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TRANSFERS OF INVESTMENT SECURITIES

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The Alberta Law Reform Institute was established on January 1, 1968, by the Government of Alberta, the University of Alberta and the Law Society of Alberta for the purposes, among others, of conducting legal research and recommending reforms in the law. Funding of the Institute's operations is provided by the Government of Alberta, the University of Alberta, and the Alberta Law Foundation.

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This report represents both an extremely complex subject matter and a topic which has changed both in focus and comprehensiveness over the course of its history. This Institute is extremely fortunate to have had the benefit of Mr. Eric Spink as the counsel having charge of this project. The report demonstrates his clarity of analysis and expression and an understanding of the industry for which the recommendations will be both relevant and timely.

Many industry representatives have been consulted on both formal and informal bases, and in particular, Canadian Depository for Securities Inc., through its Vice-President, Mr. Toomas Marley, have provided information about the operation of their depository systems. The Alberta Securities Commission has provided significant assistance by way of review of the proposals, and their effect upon the regulatory regime. We are grateful to all who have assisted in providing the information which is represented by this report.

The Advisory Committee for this project consists of Adelle Fruman (formerly managing partner of Atkinson Milvain and now Madam Justice Fruman). Glenda Campbell, Senior Legal Counsel, Alberta Securities Commission and William H. Smith of McCarthy Tétrault in Calgary. We acknowledge their significant expenditure of time and skill over several drafts.

While this report represents a response to an Alberta need, it envisages a solution which would operate best if it were adopted uniformly across the country. The industry demands uniformity of rules and regulations and the proposals recognize that need and endorse it.

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PART I — SUMMARY

SCOPE OF THIS REPORT

This report presents a comprehensive review of the existing law governing transfers and pledges of investment securities in Alberta. It also contains a detailed examination of a wide range of issues that relate to current securities trading and holding practices. It includes recommendations for the reform of Alberta law in this area. It does not include draft legislation, but proposes that uniform legislation be developed in consultation with other Canadian jurisdictions.

THE CURRENT SITUATION

The current Alberta law governing transfers of investment securities is found in the Alberta Business Corporations Act ("ABCA"). Like the provisions in most other Canadian Business Corporations Acts, it is based upon the pre-1962 version of Article 8 of the U.S. Uniform Commercial Code ("UCC"). It relies upon the concepts of possession and delivery of a physical object - the negotiable security certificate. At one time, the settlement of a normal securities transaction involved the actual delivery of certificates between buyers and sellers, but this was a laborious and intricate process. As the volume of securities trading increased, settlement involving the physical handling of certificates became an impossible task and alternatives to actual delivery became a necessity.

One alternative was the certificateless system - where no certificates are ever issued and transfers are recorded by the issuer of the securities. The UCC was revised in 1977 to provide for the use of uncertificated securities, but these provisions have not been widely used and uncertificated securities are a relatively small component in the North American securities markets.

Instead, problems with the physical handling of certificates have been alleviated mainly by the increased use of intermediaries, particularly depositories, to hold securities on behalf of others. Although some investors still take actual possession of their securities and are registered with the issuer, it is more typical for investors to allow an intermediary (such as a broker, bank or trust company) to hold securities on their behalf. Rather than keeping each customer's securities separate from one another, securities are kept in fungible bulks.

These brokers, banks and trust companies are typically participants in a securities depository, such as the Canadian Depository for Securities ("CDS"). CDS receives securities from its participants and holds them in fungible bulks. CDS registers these securities in the name of a CDS nominee, and maintains accounts showing the entitlements of each participant.

Since most transactions occur between CDS participants, these transactions can be settled merely by book entries in the records of CDS, debiting the account of the seller and crediting the account of the purchaser, without any need for movement of certificates. This "immobilization" of certificates in depositories, combined with technical improvements in the method for calculating settlement obligations, have produced an extremely efficient system for processing securities transactions.

It is clear that Alberta needs legislation to accommodate the important role of depositories in modern securities trading. In 1989 CDS proposed certain amendments to the ABCA for this purpose, based upon similar provisions that were added to the Ontario Business Corporations Act ("OBCA") in 1986. Although these proposed amendments are basically compatible with the current version of UCC Article 8, we have concluded that they are not advisable at this time, and that a reformed, more innovative approach is required.

PROBLEMS WITH EXISTING LAW

The existing law governing securities transactions has some difficulty coping with transfers of securities held in fungible bulk, whether the bulk is held by a depository or another intermediary. Because there is no actual delivery or change in possession in most of these transfers, it is impossible to rely upon the traditional method whereby a purchaser's property interest is tangibly represented by possession of a negotiable certificate. The current ABCA does not specifically recognize transfers effected by book entries in the records of a securities depository, but it does provide that a purchaser of securities that are part of a fungible bulk acquires a proportionate property interest in that fungible bulk. The current OBCA goes further, recognizing transfers recorded on the records of a depository, deeming delivery to have occurred and deeming the transferee to be in possession of a security certificate for all purposes. Under Ontario law, such a purchaser may even acquire the status of a "good faith purchaser".

Unfortunately, the property interest of a purchaser (or a secured lender) in a fungible bulk of securities is fundamentally different from the property interest of someone who acquires actual delivery or possession of a security certificate. This is so whether or not the purchaser is deemed to have acquired possession, or is a "good faith purchaser". If the fungible bulk is always sufficient to meet the claims of everyone holding a proportionate property interest in it, then there is no problem. But if the fungible bulk is inadequate, problems can arise.

A shortfall in a fungible bulk generally occurs in the context of a broker's insolvency. At that time, the broker will hold, directly or through other intermediaries, sufficient quantities of some securities to satisfy the claims of some customers, but insufficient quantities to satisfy them all. Under existing law, the accurate determination of each customer's property interest requires tracing the broker's holdings to assess the size of the fungible bulk over the entire duration of the customer's dealings. This is a difficult process at best, and under many circumstances it is practically impossible to properly determine priorities among competing claimants. To the extent that such priorities can be determined, they are random and fortuitous. Some customers may be entitled to the full amount of their claims, while others are merely unsecured creditors, depending upon exactly which securities make up the shortfall. And despite the lack of certainty in such proportionate property interests, investors have no practical means of verifying their interests with the broker from time to time.

In light of this, it is remarkable that the existing system has worked so well for so long. The reason is simple: the existing legal system has very rarely been applied to a situation involving an inadequate fungible bulk of securities. There has never been a depository insolvency in the U.S. or Canada. There have been a number of broker insolvencies but, since 1969, investor protection funds have provided compensation to the customers of such brokers, thereby avoiding the problems that might arise if customers were forced to rely upon their legal rights.

THE NEED FOR REFORM

Despite the quieting effect of investor protection funds, there is a present need to reform the law in this area. Existing law allows an unacceptable degree of uncertainty. There has been substantial concern in the U.S., where uncertainty in the existing law has caused lenders to restrict credit in critical situations. In 1990, Congress authorized the Securities and Exchange Commission, under certain conditions, to adopt rules overriding state law concerning transfers and security interests in investment securities. The following year, work began on a major reform of UCC Article 8.

In addition to the need to improve existing Canadian law, the pending reform of UCC Article 8 presents an obvious occasion for similar reform in Canada. The need for compatibility between Canadian and U.S. law has been recognized for many years, and is stronger today than ever before.

THE DIRECTION OF REFORM

The U.S. reform initiative addresses the fundamental problems arising from the use of proportionate property interests in fungible bulks, and proposes the introduction of a new concept: the "securities entitlement" or SE. The SE is a *sui generis* property interest that would replace the proportionate property interest in situations where an intermediary holds a fungible bulk of securities on behalf of others. The SE would be defined by a comprehensive set of rules stating the obligations of the intermediary and the rights of the owner of the SE.

The SE permits a more rational approach to the law of securities transactions effected through intermediaries. By recognizing that the true interest acquired is an intangible claim against the intermediary, we avoid any need to sort through or trace to property held by the intermediary. The priorities among various types of claimants, especially secured lenders, can be made more predictable and equitable.

The SE can also be used to accommodate transactions involving property that does not meet the strict definition of investment securities, such as derivatives or certain money market instruments. As long as these transactions are effected through intermediaries, there is no reason why they should be treated differently from transactions involving conventional investment securities. Use of the SE allows for the consistent legal treatment of such transactions.

Another advantage of the SE is that it avoids difficult issues concerning the *situs* of property and constitutional jurisdiction that can arise under the existing legal regime.

For these reasons, we have recommended that Alberta legislation governing securities transfers should be patterned after the pending revisions to UCC Article 8, using the concept of the SE in substitution for the proportionate property interest in securities held in fungible bulk.

THE NEED FOR A SEPARATE STATUTE

Because these provisions must apply to transfers involving a broad range of investment property, and not just securities issued by Alberta corporations, they should be removed from the ABCA and placed in a separate statute. We have also recommended that Alberta legislation should be uniform with other provincial and federal legislation governing transfers of investment securities. With the rapid growth of cross-border transactions, the need for uniformity in this area is compelling. The use of a separate statute is a vital component of uniformity because various provinces and the federal government use different types of corporate statutes and it is difficult to include uniform provisions within such different statutes.

RELATED REFORMS

The growing trend towards immobilization of securities creates other problems, not strictly related to securities transfers. Securities held through intermediaries are not registered in the name of the so-called "beneficial owner", yet there are many statutory provisions that are based on the assumption that registered and beneficial ownership coincide.

On this basis the ABCA uses the term "shareholder" in important provisions governing the rights of shareholders, communication between corporations and shareholders, and communication between shareholders. We recommend that the term "shareholder" be defined to clarify exactly who is entitled to these rights, and that provisions governing shareholder communications be reformed to permit shareholders to exercise their rights effectively. We recognize that this particular problem will require a thorough assessment of corporate governance principles and procedures for shareholder communications. That assessment is a major undertaking, not attempted in this report.

Some problems arising from the trend towards immobilization are easier to deal with, and this report includes recommendations for minor amendments to various other statutes.

AN OPPORTUNE TIME FOR REFORM

This law governing securities transfers has long been neglected in Canada. The amendments proposed by CDS recognize the overriding importance of having uniform Canadian legislation that is compatible with UCC Article 8. The present developments in the U.S. provide an opportunity for Canada to achieve these objectives, and at the same time to reform and modernize the law in this area.

THE STRUCTURE OF THIS REPORT

This report is long. Each chapter is intended to divide the report into meaningful sections, but some of the individual chapters are also quite long. The table of contents provides a detailed breakdown of each chapter, but it may be useful for readers to also have a brief general outline of some chapters.

Chapter 2 provides some historical background on the securities markets in Canada and the U.S., and the relationship between market practices and the law governing securities transfers. It reviews the circumstances that led to statutory recognition of the negotiable stock certificate, and the development of securities depositories. There is a description of the operations of the largest U.S. depository as well as both Canadian depositories. The importance of securities depositories, and their vital role in modern securities trading is discussed in **Chapter 3**.

Chapter 4 reviews the evolution of the Canadian law governing securities transfers, showing how it has tended to lag behind U.S. law in this area. There is a detailed discussion of the role of registration in share transfers under Business Corporations Acts in Canada — an area that remains the subject of some confusion. Here we also review the development of statutory provisions in Ontario dealing specifically with book-entry transfer effected through depositories, and how these provisions differ from those used in the Uniform Commercial Code.

Chapter 5 is a comprehensive analysis of the role of intermediaries in securities transactions, and the legal relationships that result. Most securities transactions involve at least one intermediary, and these legal relationships are a factor in every such transaction. They are crucial in the event the intermediary becomes insolvent.

continued on next page ...

THE STRUCTURE OF THIS REPORT (Con't)

Chapter 6 is the most important chapter in this report. It provides an analysis of the current Canadian law of securities transfers, comparing the operation of the Alberta and Ontario Business Corporations Acts to examine the effect of amendments proposed by CDS. We conclude that both the existing and proposed provisions dealing with transfers of securities held in fungible bulks are conceptually flawed, and that the law governing such transactions must be reformed. There is a discussion of the work underway in the U.S. to reform Article 8 of the Uniform Commercial Code, and the new property concept proposed as the cornerstone of reform — the "securities entitlement".

Chapter 7 deals with a number of secondary issues arising from the amendments proposed by CDS.

Chapter 8 addresses issues of constitutional jurisdiction and conflicts. These issues are unique to Canada and are particularly significant in relation to debt securities. Although the issues are complex and difficult, it appears that the reforms necessary to deal with them are relatively straightforward.

Chapter 9 discusses the situs of securities under the existing system and under a reformed system. Situs is an important factor in determining which jurisdiction's laws apply for various purposes, including taxation. Ascertaining situs under the existing system can be extremely difficult.

Chapter 10 deals specifically with issues relating to Personal Property Security Acts and depository operations. The reforms recommended are based on the same fundamental considerations discussed in Chapter 6.

Chapter 11 examines a broad range of issues relating to shareholders' rights that arise from modern securities holding practices. We identify a number of problems and make general recommendations for reform, recognizing that this is a complex area and that the development of specific reforms would require a much more detailed examination.

Chapter 12 deals with consequential amendments to several specific Alberta Acts.

PART II — REPORT

CHAPTER 1 — INTRODUCTION

A. Purpose of Report

It has been said of securities transfers that it is largely a field for nonlawyers, since millions of these transfers occur each day without the involvement of lawyers and actual litigation over securities transfers is extremely rare.[1] But this does not mean that the law of securities transfers is clear and untroubled. In fact, the need for reform in this area has been recognized by many and for a long time.

The volume and value of securities transactions in Canada and the U.S. are enormous. Hundreds of millions of securities and billions of dollars are transferred daily. The fact that this occurs smoothly is not attributable to the law; it occurs, thankfully, in spite of it. The fact that so many securities transactions are completed daily, within an uncertain legal framework, shows the power of commercial forces in this area. Securities markets move and change quickly. They must be, and are, efficient, adaptable and innovative. The securities markets have a history of applying business solutions to overcome legal problems. This is a practice born of necessity, since the law has generally tried but failed to keep pace with developments in the securities industry.

These attempts to keep pace have produced one of the most complex and specialized areas of law. Certain legal concepts have not developed rationally but have been deliberately fictionalized in an attempt to accommodate new types of securities. Terminology is often used loosely and inexactly. The securities industry is highly regulated,[2] so that the process of reforming legislation can only be a part of larger reform involving complementary changes in regulation.

The inherent need for uniformity in commercial law is particularly evident here, because securities move increasingly and freely across borders.

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1 G. Haley, reviewing Egon Guttman's *Modern Securities Transfers*, (1988) 43 Bus. Law. 1144.

2 The Regulation under the Alberta Securities Act is 375 pages. Policies, Rulings and Blanket Orders of the Alberta Securities Commission are approximately 600 pages.

This need for uniformity must also serve to mobilize all the affected parties to co-ordinate and consult. This makes overall reform a monumental challenge, and a much larger undertaking than one report could ever deal with. This report addresses some fundamental issues in the existing law and suggests general and specific reforms. The purpose of this report is to clarify the legal component of securities transfers, suggest reforms and thereby facilitate further work towards uniform law reform in this area.

B. History of the Project

In 1987, the Institute undertook a project involving a general assessment of the desirability of securities depositories, and preparing draft legislation as required. In 1989, the Minister of Consumer and Corporate Affairs for Alberta asked the Institute to assess a proposal made by the Canadian Depository For Securities Limited ("CDS"), the largest securities depository and clearing agency in Canada, for amendments to the Alberta Business Corporations Act.[3] The *CDS Proposal* recommended amendments similar to amendments made to the Ontario Business Corporations Act in 1986, intended to establish "a statutory basis for transfers and pledges of securities made by book entries".[4]

The Institute undertook the assessment. By July 1989, we had prepared a draft Report for Discussion, with the exception of one chapter dealing with the identification and discussion of issues arising from CDS operations. This chapter, in outline, was to await our receipt of more information regarding agreements being negotiated between CDS and certain Canadian securities regulators regarding the regulation of CDS operations. Time passed, and it became evident that the agreements regulating CDS operations were not imminent. In fact, the agreements are still not in place.

In the course of our work, we have found that there is a considerably expanded list of potential issues, going far beyond those arising directly from the *CDS Proposal*. We concluded that the amendments recommended in the *CDS Proposal* were not satisfactory, and that a number of difficult issues must

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3 Submission of The Canadian Depository for Securities Limited To the Minister of Consumer and Corporate Affairs For the Province of Alberta With Respect to Amendments To the Business Corporations Act, January 1989. An Addendum to this submission was forwarded in January, 1993. Both documents are reproduced as Appendix A, and are hereinafter collectively referred to as the *CDS Proposal*.

4 *CDS Proposal*, *ibid.* at 1.

be resolved if more satisfactory amendments are to be prepared. These issues are not unique to Alberta. Indeed, these issues tend to have significant national and international ramifications, which is not surprising in light of the global nature of modern securities markets and transactions.

This report discusses the issues which have arisen during our study, together with the considerations that appear to the Institute to be relevant to those issues.

CHAPTER 2 — THE EVOLUTION OF SECURITIES DEPOSITORIES

A. Introduction

The law governing transfers of investment securities[5] has been largely shaped by the demands and the circumstances of the securities markets. Canadian securities markets have always been heavily influenced by events in the much larger markets in the U.S., to such an extent as to warrant judicial notice. In the 1911 decision of the Supreme Court of Canada in *Clarke* v. *Baillie*,[6] Mr. Justice Anglin stated at page 76:

> It is common knowledge that the business of stock-brokers in this country is conducted in a manner more closely resembling that which prevails in the United States, and particularly in the State of New York, than that which obtains in England. Many customs and usages of English brokers are unknown in Canada; and many practices prevalent in our markets, which have come to us from the United States, would not be recognized on the London Stock Exchange.

In addition to the common law, Canadian statute law relating to securities transactions has been patterned closely after U.S. law in this area.[7] Moreover, Canadian law in this area has always been some years behind that of the U.S. In turn, the U.S. law has generally trailed behind events and practices within the securities industry. In examining the current issues relating to depository operations in Alberta, it is therefore necessary to look at some of the historical background which led to the existing state of the law, the introduction of securities depositories in North America and the rapid expansion of their operations.

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5 The term "investment security" refers to a share, obligation, and other interest that is of a type commonly dealt in on securities exchanges or markets or commonly recognized as a medium for investment in any area in which it is issued or dealt in. For a detailed discussion of this term, see p. 45 of this report.

6 (1911), 45 S.C.R. 50.

7 For a detailed analysis showing the differences between Canadian, American and British systems, see E. Guttman & T.P. Lemke, "The Transfer Of Securities In Organized Markets: A Comparative Study Of Clearing Agencies In The United States Of America, Britain And Canada" (1981) 19 Osgoode Hall L.J. 400.

B. Negotiability of Stock Certificates

In 1882, John Dos Passos described the disturbingly unsettled state of affairs surrounding the negotiability of stock certificates in the U.S. at that time:

> Stock certificates, as we have seen, are not, technically, negotiable instruments. They are not promises to pay money, and, in a word, lack almost every element necessary to constitute negotiability ... And the courts have everywhere with marked unanimity placed them in the category of non-negotiable instruments ...
>
> But we shall see that while the courts, on the one hand, treat them as non-negotiable, on the other hand, through the equitable doctrine of estoppel, stock certificates, with a power to transfer them endorsed in blank thereon, can be dealt in with almost the same immunity as bills, notes, and other negotiable instruments ...
>
> Indeed, it may be affirmed that stock certificates to-day constitute the chief commercial security of the age. And dealings in them are not confined to one market or locality; they are bought and sold in every market in the world, and by universal usage pass from hand to hand.
>
> In view of all of these considerations, it is a grave question whether the time has not arrived for a change in the legal character of these certificates, either by an alteration of the language of the latter so as to bring them within the rule of the law-merchant, or by the courts receiving evidence of the general usages of the commercial community, which usages, as we have seen, have been heretofore successfully invoked to raise non-negotiable securities to the full rank and dignity of negotiable instruments. [footnote omitted] This last-mentioned means has been attempted, but so far unsuccessfully.[8]

Why was the negotiability of stock certificates so important that business practices treated non-negotiable certificates as if they were negotiable? Because the legal requirements of transfer at that time — registration on the books of the issuer — took too long to complete. It also carried considerable risks. Although the seller could deliver the stock certificate complete with a dual power of attorney and assignment to the purchaser in exchange for the purchase price, the purchaser could not be certain of getting what had been bargained for, free from any adverse claim arising through the seller, until the transfer was actually registered on the books of the issuer sometime later.

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8 J.R. Dos Passos, *A Treatise on the Law Of Stock-Brokers and Stock-Exchanges* (New York: Harper & Bros., 1882; reprinted by Greenwood Press, 1968) at 595-97.

Under these circumstances, a prudent purchaser would not wish to pay until registration occurred, while a prudent seller would be understandably uneasy about delivering the stock certificate and transfer documents, then having to wait for registration to occur before receiving payment.

These circumstances suggested an obvious solution. With no means of instantaneous communication available, buyers and sellers generally met with one another to conduct business. The physical delivery of a stock certificate in exchange for payment met the needs of both parties, **provided the certificate was negotiable.** This eliminated any need for the parties to meet at the office of the issuer so that registration of the transfer could coincide with payment of the purchase price. In the securities markets of the time the negotiable stock certificate offered the fastest, and safest, method of transfer available.

(1) The Uniform Stock Transfer Act

This need for legally negotiable stock certificates was recognized in 1909 when the National Conference of Commissioners on Uniform State Laws approved the Uniform Stock Transfer Act, which was subsequently adopted, more or less promptly, by all 50 states.[9] Section 1 of the Uniform Stock Transfer Act provided that title to a certificate and to the shares represented thereby could be transferred only by delivery of the certificate, even where the issuer or the certificate itself provided that the shares were transferable only on the books of the corporation or by its registrar or transfer agent. The Commissioners' Note accompanying this section states:

> The provisions of this section are in accordance with the existing law [citation omitted] except that the transfer of the certificate is here made to operate as a transfer of the shares, whereas at common law it is the registry on the books of the company which makes the complete transfer. The reason for the change is in order that the certificate may, to the fullest extent possible, be the representative of the shares. This is the fundamental purpose of the whole act, and is in accordance with the mercantile usage. The transfer on the books of the corporation becomes thus like the record of a deed of real estate under a registry system.[10]

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9 The National Conference of Commissioners on Uniform State Laws had approved a brief Stock Transfer Act in 1898, which was subsequently declared to be superseded by the Uniform Stock Transfer Act of 1909.

10 6 U.L.A. at 2.

With the advent of the Uniform Stock Transfer Act, therefore, the stock certificate acquired certain essential attributes of negotiability, if not full-fledged status as a negotiable instrument. This distinction, and any possible debate over its implications, came to an end with the introduction of the Uniform Commercial Code ("UCC") and its subsequent adoption by all 50 states.[11] Section 8-105 of the UCC has always specifically provided that stock certificates are negotiable instruments, and Article 8 generally sets out mechanisms for the transfer and pledge of stock certificates (and other securities) that differ in a number of ways from the law applicable to other types of negotiable instruments, but still share the same basic concept of negotiability.[12]

C. Clearance and Settlement

"Clearance" may be defined as:

> The process of determining accountability for the exchange of money and securities between counterparties to a trade; clearance creates statements of obligation for securities and/or funds due.[13]

"Settlement" may be defined as:

> The completion of a transaction, wherein securities and corresponding funds are delivered and credited to the appropriate accounts.[14]

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11 The Uniform Commercial Code [hereinafter UCC] was the product of the American Law Institute and the National Conference of Commissioners on Uniform State Laws. The UCC was first promulgated in 1952 and has undergone a number of revisions since. Article 8 of the Code, entitled "Investment Securities", supersedes the Uniform Stock Transfer Act. Article 8 was significantly revised in 1962 and again in 1977. The UCC has been adopted by all 50 states. As of April, 1993, 48 states have adopted the 1977 revisions to Art. 8.

12 Article 3 of the UCC, entitled "Negotiable Instruments", was revised in 1990. It supersedes The Uniform Negotiable Instruments Law, which was promulgated by the National Conference of Commissioners on Uniform State Laws in 1896 and subsequently enacted by all 50 states. The Uniform Negotiable Instruments Law was based on the English Bills of Exchange Act, as is the Canadian Bills of Exchange Act. Article 3 of the UCC, specifically §3-102, provides that it does not apply to securities governed by Art. 8.

13 *Clearance and Settlement Systems in the World's Securities Markets* (New York: Group of Thirty, 1989) at 80.

14 *Ibid.* at 86.

In the situation discussed above, where a buyer and seller of securities meet face to face, agree on terms and exchange a stock certificate for payment of the purchase price, there is no need for any system of clearance or settlement. But where transactions are carried out through brokers on the floor of a stock exchange, an efficient system for clearing and settlement of trades is essential to the operation of an organized securities market.

The need for a stock clearing procedure was recognized by the New York Stock Exchange ("NYSE") as early as 1868, when the first informal, and ultimately unsuccessful, attempt was made to establish such a procedure. Subsequent efforts in 1877, 1879 and 1880 also failed.[15] Although the NYSE handled the sales of some 128 million shares in the year 1881,[16] the first successful attempt to establish a clearing operation was not until 1892, and the formal organization of the Stock Clearing Corporation as a subsidiary to the NYSE did not occur until 1920.[17]

Before the introduction of the clearing operation, each transaction was handled separately, with selling brokers delivering securities (certificates) to purchasing brokers against payment. This created significant problems. For example, where broker A sold 100 shares to broker B at $1 per share, then B promptly sold those same shares to broker C for $1.20 per share, broker B would be required to pay $100 to A upon receipt of the certificate, before he was in a position to relay the certificate to C and collect $120 from C. This would often compel broker B to borrow funds to settle the initial transaction.[18] It also had the effect of delaying settlement by requiring that the certificate pass needlessly through the hands of broker B.

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15 *Study Of The Securities Industry*, Hearings Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce, 92d Cong., 1st Sess. (1972) at 1929 [hereinafter *Study Of The Securities Industry*].

16 Dos Passos, *supra*, note 8 at i.

17 M. Torosian, *Modern Stock Market Handbook* (Deerfield, Illinois: Financial Associates, 1978) at 255-56.

18 *Ibid.* at 256-62.

(1) The Daily Balance Order System

There are many different types of clearance and settlement systems. Here we shall examine a form of the Daily Balance Order ("DBO") system similar to that used by the NYSE until as late as 1974.

The first step in any clearance and settlement process is trade comparison, whereby the daily records of buying and selling brokers are compared and matched. Next, the clearing agency would calculate the net position of each broker and issue each such broker a "daily balance order". In our example, assuming that none of the parties were involved in any other trades on the day in question, A would receive instructions to deliver 100 shares to C; C would be instructed to pay $100 to A and $20 to B and to expect delivery of the 100 shares from A.[19]

This example is greatly simplified, but it does demonstrate how the clearance and settlement system eliminated some unnecessary movement of money and security certificates, thus facilitating the more efficient processing of transactions. This improved efficiency helped to counter-balance the demands placed on the securities industry by large trading volumes. But even though the contribution of the clearing and settlement process to the efficient processing of transactions was significant, the system also had important limitations.

Probably the most significant limitation on this clearance and settlement system was that it dealt only with a portion of the overall set of contractual relationships which existed in a typical securities transaction. In the example we have used, each party is a broker who would normally be acting on behalf of a customer. In our example, the series of contractual relationships which arise, excluding all commissions, are as follows:

1. Broker A's customer agrees to deliver a stock certificate representing 100 shares to A in exchange for the payment of $100 by A to the customer;

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19 Sometimes delivery and payment would be effected through the clearing agency, but if either party failed to deliver or pay, this problem would have to be resolved as between the parties.

2. Broker A agrees to deliver a stock certificate representing 100 shares to Broker B in exchange for the payment of $100 by B to A;

3. Broker B's customer initially agrees to pay $100 to B in exchange for a stock certificate representing 100 shares, but this initial agreement merges with the subsequent agreement to sell those same 100 shares, so that B's customer has no further obligations and merely awaits payment of $20 from B;

4. Broker B agrees to deliver a stock certificate representing 100 shares to Broker C in exchange for the payment of $120 by C to B;

5. Broker C's customer agrees to pay $120 to C in exchange for C delivering a stock certificate representing 100 shares to the customer.

Because a broker trading on a stock exchange acts as the agent for an unnamed principal, the broker is legally bound to complete the transaction regardless of whether the customer fulfils their obligations to the broker.[20] As a result, each of the contractual obligations listed above operates independently of the others. If, for example, A's customer failed to deliver any stock certificate to A, A remains liable to deliver a certificate to B (or to C as a result of the operation of the clearing and settlement system). The failure of A's customer to deliver a stock certificate is a matter to be resolved solely between A and the customer.

Moreover, the clearance and settlement process, and the simultaneous exchange of the negotiable stock certificate against payment, operated only with respect to the brokers' obligations to one another. In our example, contracts 2 and 4 are performed simultaneously through the clearing agency, but it remains up to the brokers and their respective customers to perform contracts 1, 3 and 5. Of these, contract 3 is not problematic. Contracts 1 and 5, however, presented considerable problems relating to the handling of stock certificates.

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20 See American Law Institute, *Restatement (Second) of Agency* (St. Paul: ALI Publishers, 1958) §321, and *Bowstead on Agency* (London: Sweet and Maxwell, 1985) at 433. The by-laws or rules of most stock exchanges are to the same effect. A more detailed discussion of the agent-principal relationship is found at p. 65 of this report.

In practice, the performance of contracts 1 and 5 in our example would involve the extension of credit to brokers A and C by their respective customers. A's customer is obligated to deliver the stock certificate to A on or before the settlement date. Upon delivering the certificate to A, the customer would not generally receive payment, only a credit to the customer's account. Until the account is settled, the customer extends credit to A, evidenced by a confirmation, a receipt and an entry on A's books. Similarly, C's customer is obligated to pay $120 to C on or before the settlement date, but is unlikely to receive the certificate at that time. Instead, the customer receives a confirmation and a receipt evidencing C's obligation to deliver a certificate in due course.[21]

The movement of the stock certificate in this transaction would likely involve a number of steps. In its simplest form, a certificate representing 100 shares, registered to A's customer, would be endorsed by the customer in blank and delivered to A. A would then deliver it to C. C would then endorse the certificate again and surrender it to the transfer agent with instructions to issue a new certificate registered in the name of C's customer. The transfer agent would cancel the old certificate, issue a new one and deliver the new certificate to C, who would then deliver the new certificate to the customer. Of all these steps, only the transfer from A to C involved the simultaneous payment of the purchase price so as to require the use of a negotiable certificate, yet the existence of the negotiable certificate necessitated all the other handling of the certificate.

(2) The Paperwork Crisis

By the late 1960's, there was a startling contrast between the way trades were executed and the way they were settled. Typically, orders were transmitted verbally or electronically, often with the aid of computers. The clearing process might succeed in eliminating settlement of just over half of the total trades on any given day, leaving almost half to be settled by the physical movement of certificates. Each settlement would involve the certificate undergoing approximately 14 separate, distinct manual processes plus as many as 6 separate journeys between various locations.[22] In the case of one large

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21 See American Bar Association, Section Of Corporation, Banking And Business Law, *Report Of The Committee On Stock Certificates*, September 15, 1975 at 4-5.

22 R.B. Smith, "A Piece Of Paper" (1970) 25 Bus. Law. 923 at 925-26.

brokerage firm, it was noted that 210 pieces of paper had to be prepared and moved from point to point in order to consummate a single transaction from the time when the customer entered an order until final disposition of the stock certificate.[23]

The demands of handling stock certificates in 1965 were taxing the capacities of the securities industry in the U.S., particularly on the NYSE. By 1967, these demands and the inability of existing systems to cope with them produced the so-called "paperwork crisis", which was to have a major impact on the law of securities transfers.

In 1964, the average daily trading volume on the NYSE was 4.9 million shares. In 1966, it was 7.5 million shares and in 1967 it was 10.1 million shares.[24] A study published by the SEC in 1971 contains some startling descriptions of what occurred:

> The industry was unprepared for this veritable explosion in trading volume. With some exceptions, the financial community found itself without appropriate systems, procedures, equipment, or qualified personnel for handling its business. Further, little could be done to implement the necessary solutions on a timely basis. The problems demanded broad solutions, and no one firm could tackle them in isolation. The aftermath was virtual chaos experienced by a substantial number of firms.
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> Apart from the inability of broker-dealers to keep their records current, the number of errors in the handling and recording of transactions multiplied. The back offices of many a broker-dealer resembled a trackless forest. Since the broker-dealer industry is a highly inter-dependent community, the problems of the less efficient firms had a rippling effect on the entire broker-dealer community; and inter-dealer clearing systems, as well as the transfer facilities of banks, were similarly taxed beyond their capacities. The entire machinery for the delivery and transfer of securities and the concomitant remittance of funds became clogged. Even those broker-dealers who attempted belatedly to stem the tide by computerizing their operations or augmenting their back office personnel could not keep pace with the volume;

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23 *Study Of The Securities Industry, supra,* note 15 at 1597 (comment by Robert R. Maller, Senior Vice President, United States Trust Company of New York). The routing of certificates and related documents in a typical securities transaction are shown in S. Robbins, W. Werner, C. Johnson, A. Greenwald, "Paper Crisis In The Securities Industry: Causes And Cures" [hereinafter *The Lybrand Report*], Appendix BB, *Study Of The Securities Industry, supra,* note 15 at 2188-200, charts 3 through 8.

24 *Study Of Unsafe And Unsound Practices Of Brokers And Dealers,* Report And Recommendations Of The Securities And Exchange Commission, H.R. Doc. No. 92-231, 92d Cong., 1st Sess. (Dec. 1971) at 219 n.1 [hereinafter *Study Of Unsafe And Unsound Practices*].

> in fact, they were caught on a worse treadmill in that, by the time they were able to research their errors of a given date, they were confronted with a greater number of errors to contend with. The expensive computerized hardware which was thrown into the breach malfunctioned; and since parallel manual records were often not maintained during a reasonable trial period, the use of the computer increased the already existing confusion. Moreover, the employment of newly recruited and untrained or inadequately trained individuals who were put to work in the back offices resulted in a further increase in the number of errors. The combination of all these factors culminated in such a critical predicament for some firms that they not only lost control of their records, but experienced a new phenomenon--the loss of control over the securities which were or were supposed to be in their possession for delivery, custody or safekeeping. The efforts by the Commission and the self regulatory organizations to build a dike against this torrent proved of little avail.[25]

Most of the remedial steps taken during the crisis were obviously intended to be short-term measures. This reflected the general disbelief in the securities industry that the increase in trading volume would continue, and resulted in attempts to meet the new demands through expanded use of outmoded existing facilities.[26]

Some brokerage firms refused to handle small accounts or low-priced stocks. Branch offices were closed and emphasis was placed on institutional rather than retail business. The NYSE placed restrictions upon brokerage firms that experienced serious difficulties with their paper work, imposing limitations on trading, underwriting and solicitation of new orders for certain securities. The NYSE even imposed daily volume quotas on some firms.[27]

In August of 1967, markets began operating on shortened trading hours, and later a shortened week, in an attempt to reduce trading volume, while at the same time clerical staff were working overtime, and sometimes around the clock, in an attempt to process each day's transactions.[28] Normal trading hours did not resume until May 4, 1970.

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25 *Ibid.* at 13-14.

26 See *Problems In The Securities Industry,* Hearing Before The Subcommittee On Securities Of The Committee On Banking And Currency, United States Senate, 91st Cong., 1st Sess. (March 6, 1969) (statement of Hamer H. Budge, Chairman of the Securities and Exchange Commission) at 131.

27 *The Lybrand Report, supra,* note 23 at 2211-12.

28 *Study Of Unsafe And Unsound Practices, supra,* note 24 at 219-20.

Delivery requirements were relaxed by extending the settlement period. This extension may be seen as a reflection of the gradual but steady growth of problems of moving security certificates. Prior to 1933, the settlement period was one day. From 1933 until 1946, the settlement period was two days. In that year it was extended to three days, in 1952 to four days and on February 9, 1968 to five days.[29]

One study[30] suggested that in theory a stock certificate could be transferred from the selling customer, through all the necessary intermediaries, and into the hands of the buying customer in 10.5 days. The study noted that the actual time required, not allowing for any major delays or problems along the processing route, was 18 days. In 1969, this process often took up to 6 months or more to complete.[31]

In April of 1968, the NYSE began compiling monthly figures on "fails". A fail occurs where a broker is unable to deliver securities owed to another broker within the settlement period. One broker's failure to deliver often triggers successive fails by other brokers who have re-sold the securities. An "aged fail" is one that is 30 days or more old. The number of fails is an indicator of the operational health of the securities industry.

In April of 1968, the NYSE reported total fails of $2.67 billion, and aged fails of $478 million. Aged fails peaked in July 1968 at $837 million, then subsided slowly but steadily. Fails peaked at $4.1 billion in December, 1968, the equivalent of more than 3 days trading volume, then subsided. Over the next few years, aged fails declined to more or less acceptable levels, but total fails remained fairly high. In 1971, the average monthly total fails were $1.4 billion, while the average monthly aged fails were only $51 million, suggesting that the industry had by then achieved significant success in effecting settlement of trades in less than 30 days, but less success in effecting settlement within the prescribed 5-day period.

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29 *The Lybrand Report*, *supra*, note 23 at 2234.

30 *Ibid.* at Table 4.

31 Smith, *supra*, note 22 at 927.

(3) Reactions to the Paperwork Crisis

(a) The villainous certificate

The paperwork crisis triggered a great deal of analysis and commentary,[32] much of which focused on the role of the stock certificate in securities transactions. The SEC study expressed the following conclusion:

> There is no area of the securities business which offers more opportunity for reducing costs as well as exposure to the kind of disruption which resulted in loss to customers during the 1969-70 period, than the improvement and modernization of the systems for clearing, settlement, delivery and transfer of securities. It was the archaic method of achieving this simple objective which nearly drowned the financial community in a tidal wave of uncontrolled paper. It is clear that modern communications and computer technology have now advanced to a point where the transfer of stock ownership, the payment therefor, and the documents controlling and recording the transfer of ownership can be dramatically simplified.[33]

In June of 1971, the SEC convened its Conference on the Stock Certificate. Attendees included: the chief executive officers of various national stock exchanges, the NASD[34] and CDS; securities industry, banking industry, corporate and investment community associations, representatives of the federal bank regulatory authorities; interested bar association committees; the American Institute of Certified Public Accountants; and various experts that had written on the problems of the stock certificate. Virtually all the participants at the conference agreed that the certificate must be eliminated, but that this would take time.[35]

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32 See T.H. Jolls, "Can We Do Without Stock Certificates? A Look At The Future" (1968) 23 Bus. Law. 909; L.T. Kendall, "The Certificateless Society: A Realistic Appraisal" (1968) 24 Bus. Law. 141; *Problems In The Securities Industry, supra,* note 26; *The Lybrand Report, supra,* note 23; R.B. Smith "A Piece Of Paper", *supra,* note 22; *Study Of Unsafe And Unsound Practices, supra,* note 24; "Symposium on the Certificateless Society" (1971) 26 Bus. Law. 603; *Study Of The Securities Industry, supra,* note 15; *Securities Industry Study,* Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 92d Cong., 2d Sess. (1972); *Clearance & Settlement Of Securities Transactions,* Hearings on S.3412, S.3297 & S.2552 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing & Urban Affairs, 92d Cong., 2d Sess. (1972).

33 *Study Of Unsafe And Unsound Practices, supra,* note 24 at 35-36.

34 The National Association of Securities Dealers, Inc.

35 *Study Of Unsafe And Unsound Practices, supra,* note 24 at 168-73.

(b) Immobilization through depositories

Several participants, led by the Banking And Securities Industry Committee ("BASIC"), suggested that the immobilization of certificates in regional depositories, as part of a national comprehensive depository system, was by far the most important and promising of all projects to solve the major portion of the problems in processing securities transactions. BASIC maintained that compulsory elimination of the stock certificate before the development of a proven alternative system would be a dangerous course to pursue. BASIC proposed that the comprehensive depository system would also be the quickest of all feasible courses towards establishing a satisfactory method of accounting for security ownership and transfer without using the certificate as evidence.[36]

BASIC's claims for the effectiveness of a comprehensive securities depository were questioned, but the SEC acknowledged that a depository system would in any event be useful in improving the efficiency of the several exchanges and their clearing corporations.[37]

(c) The certificateless society

The SEC's conclusion was that:

> ... a number of very constructive approaches, independently of one another, have gone forward to solve the problems of settlement, clearance and the handling of certificates. Many of these have, however, integrated with or reacted to, some of the others with resulting mutual advances and improvements. Although the divergent elements have thus far been beneficial, the time has come for welding the existing programs admixture into a master plan, and the Commission is anxious to advance in that direction. To supervise the integration of the existing strands into a common thread, the Commission has created a special unit under the over-all guidance of the Commission to begin to direct the self-regulatory bodies in the adoption and implementation of programs toward the ultimate objectives of the certificateless society and the standardization of documents used in the clearing, settlement and delivery process.[38]

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36 *Ibid.* at 171-73, 184-90, and *Study Of The Securities Industry, supra,* note 15 at 1318-23.

37 *Study Of Unsafe And Unsound Practices, supra,* note 24 at 187.

38 *Ibid.* at 202-03.

The general recognition of the certificateless society as an ultimate objective marked a major turning point, because the existing law governing transfers and pledges of securities was predicated entirely upon the delivery of certificates. Obviously, the certificateless society would require a new legal framework.

In 1971, a committee of the American Bar Association Section of Corporation, Banking and Business Law was established to determine what legislation was necessary to eliminate negotiable stock certificates and to draft such legislation. That committee's report[39] contained two principal recommendations: 1) that the Model Business Corporation Act be amended in order to permit the issuance of uncertificated stock, and 2) that Article 8 of the UCC, and other related provisions, be revised to provide rules regarding uncertificated investment securities. Those recommendations were referred to the Permanent Editorial Board for the UCC, and after further review and amendment, comprehensive revisions to Article 8 were approved in 1977.[40]

The SEC had also recommended that it be given certain authority over the qualifications, performance, business practices and rules of entities performing transfer and depository functions.[41] In 1975, Congress amended the Securities Exchange Act of 1934 by adding §17A,[42] which required the registration of transfer agents and clearing agencies (including depositories) with the SEC. The amendments also instructed the SEC to use its authority to end the physical movement of securities certificates in connection with settlement among brokers and dealers.

