement system. The securities marketplace has long moved past a simple dichotomy between absolute transfers and simple pledges. Today, there are complex derivatives such as puts, calls and collars, securities lending transactions and many others. The characterization of many of these transactions is often (sometimes deliberately) ambiguous. For example, a securities "lending" transaction involves a transfer that could be analyzed either as a sale coupled with a return obligation or as a bailment of fungible property to which title is transferred absolutely, or as two offsetting sales; and the "collateral" posted for such a transaction typically requires an absolute transfer that entitles the secured party to dispose of the collateral freely. The market has long considered these alternative characterizations as useful for different purposes (for example tax or accounting treatment), and usually it is not necessary to choose one over the other. It would be a step backwards and a denial of market realities to require that the legal analysis of a transaction be based on the characterization of the nature of the transaction as a sale or security interest merely because it happens to involve securities governed by federal law.

Moreover, many transactions involve both absolute transfers and grants of security interests. For example, repurchase or "repo" transactions involve a short-term sale of securities coupled with an obligation to resell them to the original seller, and this obligation is almost invariably collateralized by an offsetting pledge of other marketable securities. If federal law governed absolute transfers and provincial law governed security interests, a repo of Government of Canada bonds collateralized by a pledge of Canadian T-Bills would be governed by two bodies of possibly conflicting law, introducing legal uncertainty and confusion into the analysis of these very common transactions.

As long as there is only one possible law (*i.e.* an internally consistent provincial law that governs both the STA and the PPS regimes) that applies to the creation and extinguishment of security entitlements, regardless of their intended legal effect, there is no need for intermediaries, other market participants and their legal advisers to be concerned about how to characterize the underlying transaction in order to determine what laws apply. The same rules will always apply because the governing law is that of the jurisdiction of the securities intermediary, which is determined by a clear set of rules (discussed below)[29] that consider such factors as the law chosen in the securities account agreement. However, if federal law applies to absolute transfers but not to secured transactions, it will be necessary first to characterize the transaction and then determine what law governs. If the federal rules for determining what law governs a security entitlement differ from those found in the provincial STAs, confusion and inefficiency will result.

(e) Conflict with STA Rules Establishing Law Applicable to a Security Entitlement

One great benefit of the STA is that it provides clear, straightforward rules for determining the law that governs interests in indirectly held securities. Parallel federal legislation that would produce either the same or a different result would give rise to either needless duplication or needless confusion.

STA s. 45(1) provides that the "securities intermediary's jurisdiction" governs the central issues of the acquisition of a security entitlement from the securities intermediary, the rights and duties of the securities intermediary and entitlement holder arising out of a securities entitlement, whether a securities intermediary's owes any duty to an adverse claimant and whether an adverse claimant can assert a claim against an entitlement holder. The PPSAs in turn provide that the validity and perfection of security interests in security entitlements are also governed by the security intermediary's jurisdiction.[30]

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29 See discussion in Part II 1.(e) below.

30 See, for example, the *Personal Property Security Act*, R.S.O. 1990, c. P.10 (the "**OPPSA**"), s. 7.1(3)(c). The statement in the text only applies, of course, to those provinces that have enacted the STA and made complementary amendments to their PPSAs. For a complete discussion of the interplay between the Ontario STA and the OPPSA, see John Cameron "Secured Transactions Under Ontario's *Securities Transfer Act, 2006*" (2007), 22 B.F.L.R. 309.

STA s. 45(2) then provides a series of cascading rules for determining the securities intermediary's jurisdiction:

> In this section,
>
> "securities intermediary's jurisdiction" means the jurisdiction determined in accordance with the following rules:
>
> 1. If an agreement between a securities intermediary and its entitlement holder governing the securities account expressly provides that a particular jurisdiction is the securities intermediary's jurisdiction for the purposes of the law of that jurisdiction, this Act or any provision of this Act, the jurisdiction expressly provided for is the securities intermediary's jurisdiction.
>
> 2. If paragraph 1 does not apply and an agreement between the securities intermediary and its entitlement holder governing the securities account expressly provides that the agreement is governed by the law of a particular jurisdiction, that jurisdiction is the securities intermediary's jurisdiction.. . .

Since in almost every case the securities account agreement between the entitlement holder and the securities intermediary will specify either the securities intermediary's jurisdiction or the governing law of the agreement, the remaining three rules in the cascade test will rarely apply and need not be recited here. In Canada, this chosen law will necessarily be provincial or territorial rather than federal. Parties never choose federal law alone to govern a contract, and such a choice would not be meaningful because contract law is provincial, not federal.

