**Boston College Law School**
**Digital Commons @ Boston College Law School**

Boston College Law School Faculty Papers

January 2007

# The Revision of Canadian Law on Securities Holdings Through Intermediaries: Who, What, When, Where, How and Why?

James S. Rogers
*Boston College Law School*, james.rogers@bc.edu

Follow this and additional works at: https://lawdigitalcommons.bc.edu/lsfp

Part of the Commercial Law Commons

Recommended Citation
James S. Rogers. "The Revision of Canadian Law on Securities Holdings Through Intermediaries: Who, What, When, Where, How and Why?." *Canadian Business Law Journal* 45, (2007): 49-66.

This Article is brought to you for free and open access by Digital Commons @ Boston College Law School. It has been accepted for inclusion in Boston College Law School Faculty Papers by an authorized administrator of Digital Commons @ Boston College Law School. For more information, please contact nick.szydlowski@bc.edu.

# THE REVISION OF CANADIAN LAW ON SECURITIES HOLDING THROUGH INTERMEDIARIES: WHO, WHAT, WHEN, WHERE, HOW AND WHY

*James Steven Rogers**

## I. INTRODUCTION

I'm delighted to have the opportunity to comment on the legislation that has recently been adopted in Ontario and Alberta to revise Canadian law in a fashion consistent with the changes that were made in U.S. law by Revised Article 8 of the Uniform Commercial Code (UCC).[1] I will concentrate on some of the new terminology and concepts used in the Securities Transfer Act (STA)[2] and related revisions of the Personal Property Security Act (PPSA).[3]

The old newspaper device of "who, what, when, where, how, why" provides a useful tool for a survey of the approach taken by the new STA to the commercial law of the modern indirect holding system.

## II. WHO

The indirect holding system provisions of Part VI of the STA apply to any situation in which a person holds an interest in a security or

---

* Professor, Boston College Law School. The author served as Reporter to the Drafting Committee to Revise UCC Article 8. This paper is a revised version of one given at the 36th Annual Workshop on Commercial and Consumer Law on October 27, 2006.

1. The Article 8 revision project was largely prompted by the important work on the commercial law treatment of securities held through intermediaries done by Prof. Charles W. Mooney, Jr. Prof. Mooney's article, "Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries" (1990), 12 Cardozo L. Rev. 305, sets out the basic problems with the older approach, as well as the general contours of the solution taken in Revised Article 8. For general treatment of Revised Article 8 of the UCC, see James Steven Rogers, "Revised Article 8: Investment Securities", vol. 7A of Hawkland Uniform Commercial Code Series (1996); James Steven Rogers, "Policy Perspectives on Revised UCC Article 8" (1996), 43 U.C.L.A. L. Rev. 1431.
2. Citations herein are to the Ontario enactment, Securities Transfer Act, S.O. 2006, c. 8.
3. Citations herein are to the Ontario enactment, Personal Property Security Act, R.S.O. 1990, c. P.10.

other financial asset through a securities account maintained by a "securities intermediary".[4] The arrangement that first comes to mind is that of the retail investor who holds securities through an account with a brokerage firm. But the indirect holding systems provisions apply more broadly. For example, in many circumstances an investor holds securities through an account not with a brokerage firm, but with a bank acting as a securities custodian. Moreover, the commercial law rules in the STA can apply to transactions that may be rather different from those that first come to mind.

Let me begin with a story about the activities of a fraudster named James Doyle, whose activities came to light in litigation in the United States in the late 1970s.[5] Apparently Doyle had once worked for a licensed and regulated securities firm, but was fired from that job. Fortunately for Doyle, and unfortunately for his customers, a fair number of his customers remained loyal to Doyle and continued to transact business through him. Doyle's method of operation was very simple. Doyle would purchase certificated bearer bonds and hold them on behalf of his customers. His accounting and custody system was very simple. He would place a particular bond in an envelope and write on the outside of the envelope the name of the customer who had purchased it. He kept the envelopes containing the bonds in a closet in his house.

Evidently not all went well with Mr. Doyle. He fled the country and was apprehended in the Panama Canal Zone. Along with Mr. Doyle, the authorities found several suitcases, stuffed with bearer bonds. Needless to say, Mr. Doyle had not kept the bonds in the original envelopes, nor had he kept any records matching particular bond numbers with particular customers. When the authorities searched his house, they found some bonds still in his closet, in envelopes containing names of some of his customers. The total amount of bonds found in the suitcases and closet was, unsurprisingly, not enough to satisfy the claims of all of Doyle's customers.