(4) The Continuous Net Settlement System

In the meantime, the securities industry was continuing to implement procedural reforms to improve upon settlement methods. One such reform, the Continuous Net Settlement ("CNS") system, proved to be a significant breakthrough in the development of securities depositories. The CNS system was originally developed by the Pacific Coast Stock Exchange in the 1950's,

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39 *Report Of The Committee On Stock Certificates, supra*, note 21.

40 See Reporter's Introductory Comment to the revised (1977) Article 8 of the UCC.

41 *Study Of Unsafe And Unsound Practices, supra*, note 24 at 5-6.

42 Securities Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97, 15 U.S.C. §78q-1 (1982).

and subsequently modified and improved. The NYSE in particular had been reluctant to adopt the CNS system,[43] but finally did so in 1974, together with the American Stock Exchange.

The CNS system introduced two major innovations. The first was that it placed the clearing agency between the participants in every transaction, as though each buyer or seller of securities had made their trade with the clearing agency. Trades are compared in the same way as under the DBO system, but after trades are matched, each member's obligation to deliver or pay for securities is owed to the clearing agency, which will in turn deliver certificates or pay out money to the other member. The settlement of compared trades between participating members is guaranteed by the clearing agency so that, for example, where one member fails to fulfil its obligation to deliver securities to the clearing agency in settlement of a trade, the clearing agency will make delivery to the purchasing member out of its own inventory, then deal with the defaulting member directly. This avoids the "ripple effect" of a single failure to deliver causing a series of subsequent fails. Each member who participates in the CNS system undertakes an obligation to indemnify the clearing corporation for any user default, and there are established procedures to control defaults by members.

The second major innovation of CNS was the application of the netting process to all previous unsettled transactions by members, where the DBO system only applied the netting process to each day's transactions. Thus, if a member bought 100 shares of a security one day and sold them the next, the CNS system would net both transactions so that the member would not be required to receive or deliver any securities, whereas under the DBO system that member would be required to receive securities one day and deliver them out again the next day. This aspect of CNS had the effect of markedly reducing the amount of movement of security certificates necessary to settle trades.

With all CNS settlements made through the clearing agency, it became convenient for brokers to leave certificates with the clearing agency until they were needed. The clearing agency's records reflected the entitlement of each member to receive certificates held by it, so if a broker became obligated to deliver certificates in settlement of a trade, but that broker already had

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43 See *Study Of The Securities Industry, supra,* note 15, at 1326, and 1341-42, (statements of Richard B. Howland, Executive Vice President, New York Stock Exchange, Inc.).

sufficient certificates "on deposit" with the clearing agency, settlement of that trade could be accomplished merely by the clearing agency making an appropriate change in its records. If the broker entitled to receive those certificates also elected to leave them with the clearing agency, then the entire settlement process would be accomplished without any physical movement of the security certificates.[44] This side effect of CNS corresponds with the basic goal of the securities depository system.

(5) The Securities Depository

(a) Book-entry transfers

All securities depositories are, essentially, facilities for holding fungible securities to enable book-entry transfers of those securities. A depository may also perform many other functions, but it is the concept of the book-entry transfer that is fundamental. Reduced to its simplest terms, the book-entry transfer is a method of accounting for transfers of securities using debits and credits to accounts held with the depository. The following example demonstrates this method:

> Brokers A and B each maintain accounts with a securities depository. Each broker deposits security certificates, appropriately endorsed, with the depository, whereupon the depository credits the brokers' accounts. The depository delivers the certificates to the various transfer agents with instructions to register the securities in the name of the depository or its nominee, and new certificates are issued to and stored by the depository. Broker A then sells some securities, and broker B buys them. Settlement of this transaction can be accomplished by the depository debiting A's account and crediting B's account, without any need for the movement of certificates. This same method is used if securities are pledged by A to B as security for a loan.

This example is obviously simplified to emphasize the basic mechanics of the book-entry transfer. We have ignored the complex clearing function, which is sometimes also performed by the depository. We have also ignored the fact that each broker is most likely acting on behalf of a client. These facts are significant to some the issues that are raised in this report, and will be dealt with in detail later, but they do not affect the basic mechanism on which depository operations are based.

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44 M. Aronstein, "The Decline And Fall Of The Stock Certificate In America" (1978) 1 J. Comp. Corp. Law & Sec. Reg. 273 at 276.

(b) History and development of securities depositories

Securities depositories originated in Europe.[45] The first organized depositories were regional associations of bankers in Germany (*Kassenvereine*). During the German occupation of France in World War II, this system was imposed upon the French who apparently recognized its merits and immediately after the war introduced a central depository system known as SICOVAM (*Société Interprofessionelle pour la Compensation des Valeurs Mobilières*).[46]

Although the concept of a central securities depository in the U.S. had been discussed as early as 1938,[47] the New York Stock Exchange took the first steps towards the actual establishment of such a system in the mid-1950's, campaigning for legislative changes to allow the operation of a depository.[48] The New York state legislature was the first in America to enact provisions authorizing depository operations in 1962. Those provisions were promptly used as the basis for additions to the Official Text of the UCC in 1962, the stated purpose of which was to authorize "... a newly developing and commercially useful method of transferring or pledging securities on the organized securities markets, particularly among brokers and banks but not necessarily so limited".[49]

In June of 1968, the New York Stock Exchange put its Central Certificate Service ("CCS") into operation. CCS was the first fully operational depository in the U.S.

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45 The circumstances under which depositories arose in Europe is not particularly relevant to our discussion because those circumstances are fundamentally different from the situation in North America. In Europe, major banks have long acted as brokers, and investors normally trade in securities through their banks. Also, securities in Europe are often issued in bearer form, not registered form, thus creating an inherent problem with safekeeping. The natural result was for banks to act as custodians of their customers' securities, and the problems of certificate movement experienced in the U.S. did not arise.

46 See Torosian, *supra*, note 17 at 277.

47 R. Sobel, *N.Y.S.E.: A History Of The New York Stock Exchange, 1935-1975* (New York: Weybright and Talley, 1975) at 55-56.

48 *Ibid.*

49 UCC §8-320 Official Comment.

(c) The Depository Trust Company

CCS was a basic depository which initially offered its services only to members of the New York Stock Exchange and to a number of banks. Although CCS experienced some significant operating problems for the first few years, pressure developed to broaden its operations and in 1973 the CCS was reorganized as the Depository Trust Company ("DTC"), a cooperative institution owned by the NYSE together with the American Stock Exchange, the NASD and other depository participants.

Like CCS, DTC initially operated solely on the basis of the immobilization of security certificates. In order to use DTC, one had to be a "participant" (generally brokers, banks and clearing facilities, but other entities were also eligible) meeting certain eligibility standards (financial strength, operational capability, honesty). Participants deposited certificates with DTC, whereupon DTC credited the participants' accounts. DTC had the deposited certificates registered in the name of its nominee, Cede & Co., and stored the new certificates in its vault. Once the certificates came within the DTC system, transfers, pledges and stock loans between participants could be effected by book entry without any need for certificate movement. Only when a participant requested a certificate would it be withdrawn from the depository system (e.g. where an individual purchased securities from a participant and insisted upon delivery of a certificate).

DTC operated very successfully and expanded rapidly, mainly due to the large base of participation in New York which it inherited, and also because of its superior operational capacity, as compared with other depositories.[50] Obviously, the efficiencies offered by DTC increase with the amount of participation — bigger is unquestionably better. By 1977, DTC held on deposit securities valued at approximately $111 billion.

In 1977, comprehensive revisions to the UCC were adopted to allow for the transfer of dematerialized securities. Dematerialized securities are securities for which no certificate is ever issued or available. They exist only as entries on the books of the issuer, and in the records of depositories and

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50 See *Report of the Committee on Stock Certificates, supra*, note 21 at 42, describing how the Pacific Securities Depository, which was established by the Pacific Coast Stock Exchange in September of 1971, reported in 1973 that it had 'lost' $650,000 in dividends payable to beneficial owners of deposited stock.

their participants. Many states were slow to consider adoption of the 1977 amendments because the paperwork crisis that was the original impetus for a certificateless system had been virtually eliminated, largely due to the depository system. In 1967, 10 million share average volumes, punctuated by occasional 15 million share days, precipitated the paperwork crisis. By the early 1980's, daily trading volumes regularly exceeded 100 million shares, and in October of 1987 the NYSE experienced consecutive 600 million share trading sessions, without any serious settlement or delivery problems.

DTC is by far the largest U.S. depository. At the 1990 year-end, the total value of securities held by DTC was $4.1 trillion.[51] More significantly, there has been a marked improvement in the ratio of book-entry deliveries to certificates withdrawn from DTC. In 1980, there were 1.8 book-entry deliveries for each certificate withdrawn from DTC.[52] By 1987 there were 7.8 book-entry deliveries per certificate withdrawn[53] and by 1990 there were 11 such deliveries per certificate withdrawn.[54] The total number of registered certificates provided annually to participants and investors through DTC declined from 16 million in 1980 to only 6 million in 1990. During this same 10 year period, the number of book-entry deliveries increased from 28 million to 73 million, and the value of such deliveries increased from $1.26 trillion to $8.8 trillion.

(d) The Canadian Depository for Securities

The Canadian securities industry is very similar, but not identical, to that in the U.S., with the most obvious difference being that the Canadian industry is much smaller, in terms of both absolute size and volume of activity. This and some other differences served to shield the Canadian industry from the "paperwork crisis",[55] with the result that no Canadian firms failed through loss of control of their operations. The events in the U.S. did,

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51 DTC Annual Report 1990 at 2.

52 SEC Annual Report 1985 at 121.

53 SEC Annual Report 1988 at 160.

54 DTC Annual Report 1990 at 15-17.

55 For an outline of these differences see J. Honsberger, "Failures of Securities Dealers and Protective Devices" in P. Anisman *et al., Proposals for a Securities Market Law for Canada* (Ottawa: Minister of Supply and Services, 1979) [hereinafter *Proposals for a Securities Market Law*] (Vol.3) at 1502-03.

however, prompt the Canadian securities industry to consider improvements in our clearing and settlement system.

The Canadian Depository for Securities, Limited ("CDS") was incorporated as a federal corporation in June of 1970, although the CDS initiative had begun some two years earlier. The original CDS objective was:

> To put the holdings of all market participants into Depository accounts so that transactions among participants would result merely in debit and credit entries.[56]

This fundamental objective evolved to encompass more specific aspects of the clearing and settlement of securities transfers, and other related issues, but the basic goal of CDS has remained unchanged.

Initially, CDS' operations developed quite slowly. In 1974, the Vancouver Stock Exchange, one of the original participants in the CDS project, withdrew its support and set up the Vancouver Stock Exchange Service Corp., a depository servicing members of the VSE (and later the Alberta Stock Exchange) exclusively. CDS, in the meantime, was working towards improvements in systems for clearance, settlement and related operations, with considerable success. In 1976 CDS became the clearing agency for the Montreal Stock Exchange, and in the following year for the Toronto Stock Exchange. CDS did not actually operate as a securities depository until December of 1981.

Recently, CDS' depository operations have grown rapidly. In December of 1988, the value of deposited securities was $93 billion. In December of 1991, the value of deposited securities was $399 billion. At the present time, it is in excess of $500 billion. Most of this growth was made up of debt securities.[57] The value of dividends and interest processed by CDS increased from $3.9 billion in 1988 to $28.9 billion in 1992.[58] This growth may be expected to continue.

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56 H.J. Cleland, "Applications of Automation in the Canadian Securities Industry: Present and Projected" in *Proposals for A Securities Market Law, ibid.* (Vol. 3) at 1003.

57 CDS Annual Report 1992 at 4-5.

58 *Ibid.*

Despite the increasing number and value of deposited securities, and the number of transactions handled by CDS, the number of physical withdrawals and deposits has declined steadily.[59] This reflects the efficiency available with expanded use of depositories.

(e) West Canada Depository Trust Company

As mentioned above, the Vancouver Stock Exchange Service Corp. operated a depository service for members of the VSE as early as 1974. In 1989, the clearing and depository operations formerly performed by the Vancouver Stock Exchange Service Corp. were split and divided between two new organizations, West Canada Clearing Corp. ("WCCC") and West Canada Depository Trust Company ("WCDTC").

WCCC is the designated clearing agency for trades on the Vancouver and Alberta Stock Exchanges.[60] WCCC is a B.C. company, owned 75% by the VSE and 25% by the ASE.

WCDTC is a B.C. limited purpose trust company, wholly owned by the VSE. Members of any recognized stock exchange may be depository participants, as may certain financial institutions. WCDTC handles any listed securities, including debt securities, but not OTC[61] traded securities (e.g. not treasury bills or government bonds). As at December 31, 1992, WCDTC held securities valued at approximately $3.2 billion.

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59 *Ibid.*

60 See Alberta Stock Exchange By-Laws s. 13.01, and Vancouver Stock Exchange Rules H.1.01 and A.1.08.

61 Over-the-Counter.

CHAPTER 3 — ARE SECURITIES DEPOSITORIES DESIRABLE?

A. The Easy Part

The first and most basic question to be dealt with is whether or not Alberta should consider enacting legislation to accommodate the operation of securities depositories.

We have seen that securities depositories are clearly a vital component in today's larger securities markets, but it may be noted that Alberta and B.C., each with their own stock exchange and securities industry, have thus far managed to do without such legislation.[62] We have already discussed the overwhelming pressures that led to the growth of depositories in the U.S., and the relative efficiency in clearing and settlement achieved through the use of depositories. Such overwhelming pressures do not seem to exist in Alberta at the present time, but there is certainly the potential for improvement in clearing and settlement if transfers through securities depositories were authorized by Alberta legislation.

The potential for more efficient clearing and settlement of securities transactions, by itself, presents a strong argument in favour of enabling legislation. A more cogent argument appears from a recognition of the trend towards the use of securities depositories in the larger securities markets, and the "globalization" of securities markets generally.

"Globalization" is a buzzword in the securities industry. It refers to the recent dramatic growth in systematic and widespread trading of securities on an international basis. It has been suggested that the most remarkable economic development of the 1980's was the dissolution of boundaries between national financial markets and the emergence of a truly global capital market.[63]

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62 *CDS Proposal* (Addendum), *supra*, note 3 suggests at p. 3 that B.C. has legislation providing for book entry transfers and pledges of securities. This is incorrect. B.C. has legislation providing for book entry pledges only. See Chapter 10 of this report.

63 C. Cook, "A Survey of the World Economy — Fear of Finance" *The Economist* (19 September 1992) 5. The same article notes that in 1980, gross sales and purchases of bonds and equities involving a resident and non-resident of the U.S. amounted to an equivalent of 3% of gross domestic product; in 1990, it was 93%. Japan, West Germany and the U.K. also experienced large increases in this area over the same period (*supra*, at 9).

Globalization has had and will have an enormous impact on clearance and settlement systems. After the October 1987 "Market Break", the SEC Division of Market Regulation found that, in order for international markets to be able to operate smoothly in conjunction with one another, "one of the most pressing needs is the development of compatible, safe and efficient domestic clearance and settlement systems, as well as international linkages among those systems."[64] Canada's securities markets are so closely linked with those in the U.S. that there is no alternative but to maintain compatible systems.[65]

Considerable attention has been directed towards improving the working of securities markets, with an emphasis on setting and meeting particular standards or goals by all countries with active securities markets. The Group of Thirty, which describes itself as "an international group of financial and economic leaders from both the public and private sectors", has since 1988 been vigorously pursuing a set of practices and standards for implementation throughout the world's securities markets. The Group of Thirty published its first report on this subject in March 1989[66] and continues to publish yearly status reports.[67] In its first report, it was noted that "the major risks associated with deficiencies in clearance and settlement of securities transactions affect individual market participants as well as the underlying markets in which they trade."[68] Among the deficiencies identified is the lack of book-entry processing for settlement of securities transactions in many markets.[69] The report makes 9 recommendations including that:

> Each country should have an effective and fully developed central securities depository, organized and managed to

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64 *The October 1987 Market Break*, A Report by the Division of Market Regulation, U.S. Securities and Exchange Commission, February 1988 at 11-21.

65 See for example the comments made by representatives of CDS and the TSE in relation to the Canadian decision to follow the U.S. in shortening the settlement period for corporate securities from five days to three days. E. Heinrich, "Canada to shorten period of securities settlement" *Financial Post* (23 February 1993) 18.

66 *Supra*, note 13.

67 Reports are available from the Group of Thirty at 1990 M Street, N.W., Suite 450, Washington, D.C. 20036, or Savoy Court East, P.O. Box 78, 336 Strand, London WC2R 1HB.

68 *Clearance and Settlement Systems*, *supra*, note 13 at 1.

69 *Ibid.*

> encourage the broadest possible industry participation (directly and indirectly), in place by 1992.[70]

The July, 1990 Report of the G30 Working Committee for Canada includes recommendations that:

> 1. All securities should be immobilized within depositories offering book-entry custody and settlement facilities.
>
> 2. Canada should commit to dematerialization.
>
> 3. The National Depository System in Canada should be strengthened.

The FIBV (*Fédération Internationale des Bourses de Valeurs*) formed a task force in 1987 to address issues necessary to improve the clearing and settlement of cross-border trading in securities, which task force reported in June 1989.[71] The FIBV has co-ordinated its activities with the Group of Thirty, with the G-30 concentrating on all clearing and settlement activities on a national level and the FIBV task force concentrating on settlement of cross-border securities transactions. The Commission Of The European Communities, Directorate General XV, commissioned a study into the inter-depository facilities required to settle cross-border trades, released in March 1989. The International Society of Securities Administrators ("ISSA") focused on the topic of "Global Securities Investments — Processing Issues and Solutions" at its 4th Symposium in Switzerland in May, 1988 and published 12 specific recommendations in its Symposium Report.[72] All these bodies have identified the central securities depository as a vital component in the settlement of international securities transactions.

Therefore, we feel that legislation to accommodate the operation of securities depositories in Alberta is desirable, primarily because it is a necessary step in keeping the Alberta securities market current and compatible with other markets in Canada, the U.S. and other countries.

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70 *Ibid.* at 7.

71 *Improving International Settlement: Report of the Task Force Appointed by the FIBV*, Fédération Internationale Des Bourses De Valeurs (1989).

72 The ISSA recommendations, together with a summary of the European Communities Report and a comparison of recommendations contained in these and the FIBV and G-30 reports are set out in Appendices to *Improving International Settlement, ibid.*

RECOMMENDATION 1

Alberta should introduce legislation to accommodate the operation of securities depositories.

B. The Hard Part

Legislation to accommodate the operation of securities depositories in Alberta is desirable, but that legislation must be appropriate. Our review of the *CDS Proposal* has convinced us that the proposed legislative amendments are not the best alternative available. In fact, we are convinced that our existing legislation governing securities transfers is deficient in a number of respects and needs to be reformed.

We now turn to an examination of the existing legislation.

CHAPTER 4 — THE EVOLUTION OF THE CANADIAN LAW OF SECURITIES TRANSFERS

A. Introduction

The law of securities transfers[73] is complex and difficult. Part of its complexity and difficulty arises merely from the fact that it is a highly specialized area, but part also arises from its flaws. Some flaws have existed in this area for a long time, and it is evident from a close examination of court decisions that there has been considerable confusion over certain aspects of the law.

In light of this, it becomes necessary to undertake a rather comprehensive review of how Canadian law evolved in this area.

B. Negotiability

(1) The Importance of Registration Prior to the Business Corporations Acts

We have discussed how, in the U.S., the Uniform Stock Transfer Act of 1909 made registration irrelevant to the transfer of shares.[74] In Canada, until relatively recently, shares remained transferable only on the books of the issuing company, according to traditional Anglo-Canadian company law.

For example, the Alberta Companies Act[75] provides only that:

> 74 The shares or other interest of any member in a company is personal estate, transferable in the manner provided by the articles of the company, and shall not be deemed to be of the nature of real estate.

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73 "Transfers" includes the transfer of partial interests, and so includes security interests in securities. "Security interests in securities" is a precise and accurate term, but too cumbersome for the purposes of our discussion, so we use "pledge" instead. See Chapter 10 of this report.

74 See note 10, *supra*, and accompanying text.

75 R.S.A. 1980, c. C-20.

In *Re C.A. Macdonald and Company Limited*[76] it was held that a written transfer in some form would normally be necessary to pass property in the shares either in law or in equity, and that only registration of such transfer could convey legal title to the shares.[77]

There were attempts at legislative reforms to reduce the importance of registration, at least with respect to transfers of shares listed on recognized stock exchanges. For example the Canada Corporations Act[78] contained the following provision:

> 39. (1) No transfer of shares, unless made by sale under execution or under the decree, order or judgment of a court of competent jurisdiction, is, until entry therof has been duly made in the register of transfers or in a branch register of transfers of the company, valid for any purpose whatsoever, save only as exhibiting the rights of the parties thereto toward each other, and if absolute of rendering any transferee jointly and severally liable with the transferor to the company and to its creditors.
>
> (2) Notwithstanding subsection (1), the delivery of any certificate for fully paid shares, with a duly executed transfer endorsed thereon or delivered therewith, constitutes a valid transfer of the shares comprised therein, if such shares are listed on any recognized stock exchange at the time of such delivery, but, until entry of such transfer is duly made in the register of transfers or in a branch register of transfers of the company, the company may treat the person in whose name the shares comprised in the said certificate stand on the books of the company as being solely entitled to receive notice of and vote at meetings of shareholders and to receive any payments in respect of such shares whether by way of dividends or otherwise.

Provisions similar to section 39(2) had been in effect since the federal Companies Act, 1902.[79] Before that, the provision was basically the same as section 39(1) of the Canada Corporations Act set out above, but without the exception in section 39(2) relating to the delivery of certificates representing listed shares.

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[76] (1959), 28 W.W.R. 231 (Alta S.C.A.D.).

[77] *Ibid.* at 237.

[78] R.S.C. 1970, c. C-32.

[79] 2 Ed. VII (1902), c. 15, s. 51. Considering that this pre-dates the U.S. Uniform Stock Transfer Act, it must be recognized as very progressive legislation for its time.

Until 1953, the provisions of the Ontario Companies Act[80] were essentially similar to those of the federal Companies Act prior to 1902. The Ontario Corporations Act, 1953[81] introduced section 49(2), which was comparable to section 39(2) of the Canada Corporations Act set out above. These provisions appear to have been intended to make street certificates[82] negotiable instruments, but the courts did not interpret the provisions that way.

In 1965, Ontario appointed a Select Committee to review its Corporations Act, signalling the first in a series of Canadian reform initiatives in the area of corporate law. The Select Committee found that the transfer of shares under Ontario law was occurring very much in the same manner as described by Dos Passos in 1882.[83] Street certificates were not negotiable instruments, but the brokerage community treated them as though they were in fact negotiable instruments. Unfortunately, the holder of the certificate was still subject to any infirmity in the title of the person from whom it was acquired, so that in the case of a lost or stolen certificate, no title in the shares would be acquired by the holder of the certificate.[84]

It is difficult to explain why the legislative provisions had so little effect. As described in the *Lawrence Report*:

> the courts have been disinclined to interpret Section 49(2) in accordance with the literal meaning of the language, that is, the courts have not held, as the statute provides, that delivery of certificates for shares listed on a recognized stock exchange constitutes valid transfer of the shares represented by such certificates;[85]

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80 See for example R.S.O. 1950, c. 59, s. 60.

81 S.O. 1953, c. 19, s. 49.

82 Street certificates are certificates either registered in the name of a stock exchange member and duly endorsed, or certificates registered to any other person or firm and duly endorsed with an endorsement guaranteed by a stock exchange member. See the discussion of "Advantages of street name registration" at p. 71 of this report.

83 *Supra*, note 8.

84 See *Interim Report of the Select Committee on Company Law*, Chairman A.F. Lawrence, Ontario Legislative Assembly: 1967 [hereinafter the *Lawrence Report*], at paras. 6.1.1 to 6.2.3.

85 *Supra*, note 84 at para. 6.1.7.

The *Lawrence Report* here cited *Chartered Trust & Executor Co. et al.* v. *Pagon et al.*,[86] where the owner lost a street certificate, endorsed in blank. She placed a stop-order with the issuer's transfer agent, and subsequently obtained a replacement certificate. Later the transfer agent received the lost certificate for transfer and erroneously issued new certificates. The court held that no title to shares could derive from the stolen certificate. It found that the effect of the delivery of a certificate endorsed in blank was well settled by *Colonial Bank* v. *Cady*[87] to the effect that:

> The effect of the delivery of a certificate endorsed in blank ... does not pass the property in the shares but a title, legal and equitable, which will enable the holder to vest himself with the shares without risk of his right being defeated by any other person deriving title from the registered owner ... Such a certificate is not a negotiable instrument so that a person taking it for value without notice of any infirmity in the title will have a right to hold it against a prior owner who never intended to part with it. The mere delivery of it with the endorsed blank transfer and power of attorney signed, irrespective of any act or intent on the part of the owner of the shares, is not of itself sufficient to pass the title to the shares. If the certificate for shares had been delivered by Mrs. Sinclair or with her authority, with intent to transfer them, such delivery would have been sufficient for the purpose. But if she had no intent to transfer them a good title could be obtained as against her only if she had so acted as to preclude herself from setting up a claim to them ...[88]

Although the *Pagon* decision pre-dates the introduction of section 49(2) in Ontario, the Lawrence Committee's comment on the courts' disinclination to apply the provision is accurate. In one case involving the federal version of this provision, it was held that:

> Ordinarily a document, such as a transfer of shares, is not valid until completed by the insertion of the names of the parties, or at least the transferee, and the only purpose of this provision in the Act was no doubt to validate an assignment that would otherwise be invalid, in order that the shares might be readily dealt with among brokers. It does not tend to make the document negotiable, but it obviates the necessity of having a transfer completed and registered on the books of the company each time a sale is made.[89]

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86 [1950] 4 D.L.R. 761 (Ont. H.C.).

87 *Colonial Bank* v. *Cady et al.* (1890), 15 App. Cas. 267 (H.L.).

88 *Chartered Trust & Executor Co.* v. *Pagon*, *supra*, note 86 at 767.

89 See *Whitehead* v. *Bridger, Hevenor & Co. et al.*, [1936] 3 D.L.R. 408 (Ont. C.A.) at 410. This is a County Court decision, where the appeal was dismissed without reasons.

This view may seem wrong, but it was widely held. Only one Canadian case held specifically that street certificates were negotiable instruments, and that case has stood in isolation.[90] The courts have otherwise consistently held that if certificates were endorsed in blank and delivered to a broker, then even if the broker dealt with them fraudulently, a *bona fide* purchaser for value could obtain a good title to the shares, but this was based on estoppel, not the negotiability of the certificates.[91] Where street certificates were lost or stolen, estoppel did not arise, and the true owner's claim could defeat the interest of a subsequent *bona fide* purchaser for value.[92]

In the result, registration remained necessary to perfect the rights of a purchaser.[93] As described in the *Lawrence Report*:

> This share transfer system contemplated by the [Ontario] Act is, plainly, an old fashioned "book stock" or registration of title concept which seems, historically, to have evolved in the 19th century as a result of the refusal of the law to recognize a company share as a chose in action and a share certificate as a negotiable instrument.[94]

(2) The Advent of the Business Corporations Acts

The *Lawrence Report* found that numerous substantial difficulties arose from the then existing law, and concluded that:

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90 See *Patrick* v. *Royal Bank of Canada*, [1932] 2 W.W.R. 257 (B.C.C.A.).

91 See *Smith* v. *Rogers et al.* (1898), 30 O.R. 256 (C.A.); *Macdonald* v. *Bank of Vancouver* (1915), 25 D.L.R. 567 (B.C.S.C.); *McLeod* v. *Brazilian Traction L. & P. Co., Ltd.*, [1927] 2 D.L.R. 875 (Ont. S.C.); *Robinson* v. *Bank of Toronto and R.P. Clark & Company*, [1932] 2 W.W.R. 91 (B.C.S.C.); and *Melanson* v. *McCleave* (1958), 11 D.L.R. (2d) 579 (N.S.S.C.). In the *McLeod* case, although the shares in question were listed on several recognized stock exchanges, the certificates in question were not actually sold on a stock exchange. For this reason, the provisions of the federal Companies Act were not applicable, but the court made an *obiter* comment suggesting that the Companies Act could also have been a valid defence to the plaintiff's claim.

92 See *Chartered Trust & Executor Co.* v. *Pagon*, *supra*, note 86; *Whitehead* v. *Bridger, Hevenor & Co.*, *supra*, note 89; and *Aitken* v. *Gardiner and Watson et al.* (1956), 4 D.L.R. (2d) (Ont. H.C.). A more extreme position was taken in *First City Trust Company* v. *Emery et al.* (1985), 64 B.C.L.R. 326 (S.C.), where the registered owner of a certificate was unable to convey any interest, even to a *bona fide* pledgee, because the certificate had been issued in error and the registered owner's pledge of it was fraudulent.

93 See *Colonial Bank* v. *Cady*, *supra*, note 87 at 277-78.

94 *Lawrence Report*, *supra*, note 84 at para. 6.1.6.

> (T)he law should be brought in line with the requirements of the changing stock exchange and transfer agency practices and adapted to the developing technological changes which have antiquated the concept of shares being transferred 'on the books of the company' ... There is, moreover, no reason to limit the Committee's recommendations to share transfers only — legal reform is required in respect of security transfer transactions of all kinds. The Committee has concluded that the enactment of a comprehensive code to govern and regulate all corporate security transfer transactions is desirable and in the public interest.[95]

Based upon these recommendations, Ontario introduced The Business Corporations Act, 1970,[96] which came into force on January 1, 1971.

It included provisions governing the transfer of securities, modelled upon Article 8 of the UCC, including those provisions added to the UCC in 1962 dealing with depository operations. These provisions were grouped together under the heading "INVESTMENT SECURITIES". Although the OBCA adopted the UCC concept of negotiability, it stopped short of specifying that security certificates are negotiable instruments, and it made a number of modifications to the UCC model.

At this same time, the federal government was re-examining the Canada Corporations Act. In 1967, a task force was appointed, headed by Dr. Robert Dickerson. In 1971, the *Dickerson Report*[97] was produced. It criticized the modifications of the UCC model made by the OBCA, and advocated the advantages of uniformity with the UCC.[98] The *Dickerson Report* formed the basis for The Canada Business Corporations Act.[99]

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95 *Ibid.* at para. 6.1.8.

96 The Business Corporations Act, 1970, R.S.O. 1970, c. 53. This Act was later superseded by the Business Corporations Act, 1982, S.O. 1982, c. 4. The short title was dropped at the time of the 1990 revision and consolidation of Ontario Statutes, so the statute is now simply the Business Corporations Act, R.S.O. 1990, c. B.16. All these statutes are referred to in the text as the "OBCA".

97 R. Dickerson, J. Howard and L. Getz, *Proposals For A New Business Corporations Law For Canada, vol. I, Commentary; vol. II, Draft Canada Business Corporations Act* (Ottawa: Minister of Supply and Services, 1971) [hereinafter the *Dickerson Report*].

98 *Ibid.* vol. I at 59-60.

99 Canada Business Corporations Act, originally enacted as S.C. 1974-75-76, c. 33, now R.S.C. 1985, c. C-44 [hereinafter CBCA].

Part VII of the CBCA, entitled "Security Certificates, Registers and Transfers", is patterned closely upon Article 8 of the UCC[100] — much more closely than the OBCA had been. Section 48(3) of the CBCA specifically provides that security certificates are negotiable instruments, and CBCA Part VII establishes virtually the same negotiability framework as that found in Article 8 of the UCC.

The CBCA was used as a model by a number of provinces in revising their corporate statutes. Alberta, Saskatchewan, Manitoba and Newfoundland subsequently adopted statutes containing provisions virtually identical to Part VII of the CBCA. Ontario revised the OBCA[101] in 1982 to conform more closely to the CBCA provisions. The other Canadian provinces have corporate statutes that differ from the CBCA in varying degrees.

(a) Investment securities

The term "investment security" is often used to distinguish securities which are subject to the transfer provisions of the Business Corporations Acts. This term originates with Article 8 of the UCC, which is entitled "Investment Securities".[102] The OBCA has likewise always placed its securities transfer provisions under the heading "Investment Securities". This particular term is not otherwise defined or used in Canadian legislation. Instead, the legislation defines and uses the term "security" to describe a number of different things,[103] only some of which would properly be described as investment securities.

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100 The *Dickerson Report*, *supra*, note 97, vol. I at 50-60.

101 The Business Corporations Act, 1982, S.O. 1982, c. 4.

102 UCC §8-101. As part of a comprehensive revision of UCC Article 8 currently underway, a new title is being considered: "Securities and Securities Entitlements". The comprehensive revision of UCC Article 8 is discussed commencing at p. 129 of this report.

103 Alberta legislation, for example, contains over a dozen definitions of "security" or "securities". See Alberta Energy Company Act, R.S.A. 1980, c. A-19, s. 1(1)(k); Alberta Heritage Savings Trust Fund Act, R.S.A. 1980, c. A-27, s. 1(c); Alberta Municipal Financing Corporation Act, R.S.A. 1980, c. A-33, s. 1(k); Business Corporations Act, S.A. 1981, c. B-15, s. 1(u) and s. 44(2)(n); Companies Act, R.S.A. 1980, c. C-20, s. 1(w); Financial Administration Act, R.S.A. 1980, c. F-9, s. 1(1)(v); Loan And Trust Corporations Act, S.A. 1991, c. L-26.5, s. 1(1)(ll) and s. 51; Personal Property Security Act, S.A. 1988, c. P-4.05, s. 1(1)(oo); Securities Act, S.A. 1981, c. S-6.1, s. 1(v); Small Business Equity Corporations Act, S.A. 1984, c. S-13.5, s. 1(l); Trustee Act, R.S.A. 1980, c. T-10, s. 2(d).

A number of separate issues arise in connection with the definition of "security", and these are dealt with in detail below.[104] However, a general understanding of the nature of investment securities is valuable to the context of this report, so a brief discussion of investment securities at this point is warranted.

The distinctive characteristics of investment securities may be seen clearly by contrasting the two definitions of "security" found in the Alberta Business Corporations Act.[105] The first definition is very general:

> 1
> (u) "security", except in Part 6, means a share of any class or series of shares or a debt obligation of a corporation and includes a certificate evidencing such a share or debt obligation;

A more specific definition is found in Part 6, which is entitled "SECURITY CERTIFICATES, REGISTERS AND TRANSFERS":

> 44(2)
> (n) "security" or "security certificate" means an instrument issued by a corporation that is
>
> (i) in bearer, order or registered form,
>
> (ii) of a type commonly dealt in on securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment,
>
> (iii) one of a class or series or by its terms divisible into a class or series of instruments, and
>
> (iv) evidence of a share, participation or other interest in or obligation of a corporation;

This more specific definition describes investment securities. It is identical to the definition used in the CBCA,[106] which is patterned after, and almost

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104 See the discussion accompanying Recommendations 4, 6 and 8 in this report.

105 S.A. 1981, c. B-15 [hereinafter ABCA].

106 CBCA s. 48(2).

identical to the definition used in the UCC until 1977.[107] The purpose of this type of definition is stated in the Offical Comment to the UCC:

> The definition of "security" is functional rather than formal, and it is believed will cover anything which securities markets, including not only the organized exchanges but as well the "over-the-counter" markets, are likely to regard as suitable for trading. For example, transferable warrants evidencing rights to subscribe for shares in a corporation will normally be "securities" within the definition ... On the other hand the definition does not cover anything (whether it is a "security" or not under regulatory statutes like the Securities Act of 1933 or a state Blue Sky law)[108] which is not either "of a type commonly dealt in upon securities exchanges or markets," or "commonly recognized ... as a medium for investment".[109]

Notwithstanding the recommendations in the *Laurence Report*, the first OBCA did not adopt this functional definition of security.[110] A functional definition, very similar to the existing CBCA and ABCA definitions, was adopted in the 1982 OBCA.[111] The OBCA definition was amended again in 1986.[112] Despite the differences between the definitions used in the various statutes, it seems clear that the purpose of each definition is more or less the same as that expressed above in the UCC Official Comment.

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107 See UCC §8-102 (pre-1977). The only difference is that the UCC definition required that a security be issued in bearer or registered form, while the Canadian Business Corporations Acts allow for securities to be issued in order form as well.

108 Regulatory statutes are remedial in nature, and thus use a very broad, inclusive definition of security to ensure that new investment products are subject to regulation for the protection of the public. See for example s. 1(v) of the Securities Act, *supra*, note 103; *Securities & Exchange Commission* v. *W.J. Howey Co. et al.* (1946), 328 U.S. 293 (U.S.S.C.); *State Commissioner Of Securities* v. *Hawaii Market Center, Inc., et al.* (1971), 485 P.2d 105 (Haw. S.C.); *Attorney General of Alberta* v. *Great Way Merchandising Ltd.*, [1971] 3 W.W.R. 133 (Alta. S.C.A.D.); and *Pacific Coast Coin Exchange Of Canada et al.* v. *Ontario Securities Commission* (1978), 80 D.L.R. (3d) 529 (S.C.C.).

109 Official Comment to UCC §8-102 (1973 Official Text).

110 See S. Lavine, *The Business Corporations Act* (Toronto: Carswell, 1971) at 138-40.

111 Section 53(1)(u).

112 The 1986 amendments created separate definitions for "security", "security certificate" and "uncertificated security" in s. 53(1)(u), (ua), and (xa). These same definitions are now found in s. 53(1) of the OBCA, R.S.O. 1990, c. B.16.

(i) Derivatives

It is not clear whether derivatives qualify as investment securities. Derivatives are investment products whose value depends on the values of other more basic underlying variables.[113] They include warrants, options, futures, swaps and other esoterically-named products such as collars, caps, floors and circuses. The nature of derivatives allows for an infinite variety of new products, and derivatives are one of the fastest growing areas in the financial marketplace. It is surprising, then, that relatively little attention has been paid to the legal foundation for transfers of derivatives. There is doubt over whether very simple derivatives, such as stock options, are investment securities,[114] so the categorization of more complex derivatives is even more uncertain.[115]

We have not undertaken an analysis of legal or policy issues relating to derivatives. Although we feel that such analysis could be intrinsically valuable, it is a major task and not necessary to the issues dealt with in this report. Therefore, the discussion in this report deals generally with conventional investment securities: debt and equity securities.

(3) The Role of Registration Under the Business Corporations Acts

The Business Corporations Acts use the negotiable certificate as the key element in a system governing share transfers. We will discuss various aspects of this system in detail elsewhere in this report, but at this point we will focus

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113 See J. Hull, *Options, Futures and Other Derivative Securities,* (Englewood Cliffs: Prentice-Hall, 1989) at 1.

114 See E. Guttman, *Modern Securities Transfers,* 3rd Ed., ¶ 1.04[1], ns.96 and 97.

115 It is not only the legal aspects of derivatives that remain unclear. Confusion over derivatives impacts regulators and investors. See J. Merrick, Jr., *Financial Futures Markets,* (New York: Harper & Row, 1990) at 199-216; "Taming the derivatives beast" *The Economist* (May 23, 1992) 81-82; "Stop swapping?" *The Economist* (March 13, 1992) 94; L. Jereski, "Alice in Mortgageland" *Forbes* (March 1, 1993) 46-48; and R. Lenzner & W. Hueslein, "The age of digitial capitalism" *Forbes* (March 29, 1993) 62. See also "A Survey of International Banking" *The Economist* (April 10, 1993) for a discussion of the role of derivatives in risk management by banks. A situation where certain swap transactions (involving a notional principal sum of over £6 billion) were found to be *ultra vires* one of the participants, with grievous consequences, is seen in the decisions in *Hazell* v. *Hammersmith and Fulham London Borough Council et al.,* [1990] 3 All E.R. 33 (Q.B.D. and C.A.); (rev'd) [1991] 1 All E.R. 545 (H.L.); *Westdeutsche Landesbank Girozentrale* v. *Islington LBC* and *Kleinwort Benson Limited* v. *Sandwell BC, The Times* February 23, 1993.

upon a simplified view of the system to show how the role of registration has been changed.

Section 48(3) of the CBCA provides:

> Except where its transfer is restricted and noted on a security in accordance with subsection 49(8), a security is a negotiable instrument.

Stock exchange rules generally prohibit transfer restrictions on listed shares.[116] Section 49(8) provides that restrictions on transfer are generally ineffective against a transferee who has no actual knowledge of them unless they are referred to or noted conspicuously on the security certificate. Section 60 of the CBCA provides:

> (1) On delivery of a security the purchaser acquires the rights in the security that his transferor had or had authority to convey, except that a purchaser who has been a party to any fraud or illegality affecting the security or who as a prior holder had notice of an adverse claim does not improve his position by taking from a later *bona fide* purchaser.
>
> (2) A *bona fide* purchaser, in addition to acquiring the rights of a purchaser, also acquires the security free from any adverse claim.

Section 76 provides that, subject to certain conditions, an issuer must register a transfer when a certificate is presented for registration. Section 51(1) provides that, with limited exceptions, a corporation may treat the registered owner of a security as the person exclusively entitled to vote, receive notices and dividends, and to exercise all the rights and powers of an owner of the security.

Similar provisions are found in the OBCA and ABCA.[117]

What is the effect of registration under this system? The statutes no longer state that registration is necessary to effect a transfer, but the significance of registration is not readily apparent from a reading of the statutes. The major changes in the system are designed to give a purchaser, under normal circumstances, an invincible property interest in the negotiable certificate. It is clear that the purchaser who receives a negotiable share

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[116] See for example the listing requirements set out in Alberta Stock Exchange Policy Circulars 1, 2 and 3; and Toronto Stock Exchange Policies, Part VII.