What is especially important, in the present context, is that none of the tests in the STAs point to the federal jurisdiction or the jurisdiction governing the underlying issuer of the securities as the law that governs security entitlements. On the contrary, STA s. 45(3) provides in part as follows:

> In determining a securities intermediary's jurisdiction, the following matters are not to be taken into account: …
>
> 2. If an entitlement holder has a security entitlement with respect to a financial asset, the jurisdiction in which the issuer of the financial asset is incorporated or otherwise organized.

A federal rule that determines the law governing security entitlements to federal securities by "looking through" to the law governing the underlying issuer would therefore obviously

be inconsistent with the approach taken in the STAs,[31] and is undesirable for a number of reasons discussed elsewhere in this submission.[32] The legal infrastructure for the indirect holding system could not function effectively if it depended even in part on such a "look-through" rule – especially where the jurisdiction of incorporation of the underlying issuer would be unknown to most other participants in the system. Unless the purchaser of shares of ABC Corporation takes physical delivery of the security certificate (which *ex hypothesi* is not the case for an entitlement holder), the purchaser will generally not know, or care, whether ABC is incorporated under federal, provincial or foreign law.

As between a federal STA purporting to govern transfers of federal securities in the indirect holding system and provincial STAs governing transfers of other securities, there would either be a substantive conflict, which would cause needless inefficiencies and confusion, or no substantive conflict, which would cause needless duplication and probably render the federal rules redundant.

Unlike the provincial STAs, a federal STA could mandate a particular choice of law based on the look-through approach, or like the provincial STAs, it could permit consensual private ordering. If federal law preempts the choice of jurisdiction by the parties, then the law will vary depending on the initial characterization and may not reflect the intent of the parties. If federal law were to apply on a mandatory basis to all transactions involving a security entitlement in securities of a federal issuer while provincial law also applied as the law chosen by the securities account agreement, two separate laws would apply to transactions involving the entitlement holder's security entitlements: federal law to security entitlements to securities of federal issuers, and provincial law in all other cases, even if the underlying securities involve a foreign issuer. If on the other hand, federal law were to permit the parties to opt out by contract from the application of federal laws by designating another law as the intermediary's jurisdiction in the account agreement, then the federal

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31 It would also be inconsistent with the approaches taken in UCC Article 8 and the *Hague Securities Convention, supra*, footnote 3.

32 See discussion in Part II 1.(d) above and 1.(f) below.

indirect transfer rules could well become a dead letter because opting out will become the norm.

(f) Inherent Problems with Look-Through Approach

If whether federal or provincial rules applied to a transaction involving a security entitlement turned on whether the underlying securities were those of a federal issuer, then it would be necessary to look through each such transaction to determine, if possible, the jurisdiction of the underlying issuer. Such a look-through requirement would be inconsistent with the principles underlying the securities transfer laws of other countries whose financial markets are integrated with Canada's to a significant degree, in particular, the United States. It would add substantial legal complexity and uncertainty to Canadian securities transfer laws, with no corresponding benefit. An indirect consequence might be that Canadian issuers of publicly-traded securities would avoid federal incorporation, in order to ensure that only the simpler, more coherent and consistent provincial laws would apply.

(g) International Competitiveness

Given the increasing convergence of laws governing securities settlement systems across much of the world, the heightened focus on these laws and the increased ability of parties to freely choose the law governing transactions in indirectly held securities, small differences in local laws are in future more likely to matter more than they may have mattered in the past. Federal states such as Canada, the United States and Australia, competing against unitary states in the international marketplace, must therefore be vigilant in ensuring that overlapping or inconsistent laws do not put their countries at a competitive disadvantage. We believe that this factor favours either an exclusively federal law or an exclusively provincial law, not the exercise of concurrent federal-provincial jurisdiction. However, the constitutional barrier to a federal regime and provincial occupancy of the PPS/STA field means, in the case of Canada, that exclusive provincial occupancy of the field will provide the best available legal underpinning for the country’s security settlement system.

2. OPTIONS 2 AND 3: WHY FEDERAL ROLE IN DIRECT HOLDING SYSTEM SHOULD BE ABANDONED, NOT UPDATED

The CBA Section believes that the case for repealing federal corporate provisions relating to transfers in the direct holding system is at least as compelling as the case for not enacting a federal STA, for many of the same reasons.