The ensuing litigation pitted the "closet bond" claimants against the "suitcase bond" claimants. Those customers whose names were written on the outside of envelopes left in the closet, and still containing bonds, said "We're sorry about the suitcase bond claimants, but *our* bonds are still there, in their envelopes, marked with *our* names, in the closet. So, we should get *our* bonds and the rest of the unfortunate customers should be left fighting over the division of the suitcase bonds." The "suitcase bond" claimants, that is, those customers whose names did not appear on any of the envelopes in the

4. STA, ss. 1(1) and 95.
5. See *United States v. Doyle*, 486 F. Supp. 1214 (D. Minn. 1980).

closet, said "There is no way to reliably distinguish the suitcase bond claimants from the closet bond claimants, nor any really good way to know whether the people whose names were written on the outside of the envelopes in the closet were really the ones whose money paid for those bonds. Accordingly, we should all share in all of the bonds."

I begin with this story partly because it is funny — at least if you were not one of the customers. But, more importantly, I mention the case because I think that it illustrates, in a very simple way, the fundamental problems that the law of modern securities holding systems must confront. Doyle was acting as a securities intermediary — that is, he was holding a mass of securities on behalf of customers. Doyle failed, leaving a shortfall in the securities that he held to satisfy the claims of his customers. The legal system had to decide what rules it would apply to determine how the loss would be spread among Doyle's customers. That is one of the fundamental problems addressed by the new Securities Transfer Act.

The traditional approach to the commercial law of securities holding attempted to ignore the role of securities intermediaries and describe the interest of a person who held securities through an account with an intermediary using essentially the same concepts that were developed for the older system in which the ultimate investors held physical possession of certificates representing their interests. The role of intermediaries was treated under concepts of trust, agency, bailment or the like. The main feature of the new STA is that it provides a new way of describing the interests of investors who hold through intermediaries, taking account of the realities of the modern securities holding system. So, the most obvious applications of the indirect holding system provisions of the STA are situations where investors hold interests in securities through accounts with brokers or banks acting as securities custodians.

But the indirect holding system rules also apply to other stages of the tiered system of securities holding that is common today. Suppose that Investor holds securities through an account with Broker. The STA provides that Investor's interest is described as a "security entitlement" with respect to the underlying securities. That security entitlement consists of a package of rights against Broker and interests in the property held by Broker. It is possible, though unlikely, that Broker will itself be a direct holder of the underlying securities, for example if Broker has actual physical possession of bearer certificates representing the securities. It is far more likely that Broker in turn holds through an account with another intermediary. In the simplest such arrangement, Broker may have an account with a clearing corporation, such as The Canadian Depository for Securities

Limited (CDS). The relationship between Broker and CDS is described using the same terms and concepts as the relationship between Investor and Broker. Broker has a security entitlement against CDS to the aggregate position in the underlying security. That security entitlement consists of a package of rights that Broker has against CDS and interests in the property held by CDS.

The entities that first come to mind when one thinks of securities intermediaries are all heavily regulated financial institutions. But the situation that is most likely to present serious problems for the commercial law of securities holding occurs if a person who acts as a securities intermediary does not comply with the regulatory law. Think about Doyle. If Doyle had been honest, it would make no difference what legal rules described the interests of customers who held through an intermediary. The rule could be as silly as "The customers' claims to the securities held by the intermediary are ranked in alphabetical order of the customers' last names." That would be fine. If there are sufficient securities to satisfy the claims of all customers, it does not really matter what rules apply to contests among the claimants. The time when the rules really matter is the time when there is a conflict among the customers. And the simplest way that such a conflict would arise is if the person acting as intermediary is dishonest and flaunts the regulatory system.

Note another point illustrated by the Doyle story. One of the problems was that Doyle did not keep adequate records.[6] There is a tendency to assume that the answer to the problem of inadequate records is regulation; that is, adopt laws requiring intermediaries to keep proper records, and put in place an enforcement mechanism that tries to assure that the record-keeping requirements are met, by such devices as periodic or surprise audits. Having such regulatory regimes is, without question, a very good idea. Indeed, from a practical standpoint it is probably the most important role for law and governmental institutions in controlling risk in the securities holding system. But the adequacy of the regulatory system is a completely different issue from the adequacy of the commercial law regime. We can put in place regulatory regimes that say, "Intermediaries, you must keep good records." We can put in place enforcement rules that say, "If the intermediary does not keep good records, then the responsible officials of the intermediary will be sent to jail." But no amount of regulatory law will resolve the problems that are left by intermediaries who do not comply with those laws. If our commercial

6. Even if Doyle had kept fuller records showing which bonds belonged to which customers, it is far from clear that it would have made sense to allocate the remaining securities on the basis of those records.

law rules work only if the intermediary has kept proper records, then our commercial law rules have simply not answered the question. To put it simply, regulatory law says "Thou shalt not steal." Commercial law tells us what happens to the victims of those who do steal. A commercial law that applies only to people who do not steal is not very useful.