[117] See OBCA ss 53(3), 56(3), 67(1), 69 and 86; ABCA ss 44(3), 47(2), 45(8), 56 and 71.

certificate will usually acquire a right to become registered as owner of shares. Recognizing that many transactions in modern securities markets do not involve any change in registered ownership on the books of the issuer, it is important to determine who is the owner[118] of shares when the registered owner has transferred the certificate to a *bona fide* purchaser.

This particular question has seldom been addressed, with the result that there is sometimes confusion on this point. For example, Professor Welling's discussion of "Share Transfers" does not deal directly with this question.[119] He emphasizes the necessity of distinguishing between the tangible certificates and the intangible shares, pointing out that the transfer system gives the purchaser rights in the certificates only. He clearly implies that a regular transfer of the certificate does not transfer shares until registration:

> The process is admirably simple. Where the transfer of possession of the endorsed share certificate has been routine, the transferee is the owner of the certificate because it is a negotiable instrument. The original owner becomes uninteresting so far as the "security" analysis goes. That is, he is still the shareholder of record, registered in the corporate books, but he is no longer the owner of the security, which is defined as the share certificate, not the shares. The security is now owned by the transferee. As owner, he is entitled to become registered as a shareholder. The endorsement on the transferred security will indicate that the registered shareholder intended by the transfer to divest himself both of his property in the certificate and, **eventually, of his shares.** [emphasis added][120]

Similar views have been expressed elsewhere:

> Shares may only be transferred, so as to effect the company, by registration of the transfer on the books of the company as maintained either by the company or by its appointed registrar and transfer agent. A shareholder may, however, transfer all rights that the holder possesses in the share to another simply by endorsing the share certificate for transfer, either in the name of transferee or in blank.[121]

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118 The ownership of a share is a complex concept. A share, as intangible property, is a collection of valuable rights enforceable by law. Ownership is a more difficult matter to define, but for our purposes it may be viewed as "the entirety of the powers of use and disposal allowed by law." This definition is taken from Pollock's *First Book of Jurisprudence* (New York: Burt Franklin, 1896) at 166.

119 B.Welling, *Corporate Law In Canada*, 2nd ed. (Toronto: Butterworths, 1991) at 701-31.

120 *Ibid.* at 725-26.

121 T. Hadden, R. Forbes and R. Simmonds, *Canadian Business Organizations Law*, (Toronto: Butterworths, 1984) at 314. See also D.D. Prentice, "The Transfer of Shares: Part VI of The Canada Business Corporations Act 1975" (1977) 23 McGill L.J. 565 at 582-83.

We feel that the former position is incorrect, and the latter is imprecise. We do not agree that shares can only be transferred by registration. In our view, registration may affect the share owner's dealings with the corporation, but it does not affect the transfer of ownership of the shares.

Each author points to the fact that the corporation may treat the transferor as the owner until the transfer is registered. Professor Welling emphasizes that the share register still reflects whoever has the status to invoke the full range of shareholder rights and remedies against the corporation.[122] This is not strictly correct.

The statutory authority[123] for the issuer to treat the registered shareholder as the owner of shares is permissive, not mandatory, so it would seem that the issuer could recognize an unregistered shareholder if it chooses to do so.[124] The Business Corporations Acts all contain provisions defining and recognizing the rights and obligations attached to "beneficial ownership" of shares. The CBCA and ABCA provide that if shares are registered in the name of a registrant (broker), but are not beneficially owned by the broker, then the broker cannot vote those shares without the written instructions of the beneficial owners.[125]

Does the recognition of "beneficial ownership" of shares imply that registration controls legal ownership? Apparently not, since other provisions refer to transfers of shares without registration in simple terms of ownership, and as giving the unregistered transferee rights, as a "shareholder" to make proposals and to vote at meetings.[126] The Business Corporations Acts do not

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122 *Supra*, note 119 at 710.

123 ABCA s. 47(1); OBCA s. 67(1); CBCA s. 51(1).

124 See the Official Comment to UCC §8-207.

125 See ABCA s. 147(1) and (2); CBCA s. 153 (1) and (2).

126 See for example ss 128, 129 and 132 of the ABCA (comparable to CBCA ss 134, 135 and 138; OBCA ss 95, 96 and 100). ABCA s. 132 details how an unregistered transferee who acquired shares from a person named on the issuer's list of shareholders may become entitled to vote those shares. These sections fall short, however, of providing a comprehensive regime dealing with unregistered owners. For example, they do not provide for a situation where a registered owner transferred shares, prior to the record date, to a transferee who, after the record date, wishes to vote the shares. In that situation, the sections provide no mechanism whereby the transferee can vote the shares, even if the transfer is registered after the record date. This area is discussed in detail in Chapter 11 of this report, commencing at p. 231.

give the term "shareholder" a comprehensive definition, and the term is used rather loosely in the statutes. Some provisions have been interpreted to use the term as meaning "registered shareholders", others obviously do not contemplate registration.[127]

In our view, registration under the Business Corporations Acts does not determine ownership of the shares in any way. We approach the question somewhat differently than the authors quoted above. Our primary concern is with the property rights of the parties, not with statutory rights that flow from a listing in the issuer's share register. It makes no sense to say that a registered shareholder transfers their entire property interest to a purchaser, but somehow retains a property interest as against the corporation.

It seems more accurate to treat registration as a matter of convenience for the issuer, but irrelevant to the question of ownership of the shares. This is more consistent with the concept of the negotiable certificate. One of the principal drafters of the CBCA, Mr. John L. Howard, has said that the intent of section 48(3) of the CBCA, declaring securities to be negotiable instruments, is to make the security certificate the embodiment of the rights and privileges attached to the securities mentioned in it, so that when the security certificate is transferred, so also is the ownership of the underlying securities.[128] This point has not been judicially considered in Canada, but our view is also consistent with U.S. law. As stated in *Corpus Juris*:

> Except where a statute, by-law, or charter provision requires it, registration or transfer on the corporate books is not generally necessary to vest an assignee with title to stock assigned to him.[129]

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127 *Ibid.*, and see *The Manitoba Securities Commission* v. *Versatile Cornat Corporation and Mesman*, [1979] 2 W.W.R. 714 (Man. Q.B.); and *Westmin Resources Limited* v. *Hamilton*, [1991] 3 W.W.R. 716 (B.C.S.C.). These cases deal with the availability of the statutory right to dissent, and held that it is available only with respect to shares registered in the name of the dissenting shareholder. The *Versatile Cornat* case includes a review of authorities dealing with the question of who is a shareholder in other contexts, several of which held that registration is not necessary. See also *Strait Line Contractors Ltd. (Receiver of)* v. *Rainbow Oilfield Maintenance Ltd.*, [1991] 4 W.W.R. 376 (Alta. C.A.), where the court looked behind the registered ownership of shares and considered equitable interests in determining whether one corporation was a wholly owned subsidiary of another for purposes of ABCA s. 42(2)(c).

128 See Alberta Institute of Law Research and Reform Report No. 36, *Proposals For A New Alberta Business Corporations Act*, Vol. 1 at 83-87.

129 18 *Corpus Juris Secundum* §272 a.

If the corporation's articles state that registration is required in order to transfer shares (which would rarely be the case), this should be noted on the certificate in accordance with CBCA section 49(8). Even then, delivery of the certificate should operate as a transfer of the shares as between the parties to the transaction. As stated by the New York Court of Appeals in *McNeil* v. *The Tenth National Bank*:

> It has also been settled, by repeated adjudications, that, as between the parties, the delivery of the certificate, with assignment and power indorsed, passes the entire title, legal and equitable, in the shares, notwithstanding that, by the terms of the charter or by-laws of the corporation, the stock is declared to be transferable only on its books; that such provisions are intended solely for the protection of the corporation, and can be waived or asserted at its pleasure, and that no effect is given to them except for the protection of the corporation; that they do not incapacitate the shareholder from parting with his interest, and that his assignment, not on the books, passes the entire legal title to the stock, subject only to such liens or claims as the corporation may have upon it, and excepting the right of voting at elections, etc. [citations and footnote omitted][130]

Note that the delivery of the certificate is said to pass the entire legal and equitable title **as between the parties**. In our view this is just another way of drawing the distinction between the rights of a registered owner and an unregistered owner with respect to such matters as voting at a time when unregistered owners could not vote, receive dividends, etc.. The right to vote, etc. should be recognized as not necessarily evidencing a property right — it can and does arise sometimes merely as a consequence of a name appearing on a list.

In our view, then, the negotiable share certificate remains distinguishable from the shares, but it also operates as the mechanism to transfer such shares, notwithstanding the state of the issuer's share register. Although the issuer may rely upon its share register for some purposes, **the share register no longer reflects ownership of the shares themselves**. It follows that the lawful possessor of the certificates is the owner of the shares, whether registered or not.

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130 *McNeil* v. *The Tenth National Bank*, 46 N.Y. 325 (1871) (N.Y. Court of Appeals) at 331; See also Guttman, *supra*, note 114 at 4-5 n.12, and 6-26 n.111; *Chemical Nat. Bank Of New York* v. *Colwell et al.*, 30 NE 644 (1892) (N.Y. Court of Appeals).

Because the relationship and the distinction between shares and the share certificate is difficult to grasp, we will examine it in some common situations.

If Jane Doe is the registered shareholder and is in possession of a corresponding share certificate, she clearly owns the certificate. But her total interest is not limited to the certificate. She has rights beyond mere ownership of the certificate, even though the negotiable share certificate is, to a very great extent, the embodiment of her rights as against the issuer. The certificate is properly viewed as evidence of those rights, but some rights exist even in the absence of the certificate, and others are strictly limited to the certificate itself.

For example, if Jane Doe had endorsed the certificate in blank, and subsequently the certificate was accidentally destroyed, Jane would still have the right to vote, receive dividends, etc., even though the certificate has ceased to exist. But in order to transfer or pledge the shares, she would have to obtain a replacement certificate from the issuer.

If the endorsed share certificate was not destroyed, but was stolen, Jane Doe is faced with a major problem. She still owns the shares, but a thief can use the stolen certificate to effectively transfer those shares. There is a high probability that the certificate will end up in the hands of a *bona fide* purchaser, with the result that Jane Doe will sustain the entire loss of the shares.[131] This outcome seems to conflict with the notion that Jane Doe has an interest beyond the certificate. It does not, however, because if the certificate had not been endorsed in blank at the time it was stolen, Jane Doe might obtain a replacement certificate and avoid the loss of the shares. This example demonstrates the most important quality of the negotiable certificate — its power to control the transfer of the shares.

If Jane Doe is in possession of a certificate endorsed in blank, but is not registered as a shareholder on the books of the issuer, then the certificate is even more important. She owns the shares and still has some rights in the absence of the certificate, so that, for example, she could obtain a new certificate (with some expense and difficulty) in the event the certificate is

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[131] See ABCA ss 44(2)(c), 74(1) and 75.

accidentally destroyed.[132] But if the certificate were to be stolen, Jane Doe's situation is akin to having an endorsed cheque stolen. She could recover the certificate directly from the thief, but once the thief negotiates the certificate to a *bona fide* purchaser, Jane Doe's rights are extinguished.[133]

Therefore, although the entire interest of a registered shareholder in possession of a certificate is intangible and not limited to the share certificate, the certificate evidences the shareholder's interest and is a very powerful device controlling the transfer of that interest. In practical terms, the shareholder cannot effect a transfer or pledge of the intangible interest without giving up possession of the certificate. Moreover, the Business Corporations Acts provide that, in a regular[134] transfer or pledge transaction, giving up possession of the certificate effectively transfers or pledges the entire intangible interest.

In most circumstances, then, the certificate may be viewed as if it were the embodiment of the underlying intangible interest, because lawful possession of the certificate gives complete control over the transfer of the underlying interest.

Aside from the need to maintain a precise view of the transfer process, this point is critical when we consider property interests held by brokers on behalf of clients. Before doing that, we will examine other aspects of the Business Corporations Acts dealing specifically with securities depositories.

C. Depository Provisions in the Business Corporations Acts

It is remarkable that the only significant difference between Part VII of the CBCA and Article 8 of the UCC is that the CBCA did not include any of the 1962 revisions to Article 8 dealing with the operations of securities

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132 ABCA s. 75 governs the right to obtain a replacement security. Under s. 75(2), in addition to satisfying the issuer that she was the owner of the certificate, she would also have to provide an indemnity bond.

133 If Jane Doe obtained a replacement security, then upon presentation of the stolen certificate for registration of transfer by a bona fide purchaser, the issuer would likely purchase a security on the market for registration in the name of the bona fide purchaser (to avoid overissue under s. 48), then either reclaim the replacement security from Jane Doe under s. 75(4) or exercise its rights under the indemnity bond.

134 That is, in the absence of forgery, fraud, adverse claims, etc..

depositories.[135] The *Dickerson Report*[136] recommended such provisions and included them in the Draft Act, but by the time Bill C-213 was tabled in the House of Commons in July of 1973 those provisions had disappeared. Bill C-213 died on the order paper. In October of 1974 Bill C-29, a somewhat amended version of Bill C-213, but still without provisions for depository operations, was tabled. After further amendments Bill C-29 eventually passed and came into force on January 1, 1976. The lack of any provisions for depository operations does not appear to have been raised during the parliamentary debates surrounding the CBCA, nor did the debates touch upon any topical issues relating to securities transfers. This is puzzling in light of the fact that, during this same period, a very great deal of attention was being directed towards these issues in the U.S.

At present, only Ontario and Quebec have any statutory provisions dealing with depository operations.[137] The Quebec provisions are contained in the Securities Act,[138] and operate within a legislative framework significantly different from that which exists in Alberta. As such, the Quebec provisions are practically irrelevant for the purposes of this report. The Ontario provisions operate within a legislative framework very similar to Alberta's, and so are particularly relevant for our purposes. We shall examine the history of the Ontario provisions in some detail.

(1) The Ontario Business Corporations Act, 1970

In 1970 Ontario included section 91 in the OBCA which was practically identical to then UCC §8-320. Both provisions operated by deeming transfers and pledges recorded on the books of a clearing corporation to have the effect of delivery of a suitably endorsed security certificate. Thus, book entries became compatible with other provisions of the OBCA and UCC which made delivery of a security certificate the key element of a transfer. OBCA section 91 (now section 85) read:

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135 *Supra*, note 49.

136 *Supra*, note 97.

137 The B.C. PPSA contains provisions dealing with pledges of securities held by depositories, but B.C. has no legislative provisions dealing with transfers of such securities. See also *supra*, note 62.

138 R.S.Q. 1977, c. V-1.1, as am. by S.Q. 1984, c. 41, ss 10.1-10.5.

(1) If a security,

(a) is in the custody of a clearing corporation or of a custodian or nominee of either, subject to the instructions of the clearing corporation;

(b) is in bearer form or endorsed in blank by an appropriate person or registered in the name of the clearing corporation or custodian or a nominee of either; and

(c) is shown on the account of a transferor or pledgor in the records of the clearing corporation,

then, in addition to other methods, a transfer or pledge of the security or any interest therein may be effected by the making of appropriate entries in the records of the clearing corporation, reducing the account of the transferor or pledgor and increasing the account of the transferee or pledgee by the amount of the obligation or the number of shares or rights transferred or pledged.

(2) Under this section entries may be in respect of like securities or interests therein as part of a fungible bulk and may refer merely to a quantity of a particular security without reference to the name of the registered owner, certificate or bond number or the like and, in appropriate cases, may be on a net basis taking into account other transfers or pledges of the same security.

(3) A transfer or pledge under this section has the effect of a delivery of a security in bearer form or duly endorsed in blank representing the amount of the obligation or the number of shares or rights transferred or pledged.

(4) If a pledge or the creation of a security interest is intended, the making of entries has the effect of a taking of delivery by the pledgee or a secured party.

(5) A transferee or pledgee under this section is a holder.

(6) A transfer or pledge under this section does not constitute a registration of transfer under sections 92 to 96.

(7) That entries made in the records of the clearing corporation as provided in subsection 1 are not appropriate does not affect the validity or effect of the entries nor the liabilities or obligations of the clearing corporation to any person adversely affected thereby.

(2) The Ontario Business Corporations Act, 1982

In 1982, the OBCA was substantially revised, bringing its securities transfer provisions much closer to the CBCA (and UCC Article 8) model of negotiability. Part VI of the OBCA, entitled "INVESTMENT SECURITIES", adopted the CBCA's definition of "security" and "*bona fide* purchaser", as well as the provision that a security is a negotiable instrument.

Of course, the CBCA still lacked any provisions respecting the operation of securities depositories, so in this area the OBCA had surpassed the CBCA in its resemblance to the UCC Article 8 model. The 1982 revision added the CBCA's definition of "fungible" to the OBCA, even though the term "fungible" had been used in the OBCA since 1970. Section 85(8) was added, providing:

> (8) For the purposes of this section, if a clearing corporation or its nominee is registered in the securities register of a body corporate as the owner of a share, participation or other interest in or obligation of the body corporate, but such body corporate has not issued a security certificate in respect thereof,
>
> (a) the clearing corporation or its nominee shall be deemed to have custody of a security certificate in respect of such share, participation or other interest in or obligation of the body corporate; and
>
> (b) such security certificate shall be deemed to be registered in the name of the clearing corporation or its nominee, as the case may be.

This particular provision is noteworthy because it had no predecessor in Article 8 of the UCC. Its appearance is linked to the addition of section 54(1) to the OBCA. Section 54(1) was taken almost verbatim from section 49 of the CBCA. It also had no predecessor in Article 8 of the UCC,[139] or anywhere in U.S. corporation law.[140] The relevant portion is as follows:

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139 In Crawford and Falconbridge, *Banking and Bills Of Exchange*, 8th ed. (Toronto: Canada Law Book Inc., 1986) [hereinafter *Crawford and Falconbridge*], at 181-82, it is suggested that the practice of providing written acknowledgements instead of conventional certificates is an American practice, and that s. 45(1) of the original CBCA [now s. 49(1)], was based loosely on UCC §8-401. This seems to be incorrect. UCC §8-401 contains no provision even remotely similar to CBCA s. 45(1). §8-401 was clearly the model for s. 71 in the original CBCA [now s. 76]. We are unaware of any significant use of written acknowledgements in lieu of certificates in the U.S. that would explain the introduction of CBCA s. 45(1). To the extent that any such practice existed prior to 1977, it would have been contrary to U.S. corporate law. See *infra*, note 140.

140 In 1977, revisions to the U.S. Model Business Corporations Act ("MBCA") were proposed to authorize the issuance of dematerialized shares. The proposed revisions were adopted in 1978 by the American Bar Association's Committee on Corporate Laws. State laws do not conform to the MBCA to the same extent as to the UCC, but prior to 1978 all states had in their legislation a basic provision analogous to MBCA s. 23 which required that shares be represented by certificates. See *Report Of The Committee On Stock Certificates*, *supra*, note 21 at A-1.

> 54.(1) Every security holder is entitled at his option to a security certificate in respect of the securities held by him that complies with this Act or to a non-transferable written acknowledgement of his right to obtain a security certificate from a corporation in respect of the securities of the corporation held by him ...

This provision adds an unusual wrinkle by creating the possibility of a security for which a certificate is available, but for which no certificate may exist at any given time. These may be referred to as certificate-optional ("COP") securities. Note that for the time such securities are not evidenced by a certificate, they must be evidenced by a non-transferable written acknowledgment ("NOTWRACK"), and that a NOTWRACK is not itself a security. COP securities create substantial confusion over terminology, because they are properly referred to as "uncertificated securities" for such time as they are not evidenced by certificates. The confusion stems from the fact that the post-1977 UCC provisions refer also to "uncertificated securities", but the UCC clearly contemplates uncertificated securities for which no certificate is ever available — dematerialized securities.

The *CDS Proposal* suggests that CDS could benefit from holding securities on a "non-certificated basis", as this would eliminate the possibility of security certificates being lost or misappropriated and would substantially reduce safekeeping costs incurred by CDS.[141] This use of section 54(1) by CDS would explain the need for section 85(8).[142]

We should also recognize that section 85(8) could be viewed as a small and preliminary step towards accommodating the transfer of dematerialized securities, in response to the 1977 revisions to Article 8 of the UCC. If this was the intent, then section 85(8) is significant because it represents a clear departure from the approach taken by the 1977 revisions to UCC Article 8. The 1977 revisions introduced a comprehensive set of new provisions, amending almost every section of Article 8. The intent was to create a legal framework to handle dematerialized securities which, as closely as possible, paralleled the existing law applicable to transfers of certificated securities.[143]

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141 See *CDS Proposal, supra*, note 3 at 6 and Addendum at 2-3.

142 A detailed discussion of issues arising from the operation of the ABCA equivalent of OBCA s. 54(1) is found commencing at p. 142 of this report.

143 See Reporter's Introductory Comment to Revised (1977) Art. 8 Of The Uniform Commercial Code.

By comparison, the OBCA section 85(8) might be seen as purporting to handle transfers of dematerialized or COP uncertificated securities within CDS merely by deeming such securities to be certificated. Subsequent amendments to the OBCA make a detailed evaluation of the effectiveness of section 85(8) in this context unnecessary, but it still interesting to speculate on the actual intent of this provision.

(3) 1986 Amendments to the OBCA, 1982

In 1986 the OBCA was further amended. Significant changes were made to Part VI. A definition of "uncertificated security" was introduced, similar to that used in the 1977 revisions to the UCC. The definitions of "security" and "*bona fide* purchaser" were amended. Section 85 was expanded considerably. There were also some consequential amendments to other definitions and sections.

There have been no substantive amendments to Part VI of the OBCA since 1986, although some wording changes were made as part of the 1990 revision and consolidation of all Ontario statutes.[144] The OBCA provisions prior to the 1990 revision and consolidation are the model for the amendments proposed for the ABCA in the *CDS Proposal.*

D. Conclusion

We have seen that the Canadian law governing transfers of investment securities has largely been patterned upon Article 8 of the UCC, but that it has not developed uniformly within Canada. Ontario is the only jurisdiction with provisions in its Business Corporations Act dealing with book-entry transfers of securities held in a depository.

Before proceeding further with an examination of the operation of the existing legislation, it is necessary to examine the broker-client relationship.

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144 For example, "*bona fide* purchaser" became "good faith purchaser", and references to "him" became "the person". We have assumed that such changes in wording have no substantive effect on the provisions.

CHAPTER 5 — THE ROLE OF INTERMEDIARIES

A. Introduction

It is possible to transfer an investment security without using any intermediaries: e.g. where an individual seller in possession of a security certificate makes a private bargain with a purchaser, then endorses and delivers the certificate to the purchaser in exchange for payment. Such transactions are rare.[145] A more common transaction not involving intermediaries is the pledge: where a borrower delivers a suitably endorsed certificate to a lender as security for the loan.[146] But the vast majority of modern securities transactions involve sales with intermediaries acting on behalf of the seller and the purchaser. Sometimes the same intermediary will act on behalf of both parties. Most pledges also involve at least one intermediary.

A thorough understanding of the role of such intermediaries is fundamental to any examination of the law of securities transactions. More important, securities depositories deal only with intermediaries, who, in turn, are usually acting on behalf of a client. Before we can accurately assess the effect of depository operations on, say, an individual investor, we must know the relationship that exists between that investor and the intermediary through whom the investor conducts securities transactions.

(1) Brokers

The term "broker" requires some explanation. The term is often used loosely and its meaning has changed somewhat over past years.

Until fairly recently, if a person wanted to buy or sell securities on a stock exchange, they did so through an independent securities firm whose sole business was securities trading. Such firms were often referred to as "brokers". Securities firms were once one of the "four pillars" of the Canadian financial services industry, together with banks, trust companies and insurance companies. Foreign control and cross-ownership of these businesses were

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145 This practice is vigorously discouraged by the provisions of the Securities Act, *supra*, note 103, which strictly limit who may "trade" in securities. See ss 54, 65 and 66.

146 This is not a "trade" according to s. 1(x)(i)(B) of the Securities Act, *ibid.*

prohibited in order to prevent conflicts of interest. At that time the business of securities firms was clearly defined and limited. In June of 1987, as part of an international movement towards deregulation of the financial services industry, long-standing regulatory barriers were removed to allow banks, trust and insurance companies to own and operate securities firms in Canada. As a result, the business formerly conducted solely by independent securities firms may now also be conducted by firms owned and operated by banks, trust and insurance companies. Thus, the term "broker" may now encompass some operations of a bank, trust or insurance company — something that was previously unthinkable.

Securities firms, independent or otherwise, generally perform two distinct functions in securities transactions. Sometimes they trade as "dealers", buying or selling securities on their own behalf. Sometimes they trade on behalf of customers, as "brokers". In the past, firms normally performed only one function or the other, and were known as either "dealers" or "brokers". At that time there was a clear distinction between the two terms, but now firms almost always perform both functions and the terms are often used interchangeably.

The distinction between the two functions remains significant. The critical difference is that as a "dealer", the firm acts on its own behalf, while as a "broker" the firm acts as intermediary for its customer. Because we are here focussing upon the role of intermediaries, it is the "broker" function that is most important. So, when we use the term "broker" in this Chapter, we are generally referring to a securities firm, whether owned or operated independently or by a bank, trust or insurance company, which functions as an intermediary in securities transactions.

(2) Cash and Margin Accounts

Since we will refer to cash and margin accounts during the course of our discussion of the broker-client relationship, we will briefly review the distinction between each type of account.

(a) Cash accounts

The essence of cash accounts is that clients settle all trades with their own funds or securities within the established settlement period. Credit is not advanced by the broker and the explicit understanding is that, for purchases, the client will pay the amount due, or deliver the necessary securities, by the settlement date. Brokers generally expect to receive the necessary funds or securities prior to executing the client's order. Should a cash account become overdue, the broker may implement trading restrictions upon the client until the outstanding balance is paid. Common means of settling cash account transactions include paying cash, transferring funds or securities from other accounts held with the broker, or using proceeds from the sale of securities.

Brokers are not inclined to tolerate overdue cash accounts. Every brokerage firm is subject to regulatory capital requirements, and overdue cash accounts constitute a charge against the firm's capital. This operates as a heavy disincentive to carrying cash account customers beyond the settlement date.

(b) Margin accounts[147]

Margin accounts are accounts allowing clients to buy securities on credit, borrowing a portion of the purchase price from the broker.

Margin accounts also allow clients to sell securities that they do not own. This is called "short selling". Short sales operate on principles similar to the purchase of securities on margin, except that the customer borrows securities from the broker instead of money. It is a speculative practice, since the customer may theoretically lose an unlimited amount on a short sale. For our purposes, we will limit our discussion to margin account purchases of securities by a customer.

"Margin" refers to the amount the client must personally provide. This deposit is security only. It does not represent satisfaction of any portion of the customer's debt to the broker.

Not all securities may be carried on margin, and the proportion of the value of a security that must be provided as margin varies with the type and value of the security. For example, securities trading at below $1.50 cannot be carried on margin. Certain securities trading at above $2.00 require a

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147 A detailed examination of margin accounts is found in the article by M. Jay-Goldman, "The Relationship Between Investment Dealer and Margin Client: A Canadian Perspective" (1990) 19 Manitoba L.J. 260.

minimum client margin of 50% of market value, but if the price falls to $1.99, then the margin required rises to 60% of market value. In that situation, the broker may issue a "margin call" to the customer — a request for sufficient funds or securities to bring the account up to full margin.[148]

B. The Components of the Broker-Client Relationship

The broker-client relationship is complex and unique. It encompasses aspects of several different legal relationships. Broker-client interactions may in various circumstances be characterized as one (or more) of agent-principal, bailee-bailor, pledgee-pledgor, trustee-beneficiary, or creditor-debtor.

How the relationship is characterized in any particular situation depends upon the arrangement between the broker and the client, and the functions performed by the broker. To some extent brokers and their clients are free to make whatever arrangements they wish. However, the securities industry is highly regulated and the conduct of brokers is governed by provincial securities legislation and by the by-laws of self-regulating organizations such as the Investment Dealers Association of Canada and the stock exchanges. Altogether these comprise a rather comprehensive set of rules which have a definite effect upon the broker-client relationship.

Slight differences in arrangements may significantly affect the legal relationship between broker and client, thereby altering each party's rights and obligations. Although we will discuss some of the most common types of arrangements between brokers and clients, we cannot possibly discuss them all, nor would such a discussion be useful for our purposes. Our examination will therefore be limited to some of the most significant elements that influence the broker-client relationship. We shall analyze the broker-client relationship in two situations that are particularly relevant:

- where the broker purchases or sells securities for the client; and

- where the broker holds securities for the client.

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148 The minimum amount of margin which must be collected from clients on various securities is specified in the by-laws of each stock exchange and the Regulations of the Investment Dealers Association of Canada. See for example s. 16.15 of the Toronto Stock Exchange By-Laws, s. 17.07 of the Alberta Stock Exchange By-Laws, and IDA Reg. 100.8. These uniform provisions set minimum margin requirements only. Firms may require that greater amounts be deposited.

C. Where the Broker Purchases or Sells Securities for the Client

(1) Agent — Principal

It is clear that a broker who purchases or sells securities on an exchange does so as agent for a client.[149] This agent—principal relationship may be seen as the foundation upon which other aspects of the relationship are superimposed.

There is some confusion over the proper characterization of the client's position. The client has been referred to as an "undisclosed principal",[150] but it is more accurate to describe the client as an "unnamed principal".[151] "Unnamed principals" are a subset of "disclosed principals", and ought to be quite distinct from "undisclosed principals".[152] Whenever a broker places an order to purchase or sell securities through a stock exchange, there is an expectation that the broker is acting as agent for a customer, even though the identity of the customer is not disclosed. If the broker is acting as principal, the rules of the stock exchange will require that the order be designated as such,[153] so the other party to a trade should always know whether they have contracted with a principal or an agent.

When a broker makes an authorized trade on behalf of an unnamed principal, it is a basic rule of contractual liability that the principal may sue or be sued on the contract.[154] Moreover, the broker is legally bound to

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149 *Re Stout & City of Toronto*, [1927] 2 D.L.R. 1100 (Ont. C.A.); *Laskin* v. *Bache & Co. Inc.* (1971), 23 D.L.R. (3d) 385 (Ont. C.A.); *R.H. Deacon & Co. Ltd.* v. *Varga* (1972), 30 D.L.R. (3d) 653 (Ont. C.A.); aff'd (1974), 41 D.L.R. (3d) 767n (S.C.C.), at 659 (Ont. C.A.); *Picavet* v *Bache & Co Inc*, [1973] 1 O.R. 8 (C.A.) at 14; *Maghun* v. *Richardson Securities of Canada Ltd.* (1987), 34 D.L.R. (4th) 524 (Ont. C.A.); *Jones* v. *Davidson Partners Ltd. et al.* (1981), 121 D.L.R. (3d) 127 (Ont. H.C.) at 134; *Higgins* v *Edington* (1987), 11 B.C.L.R. (2d) 171 (B.C.S.C.) at 174, (1988), 31 B.C.L.R. (2d) 203 (B.C.C.A.); *Midland Doherty Ltd* v. *Rohrer* (1984), 25 B.L.R. 81 (N.S.S.C.); aff'd (1985), 20 D.L.R. (4th) 188 (N.S.C.A.) at 127 (N.S.S.C.) and 218 (N.S.C.A.).

150 See for example *Allen et al.* v. *F. O'Hearn & Company*, [1937] 1 W.W.R. 258 (P.C.) at 261; and J. Honsberger, "Failures of Securities Dealers and Protective Devices" in *Proposals for a Securities Market Law for Canada, supra*, note 55 (Vol. 3) at 1496.

151 See American Law Institute, *Restatement (Second) of Agency* (St. Paul: ALI Publishers, 1958) §321, and *Bowstead on Agency* (London: Sweet and Maxwell, 1985) at 23-24 and 433.

152 *Bowstead on Agency, ibid.* at 23-24.

153 See for example s. 11.20 of the by-laws of both the Alberta and Toronto Stock Exchanges.

154 G.H.L. Fridman, *The Law of Agency*, 6th ed. (Toronto: Butterworths, 1990) at 194.

complete the transaction, both at common law (as a matter of trade usage) and according to specific stock exchange rules.[155] In a situation where a client fails to provide the broker with money or securities necessary to settle a trade, the broker will normally settle the trade from its own resources, and then pursue the client for indemnification.

(2) Stock Exchange Rules and Customs

We have already discussed some of the specific stock exchange rules that affect the broker-client relationship — the disclosure of principal trades, margin requirements, and the broker's liability to settle trades. The stock exchange rules, in their entirety, and the customs of the exchange, are an implicit part of the definition of the broker-client relationship:

> In the absence of evidence to the contrary, the respondent [client], who gave authority to the appellants [brokers] to do business for him on the Exchange, should be deemed to have contracted subject to the rules and customs of the Exchange; and the nature of the powers and the duties would be determined by the usage and course of dealing in transactions of this character between broker and customer in Vancouver.[156]

In many instances, the broker---client relationship will be almost entirely defined by the stock exchange rules and customs because no special contractual arrangements are made. Even where special contractual arrangements exist, these tend to reflect stock exchange rules and customs. For example, with margin account customers, brokers are required to have written margin agreements defining the arrangements for operation of the account.[157] The margin agreement is normally drafted by the broker, and gives the broker wide powers, including the right to buy or sell securities for the client's account when it becomes under-margined. For cash account customers, there will often be no special contractual arrangements between the

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155 See the *Restatement* and *Bowstead on Agency*, *supra*, note 151, and see also Parts 13 and 14 of the by-laws of the Alberta and Toronto Stock Exchanges, which make members of the exchange directly liable to settle trades.

156 Rinfret, J. in *Solloway, Mills et al.* v. *Blumberger*, [1933] 3 D.L.R. 86 (S.C.C.) at 95, citing Parke, B., in *Foster* v. *Pearson*, 1 Cr. M.&R. 849 at 859, 149 E.R. 1324; *Clarke* v. *Baillie*, *supra*, note 6; *Cartwright & Crickmore Ltd.* v. *MacInnes*, [1931] 3 D.L.R. 693 at 695-97; *Forget* v. *Baxter*, [1900] A.C. 467.

157 See for example Toronto Stock Exchange by-laws s. 16.18, and Alberta Stock Exchange by-laws s. 16.04.

parties because there are no rules or regulations requiring such arrangements.[158] The broker and client are free to make their own arrangements. Where this occurs, it is generally done by way of a standard form agreement drafted by the broker.

(3) Fiduciary Obligations

Agents are by nature fiduciaries, and so have certain equitable duties placed upon them. Therefore, in every broker-client relationship, the broker has fiduciary duties to the customer. It is important to recognize that the extent of the fiduciary obligation may vary widely, and depends upon the particular facts of the case.

In *Midland Doherty Ltd.* v. *Rohrer*[159] the Nova Scotia Supreme Court discussed the nature of the broker-client relationship, stating:[160]

> A broker-client relationship is a relationship of a principal and agent and accordingly gives rise to *some* fiduciary duties on the part of the broker. As stated in 1 Hals. (4th ed.), p.461 para.771:
>
>> "The relationship of agency is of a fiduciary nature. In some cases, commonly where property or money has been placed in the hands of the agent for a specific purpose, the agent becomes a trustee for his principal. In all cases the agent owes the principal duties of a fiduciary character, for example to keep accounts, to disclose any conflict of interest and not to receive any secret commission or bribe."

In dealing with the extent of a broker's fiduciary obligations to a client, the *Midland Doherty Ltd.* v. *Rohrer* case draws a critical distinction between fiduciary and non-fiduciary duties owed by a broker.[161] In order for a breach of fiduciary duty to occur, it is not enough that there is a fiduciary relationship and a breach of a duty by the broker. The breach of duty must relate to a particular fiduciary obligation owed by the broker to the client. This

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158 Adherence to the "Know Your Client" rule requires only the completion of a New Client Application Form setting out essential information about the client. See *infra*, note 165.

159 *Supra*, note 149.

160 *Ibid.* at 127.

161 *Ibid.* at 126-30.

distinction is not always clearly expressed,[162] but it is obviously important because of the value and greater efficacy of the equitable remedies available upon the breach of a fiduciary duty.[163]

Many of the cases dealing with additional fiduciary duties owed by the broker (beyond the basic fiduciary obligations arising from agency that exist in every broker-client relationship) revolve around the giving of advice by the broker. A brief discussion of this area is necessary.

(a) Discretionary and non-discretionary accounts

Discretionary[164] and non-discretionary accounts differ with respect to who controls trading activity. In a non-discretionary trading account, the broker acts only upon the client's instructions, as the client's agent. In discretionary trading accounts, the client authorizes the broker to vary the client's stock portfolio without acquiring consent prior to each trade. Discretionary accounts are used by clients who are unable or unwilling to exert direct control over their accounts.

Even in a non-discretionary account, the broker may offer investment advice, and may be obligated to do so in some circumstances. The "Know Your Client" rule[165] requires that the broker understand the client's position

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162 For example, comments in several Canadian decisions dealing with the broker-client relationship seem to imply that, depending upon the facts of the case, a fiduciary relationship may not exist at all. See *Burke* v. *Cory* (1959), 19 D.L.R. (2d) 252 (Ont. C.A.) at 258-59, and *Elderkin* v. *Merrill Lynch, Royal Securities Ltd.* (1977), 80 D.L.R. (3d) 313 (N.S.C.A.) at 323. In each case, the broker was alleged to have given defective advice to a client. Therefore, the issue in each case involved the specific question of whether the broker owes a particular fiduciary duty with respect to the giving of advice, and the comments made must be viewed in this context. Although it is not stated clearly in these cases, it is implicit that they do not address the general question of whether the broker owes any fiduciary duty to the client because that question is irrelevant to the particular facts involved. See also *Midland Doherty Ltd.* v. *Rohrer*, *supra*, note 149, and *Duffy* v. *Cavalier* (1989), 259 Cal. Rptr. 162 (Cal. C.A.), for decisions where the court explicitly draws this distinction. For an example of a situation where the court found a breach of the basic fiduciary duty owed by the broker as agent, see *Laskin* v. *Bache & Co. Inc.*, *supra*, note 149.

163 See M.D. Talbott, "Restitution Remedies in Contract Cases: Finding a Fiduciary or Confidential Relationship to Gain Remedies" (1959) 20 Ohio St. L.J. 320.

164 Some discretionary accounts are also referred to as "managed" accounts.

165 The "Know Your Client" rule is found in practically identical terms in the regulations and by-laws applicable to brokers throughout the U.S. and Canada. For example, the Alberta (continued...)

and goals in investing, and advise accordingly, whether trading with discretionary or non-discretionary accounts.

Once advice is given, a special fiduciary duty of care arises.[166] Because of the high degree of trust and reliance placed in the broker in the control of a discretionary account, the law places higher fiduciary obligations upon both the individual broker and the broker's firm.[167] Brokers may sometimes have a duty to keep clients from making improvident transactions, even where the client orders such transactions.[168]

An in-depth discussion of discretionary accounts, or the duties and obligations arising in relation to advice given by brokers on non-discretionary accounts, is beyond the scope of this report. It is sufficient to recognize that the particular arrangements between broker and client determine what duty, if

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[165](...continued)
Stock Exchange by-law, s. 16.01 provides:

> (1) Every member shall use due diligence:
> (a) to learn the essential facts relative to every customer and to every order or account accepted;
> (b) to ensure that the acceptance of any order for any account is within the bounds of good business practice; and
> (c) to ensure that recommendations made for any account are appropriate for the client and in keeping with his investment objectives.

Essentially the same requirement is imposed by s. 30 of the Regulation under the Alberta Securities Act (Alta. Reg. 46/87).

166 See *Nocton* v. *Ashburton*, [1914] A.C. 932 (H.L.) at 947-48; *Glennie* v. *McDougall & Cowans Holdings Ltd.*, [1935] 2 D.L.R. 561 (S.C.C.) at 579; *Burke* v. *Cory*, *supra*, note 162 at 258-60; *Elderkin* v. *Merrill Lynch, Royal Securities Ltd.*, *supra*, note 162 at 323-25; *Midland Doherty Ltd.* v. *Rohrer* (N.S.S.C.), *supra*, note 149 at 126-28; *Duffy* v. *Cavalier*, *supra*, note 162 at 167-73; *Pielsticker and Draper Dobie & Co.* v. *Gray*, [1947] 3 D.L.R. 249 (Ont. C.A.) at 252-53; *Maghun* v. *Richardson Securities of Canada Ltd.*, *supra*, note 149; *Culling* v. *Sansai Securities Ltd.* (1974), 45 D.L.R. (3d) 456 (B.C.S.C.) at 462-63; and *Vanderburgh* v. *ScotiaMcLeod Inc.* (1992), 4 Alta. L.R. (3d) 138 (Alta. Q.B.) at 144.

167 See *Stevens* v. *Abbott, Proctor & Paine* (1968), 288 F. Supp. 836 (U.S. District Ct); *Ryder* v. *Osler, Wills, Bickle Ltd.* (1985), 16 D.L.R. (4th) 80 (Ont. H.C.J.); *Franklin* v. *Richardson Greenshields*, [1988] 3 W.W.R. 205 (Sask. Q.B.); and *Duffy* v. *Cavalier*, *supra*, note 162.

168 See *Duffy* v *Cavalier*, *supra*, note 162; and J. Lyons, "Ya shouldn't a let me do it" *Forbes* (July 23, 1990) 96. The facts in the *Duffy* case involved a degree of discretion being exercised by the broker, as well as a history of advice being offered by the broker and accepted by the client. There is Canadian authority holding that a broker has no duty to advise a client against an improvident stock purchase, but that case involved a situation where the client did not seek the broker's advice: see *R.H. Deacon & Co. Ltd.* v. *Varga*, *supra*, note 149.

any, there is upon the broker to give advice, and that there are onerous fiduciary obligations that accompany the giving of advice by the broker.

Because the giving or withholding of advice by a broker may have a profound effect on the broker-client relationship, it must be considered in any assessment of that relationship. But since additional fiduciary duties complicate an already complex relationship, the focus from this point forward will be on non-discretionary trading accounts, where the broker acts only on reasonable client instructions. Thus, we shall ignore any possibility that a customer may have acquired particular rights by reason of advice given, or not given, by the broker.