(a) Boundary Between Corporate Law and Securities Transfer Law (Revisited)

First, while the STAs respect the boundary between corporate law and securities transfer law, they also provide a comprehensive set of rules that link rationally with corporate law and render federal legislation in the area largely redundant. The STA draws a clear line of demarcation between corporate law (including the validity of a security and the enforcement of the holder's underlying corporate and contractual rights against the issuer) and securities transfer law (which deals with the effect of registration on the books of the issuer and the associated cut-off rules). STA s. 44(1) governs the validity of the underlying security, which is generally the jurisdiction under which the issuer is incorporated or governed. STA s. 44(2) provides that the law of the issuer's jurisdiction governs the rights and duties of the issuer with respect to the registration of transfer, the effectiveness of the registration of transfer, whether the issuer owes any duties to an adverse claimant to a security and whether an adverse claim can be asserted against a person to whom the transfer of a security is registered. Hence, s. 44(2) is to the direct transfer system what s. 45(1) is to the indirect system.

STA s. 44(5) defines "issuer's jurisdiction", in the case of a CBCA corporation or other federally-incorporated issuer, as the province or territory in Canada in which the corporation has its registered office or head office. This gives every federally-incorporated issuer 13 jurisdictions from which to choose. To give even further flexibility, the STA contemplates that federal law can simply allow the federal corporation to choose the law of any jurisdiction within or outside Canada and that the "issuer's jurisdiction" can be chosen independently of the location of the federal corporation's registered office or head office. The CBCA and other federal corporate legislation ought to be amended to expressly permit federal corporations to select the law of a province or territory other than that where the

registered office or head office is located as the law governing the registration of transfer and the effect of the registration. There is no crucial connection between the location of the registered office or head office of a federal corporation and the law governing the matters set out in s. 44(2). STA s. 44(5) merely provides a default rule for determining a federal issuer's jurisdiction. One issue for federal policy is the extent to which federal corporate legislation ought to permit federal corporations to select the law of a foreign jurisdiction for the purposes of s. 44(2).

(b) Conflicting Laws Governing Security Certificates

STA s. 46 states:

> The law, other than the conflict of law rules, of the jurisdiction in which a security certificate is located at the time of delivery governs whether an adverse claim may be asserted against a person to whom the security certificate is delivered.

This is not referring to the federal jurisdiction as the place where a security certificate is delivered. Delivery must occur within a province or territory of Canada or in a foreign state.

Once again, s. 46 clashes with the CBCA and other federal corporate legislation governing adverse claims that is based, not on the jurisdiction where delivery of the security certificate takes place but the jurisdiction under which the issuer of the security is incorporated or governed. Hence, the clash of two laws (federal and local) will inevitably occur where delivery of a security certificate in a federal corporation is involved.

Nor, at the moment, is this clash necessarily innocuous. For example, the CBCA and the Ontario STA define "adverse claim" very differently. The CBCA defines "adverse claim" broadly to include "a claim that a transfer was or would be wrongful". Wrongful is not defined. A "wrongful" transfer could, for example, include knowledge of the lack of board approval under share transfer restrictions contained in the articles of a CBCA corporation that is a private issuer under National Instrument 45-106 (*Prospectus and Registration Exemptions*). It could include other such externalities, *i.e.* issues going beyond the *in rem* rights of a rival claimant to the securities embodied in the transferred security certificate. It is not clear how far "includes" extends notice of an adverse claim beyond "a claim that a transfer was…wrongful".

In contrast, the STA defines "adverse claim" narrowly:

> "adverse claim" means a claim that,
>
> (a) the claimant has a property interest in a financial asset, and
>
> (b) it is a violation of the rights of the claimant for another person to hold, transfer or deal with the financial asset.

The STA definition focuses exclusively on competing *in rem* rights, not on externalities. While federal law could be conformed to the STA, this would merely replace an existing inconsistency with an entirely duplicative provision.

(c) Needless Duplication and the Risk of Inconsistency

Thus, the STAs exhaustively cover the applicable law governing the transfer of securities of federal corporations. Except for the validity of the security and other rights and obligations between the federal corporation and the registered holder on its books, the STAs give federal corporations great freedom of choice with respect to the law governing the registration of transfers, effect of registration and defences of the federal corporation to the enforcement of a security by a purchaser for value without notice of the defence.

Currently, Part VII of the CBCA (sections 48-81 inclusive) is almost totally at odds with the STA conflict of laws rules set out in s. 44. Most fundamentally, Part VII sets out a separate regime governing the registration of securities transfers, effect of registration, cut-off rules and the effectiveness of defences of a CBCA corporation against a purchaser for value without notice. While, in most cases, the substantive effect of Part VII of the CBCA can be expected to be the same as the result under the STA, it is nevertheless the source of considerable uncertainty and incoherence to have different federal and provincial laws purporting to cover the same legal issues. For example, CBCA s. 70(1)(c) sets out a regime providing for constructive delivery of a security when a broker of the purchaser "sends the purchaser confirmation of the purchase and identifies in a record a specific security as belonging to the purchaser". Like its now repealed counterpart in former s. 78(1)(c) of the *Business Corporations Act*,[33] such a provision cannot be reconciled with the whole concept of a security entitlement that arises once a financial asset is credited to the securities account

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[33] R.S.O. 1990, c. B-16 (the "**OBCA**"). Clause 78(1)(c) was repealed when the Ontario STA came into force.

of the purchaser. In the STA, "delivery" is a concept that applies only in the direct holding system and the fiction of "constructive delivery" has been abandoned for the indirect holding system.