The fact that people who violate regulatory law are the most likely to create problems requiring a commercial law solution has important implications for issues of the scope of the indirect holding system rules. When one writes rules for the indirect holding system, one naturally has in mind the activities of regulated intermediaries. There is a tendency to allow that natural focus to shift into a statement of the coverage of the indirect holding system rules. Yet if one writes a system of commercial law rules for the indirect holding system and ties the coverage of those rules to the regulatory law that determines who is permitted to act as a securities intermediary, one would have failed to deal with the most important problem — what to do if the entity that has failed did not comply with regulatory requirements. As a result, the U.S. and Canadian processes ended up with a structure of indirect holding system rules that applies to any entity that is in fact engaged in the business of maintaining securities accounts for others, whether or not it is permitted to do so by regulatory law and whether or not it has complied with regulatory responsibilities. Thus, if Mr. Doyle's activities occurred in the United States or Canada today, the rights of his customers would be governed by the indirect holding system rules in revised UCC Article 8 or the STA, regardless of the fact that he was not operating as a properly regulated securities intermediary.

## III. WHAT

The indirect holding system provisions of the STA apply to any situation in which a person holds an interest in a "financial asset"[7] through a securities account maintained by a securities intermediary. The definitional structure here is, regrettably, a bit complex. The term "security"[8] is used to refer to the narrowest class of instruments that have traditionally been the subject of securities transfer law, such as shares of stock and bonds. The direct holding system provisions of the STA describe the rights and duties of issuers and holders of "securities" as well as the process of transfer of directly held interests in securities.[9]

7. STA. s.1(1).
8. *Ibid.*
9. STA, Parts III to V.

The definitional structure would be a bit simpler if one said that the new indirect holding system rules applied only to the same category of investment vehicles as the traditional direct holding system rules — that is "securities". But that approach would present serious problems.

Consider, for example, bankers' acceptances. In the securities business, bankers' acceptances would be thought of as merely one category of short-term money market instruments, along with commercial paper and certificates of deposit. For purposes of commercial law, however, a bankers' acceptance would be regarded as a bill of exchange, governed by the Bills of Exchange Act, rather than as a security.[10] That is an entirely appropriate classification, even for those bankers' acceptances that are handled as investment media in the securities markets, because the STA, unlike the Bills of Exchange Act, does not contain rules specifying the standardized obligations of parties to instruments. For example, Bills of Exchange Act rules on the obligations of acceptors and drawers of drafts are necessary to specify the obligations represented by bankers' acceptances, but the STA contains no provisions dealing with these issues.

Immobilization through a depository system is, however, just as important for money market instruments as for traditional securities. If the indirect holding system rules applied only to the narrower category of "securities", then they would be of no use for a system in which bankers' acceptances are held through a depositary system. The STA solves that problem by using the broader term "financial asset" in setting the scope of the indirect holding system rules. Thus, even though a bankers' acceptance is itself a bill of exchange rather than a "security", it would still fall within the definition of "financial asset". Accordingly, if the instrument is held through a clearing corporation or other securities intermediary, the indirect holding system rules of the STA apply.[11]

Indeed, the term "financial asset" that sets the scope of the indirect holding system rules is intentionally left very broad. It covers "any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial

10. See Ontario Business Corporations Act, R.S.O. 1990, c. B.16, s. 53(2).

11. STA s. 13 makes this explicit: "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 it is held in a securities account." For general discussion of the difference between the terms "security" and "financial asset", see Rogers, Hawkland Series, *supra*, footnote 1, at [Rev] § 8-102:04.

asset under this Act".[12] This provision captures a thought that only became apparent after considerable work on the UCC Article 8 revision project — that the rules of the indirect holding system were rules about *how* property is held, not *what* that property is. In the quip that became part of the folklore of the UCC Article 8 revision project, the indirect holding system rules could just as well apply to a banana as to a bond. If a clearing corporation or other intermediary wishes to hold bananas for its customers in a securities account and is willing to treat its customers as having the same package of rights with respect to those bananas as with respect to traditional securities held in the account, so be it. There is no reason to make it impossible for the parties to use the same package of indirect holding system rules for security entitlements with respect to bananas as for security entitlements with respect to shares of Microsoft common stock.