D. Where the Broker Holds Securities on Behalf of the Client

(1) Alternative Methods of Holding Securities

A client who purchases securities through a broker may choose from several different methods of holding those securities.

One alternative is for the client to take actual possession of the security certificates. If the securities are in registered form, the client can become registered with the issuer as owner of the securities. This use of this method, once common, is declining. It remains practical for a client who plans to hold securities for an extended period, but is less practical for one who trades actively, and may hold securities for only a short time. Most brokers charge extra to receive or deliver certificates registered in the name of the client. The delivery of certificates takes time and can delay a sale. There is always a risk of loss or theft of certificates.[169] This is a major consideration with bearer securities, which are as vulnerable as cash.

Another alternative is for the client to allow the broker to hold securities in "safekeeping". This arrangement involves the broker retaining certificates, fully registered in the name of the client. It is more practical for the client who is an active trader because there is no need to physically transport certificates to and from the broker. There may still be some delay in sales of such

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169 If a registered certificate is lost or stolen, it can be replaced, but the issuer is entitled to an indemnity bond [see ABCA s. 75(2)(b)] costing roughly 2% of the value of the security. Another significant factor is that, until a replacement certificate is issued, the owner cannot sell the security.

securities, because the broker would require that the certificates be endorsed by the client, or that an appropriate power of attorney be provided so that the broker could endorse the certificates. The risk of loss or theft of the certificates is borne by the broker. Brokers impose significant service charges for this type of arrangement.[170]

By far the fastest-growing and most common arrangement is for the client to allow the broker to hold securities in street name. With registered form securities, the practice of intermediaries holding such securities in nominee or street name has been common for many years. Nominee registration refers generally to the use of nominees for registration of securities; street name registration is a specialized type of nominee registration where a broker registers securities in its name or in the name of its nominee.[171]

Although these are industry terms, subject to imprecise use and not formally defined, we may note a subtle distinction between a certificate registered in street name, and a street certificate. A street certificate is a certificate registered in street name, endorsed either by the broker (if registered in the broker's name), or endorsed by the nominee registered owner with that endorsement guaranteed by the broker. Such endorsement makes the certificate transferable by delivery.

(a) Advantages of street name registration

In the 1930's, street name registration was used primarily as a convenient method of holding securities pledged by clients in margin transactions and as a means of avoiding transfer taxes.[172] Nominee registration then began to be used extensively by institutions to avoid onerous transfer requirements imposed by issuers seeking to protect themselves from

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170 Some brokers impose a charge for each securities position held by the client. Others impose a flat fee per account. Safekeeping arrangements are apparently not popular with brokers, and we were advised by one senior representative of a major Canadian brokerage firm that high safekeeping fees are intended to discourage clients from using this service.

171 See *Final Report Of The Securities And Exchange Commission On The Practice Of Recording The Ownership Of Securities In The Records Of The Issuer In Other Than The Name Of The Beneficial Owner Of Such Securities*, 94th Cong., 2d Sess., House Comm. on Interstate and Foreign Com. (Comm. Print 1976) at 1.

172 *Ibid.*

liability for improper transfers.[173] Today, street name and nominee registration are more widely used than ever before, because of the advantages they offer.

We will focus upon the advantages of street name registration because these relate more closely to our broker-client relationship. The use of other kinds of nominee registration offer comparable advantages, but are generally used by institutional investors and financial intermediaries.

From the beneficial owner's standpoint, allowing a broker to hold securities in street name means that the owner no longer has to be concerned with the safekeeping of certificates. An owner can sell securities quickly with a telephone call to the broker, or merely at the broker's discretion in some cases. Such securities are also instantly available for use as margin. Perhaps the most significant advantage is that brokers will generally not impose any service charge for holding the client's securities in street name.

From the broker's standpoint, holding customers' securities in street name also reduces the risks of certificate handling, facilitates the sale of such securities and their use as margin. But the greatest advantage is in expediting and simplifying the process of settlement. This advantage was recognized before the widespread use of depositories, and represents, in effect, brokers operating as mini-depositories. For brokers conducting a large number of transactions daily, the netting process will reduce the total number of deliveries required, but this would be of relatively small benefit if each broker still had to receive or deliver certificates from each customer in respect of each trade.[174] The use of street name registration by customers allows the broker to net out trades between the broker's various customers, eliminate a portion of the certificate deliveries necessary to settle, and thus trade more efficiently. By passing on reduced transaction costs to customers, brokers encourage more market activity.

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173 *Ibid.*

174 This process is particularly laborious because it generally involves two registered transfers. When a customer delivers a registered certificate to a broker for sale, the practice is for the broker to obtain a new certificate registered in the name of a broker or a nominee, and then to endorse and deliver this street certificate in settlement of the trade. This is done to prevent disclosure of the identity of the vendor, not because the vendor necessarily wants to remain anonymous, but because brokers wish to keep the names of their clients to themselves.

From the issuer's standpoint, a reduction in the number of certificates being processed saves money. Whenever a transfer is registered, the issuer may be required to issue a new certificate. The issuer is generally allowed only a nominal fee for this service,[175] far below the actual cost to the issuer. Therefore, issuers obtain some benefit from the reduction in registered transfers achieved through street name registration.

We must recognize, though, that the decision to use (or to not use) street name registration is not up to the issuer: it is the decision of either the client or the broker. If the security is fully paid for, the decision is the client's. If the security is held by the broker as margin, it will be up to the broker.

(b) Fungibility of securities

Security certificates are fungible in that every certificate is no more or less valuable than any other similar certificate. At one time there was some question as to the fungibility of certificates, but the courts were quite consistent in supporting the concept of fungibility because it was the practice of brokers to treat certificates as fungible.[176] Fungibility is now consistently defined and established by legislation. The ABCA provides that:

> 44(1)
> (g) "fungible" means, in relation to securities, securities of which any unit is, by nature or usage of trade, the equivalent of any other like unit;
>
> 50 Unless otherwise agreed, and subject to any applicable law, regulation or stock exchange rule, a person required to deliver securities may deliver any security of the specified issue in bearer form or registered in the name of the transferee or endorsed to him or in blank.[177]

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175 Under the ABCA, this amount is $5.00. See Alta. Reg. 27/82 s. 2(1.1), Alta. Reg. 408/87 s. 2.

176 See *Clarkson* v. *Snider* (1886), 10 O.R. 561; *Long* v. *Smiley* (1913), 12 D.L.R. 61 (Ont. S.C.A.D.); *Cartwright & Crickmore Ltd.* v. *MacInnes*, *supra*, note 156, and *Solloway, Mills* v. *Blumberger*, *supra*, note 156. See also the discussion of fungibility of certificates commencing at p. 82 of this report.

177 Similar provisions are found in OBCA ss 53(1) and 61(1), and CBCA ss 48(2) and 54. These provisions are all based upon UCC provisions §1-201(17) and §8-107(1).

(2) Aspects of the Legal Relationship

As might be expected, issues requiring the determination of rights where a broker holds securities on behalf of a client often arise in the context of a broker's insolvency. Decisions regarding those rights have, in turn, influenced legislation and regulatory requirements in this area. Although we will examine particular aspects separately, it bears repeating that the complete broker-client relationship is a combination of the various aspects which apply in any particular circumstance.

It will be observed that virtually all of the cases commenting on the broker-client relationship pre-date the introduction of the Business Corporations Acts. The reason for this will be discussed later,[178] but the fact does not render these decisions irrelevant. It is important to ascertain the principles laid down by these decisions so that they may be applied within the context of current legislation.

(a) Creditor-debtor and pledgee-pledgor

In *Re Stout & Toronto*,[179] the court quoted with approval the statement that:

> The broker acts in a threefold relation: first, in purchasing the stock he is an agent; then, in advancing money for the purchase, he becomes a creditor; and, finally, in holding the stock to secure the advances made, he becomes a pledgee of it. It does not matter that the actual possession of the stock was never in the customer.[180]

Margin account agreements universally provide for a lien on behalf of the broker, as do some cash account agreements, but a similar common law lien exists in cash account transactions to the extent of any indebtedness by the client.[181]

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178 At p. 90.

179 *Supra*, note 149.

180 *Re Stout*, *ibid.* at 1105, quoting *Jones on Pledges*, 2nd ed. at 528 para. 496.

181 *Jones* v. *Davidson Partners Ltd.*, *supra*, note 149. This case dealt with an unusual situation where the broker advanced the entire purchase price of certain securities bought for a cash account customer. The court held that property in the securities vested in the broker. If it had been a margin account transaction, title would have vested in the customer (continued...)

Note that the underlying agency relationship is critical. If the broker acts simply as vendor of the securities, and the client as purchaser, then even if the client has paid in full the relationship may be only that of creditor-debtor, unless securities in the possession of the broker have been set apart or earmarked as the property of the client.[182] If the client has not paid in full, it would also seem necessary for the broker to appropriate specific securities to the contract in order for a pledge to exist, because otherwise no property would pass to the purchaser.

The common law recognized a limited right in the broker to pledge the client's securities for an amount not exceeding the client's indebtedness to the broker.[183] If the broker desires the power to pledge the client's securities for any greater amount (e.g. to secure the broker's general indebtedness with a bank), then a clear and unequivocal agreement between the parties must be shown.[184] Even if the broker improperly pledges the client's securities to secure the broker's general indebtedness, the pledge will likely be effective, because the pledgee will generally have acquired the certificates in good faith and for value.[185]

(b) Bailment and trust

In a strict technical sense, the concepts of bailment and trust are completely separate and distinguishable.[186] However, both terms have been used to describe similar broker-client relationships, so it is necessary to

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[181](...continued)
(pp. 134-35). Note that this decision does not refer to the statutory transfer mechanisms under the OBCA.

[182] See *Re Stobie-Forlong-Matthews, Ltd.; Re Claims of Kern Agencies, Ltd.*, [1931] 1 W.W.R. 817 (Man. C.A.), and specifically the portions of the judgement dealing with the claim of Leany, and *Re R.P. Clark & Co. (Vancouver) Ltd.*, [1931] 3 W.W.R. 79 (B.C.S.C.).

[183] See *Conmee* v. *Securities Holding Co.* (1907), 38 S.C.R. 601, and *Clarke* v. *Baillie*, *supra*, note 6.

[184] *Ibid.*

[185] See Annotation "Stockbrokers' Bankruptcies", [1933] 4 D.L.R. 1, by Sidney Smith at 7-12. The pledgee's claim may be based either on the negotiability of the certificates, or on the fact that the client was estopped from denying the broker's authority to pledge the certificates. See also *supra*, note 91 and accompanying text.

[186] See N.E. Palmer, *Bailment*, 2nd ed. (Sydney: Law Book Co. Ltd., 1991) at 189-92; W.F. Fratcher, *Scott on Trusts*, 4th ed., vol. I (Toronto: Little, Brown & Co., 1987) at 56-64.

examine them together. This aspect of the broker-client relationship is of vital importance because it largely determines the rights of clients to securities held by the broker if the broker becomes insolvent. It is in this context that the decisions often reveal much confusion about the nature of the property interests held by brokers and clients in different situations.

It is also important to examine this area in some detail because CDS' position is that its relationship with its participants is that of bailee-bailor.[187]

As will become apparent during the discussion, there is some danger in placing too much reliance upon the terminology used to describe the broker-client relationship, because such terminology is not always used consistently or with precision. It is more important to recognize the fundamental characteristics that are found to exist in the broker-client relationship, and how these influence the client's rights, however these characteristics may be labelled.

We will briefly discuss the basic nature of bailment and trust, then proceed to examine how the courts in Canada and the U.S. have characterized the broker-client relationship. Finally, we will offer some suggestions on the proper terminology to be used in this area.

(i) Characteristics of bailment

It has been said that "bailment eludes precise definition because the term covers a host of legal relationships which have as a common denominator only that one is in possession of another's chattel".[188] A useful starting point is stated in Halsbury's 4th edition:

> A bailment, traditionally defined, is a delivery of personal chattels on trust, usually on a contract, express or implied, that the trust shall be duly executed, and the chattels redelivered in either their original or an altered form, as soon as the time or use for, or condition on, which they were bailed shall have elapsed or been performed. Under modern law, a bailment arises whenever one person (the bailee) is voluntarily in

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187 Letter from CDS, March 14, 1991.

188 E. Tyler and N. Palmer, *Crossley Vaines' Personal Property*, 5th ed. (London: Butterworths, 1973) at 70.

> possession of goods belonging to another person (the bailor). [footnotes omitted][189]

It is clear that the reference to "trust" in the traditional definition is not used in the technical sense of legal title in trust for another who has the beneficial enjoyment. In bailment no legal or equitable title is acquired by the bailee.[190] This lack of title need not impair the bailee's ability to convey good title to a *bona fide* purchaser of the property.[191]

Because possession is the essential element of bailment, only tangible personal property can be bailed.[192] Thus, bailment can only apply to certificates, and not to the underlying shares.[193] Of course, the certificates are evidence of the shares, and if the certificates are also negotiable instruments, then from a practical standpoint they are the embodiment of the shares. This is reflected in the fact that the cases often use the term "shares" rather loosely. Sometimes the usage is innocuous, but it is occasionally problematic.

Fungible property may be bailed, but it is not clear whether this requires that the specific property remain identifiable, and returned *in specie*. In the U.S., the law does not maintain the requirement of redelivery *in specie*, and it has been clearly established that:

> in the case of a bailment of shares of stock the person in possession of the certificates may mingle them with others and satisfy his obligation by returning certificates of like kind, at least provided an equivalent amount of securities of the same description remain available, under his control, for delivery to the bailor.[194]

The conflicting view is that bailment concepts can apply only if it is made clear from the terms of the bailment itself that the fungible property is to be

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189 2 Hals. (4th ed. reissue), para. 1801.

190 See W.B. Raushenbush, *Brown on Personal Property*, 3rd ed. (Chicago: Callaghan & Co., 1975) §10.1 n.1; and Halsbury's, *ibid.* para. 1801 n.1.

191 For example, where the bailee is a mercantile agent as defined by the Factors Act, R.S.A. 1980, c. F-1, or where the property bailed is a negotiable instrument.

192 See Palmer, *supra*, note 186 at 7-8.

193 Or the underlying debt, as in the case of a bond.

194 *Re Ellis' Estate*, 6 A.2d 602 (1939) at 612. Note the reference to "a bailment of shares". See also *Brown on Personal Property*, *supra*, note 190 at 237-44.

returned *in specie* and not merely in an equivalent form.[195] Although this particular issue has not been directly addressed in Canada in relation to security certificates, "Canadian decisions confirm the trend of Australian case law in this area, and stress the need for redelivery *in specie* as a central feature of bailment."[196]

Almost all cases discussing bailment of securities have come from the U.S. and particularly in the context of pledges of certificated securities and §9-305 of the UCC. Prior to the 1977 amendments to the UCC, §9-305 provided for the perfection of a security interest in a security certificate by possession, including circumstances when the certificate was held by a bailee.[197] In Canada, Personal Property Security legislation, although similar to the UCC, does not use the word "bailee" in this context.[198]

(ii) Characteristics of trust

In the strict technical sense, a trust is a fiduciary relationship whereby a trustee acquires legal title to property and holds it for the benefit of the equitable owner, the beneficiary. This is obviously not a comprehensive

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195 See Palmer, *supra*, note 186 at 13 and 135-37; and G.W. Paton, *Bailment in The Common Law*, (London: Stevens & Sons, 1952) at 25-29, referring to *South Australian Insurance Co. Ltd.* v. *Randell* (1869), L.R. 3 P.C. 101, and *Chapman Bros.* v. *Verco Bros. & Co. Ltd.* (1939), 49 C.L.R. 306 (Aus. H.C.).

196 Palmer, *ibid.* at 137, citing *O'Flynn* v. *Carson* (1908), 7 W.L.R. 463; *Lawlor* v. *Nichol* (1898), 12 Man. R. 224; *Cargo* v. *Jovner* (1889), 4 Terr. L.R. 64; *Re Williams* (1871), 3 U.C.Q.B. 143; *Stephenson* v. *Ranney* (1852), 2 U.C.C.P 196; *Clark* v. *McClellan* (1892), 23 O.R. 465; *Crawford* v. *Kingston and Johnston*, [1952] 4 D.L.R. 37; and *Tilt* v. *Silverthorne* (1855), 11 U.C.Q.B. 619. See also *Busse* v. *Edmonton Grain & Hay Co.*, [1932] 1 D.L.R. 744 (Alta. S.C.A.D.). It seems unfortunate that Canadian law has failed to follow the U.S. position in this area. The U.S. position evolved in response to the commercial realities of grain storage. Huge quantities of grain were intermingled and stored in elevators. The courts were understandably reluctant to characterize the deposit of grain on such basis as a sale, so they changed the law respecting bailment of fungible goods. This same law was later conveniently applied to securities. In Canada, however, the grain situation was handled by the Canada Grain Acts, so there has not yet been sufficient commercial pressure to produce a change in our common law of bailment. In an appropriate case involving investment securities, a court might consider following the U.S. position.

197 See R. Haydock, Jr., "When Is a Broker a Bailee or Is an Interest in Securities a General Intangible?" (1981) 35 Ark. L. Rev. 10.

198 See for example s. 24 of the Alberta PPSA, which refers to "possession of the collateral by the secured party, or on his behalf by another person" but also provides that "a secured party does not have possession of collateral that is in the actual or apparent possession or control of the debtor or the debtor's agent".

definition, but only a description of certain distinguishing characteristics of trust.[199]

Trust property may include intangible property such as shares, debts and other rights, whether evidenced by certificates or not.

As we have already seen in the traditional definition of bailment, the term "trust" has also been widely used in a more general sense. In this general sense, "trust" has been "sometimes used to include various fiduciary relationships; not only trust in the narrower sense, but also bailment, executorship, guardianship and agency."[200] In the famous decision *Re Hallett's Estate*,[201] Jessel, M.R., stating the scope of the equitable right to trace property, uses the word "trustee" as "including all persons in a fiduciary relation" such as express trustees, agents and bailees.[202]

It is trust in this more general sense that is prevalent in discussions of the broker-client relationship, particularly in Canadian cases.

(iii) Canadian cases

(A) On bailment generally

In *Cole* v. *Merchant's Fire Insurance Co.*,[203] the issue was whether an insurance policy covering stock in trade "held in trust" applied to goods held as a bailee. The court held that it did, noting that a "bailee is commonly, and not improperly, called a trustee for the person whose goods he has in bailment".[204] The court also stated that the word "trust" has no technical meaning, and that "goods held in trust" had a recognized meaning in insurance matters that did not import a trust in the strict sense.

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199 See *Scott on Trusts*, *supra*, note 186, vol. I at 40-42, and D.W.M. Waters, *Law of Trusts in Canada*, 2nd ed. (Toronto: Carswell, 1984) at 10-15.

200 *Scott on Trusts*, *ibid.* vol. I at 38.

201 (1880), 13 Ch. D. 696 (C.A.).

202 *Ibid.* at 709.

203 (1922), 67 D.L.R. 300 (Ont. S.C.A.D.).

204 *Ibid.* at 306.

As recently as 1986, the Ontario Court of Appeal referred to a definition of bailment as "the delivery of personal chattels on trust ...".[205] The decision did not discuss the concept of trust any further, so although the court may have been expected to refer to a more currently acceptable definition of bailment, the decision is reasonably compatible with fundamental principles of both.

(B) Bailment of share certificates

More problematic are the decisions in *Elgin Loan and Savings Co. et al.* v. *National Trust Co.*[206] In this case, the plaintiff loan company (Elgin) deposited certain share certificates, endorsed in blank, with the defendant for safekeeping, under an arrangement where the defendant, for a fee, would collect dividends and deliver up the certificates and dividends upon demand under proper authority. The shares were registered in the name of the defendant.[207] Another loan company (Atlas) had an interest in the prospective profits to be derived from the sale of some of the deposited shares. Both loan companies went into liquidation, with the plaintiff trust company acting as liquidator of Elgin and the defendant acting as liquidator of Atlas. The plaintiff trust company demanded the certificates from the defendant but the defendant refused to deliver them, so damages were sought for their detention.

The defendant claimed to have been a trustee, and to have acted honestly and reasonably so as to be excused for their breach of trust under the provisions of the Act respecting Liability of Trustees.[208] This argument was rejected at the High Court of Justice, and by the majority in the Court of Appeal, but the decisions leave some doubt as to the true characterization of the relationship. The basis of the decisions of both courts was that the defendant was not a trustee within the scope of the Act because the Act clearly contemplated trustees engaged in administrative duties with respect to

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205 See *Punch* v. *Savoy's Jewellers Ltd.* (1986), 26 D.L.R. (4th) 546 (Ont. C.A.) at 551.

206 (1903), 7 O.L.R. 1 (H.C.), aff'd (1905) 10 O.L.R. 41 (C.A.).

207 This fact appears to conflict with the document issued by the defendant upon receipt of the certificates, in which the defendant agreed "that the above certificates will be kept safely in its deposit vaults and delivered upon demand under proper authority" (see H.C. decision at 4-5).

208 An Act to Amend the Law Respecting the Liability of Trustees, S.O. 1898-99, 62 Vict. (2), c. 15, s. 1.

property. The decisions stopped short of holding that the defendant was not a trustee in any sense. The courts held that the defendant was a bailee, but then went on to say that even if the defendant was a trustee, it was liable notwithstanding the Act. One judge of the Court of Appeal was of the view that the defendant was a trustee. There was no comprehensive discussion of the distinction between bailment and trust in general.

Professor Waters[209] notes that a problem with the *Elgin* case is that it implies that bailment and trust are not mutually exclusive. He suggests that the distinction is "probably" as follows:

> If the intention is merely to give another custody, and that other is given "the indicia of property" in order to assist his custodianship, then bailment is created. But if title passes in order to allow a range of duties to be discharged by the other, then a trust is created.[210]

Even if this is the correct distinction, the *Elgin* decisions leave some critical questions unanswered.

Did title pass? Because only tangible property can be bailed, the only bailment that could exist would be that of the specific certificates. The *Elgin* contract between the parties described specific numbered certificates and clearly requires the return of those same certificates. If the same certificates were kept, then it would seem obvious that no title passed and the relationship was a bailment. But there is no explanation of how "the scrip certificates representing this stock were put into the name of the National Trust Company",[211] even though this would ordinarily have involved the surrender and replacement of the original certificates. Is the registration of shares in the name of the trust company a transfer of the legal title, or is it simply the custody of "the indicia of property"?[212] Moreover, new certificates preclude any possibility of redelivery in specie, and so would seem to rule out the application of bailment concepts according to existing Canadian law.[213]

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209 See Waters, *Law of Trusts in Canada, supra*, note 199 at 65-67.

210 *Ibid.*

211 High Court decision at 4.

212 At the time, registration was the only event that passed legal title to the shares. See the discussion in Chapter 4 of this report.

213 See *supra*, note 196.

In our view, legal title to the shares must have passed to the National Trust Company, which held such title as trustee for Elgin. The only possible way to rationalize the *Elgin* decisions is on the basis that there is no need for a bailee of fungible certificates to redeliver them in specie. Although it can be argued that this is an enlightened interpretation of bailment,[214] the fact that it is not even briefly addressed makes it unsafe to assume that it is a basis of the *Elgin* decisions.

Despite their inconsistencies, the decisions do seem to establish that there is a bailment where specific, identified certificates are held by a broker for a client under a safekeeping arrangement. This principle is of limited use because, as we have seen, it is much more common for brokers to hold clients' securities in fungible bulks. The situation considered in *Elgin* is also rather unique in that the bailee's duties were very limited, lacking the broad agency functions that more often characterize the broker-client relationship.

No other Canadian decision deals with a simple safekeeping arrangement like that in the *Elgin* decisions. A wide variety of arrangements have been considered, but no other Canadian decision discusses a broker holding securities on behalf of a client in terms of bailment, even where there is some specific identifiable property involved.

(C) Fungibility of certificates

In a series of cases dealing with the fungibility of stock certificates, Canadian courts have held that, in the absence of a special agreement, there is generally no obligation on a broker to retain specific certificates for each customer, provided the broker at all times retains sufficient certificates to satisfy the entitlements of all clients.[215] In each case, the issue was whether or not there had been a conversion of specific certificates by the broker. Although none of these decisions refer to concepts of bailment or trust, the position taken is exactly the same as that taken in the U.S., except that the U.S. decisions speak with reference to bailment.[216]

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214 *Ibid.*

215 See *supra*, note 176.

216 See *supra*, note 194 and accompanying text.

In *Solloway, Mills* v. *Blumberger*, the Supreme Court of Canada adopted the following statement from the U.S. Supreme Court decision in *Gorman* v. *Littlefield*:[217]

> The certificates of stock were not the property itself, but merely the evidence of it ... a certificate for the same number of shares ... (represents) precisely the same kind and value of property as another certificate for a like number of shares in the same corporation; that the return of a different certificate or the substitution of one certificate for another made no material change in the property right of the customer ... such shares were unlike distinct articles of personal property, differing in kind or value, as a horse, wagon, or harness, and that stock has no earmark which distinguishes one share from another, but is like grain of a uniform quality in an elevator, one bushel being of the same kind and value as another.[218]

This statement seems to suggest that the property held for the customer by the broker is the shares, and not merely the certificates. If so, this would rule out the application of bailment, because the shares are clearly choses in action, incapable of being possessed and thus incapable of being bailed.

Unfortunately, it is difficult to place much reliance on these decisions for the proposition that shares, not certificates, are the property held for the customer by the broker. The U.S. position relied upon is predicated on the certificates operating as negotiable instruments, delivery of which effectively transfer the underlying shares. But at the time these Canadian cases were decided, our law still attached considerable importance to registration of ownership of shares, so that the property in the shares was not entirely transferable by delivery of street certificates, even though this was commercial practice.[219] Strictly speaking, a broker in possession of street certificates, but not registered as owner of the shares, did not have legal title to those shares. Thus, the property interest held by the broker on behalf of the client was, in fact, often limited to the certificates. It would be more accurate to say that the property held by the broker was the certificates and whatever property in the underlying shares as may accompany those certificates. Either way, the certificates are clearly fungible.

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217 (1913), 229 U.S. 19 at 23. The statement is a summary of the U.S. Supreme Court's earlier decision in *Richardson* v. *Shaw* (1908), 209 U.S. 365.

218 *Solloway, Mills* v. *Blumberger*, *supra*, note 156 at 95.

219 See the discussion of negotiability commencing at p. 39 of this report.

If the shares were registered in the name of the broker, then according to Canadian law legal title to those shares was in the broker, in which case all the elements of a trust in the technical sense are in place. This would have been a very common circumstance, but as we will see, the question of registered ownership or legal title to shares, as opposed to certificates, plays no significant part in most Canadian decisions. Virtually all cases approach the question of property as between broker and client as though the certificates are the property, not the underlying shares.

This would not be a major problem because, in the absence of adverse claims, it makes little difference whether the cases focus upon the shares or the certificates. It is more significant that many of the cases that we will examine also fail to treat certificates as being truly fungible.

(D) Broker buying or selling securities

In *Re Bryant Isard & Co. (Ex Parte Hanneman)*[220] a broker purchased securities for a client and, at the date of the broker's bankruptcy, held certificates registered in the broker's name but earmarked or identified with the client's account. The client had paid in full for the securities, and claimed that they were left with the broker "for safekeeping and in trust for him".[221] The trustee in bankruptcy argued that legal title was in the broker, and that the client was only an unsecured creditor. The decision did not mention trust or bailment, but held that the client was the owner of and entitled to delivery of the securities.[222]

This case is a good example of the court using the term "shares" in a context where it must be taken to refer to certificates, because the discussion deals with possession and delivery.

In *Plummer* v. *Mack & Timms*[223] the plaintiff client delivered certificates (evidencing 60 shares) to her broker with instructions to sell at the market price. The broker then sold 265 shares of the stock in question at the market

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220 (1922), 22 O.W.N. 537; aff'd (1922), 23 O.W.N. 113.

221 *Ibid.* at 538.

222 *Ibid.*

223 [1930] 2 W.W.R. 107 (Alta. D.C.); aff'd [1930] 3 W.W.R. 188 (Alta. S.C.A.D.).

price and delivered certificates in this amount, including those received from the plaintiff, but informed her that her shares were not sold. The market fell and eventually the broker redelivered other certificates to the plaintiff, but she learned that her original certificates had been delivered to a purchaser and sued to recover the proceeds. The court held for the plaintiff, stating:

> The defendants' relation to the plaintiff was a fiduciary one. In their hands the certificates were impressed with a trust. Their rights and authorities must not be confused with their rights and authorities over certificates deposited on margin or certificates purchased for customers on margin. Their actual dealing with the certificates was consistent only with a sale of same. Their delivery of the certificates to the purchaser appropriated these certificates to the particular sale. The plaintiff was effectually estopped from claiming a redelivery of the certificates from the purchaser. In my opinion the defendants as trustees or as agents acting in a fiduciary capacity should not be heard to give any explanation of their actions inconsistent with their authority: *Harris v. Truman* (1882) 9 Q.B.D. 264, 51 L.J.Q.B. 338, 46 L.T. 844.[224]

Again, the court drew no distinction between shares and certificates in this case, although it obviously treats the property held by the broker for the plaintiff as the specific certificates, not the underlying shares. If the court had treated the certificates as fungible, then it seems that the plaintiff's claim should have failed.[225]

(E) Client's property rights upon the broker's insolvency

We have already seen one example where the courts held that a client was the owner of certificates in the possession of a bankrupt broker, without dealing directly with any question of trust or bailment.[226] Although some other cases involving the insolvency of brokers also deal with the property rights of clients without discussing trust or bailment, many cases include discussions of the broker-client relationship in terms of trust. This stems from

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224 *Ibid.* at 109.

225 The broker claimed that the sale of 265 shares was made on behalf of other customers, and the court did not question the broker's honesty (see pp. 109-110). If the certificates were treated as fungible, then there would be no basis for the contention that the plaintiff's property was sold, and the plaintiff would only have been entitled to the redelivery of fungible certificates evidencing 60 shares.

226 *Re Bryant Isard & Co. (Ex Parte Hanneman), supra,* note 220.

the fact that, in bankruptcy, property held by the broker in trust is not divisible amongst the broker's creditors.[227]

One basic principle that has been applied is stated in the headnote to the Supreme Court of Canada decision in *Carter* v. *Long & Bisby*:[228]

> If an agent is entrusted by his principal with money to buy goods the money will be considered trust funds in his hands and the principal has the same interest in the goods when bought as he had in the funds producing it.
>
> If the goods so bought are mixed with those of the agent the principal has an equitable title to a quantity to be taken form the mass equivalent to the portion of the money advanced which has been used in the purchase, as well as to the unexpended balance.

Although *Carter* v. *Long & Bisby* did not involve a stockbroker, this principle has been applied in several authoritative cases involving the insolvency of brokers.[229]

Re Stobie-Forlong-Matthews dealt with a variety of claims against an insolvent broker. The Manitoba Court of Appeal drew an important distinction between the rights of clients "where the relationship of the broker and the claimant was that of vendor and purchaser and the case where the relationship was that of agent and principal."[230] In the vendor-purchaser situation, the client is only a general creditor until such time as certificates are set apart or appropriated to the contract.[231]

Where an agent-principal relationship existed, the court held, referring to *Carter* v. *Long & Bisby*, that margin clients were the owners of street certificates that had been purchased by the broker on their behalf and earmarked to the individual client's account, subject to payment by the client

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227 Bankruptcy And Insolvency Act, R.S.C. 1985, c. B-3, s. 67(1)(a).

228 (1896), 26 S.C.R. 430.

229 See *Re Stobie-Forlong-Matthews, Ltd.*; *Re Claims of Kern Agencies, Ltd.*, *supra*, note 182 at 820; *Re R.P. Clark & Co. (Vancouver) Ltd.*, *supra*, note 182 at 85-86; and *Re Kern Agencies, Ltd. (No. 3)*, [1932] 1 W.W.R. 585 (Sask. K.B.) at 587.

230 *Ibid.* at 817 (headnote).

231 *Ibid.* at 823, 828-89 and 834-35.

of any balance owing.[232] Where certificates had not been earmarked, the court followed U.S. authorities, stating:

> The Supreme Court of the United States has held that if, upon bankruptcy, the earmarked certificates of a certain security are not traced and demanded, and there is enough of that kind of security to satisfy all customers entitled thereto, such customers, upon meeting any obligations of indebtedness or contribution, may be satisfied in full. If there is not enough of the particular security to satisfy all the "long" customers who claim ownership therein, such "long" customers, as owners as tenants in common, have rights proportionate to the amount of their claims: [citations omitted]. I can see no reason why the above principles should not be applicable here.[233]

A detailed discussion of the broker-client relationship in terms of trust is found in *Re R.P. Clark & Company (Vancouver) Limited*,[234] a decision rendered just a few months after *Stobie-Forlong-Matthews*. The *R.P. Clark* case also involved various claims against a bankrupt broker. The B.C. Supreme Court agreed with and followed the judgement in *Stobie-Forlong-Matthews*, including a close analysis of the U.S. authorities relied upon. The court also undertook a detailed examination of the principle stated above from *Carter* v. *Long & Bisby*, noting that the case supported the proposition that:

> ... where goods are found in the possession of an agent and mixed with his own but not capable of identification through not being earmarked, the Court in that event will, upon what may be termed "a *cy-pres* doctrine" give effect to the trust imposed upon the agent and afford relief to the principal.[235]

On this basis it was held that:

> ... where there are sufficient shares of any particular description to satisfy orders given by customers to the debtor, then that they should be delivered to such customers who have purchased shares of that description ... If, however, any of these customers have not paid in full pursuant to their several orders for purchase, then, aside from any liability to make payment before being entitled to the certificates representing the shares so purchased, they should be required to make payment of the balance payable by them in respect of their purchase with interest, as well as making payment of any other indebtedness by them to

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232 *Ibid.* at 818-23.

233 *Ibid.* at 822-23, citing *Gorman* v. *Littlefield*, *supra*, note 217, and *Duel* v. *Hollins* (1916), 241 U.S. 523.

234 *Supra*, note 182.

235 *Ibid.* at 86.

> the debtor ... Then, if there were not sufficient certificates available of a particular description to satisfy the purchases by the different customers, the course referred to in the *Duel v. Hollins* case, *supra*, ... should be followed. There should be awarded to the customers "their *pro rata* part" of the shares, so insufficient to satisfy claims of the customers.[236]

In *Re Kern Agencies, Limited (No. 3)*[237] a broker had ordered shares on behalf of various customers, but had not yet received delivery at the date of the bankruptcy, and these shares were, in effect, pledged to certain correspondents. These correspondents sold sufficient stock to pay off the broker's indebtedness to them, then forwarded the remaining stock and cash to the trustee in bankruptcy. The court held that the purchasers need only be able to trace their claims to a type of stock, and not to specific certificates. The cash and stock received from the correspondents was shared pro-rata by the claimants who could so trace, on the basis that:

> The broker is the agent of the customer and can only acquire the shares as agent for its principal, and does not acquire any rights of property in the shares himself at any time. [citations omitted][238]
>
> The proceeds of stock sold that were forwarded in cash to the trustee stand, in my opinion, on the same footing as the shares that were forwarded; for it is a well- established principle that, as long as the proceeds of trust funds can be traced, *cestuis que trustent* are entitled to follow such proceeds. [citations omitted][239]

Re Carroll & Wright, Ex parte Bain[240] dealt with a situation where a broker properly pledged securities held on behalf of various clients. After the broker's bankruptcy, the pledgee sold some of the shares, then returned some shares and excess cash to the trustee in bankruptcy. The court adopted the U.S. doctrine of "sharing the burden of the loan", whereby the customers whose securities remain unsold have no greater rights than the customers whose securities were sold. They all share *pro rata*, even if some customers can specifically trace and identify their securities by certificate number, provided the equities of all claimants are equal.[241] Canadian decisions have

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236 *Ibid.* at 86-87.

237 *Supra*, note 229.

238 *Ibid.* at 587.

239 *Ibid.* at 588.

240 [1932] 3 D.L.R. 410 (Ont. S.C.).

241 *Ibid.* at 412.

applied this doctrine in a slightly different manner than some U.S. cases.[242] Canadian decisions draw no distinction between cases where the pledge was proper or improper, or between overpledging and outright conversion.[243]

It is important to note that the doctrine of "sharing the burden of the loan", like the decision allowing customers to trace their securities in kind, is contrary to traditional trust tracing principles, and was strongly criticized for being so.[244] A particularly difficult aspect to reconcile with trust principles is the loss of rights by those who can trace to a specific certificate. The Canadian cases are not entirely clear on this point, and several have upheld the rights of clients who can trace to a particular certificate on the basis that such a certificate remains the property of the client and cannot be affected by other claimants.[245] The conflict between the doctrine of "sharing the burden of the loan" and traditional trust tracing principles may be seen as a conflict between established trust and property concepts and practical considerations necessitated by the unique nature of the broker-client relationship.

Practical considerations have prevailed. A major variation from traditional trust tracing principles, and from some of the principles developed in earlier cases, was stated in *Re Waite, Reid & Co. Ltd.*[246] The headnote reads:

> As a result of the computerization of the accounting procedures of the Toronto Stock Exchange and of many of its members, it is practically impossible for any client of a bankrupt broker to trace and claim

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242 The U.S. doctrine is fully described in C.H. Meyer, *The Law of Stockbrokers and Stock Exchanges* (New York: Baker, Voorhis & Co., 1931) at 631-62.

243 See L. Houlden and C. Morawetz, *Bankruptcy Law of Canada*, 3rd ed., Vol. 1 (Scarborough: Carswell, 1989) at 3-22 to 3-22.1, citing *Re Clark Martin & Co.* (1933), 15 C.B.R. 89 (Man. C.A.) and *Re Nakashidze*, [1948] 1 D.L.R. 346 (Ont. H.C.). See also *Re C.A. Macdonald and Co. Ltd.* (1958), 26 W.W.R. 116 (Alta. S.C.), rev'd on other grounds (1959), 28 W.W.R. 231 (A.D.); *Re C.A. Macdonald and Co. Ltd. (No. 2)* (1961), 35 W.W.R. 565 (Alta. S.C.A.D.); and *Re Waite, Reid & Co. Ltd.* (1969), 5 D.L.R. (3d) 229 (Ont. S.C.) aff'd (1969), 13 C.B.R. (N.S.) 330n (C.A.).

244 This is argued in great detail by Sidney Smith, then Dean of Dalhousie Law School, in his Annotation, "Stockbrokers' Bankruptcies", *supra*, note 185.

245 See *Re Nakashidze (No. 2)*, [1948] 2 D.L.R. 522 (Ont. S.C.); *Re J.T. Richards & Co. Ltd.* (1938), 20 C.B.R. 140 (Ont. S.C.); *Re W.H. Magill* (1933), 15 C.B.R. 154 (Ont. S.C.); *Re Wiggins Limited, Ex parte Robertson* (1930), 12 C.B.R. 105 (Ont. S.C.), aff'd 12 C.B.R. 343 (A.D.); and *Haggart* v. *Trustee of Heron* (1930), 11 C.B.R. 163 (Ont. S.C.).

246 *Supra*, note 243.

> specifically securities purchased by the broker on his account and either retained by the broker or pledged by him to his bank to secure advances. Even in the occasional case in which tracing might be possible (apart from specific deposits of securities by clients with the broker either expressly for safe-keeping or to cover margin requirements) the "odds" against it are so great that the Court would be in the unacceptable position of supervising a lottery if it were to afford specific restitution to the lucky few. When there is added to this the impracticality of discovering from the computer the extent of over-pledging or improper pledging of client's securities, the argument for applying the equitable doctrine of sharing the burden of the loan becomes compelling. According to that doctrine, all the pledged shares and securities returned to the trustee unsold by the banks are sold by the trustee and the proceeds distributed *pro rata* among the owners of the original mass.

The *Waite Reid* case is one of the last to consider the rights of clients upon the bankruptcy of a broker. In 1969 the National Contingency Fund (now known as the Canadian Investor Protection Fund) was established by the Toronto, Montreal and Vancouver stock exchanges and the Investment Dealers Association of Canada.[247] The purpose of the Fund is to protect customers who have suffered financial loss due to the failure of a member firm. It does this by reimbursing customers for such losses. The Fund is discussed in more detail below,[248] but for now we need only note that an effect of the Fund has been to obviate court decisions in this area. Consequently, there are no cases discussing client claims upon bankruptcy under the Business Corporations Acts.

On the basis of cases available, the rights of clients in various situations at the date of the bankruptcy appear to be settled as follows:

(1) If the broker is in possession of securities that can be traced *in specie*, by reason of their being earmarked or identified by the broker, then these securities belong to the respective clients, subject to payment by the clients of any indebtedness to the broker.[249]

(2) If the broker is in possession of securities not earmarked or identified by the broker, but which a client can somehow trace to a transaction involving that client, the client is in no better position

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247 The Alberta Stock Exchange has since joined the original participants.

248 See the discussion under "Investor Protection Funds" commencing at p. 133 of this report.

249 See *Re Bryant Isard & Co. (Ex parte Hanneman)*, *supra*, note 220; *Re J.T. Richards Company Ltd. Ex parte Byrne* (1944), 25 C.B.R. 317 (Ont. S.C.); *Re Nakashidze (No. 2)*, *supra*, note 245; and *Re Waite, Reid & Co. Ltd.*, *supra*, note 243.

than any other client who can trace their securities in kind, but not *in specie.*[250]

(3) If clients cannot trace their securities, at least in kind, to any securities held by the broker, such clients will be unsecured creditors only.[251]

(4) If the broker has sufficient securities of an issue to satisfy all claimants who can trace (*in specie* or in kind), these are recognized as the property of the claimants, subject to payment of the balance owing, if any, by the claimant.[252]

(5) If the broker does not have sufficient securities of an issue to satisfy all claimants who can trace, claimants of that issue share proportionally in those securities, subject to payment of the balance owing, if any, by the claimant.[253]

(F) Reconciling the cases with property concepts

It is difficult to reconcile the rights of clients in the situation described in items (1) and (2) above. Consider a situation where a client pays in advance and purchases 100 shares of X Co. through a broker. The broker executes the trade and obtains a street certificate representing 100 shares, but the certificate is not earmarked to the client's account. The broker improperly pledges the certificate, along with others, and later declares bankruptcy. The pledgee then sells enough of the pledged securities to satisfy the broker's debt and returns the remaining securities to the bankruptcy trustee. The only remaining securities happen to be the same 100 share street certificate purchased on behalf of the client. By some means the client is able to identify and trace this certificate as the one purchased with the client's money. Unfortunately, this

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250 *Re Waite, Reid & Co. Ltd., ibid.; Re Carroll & Wright, Ex parte Bain, supra,* note 240; *Re Clark Martin & Co., supra,* note 243.