Again, while federal direct securities transfer rules could be conformed to the provincial STAs, there is no need for such legislative duplication. Assuming, for the sake of argument, that it were possible to pass and maintain a federal securities transfer law governing federal corporations that repealed the federal provisions covered by the STAs and precisely replicated the STAs at the federal level, the separate federal code would merely duplicate provincial law and override the STA conflict of laws rules with respect to federal issuers. If the federal legislation differed from the provincial STAs, what would justify that difference and the uncertainty created by maintaining substantively inconsistent and overlapping federal and provincial securities transfer laws? Finally, even if federal corporate legislation could be passed that was uniform word-for-word with provincial direct transfer laws, could that uniformity be maintained? Even now, it is difficult to achieve legislative uniformity at federal and provincial levels. Coexisting federal and provincial legislation would run the risk of gradually drifting apart, creating needless uncertainty and inconsistencies.

Stated otherwise, federal law governing the direct transfer of securities in federal corporations would, if completely consistent with provincial law, be redundant and, if not, would undermine the coherency and certainty of Canada's securities transfer laws.

(d) Conflicting Laws Applicable to Security Interests in Securities

As with the indirect holding system, the fact that security interests in directly held securities are governed by provincial PPSAs make the continued existence of a separate federal regime for transfers in the direct holding system awkward and less workable. CBCA s. 48(1) defines "purchaser" as including not only a buyer, but a person who takes an interest in a security by "mortgage", "hypothec", "pledge" and any other voluntary transaction. Thus, Part VII of the CBCA purports to apply to security interests in securities issued by CBCA corporations. In particular, CBCA s. 60(2) states that:

> A *bona fide* purchaser, in addition to acquiring the rights that the transferor had or had authority to convey, also acquires the security free from any adverse claim.

However, as stated above, neither the CBCA nor any other federal statute provides for any of the other rules that are needed for a regime purporting to govern security interests in securities. In particular, the CBCA does not contain any attachment, perfection or priority rules. In Canada, a complete set of rules governing security interests in investment property such as securities can only be found in provincial PPS legislation such as the OPPSA.[34] Effective January 1, 2007, the OPPSA was amended to provide for a conflict of laws regime that precisely dovetails with the Ontario STA. The provisions relating to directly held securities are as follows:

> 7.1 (1) The validity of a security interest in investment property shall be governed by the law, at the time the security interest attaches,
>
> (a) of the jurisdiction where the certificate is located if the collateral is a certificated security;
>
> (b) of the issuer's jurisdiction if the collateral is an uncertificated security; …
>
> (2) Except as otherwise provided in subsection (5), perfection, the effect of perfection or of nonperfection and the priority of a security interest in investment property shall be governed by the law,
>
> (a) of the jurisdiction in which the certificate is located if the collateral is a certificated security;
>
> (b) of the issuer's jurisdiction if the collateral is an uncertificated security;…
>
> (3) For the purposes of this section,
>
> (a) the location of the debtor is determined by subsection 7 (3);
>
> (b) the issuer's jurisdiction is determined under section 44 of the *Securities Transfer Act, 2006*;
>
> (5) The law of the jurisdiction in which the debtor is located governs,
>
> (a) perfection of a security interest in investment property by registration; …

OPPSA s. 1(1) defines "investment property" as including "securities". These would include securities in a federal corporation. Again, it undermines legal certainty to maintain two sets of fundamentally inconsistent conflict of laws rules: a federal law that purports to apply federal law to pledges or other security interests of securities issued by federally

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[34] *Supra*, footnote 30.

incorporated issuers, and a provincial law that applies the law of the jurisdiction in which the securities certificates are delivered, the uncertificated securities are registered or the debtor is located. The OPPSA does not contemplate the application of federal law to security interests in federal issuers and rightly so because there is no such law. The only way to reconcile this inherent conflict is for Parliament to vacate the field with respect to federal laws purporting to deal with the pledge of, or other security interests in, securities of federal issuers.

(e) Characterization of Underlying Transaction as Absolute Transfer or Security Interests

In Part II.1(d) above, we made the point that, under the indirect holding system, a distinction between the creation and extinguishment of security entitlements to effect absolute transfers on the one hand and to effect create a security interest on the other hand would not be practicable and would seriously undermine the efficiency of the indirect holding system. The same point applies to the direct holding system.