To take a somewhat more realistic example, suppose that Canadian Investor wishes to hold a position in an equity security issued by French Company through an account with Canadian Broker. Canadian Clearing Corporation has made the necessary arrangements to hold the equity security through whatever system is in place for such investments in France, and therefore Canadian Clearing Corporation is willing to hold the position for its customers, such as Canadian Broker. Canadian Broker in turn is willing to hold the position for Canadian Investor. If the scope of the Canadian domestic law of securities holding were limited to "securities", then one could not conclude that the Canadian STA provisions concerning security entitlements applied unless one could conclude that the underlying equity security issued by French Company fit within the definition of "security" set out in Canadian law. But it is quite possible that differences between the domestic law of France and Canada would make it extremely difficult to decide whether the French equity interest does or does not fall within the definition of "security" set out in Canadian law. Under the definitional structure used in the STA, there is no need to ask or answer that question. The French equity probably falls within the Canadian definition of "financial asset" even without any special action,[13] and even if there is doubt on that score, the problem can be resolved by an agreement or rules of the clearing corporation providing that the interest is to be treated as a "financial asset".[14]

---

12. STA, s. 1(1).
13. See STA, s. 1(1): "'financial asset' means . . . a share, participation or other interest in a person, or in property or an enterprise of a person, . . . (c) that, (i) is, or is of a type, dealt in or traded on financial markets, or (ii) is recognized in any other market or area in which it is issued or dealt in as a medium for investment."

A final definitional complexity affects the coverage of the new security interest rules. The new security interest rules apply to "investment property".[15] That term includes both "securities" and "security entitlements", so it covers both any direct interest in a traditional security as well as any "security entitlement" to the broader category of "financial asset". But, the term "investment property" also includes a "futures contract" or "futures account". The idea here is that the needs of the commercial law regime for the description of the rights of investors in commodity futures arrangements may be different from the needs of the commercial law regime for investors in securities. On the other hand, the new secured transaction rules are appropriate for futures. Thus, the STA definitional scheme explicitly excludes commodity contracts from the scope of both the term "security" and the term "financial asset".[16] Accordingly, the STA itself does not apply either to the analysis of the obligations of the parties to a commodity contract itself, or to the relationships between commodity customers and commodity brokers or between commodity brokers and commodity clearing entities. If, however, the customer wished to use a position in a commodity contract or commodity account as collateral in a secured transaction, the new secured transaction rules will apply, because the secured transaction rules apply to "investment property".

## IV. WHEN

It is common for newly enacted statutes to provide that the new law does not apply to transactions or events that took place before the statute became effective. The STA takes a different approach to transition issues. No one, of course, would dispute the general proposition that a legislative act should not retroactively disrupt legitimate settled expectations. One cannot, however, decide how that general principle applies to a particular proposed legislative act without carefully analyzing whether application of the act would

14. See STA, s. 1(1): "'financial asset' means . . . (d) any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under this Act."; STA, s. 7(1): "A rule adopted by a clearing agency governing rights and obligations between the clearing agency and its participants or between participants in the clearing agency is effective even if the rule conflicts with this Act or the Personal Property Security Act and affects another person who does not consent to the rule."

15. PPSA, s. 1(1): "'investment property' means a security, whether certificated or uncertificated, security entitlement, securities account, futures contract or futures account".

16. STA, s. 16(1).

disrupt legitimate settled expectations. If the effect of the new enactment is to change rules from one settled state to a different settled state, fairly elaborate transition rules may be needed to preserve the effect of transactions effected under old law. By contrast, if a statutory enactment is designed primarily to foreclose the possibility of unfortunate consequences that might follow from unfortunate interpretations of prior law, it is hard to see what objection there could be to giving full retroactive application to the new law. The point of the STA project is not to change the ultimate outcome of potential disputes, but to eliminate uncertainties that might stand in the way of reaching a sensible result. It is a bit hard to see how anyone can claim to have a legitimate reliance interest in uncertainty.