251 *Re Wiggins Ltd.,* [1931] 4 D.L.R. 338 (Ont. C.A.); *Re Ord, Wallington & Co. Ltd.* (1971), 15 C.B.R. 66 (Ont. S.C.).

252 *Re R.P. Clark & Co. (Vancouver) Ltd., supra,* note 182; *Re J.T. Richards and Co. Ltd., supra,* note 245; *Re Stobie-Forlong-Matthews, Ltd., supra,* note 182; *Re Ord, Wallington & Co. Ltd., ibid.*

253 *Re Stobie-Forlong-Matthews Ltd., supra,* note 182; *Re Ord, Wallington & Co. Ltd., supra,* note 251.

does not help the client at all. The client must share the burden of the loan, and will be entitled to a *pro rata* claim against the 100 shares together with all other clients whose securities were pledged by the broker.

This result is consistent with decisions involving the intermixture[254] or confusion[255] of goods, but those doctrines do not apply where a party can trace and identify their property.

If the 100 share certificate had been earmarked by the broker, then the client would be entitled to receive the certificate. Earmarking facilitates tracing, but where a non-earmarked certificate can also be traced *in specie* there seems to be no rational distinction between the two situations. The practical considerations dictate that certain fortunate clients should not benefit disproportionately in comparison with other less fortunate clients in a similar position. But as between clients who own earmarked certificates wrongfully pledged by the broker, the luck of the draw still prevails. If the pledgee sells one client's earmarked certificate, but not another's, the latter client receives his entire claim, while the less fortunate client must share in the residue on the same basis as a client whose certificates were properly pledged, and who can only trace in kind.

The situation is even more difficult to understand if we ask the question: who owned the traceable non-earmarked certificate? According to the cases, the certificate was owned at all times by the unfortunate client. The pledgee acquired a special property in the certificate for the duration of the pledge, but once the broker's loan was paid, the pledgee's interest ended. Somehow, the client's property, which on a classic trust tracing analysis should not even be subject to the bankruptcy proceedings, gets divided amongst the broker's creditors.

The final result may be fair, or at least more fair than the result of strict adherence to property and tracing principles. But the cases fall short of providing any alternative principle that explains and justifies the result. We must speculate upon what alternative principles the courts might have used.

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254 See *Crossley Vaines, supra,* note 188 at 434-35.

255 See *Brown on Personal Property, supra,* note 190 at §6.8.

It is possible to reach the same result, in a much more rational manner, by analyzing the situation using a revised property concept for the client's interest. The revised property concept assumes that the client acquires no interest in any specific certificate unless that certificate is earmarked by the broker. In the case of non-earmarked certificates, even if a certificate can be traced to a specific transaction, it does not render that certificate the property of the client because such certificates are fungible. Instead, the client who purchases securities acquires a proportionate property interest in the fungible bulk of non-earmarked securities held by the broker. All the non-earmarked securities of a particular issue are the common property of clients who can trace in kind to that issue. This approach achieves the same result without doing violence to established trust and tracing principles.

This approach is the same one used in the UCC and imported into the Business Corporations Acts.[256] It is not the only approach that can be used to reconcile the results of the cases.

Another approach would also assume that the client acquires no interest in any specific certificate unless that certificate is earmarked by the broker. Where no certificate is earmarked, however, it could be said that the client has only an intangible claim against the broker for securities, not attributable to any specific property held by the broker, but with priority over general creditors of the broker. Claimants of this type would share pro rata in all non-earmarked securities held by the broker upon bankruptcy. This "special claim" approach is clearly not contemplated by the cases,[257] but it, like the proportionate property interest approach, is a more rational way of dealing with the practical considerations than that actually applied.

One remarkable aspect of the "special claim" approach is that it alters the nature of the transaction. A practical problem with any property approach, acknowledged in *Re Waite Reid,* is that the clearing and settlement process makes it virtually impossible to trace property interests through the

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256 See UCC §8-313; CBCA s. 70; OBCA s. 78; and ABCA s. 66.

257 If it were applied, all customers with claims to non-earmarked securities that the broker ought to have been holding would share pro rata in whatever securities were available. A customer claiming against a certain issue of securities would not be relegated to unsecured creditor status merely because the broker did not happen to have any securities of that issue at the date of bankruptcy. This is consistent with the application of "sharing the burden of the loan" as stated in *Re Macdonald and Co. Ltd., supra,* note 243 at 130 (Alta. S.C.).

course of any given transaction. This may be seen not just as a practical problem, but as a fact defining the true nature of the transaction.[258] If we examine a typical transaction where clients purchase and sell 100 shares of X Co. through brokers, a stock exchange and a clearing agency, it is impossible to trace any specific property from one end of the transaction to the other. The result of the transaction is that the purchaser's claim against a broker is increased by 100 shares of X Co., while the vendor's claim against another broker is accordingly decreased. It would almost certainly be wrong, however, to say that these are the same 100 shares.[259] It seems, then, that there is no transfer as between the parties. Instead, each client engages in a transaction with their respective broker, and that is the limit of their rights and obligations. The dealings of brokers with each other, and with the clearing agency are separate and irrelevant to the client's claim.

(iv) U.S. cases

The U.S. position may be summarized briefly. In many respects it is the same as the position in Canada, because Canadian cases have relied heavily upon U.S. law in this area.

Where a client delivers securities to a broker for exchange or sale, the relationship is one of agency or bailment, and is of a fiduciary nature.[260]

Where the broker has purchased securities for, and holds them on behalf of the customer, the "relationship is unique, partaking of various aspects of an agency, bailment trust and pledge."[261] Title to the securities generally vests at once in the customer.[262] If the broker becomes insolvent, customers

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258 This view of the typical securities transaction is examined in detail by J.S. Rogers "Negotiability, Property and Identity" (1990) 12 Cardozo. L.R. 471.

259 It is conceivable that they would be the same shares, but the likelihood of this occurring are infinitesimal, and the chances of being able to prove that it occurred are similarly remote.

260 See Annotation, "Relation between customer and broker receiving bonds or other securities for sale or exchange", 52 A.L.R. 501.

261 See Official Comment to UCC §8-313 (1962 version), citing *Re Rosenbaum Grain Corp.* (1939), 103 F.2d 656; *Re Ellis' Estate, supra*, note 194; and *Parsons* v. *Third National Co.* (1936), 94 S.W.2d 1057.

262 See Annotation "Title to securities in possession of broker (or his pledgee) who has purchased them for or sold them to customer", 41 A.L.R. 1258.

may reclaim their securities, provided they can trace them *in specie* or in kind.[263] Prior to the introduction of the UCC, a customer who was able to trace securities in the possession of the broker by certificate number could reclaim them in full.[264] With the introduction of the UCC, customers' rights were defined by §8-313.[265] The UCC uses the proportionate property interest approach to interests in fungible bulks of non-earmarked securities.[266]

(v) More appropriate terminology

It appears that the most persistent problem arising in cases discussing brokers holding securities for clients, whether in terms of bailment or trust, is that too little attention has been paid to the true nature of the property interest being held, and too much emphasis placed on labelling the broker-client relationship.

Both bailment and trust have been used to describe similar arrangements, with bailment applied in the U.S. and trust applied in Canada to produce virtually identical rights and obligations. We have seen, though, that bailment was more readily applied in the U.S. because of their earlier development of the negotiable stock certificate, and the lack of a requirement for redelivery *in specie*. Even if Canadian law followed the U.S. in this latter regard, there would still be serious limitations on the application of bailment concepts to securities holdings by intermediaries, because bailment cannot be applied to intangible property interests such as the underlying shares, or an interest in a fungible bulk of securities.[267]

Trust principles have been applied to this aspect of the broker-client relationship in both the U.S. and Canada as a matter of necessity, reflecting the

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263 See generally *Meyer on Stockbrokers, supra,* note 242 at 618-31, *Gorman* v. *Littlefield, supra,* note 217 and *Duel* v. *Hollins, supra,* note 233.

264 *Meyer on Stockbrokers, ibid.* at 625-26. It is not clear whether such identification depends upon earmarking of certificates by the broker, but it probably does not.

265 See Official Comment (1962 version).

266 See the discussion at p. 93 of this report.

267 Problems in applying the concept of bailment to interests in fungible bulks under the pre-1977 UCC are discussed in Haydock, "When Is A Broker A Bailee?", *supra,* note 197, and M.J. Aronstein, "The New/Old Law of Securities Transfer: Calling a 'Spade' a 'Heart Diamond, Club or the Like'" (1990) 12 Cardozo L.R. 429 at 431.

fiduciary nature of the relationship. One problem with applying trust principles is in defining their limits consistently in light of the many variations presented in arrangements between broker and client. In Canada, the courts initially relied heavily upon trust principles, then retreated in respect of tracing. In the process, there has been confusion over the nature of the property interests involved.

The optimal approach seems to be the use of statutory and regulatory provisions to establish the rights of all the parties involved, which is the approach adopted by the Business Corporations Acts.

(c) Segregation of securities

Current stock exchange by-laws and provincial securities Regulations generally include requirements as to broker's methods of holding certain securities for clients.[268]

Section 16.12 of the current Toronto Stock Exchange by-laws includes the following:

> (1) Subject to any special agreement with the client, all fully-paid or excess margin securities held by a member for a client shall be segregated and identified as being held in trust for such client in accordance with Exchange requirements and shall at all times be kept available for such client on demand.
>
> ...
>
> (3) The securities of all clients of a member held in accordance with subsection (1) may be segregated in bulk for all such clients, other than those clients whose securities are held apart from all other securities pursuant to a written safekeeping agreement.

The by-laws allow the exchange to prescribe the manner in which securities are to be so segregated and held, and provide that segregated securities may be deposited and held outside the physical possession of a member at a wide variety of specified locations, including securities depositories around the world, banks, trust companies, and brokerage firms.[269]

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268 Such provisions apparently made their first appearance in Canada in the TSE by-laws in the late 50's or early 60's. They were introduced into the Regulation made under the Ontario Securities Act in 1979.

269 See Toronto Stock Exchange by-laws ss 16.12 and 16.12A. Alberta Stock Exchange by-laws ss 16.09 and 16.09A are to the same effect.

There are no Canadian cases dealing with claims upon insolvency against securities held "in trust for such client".

E. Conclusion

We have seen that Canadian courts have consistently discussed the broker-client relationship in terms of trust, but that trust and tracing principles have not been consistently applied in cases of broker insolvency. Modern industry regulation continues this tradition of applying trust terminology. There has been persistent confusion over the nature of the property interest of the customer when securities have been held by brokers.

Having examined some of the implications of the broker-client relationship, we may now turn to an examination of the transfer of securities under current Canadian law.

CHAPTER 6 — CURRENT CANADIAN LAW OF SECURITIES TRANSFERS

A. Introduction

Since the amendments proposed by CDS for the ABCA are based on the provisions of the OBCA,[270] an analysis of the existing ABCA and OBCA provisions will serve to illustrate some aspects of the operation of the existing and proposed law of securities transfers in Alberta. As noted earlier, the existing CBCA provisions relating to securities transfers are very similar to those in the existing ABCA.

Although portions of the legislation being discussed are set out in the text, Part VI of both the ABCA and OBCA, in their entirety, are found in Appendices B and C to this report.

B. The Transfer Mechanism Under the ABCA

(1) The Importance of Delivery

Under the ABCA, delivery is the key element of a transfer of a security.[271] In section 44(2)(n) of the ABCA a "security" or "security certificate" is defined as being "an instrument" evidencing a share, participation or other interest in or obligation of a corporation. Because a security is a negotiable instrument,[272] it may be seen as the tangible embodiment of the underlying intangible interest, and an effective transfer of the security is also an effective transfer of the intangible interest.[273]

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270 As noted above, the *CDS Proposal* was based on the OBCA provisions as they existed prior to the 1990 revisions to the OBCA, which appear to have had no substantive effect on the provisions.

271 It is important to note that under the ABCA (as well as the CBCA, OBCA and pre-1977 UCC Article 8) delivery is an event that triggers a transfer, but delivery is not absolutely necessary for a transfer of property to occur. The common law recognizes that a transfer of property may occur without delivery. See *Re R.P. Clark & Company (Vancouver) Limited, supra*, note 182; *Re Bryant Isard & Co. (Ex Parte Hanneman), supra*, note 220; *Re Stobie-Forlong-Matthews, Ltd.*; *Re Claims of Kern Agencies, Ltd., supra*, note 182; *Re Ord, Wallington & Co. Limited, supra*, note 251; and *Re Stout and City of Toronto, supra*, note 149.

272 ABCA s. 44(3).

273 See the discussion of "The Role of Registration Under the Business Corporations Acts" commencing at p. 48 of this report.

ABCA section 56 reads in part:

> (1) On delivery of a security, the purchaser[274] acquires the rights in the security that his transferor had or had authority to convey ...[275]
>
> (2) A *bona fide* purchaser, in addition to acquiring the rights of a purchaser, also acquires the security free from any adverse claim.[276]
>
> (3) A purchaser of a limited interest acquires rights only to the extent of the interest purchased.

A "*bona fide* purchaser" is defined in section 44(2)(c) as:

> ... a purchaser for value in good faith and without notice of any adverse claim who takes delivery of a security in bearer form or order form or of a security in registered form
>
> (i) issued to him, or
>
> (ii) endorsed to him or endorsed in blank by an appropriate person as defined in section 61

"Delivery" is defined in section 44(2)(e) as "voluntary transfer of possession", but section 66 goes further, deeming delivery to occur in four situations where the security does not reach the actual possession of the purchaser:

> (1) Delivery to a purchaser occurs when
>
> (a) he or a person designated by him acquires possession of a security,
>
> (b) his broker acquires possession of a security specially endorsed to or issued in the name of the purchaser,

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274 "Purchaser" is defined by ABCA s. 44(1)(m) to include a person who takes by sale, mortgage, pledge, gift or any other voluntary transaction creating an interest in a security. Note that a broker, acting as agent, often acquires no interest in a security and thus cannot be a purchaser.

275 This provision expresses the so-called "shelter principle" that the purchaser receives everything the transferor could convey. A corollary of this principle is that no one can give a purchaser a better title than their own: *nemo dat quod non habet*. See J.F. Dolan, "The U.C.C. Framework: Conveyancing Principles and Property Interests" (1979) 59 Bos. U.L.R. 811 at 812. The shelter principle may allow a purchaser, even though not a bona fide purchaser, to claim through the transferor all the rights of a bona fide purchaser if the transferor had such rights. See also Guttman, *supra*, note 114 at 6-42.

276 This is an exception to the shelter principle, allowing *bona fide* purchasers for value to acquire a better title than that held by the transferor. The background and development of this exception is discussed at p. 119 of this report.

(c) his broker sends him confirmation of the purchase and the broker in his records identifies a specific security as belonging to the purchaser, or

(d) with respect to an identified security to be delivered while still in possession of a third party, that person acknowledges that he holds it for the purchaser.

(2) A purchaser is the owner of a security held for him by his broker, but a purchaser is not a holder except in the cases referred to in subsection (1)(b) and (c).

(3) If a security is part of a fungible bulk a purchaser of the security is the owner of a proportionate interest in the fungible bulk.

(4) Notice of an adverse claim received by a broker or by a purchaser after the broker takes delivery as a holder for value is not effective against the broker or the purchaser, except that, as between the broker and the purchaser, the purchaser may demand delivery of an equivalent security in relation to which no notice of an adverse claim has been received.[277]

Section 44(2)(j) defines "holder" as "a person in possession of a security issued or endorsed to him or to bearer or in blank".

(2) Delivery Mechanisms

The operation of these provisions is relatively simple. Where a client purchases a security through a broker,[278] and pays in full, there are several alternatives covered by the ABCA:

• If the client wants to obtain actual possession of the certificate, the broker will hand it over. This is "delivery" under section 44(2)(e) and section 66(1)(a), so it allows the client to achieve *bona fide* purchaser status. Because there is an actual transfer of possession of the certificate, there is no need for the certificate to be earmarked,[279] and it

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277 Section 66(4) operates similarly to s. 56(1), so that even a purchaser who is not a *bona fide* purchaser is sheltered from adverse claims if notice of the adverse claim is not received until after the purchaser's broker has taken delivery as a holder for value. See *supra*, note 275. Note that the broker is described as "a holder for value". This is because in many instances the broker may not meet the definition of a purchaser. See *supra*, note 274.

278 We will assume that the transaction has been completed and cleared through a stock exchange. The duties of the selling customer and broker in this regard are set out in ABCA s. 67.

279 This term was widely used in cases dealing with the broker-client relationship before the introduction of the Business Corporations Acts, discussed in the previous chapter. In that (continued...)

makes no difference whether the certificate is registered in the name of the client, specially endorsed to the client, or endorsed in blank.

• Someone designated by the client may obtain actual possession of the certificate. This is "delivery" under section 66(1)(a), and allows the client to achieve *bona fide* purchaser status. It seems that the "designated person" is someone other than the broker, because otherwise section 66(1)(a) would implicitly conflict with section 66(1)(b) and (c). Again, because there is an actual transfer of possession of the certificate, earmarking is unnecessary.

• The broker may acquire and hold a certificate specially endorsed to or issued (registered) in the name of the client, which constitutes delivery under section 66(1)(b). In this situation, the special endorsement or registration earmarks the specific certificates. This makes the client a "holder" pursuant to section 66(2), so the client may also achieve *bona fide* purchaser status. This situation may be characterized as a type of safekeeping arrangement.

• The broker may send the client confirmation of the purchase, and identify a specific certificate held by the broker as belonging to the purchaser.[280] This is delivery under section 66(1)(c) and makes the client a "holder" pursuant to section 66(2), so the client may also achieve *bona fide* purchaser status. The earmarked certificate would be either a

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[279](...continued)
context, the term was not precisely defined, but was used generally to describe certificates that were somehow identifiable with a particular customer or claimant. This term is not used in the Business Corporations Acts, but the legal requirements for identifying specific certificates for the purpose of delivery, which we will refer to as earmarking, are described in detail by the legislation.

[280] On the question of whether a security is "identified" and/or "specific", see Guttman, *supra*, note 114, at p. 8-4 n. 14. He summarizes the situation as "What is specific will be identified; what is individually identified, as opposed to being part of a bulk, will be specific." A specific certificate would be identified by certificate number, CUSIP number and the number of shares or amount of debt represented by the certificate. In most instances, placing a certificate in an envelope marked for the purchaser would seem to be sufficient. See *Louisiana State School Lunch Employees Retirement System* v. *Legel, Braswell Government Securities Corp.* (1983), 699 F2d 512 (11th Cir. C.A.) and compare with *U.S.* v. *Doyle* (1980), 486 F.Supp. 1214 (D. Minn.), where placement of certificates in marked envelopes was not sufficiently specific, apparently because certificate numbers were not recorded on the envelopes and there was evidence that the broker sometimes removed the contents of the envelopes. See also *Matthysse* v. *Securities Processing Services, Inc.* (1977), 444 F. Supp. 1009 (S.D.N.Y.). Guttman notes that "...it is not possible to claim that a security in a bulk of securities is identified."

street certificate or an unendorsed certificate registered in the name of the broker, which distinguishes this situation from that contemplated by section 66(1)(b). This may be also be characterized as a type of safekeeping arrangement.

• A third party in possession of an identified certificate could acknowledge holding that certificate for the client. This is delivery under section 66(1)(d), but according to section 66(2), it does not make the client a holder, so the client cannot be a *bona fide* purchaser.[281] This provision is more applicable to a purchase of securities on margin. It also applies where the paid-for and identified security is held by a third party, but this would be an unusual situation.

(3) Securities Forming Part of a Fungible Bulk

Securities that are not delivered are part of a fungible bulk,[282] to which section 66(3) would apply. The purchaser is the owner of a proportionate property interest in the fungible bulk, but does not take delivery and cannot achieve *bona fide* purchaser status.[283] It is surprising that the statute does not

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281 As noted by Guttman, *supra*, note 114 at 8-3, the logic of this provision is difficult to follow. It seems arguable that if the third party is "designated" by the purchaser, and is not the broker, then the purchaser could achieve *bona fide* purchaser status under s. 66(1)(a). There is an inconsistency between the definition of *bona fide* purchaser as someone who takes "delivery" of a security, and the operation of s. 66(2), which seems to deny *bona fide* purchaser status to anyone who is not a "holder". This inconsistency is not addressed in the Official Comment to the pre-1977 UCC §8-313, although it is implicit that only a "holder" can be a *bona fide* purchaser. The 1977 revisions to the UCC include changes to the definition of *bona fide* purchaser in §8-302 and to the transfer mechanics in §8-313 to make this explicit. The Official Reasons for 1977 Change to both these provisions state clearly that a person must be a "holder" to qualify as a *bona fide* purchaser.

282 This would be so even in the rare instance where a broker held only one certificate of a particular issue of security on behalf of a single client. The defining characteristic of the fungible bulk appears to be the nature, not the quantity, of the securities that comprise it. In the case of the single certificate in the possession of the broker, if it is not earmarked then the client does not receive delivery under ABCA s. 66, and the certificate is therefore a fungible bulk.

283 It has been suggested that it is possible for a customer to receive delivery of a security held by a clearing agency in a segregated account for the customer's broker, so that the customer could become a *bona fide* purchaser, but this does not seem to apply to securities held in a fungible bulk. See Guttman, *supra*, note 114 at ¶ 8.02[2][c][iii], and note that, if this approach is applied to securities forming part of a fungible bulk, then it conflicts with the position outlined by Guttman in ¶ 8.01[1]. See *supra*, note 280. This approach relies upon the broker acquiring constructive possession of an identified, specific security,

(continued...)

specify any transfer mechanism describing how a purchaser of an interest in a fungible bulk acquires that interest, but instead leaves this transfer to occur under the common law.[284]

The fungible bulk itself may not be comprised of certificates in the actual possession of the broker. It could also be comprised of the broker's account with a depository such as WCDTC or CDS, or with another broker, or with a bank or trust company, or a combination of such accounts.[285]

(a) The nature of a proportionate property interest in a fungible bulk

Is the proportionate property interest tangible or intangible? The legislation appears to view every person with a proportionate property interest as an owner in common of tangible property (the fungible bulk of certificates). This is, to some extent, comparable to the law applicable to fungible goods.[286] A purchaser who acquires a proportionate property interest in a fungible bulk held by a broker will not have possession of any of the tangible property in that bulk. The purchaser may be said to have the right to acquire possession of a certificate from the broker, who will in turn have a right to acquire possession of a certificate from CDS, another broker, a bank, trust company, etc. In our view, this is clearly an intangible interest — a chose in action that will generally be capable of enjoyment without legal action necessarily being taken in respect thereof.[287]

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[283](...continued)
sufficient to satisfy the UCC equivalent of ABCA s. 66(1)(c). Guttman cites *Matthysse* v. *Securities Processing Services, Inc., supra*, note 280, and *Louisiana State School Lunch Employees Retirement System* v. *Legel, Braswell Government Securities Corp., supra*, note 280, but those cases involved constructive delivery of specific, identified, security certificates — not fungible bulks. In our view, it is impossible to identify a specific security in a fungible bulk in order to achieve constructive delivery under ABCA s. 66(1)(c). See the analysis on this point by C.W. Mooney Jr. in "Beyond Negotiability: A New Model For Transfer and Pledge of Interests in Securities Controlled By Intermediaries" (1990) 12 Cardozo L.R. 307 at 366-71.

[284] It is clear, though, that a property interest passes to the broker's client immediately. See *supra*, note 271.

[285] See the discussion of segregation of securities commencing at p. 96 of this report.

[286] See for example s. 15 of the Alberta Warehouse Receipts Act, R.S.A. 1980, c. W-2.

[287] See *Crossley Vaines, supra*, note 188 at 263. See also Haydock, "When Is a Broker a Bailee", *supra*, note 197 at 19, where Mr. Haydock poses this same question in terms suggesting
(continued...)

The true nature of a proportionate property interest in a fungible bulk is seen more clearly if we consider a large fungible bulk, maintained by a major broker. Assume that the broker holds a fungible bulk comprising 100,000 shares, all in the form of street certificates. 1000 of these shares were acquired by the broker on behalf of Client X, so X is the owner of 1/100 of the fungible bulk. Assume that, due to an administrative error, the broker sells 100 shares without authority and delivers out corresponding certificates from the fungible bulk. Does this affect X's interest? In one sense it does not; X still owns 1/100 of the fungible bulk. But if the nature of the interest is unchanged, the value of that interest is certainly changed; that interest is now the equivalent of only 999 shares. Perhaps the broker will detect and correct the error, restoring the fungible bulk to its proper size, in which case X's interest will again be equivalent to 1,000 shares. But if the broker declares bankruptcy before correcting the error, X's claim as owner is limited to 999 shares because it is so defined by the size of the fungible bulk. X will be an unsecured creditor with respect to the one share shortfall.

The intangible nature of a proportionate property interest in a fungible bulk is also evident if we consider a situation like the one described above, except where the broker maintains an account with a depository instead of retaining possession of the street certificates. In that situation, X is the owner of an interest in the broker's claim against the depository, and it is the size of the broker's claim that fluctuates with the administrative error and disposal of 100 shares. Note that the broker's claim against the depository will be a claim against a fungible bulk,[288] so the broker's claim is also an intangible property interest.

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[287](...continued)
that ownership in common of tangible property is not a chose in action. This could be the case where the ownership interest in question is that of the owner (broker) who is in possession of the fungible bulk, but not so when the bulk is in the possession of another party.

[288] CDS' Depository Service Rule 2.4.3 provides: "Securities deposited in the Depository Service and identified by the same Security Identifier form a fungible bulk and any number or par value of such Security shall be the equivalent of the same number or par value of that Security. Entries may be made in respect of such Securities in the records of CDS as part of a fungible bulk and such entries may refer merely to the number or par value of the particular Security without reference to the name of the registered owner, certificate or bond number or the like. Any registration in the name of, or any certificate or other instrument issued to, CDS, a Nominee, a Custodian or a nominee of a Custodian may represent Securities held for the Accounts of more than one Participant, and CDS shall be under no obligation to keep Securities held for the Account of a Participant, or certificates or other instruments evidencing such Securities, separate and apart form those held for the Accounts of other Participants."

(4) The Advantages of Being a *Bona Fide* Purchaser Under the ABCA

Many of the ABCA transfer provisions operate to distinguish precisely between circumstances where a purchaser does or does not achieve *bona fide* purchaser status. How important is this status and how much extra protection does it provide?

Section 56(2) provides that a *bona fide* purchaser "acquires the security free from any adverse claim." Section 44(2)(a) defines an adverse claim as including "a claim that a transfer was or would be wrongful or that a particular adverse person is the owner of or has an interest in the security." To illustrate the advantages of being a *bona fide* purchaser, we will briefly consider the operation of the ABCA when adverse claims arise, using a very simple example.

Adverse claims can arise in many ways, but such claims may be seen as falling into two main categories:[289]

1. Those based on unauthorized signature, such as where an unendorsed certificate has been lost, and the necessary endorsement has been subsequently forged.

2. Those not based on unauthorized signature, such as where an endorsed certificate has been lost.

For the purposes of our discussion, we will consider each type of adverse claim. We will assume in each case that there is no dispute over facts, the adverse claimant was the registered owner of shares at the time the certificate was lost, and that a written notice of adverse claim was given to the issuer upon discovery of the loss.

In the case where the certificate was endorsed at the time it was lost, the *bona fide* purchaser issue is critical. If a *bona fide* purchaser has acquired the certificate,[290] then that purchaser is entitled to have the transfer of the

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[289] See Guttman, *supra*, note 114 at 14-2.

[290] Such as where the finder sold the security to an innocent purchaser for value, who then sold it to another innocent purchaser for value who took actual possession of the certificate endorsed in blank.

security registered.[291] But if the person who presents the security for registration is not a *bona fide* purchaser,[292] then the issuer will act upon the adverse claim[293] and the security will be either returned to the original owner or cancelled by the issuer.[294]

In the case where the certificate was not endorsed at the time of loss, and an endorsement was subsequently forged, then the *bona fide* purchaser issue is irrelevant because, by definition, no one can become a *bona fide* purchaser of a certificate bearing a forged endorsement.[295] Even if a purchaser for value without notice of adverse claims presents the certificate for registration, the adverse claim will prevail.[296] If such a purchaser registered a transfer and received a new security before the issuer received notice of the adverse claim, then that purchaser would be protected against the adverse claim,[297] but the original owner would then have a claim against the issuer for improper registration under section 73(5).[298]

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291 See ABCA ss 71-75.

292 Such as where the security was received as a gift, so that the purchaser gave no value.

293 See s. 73(2).

294 As where the original owner has already obtained a replacement certificate under s. 75(2).

295 See ss 44(2)(c)(ii), 56(4) and 61(3). The ABCA provisions in ss 44 and 56 are more explicit than the comparable provisions in the CBCA or OBCA but are intended to have the same effect. The additional explicit provisions in the ABCA were inserted at the suggestion of the ILRR in 1980 on the basis that an unauthorized endorsement is not an endorsement "as defined by s. 61(3)", and in an effort to make clear the risk of an adverse claim based upon an unauthorized endorsement. See Report No. 36, *supra*, note 128, comments on ss 44(2)(a), 44(2)(c), 56(4), 61, 64 and 68. Upon reflection, the basic premise for these changes may be wrong. It seems unlikely that s. 61(3), or UCC §8-308(1) upon which it was based, are intended to completely define the term "endorsement". If that is so, a person acquiring a security bearing a forged endorsement could be, in fact, a bona fide purchaser (this is implicitly acknowledged in the Official Comment to UCC §8-311). This interpretation does not give the bona fide purchaser any additional rights because the owner may still assert the ineffectiveness of the forged endorsement under ss 64 and 68. Whichever interpretation is preferred, the provisions should be re-drafted and made uniform.

296 ABCA s. 64.

297 *Ibid.*

298 The issuer, in turn, would look to recover on the warranty given by whoever guaranteed the forged signature on the lost certificate. See s. 65 setting out the warranties, and ss 71 and 72 authorizing the issuer to require a guarantee of an endorsement as a condition of registration.

(5) Purchasers' Rights Upon the Broker's Insolvency

From a client's perspective, *bona fide* purchaser status offers some protection in situations where the client's broker has become insolvent.

Where a client was a *bona fide* purchaser of earmarked street certificates held by the broker, and if those certificates are then improperly sold or pledged by the broker, the client has an adverse claim against the purchaser or pledgee. Such adverse claim may be successful, unless the purchasers or pledgees have become *bona fide* purchasers, in which case the client's adverse claim would be ineffective against them. Where the broker improperly endorsed[299] earmarked securities issued or endorsed to the client, that client could assert an effective adverse claim even against a subsequent good faith purchaser, but only up to the point where the subsequent purchaser registers their transfer and obtains a new certificate. In that case the client would be left with a claim against the issuer for improper registration.

In either case, if the client is unable to obtain the earmarked securities, the client can still trace in kind, and would then be entitled to a proportionate share of any fungible bulk of similar securities held by the broker.

It is apparent that, in the event of a broker's insolvency, the overall effect of the ABCA transfer provisions leaves purchasers in virtually the same position as they would have been before the introduction of the ABCA. Earmarked certificates that are still held by the bankrupt broker may be claimed by the client as owner, but non-earmarked securities, even if they could somehow be traced by a purchaser, form part of the fungible bulk of which the purchaser is owner of a proportionate interest.[300]

(6) Depository Operations Under the ABCA

There are no provisions in the ABCA dealing with the operation of securities depositories. How then does the West Canada Depository Trust Company ("WCDTC")[301] function under this regime?

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[299] By forging the client's signature.

[300] See *supra*, notes 250 and 256 and accompanying text.

[301] See the description of WCDTC and WCCC at p. 33 of this report.

When a trade is made on the Alberta Stock Exchange, it is cleared through West Canada Clearing Corp. ("WCCC"). ABCA section 67(1)(b)(ii) allows a selling broker to fulfil the duty to deliver by effecting clearance in accordance with the rules of the exchange. If both the buying and selling broker are participants of WCDTC, then the trade may be settled by WCCC informing WCDTC of the clearance obligations and WCDTC then makes the appropriate book-entries in the accounts of the respective brokers. This is not "delivery" under section 66[302] but it effects a transfer to the buying broker at common law and under the participants' contractual arrangements with WCDTC.

This type of operation is certainly more efficient than making actual delivery of certificates, but it has limitations. It does not apply to pledges of securities,[303] or to OTC securities such as government bonds.[304]

CDS operates on a much larger basis, both in terms of the quantity of securities held, and the range of services provided. A significant proportion of CDS securities holdings are OTC securities such as government bonds, and the capacity to effect pledges of securities is an important aspect of CDS' services. Therefore, CDS cannot operate effectively under the existing ABCA provisions.

C. The Transfer Mechanism Under the OBCA

(1) Delivery

Delivery remains the key element in the transfer of securities under the OBCA. As it applies to earmarked security certificates or non-earmarked certificates held by a broker for a purchaser, the operation of the OBCA is practically identical to that of the ABCA.

The OBCA shares similar definitions of "adverse claim", "delivery", "holder" and "purchaser" with the ABCA. OBCA section 69 is essentially similar to ABCA section 56, describing the effect of delivery of a security,

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302 Section 66(1)(d) could apply, but only if WCDTC identified a particular security and acknowledged holding it for the buying broker. This would not occur with book-entries recording interests in a fungible bulk held by WCDTC.

303 Because s. 67 does not apply to these transactions.

304 Because WCDTC does not handle OTC securities.

except that it uses the term "good faith purchaser" instead of "*bona fide* purchaser". The other OBCA provisions dealing with the transfer of securities, however, reflect a number of differences intended to accommodate book-entry deliveries through securities depositories.[305]

OBCA section 53(1) includes the following definitions:

> "security" means a share, participation or other interest in property, rights or an enterprise of an issuer, or an obligation of an issuer, or any right to acquire such a share, participation, interest or obligation, of a type commonly dealt in upon securities exchanges or markets or commonly recognized as a medium for investment in any area in which it is issued or dealt in;
>
> "security certificate" means an instrument in bearer, order or registered form, issued by an issuer evidencing a security;
>
> "uncertificated security" means a security, not evidenced by a security certificate, the issue and any transfer of which is registered or recorded in records maintained for that purpose by or on behalf of the issuer;
>
> "good faith purchaser" means a purchaser for value, in good faith and without notice of any adverse claim,
>
> (a) who takes delivery of a security certificate in bearer form or order form or of a security certificate in registered form issued to the purchaser or endorsed to the purchaser or endorsed in blank,
>
> (b) in whose name an uncertificated security is registered or recorded in records maintained by or on behalf of the issuer as a result of the issue or transfer of the security to the purchaser, or
>
> (c) who is a transferee or pledgee as provided in section 85;

OBCA section 78 provides:

> (1) Delivery to a purchaser occurs when,
>
> (a) the purchaser or a person designated by the purchaser acquires possession of a security;
>
> (b) the purchaser's broker acquires possession of a security specially endorsed or issued in the name of the purchaser;

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305 The OBCA does not refer directly to securities depositories. They fall under the definition of "clearing agency" in s. 53. For convenience, we will sometimes refer simply to CDS, although the discussion could apply as well to any other depository meeting the OBCA definition of "clearing agency".

(c) the purchaser's broker sends the purchaser confirmation of the purchase and the broker in the broker's records identifies a specific security in the broker's possession as belonging to the purchaser;

(d) with respect to an identified security to be delivered while still in possession of a third person, that person acknowledges that it is being held for the purchaser; or

(e) appropriate entries in the records of a clearing agency are made under section 85.

(2) A purchaser is the owner of a security held for the purchaser by a broker, but is not a holder except as specified in clauses (1)(b), (c) and (e).

(3) If a security is part of a fungible bulk, the purchaser is the owner of a proportionate interest in the fungible bulk.

(4) Notice of an adverse claim received by a broker or by a purchaser after the broker takes delivery as a holder for value is not effective against the broker or the purchaser, except that as between the broker and the purchaser, the purchaser may demand delivery of an equivalent security as to which no notice of an adverse claim has been received.

OBCA section 85 provides:

(1) If a security shown in the records of a clearing agency is evidenced by,

(a) a security certificate in the custody of the clearing agency or a custodian or of a nominee of either, subject to the instructions of the clearing agency, and is in bearer form or endorsed in blank by an appropriate person or registered in the name of the clearing agency or a custodian or of a nominee of either; or

(b) an uncertificated security registered or recorded in records maintained by or on behalf of the issuer in the name of the clearing agency or a custodian or of a nominee of either, subject to the instructions of the clearing agency,

then, in addition to other methods, a transfer or pledge of the security or any interest therein may be effected by the making of an appropriate entry in the records of the clearing agency.

(2) Under this section, entries may be in respect of like securities or interests therein as part of a fungible bulk and may refer merely to a quantity of a particular security without reference to the name of the registered owner, certificate or bond number or the like and, in appropriate cases, may be on a net basis taking into account other transfers or pledges of the same security.

(3) A transfer or pledge under this section has the effect of a delivery of a security in bearer form or duly endorsed in blank representing the amount of the obligation or the number of shares or rights transferred or pledged.

(4) If a pledge or the creation of a security interest is intended, the making of entries has the effect of a taking of delivery by the pledgee or a secured party and the pledgee or secured party shall be deemed to have taken possession for all purposes including the purposes of the Personal Property Security Act.

(5) A person depositing a security certificate or an uncertificated security with a clearing agency, or a transferee or pledgee of a security under this section, is a holder of the security and shall be deemed to have possession of the security so deposited, transferred or pledged, as the case may be, for all purposes, including, if a pledge or the creation of a security interest is intended for the purposes of the Personal Property Security Act.

(6) A transfer or pledge under this section does not constitute a registration of transfer under sections 86 to 90.

(7) That entries made in the records of the clearing agency as provided in subsection (1) are not appropriate does not affect the validity or effect of the entries nor the liabilities or obligations of the clearing corporation to any person adversely affected thereby.

(8) In this section,

"issuer" includes a person, other than an individual, and a government or agency thereof,

(a) that is required by this Act to maintain a securities register,

(b) that directly or indirectly creates fractional interests in its rights or property and issues security certificates or uncertificated securities as evidence of the fractional interests,

(c) that places or authorizes the placing of its name on a security certificate, otherwise than as an authenticating trustee, registrar or transfer agent, or that otherwise authorizes the issue of a security certificate or an uncertificated security evidencing a share, participation or other interest in its property or in an enterprise or evidencing its duty to perform an obligation, or

(d) that becomes responsible for or in place of any other person described as an issuer in this section; and

"security", "security certificate" and "uncertificated security", in addition to the meaning each has for the purposes of this Part, are extended to include a security, security certificate or uncertificated security, as the case may be, of an issuer within the meaning of this section.

A fundamental problem with these provisions, and with Part VI of the OBCA generally, is their failure to consistently recognize the distinctions made in section 53 between the intangible "security" and the tangible evidence of same: the "security certificate". Although section 85 refers to "delivery of a security", "holder of a security", and to deemed "possession of the security", these are absurd concepts because the intangible security can not be delivered or possessed. The tangible security certificate can be delivered or possessed, and it is evident from the wording of several of the offending sections that references to "security" are made in a context where only a reference to "security certificate" makes any sense (e.g. the section 53 definition of "holder", and section 85(3) where the reference is to a security in a particular form or suitably endorsed). Even section 53(3) declares that "... a security is a negotiable instrument".

These erratic references are intended to accommodate transfers of "uncertificated securities". This is one of a number of issues raised by the OBCA provisions that are dealt with in Chapter 7. At the moment, we shall assume that the provisions refer to security certificates so that we can focus more clearly upon how they operate with securities held by CDS.

(2) Transfer of Securities Held by CDS

Recall that only "participants" can deal with CDS. Most brokers are participants, and their clients are not participants. We shall consider a situation where a broker, acting on behalf of a client, purchases securities held by CDS. This necessarily assumes that the seller's broker is also a participant. The transaction is effected through the stock exchange, payment is made, and in the records of CDS the seller's broker's account is debited, and the purchaser's account is credited, with the correct number and type of securities. We will also assume that everyone involved is acting in good faith and without notice of adverse claims.

(a) Constructive delivery and deemed possession

According to section 85(3), the transfer on the records of CDS "... has the effect of a delivery of a security ...". Just as with the ABCA, it is delivery of a security that conveys certain rights to a purchaser (see OBCA section 69 and the definition of "good faith purchaser" in section 53(1)). OBCA section 78(1) specifies when delivery to a purchaser occurs, including when "... appropriate entries in the records of a clearing agency are made under section 85".

Section 85(5) provides that a transferee "... is a holder of the security and shall be deemed to have possession of the security ... for all purposes ...".

OBCA section 78(2) provides that a purchaser is the owner of a security held for the purchaser by a broker, but is not the holder except in certain specified situations, including as specified in section 78(1)(e), when "appropriate entries in the records of a clearing agency are made under section 85". Section 78(3) states that if a security is part of a fungible bulk, the purchaser is the owner of a proportionate property interest in the fungible bulk.

It is difficult to determine the exact effect of these provisions. They have not been judicially considered in Canada and, although the provisions are based on the pre-1977 UCC, they are not identical to the corresponding provisions of the UCC.