Without a federal PPSA, a transfer of securities of a federal issuer would still have to be characterized as either an absolute transfer (to be governed by the federal direct transfer rules) or an acquisition of control to perfect a security interest in the underlying securities (to be governed by provincial PPS laws). As in the indirect system, the characterization of a transfer as absolute or as a security interest is largely dependent on documents other than the endorsed security certificate, and sometimes even those documents are ambiguous (often deliberately so) as to the appropriate characterization. The issuer or its registrar and transfer agent cannot be expected to make this determination. Yet, without this determination, the issuer or its registrar and transfer agent will not know whether federal or provincial rules apply to the transfer.

(f) Control of a Security

Unlike provincial PPSAs, neither the CBCA nor any other federal law contains express rules dealing with priorities of competing security interests in the securities of federal issuers.

Also, the STA contains the concept of control, defined in sections 23 to 28. The CBCA contains no such concept.

OPPSA s. 30.1(2) provides that a security interest of a secured party having control of securities (or other investment property) has priority over a security interest of a secured party that does not have control. In addition, a security interest in a certificated security in registered form which is perfected by taking delivery of the unendorsed certificate has priority over a conflicting security interest perfected by a method other than control. The CBCA provides no parallel set of rules for federal securities.

The concepts of "security interest", "control", "perfection" and "priority" in the OPPSA and the STA are completely foreign to the CBCA and, even if they could be duplicated under federal law so as to harmonize with provincial STA/PPS regimes, would add nothing.

(g) Proceeds

Another area of uncertainty created by the coexistence of federal securities transfer rules alongside those in the STA occurs if there are proceeds from the federal securities. The proceeds can take the form of dividends paid or payable on shares, interest paid or payable on debt obligations, proceeds from disposition of securities or redemption proceeds. A holder of securities might take the proceeds from the redemption of shares in a CBCA issuer and use those proceeds to purchase securities in a non-federal issuer. At some point, the law applicable to the shares in the federal issuer must cease to apply and provincial laws must apply. But where, exactly? Shares can be sold for a promise to pay other than a negotiable instrument or they could be sold for cash. If the shares are sold in exchange for a negotiable instrument, the BEA will continue to apply to the instrument. In all other cases, provincial laws will apply. Whether federal or provincial laws apply to the proceeds on the disposition of securities will depend on the timing and nature of the consideration received on the disposition. Again, this adds another level of complexity to the analysis of the rules applicable to securities and their proceeds.

(h) Overlap and Inevitable Inconsistency

As in the indirect holding system, the coexistence of a federal securities transfer regime undermines legal certainty in the direct holding system. Market participants must first determine which set of rules apply and whether there are differences in these rules. The co-existence of federal and provincial transfer rules entails legislative overlap and inconsistency. In effect, there will have to be a federal override or carve-out for federal

securities from provincial securities transfer rules. Even if the federal transfer rules were designed to harmonize with the provincial rules, differences would remain in areas such as conflict of laws. In particular, provincial PPS laws are closely integrated with provincial STA regimes and would have to be rewritten to be consistent with both provincial and federal STA regimes. If, at the end of the day, the federal transfer rules are identical to those of the provincial laws, then federal rules will only add an additional layer of unnecessary complexity to Canada's STA and PPSA regimes at the provincial level.

3. RESPONSES TO ARGUMENTS AGAINST OPTION 2 (General Repeal of the Federal Securities Transfer Provisions)

The Consultation Paper alludes to several arguments that might be made against Option 2, to repeal federal securities transfer rules. We believe that these arguments have little merit.

(a) Are there Meaningful Gaps and Transitional Problems?

One of the issues raised is whether the immediate repeal of the federal transfer rules could create transitional issues and create possible gaps in the rules governing direct holdings and transfers of the securities of federal issuers. Any such concerns seem to us exaggerated.

First, the STAs contain conflict of laws rules that govern federal corporate issuers. For the direct system, the applicable law for a federal corporate issuer is the province or territory in which the federal issuer has its registered office unless the federal issuer is permitted by federal law to choose another law. Accordingly, any federal issuer that does not already have its registered office in an STA province can change it to an STA province. In due course, the federal issuer can choose one of 13 statutes to govern it – each substantively identical. Thus, even before the remaining provinces and territories enact the STA, there are no meaningful gaps or transitional problems that justify retaining or expanding federal securities transfer rules.

There are no gaps under the indirect system because the applicable law for the indirect system depends on the jurisdiction of the securities intermediary, not on the jurisdiction governing the issuer of the underlying securities. A federal presence is irrelevant to the indirect holding system because parties to a securities account agreement will not and in fact

cannot choose "federal" law to govern their agreement. It is to be expected that such parties will choose the law of a province that has enacted the STA.