Accordingly, Section 9 of the STA provides simply that the act "does not affect a legal proceeding that was commenced before this section came into force". The point is only to avoid disruption of ongoing litigation by having the law governing a given lawsuit change while that suit is pending. But, aside from that limitation, the STA is fully effective and applies to any transactions that occurred before or after its effective date. The transition rules for the revision of the secured transaction rules are only slightly more complex. They provide that if action was taken to perfect a security interest prior to the effective date, and that action would suffice for perfection under the new law, then no further action is required.[17] The only significant transition issue would be presented by the relatively unusual circumstance of action that was sufficient for perfection under old but not new law. In that case, there is a four-month grace period after the revisions become effective to take the necessary action.[18]

## V. WHERE

By its very nature, the modern securities holding system tends to transcend political borders. If an investor in Toronto opens an account with a brokerage firm that does business exclusively in Toronto, or if that investor wishes to pledge all or a portion of its securities account to a bank located in Toronto as collateral for a loan, one would think that only the law of Ontario need be considered. Ironically, however, traditional approaches to conflict of laws make that conclusion relatively unlikely. If one thinks of the transaction as the transfer of an interest in the underlying securities, then the traditional *lex situs* approach to conflicts would lead one to

17. PPSA, s. 84(2).
18. PPSA, s. 84(3).

conclude that the law governing the transaction is determined by the location of the underlying securities. Even in a fairly simple situation, that might be difficult to determine. But if the investor holds through the account a diversified portfolio of securities issued by companies around the world it may be difficult or impossible to decide which country's law applies to the transaction.

Fortunately, the conflict of laws analysis becomes much simpler under the STA. Section 45 provides that, in general, the law governing a securities entitlement is not determined by the location of the underlying securities. Rather, the law governing a securities entitlement is determined by the securities intermediary's jurisdiction. Moreover, to eliminate possible problems in determining that jurisdiction, STA s. 45(2) provides that an agreement between the intermediary and customer can settle the question. Similarly, the conflict of laws provisions of the new secured transaction rules provide, in general, that the law governing perfection of a security interest in a security entitlement is the law of the securities intermediary's jurisdiction.[19]

There is, however, a problem that cannot be resolved merely by enacting sensible modern conflict rules in Canada. Those rules will apply only if the litigation takes place in Canada. If the litigation happens to occur elsewhere, a court in that jurisdiction would have no choice but to look to its own conflict of laws rules to decide which jurisdiction's law applies. So, parties doing a deal must first make some educated guesses about the most likely place of litigation. If the result of that analysis is a conclusion that any litigation is likely to occur either in a Canadian province that has enacted the STA, or in a state of the United States, then the conflicts issues should not be complex. If, however, there is a significant likelihood that potential litigation might occur in another place, then there really is no simple answer to the transactional lawyer's desire to know "which jurisdiction's law will apply". Those problems are the subject of a proposed international convention, the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.[20]

---

19. PPSA, s. 7.1(2)(c).
20. See Bradley Crawford, "The Hague 'Prima' Convention: Choice of Law to Govern Recognition of Dispositions of Book-Based Securities in Cross Border Transactions" (2003), 38 C.B.L.J. 157; James Steven Rogers, "Conflict of Laws for Transactions in Securities Held Through Intermediaries" (2006), 39 Cornell Int'l L.J. 285.

## VI. HOW

The key element of the definitional and coverage structure of the STA is the "how" question, that is, how does the entity that might be covered by the new indirect holding system rules undertake to treat the persons for whose benefit it is acting? As noted above, neither the "what" question nor the "who" question plays a critical role in setting the scope of the STA. The STA applies to any asset that a securities intermediary has undertaken to hold in a securities account, and anyone who holds assets in a securities account is a securities intermediary. Accordingly the main burden of distinguishing situations to which the STA applies from other arrangements falls to the "how" question. The significant issue is whether someone (the securities intermediary) has agreed to treat something (the financial asset) as being held for someone else (the entitlement holder) in a "securities account". "Securities account" is the most important definitional provision. It plays a role for the indirect holding system rules akin to the defined term "security" for the direct holding system rules. If one wants to know whether the direct holding system rules apply, the first step is to look at the definition of "security". If one wants to know whether the indirect holding system rules apply, the first step is to look at the definition of "securities account".

Section 1(1) of the STA provides that

> "securities account" means an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that constitute the financial asset.