The first question is: who is the transferee referred to in section 85? Is it the broker or the broker's client? Under UCC §8-320[306] it is clearly the broker, because the UCC provisions describe "appropriate entries on the books of the clearing corporation" as "reducing the account of the transferor or pledgor and increasing the account of the transferee or pledgee". OBCA section 85 does not include any such provisions, leaving the question open to some doubt. In our view, section 85 should be interpreted as though the missing UCC provisions were included, so that only participants can be transferees. This position is supported by our present examination of the effect of constructive delivery and deemed possession under section 85.

Who gets delivery? Under section 85, the transfer must, at the very least, have the effect of delivery to the broker. But does the client also receive deemed delivery under section 78(1)(e)? Apparently not. OBCA section 78(1)(e) is practically identical to pre-1977 UCC §8-313(1)(e), and the Official Comment states that it does not apply "unless both transferor and transferee are in account with the clearing corporation".[307] However, this interpretation restricts the operation of section 78(1)(e) significantly, because it deals only with "delivery to a purchaser", and the broker very often fails to meet the definition of a "purchaser" because the broker acquires no interest in the security.

306 Pre-1977 version.

307 See Official Comment to UCC §8-313 (1962 version).

Does the client receive delivery at all? No, the client does not. Actual delivery is impossible, and since CDS holds securities in fungible bulk,[308] it is also impossible for constructive delivery of an earmarked security to occur under section 78.[309]

Who is a holder and who has possession? Clearly, section 85(5) makes the broker a holder and gives the broker deemed possession. This creates an interesting situation where the broker and CDS are both holders and both in possession of the same security. If the broker also meets the definition of "purchaser", then both the broker and CDS may be "good faith purchasers" of the same security. Fortunately, the interests of the broker and CDS are not adverse — they are a side-effect of the peculiar relationship between a depository and its participants.

If we were to interpret the provisions more liberally to include the broker's client as transferee under section 85, and to receive delivery under section 78(1)(e), then the client would have deemed possession, and be a holder and a good faith purchaser together with CDS. This interpretation would take the broker entirely "out of the loop", but that seems impossible because it is only the broker who has the account with CDS. Therefore, we cannot accept this interpretation.

What is the property interest of the client? Because the broker is deemed to be a holder in possession of a security, and that security is clearly part of a fungible bulk,[310] then the client is the owner of a proportionate property interest in the fungible bulk. The client's claim is against the broker, who does not actually have possession of the security. The broker has an account with CDS, so the client has a proportionate property interest in the broker's claim against CDS under that account. The client's interest here seems to be exactly the same as that which exists under the ABCA where the client's broker holds a fungible bulk with CDS.

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308 See *supra*, note 288.

309 See *supra*, notes 280 and 283, and accompanying text, dealing with ABCA s. 66, which is practically identical to OBCA s. 78 in this respect. The only difference is the OBCA's definition of "security", which is an apparent drafting error, and does not alter the basic impossibility of sufficiently identifying a specific security to achieve "delivery" to the broker's client.

310 More precisely, it is part of a notional fungible bulk in the hands of the broker, and an actual fungible bulk in the hands of CDS.

(b) Good faith purchaser status

We have seen that the OBCA provisions allow for the possibility of a broker, or other CDS participant, to become a good faith purchaser of a security held by CDS. This is one of the stated objectives of the *CDS Proposal*.[311] This can only occur where the broker acquires an interest in the security, either by purchasing the security for the broker's own account, or where the broker holds the security as pledgee for a margin account client.[312] In the former case, the transferor of the broker's interest would be the selling CDS participant, while in the latter case, the broker's interest as pledgee is acquired from the client.

A number of questions arise concerning the nature of the good faith purchaser's interest in a security held by CDS. Is the interest the same as that of a good faith purchaser who takes actual delivery of a certificate? Is it the same as the interest of a good faith purchaser who obtains constructive delivery of an earmarked certificate under section 78(1)(b) or (c)? The answer to these questions is no.

The interest of a good faith purchaser's interest in a security held by CDS is unique in a number of ways. First, it is an interest in a fungible bulk. According to section 78(3), therefore, the purchaser is the owner of a proportionate property interest in the fungible bulk.[313] As we have already discussed, such a proportionate property interest is intangible property — a chose in action. There is no specific tangible certificate that the purchaser can point to and say, "That is my property."

This has a significant effect upon the rights associated with good faith purchaser status. We have seen that, even with actual possession of a certificate, the good faith purchaser is still vulnerable to an adverse claim based on an unauthorized endorsement, but can obtain complete protection

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311 *CDS Proposal*, *supra*, note 3 at 9.

312 Otherwise, the broker cannot meet the definition of a "purchaser". See *supra*, note 274.

313 Even with the OBCA's introduction of separate definitions for "security", "certificated security" and "uncertificated security", it would seem that "fungible bulk" must refer to a bulk of fungible certificates. Section 61(1), although it does not use the word "fungible", ascribes the quality of fungibility to securities under the OBCA. Section 61(1) refers to "securities" but obviously should refer to "security certificates", as only a certificate could be delivered "in bearer form or registered in the name of the transferee or endorsed to the transferee or in blank."

against adverse claims by becoming the registered owner of the security and obtaining a new certificate.[314] In order for the good faith purchaser of an interest in a fungible bulk to obtain such protection, it would be necessary to first obtain actual delivery of a certificate. Moreover, unless actual delivery is obtained, the good faith purchasers' interest in a fungible bulk is conceptually more vulnerable than that of their counterparts who have actual possession of certificates.

We say **conceptually** more vulnerable because there are a number of auxilliary safeguards that shield most clients from exposure to such risk.[315] In fact, we are not aware that anyone in Canada has ever sustained a loss because of the difference between the property interests of each type of good faith purchaser status. The distinction is important, however, because it demonstrates the difficulty of applying traditional legal concepts to modern securities holding practices.

The good faith purchaser of a security held by CDS need not worry about an adverse claim based on an unauthorized endorsement because CDS (or its nominee) will have become the registered owner and have received new certificates for the securities it holds in fungible bulk. If CDS is a good faith purchaser of those securities, this is complete protection against adverse claims based on an unauthorized endorsement.[316] Even if CDS is not a good faith purchaser, the contractual arrangements between CDS and its participants provide some protection in the event of delivery by CDS of a "Defective

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314 OBCA s. 76.

315 For example, the Canadian Investor Protection Fund has provided protection against losses arising from broker insolvency since 1969. See the discussion under "Investor Protection Funds" commencing at p. 133 of this report. The regulation of brokers by provincial securities commissions also provides considerable protection against the risk of broker insolvency. Our discussion does not purport to be an overall assessment of the relative risks of different methods of holding securities. We acknowledge that, for many investors, the risk of loss or theft of certificates weighs heavily against their taking actual possession of such certificates.

316 It is questionable whether CDS acquires an interest in the securities it holds on behalf of its participants sufficient for CDS to meet the definition of "purchaser". CDS' Depository Service Rule 2.2.4 states that "CDS gives value to the Participant depositing Securities by Crediting the Participant's Securities Account and permitting the deposited Securities to be held in the Depository Service and made available for transactions in the Settlement Services. Therefore, all Securities deposited into the Depository Service at any time are acquired by CDS as a *bona fide* purchaser for value." Rule 2.2.4, by itself, appears to be inadequate because it does not establish that CDS acquires any interest in the deposited securities. CDS' General Rule 1.17 gives CDS a general security interest in some, but not all, securities held by CDS on behalf of its participants.

Security".[317] But what if there is an ultimate shortfall[318] in the fungible bulk held by CDS? In that case, the good faith purchaser's proportionate property interest is less valuable than expected, but the startling aspect of this situation is that there may be a number of other good faith purchasers with identical competing claims to the inadequate fungible bulk.

In our view, these competing claims do not meet the definition of "adverse claim"[319] because the claimants do not assert that any transfer would be unauthorized or wrongful, nor can they claim to be the owner or to have an interest in any specific security. In a sense they are not adverse at all, because they do not contend that any other claimant is not entitled to a proportionate property interest in the fungible bulk — they merely find themselves with similar interests in the inadequate fungible bulk. Whether or not such claims meet the definition of "adverse claim", the critical point is that good faith purchaser status offers no protection against them.

In comparison, a good faith purchaser who receives constructive delivery of earmarked certificates under section 78(1)(b) or (c) is in a superior position. If the earmarked certificates remain in the hands of the broker, the purchaser is their indisputable owner. If the certificates are wrongfully sold or pledged by the broker, the owner may be able to successfully assert an adverse claim.[320] Failing that, the purchaser can still trace in kind, and is entitled to a proportionate claim against the fungible bulk. So, the worst that can happen to this type of good faith purchaser is to fall into the same class as the good faith purchaser of an interest in the fungible bulk.

An even better position is that of the good faith purchaser who obtains actual possession of a certificate, optimally, a certificate registered in their name. This interest is the same as where the certificate is left with the broker,

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317 See CDS' Depository Service Rule 2.1.9.

318 By "ultimate shortfall" we mean a shortfall upon liquidation. Minor discrepancies, including temporary shortfalls, may be expected as an incidence of normal clearing operations, as there are inevitably small irregularities in deliveries to CDS amongst the large volume of daily transactions. CDS has extensive mechanisms to deal with and correct these irregularities promptly as they arise, but it is possible that such irregularities may produce brief fluctuations in participants' interests, similar to that described at p. 105 of this report.

319 OBCA s. 53(1).

320 See the discussion of adverse claims at p. 106 of this report.

except that it takes the responsibility for safekeeping away from the broker. If the good faith purchaser takes actual delivery of a certificate registered in the name of the purchaser, and properly safeguards the certificate, their property interest is unassailable.

(c) Should section 85 convey good faith purchaser status?

In our view, section 85 should not bestow good faith purchaser status upon those who acquire interests in securities held by CDS. As we have seen, the status in this context offers less protection than the same status in a purchaser who takes actual delivery, so to describe them both in the same terms may be misleading. Moreover, good faith purchaser status is also fundamentally incompatible with an interest in a fungible bulk.

Good faith purchaser status is an exception to the shelter principle reflected in section 69(1). The shelter principle dictates that a purchaser normally acquires whatever interest the transferor has to convey, but the implication is also that the purchaser can acquire no greater interest than that held by the transferor.[321] The good faith purchaser exception is manifested in many areas of property law,[322] but its application in the law of securities transfers may be traced to the law of negotiable instruments. The exception, which has been recognized since before 1700, is part of the definition of negotiability.[323] It arises from commercial practices and needs. It has long been recognized that the good faith purchaser should acquire a secure property interest, regardless of defects earlier in the chain of title, in order to achieve commercial certainty in regular transactions.[324] Accordingly, the good faith purchaser may acquire a better title to property than that possessed by the transferor.

The interest of a good faith purchaser has traditionally been in specific, tangible property. Until the 1962 UCC introduced the *bona fide* purchaser of a proportionate property interest in a fungible bulk, the interest of a good faith

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321 The maxim is *nemo dat quod non habet*.

322 See for example s. 27 of the Sale of Goods Act and s. 73 of Bills of Exchange Act.

323 See J.M. Holden, *The History of Negotiable Instruments in English Law* (London: Athlone Press, 1955) at 63-65.

324 The historical development of the law of negotiable instruments is discussed in *Goodwin* v. *Robarts* (1875), 10 L.R. Ex. 337 at 346-58.

purchaser (by whatever name) was in a specific instrument or document in their possession. This may be seen as axiomatic: if commercial certainty requires that a "good faith purchaser" acquire an unassailable property right, that right needs to be distinguishable from every other competing interest, and this is accomplished by obtaining possession of an identifiable instrument. Possession allowed a good faith purchaser to preserve their unassailable interest by safeguarding the instrument, because no one else could successfully advance a competing claim without possession of the instrument.

Deeming the purchaser with a claim against a fungible bulk in CDS to be a good faith purchaser in possession of a certificate cannot accomplish the same thing because deemed possession does not enable the purchaser to safeguard the certificate, or to do anything to prevent someone else from obtaining deemed or actual possession of a certificate from the fungible bulk. In light of this, the good faith purchaser status, as it applies to an interest in a fungible bulk, is rather deceptive since it affords none of the protection associated with that status when it is accompanied by actual possession of a certificate.

No one with a proportionate property interest in a fungible bulk can practically ascertain whether, at any given moment, the bulk is sufficient to meet the claims of every good faith purchaser. If the fungible bulk is inadequate, every other good faith purchaser is a competing claimant. The protection ostensibly provided to such good faith purchasers by section 69(2) is, therefore, illusory.

If we consider the position of clients who have claims against their broker in respect of a fungible bulk held by CDS, we see that the designation of the broker as a holder, the broker's deemed possession and the statement that the book-entry transfer on the records of CDS has the effect of a delivery, are also illusory. These provisions lead directly to the second-class good faith purchaser status.

(d) Inadequate bulks

At this stage we must acknowledge the position that CDS would take in response to the suggestion of an ultimate shortfall in their fungible bulk: "It won't happen." There have not been any problems of this nature with CDS to date, and CDS takes elaborate precautions to ensure that there never will.

Could there be an ultimate shortfall in a fungible bulk held by CDS? Yes. If this occurred, it would most likely be the result of fraud or theft of certificates from CDS.[325]

Our comments on the second-class good faith purchaser status deal only with inherent legal characteristics of property interests in fungible bulks of securities, not with the probability of shortfalls. The security of CDS operations are an entirely separate, and largely irrelevant, issue in this discussion. The key point is that the interest of a CDS participant, like the interest of any customer with a claim against a fungible bulk, is defined by that fungible bulk. As such, it is conceptually different from the interest of a person in possession of a registered certificate, or for whom a broker is holding an earmarked certificate.

This same difference between a tangible property interest and in intangible property interest exists under the ABCA. The problem is that the transfer mechanisms that work very well with tangible earmarked certificates do not translate well when applied to intangible interests in fungible bulks. Securities depositories have not created this problem, but their operations make it an increasingly large problem.

(3) Claims Against Fungible Bulks Upon Insolvency

An ultimate shortfall in a fungible bulk held by CDS is highly unlikely. There has never been a failure of a modern depository or clearing agency. This is not to say that shortfalls in fungible bulks do not occur. They can and do arise in cases of broker insolvency, whether or not the broker is a CDS participant. As noted earlier,[326] one effect of the Canadian Investor Protection Fund has been to obviate court decisions dealing with customer claims upon the insolvency of a broker. Still, broker insolvencies raise

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325 The risk of such fraud or theft can be effectively controlled. The primary risk faced by CDS is not of a shortfall in their fungible bulk of securities, but a shortfall of money needed to fulfill their settlement obligations. If this occurred, it would most likely be in the context of a major market event such as that of October 1987, when there could be large-scale defaults by CDS participants in their settlement obligations to CDS. See *The October 1987 Market Break*, *supra*, note 64 at 10-20, and *Trading Around the Clock: Global Securities Markets and Information Technology*, Background Paper, Congress of the United States, Office of Technology Assessment, July 1990, at 81 n.3.

326 *Supra*, p. 90. See also the discussion under "Investor Protection Funds" commencing at p. 133 of this report.

questions about the legal priorities amongst various claimants. In our view, the existing legislation does not provide satisfactory answers to such questions.

There are almost limitless possibilities for different types of claims against fungible bulks upon insolvency. We will examine a few basic examples to demonstrate some of the issues raised in these situations.[327] In our examples, we will consider the application of the OBCA, but it should be noted that exactly the same issues arise under the provisions of the ABCA or CBCA.

(a) Proportionate property interests

Assume that a broker who is a CDS participant has 3000 shares of A Co. in its CDS account. The broker is the beneficial owner of 1000 of those shares, and the other 2000 shares have been purchased and held for client X. A new client, John Smith, asks the broker to purchase and hold 500 shares of A Co., and on the same day the broker decides to sell 500 of its own shares. The transaction is effected through the TSE.[328] The net effect of the transaction on the broker's account with CDS is nil. A month later, another new client, Jane Doe, asks the broker to buy and hold 1500 shares of A. Co.. On the same day, the broker decides to sell some more shares of A. Co., but as a result of an error in its records (or fraud), the broker purports to sell 1500 shares. Again, the transaction is effected without any change in the broker's account with CDS. Two months later, despite the cash generated by the broker's sales of A. Co. shares, the broker becomes insolvent.

In the broker's account with CDS are 3000 shares of A Co. — the exact amount there should be insofar as CDS is concerned. Unfortunately, the broker's clients' collective claims total 4000 shares.

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327 These examples are loosely based upon a much more detailed and complex example used by Professor C.W. Mooney, Jr. to analyze priorities under the current UCC in "Beyond Negotiability", *supra*, note 283. Professor Mooney's example deals with priorities in a situation involving three levels of intermediaries, competing purchasers and pledgees. Diligent readers will note that our analysis differs slightly from that of Professor Mooney in that his interpretation of Art. 8, applied to Canadian legislation, allows for even more uncertainty in determining priorities upon insolvency.

328 This may be a violation of stock exchange by-laws by the broker, but that is irrelevant to our present discussion.

Can John Smith and client X assert any priority over Jane Doe on the basis that the broker could only have sold her an interest in, at most, 500 shares, based on a *nemo dat* argument?[329] Probably not. None of the clients is a good faith purchaser, because none of them has received delivery. And even though the OBCA does not specify exactly how the interest is transferred, it seems clear at common law that each client has purchased something.[330] Section 78(3) of the OBCA describes that something as a proportionate property interest in the fungible bulk. Jane Doe, probably contrary to her expectations, did not acquire an interest in any specific number of shares. Instead, she acquired a proportionate interest in whatever the fungible bulk happened to comprise, just like John Smith and client X. The result is that they all share proportionately in the inadequate fungible bulk.

The vulnerability of the proportionate property interest in the fungible bulk is demonstrated if we consider a slight variation in the example. Suppose Jane Doe asked the broker for a share certificate two weeks after her purchase. The broker made a request to CDS and received a certificate[331] that was placed in an envelope with Jane Doe's name and account number on it, just before the broker became insolvent. In this situation, Jane Doe is apparently a "good faith purchaser" of the earmarked certificate, so she can demand that certificate, then proceed to become the registered transferee of 1500 shares. None of the broker's other customers would seem able to advance successful claims to those shares. Jane Doe's actions significantly reduced the property interests of others by reducing the fungible bulk. Before Jane withdrew her certificate, John Smith's interest comprised $(500 \div 4000) \times 3000 = 375$ shares. Afterwards, his interest was only $(500 \div 2500) \times 1500 = 300$ shares.

(b) Interests in a non-existent bulk

Now assume that the broker had also purported to purchase 100,000 shares in B. Co. on behalf of a client X, but actually did not purchase the shares and did not, at that time, hold any shares in B. Co. at all. In fact, the

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329 Supported by OBCA s. 69(1) or ABCA s. 56(1).

330 The cases (see *supra*, note 271) do not deal directly with fungible bulks held in depositories, but there is no reason why this extra layer of intermediary should affect the purchaser's rights against the broker to claim a proportionate property interest in the fungible bulk "held" by the broker.

331 In fact, there would probably be 15 certificates representing 100 shares each, but a single certificate simplifies the example.

broker used the purchase money received from client X to pay the broker's outstanding phone bill. Six months later, acting on behalf of client Y, the broker acquired 100,000 shares of B. Co. for client Y. The 100,000 shares of B. Co. are held by the broker in a fungible bulk on the date of bankruptcy.

Does client X have any interest in that fungible bulk? It is clear that client Y provided the money used by the broker to purchase the shares, and it is impossible to trace client X's purchase money to these particular shares. Client Y could argue that, since the broker held no fungible bulk of B. Co. shares at the time, client X could not acquire a proportionate property interest in such a bulk, but is limited to an unsecured claim. Client X cannot claim to be a good faith purchaser. Client Y's argument would be consistent with OBCA section 69(1), *nemo dat* and a strict property analysis: it is impossible for client X to have acquired a proportionate interest in property that did not exist.

Client X must argue for an ownership interest in the fungible bulk of B. Co. shares. Can client X successfully argue that, for the six month period before the broker acquired the B. Co. shares, the broker somehow owed client X 100,000 shares, so that an ownership interest arose instantly when the broker acquired them? This seems unlikely. It seems more probable that client X's true claim against the broker is for breach of contract or conversion of money, with damages measured against the value of 100,000 B. Co. shares. It seems that client X cannot establish any property interest in any shares, and will be an unsecured creditor in the bankruptcy.

But the result is quite different if, at the time client X paid the broker for 100,000 B. Co. shares, the broker happened to be holding 1000 undelivered B. Co. shares for another client. Client X then acquires a proportionate property interest in the fungible bulk of 1000 shares. That interest is not then particularly valuable (999 shares), but it becomes substantially more valuable once client Y contributes 100,000 more shares to the fungible bulk. Client X's ownership interest in the bankruptcy would then be $(100{,}000 \div 201{,}000) \times 101{,}000 = 50{,}249$ shares. It is remarkable that the fortuitous existence of 1000 shares spells the difference between client X receiving 50,249 shares versus 0 shares. Client Y might choose a word other than fortuitous to describe the event: it reduced client Y's claim almost by half.

Fortuitous priorities flow from even the most straightforward circumstances. In light of the broker's conduct that we have already postulated, it would not be surprising if, upon bankruptcy, we discover that there are many other customers for whom the broker purchased or purported to purchase securities and hold them in fungible bulks, but that no such securities are held by the broker at the date of bankruptcy. At common law[332] and under the Business Corporations Acts,[333] these customers are left as unsecured creditors. Is this fair, considering that other customers will be able to successfully assert ownership claims to those fungible bulks that do exist upon bankruptcy? Some of these fortunate customers may even recover their entire claims.

In our view, this is an unfair and undesirable result. All the customers stood in a similar position and took the same risks, yet some will receive nothing, and others may receive their entire claims, depending upon which fungible bulks were dissipated or preserved by the broker. We may justify giving priority to Jane Doe, who requested a certificate because she was not content to bear the risk of allowing the broker to hold her securities in a fungible bulk, over those who were willing to take that risk. But in our view there is no justification for giving fortuitous priorities to some fungible bulk clients over others. When such clients dealt with the broker, they all assumed that their interests were secure, otherwise they would have demanded certificates or dealt with another broker.

It is practically impossible for such clients to check whether the broker is properly maintaining the fungible bulks. Such clients rely upon the broker's financial and moral integrity. Cash account customers have a choice not to rely upon the broker to such a degree, and may demand that their certificates be delivered. Margin account customers have little choice but to rely upon the broker. It is fair to say that all customers perceive that the broker's financial and moral integrity are to some extent backed by the existence of regulatory bodies and regulatory controls. Customers ought to know that regulatory safeguards cannot afford absolute protection, and that the risk of broker insolvency exists. But it is unacceptable, in our view, that customers may suffer the consequences of that risk in such an unequal and random manner.

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332 See *supra*, note 251.

333 Whether or not the broker ever held a fungible bulk on behalf of such customers, at the time of bankruptcy they "own" proportionate property interests in nothing.

(c) Extending the property analysis

If we follow the property analysis carefully, we see that it can produce some astonishing results. In our earlier example where Jane Doe obtained a certificate, John Smith might claim that Jane Doe should never have received 1500 shares, because her proportionate property interest in the fungible bulk only ever comprised $(1500 \div 4000) \times 3000 = 1125$ shares. John Smith could argue that Jane Doe only became a good faith purchaser of 1125 shares, and not the additional 375 shares, because she never became a "purchaser" of those additional shares, or perhaps because she did not give value for them.[334] Clearly the fungible bulk is trust property held by the broker for the clients, so John Smith may try to trace to those 375 shares and recover them from Jane Doe.

In situations where the broker held an inadequate fungible bulk on the date of bankruptcy, customers who recently purchased securities through the broker might check the broker's records to determine whether the fungible bulk ever dropped to zero before they acquired their interests. If it did, they could argue that this effectively extinguished all previous ownership claims, thereby reducing the number of claimants.

If these arguments are sound, their implications are staggering. Every time there is a shortfall in a fungible bulk, or a non-existent fungible bulk, this could diminish or entirely defeat interests defined by and based on such bulks. In order to accurately determine what property interests were actually created, it would be necessary to assess the adequacy of the fungible bulk at the time of every transaction. With a large broker, this task would be incredibly complex, if it is possible at all. The results would spell the end of certainty in securities transactions of this type.

In fact, the practical considerations weigh so heavily against a strict property analysis, we must question whether the court could apply such an analysis even if it wanted to. We have already seen instances where the courts

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334 These arguments seem perverse, but they may both be correct. There is no doubt that Jane Doe's ownership interest in the fungible bulk at no time exceeded the equivalent of 1125 shares, so it seems accurate to say that she was only the "purchaser" of that many shares. Similarly, although she paid the broker a price equivalent to 1500 shares, by agreeing to accept a proportionate property interest in a fungible bulk, she actually agreed to pay such price for the equivalent of 1125 shares, and so gave no value for the additional 375 shares she received with the certificate.

have allowed practical considerations to override the strict application of property and trust principles.[335] As pointed out in *Re Waite Reid & Co. Ltd.*[336] in the context of "sharing the burden of the loan", this type of analysis is an exhausting, often impossible, exercise that would only serve to produce fortuitous priorities among parties where the equities appear to be almost exactly equal. Similar considerations apply in this context.

D. The Need for Reform

The need for reform is obvious. The current legal treatment of transfers of interests in fungible bulks as property interests in such bulks is conceptually flawed, and raises several problems:

- **it is difficult or impossible to sort out the interests of competing claimants in the event of insolvency;**

- **there is a lack of certainty in the interests acquired;**

- **clients have no means of verifying their interests; and**

- **the system produces fortuitous and random priorities.**

The OBCA provisions for deemed delivery, possession and good faith purchaser status cannot overcome these problems because they do not alter the fundamental nature of the property interest held by CDS participants or anyone else with a proportionate property interest in a fungible bulk.

The root cause of all these problems seems to be the attempt by existing legislation to use the same property transfer mechanisms for conceptually distinct types of property. Existing legislation works well when applied to earmarked negotiable certificates. These are tangible property interests. An interest in a fungible bulk of securities held by an intermediary is intangible property, much more closely resembling a debt. But existing legislation attempts to treat such interests as ownership interests in the underlying securities. The transfer of such interests is effected entirely through book-entries, and never by actual delivery to the purchasers. But if a shortfall

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335 See the discussion at p. 89 of this report.

336 *Supra*, note 243 at 242-44.

occurs, the legal rights of each claimant can only be determined by looking behind those book-entries at the imaginary ownership interests to determine priorities.

It is not surprising that there is legal uncertainty within the existing system. It is comparable to treating bank account depositors as having a property interest in the money deposited with the bank.[337] Such a system can function adequately, provided there is no need to sort through property interests upon insolvency. Upon insolvency, the system cannot deal rationally with competing claimants.

This explains why the existing system has been able to operate for so long. There have been no depository insolvencies, and although there have been a number of broker insolvencies, the impact of these has been largely absorbed by the Securities Investor Protection Corporation ("SIPC") in the U.S., and by the Canadian Investor Protection Fund ("CIPF") in Canada.

The need for reform exists notwithstanding the operation of these organizations. They provide some assurance to market participants that, in the event of a broker insolvency, those affected will be treated fairly. Reforms to this area of the law are required for exactly the same purpose. Investor Protection Funds are not a substitute for a rational and predictable system of legal rights for those involved in securities transactions. It is apparent that the securities industry operates on the underlying assumption[338] that brokers and other intermediaries are generally honest and solvent, so that transactions effected through them will produce certain and regular results. It could not operate otherwise. Any uncertainty about the rights of clients or other industry participants arising from common transactions constitutes a threat to this assumption, and needs to be corrected.

RECOMMENDATION 2

Amendments to the existing security transfer provisions of Part 6 of the ABCA are required. Such amendments should not follow the approach suggested in the *CDS Proposal* because that approach

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337 See Mooney, "Beyond Negotiability", *supra*, note 283 at 350.

338 Which assumption is supported by regulatory controls.

contains the same basic conceptual flaw as the existing provisions. The conceptual flaw is the characterization of the property interest of a claimant against a fungible bulk of securities as a property interest in the underlying securities that comprise the fungible bulk.

E. The U.S. Reform Initiative

(1) Revisions to UCC Article 8

Our views on the inadequacy of the current Canadian legal regime governing securities transfers and the need for reform are supported by recent developments in the United States. Although the current version of UCC Article 8 is not identical to either the current OBCA or ABCA, it reflects a more refined application of the same concepts. In the spring of 1991, the National Conference of Commissioners on Uniform State Laws formed a Drafting Committee to Revise UCC Article 8.

The U.S. reform initiative is a response to serious concerns that the existing Article 8 does not adequately deal with current securities holding and trading practices. In the aftermath of the October 1987 "Market Break" and the collapse of Drexel, Burnham, Lambert, it was recognized that there were problems with the Article 8 treatment of interests in securities held by financial intermediaries, particularly in the perfection of security interests in such securities. This led to U.S. federal legislation[339] which gave the SEC the authority to adopt rules overriding state law concerning transfers and security interests in investment securities.[340] This legislation has provided a powerful impetus for reform.

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339 Market Reform Act of 1990, Pub. L. No. 101-432, 104 Stat. 963.

340 See 15 U.S.C. §78q-1(f). Before the SEC may adopt such rules, it must make certain findings, including: that such rule is necessary for the protection of investors or in the public interest; that the absence of a uniform rule substantially impedes the safe and efficient operation of the national system for clearance and settlement of securities transactions; and that the benefits of such rule outweigh any impairment of the rights of those affected. See §78q-1(f)(2)(A).

The Committee has produced a series of drafts for discussion,[341] and it would be premature to treat any part of the draft revisions as being finally settled. In general terms, the basic thrust of the revisions is to retain the existing basic concepts and rules as these apply to transactions in securities registered, payable or endorsed to a specific investor. However, for securities held by an intermediary such as a broker or a depository (referred to by the Committee as the "indirect holding system"), a new concept is being considered: the "securities entitlement".

(a) Securities Entitlement ("SE")

A detailed discussion of the indirect holding system, the SE and its implications are found in the drafts for discussion prepared by the UCC Article 8 Drafting Committee. A comprehensive analysis of the SE will depend upon the specific provisions that govern it, and these are not yet finalized. At this stage, it is enough to recognize the essential characteristics of the SE and see how these characteristics respond to the need for reform.

The SE represents the property interest of a person who holds securities through an intermediary. Such an investor, under the present system, owns a proportionate property interest in a fungible bulk of securities held by the intermediary. The draft revisions to UCC Article 8 contemplate a comprehensive set of rules stating the obligations of intermediaries to their account holders, and rules specifying the rights of account holders in the event an intermediary cannot satisfy all its obligations.

In our view, the SE is the key element of reform in this area. Statutory recognition of the SE as a *sui generis* property claim against the intermediary lays the foundation for rationalizing the law of securities transactions. The SE must be intangible property, but with special rights of priority over general creditors in the event of the intermediary's insolvency. This eliminates any need to attempt to sort through or trace property interests held by the intermediary on behalf of its customers. It allows for a more predictable and equitable treatment of customers' claims than that which occurs under the existing system.

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341 The most recent Draft for Discussion is dated April 1, 1993. These are available from the National Conference of Commissioners on Uniform State Laws, 676 North St. Clair Street, Suite 1700, Chicago, Illinois, 60611.

Moreover, recognition of the SE allows a much more realistic approach to each transaction, by limiting the direct implications of the transaction to just two parties: the investor and the broker being dealt with, for example. Indirectly, of course, each transaction between a client and an intermediary may trigger a series of consequential transactions: between brokers; between brokers and other intermediaries, including depositories and clearing agencies; and between a broker and another investor. Each of these may create a separate SE between the particular parties involved, but all these consequential transactions must be recognized as separate and distinct from the initial transaction between the investor and the broker. Whatever may happen in those consequential transactions, they should not affect the nature of the investor's SE as against the broker. This greatly simplifies the legal effect of each transaction.

(i) Financial assets

Another notable characteristic of the SE is that it can (and should) operate with property which does not meet the strict definition of investment securities. The latest draft revision to UCC Article 8 defines "securities entitlement" in terms of the property interest of a person with respect to a "financial asset" held through an intermediary. Financial assets include investment securities, but also include other types of investment property, such as certain types of derivatives and money market instruments commonly held through intermediaries.[342]

By defining the SE in such terms, it is possible to apply the same rules to all investment property held indirectly. This recognizes that the rules applicable to traditional investment securities may be innappropriate if applied to all investment property.[343] For example, the provisions governing the rights and obligations of issuers of investment securities, transfers by actual

342 See April 1, 1993 Draft for Discussion, §8-102.

343 At one point, the Drafting Committee considered using an expanded definition of "security" to capture certain money market instruments, options and other interests. See §8-103 of the Draft for Discussion presented at the National Conference of Commissioners on Uniform State Laws in San Francisco, July 30 - August 6, 1992. That approach served the same ultimate purpose of allowing broad application of new indirect holding system rules based on the securities entitlement concept. Apparently the Committee felt that the "financial asset" approach is a preferable method of reaching that goal.

delivery, and registration of transfers are not appropriate to derivatives[344] or to various money market instruments.[345] Because such derivatives and money market instruments are generally held in the indirect holding system in much the same manner as immobilized investment securities, it is desirable that they be handled in a consistent manner.

(2) The Need for Uniformity

The U.S. reform initiative has significant impact upon Canada. The Canadian and U.S. securities markets are closely linked, although the U.S. market is obviously much larger. Even before the introduction of the Business Corporations Acts, our laws relating to securities trading tended to follow American law. This tendency became more pronounced as the Business Corporations Acts' provisions governing securities transfers were closely based upon the UCC. The *Dickerson Report* refers to "the obvious need for uniform laws within the North American securities markets", and states: "Clearly it would be preferable for all Canadian jurisdictions ... to adopt a uniform law that adheres as closely as possible to the UCC model. Such co-operation on what is purely a technical as distinct from a policy problem would virtually eliminate very complex arguments based on constitutional powers or conflicts between local laws."[346]

With the globalization of securities markets, the need for uniformity is certainly greater today than ever before, so that it would make little sense for any Canadian province to act unilaterally and introduce a new set of provisions governing the transfer of securities without consideration of the pending revisions to the UCC, and of the intentions of other Canadian jurisdictions. Alberta should consult with other provinces, the federal government, and representatives of the securities regulators and industry to develop reformed, uniform provisions governing the transfer of securities, compatible with the UCC, using the concept of the SE.

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344 Exchange traded options such as puts or calls have no issuer in the usual sense. Instead, the clearing corporation acts as counterparty to every contract.

345 Bankers' acceptances and other single-issue negotiable instruments are governed by UCC Article 3 in the U.S., or the Bills of Exchange Act in Canada, which detail the obligations of drawers, acceptors and endorsers. Such obligations are quite different than would arise under UCC Article 8 or the Canadian Business Corporations Acts.

346 *Dickerson Report*, *supra*, note 97, vol. I at 59-60.

RECOMMENDATION 3

Amendments to Alberta legislation governing securities transfers should be patterned after pending revisions to Article 8 of the Uniform Commercial Code, using the concept of a Securities Entitlement in substitution for the proportionate property interest in securities held in fungible bulk. Alberta legislation should, if possible, be uniform with federal and provincial legislation in this area.

(3) Investor Protection Funds

In considering legislation aimed at compatibility with UCC Article 8, it is important to recognize that the proposed revisions to Article 8 dealing with the rights of holders of securities entitlements upon the insolvency of an intermediary are predicated upon the rights of customers under the Securities Investor Protection Act of 1970 ("SIPA").[347] The SIPA provides a clear mechanism for claims entitlements that can be relied upon by investors to ensure protection against the consequences of intermediary insolvency, and the existence of such protection has strongly influenced the approach taken to Article 8 revisions.[348]

The Canadian Investor Protection Fund ("CIPF") operates on a fundamentally different basis. It is a discretionary trust, and the Governors of the Fund have "sole and complete discretion with respect to any and all payments which are to be made out of the Fund".[349] The CIPF exercises its discretion in accordance with certain policies, and it is not suggested that such

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347 Pub. L. No. 91-598, 84 Stat. 1636 (codified as am. at 15 U.S.C. §§78aaa-*lll).*

348 SIPA protection for customers is an essential component of the "Upper Tier Priority" (UTP) system reflected by the draft revisions to Art. 8. See the discussion of UTP in Mooney, "Beyond Negotiability" *supra*, note 283; the discussion and recommendation of incorporating the UTP concept into the revised Art. 8 in the American Bar Association Section of Business Law "Interim Report of the Advisory Committee on Settlement of Market Transactions" Exposure Draft for Comment, Feb. 15, 1991 at 35-40; National Conference of Commissioners on Uniform State Laws Feb. 5, 1992, Draft Revised Art. 8 at 41; and April 1, 1993 Draft §8-503. See also M.E. Don and J. Wang, "Stockbroker Liquidations Under the Securities Investor Protection Act and Their Impact on Securities Transfers" (1990) 12 Cardozo L.R. 509.

349 See *Pelensky* v. *Alberta Stock Exchange* (1992), 4 Alta. L.R. (3d) 375 (Alta. Q.B.).

discretion has ever been improperly exercised. In fact, it must be emphasized that the CIPF has been very effectively protecting investors since its inception in 1969, and continues to improve the protection offered.

The Fund paid almost $30 million as a result of the insolvency of Osler Inc. in 1987, and has recently doubled its coverage for security losses to $500,000 per account.[350] The Canadian Securities Administrators have proposed a policy (National Policy 49) that would compel almost all brokers to contribute to the Fund.[351]

There remains, however, an important difference between the status of customers under the CIPF and the SIPA. In order to achieve uniformity between Canadian and U.S. legislation regarding securities transfers, it may be necessary to consider changes to the structure of the CIPF. This is not to suggest that the CIPF must be converted into a clone of the SIPA — it may be possible for the CIPF to continue in its present form, but with more formalized rights and procedures available to potential claimants.

F. Conclusion

The existing securities transfer provisions in the ABCA are fundamentally flawed by their unrealistic treatment of the property interests that arise from the use of fungible bulks. This fundamental flaw undermines the amendments contained in the *CDS Proposal* and makes them unsuitable. These provisions need to be reformed.

We emphasize that our rejection of the *CDS Proposal* does not reflect any disagreement with the basic goals of CDS. At the time CDS began pressing for amendments to the ABCA,[352] those amendments were generally compatible with the current version of UCC Article 8.[353] Subsequent events have raised valid concerns about the operation of Article 8, leading to the present U.S.

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350 M. McHugh, "Fund doubles protection on security loss" *The Financial Post* (23 September 1992) 16.

351 D. Kelly, "Brokers pushed to join fund" *The Financial Post* (16 October 1992).

352 CDS' first proposal to the Alberta government was in February of 1985. See *CDS Proposal, supra*, note 3 at 1.

353 It should also be noted that CDS is not solely responsible for the drafting of the existing OBCA provisions, but that CDS has been put in a position where, in order to promote uniformity, it must use the Ontario provisions as the best (i.e. only) Canadian model.

reform initiative. Viewed in this context, it must be recognized that the *CDS Proposal* represents an attempt to achieve uniformity within Canada and compatibility with UCC Article 8. We are in complete accord with these objectives.

We have recommended the development of uniform Canadian legislation based upon concepts used in Draft revisions to UCC Article 8, because these offer 1) a rational legal basis for modern securities transfers; and 2) compatibility with the system being developed in the United States.

In the following chapters, we will discuss some other issues that need to be addressed in the overall reform of this area of law.

CHAPTER 7 — OTHER ISSUES RAISED BY THE PROPOSED AMENDMENTS

A. Introduction

Although we have recommended against adoption of the amendments set out in the *CDS Proposal,* we recognize that some of the proposed amendments raise important issues that need to be addressed as part of an overall reform of this area of the law. This chapter raises and discusses some of those issues.

As we have already observed, the amendments to the ABCA proposed in the *CDS Proposal* would bring the ABCA generally in line with the OBCA as it was before the 1990 consolidation and revision. The 1990 consolidation and revision included some minor changes in the language of some of the sections under consideration, but these changes do not have any substantive effect. In our discussion of the *CDS Proposal* we shall refer to the 1990 version of the OBCA. We shall assume that where the 1990 version has revised sections of the OBCA that formed the basis for the *CDS Proposal,* it is the revised version that has been proposed for use in the ABCA.

B. Issues Raised by the Proposed Amendments

(1) Change in Definition of "Security"

The amendments proposed by CDS include replacement of the existing ABCA definition of "security". The current section 44(2)(n) reads:

> (n) "security" or "security certificate" means an instrument issued by a corporation that is
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> (i) in bearer, order or registered form,
>
> (ii) of a type commonly dealt with in on securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment,
>
> (iii) one of a class or series or by its terms divisible into a class or series of instruments, and
>
> (iv) evidence of a share, participation or other interest in or obligation of a corporation;

The proposed replacement sections are identical to portions of OBCA section 53(1):

> "security" means a share, participation or other interest in property, rights or an enterprise of an issuer, or an obligation of an issuer, or any right to acquire such a share, participation, interest or obligation, of a type commonly dealt in upon securities exchanges or markets or commonly recognized as a medium for investment in any area in which it is issued or dealt in;
>
> "security certificate" means an instrument in bearer, order or registered form, issued by an issuer evidencing a security.
>
> "uncertificated security" means a security, not evidenced by a security certificate, the issue and any transfer of which is registered or recorded in records maintained for that purpose by or on behalf of the issuer.

These provisions were introduced to the OBCA in 1986. There are a number of issues arising from the proposed definitions. We will attempt to deal with these separately.

(a) "Uncertificated securities"

(i) Definition of "uncertificated security"

The provisions for transfer of an uncertificated security proposed as section 70.2 are virtually identical to OBCA section 85, portions of which are as follows:[354]

> (1) If a security shown in the records of a clearing agency is evidenced by,
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> ...
>
> (b) an uncertificated security registered or recorded in records maintained by or on behalf of the issuer in the name of the clearing agency or a custodian or of a nominee of either, subject to the instructions of the clearing agency,
>
> then, in addition to other methods, a transfer or pledge of the security or any interest therein may be effected by the making of an appropriate entry in the records of the clearing agency.
>
> ...