Second, no federal laws govern the indirect holding system for federally incorporated issuers except for the rudimentary constructive delivery provisions in CBCA s. 70 and provisions dealing with transfers through clearing agencies in federal financial institutions legislation (such as s. 121 of the *Bank Act*[35] and corresponding provisions in the *Trust and Loan Companies Act*,[36] *Insurance Companies Act*[37] and *Cooperative Credit Associations Act*[38]).

Nor will any meaningful gap or transitional issues arise under the direct holding system because Ontario STA s. 44 (and equivalent conflict of laws provisions in other provincial STAs) gives federal issuers extensive latitude to choose the law applicable to registration of transfers in their securities, effect of registration, adverse claims and limitation of defences. While these matters are governed by the law of the province or territory where the registered office or head office is located, in practice, it is not difficult to change the location of the registered office of a CBCA corporation. Moreover, at least with respect to the securities transfer matters set out in s. 44(2), it is possible for federal law to take advantage of the additional flexibility that s. 44(5) affords. Federal law could, and should, permit a federal corporation to specify its "issuer's jurisdiction" as a law other than the province or territory in which its registered office or head office is located.

Third, with respect to the direct holding system, all provinces have laws governing security interests in securities (the PPSAs in the case of all provinces other than Quebec).

Finally, even if there are "gaps" that must be filled by resort to the common law, these are at most temporary. All the provinces and territirues are rapidly proceeding to adopt STAs. Five provinces have now done so, with complementary amendments to their PPSAs. Our

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35 Supra, footnote 24.

36 S.C. 1991, c. 45.

37 S.C. 1991, c. 47.

38 S.C. 1991, c. 48.

understanding is that the other provinces and territories will soon follow. In light of the remarkable degree of cooperation among the provinces and the unprecedented degree of uniformity in the legislative texts to date, any fear of a meaningful lack of responsiveness at the provincial and territorial levels would appear unfounded. Moreover, given the relatively long gestation period for complex commercial legislation, it may well be a misallocation of resources to devise an elaborate federal scheme, requiring complementary amendments to provincial STA/PPS regimes, to fill "gaps" that either are not "gaps" at all or are at worst short term, if the need for a scheme will have disappeared by the time it becomes law.

(b) Legislative Simplicity and Regulatory Burdens

The Consultation Paper raises the concern that repealing federal direct transfer rules may not be attractive to closely-held federally-incorporated issuers who currently enjoy the convenience of dealing with one statute for corporate governance and securities transfer rules. It argues that requiring closely-held federally incorporated issuers to follow federal law for corporate governance and provincial law for securities transfers could cause confusion and difficulties. We believe that these "regulatory burden" concerns can be readily answered.

First, based on our collective experience, we doubt that share transfer rules often become a burden on closely-held corporations. Because share transfers are relatively infrequent in most such corporations and, by definition, require approval of the directors or shareholders under typical private issuer transfer restrictions, the validity of transfers is seldom contested and therefore seldom requires legal analysis under the applicable transfer rules.

Second, while it is desirable for only one statute to apply to closely-held federal issuers, we believe that this argument favours repeal of the federal direct transfer rules. As long as there are direct transfer rules at the federal level, both federal and provincial laws will apply to every closely-held federal issuer. The simplest way to achieve one set of statutory rules is to repeal the federal transfer rules. If federal transfer rules continue, they will coexist alongside provincial STAs and PPS legislation, creating confusion and regulatory overlap.

Third, the regulatory burden argument wrongly conflates corporate governance and security transfer rules. Corporate governance and securities transfer rules are entirely different and the points of intersection between the two, other than approval of transfers under private issuer transfer restrictions, are non existent. Securities transfer rules are essentially commercial property transfer rules and have nothing to do with corporate governance. A corporation will, of course, decide the characteristics attached to its shares and debt obligations. In the case of shares, these will be set out in the rights, privileges, restrictions and conditions attached to the share provisions contained in its articles. These share provisions include rights to elect directors.[39] A corporation must also comply with its corporate statute in issuing securities. However, securities transfer laws are not about the rights attached to securities or the internal governance requirements for valid issuance of the securities. Securities transfer laws concern only the transfer, pledge or holding of securities. The STA in effect provides that non-compliance by a corporation with its internal governance rules applicable to the issuance of the securities (such as ensuring that the person signing the security certificate had the requisite authority), provides no defence against a purchaser for value without notice of the non-compliance.[40]

Canadians are used to having federal rules apply to one sphere of activity and provincial laws apply to another. As long as the boundaries between the federal and provincial laws are well-defined and regulatory overlap is minimized, it will not be difficult for federal corporations to look to the corporate statute for corporate governance rules and to provincial STAs and PPSAs for rules governing security transfers in the securities of all issuers. Federally incorporated companies must look to provincial laws for many other facets of their activities including, for example, securities regulation, most real estate transactions, PPS legislation, most licensing requirements, most personal property transfers (other than intellectual property), contract law, and often employment, electronic commerce and privacy laws. As long as there is a coherent separation between federal corporate governance laws

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39 See, for example, the default rules set out in the CBCA, ss. 24(3)(a) and (4)(b) read in conjunction with s. 135(5).