There is an inevitable element of circularity here. If a relationship falls within the definition of "securities account", then the intermediary and customer have the rights and duties set out in the indirect holding system rules in Part VI of the STA. But whether an arrangement does or does not fall within the definition of "securities account" depends on whether it makes sense to treat the arrangement as one in which the intermediary has undertaken to treat the customer as entitled to exercise the rights set out in Part VI of the STA. Those who care more for abstract conceptual tidiness will find this somewhat distressing. But those who see law as a sensible, purposive human undertaking will find the approach comfortable. In a sense, all of Part VI of the STA is part of the definition of "securities account".[21] Thus, to understand

21. As the comment to the equivalent provision of U.S. law notes, "the question whether a given arrangement is a securities account should be decided not by dictionary analysis of the words of the definition taken out of context, but by

both the definition of "securities account" and the basic approach that the STA takes to articulating the rights and duties of securities intermediaries and account holders, we need to survey the substantive provisions set out in Part VI of the STA.

Section 95 of the STA sets out the basic rule that a person acquires a security entitlement "if a securities intermediary . . . indicates by book entry that a financial asset has been credited to the person's securities account". Though it may not be immediately obvious, this represents a significant change from the approach taken under prior law. Under prior law, the way that a person acquired an interest in a security, other than upon original issue, was by "transfer". As prior law stated, "upon delivery of a security, the purchaser acquires the rights in the security that the transferor had . . .".[22] As applied to simple, off-market transactions in which an identified person sells a security to another identified person, that conceptual structure is workable. But — though this is a point that lawyers have been overlooking for a long time — that conceptual approach makes no sense as applied to the real world. In a typical market transaction, the buyer of a security through a broker has no idea who the seller is. Moreover, if we are analyzing the acquisition of property interests, the focus should not be the contract for sale that is entered into by the parties' brokers as agents for undisclosed principals, but the actual performance of the contract, that is, the process of settlement of trades. In the settlement system for modern securities trading, trades are commonly settled on a net basis among brokers. In that case, it will frequently be impossible to identify any movement of securities from a particular seller to a particular buyer.[23]

Section 95 of the STA takes a completely different approach to the acquisition of an interest in securities in the indirect holding system. A buyer's acquisition of a property interest does not depend on any concept of "transfer" from someone else. Rather, the buyer acquires a security entitlement when the intermediary credits the position to the buyer's account. At that moment, the buyer has the property interest — known as a "security entitlement" — that is described by Part VI of the STA.

Section 96 of the STA provides that "a legal proceeding based on an adverse claim to a financial asset, however framed, may not be brought against a person who acquires a security entitlement under section 95 for value and without notice of the adverse claim". One

considering whether it promotes the objectives of Article 8 to include the arrangement within the term securities account." UCC § 8-501 cmt 1.

22. Ontario Business Corporations Act, *supra*, footnote 10, s. 69(1).

23. See Rogers, *supra*, footnote 20, at pp. 318-27.

might think of this rule as "son of bfp". It plays a role for the indirect holding system analogous to the role played by traditional adverse claim cut-off rules in the direct holding system. The difference is that the rule is not stated in terms of the buyer taking free from adverse claims, because it is really not accurate to say that a buyer has the "same thing" that used to belong to someone else. But, even if someone were able to assert a claim, based on equitable tracing notions or whatever, to the property in the hands of the buyer, the buyer would be protected against any such adverse claim by the rule of s. 96.

Section 97 of the STA establishes the important point that a security entitlement is a form of property interest. In the drafting of UCC Revised Article 8 in the United States, a great deal of attention was devoted to considering how lawyers who were not familiar with the new law, or lawyers from other legal systems, would understand the redescription of the rights of investors who hold through intermediaries. Several of the early drafts avoided explicit mention of the concept of "property interest" on the theory that the use of the older language might be problematic. It is certainly true that a security entitlement is not a property interest in some specific item held by the intermediary, of the sort that might be asserted against someone else to whom that specific security has been transferred. But that does not mean that a security entitlement is not a special form of property interest. For example, it would be completely inconsistent with the general understanding of the relationship between a securities firm or custodian and its customers to treat the customers as having merely a contractual claim against the intermediary. One possibility would have been to avoid altogether any attempt to categorize a security entitlement as a "property interest" or as some other form of legal right. However, many lawyers who were involved in the project warned that lawyers from other legal systems would be confused if it were not possible to provide a simple answer to the question "Is a security entitlement a property interest?" In response to those concerns the language used in the statute was changed to make it possible to provide a simple, unambiguous answer to exactly that question. The answer is "Yes. A security entitlement is a property interest." The text makes this point absolutely clear.