[354] OBCA s. 85 is set out in its entirety at p. 111 of this report.

(3) A transfer or pledge under this section has the effect of delivery of a security in bearer form or duly endorsed in blank representing the amount of the obligation or the number of shares or rights transferred or pledged.

(4) If a pledge or the creation of a security interest is intended, the making of entries has the effect of a taking of delivery by the pledgee or a secured party and the pledgee or secured party shall be deemed to have taken possession for all purposes including the purposes of the Personal Property Security Act.

(5) A person depositing a security certificate or an uncertificated security with a clearing agency, or a transferee or pledgee of a security under this section, is a holder of the security and shall be deemed to have possession of the security so deposited, transferred or pledged, as the case may be, for all purposes, including, if a pledge or the creation of a security interest is intended for the purposes of the Personal Property Security Act.

(6) A transfer or pledge under this section does not constitute a registration of transfer under sections 86 to 90.

...

We have a number of concerns with these provisions.

(ii) A flawed definition

Since a transfer of an "uncertificated security" under section 85 does not constitute a registration of transfer, how can the references to "uncertificated security" in section meet the definition in section 53(1), which requires that "... **any** transfer of which is registered or recorded in records maintained for that purpose by or on behalf of the issuer"? On a plain reading, they cannot meet such a definition, with the result that the provisions may provide no statutory basis for the transfer of an "uncertificated security" as defined. The proposed definition of "uncertificated security" may be contrasted with that in UCC §8-102(1)(b), which uses "the" instead of "any". The UCC definition[355] serves to require that all "uncertificated securities" be issued in registered form. For the purpose of our further discussion of the existing OBCA provisions and the amendments proposed for the ABCA, we shall assume that the definition uses "the" instead of "any".

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355 The UCC definition is capable of, but does not require and has never been given, the same problematic interpretation as the OBCA definition. An improvement might be for the definition to provide that the transfer "may be registered or recorded in records maintained for that purpose by or on behalf of the issuer" instead of "is registered".

(iii) Transfers of uncertificated securities outside a clearing agency

OBCA section 85(5) refers to the deposit of an uncertificated security with a clearing agency. How can an uncertificated security be deposited with a clearing agency as provided by section 85(5) when no mechanism exists for the transfer of uncertificated securities except when they are already registered or recorded in the name of a clearing agency pursuant to section 85(1)(b)?

CDS has suggested that OBCA section 86 (and ABCA section 71) can be interpreted broadly enough to allow issuers to register transfers of uncertificated securities. We cannot agree. Those sections refer to a security "presented for registration of transfer", which can only refer to a security certificate.

CDS points out that the sections are not exclusive, and that an issuer may register a transfer under circumstances other than those specified. It is true that an issuer can register any transfer it chooses, but of course it does so at its own risk, without any of the protection available to the issuer under the existing statutory provisions. We believe, however, that it is an error to amend legislation to provide for a specific mechanism for the transfer of uncertificated securities in the custody of a clearing agency, but at the same time to allow the legislation to implicitly recognize some other unspecified means of transferring such securities outside a clearing agency.

This same error appears in the reference to "other methods" of transferring or pledging uncertificated securities in OBCA section 85(1). If no "other methods" are to be provided for in the legislation, then in our view the legislation should contain no references to them.

Further, we do not see any reason why uncertificated securities outside a clearing agency should be transferable, unless the legislation is intended to accommodate transfers of dematerialized securities. Uncertificated securities of the type allowed by ABCA section 45(1) or similar provisions in the OBCA or CBCA, if they are registered to anyone other than a clearing agency, are probably in uncertificated form as a means of safekeeping. This would be an illusory form of safekeeping if the securities could be effectively transferred in that form.[356] It seems to us more sensible to require that such securities be converted to their certificated form in order to be transferred on the books of the issuer. The question of whether or not such securities should exist at all will be addressed below.[357]

(iv) Dematerialized uncertificated securities

On the other hand, if the legislation is to accommodate dematerialized securities, then it must provide for the transfer of such securities outside clearing agencies. Otherwise, such securities could not be transferred to clearing agencies, or directly between parties. The 1977 revisions to Article 8 of the UCC contain specific provisions for the transfer, pledge or release from pledge of dematerialized securities,[358] either within or outside a clearing agency. These provisions are in the process of being revised again.

We have assumed that the amendments proposed by CDS are not intended to accommodate transfers of dematerialized securities because there is no mechanism provided for such transfers outside of a clearing agency. The important question is whether or not Alberta legislation should accommodate transfers of dematerialized securities. There is no need, at this time, to consider whether ABCA corporations should be empowered to issue

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356 It is possible to speculate almost endlessly about the methods by which an uncertificated security could be transferred outside of a clearing agency, but such methods would seem unlikely. Under ABCA s. 45(1), for example, the registered owner of the security will have received a non-transferable written acknowledgement ("NOTWRACK"). It is inconceivable that the issuer would register a transfer without retrieving the NOTWRACK, and obtaining some form of written authorization from the registered owner. Because the NOTWRACK may have been lost or stolen, and because the written authorization may be forged, the prudent issuer would require some assurance or guarantee that the authorization is genuine. The most sensible approach for the issuer would be to issue a certificate to the would-be transferor, so that the issuer could rely upon the protection afforded by ABCA ss 71-75, which substantially limit the issuers' potential liability for wrongful registration of transfer at common law (see the Official Comment to UCC §8-401). The only circumstance where a prudent issuer would ordinarily forego such an approach is where it is dealing with a clearing agency such as CDS. CDS advises us that, as a security measure, it never delivers out any certificates registered to CDS or its nominee. When a participant requests a certificate, CDS obtains one in the name of the participant. If CDS happened to be holding the securities in uncertificated form, it is conceivable that it could provide the issuer with sufficient assurances, based upon its size and stability, to convince the issuer to issue a new certificate in the name of the withdrawing participant, without the intermediate step of issuing a certificate to CDS or its nominee.

357 See the discussion of ABCA s. 45(1) commencing at p. 142 of this report.

358 See for example UCC §§8-308, 8-313, 8-320 and 8-401.

dematerialized securities. In fact, it would be unwise to consider this latter question until the new revisions to UCC Article 8 are completed and assessed.

It is possible to introduce amendments that would accommodate the book entry transfer and pledging of dematerialized uncertificated securities without introducing any provisions authorizing Alberta corporations to issue such securities. This would allow Albertans to buy, sell and pledge such securities in Alberta. In the U.S., a number of states have adopted the provisions of revised Article 8 of the UCC without authorizing local corporations to issue uncertificated shares.

Although it may seem to be fundamentally incongruous to have transfer and pledge provisions for dematerialized securities without having authorized their issuance by Alberta corporations, we should not ignore the trend towards globalization of securities markets. Albertans may now buy, sell and pledge securities that are listed on foreign exchanges almost as easily as they deal with securities listed on Canadian exchanges. We must recognize that Albertans will be dealing with dematerialized securities issued in other jurisdictions regardless of whether or not Alberta corporations are authorized to issue similar securities, and regardless of whether or not Alberta law provides any mechanisms governing their transfer or pledge. Viewed in this way, there is no reason why Alberta should not introduce such provisions. The actual provisions should be patterned after those in the upcoming revised UCC Article 8.[359]

RECOMMENDATION 4

The amended legislation should include provisions dealing with the transfer of dematerialized securities.

(v) Should ABCA section 45(1) be repealed or amended?

Section 45(1)[360] entitles a security holder to opt for either a security certificate or a non-transferable written acknowledgement ("NOTWRACK") of

[359] Questions of jurisdiction and conflicts relating to transfers of dematerialized (and other) securities are dealt with commencing at p. 207 of this report.

[360] CBCA s. 49(1) and OBCA s. 54(1) are practically identical to ABCA s. 45(1).

the right to receive a security certificate. Essentially, it gives a dual identity to securities issued pursuant to the Business Corporations Acts, allowing them to be either certificated or uncertificated at the option of the holder. For the purposes of this discussion, we may conveniently refer to them as "COP" (certificate-optional) securities. We feel that consideration should be given to either the repeal or amendment of ABCA section 45(1), although it is not clear which route is preferable.

The primary argument supporting repeal of this provision is that it would end confusion between "uncertificated securities" of this type and dematerialized securities issued in the U.S. and elsewhere. Since we have recommended that Alberta should have legislation dealing with the transfer of dematerialized securities, we feel that this argument is almost compelling. There appears to be no equivalent to ABCA section 45(1) in any corporate legislation outside Canada, and the peculiar nature of COP securities can complicate any attempt at uniform securities transfer legislation.

In November, 1992 CDS implemented its Non-Certificated Inventory ("NCI") Project.[361] The NCI facility uses "uncertificated securities" of the type provided for in ABCA section 45(1) or equivalent provisions in the OBCA or CBCA, and thus relies upon such provisions. There are undoubtedly advantages to CDS in using these provisions to reduce the need for safekeeping and handling of certificates. It is not clear just how valuable those advantages will be, but they may be significant in light of the large scale of depository operations.

The argument in favour of retaining the general concept of section 45(1) is that it offers unique advantages. As a means of safekeeping for smaller investors, it is clearly the best available. There is none of the cost associated with holding through an intermediary and no risk of the insolvency of an intermediary. The registered owner will also receive shareholder communications directly from the issuer. For an individual investor who wanted to use the section as a means of safekeeping, the alternative would be to allow an intermediary to hold the securities. With improvements to the Canadian Investor Protection Fund,[362] it would be fair to say that most

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[361] See *CDS Proposal*, *supra*, note 3 (Addendum) at 2-3, and CDS First Quarter Report, Jan. 31, 1993.

[362] See the discussion commencing at p. 133 of this report.

individual investors would be as well, or better, protected with their securities held by an intermediary. In that case, one possibility might be to amend the provision so that it could only be used by depositories and clearing agencies, who are in a better position take advantage of it.

Complications in achieving uniformity of securities transfer legislation may be difficult, but not impossible, to overcome. Issues and potential reforms relating to shareholder communications and the risk of holding through intermediaries are discussed in detail elsewhere in this report. The advantages currently offered by section 45(1) must be weighed against the outcome of potential reforms in those areas.

If section 45(1) is to be retained, it must be amended because its present wording is unsatisfactory.

One problem with the existing section arises from its use of the term "holder" to describe the person entitled to this option, as well as the person who has exercised this option. Since "holder" is defined as a person in possession of a security certificate, it is clearly contradictory to refer to a NOTWRACK of a person's right to obtain a security certificate in respect of securities "held" by that person.

Also, in granting the option to a "holder" the existing section seems to require registered owners of securities to first obtain possession of certificates before exchanging them for non-transferable acknowledgements. With non-registered securities, this requirement is logical because only a holder in actual possession of a security would be in a position to surrender the security to the issuer in exchange for a non-transferable acknowledgement. With registered securities, however, persons who wish to exercise their option to obtain a NOTWRACK will often do so at the same time as they become registered as owners of the securities. Such persons want to receive the NOTWRACK instead of a security certificate, but the existing provision seems to require that they first obtain possession of the certificate (to become a "holder"), then exchange it for the non-transferable acknowledgment. This seems to be an unnecessary step, except for the fact that under ABCA sections 59(1) and 64, the receipt of a new security by a *bona fide* purchaser for value is necessary in order to preclude an adverse claim based on an unauthorized endorsement, and to limit the warranties given to the issuer on registration of transfer.

We therefore feel that, if section 45(1) is to be retained, it should be redrafted to eliminate the contradictory use of the term "holder". Amendments to other sections would also be necessary to give a registered owner with a NOTWRACK the same protection against adverse claims based on unauthorized endorsements as if the owner were the holder of a new certificate.

RECOMMENDATION 5

ABCA section 45(1) should be repealed or amended.

(b) The deletion of current ABCA section 44(2)(n)(iii)

The current section 44(2)(n)(iii) requires that a "security" or "security certificate" be:

> (iii) one of a class or series or by its terms divisible into a class or series of instruments,

This requirement is not included as part of the definition of "security" proposed by CDS. The reason for its deletion is set out in the *CDS Proposal* as follows:

> A number of securities likely to be made eligible for the BBS [book-based system] would not necessarily conform to this definition. For instance, we have indicated that CDS is creating a system for the clearing of transactions in money market instruments. In some cases, these instruments are issued individually and it would be difficult to argue that they are one of a class or series. It appears that the more important part of the definition is the functional one requiring that the security be of a type dealt in upon securities exchanges or markets. The proposed change would emphasize the fact that the definition of a security is functional.[363]

We have considerable difficulty accepting this reasoning, and find it to be in error.

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363 *CDS Proposal*, *supra*, note 3 at 7.

(i) The function of section 44(2)(n)(iii)

For the moment, we shall leave aside the question of whether or not the proposed definition successfully captures individually issued money market instruments. What else is captured by the definition? We have not exhausted all the possibilities in this area, but even a brief exploration of the limits of the proposed definition reveals a problem.

If we look at the background of section 44(2)(n)(iii), we find that this provision was modelled after the original 1952 UCC definition of "security" in §8-102(1)(a)(iii). The UCC definition has been revised since then but this particular requirement of the definition remains essentially unchanged. When the UCC adopted a definition of "uncertificated security" in 1977, it retained this particular requirement but dropped the requirement that such securities be "commonly recognized ... as a medium for investment". This was done because it was felt that the omitted language might otherwise bring interests such as bank chequing and savings accounts within the scope of the definition.[364] Unfortunately, the definition proposed by CDS would likely include such interests.[365]

This may be seen by examining the operation of the comparable provisions of the OBCA.

All Schedule I and Schedule II banks under the Bank Act[366] are bodies corporate. Thus, we may safely assume that most, if not all, banks meet the criteria in OBCA section 53(1) to qualify as "issuers". Chequing and savings account deposits constitute debts owed by the bank, and are thus "an obligation of an issuer", and are everywhere "commonly recognized as a medium for investment" within the meaning of OBCA section 53(1), defining "security". Although there would be no documents issued in connection with a bank savings or chequing account which would meet the definition of "security certificate" in section 53(1) because such documents are not "in bearer,

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364 See UCC §8-102, Official Reasons for 1977 Change and Official Comment.

365 The *CDS Proposal* does not include a proposed amendment to the definition of "issuer" in ABCA s. 44(1)(k). That definition ought to be amended to refer to a "body corporate" instead of a "corporation", as discussed at p. 207 of this report. With such an amendment, the definition of "security" proposed by CDS would operate like the existing OBCA definition.

366 S.C. 1991, c. 46.

order or registered form", the accounts do meet the definition of "uncertificated security" in section 53(1) because the bank's records will reflect all account activity. These same considerations would apply to other deposit-taking bodies such as trust companies and credit unions.

We are aware of no jurisdiction other than Ontario which uses such a definition of "security". What is the effect of savings and chequing accounts falling within the proposed definition of "security"? We don't know. The provisions governing transfers of securities are alien and inappropriate to savings and chequing accounts. The issue has not yet been raised in Ontario, and it is not necessary, in our view, to speculate on what might happen if a court was called upon to deal with this issue. It is sufficiently clear that the proposed definition is flawed and that it is not desirable to include chequing and savings accounts within the definition of "security".

More importantly, the stated purpose of the amendment — to make the transfer provisions of the ABCA applicable to individually issued money market instruments — may not be possible by way of provincial legislation. This issue is discussed in detail in the next chapter.

(c) Book Entry Only ("BEO") Securities

BEO securities are a fast-growing type of security[367] that present an interesting example of the innovative developments within the securities industry, and consequential legal anomalies.

They are generally debt securities, represented by a single global certificate issued to a depository, and according to the terms of their issue no certificate is generally available to any other person. All transfers or pledges are transacted through a depository participant on the records of the depository. As investors become more comfortable holding securities through intermediaries, more issuers are likely to take advantage of this inexpensive method of issuing securities.

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367 Issuers distributed $325 billion in BEO securities through DTC in 1990. See DTC Annual Report, 1990 at 25.

Although some BEO securities do contain provisions authorizing the issuance of individual securities under extreme circumstances,[368] some do not. These "true" BEO securities make it legally impossible for anyone other than the clearing agency to ever be recognized as the security holder by the issuer.[369] Even with those BEO securities that contain contingency provisions for the issuance of individual securities, there will under normal circumstances be no entitlement to certificates.

The legal anomaly is that BEO securities are probably not "securities" as defined in the various legislation. They seem clearly not to meet the definition in ABCA section 44(2)(n)(iii) because they are not "... one of a class or series or by its terms divisible into a class or a series of instruments ...". This same definition appears in the CBCA. The OBCA definition used to be the same but it was changed in 1986 to delete this particular requirement (apparently at the request of CDS).

Unfortunately, the amended OBCA definition still does not capture all aspects of BEO securities. It would seem to capture the single "security" issued by, say, ABC Co. to the depository, but it does not seem to capture the fractional interests allocated to and traded amongst depository participants. Those fractional interests are not any kind of share, participation, interest in or obligation of ABC Co. — they are claims by participants against the depository. These claims meet the definition of "security" only if they are viewed as being "issued" by the depository. They appear to be dematerialized securities: interests in the property or rights of the depository.

Consequently, with a true BEO security, there are always two separate and distinct issuers. First, the BEO security is issued to the depository by, say, a municipality. Secondly, the depository "issues" interests, not in its BEO security, but claims against the depository defined in terms of the BEO security, which interests are traded amongst various customers.

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368 Typical circumstances would be if DTC or CDS became unable or unwilling to continue to act as depository.

369 It has been suggested that no "true" BEO securities held by any U.S. depository. See E. Guttman, "Transfer of Securities: State and Federal Interaction" (1990) 12 Cardozo L.R. 437 at 449. We are advised by CDS that it does hold such securities. See, for example, the Offering Circular dated June 25, 1991 regarding Export Development Corporation (An agent of Her Majesty in right of Canada) U.S. $75,000,000, S&P 500 Protected Index Notes Due 1997; and Canada Trustco Mortgage Company Term Deposit Receipt Number 2, Issue Date: Sept. 13, 1990, Maturity Date: Sept. 20, 2089, Principal Sum $500,000,000, CUSIP No. 135282AB7.

Existing legislation leaves an undesirable degree of uncertainty surrounding BEO securities, which needs to be addressed.

There are several possible methods of dealing with this. One is to expand the definition of "security" to encompass both the global certificate and the interests issued by the depository. Another is to amend the definition of "security" to include the global certificate, and to authorize and regulate the issuance of securities by depositories. The simplest solution available within the existing legislative format would be for regulators to prohibit the issuance of "true" BEO securities, and to require that all BEO securities contain contingency provisions allowing the issuance of individual certificates. Such contingency provisions will practically never arise, so they should not interfere with the inherent advantages of BEO securities.

The best solution, in our view, would be to reform the securities transfer legislation as we have recommended, using the SE concept defined in terms of a property interest in relation to a financial asset.[370] This approach provides the most rational and flexible method of dealing with BEO securities and trades in partial interests in securities generally.

(2) Securities Held by the Depository

OBCA section 85(1), which is identical to proposed ABCA section 70.2, limits its application to certificated securities shown in the records of a clearing agency "in the custody of the clearing agency or a custodian or of a nominee of either, subject to the instructions of the clearing agency", or to uncertificated securities registered "in the name of the clearing agency or a custodian or of a nominee of either, subject to the instructions of the clearing agency".

In the OBCA, "custodian" is defined in section 53(1) to mean "a person acting as a custodian for a clearing agency". The definition proposed for ABCA section 44(2)(ddd) is broader, but no more helpful: "a person acting as a custodian for a clearing agency or for any such custodian".

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370 See the discussion under "Securities Entitlement" and "Financial assets" commencing at p. 130 of this report.

We are concerned that neither the OBCA, nor the proposed ABCA provisions deal explicitly with securities in the custody of another clearing corporation. Some provision is needed to cover securities held pursuant to the interface agreements between depositories. UCC §8-320(1) refers specifically to securities in the custody of another clearing corporation. If "custodian" is intended to cover this situation, then it ought to be more clearly defined.

CHAPTER 8 — CONSTITUTIONAL JURISDICTION AND CONFLICTS

A. Introduction

There are many different kinds of investment securities and issuers. To some extent, it is impossible to avoid having different transfer provisions for different types of securities.[371] Unfortunately, in Canada we seem to have an overabundance of transfer provisions for securities, with resulting confusion and constitutional disputes over which provisions are applicable. This chapter will discuss the variety of statutory transfer provisions and the problems they create.

B. Overlapping Statutory Provisions

Before addressing particular issues of constitutional jurisdiction, it is useful to examine the various statutory provisions that may apply to particular transactions. In some instances, there is confusion over which statute applies, quite aside from any consideration of constitutional jurisdiction. We will discuss a number of examples that demonstrate areas where statutes may overlap.

(1) Shares

In Canada, a corporation may be created pursuant to a provincial corporations statute (such as the ABCA or OBCA), the federal corporations statute (CBCA), a specific federal statute (such as the Bank Act),[372] or a specific provincial statute (such as the Alberta Opportunity Company, created by the Alberta Opportunity Fund Act).[373] Some corporations are created under one statute but also be specifically governed in some respects by a separate statute (such as Pacific Western Airlines Corporation, a corporation continued under the ABCA but whose shares are subject to the Pacific Western Airlines Act).[374] As a result, it is sometimes difficult to discern what statutory provisions are applicable to the transfer of shares in any given situation.

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371 We have seen, for example, that uncertificated securities cannot be "delivered".

372 *Supra*, note 366.

373 R.S.A. 1980, c. A-34.

374 S.A. 1983, c. P-0.5.

For example, both the CBCA and OBCA contain provisions governing the transfer of a "security". The CBCA definition of "security" captures only those shares issued by a corporation incorporated under the CBCA,[375] but the definition of "security" in the OBCA is more expansive, applying to shares issued by any body corporate including those incorporated under the CBCA.[376] Assume that a CBCA corporation, with its share register in Toronto, has its shares listed on the TSE, and that a prospective buyer and seller, both resident in Toronto, place orders through a Toronto broker for 100 shares in the stock of that CBCA corporation. All parties have agreed that the law of Ontario will apply to the transfer. Which statute governs the transaction?

The answer is not clear. Perhaps both apply. The law of Ontario includes applicable federal and Ontario legislation. If we assume that both statutes' provisions are constitutionally valid, then the doctrine of paramountcy will not operate unless there is a conflict between the two provisions. Whether or not such a conflict exists is a nice question,[377] but if it does, then the CBCA would clearly prevail.

The same considerations would apply to the transfer in Ontario of shares in a bank subject to the Bank Act. Since the recent revision of the Bank Act included the addition of book-entry transfer provisions practically identical to those in the OBCA, there would almost certainly be no conflict to trigger the operation of the paramountcy doctrine.

As observed by Crawford and Falconbridge, "... there is still the fact of significant duplication of legislative provisions which, although somewhat confusing, does not seem to have caused any serious problems yet."[378] The lack of problems in this area may be explained largely by the lack of significant conflict between the various legislation, and also by the general

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375 See the definitions of "corporation" in s. 2(1) and of "security" in s. 48(2).

376 See the discussion at p. 207 of this report.

377 Without pretending to have dealt with the point exhaustively, we suspect that no conflict exists. The provisions of each Act are very similar, with the major exception that the OBCA contains provisions intended to accommodate book-entry transfers. The book-entry transfer provisions clearly do not purport to bind the issuer, so there is no express contradiction between the provisions.

378 *Banking and Bills Of Exchange, supra*, note 139 at 178-79.

aversion of major securities market participants to engage in disputes over such matters.[379]

But what if there is a clear conflict? As between valid federal and provincial legislation, the doctrine of paramountcy would dictate that the federal legislation would prevail. As between valid provincial legislation, the issue is not so simple. Strictly speaking, the legislation of two different provinces cannot overlap, but a securities transaction may involve several discrete steps, with the law of separate jurisdictions being applicable to each step. Where those laws conflict, the outcome may be troubling to the transacting parties.

Consider a hypothetical example where the shares of an Alberta corporation were purportedly transferred between two persons in Ontario, and there was a definite conflict between Ontario and Alberta law regarding the transfer. Assume that under Alberta law, the transfer would be unlawful, but that the transfer is legal in Ontario.[380] In this situation, it seems clear that, as between the transacting parties, the transfer is effective because Ontario law is the proper law of their contract. If we assume that the transaction involved the delivery of a share certificate, then this translates into the purchaser having legally acquired title to the certificate in Ontario. However, as between the purchaser and the Alberta corporation, the law of Alberta will apply, and the purchaser may be unable to become registered as transferee of the shares on the records of the corporation in Alberta. Even if the corporation had a securities register in Ontario and the purchaser was able to compel registration there under Ontario law, Alberta law could overrule such registration. This is

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379 Securities market participants have an obvious vested interest in supporting the stability and reliability of the fundamental mechanics of transactions.

380 This type of situation arose regularly in cases involving the expropriation of enemy property during wartime. See *Brown, Gow, Wilson et al.* v. *Beleggings-Societeit N.V.* (1961), 29 D.L.R. (2d) 673 (Ont. H.C.); *Braun* v. *The Custodian*, [1944] 3 D.L.R. 412 (Ex.), [1944] 4 D.L.R. 209 (S.C.C.), and the discussion accompanying note 528, *infra*. In peacetime, this situation could arise as a result of the application of statutory shareholder constraints such as those found in Part 3 of the Alberta Energy Company Act, *supra*, note 103. Those provisions restrict shareholdings by non-residents of Alberta, and state that the Company shall refuse to register certain transfers of shares to non-residents. See also the discussion of constrained shares generally in Chapter 11 of this report.

consistent with the effect of OBCA section 60.[381] Fortunately, situations like this seldom arise.[382]

There are obviously significant advantages to having uniform provisions governing transfers of all types of investment securities. Uniformity eliminates any concern over conflicts or paramountcy. These advantages have apparently been recognized by the federal government as reflected by the recent revisions to the security transfer provisions of the Bank Act,[383] making them similar to those of the OBCA. Parallel revisions to the security transfer provisions have also been recently introduced in the Trust and Loan Companies Act,[384] Insurance Companies Act,[385] and the Cooperative Credit Associations Act.[386] Although it seems clear that the model used is in need of reform, the movement towards uniformity is certainly laudable.

(2) Debt Securities

The situation with debt securities is more difficult. It is severely complicated by the existence of the Bills of Exchange Act.[387] A significant proportion of debt securities are either bills or notes as defined by the Bills of Exchange Act, which includes very comprehensive provisions regarding their transfer.

A number of statutes deal specifically with this overlap. Section 53(2) of the OBCA states:

> This Part does not apply to a promissory note or bill of exchange to which the *Bills of Exchange Act* (Canada) applies.

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381 See the discussion of "Conflicts re: issuers" at p. 209 of this report.

382 With respect to conflicts due to the application of statutory constraints on shareholdings, it may well be that such situations would arise more frequently if there existed more effective methods of checking for compliance with the constraints. See the discussion of constrained shares in Chapter 11 of this report.

383 *Supra*, note 366.

384 S.C. 1991, c. 45.

385 S.C. 1991, c. 47.

386 S.C. 1991, c. 48.

387 R.S.C. 1985, c. B-4.

Section 83(1) of Bank Act[388] provides that:

> A security is a negotiable instrument but, in the case of any inconsistency between the provisions of the *Bills of Exchange Act* and this Act, this Act prevails to the extent of the inconsistency.

Provisions identical to those in the Bank Act are found in the Trust and Loan Companies Act, Insurance Companies Act, and the Cooperative Credit Associations Act.

No similar provision is found in the ABCA or the CBCA. With respect to the ABCA, one explanation for the lack of such a provision is the fact that provincial legislation cannot apply to this area even if it purported to.[389] With respect to the CBCA, it originally contained, in section 44(3), a provision quite similar to section 83(1) of the Bank Act, but that portion dealing with conflict with the Bills of Exchange Act was deleted in 1978.[390]

This creates a unique and difficult situation that does not exist with respect to transfers of shares — two overlapping and conflicting pieces of legislation of concurrent jurisdiction.

Conflicts between the CBCA and the Bills of Exchange Act are discussed in some detail in the current edition of Crawford and Falconbridge.[391] They note that there are serious conflicts between the CBCA and the Bills of Exchange Act on many important points relative to negotiable bills and notes issued into the money market by CBCA corporations.[392] Their conclusion is that although there are some principles of statutory interpretation that favour application of the CBCA, such application would create significant confusion because it would produce a situation where virtually identical instruments

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388 *Supra*, note 366.

389 Crawford and Falconbridge, *supra*, note 139 at 1223 n.2, citing *Duplain* v. *Cameron* (1961), 30 D.L.R. (2d) 348 (S.C.C.).

390 See S.C. 1974-75-76, c. 33, s. 44(3), substituted by S.C. 1978-79, c. 9, s. 18(3).

391 *Supra*, note 139 at 1223-25.

392 *Ibid.* at 1224. The effect of forgery by an employee is the only conflict specifically mentioned there, but there are others discussed at 180-81 in the context of comparable provisions of the previous Bank Act. One conflict that seems particularly noteworthy relates to liability of an endorser. CBCA s. 65(8) provides that endorsers generally do not assume any liability, whereas s. 132 of the Bills of Exchange Act imposes significantly more onerous obligations upon endorsers.

issued by CBCA and OBCA corporations would be governed by entirely different statutory regimes. Accordingly, they conclude that the courts would be reluctant to create such confusion and that the Bills of Exchange Act provisions would be applied in the event of a conflict. They further recommend that parliament deal with this issue and resolve it in favour of application of the Bills of Exchange Act.

Although the arguments advanced in Crawford and Falconbridge are persuasive, recent developments suggest strongly that their conclusion is wrong. Crawford and Falconbridge note that the Bank Act (as it was in 1986) did not apply to negotiable bills and notes issued by banks, only to bank shares and bank debentures,[393] so that the Bills of Exchange Act would apply to such bills and notes issued by banks. The recent revisions to the Bank Act, effective June 1, 1992, give its transfer provisions (which are practically identical to those of the OBCA) much wider application, including application to some negotiable bills and notes issued by banks.[394] The Trust and Loan Companies Act, Insurance Companies Act, and the Cooperative Credit Associations Act all contain provisions similar to the Bank Act. In the result, the transfer of a negotiable bill or note issued by an OBCA or ABCA corporation would be governed by the Bills of Exchange Act, but similar instruments issued by banks, insurance companies, etc. may be governed by

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393 *Ibid.* at 1223. The definition in s. 75(2) of the former Bank Act stated:

> "security" or "security certificate" means an instrument that is issued by a bank as evidence of a share or other interest in the capital stock of the bank or as a bank debenture of the bank;

394 This change is effected through a broader definition of "security" in s. 81:

> "security" or "security certificate" means an instrument issued by a bank that is
> (a) in bearer, order or registered form,
> (b) of a type commonly dealt in on securities markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment,
> (c) one of a class or series or by its terms divisible into a class or series of instruments, and
> (d) evidence of a share, participation or other interest in or obligation of a bank,
> but does not include an instrument evidencing a deposit;

This broader definition will capture some, but not all, negotiable bills and notes issued by banks. Some negotiable bills and notes will not meet the requirements of sub (b) and others will not meet those of sub (c). See the discussion of the significance of sub (c) commencing at p. 146 of this report.

the transfer provisions of their corresponding statutes, which are essentially identical to those of the OBCA.

This is definitely a confusing situation, not consistent with the need for certainty in commercial transactions, but since the Bank Act and similar statutes provide specifically that their provisions prevail in the event of any inconsistency with the Bills of Exchange Act, it seems clear that parliament accepts the application of two different legal regimes to the transfer of similar instruments.

These developments substantially negate the cogent arguments advanced in Crawford and Falconbridge. In light of the confusion already arising from the operation of the revised Bank Act and similar statutes, there is no reason to believe that the courts would resist applying the CBCA transfer provisions over those of the Bills of Exchange Act with respect to negotiable bills and notes issued by CBCA corporations, notwithstanding that this would add to the confusion.

One position taken by Crawford and Falconbridge in this regard remains particularly valid: "... it is very undesirable to have any doubt at all on such a fundamental question."[395]

Perhaps the recent revision of the Bank Act indicates a trend away from the application of the Bills of Exchange Act to those bills and notes that meet the definition of investment securities. The Bills of Exchange Act derived from the law merchant applicable to instruments used for payment. With the growth in the use of such instruments as a means of short term financing, and secondary trading in such instruments in the money market, many bills and notes are no longer properly considered solely as payment instruments. They are also treated as investment securities, subject to significantly different considerations than payment instruments. For example, under the Bills of Exchange Act, an endorser is primarily liable, whereas under statutes governing the transfer of investment securities, an endorser is not liable. This reflects the acceptance of "market risk" with investment securities, contrasted with the commercial need for near-absolute recourse in a payment situation.

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[395] Crawford and Falconbridge, *supra*, note 139 at 1224.

The UCC currently operates on the basis of this distinction. If, for example, a negotiable note meets the definition of security in §8-102, then it is governed by Article 8 dealing with investment securities, but if it does not, then it is governed by Article 3 dealing with negotiable instruments. This is a superior approach, recognizing the need for uniformity in transfers of investment securities of all types.[396]

With respect to bills or notes that do not meet the definition of investment securities, we must distinguish between transfers of the actual instruments, and transfers of SEs when the instruments are held by intermediaries. Transfers of the actual instruments, and the obligations of endorsers, etc., should still be governed by the Bills of Exchange Act. But when such instruments are held through intermediaries (as they very often are), transactions are in SEs and should be governed by securities transfer legislation.[397]

RECOMMENDATION 6

The federal government should be asked to amend the securities transfer provisions of the CBCA to provide specifically that they prevail over the Bills of Exchange Act in the event of conflict. The Bills of Exchange Act should also be amended to defer to the CBCA in the event of conflict.

C. Constitutional Conflicts in the Money Market

We mentioned earlier[398] that one of the stated purposes for a proposed change in the definition of "security" (by deleting section 44(2)(n)(iii) of the current ABCA) was to make the transfer provisions of the ABCA applicable to individually issued money market instruments. This directly raises the

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396 This point is briefly touched upon in Crawford and Falconbridge, *supra*, note 139 at 180-81.

397 See Recommendation 3 and the discussion of how securities entitlements include property interests in financial assets held through intermediaries commencing at p. 131 of this report.

398 At p. 146.

question of whether provincial legislation such as the ABCA or OBCA can affect the transfer of such instruments.

A similar question arises with respect to the proposed amendment to the definition of issuer. At present, there is only one definition of "issuer" in the ABCA, that being section 44(2)(k):

> "issuer" includes a corporation
>
> (i) that is required by this Act to maintain a securities register, or
>
> (ii) that directly or indirectly creates fractional interests in its rights or property and that issues securities as evidence of those fractional interests;

The amendments proposed by CDS include the following provision as section 70.2(8):

> *Definitions.* In this section, "issuer" includes a person, other than an individual, and a government or agency thereof,
>
> (a) that is required by this Act to maintain a securities register,
>
> (b) that directly or indirectly creates fractional interests in its rights or property and issues security certificates or uncertificated securities as evidence of the fractional interests,
>
> (c) that places or authorizes the placing of its name on a security certificate, otherwise than as an authenticating trustee, registrar or transfer agent, or that otherwise authorizes the issue of a security certificate or an uncertificated security evidencing a share, participation or other interest in its property or in an enterprise or evidencing its duty to perform an obligation, or
>
> (d) that becomes responsible for or in place of any other person described as an issuer in this section; and
>
> "security", "security certificate" and "uncertificated security", in addition to the meaning each has for the purposes of Part 6, are extended to include a security, security certificate or uncertificated security, as the case may be, of an issuer within the meaning of this section.

According to CDS' submission, this amended definition of "issuer" is intended to make it clear beyond doubt that securities issued by governments and their agencies are included, as part of its plan to make debt securities issued by governments and their agencies eligible for book-entry transfer.[399]

The proposed expanded definition of "issuer" raises the issue of whether or not a province has constitutional jurisdiction to legislate in respect of the transfer of such securities. Although the provision is clearly intended to be far-reaching, and so may encompass various esoteric forms of investment securities, it is mainly focused upon government debt securities. The most common of these are government of Canada short term bonds and treasury bills, which make up the bulk of the Canadian money market. Provincial and municipal government bonds and treasury bills make up a much smaller, but still significant, portion of the Canadian money market.

Can provincial legislation validly affect the transferability of these securities?[400] This question is complex and the answer is not entirely clear, but in our view such provincial legislation is likely invalid.

(1) Characterization of Money Market Instruments

Legislative authority over bills of exchange and promissory notes rests exclusively with the federal government.[401] Provincial legislation may deal with "property and civil rights in the province",[402] but such provincial legislation cannot trench upon any area reserved to the federal government. Clearly no provincial legislation may conflict with the provisions of the Bills of Exchange Act, so to the extent that any security purportedly caught by the expanded definition of "issuer" falls under the Bills of Exchange Act, the federal act will prevail.

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399 See *CDS Proposal, supra,* note 3 at 10 and Addendum at 2.

400 This question applies only to provincial legislation such as the existing provisions of the OBCA and the ABCA amendments proposed by CDS, because that legislation purports to effect transfers of the securities. It should be emphasized that this question would not arise under a reformed system as recommended in this report, because under a reformed system book-entry transfers would reflect only changes in SEs, and not transfers of underlying securities.

401 Constitution Act, 1867 (U.K.), 30 & 31 Vict., c. 3 (formerly British North America Act, 1867), s. 91(18).

402 Constitution Act, 1867, *ibid.* s. 92(13).

(a) Government debt securities

As noted above, treasury bills and short term bonds are the most commonly traded government debt securities traded within the Canadian money market. Other government debt securities include notes and debentures.

Are these government debt securities governed by the Bills of Exchange Act? It is surprising that there is uncertainty on this point. We have had the benefit of receiving extensive material from CDS, setting out their position on various aspects of this issue. Each aspect warrants discussion in some detail.

(i) Tripartite relationship

Section 16 of the Bills of Exchange Act states:

> (1) A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring that the person to whom it is addressed to pay, on demand or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person or to bearer.
>
> (2) An instrument that does not comply with the requirements of subsection (1), or that orders any act to be done in addition to the payment of money, is not, except as hereinafter provided, a bill.
>
> (3) An order to pay out of a particular fund is not unconditional within the meaning of this section, except that an unqualified order to pay, coupled with
>
> (a) an indication of a particular fund out of which the drawee is to reimburse himself or a particular account to be debited with the amount, or
>
> (b) a statement of the transaction that gives rise to the bill,
>
> is unconditional.

CDS has suggested that a bill of exchange must evidence a tripartite relationship, and that in the case of government debt securities there is no drawee, so the Bills of Exchange Act cannot apply to such securities. We disagree with that suggestion.

Initially, we must note that some government debt securities are drafted in the form of promissory notes meeting the definition in section 176(1) of the Bills of Exchange Act:

> (1) A promissory note is an unconditional promise in writing made by one person to another person, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person or to bearer.

Treasury bills also appear to be promissory notes within that definition[403] and bonds may be as well, but this is less clear.[404] Promissory notes are seldom tripartite instruments. As noted in *MacLaren on Bills Notes And Cheques*:

> Ordinarily there are two parties to a promissory note, the maker and the payee. The maker may make the note payable to his own order or to bearer, in which case there is only one person named.[405]

By virtue of section 186 of the Bills of Exchange Act, the provisions relating to bills generally apply to notes as well. It is therefore wrong to suggest that a tripartite relationship is required before the Bills of Exchange Act can be applicable to any given security.

With respect to bonds and treasury bills, it is correct to say that the drawer and drawee are one and the same. Does this prevent such instruments meeting the definition of bills of exchange in the Act? In our view it does not, although again there is some confusion on this point.

Crawford and Falconbridge state that where the drawer and drawee are one and the same person, section 25 provides that "the holder may treat the instrument, at his option, either as a bill of exchange or as a promissory note", but that the instrument is neither a bill nor a note; it simply may be treated as either.[406] The stated reason why it fails to qualify as a bill is that it is not drawn by one person upon another, as required by section 16(1) of the Act. This relies upon comments in certain cases, particularly *In re British Trade*

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403 Treasury bills have not been the subject of any judicial consideration on this point, but have been referred to as "negotiable bearer promissory notes of the Government of Canada" (see S. Sarpkaya, *The Money Market in Canada*, 3rd edition (Don Mills: CCH, 1984) at 21. We must assume, however, that the term "promissory notes" is used there in a general sense, and not specifically in reference to the Bills of Exchange Act.

404 A typical federal government treasury bill states: "The Government of Canada, for value received, will pay to the bearer the sum of ___ dollars on the above mentioned due date ...". A typical federal government bond uses practically identical language, but adds terms regarding interest payments, transfers and exchanges.

405 *MacLaren on Bills, Cheques and Notes*, 5th ed., (Toronto: Carswell, 1916) at 453.

406 *Supra*, note 139 at 1266-67.

Corporation, Limited.[407] There both Greer and Romer L.JJ. expressed the view[408] that section 5(2) of the English Bills of Exchange Act[409] meant that a document in the form of a bill of exchange, but which is not a bill of exchange because it is not a promise made by one person to another (the drawer and drawee being the same person) may be treated by the holder as though it were a bill of exchange, or a note, even though it is neither.

That position may be correct under the U.K. Act, but Crawford and Falconbridge appear to overlook an important distinction between the U.K. and Canadian statutes. In the Canadian Bills of Exchange Act section 16(2) provides:

> An instrument that does not comply with the requirements of subsection (1), or that orders any act to be done in addition to the payment of money, is not, **except as hereinafter provided**, a bill. [emphasis added]

The emphasized words do not appear in the U.K. Act,[410] and they would appear to resolve an otherwise confusing aspect of section 25 of the Canadian Act. Section 25, and its equivalent in the U.K. Act, describe the instrument wherein drawer and drawee are the same person as "a bill" which, at the option of the holder, may be treated as either a bill or a note. Under the U.K. Act that reference is incompatible with the definition of "bill of exchange", and even the court's comments in the *British Trade* case leave a contradiction which could be removed if the section referred to "an instrument that would be a bill but for the fact that ...". Under the Canadian Act, however, the situation seems much clearer: the instrument referred to in section 25 is a bill, but it may be treated by the holder at his option as either a bill or a note.