40 See, for example, Ontario STA, s. 57(3).

and provincial security transfer laws, the separation of these functionally different laws will reduce, not add to, the regulatory burden imposed on federal corporations.

III DBNA AND BEA (Consultation Paper Part 3D)

1. Depository Bills and Notes Act

The CBA Section recommends amending the DBNA[41] to remove the references to constructive possession. This would be more of a clean-up exercise than introduction of a substantive legal change.

STA s. 14 provides:

> A depository bill or note to which the *Depository Bills and Notes Act* (Canada) applies is not a security, but is a financial asset if it is held in a securities account.

What this means is that:

> (a) an investor in a depository bill or note will be regarded as holding a security entitlement to that bill or note so long as it is held in a securities account, making the STA and the PPSA fully applicable; and
>
> (b) the STA will not apply to the direct holding of a depository bill or note, which, in practice, only applies on the issuance of the depository bill or note to CDS as the clearing agency.

Thus, consistent with s. 14, the CBA Section recommends that the DBNA be confined to direct transfers of federal depository bills and notes to and from the clearing agency. The DBNA should no longer apply to indirectly held bills and notes, *i.e.* security entitlements in depository bills and notes. This line of demarcation is the only one that would be consistent with the STAs. The STAs do not purport to govern the issuance of depository bills and notes by the federal government to the clearing agency, CDS.

While the DBNA currently provides for the indirect holding of depository bills and notes, it relies on the antiquated fiction of deemed possession modeled on former s. 85 of the OBCA. The DBNA was enacted as temporary stopgap legislation pending the arrival of the STAs and is deficient in comparison to the clarity and precision of the STAs. Currently, there is a

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41 *Supra*, footnote 6.

significant overlap between the DBNA and the STAs regarding transfers of depository bills and notes in the indirect holding system. Under the rules of CDS, these are regulated by both the DBNA and the STA – a confusing result that ought not to be perpetuated. The arguments against the federal government expanding its role in the indirect holding system also support the repeal of the DBNA provisions that cover the indirect holding of these instruments. Provincial STAs are more than adequate to deal with depository bills and notes held indirectly and provide a coherent, comprehensive one-stop set of rules for all indirectly held financial assets. A separate set of rules for indirectly held depository bills and notes perpetuates the co-existence of two inconsistent systems and the look-through rule to determine the nature of the underlying investment property. The resultant complexity and inconsistency undermine legal certainty with no offsetting gains.

In contrast, the DBNA provisions that relate to the issuance of depository bills and notes to CDS are not objectionable since provincial STAs do not apply to that issuance.

2. Bills of Exchange Act

No changes to the BEA[42] are needed to accommodate the implementation of the STAs. Accordingly, we recommend that no changes be made to the BEA.

STA s. 13 provides:

> A bill of exchange or promissory note to which the *Bills of Exchange Act* (Canada) applies is not a security, but is a financial asset if held in a security account.

Provincial STAs do not, and, under the Canadian Constitution, cannot apply to the issuance, endorsement or delivery of negotiable instruments under the BEA. However, the BEA does not apply to the indirect holding system.[43] If a negotiable instrument is held by an intermediary in a securities account for a customer, the negotiable instrument becomes a financial asset like any other and should be governed by the same rules that apply to all other financial assets. Otherwise, again, separate systems for different types of financial assets would lead to overlap, inconsistency, uncertainty and inefficiency.

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42 *Supra*, footnote 7.

43 Indeed, this was one reason that the DBNA was enacted.

A financial asset can include any asset that is agreed to be treated as a financial asset as between the intermediary and the entitlement holder.[44] It is a hallmark of the security entitlement concept that the attributes of the underlying financial asset are largely irrelevant to the rules governing its transfer. One of the drafters of Article 8 once remarked that the rules governing security entitlements could apply just as well to a banana as to a bond.[45] If financial assets can include bananas, then it is illogical to exclude negotiable instruments (or securities of federal corporations or federal depository bonds or notes).