"Security Entitlement" is defined in STA , s. 1(1) as "the rights *and property interest* of an entitlement holder with respect to a financial asset that are specified in Part VI". Turning from the definition to the substantive provisions describing a security entitlement, the key provision is STA s. 97, entitled "Property interest of entitlement holders in financial asset." That provision begins in subsection (1) by

stating that to the extent needed to satisfy the claims of all of its entitlement holders having security entitlements to a certain financial asset,

> all interests in that financial asset held by the securities intermediary,
> (a) are held by the securities intermediary for the entitlement holders;
> (b) are not the property of the securities intermediary; and
> (c) are not subject to claims of creditors of the securities intermediary, except as otherwise provided in section 105.

The remainder of STA s. 97 explains in more detail the precise incidents of the entitlement holder's property interest. So long as the intermediary remains solvent, or, even if insolvent, has sufficient securities to satisfy the claims of customers to a particular security, the entitlement holder's property interest can be enforced only by exercise against the intermediary of the rights described in more detail in STA ss. 99-102. However, if the intermediary is insolvent, it is possible for the entitlement holder's property interest to be asserted against other parties. That property interest, however, can not be asserted against any purchaser who gave value, obtained control, and did not act in collusion with the intermediary in violating the intermediary's obligations to its entitlement holders.[24]

STA ss. 98-102 can be thought of as a thumbnail sketch of the rights that we assume that a customer has against a brokerage firm or securities custodian who holds a securities position on behalf of the customer. Thus, these sections describe the package of rights that make up a security entitlement. Section 98 provides that the intermediary has a duty to obtain and maintain financial assets sufficient to satisfy all of its customer's security entitlements. Section 99 provides that the intermediary has a duty to obtain and turn over to the entitlement holder any dividends or other distributions that are made by the issuer. Section 100 provides that the intermediary shall exercise any rights with respect to a financial asset, such as voting rights, in the fashion directed by the entitlement holder. Section 101 provides that the intermediary shall comply with entitlement orders originated by the entitlement holder, such as an order to transfer the position to someone else upon a sale. Section 102 provides that the intermediary shall follow the entitlement holder's instructions to convert the holding to any other form of securities holding for which the entitlement holder is eligible. For example, if the issuer will issue certificates or otherwise directly record ownership on its books, the intermediary shall follow the directions of its customer if the customer wishes to convert to that form of holding.

24. STA, ss. 97(4) and (7).

If one were pressed for precise details of exactly how an intermediary should carry out the duties stated in ss. 98-102, or asked whether there might be any circumstances that would warrant some form of exception or qualification to the duties stated in those sections, one would quickly realize that a complete answer would require an extensive treatise on the law concerning the rights and duties of securities firms and their customers. Moreover, that relationship is typically the subject of detailed regulation. The idea of ss. 98-102 is not to provide a comprehensive answer to all such questions. Rather, the idea is to highlight the key features that identify the securities intermediary-entitlement holder relationship and distinguish it from other relationships. Accordingly, the articulation of duties in ss. 98-102 is subject to two other principles. First, the sections stating specific duties of an intermediary all state that the intermediary satisfies that duty if it acts in accordance with an agreement between it and the entitlement holder, or, in the absence of an agreement, if the intermediary exercises due care in accordance with reasonable commercial standards. Second, s. 103 provides that if another law or regulation provides details on the performance of the duty in question, then compliance with that other law constitutes compliance with the duty as articulated in the STA.

One way to see how the substantive provisions in Part VI of the STA function in tandem with the definition of "securities account" is to consider how the relationship between a securities intermediary and its entitlement holder differs from a variety of other relationships. For example, consider the relationship between an investor and a mutual fund. The mutual fund is holding a portfolio of securities for the benefit of its shareholders. Similarly, one could describe a securities intermediary as holding a portfolio of securities for the benefit of its entitlement holders. But the relationship is very different. Suppose that a shareholder of a mutual fund calls up the fund manager and says "I don't think you should invest in Acme Inc. I think you should sell Acme Inc. and buy Beta Inc." The appropriate response from the fund manager is something along the lines of "That's interesting, but irrelevant. If you don't like my management, don't invest in the fund." By contrast, suppose that an entitlement holder holds shares of Acme Inc. through a securities account with a securities intermediary. If the entitlement holder directs the intermediary to sell Acme and buy Beta, the intermediary will do so. Part of what it means to be a securities intermediary operating a securities account for an entitlement holder is that, as STA s. 101 provides, "a securities intermediary shall comply with an entitlement order" originated by its entitlement holder.