IV IMPACT OF PROVINCIAL STAS ON FEDERALLY INCORPORATED ENTITIES (Consultation Paper Part 3A)

Until the advent of the STAs, there were significant gaps in provincial coverage of the indirect holding system. What little legislation existed was confined to OBCA s. 85, some provisions of the *Securities Act* (Quebec),[46] the DBNA and federal financial institution legislation. So far, the most significant impact of STAs has been to fill these gaps in the law governing the indirect holding system and provide a comprehensive, coherent system. Provincial STAs are an immense improvement on the outdated constructive possession provisions still contained in those statutes.

Perhaps the second most significant impact of provincial STAs on federally incorporated issuers is the overlap and inconsistency in the rules governing directly held securities. Here, two sets of legal rules currently co-exist: federal rules covering securities in federal corporations and provincial rules covering all other securities regardless of the jurisdiction of the underlying issuer. Thus, in the case, for example, of a CBCA corporation, a complete analysis requires a consideration of Part VII of the CBCA and the applicable provincial STA/PPS regime.

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44 See clause (d) of the definition of "financial asset" in the Ontario STA.

45 James Steven Rogers, "The Revision of Canadian Law on Securities Holding Through Intermediaries: Who, What, When, Where, How and Why" (2007), 45 Can. Bus. L. J. 49 at 55.

46 R.S.Q. c. V-1.1.

Federal issuers would enjoy efficiency gains and other benefits if only provincial STAs applied to transfers of their securities. Provincial STAs are highly integrated with PPSAs. There are no federal counterparts of the provincial PPS regimes. Provincial STA direct transfer rules represent a significant improvement on the provisions of Part VII of the CBCA and other comparable federal laws. Provincial STAs allow federal issuers the benefit of one statute containing a comprehensive code on the direct transfer of securities.

With respect to the direct holding system, there are also no meaningful gaps. The provincial STAs cover federal issuers. Federal issuers are freely able to choose the applicable provincial STA. A federally incorporated issuer with its registered office in a province without a STA need not even wait until its province passes an STA. The federal issuer can choose another provincial law to govern the direct transfer of its securities. It can do this easily by relocating its registered office to a province that has enacted an STA or can choose another law if permitted to do so under its federal incorporation statute.

V INTERACTION OF PROVINCIAL STAS ON THE OVERALL LEGISLATIVE AND REGULATORY FRAMEWORK FOR FEDERALLY INCORPORATED ENTITIES (Consultation Paper Part 3C)

We defer commenting in detail on the amendments that should be made to Part VII of the CBCA, the *Canada Cooperatives Act*[47] and federal financial institution legislation such as the *Bank Act*, *Trust and Loan Companies Act*, *Insurance Companies Act* and *Cooperative Credit Associations Act*.[48] The threshold question is whether provisions that overlap with provincial STAs should be repealed (Option 2) or retained in modified form (Option 3). Until that decision is made, a detailed analysis of what provisions of the CBCA and federal other corporate statutes should be repealed, retained or modified is premature.

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47 S.C. 1998, c.1.

48 See footnotes 24, 36, 37 and 38, *supra*, for references to the federal financial institutions statutes.

If the decision is to repeal federal securities transfer provisions (with the exception of the BEA and the DBNA direct transfer rules), we would welcome the opportunity to comment further on the following matters:

(a) securities registers;

(b) transmission of securities;

(c) differentiating use of the terms "entitlement holder" and "beneficial owner" within the corporate statutes;

(d) amendments to proxy solicitation rules and proposals;

(e) whether to extend various shareholder remedies to entitlement holders;

(f) whether changes are needed to federal rules respecting dividends and liquidation distributions, notices of meeting of shareholders, distribution of financial statements and interim financial statements, dissent and appraisal rights, take-over bids and going-private transactions, unanimous shareholder agreements and unanimous shareholder declarations; and

(g) dematerialization.[49]

However, detailed analysis of these subsidiary questions must await the pivotal decision on whether the transfer provisions in federal corporate statutes should be expanded, updated or repealed.

VI CONCLUSION

With the provincial STAs, for the first time in Canadian legislative history, we are close to having a major commercial law statute that addresses issues of profound importance for the capital markets that is truly uniform across the country. The STAs create a coherent and well integrated legal infrastructure for securities transfers that finally reflects modern market realities and puts Canada on an equal footing with our trading partner to the south. The CBA Section strongly believes that federal legislation in this area would mark a regrettable step backwards that could undo much of the good work done by the architects of the STAs. We hope that Finance Canada and Industry Canada will take our concerns to heart in considering what role Parliament should take in reforming this critical area of the law.

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[49] See, for example, the OBCA, s. 54, permitting dematerialization of any class or series of shares of an OBCA corporation.