To take another example, consider the relationship between a trustee and beneficiary in a situation where the trust corpus is invested in a portfolio of securities. The trustee is holding a portfolio of securities for the benefit of the trust beneficiary. So too, a securities intermediary is holding a portfolio of securities for the benefit of its entitlement holders. But again, the relationships are very different. In the trust arrangement, the beneficiary has no right to give directions to the trustee about what securities to hold. By contrast, that is an essential part of the relationship between a securities intermediary and its entitlement holder.

## VII. WHY

So why should Canada or any other nation undertake the project of revising the commercial law of securities holding? The commercial law rules of the securities holding and transfer system are a bit like the utility systems of a building. When they are working right, no one notices them. As they age, it takes more and more effort to keep them working and they may break down altogether under heavy load. At some point prudence demands that they be replaced with modern systems, even though they are still "working". By the late twentieth century, an inordinate amount of legal time — which, of course, means cost — was required to fit modern securities transactions into the conceptual scheme of a prior era. Moreover, the poor fit between law and practice means that legal advisors are unlikely to be able to provide quick and certain answers when they are most needed.

The STA establishes clear legal rules designed specifically for modern securities holding practices. Understanding the new law will, of course, require some expenditure of time and effort by lawyers and business people. However, once one undertakes that process, I think that one will see that the new law does not so much change the law as reformulate the language of the law to bring it into compliance with developments in the marketplace.

Consider, for example, one of the issues that prompted some discussion in the United States project, that is, the rule on potential disputes between secured creditors and customers of a securities firm that fails leaving a shortfall in the securities needed to satisfy all claims. Under STA s. 105, the customers of a failed firm have priority, unless the secured creditor has obtained "control". When one first hears of the issue, many people are likely to think that the rule should be that customers always beat secured creditors. I confess that was my initial reaction.[25] But once one thinks through the issue carefully, one

25. See Rogers, "Policy Perspectives", *supra*, footnote 1, at p. 1512.

sees that the initial reaction is misguided. In the first place, the only change made by s. 105 is to state with a bit more clarity an outcome that has been the law for centuries. Suppose that a securities firm has physical possession of bearer bonds that it is holding for its customers. The firm wrongfully pledges them to a lender who takes possession. The firm fails. Can the customers recover the bonds from the firm's secured creditor? Clearly not. The secured creditor can qualify as a "bona fide purchaser" who takes free from adverse claims. That has been true for ages. The main thing that s. 105 does is state that principle in modern language. Should that rule have been changed? It is hard to see why. For one thing, drawing the line between "secured creditors" and "customers" is not as easy as it first seems. One of the ways that securities firms obtain financing is by repurchase agreements. Among the main sources of repo financing are money market mutual funds. So, if one really wanted to say that "customers" have priority over "lenders", then one would end up saying that the loss should be shifted from the customers of the failed firm to the shareholders of a money market mutual fund that did repo transactions with it.[26] A key concern in the modern securities clearance and settlement system is the control of systemic risk — that is, the risk that a failure of one securities firm might cause others to fail. In the United States, government agencies that oversee the securities markets became particularly concerned with these issues after the October 1987 stock market break indicated that uncertainty concerning the application of the old Article 8 rules to modern securities transactions adversely affected liquidity and placed significant stress on the securities clearance and settlement system. As one knowledgeable observer remarked, "That's an interesting question" is not an acceptable answer to questions about the legal rights of securities firms and their lenders in times when the prospect of the collapse of the financial system is a matter of more than theoretical concern. Commercial law cannot itself provide adequate protections to customers of securities firms. That is a matter for regulatory law and, in the event that failures occur, for insurance and bankruptcy law. Even if there were inadequacies in the other law that protects investors in the indirect holding system, there is nothing that commercial law rules can do about the risk that an intermediary might not have the securities. What led to revision of Article 8 in the United States was not intermediary risk itself, that is, the risk that customers of a failed intermediary might suffer loss, but systemic risk, that is, the risk that a failure of one securities firm might cause others

26. *Ibid.*, at pp. 1527-28.

to fail. Commercial law can not protect against the failure of one's own intermediary; it can help protect against the risk that an investor will suffer as a result of the failure of someone else's intermediary.