On this point, then, we conclude that there is actually no "requirement" of a tripartite relationship in order for the Bills of Exchange Act to apply. Some government debt securities are clearly expressed to be promissory notes, not subject to the definition in section 16. With respect to bonds and treasury bills, these may either: 1) be interpreted as promissory notes payable to bearer,

407 [1932] 2 Ch. 1 (C.A.).

408 *Ibid.* at 11 per Greer L.J., and at 13-14 per Romer L.J.

409 Bills of Exchange Act 1882 (U.K.), 45 & 46 Vict., c. 61. Section 5(2) of the U.K. Act is the equivalent of s. 25 of the Canadian Act.

410 See Bills of Exchange Act 1882 (U.K.), *ibid.* s. 3(2).

and thus subject to the Act by virtue of sections 176 and 186; or 2) be considered as bills covered by section 25 where the drawer and drawee are the same, so that the holder may treat them either as a bill or as a note.

(ii) Unconditional order or promise

Section 16(3) of the Bills of Exchange Act requires that an order to pay be unconditional, and that an order to pay out of a particular fund may not be unconditional.

Treasury bills and notes generally provide on their face that they are payable out of the issuing government's consolidated or general revenue fund. Even in the case of bonds or other instruments where this is not specified, legislation generally provides for a specific fund or funds from which government debt securities will be paid.[411]

CDS has suggested that, by reason of their being payable out of specific funds, most government debt securities are not unconditional and therefore cannot meet the definitions of bills and notes in the Bills of Exchange Act. In our view, that suggestion is incorrect.

The provisions of section 16(3) of the Bills of Exchange Act are difficult to apply to government securities, and there is only one case that even attempts to do so. In *Canada Trust Co.* v. *The Queen*[412] the Trial Division of the Federal Court dealt with a situation involving Old Age Pension "cheques" drawn on the account of the Receiver General of Canada. Although commonly referred to as "cheques", these instruments were agreed by the plaintiff and the defendant to be bills of exchange. The court noted that the instruments could be construed as having the same drawer and drawee, and that according to the Financial Administration Act, payment shall be made out of the Consolidated Revenue Fund, but stated very briefly that neither of these facts prevented the

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411 In Alberta, Part 6 of the Financial Administration Act, *supra*, note 103, provides for several funds to pay direct government debt, most funds being backed up by the General Revenue Fund. Section 54 of the federal Financial Administration Act, R.S.C. 1985, c. F-11, provides that:

> The payment of all money borrowed and interest thereon and of the principal of and interest on all securities issued by or on behalf of Her Majesty with the authority of Parliament is a charge on and payable out of the Consolidated Revenue Fund.

412 [1982] 2 F.C. 722 (F.C.T.D.).

instruments from being bills of exchange as defined by the Bills of Exchange Act.[413] The comments are *obiter* and the case offers no detailed reasoning for these conclusions. As discussed in detail below,[414] this case is of somewhat dubious value and it may be unwise to place much reliance upon it.

Even without relying upon the *Canada Trust* decision, it seems unlikely that section 16(3) operates to remove government debt securities from the application of the Bills of Exchange Act. We will use federal treasury bills as an example, but similar considerations will apply to other government debt securities. Federal treasury bills are, on their face, expressly payable out of the Consolidated Revenue Fund of Canada. The initial impression is that this may render them conditional according to section 16(3), but section 16(3) is subject to an exception, whereby an unqualified order to pay, coupled with an indication of a particular account to be debited with the amount, is unconditional.

The cases on this particular exception, from both before and after codification of negotiable instruments law in the Bills of Exchange Act, are not easy to apply to a federal treasury bill.[415] Although cases have generally found that the use of the words "out of" in the order to pay render it conditional, none of those cases dealt with a fund comparable to the Consolidated Revenue Fund of Canada. As noted by Crawford and Falconbridge,[416] it is not the size of the fund that is determinative, but rather the intent being expressed. In the cases, references to payment "out of" a particular fund always reflected a lack of intent that the bill should be paid "absolutely and at all events" because of course the particular fund was understood by everyone to be limited. But does the reference to payment "out of the Consolidated Revenue Fund of Canada" reflect such a lack of intent? In our view it does not.

The Consolidated Revenue Fund is finite, but certainly not in the same way as any of the particular funds which have been considered in the cases.

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413 *Ibid.* at 741.

414 See p. 170 of this report.

415 See Crawford and Falconbridge, *supra*, note 139 at 1228-29, citing *Hall* v. *Prittie* (1890), 17 O.A.R. 306; *Bank of British North America* v. *Gibson* (1891), 21 O.R. 613 (H.C.J.); and *Ockerman* v. *Blacklock* (1862), 12 U.C.C.P. 362.

416 *Ibid.*

Since the Consolidated Revenue Fund of Canada is defined in the Financial Administration Act[417] as the aggregate of all public moneys on deposit at the credit of the Receiver General, and public money is defined as all money belonging to Canada received or collected by the Receiver General or any other public officer,[418] and all public money must be deposited to the credit of the Receiver General,[419] the Fund is actually comprised of a multitude of particular accounts. Any consideration of the limits of the Consolidated Revenue Fund quickly becomes speculative. What if the Fund were exhausted completely — with a zero balance? This is hypothetically possible, but this would mean that the government had absolutely no income or revenue or monetary assets. That situation is so apocalyptic as to imply that the nation would likely have ceased to exist, and its currency along with it.

To the extent that this is a real possibility, treasury bills are conditional even without any reference to the Consolidated Revenue Fund, but so, too, is every bill payable in Canadian currency. For the purposes of the Bills of Exchange Act it is much more reasonable to treat the obligation as unconditional, and the reference to payment out of the Consolidated Revenue Fund as an indication of the "particular fund to be debited with the amount" as per section 16(3)(a).

This view is supported by the fact that government debt securities are recognized as negotiable instruments, even without reference to the Bills of Exchange Act.[420] At common law it was required that all negotiable instruments be payable unconditionally.[421] In *Wookey* v. *Pole*[422] the court considered the status of an exchequer bill, which on its face stated that it was "... payable out of the first aids or supplies to be granted the next session of Parliament ...". The issue of whether or not the bill was unconditional was not raised, but the court found that the exchequer bill was negotiable in the same manner as bills of exchange. The suggestion that such instruments are

417 *Supra*, note 411, s. 2.

418 *Ibid.*

419 *Ibid.* s. 17.

420 As to the recognition of usage as proof of negotiability by the law merchant, see *Edelstein* v. *Schuler & Co.*, [1902] 2 K.B. 144.

421 *Chalmers on Bills of Exchange*, 6th ed., (London: Stevens And Sons, 1903) at 11.

422 (1820), 106 E.R. 839 (K.B.).

conditional thus challenges one of the cornerstones of the law of negotiable instruments.

Some government securities do not specifically state that they are payable out of a specific fund. These securities seem clearly to be unconditional within the meaning of the Bills of Exchange Act. In such securities, the provisions of section 54 of the Financial Administration Act are not an integral part of the promise to pay, nor is the promise grammatically qualified by reference to a particular fund. Section 54 does not appear to limit the claim of, say, a bondholder to the Consolidated Revenue Fund: it merely states that money borrowed and securities issued by or on behalf of Her Majesty are a charge on and payable out of that Fund. The argument that such instruments are conditional appears to be particularly weak.

(iii) The government as a "person"

CDS suggests that the Bills of Exchange Act does not apply to government debt securities because the government is not a "person". This is an intriguing point, and CDS may be correct, but there is considerable uncertainty surrounding this issue.

In *Weidman Bros. Ltd.* v. *Guaranty Trust Co.*,[423] Spence J. found that a Government of Canada bearer bond was not a promissory note as defined by section 176(1) of the Bills of Exchange Act, stating:

> A bond is not an unconditional promise to pay, but the bond itself ... is a promise to pay subject to all the conditions referred to in the bond. Moreover, I am very doubtful whether the Dominion of Canada can be included in the word "person" as that word appears in s. 176.[424]

The decision turned upon the finding that the bond was not unconditional,[425]

423 [1955] 5 D.L.R. 107 (Ont. H.C.J.), aff'd *loc. cit.* (C.A.).

424 *Ibid.* at 110.

425 As it relates to the bond being conditional, the decision was criticised by Dean Falconbridge (see *Falconbridge On Banking And Bills Of Exchange*, 7th ed. (Toronto: Canada Law Book, 1969) at 890-91). That criticism was partially retracted in the more recent edition of that treatise (see Crawford and Falconbridge, *supra*, note 139 at 1814-15), but since the *Weidman* decision does not specify the conditions of the bond which prevented it from being an unconditional promise to pay, it is unclear how this case affects the (continued...)

so as it relates to the interpretation of "person", the comment is *obiter*, and must be taken to leave that question open.

Whether or not the government is a "person" to whom the Bills of Exchange Act applies turns largely upon the applicability of section 17 of the Interpretation Act,[426] which provides:

> 17. No enactment is binding on Her Majesty or affects Her Majesty or Her Majesty's rights or prerogatives in any manner, except as mentioned or referred to in the enactment.

The starting point of our analysis must therefore be the position that the Bills of Exchange Act does not apply to the federal or provincial governments. However, there are a number of available exceptions that must be considered and that, in our view, leave the question of the applicability of the Bills of Exchange Act entirely open. We will discuss these briefly.

Notwithstanding section 17 of the Interpretation Act, a statute may apply to the Crown as a result of the benefit/burden exception, sometimes referred to as the "waiver" exception, whereby reliance by the Crown upon a statute may result in the Crown being bound by that statute. The application of this doctrine so as to render the Crown subject to the Bills of Exchange Act was considered in *Bank of Montreal* v. *Bay Bus Terminal (North Bay), Ltd.*[427] The Ontario High Court, in an *obiter* comment, stated that because the Bank of Canada Act authorized the Bank of Canada to transact business on the money market, where it must necessarily rely on the provisions of the Bills of Exchange Act in its everyday dealings, the Bank of Canada must be subject to the Bills of Exchange Act notwithstanding section 17 (then section 16) of the Interpretation Act.[428]

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[425](...continued)
question of whether the government bonds currently being traded in the money market would be considered promissory notes, aside from the question of whether the government is a "person".

[426] R.S.C. 1985, c. I-21.

[427] (1971), 24 D.L.R. (3d) 13 (Ont. H.C.) at 20, aff'd (1972), 30 D.L.R. (3d) 24 (Ont. C.A.), aff'd (equal division) (1977), 76 D.L.R. (3d) 385 (S.C.C.). It should be noted that the benefit/burden exception was not considered by the Supreme Court of Canada decision.

[428] *Ibid.*

This exception, and the appropriateness of comments made in the *Bank of Montreal* case were dealt with in *Sparling* v. *Quebec.*[429] The *Sparling* decision expressly disapproved the description of the exception in *Bank of Montreal* as being too broad, but did not comment on whether the exception would properly have applied to the facts in *Bank of Montreal.*

The benefit/burden exception was again examined by the Supreme Court in *Alberta Government Telephones* v. *C.R.T.C.*[430] The majority applied the reasoning in *Sparling*, interpreting it as requiring a very close connection between the benefit taken and the burden imposed in order for the exception to apply. Wilson J., in dissent, suggested that the majority decision interpreted *Sparling* too narrowly and that the connection between the benefit obtained and the burden sought to be imposed could be more broadly based. Wilson J. acknowledged that the doctrine was too broadly applied in *Bank of Montreal,* but did not comment on the result that might have emerged had the doctrine been properly applied in that case.

Another exception which might operate to make the Bills of Exchange Act apply to the government is the "necessary implication" doctrine, also discussed in the *AGT* case.[431] This was a common law doctrine, set out by the Privy Council in *Bombay (Prov.)* v. *Bombay Mun. Corp.*[432] Although it seems clear that the common law has been supplanted by the Interpretation Act, the doctrine is still alive, as noted by Dickson C.J.C. in the *AGT* case:

> However, the qualifications in *Bombay* are based on sound principles of interpretation which have not entirely disappeared over time. It seems to me that the words "mentioned or referred to" in s. 16 are capable of encompassing (1) expressly binding words ("her Majesty is bound"), (2) a clear intention to bind which, in *Bombay* terminology, "is manifest for the very terms of the statute", in other words, an intention revealed when provisions are read in the context of other textual provisions, as in *Ouelette*, and (3) an intention to bind where the purpose of the statute would be "wholly frustrated" if the government were not bound or, in other words, if an absurdity (as opposed to simply an undesirable result) were produced. These three points should provide a guideline for when a statute has clearly conveyed an intention to bind the Crown.[433]

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429 [1988] 2 S.C.R. 1015.

430 (1989), 68 Alta. L.R. (2d) 1 [hereinafter *AGT*].

431 *Ibid.* at 40-45.

432 [1947] A.C. 58.

433 *Supra*, note 430 at 44.

This doctrine has never been considered in relation to the Bills of Exchange Act and it would add little to the present discussion to review the possible arguments for and against such application. It is sufficient to note that the arguments could be made, and that the law is not settled on this point.

It is also necessary to recognize the possible impact of the Supreme Court's decision in *Bank of Montreal* v. *Attorney-General of Quebec*,[434] where the court found that the Crown was bound by the Bills of Exchange Act because it was deemed to be an implied term in a contract binding the Crown. This case dealt with the operation of the Quebec Civil Code, and so the precise manner by which the implied term was included in the contract is thus distinguishable from any comparable situation arising in a common law province. Whether such an implied term would attach at common law is another open question.

There are a number of comments in the majority decision in *AGT* that could be interpreted as invitations to parliament to eliminate the current presumption of Crown immunity, as has been done provincially in B.C. and P.E.I. Speaking for the majority, the Chief Justice stated:

> A broad benefit/burden test would be overly legislative in the face of the current formulation of section 16. Regretfully perhaps, but undeniably, the statutory Crown immunity doctrine does not lend itself to imaginative exceptions to the doctrine, however much such exceptions may conform to our intuitive sense of fairness.[435]

In *Canada Trust Co.* v. *The Queen*[436] the court held that Her Majesty was not bound by the Bills of Exchange Act by virtue of section 17 (then section 16) of the Interpretation Act, but unfortunately the decision offers little in the way of reasons to support the conclusion reached. The decision distinguishes *Bank of Montreal* v. *A.-G. Quebec* on the basis that there was no contract between the parties incorporating provisions of the Bills of Exchange Act by implication.[437] The decision also found that the Crown had not invoked any particular section of the Bills of Exchange Act to its advantage so

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434 (1978), 96 D.L.R. (3d) 586.

435 *AGT*, *supra*, note 430 at 51.

436 *Supra*, note 412.

437 *Ibid.* at 739-40.

as to invoke the benefit/burden exception.[438] On these points there is no discussion of any argument for or against the conclusions stated. Having decided that the Bills of Exchange Act is inapplicable to the Crown, it follows that the rights of the parties should have been determined according to the common law. The decision includes a brief statement purporting to summarize the applicable common law, but the statement is confused and inaccurate.[439] Moreover, there is no attempt to apply the common law to the facts of the case, so we are left with considerable doubt as to the real basis for the decision.[440]

The impact of the *Canada Trust* decision is difficult to assess. It has not been judicially considered, nor was it mentioned in the 1986 edition of Crawford & Falconbridge. Although it is a lower court decision, it nonetheless stands as an authority until the same issues arise again for judicial consideration. Since the decision offers little in the way of explanations for its conclusions, we cannot say whether or not the next case would reach similar conclusions on these issues.

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438 *Ibid.* at 738-39.

439 *Ibid.* at 730. The statement reads:

> At common law the acceptor of a bill by accepting it was precluded from denying to a holder in due course the existence of the payee, his capacity to endorse and the authenticity of his endorsement. This was based upon the principle of estoppel. The exception, in which estoppel did not prevail, was that a bill drawn to the order of a fictitious or non-existent payee might be treated as payable to bearer. The estoppel only applied against parties who at the time they became liable on the bill knew that the purported payee was fictitious or non-existent.

In fact, there was no estoppel generally precluding an acceptor from denying the authenticity of a payee's endorsement (see *Robarts* v. *Tucker* (1851), 16 Q.B. 560). This is reflected in ss 48 and 128 of the Bills of Exchange Act. The exception existed where estoppel did operate in the cases of bills drawn to the order of a fictitious or non-existent payee, so that such bills might be treated as payable to bearer, but only against the parties who at the time they became liable on the bill were cognizant of the fictitious character or non-existence of the supposed payee (see the review of the common law by Bowen L.J. in *Vagliano Brothers* v. *The Bank of England* (1889), 23 Q.B.D. 243 (C.A.) at 260).

440 The most charitable interpretation of the decision would be that the court felt that the plaintiff's claim at common law was so obviously doomed that the entire matter was determined by the finding that the plaintiff could not rely upon s. 21(5) [now s. 20(5)] of the Bills of Exchange Act. This interpretation is difficult to reconcile with the decision's long discussion concluding that the payee was non-existent, but not fictitious. Although at common law the plaintiff's claim may very well have failed, this case would have represented a unique fact situation: a bill made payable to a non-existent payee where neither the drawer or drawee was aware of the non-existence of the payee. As such, one would expect at least some comment on the application of common law principles to these facts.

(iv) Conclusion

In our view, it is very much an open question whether most government debt securities constitute bills of exchange or promissory notes within the meaning of the Bills of Exchange Act. There is much ambiguity in this area, but it would seem that treasury bills, notes and bonds are quite possibly subject to the Act. The applicability of the Act would appear to rest solely upon the definition of "person" — an issue which has never been clearly decided. If the government is a "person", then a substantial portion of government debt securities are subject to the Act, and provincial legislation such as OBCA section 85 cannot give a statutory foundation to book entry transfers and pledges of such securities.

Given that government debt securities make up such a large component of the Canadian money market, it is certainly undesirable to have any doubt over the legal mechanisms for their transfer. Such doubt could be removed if the CBCA and provincial securities transfer provisions specifically provide that they are binding on Her Majesty.[441] It may not seem absolutely necessary for provincial legislation to include such provisions, because to the extent that government debt securities are bills or notes, they fall under federal jurisdiction. However, some government debt securities, such as debentures, are probably not bills or notes, and there is always the possibility of new forms of securities being issued. Having such provisions in uniform federal and provincial legislation is highly desirable because it renders academic arguments over the characterization of those securities for constitutional purposes, and allows commercial certainty in respect of transfers.

RECOMMENDATION 7

Federal and provincial legislation governing securities transfers should specifically provide that it is binding on Her Majesty.

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441 The Alberta Law Reform Institute is currently working on a project dealing with s. 14 of the Alberta Interpretation Act, considering whether to recommend reversal of the presumption of Crown immunity from statute.

D. Provincial Book-Entry Legislation and Heads of Power Under the Constitution Act, 1867

What gives a province the constitutional authority to enact book-entry legislation? Can that authority extend far enough to apply to the transfer of federal government debt securities and other money market instruments? The same considerations would apply in each individual province, so it is convenient to address these questions in the context of assessing the constitutional validity of OBCA section 85, and particularly section 85(8).

For the purposes of this discussion, we should assume that the Bills of Exchange Act does not apply to government debt securities or the other money market instruments being considered, because to the extent that such securities are governed by the Bills of Exchange Act, the OBCA does not even purport to apply to them. CDS suggests that such securities are not governed by the Bills of Exchange Act, and the issue addressed here is whether OBCA section 85(8) can validly operate in the event that CDS' position is correct.

The proper approach to an analysis of the constitutional validity of section 85(8) is that which would be employed by the courts in the course of a judicial review. The primary issue is the determination of its characterization as in relation to a "matter" coming within the "classes of subjects" enumerated within sections 91 and 92 of the Constitution Act, 1867. If section 85(8) is properly characterized as being in relation to a provincial head of power, then it would appear to be constitutionally valid. If section 85(8) is properly characterized as being in relation to a federal head of power, then it is *ultra vires* and invalid. In the latter situation, it would be irrelevant that section 85(8) does not conflict with any specific federal legislation.

Determining the purpose or characterization of OBCA section 85(8) is an enormous task. We do not propose to undertake a complete analysis in this report. As is frequently the case with constitutional issues, the outcome is not entirely clear. Academic debate on this issue is interesting, but cannot realistically produce a definite answer. We feel that it is valuable to recognize some of the major arguments and factors relating to this issue, but even though we may be inclined to prefer one side of the argument, we must ultimately leave the question open, recognizing that only a court challenge can produce a final answer. We will discuss each prospective head of power separately.

As a preliminary point, the first thing that should be recognized as we analyze section 85(8) is that it has absolutely nothing to do with provincial business corporations even though it appears in the OBCA. We discuss later[442] how expansive definitions of "security" and "issuer" used in other provisions of Part 6 of the OBCA render the book-entry transfer and pledging procedures applicable to securities other than those issued by OBCA corporations. Although there are practical reasons why these provisions are found in the provincial corporations statute, it seems clear that they do not belong there.[443] A realistic assessment of the constitutionality of these provisions should involve their characterization as if they were separated from provincial corporations law and placed in a discrete statute.[444]

(1) Property and Civil Rights in the Province

CDS has provided us with an opinion that deals with the question of whether OBCA section 85 may constitutionally apply to intraprovincial transfers of federal government debt securities. It addresses this question by discussing whether section 85 is legislation in respect of "property and civil rights in the province" — a provincial head of power,[445] or legislation with respect to "the public debt and property" — a federal head of power. The opinion concludes that section 85 is *intra vires* and valid.

It seems clear that if section 85(8) is *intra vires*, then it is because it is characterized as being legislation with respect to "property and civil rights in the province". There is no other provincial head of power that seems appropriate.

Although there are no decisions that bear directly upon the issue of the characterization of legislation dealing with the mechanics of securities transfers, there are a number of decisions supporting the position that securities regulation falls within the scope of "property and civil rights in the

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442 At p. 207.

443 See the discussion accompanying Recommendation 9 at p. 209 of this report.

444 For a discussion of constitutional issues arising with respect to corporate activities in Canada, see J. Ziegel, "Constitutional Aspects of Canadian Companies" in J. Ziegel (ed.), *Studies In Canadian Company Law*, (Toronto: Butterworths, 1967) at 149-94.

445 Constitution Act, 1867, *supra*, note 401, s. 92(13)

province".[446] It is generally accepted that the creation and transfer of property rights fall under this head, and the provinces may be expected to continue to legislate in this area until they are successfully challenged.

We will now examine some of potential arguments that might be used in such a challenge.

(2) The Public Debt and Property

"The public debt and property" is a federal head of power.[447] We will discuss this particular head because CDS raised it in the opinion they provided to us. It may be dealt with briefly. CDS' opinion concludes that provincial book-entry legislation would not be characterized as falling under this particular head of power, and we agree.

Although section 60 of the Financial Administration Act authorizes the making of regulations for the transfer, transmission, etc. of government debt securities, that authority has not yet been used in any manner which deals with intraprovincial transfers or pledges of such securities, except for provisions relating to the maintenance of registers for the transfer of registered bonds. Therefore, it does not appear that provincial book-entry legislation such as OBCA section 85 would be characterized as a law in relation to "the public debt and property".

In our view, however, it not possible to confine the analysis to this one federal head of power. There are much more difficult and relevant constitutional issues in this area, and we now turn to a discussion of those issues.

(3) Bills of Exchange and Promissory Notes

"Bills of Exchange and Promissory Notes" is a federal head of power under section 91(18) of the Constitution Act, 1867.

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446 See *Lymburn* v. *Mayland*, [1932] 2 D.L.R. 6 (P.C.); *Gregory & Co. Inc.* v. *Quebec Securities Commission* (1961), 28 D.L.R. (2d) 721 (S.C.C.); *Duplain* v. *Cameron*, *supra*, note 389; and *Multiple Access Ltd.* v. *McCutcheon* (1982), 138 D.L.R. (3d) 1 (S.C.C.).

447 Constitution Act, 1867, *supra*, note 401, s. 91(1A).

With respect to the possibility that the legislation is *ultra vires* because it may be characterized as legislation in respect of "bills of exchange and promissory notes", this may at first seem to be the same question as considered above: whether government debt securities are bills or notes within the meaning of the Bills of Exchange Act. In fact, this issue is quite separate, but is just as complex and troublesome as that considered above.

Although some decisions have dealt with particular issues involving conflicts between provincial legislation and the Bills of Exchange Act,[448] there are no cases clearly interpreting the limits of the federal power under section 91(18) of the Constitution Act, 1867. Any discussion of the precise limits of that power is admittedly speculative, but there are factors which suggest that perhaps only federal legislation could validly authorize book-entry transfers and pledges of government debt securities.

Codification of the law relating to bills of exchange did not occur until 1882 in Britain and 1890 in Canada, so that at the time this particular power was allotted to parliament, it captured an evolving body of the common law comprising a portion of the law merchant. The law merchant has always been dynamic and this creates special problems when trying to determine the scope of the federal power over "bills of exchange and promissory notes". If we examine the state of the common law as at 1867[449] we find that bills and notes are clearly defined types of instruments, distinguishable from other types of negotiable instruments, but the law applicable to all negotiable instruments was essentially the same. Bills and notes comprised the vast bulk of negotiable instruments, so the law relating to them had become well-defined. If other instruments somehow acquired the attribute of negotiability, the law of bills and notes was applied *mutatis mutandis*.

The effect of codification was to consolidate and to some extent modify the common law, but only with reference to bills and notes. Other negotiable instruments remained subject to the common law (law merchant). The major difference between the law applicable to other negotiable instruments and that which applied to bills and notes involved categorization of the instruments. If

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448 *John Deere Plow Co.* v. *Agnew* (1913), 4 W.W.R. 1013 (S.C.C.); *A.-G. Alta. and Winstanley* v. *Atlas Lumber Co.*, [1945] 1 D.L.R. 625 (S.C.C.).

449 The best statement of the relevant common law, including the history of the law merchant and the application of principles of negotiability to bills, notes and other instruments is found in *Goodwin* v. *Robarts*, *supra*, note 324.

an instrument met the definition of a bill or note under the Bills of Exchange Act, then it was negotiable as provided in the Act. If the instrument was not a bill or note, but was negotiable according to some other statute or the law merchant, then the method of negotiation and the rights and obligations of the parties involved were generally the same as for a bill or note under the Act.

Both before and after codification, but particularly before, references to "bills of exchange" and "negotiable instruments" were often used interchangeably, even by those who understood the distinction perfectly.[450] It could be suggested, therefore, that the federal power over bills and notes is actually a power over negotiable instruments.

It certainly seems wrong to suggest that the limits of operation of the Bills of Exchange Act exhaust the federal government's power under this head. Would government treasury bills, notes and short term bonds, if issued in 1867, have been classified as bills or notes at common law? Probably, yes. There would be no issue over the Crown being a "person", and as discussed earlier, the instruments otherwise seem to meet the common law requirements as to form, which were not modified upon codification.

We may then ask: if parliament were tomorrow to amend the Bills of Exchange Act to make it applicable to the Crown, would that amendment be *intra vires* the federal government's power under section 91(18)? It seems obvious that it would. And if the Act were further amended to provide that an order or promise is not made conditional because payment is limited to payment from a particular source or fund,[451] would that amendment be similarly *intra vires*? Yes it would, and the consequence of such amendments would be that government treasury bills, notes and short term bonds would indisputably be bills or notes within the meaning of the Act.

As noted above, if provincial legislation is characterized as in relation to a federal head of power such as "bills of exchange and promissory notes", then

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450 E.g. the draftsman of the Bills of Exchange Act, Sir Mackenzie Chalmers. The paper Chalmers presented to the Institute of Bankers, and which led directly to the drafting of the Act, was entitled "On The Codification of Mercantile Law, with Especial Reference to the Law of Negotiable Instruments". For a description of the background of codification see Holden, *supra*, note 323 at 199-203, and the introduction to the 3rd ed. of *Chalmers on Bills of Exchange* (London: Stevens & Sons Ltd., 1883).

451 The Uniform Commercial Code was revised in 1990 to this effect. See §3-106(b)(ii) and the accompanying Official Comment.

it is *ultra vires* and invalid, even though it does not conflict with any specific federal legislation. This presumes that the legislation does not fall within the application of the "double aspect" doctrine.[452] It has been recognized that "subjects which in one aspect and for one purpose fall within section 92, may in another aspect and for another purpose fall within section 91".[453] Provincial law may be applicable, but only to the extent that it does not deal with the law of bills and notes in the strict sense[454] — the form, issue, negotiation and discharge of bills and notes.

Does OBCA section 85(8) deal with the law of bills and notes in the strict sense? In our view it does. Section 85(8) operates to make a negotiable instrument such as, say, a federal government treasury bill, a "security" for the purposes of section 85. As such, it is transferable by a book entry in respect of a fungible bulk, and the transferee is deemed to be a holder in possession of that security for all purposes. This deals directly with the "negotiation" of the treasury bill, as negotiation is defined in section 59(1) of the Bills of Exchange Act:

> A bill is negotiated when it is transferred from one person to another in such a manner as to constitute the transferee the holder of the bill.[455]

Under the Bills of Exchange Act and the common law, a "holder" was someone in possession of the negotiable instrument. Such possession could be actual or constructive.[456] The concept of deemed possession, especially deemed possession of an instrument that is part of a fungible bulk, represents a significant change in negotiation from the common law situation reflected in

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452 For an example of the application of this doctrine in the area of securities regulation, see *Smith* v. *The Queen*, [1960] S.C.R. 776.

453 *Hodge* v. *The Queen* (1883), 9 App. Cas. (P.C.) 117 at 130.

454 "The law of bills and notes in the strict sense" is a phrase coined by Dean Falconbridge in an earlier edition of *Banking & Bills of Exchange*, and used by two Justices of the Supreme Court of Canada in the decision in *Duplain* v. *Cameron*, *supra*, note 389 at 361 and 366. See also Crawford and Falconbridge, *supra*, note 139 at 1184-87, and B. Geva, "Preservation Of Consumer Defences: Statutes And Jurisdiction" (1982) 32 U.T.L.J. 176 at 197-203.

455 This provision, like most provisions of the Bills of Exchange Act, represents a codification of the common law. See the list of sections which did alter the common law in Chalmers, *supra*, note 421 at 2.

456 Constructive delivery and possession are discussed in detail commencing at p. 181 of this report.

the Bills of Exchange Act. Deemed possession is plainly incompatible with the common law principles of negotiability. This may be seen by examining how a holder, in deemed possession of an instrument that is part of a fungible bulk, may acquire the right to sue on the instrument in his own name.[457] Obviously, the holder cannot sue on an instrument until a particular instrument is identified as being that transferred to the holder — something that does not occur when a transferee acquires deemed possession of an instrument that is part of a fungible bulk under section 85. Consequently, the "holder" under section 85 acquires inferior rights and powers than at common law.

If government t-bills and short term bonds are instruments within the meaning of "bills of exchange and promissory notes" in section 92(18) of the Constitution Act, 1867, is provincial legislation such as OBCA section 85(8) constitutionally valid? In our view, it is probably not valid. Unlike other provisions of section 85, section 85(8) is specifically intended to apply to instruments that would not otherwise be captured by the OBCA definition of "security". It could only be characterized as legislation with respect to "bills of exchange and promissory notes" and thus *ultra vires.*

(4) The Regulation of Trade and Commerce

This is a federal head of power under section 91(2) of the Constitution Act, 1867.

Federal government interest in securities law seems to fluctuate. The possibility of federal securities legislation was studied extensively in the late 1960's and throughout the 1970's, culminating in the publication of *Proposals for a Securities Market Law for Canada*[458] by the federal Department of Consumer and Corporate Affairs in 1979. The constitutional issues arising in relation to this area and the jurisdiction available to the federal government to enact securities legislation are addressed in one of the background papers by P. Anisman and P.W. Hogg. They suggest that the trade and commerce power may be sufficient to justify a comprehensive federal regulatory scheme

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457 This is a fundamental right at common law, reflected in s. 73(1) of the Bills of Exchange Act.

458 *Supra,* note 55.

governing securities.[459] Although their major emphasis is on the investor protection aspects of regulation, they argue that the secondary market, consisting of a large number of mostly intra-provincial transactions, "as a whole transcends provincial authority and is a matter of national concern, that is, of general trade and commerce."[460] They do not specifically address the law governing securities transfers, but similar considerations would apply, as well as those discussed under the next heading.

(5) Exceptions to Local Works and Undertakings

"Local works and undertakings" is an area made subject to exclusive provincial jurisdiction by section 92(10) of the Constitution Act, 1867, with certain very significant exceptions, including:

> (a) Lines of Steam or other Ships, Railways, Canals, Telegraphs, and other Works and Undertakings connecting the Province with any other or others of the Provinces, or extending beyond the Limits of the Province;
>
> ...
>
> (c) Such Works as, although wholly situate within the Province, are before or after their Execution declared by the Parliament of Canada to be for the general Advantage of Canada or for the Advantage of Two or more of the Provinces.

Anisman and Hogg suggest that this head may well authorize federal regulation over the various Canadian stock exchanges, and particularly the clearing and settlement facilities.[461] If they are correct in this regard, and especially if they are also correct in their assertion that the general trade and commerce power gives the federal government authority to regulate the securities industry, it is certainly arguable that the federal authority might extend to the law governing the mechanics of securities transfers.

(6) Conclusion

There is significant potential for challenges to provincial book-entry legislation, particularly OBCA section 85(8). Although no such challenges have

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459 P. Anisman and P.W. Hogg, "Constitutional Aspects of Federal Securities Legislation" in *Proposals for a Securities Market Law for Canada, ibid.* Vol. 3 at 135.

460 *Ibid.* at 167.

461 *Ibid.* at 171-76.

been forthcoming to date, it would be myopic to simply assume that such legislation is *intra vires* the provincial legislatures. It is more accurate to say that such legislation may be *intra vires*, but that potential constitutional challenges could be launched on several grounds. Those potential challenges should not be dismissed as frivolous or hopeless. We should recognize a successful challenge might have enormous impact upon securities regulation, and the law relating to securities transfers in Canada.

Regardless of how a constitutional challenge might be answered, any amount of uncertainty is undesirable in the securities markets. Therefore, it would be preferable to have uniform federal and provincial provisions dealing with securities transfers. This would not eliminate constitutional wrangling over securities regulation, but it would render the debate academic from the standpoint of the legal validity of the securities transfers.

E. Constructive Delivery of Money Market Instruments

The opinion provided by CDS discusses the effect of CDS' book-entry "transfers" of government debt securities in provinces (like Alberta) without legislation dealing with book-entry transfers. It proceeds on the basis that government debt securities are negotiable instruments even though they are not bills, notes or cheques as defined by the Bills of Exchange Act.

The opinion goes on to deal with transfers of other money market instruments, particularly: corporate debt securities, bankers' acceptances and deposit receipts issued by financial institutions. Of these, corporate debt securities comprise a relatively small, but still significant, segment of the money market. Some corporate debt securities are subject to the Bills of Exchange Act, others are issued by CBCA corporations,[462] while others are undoubtedly subject to provincial securities transfer legislation. Bankers' acceptances constitute a much larger, and rapidly growing, segment of the money market, and these are definitely subject to the Bills of Exchange Act. A large proportion of financial institution deposit receipts are not transferable, and appear in the money market only for primary distribution. Of those deposit receipts that are transferable and actively traded in the money market, many would be subject to the Bills of Exchange Act.

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462 These are subject to the considerations of overlapping statutory transfer provisions, discussed at p. 152 of this report.

The opinion asserts that, for money market instruments subject to the Bills of Exchange Act and those instruments that are negotiable but not subject to the Act, transfers may be effected by book-entry on the basis of constructive delivery. Constructive delivery is the transfer of constructive possession, which may constitute delivery of a negotiable instrument both at common law and pursuant to the Bills of Exchange Act.[463]

As a preliminary point, we observe that, although not stated in the opinion, the position taken by CDS amounts to an argument that book-entry legislation is not necessary to deal with the transfer of negotiable money market instruments amongst CDS participants. The CDS Participant Agreement and Service Rules provide that the book delivery of a security held by CDS constitutes the attornment of CDS that the security delivered is held for the transferee and is thereby constructively delivered to the transferee.[464] Therefore, to the extent that CDS' opinion is correct, there is no need for book-entry legislation in order to deal with transfers of negotiable money market securities as between CDS participants. There would then be no need for the expanded definitions of "security"[465] or "issuer"[466] proposed by CDS.

In our view, however, there is considerable doubt as to how far constructive delivery may be relied upon with respect to the transfer of money market instruments.

Although constructive possession has been considered in many cases, none of these cases considers anything comparable to a modern depository system.[467] It is clear that constructive delivery can occur, without actual

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463 Section 2 of the Bills of Exchange Act includes the following definition:

> "delivery" means transfer of possession, actual or constructive, from one person to another;

464 See Rules 2.7.4, 3.2.6, and 4.2.15.

465 The proposed deletion of current ABCA s. 44(2)(n)(iii), discussed in detail commencing at p. 145 of this report.

466 Proposed ABCA s. 70.2(8), which is comparable to the current OBCA s. 85(8).

467 See *Dickson* v. *Chamberland*, [1926] 3 D.L.R. 765 (Alta. C.A.); *Field* v. *Carr* (1828), 6 L.J.(o.s.)C.P. 203; *Bosanquet* v. *Forster* (1841), 173 E.R. 999; *Belcher* v. *Campbell* (1845), 115 E.R. 773 (Q.B.); *Watson* v. *Bradshaw* (1881), 6 O.A.R. 666; *Lysaght* v. *Bryant* (1850), 137 E.R. 808; *Adams* v. *Jones* (1840), 113 E.R. 884 (Q.B.); *Brind* v. *Hampshire* (1836), 150 E.R. 475 (Exch.).

movement of the instrument, where the instrument is held at all times by an agent, first on behalf of the vendor and then on behalf of the purchaser. In the cases where constructive delivery was found to occur, the person making the constructive delivery has been in actual possession or control of the instrument.[468] This would appear to be the situation only if a transaction was strictly as between CDS participants, such as where brokers or banks were trading for their own accounts and not on behalf of their customers. CDS would in these circumstances be the agent in possession, first on behalf of the vendor, then on behalf of the purchaser.

In some situations, however, depository participants are trading on behalf of their customers. This adds an additional intermediary layer to each side of the transaction — something that has never been considered by any case dealing with constructive possession. In our view, this extra intermediary changes the situation significantly.

Consider the situation where a broker has received a money market instrument from a customer and deposited it with CDS, then that customer sells the instrument to another customer of the same broker, and the purchasing customer chooses not to take delivery of the instrument from the broker. In the records of CDS there is no change in the account of the broker. The broker's records will reflect a change, but in the absence of book-entry legislation, the broker is not a "holder" of the security nor can the broker be said to have possession or control of the security. The "holder" is CDS, who also has possession or control of the security, and there is no acknowledgement or recognition by CDS of any transfer that might be construed as constructive delivery.

Even in a situation where the transaction involves customers of two different brokers so that CDS' records do show a transfer, those records do not reflect the interests of the actual purchaser and vendor, only those of their respective agents. There is still a complete separation between the purchaser or vendor and the entity making the purported constructive delivery — a situation that has never been considered by the courts within the context of

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468 The necessity of possession or control in order to make a constructive delivery is stated in *Horn* v. *Nicholas* (1918), 201 S.W. 756 (Tenn. S.C.). The fundamental principle is stated by Chalmers, *supra*, note 421 at 4 as follows: "A person is said to have constructive possession of a thing when it is in the actual possession of his servant or agent on his behalf;".

this issue. In our view, it is not clear that this situation would be found to amount to constructive delivery.

Of course, our discussion of this issue has proceeded on the basis that we are dealing with the transfer of negotiable instruments. This is the assumption behind the proposed legislation. As noted earlier, we feel that this assumption is incorrect and misleading, and that we are actually dealing with the transfer of intangible claims against intermediaries. If we are correct in this regard, there is no need to debate or resolve the issue of constructive delivery.

CHAPTER 9 — *SITUS* OF SECURITIES

A. Introduction

We have already discussed the globalization of modern securities markets. International securities transactions raise obvious questions about the *situs* of securities, and about which jurisdiction's laws apply to such transactions. Similar questions arise with respect to transactions within Canada. This chapter will examine some of these questions and consider the effect of depository operations on them.

The reforms we have recommended will have a significant impact upon *situs* and jurisdiction. The impact of the reforms is discussed later in the chapter, after reviewing the existing law.

B. *Situs* of Securities

(1) Why is *Situs* Important?

Situs may influence or determine a number of issues. Securities may have connections with many different jurisdictions, and move rapidly from one jurisdiction to another. Each jurisdiction may have very different laws applicable to those securities.

Situs may affect the exigibility of securities by judgement creditors. It may also influence what law is applicable to contracts dealing with securities, and whether or not securities have been validly transferred.

Situs may determine the applicability of laws relating to the administration of the estates of deceased persons, the succession of property on death, and the taxation of property situated within a particular jurisdiction.

Situs may also trigger important consequences by determining the applicability of other specific statutory provisions, such as:

i) Personal Property Security Act(s) ("PPSA"). The Alberta PPSA[469] defines "security" in section 1(1)(oo) solely in terms of a physical

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[469] *Supra*, note 103.

document, and section 5 provides that the validity, perfection and effect of perfection or non-perfection of a possessory security interest in a security is governed by the law of the jurisdiction where the collateral is situated at the time the security interest attaches. The comparable Ontario PPSA[470] provisions are practically identical to Alberta's, but the B.C. PPSA[471] contains an additional provision stating that a security with a clearing agency is situated where the records of the clearing agency are kept.

ii) Insurance Act(s). Section 43(2) of the Alberta Insurance Act,[472] dealing with the sufficiency of insurers' assets, contains a reference to insurers' "assets in Alberta". Section 437(5) of the Ontario Insurance Act[473] requires that all securities of an insurer shall be held "in Ontario".

(2) Distinguishing Between Tangible and Intangible Property

The determination of *situs* is, unfortunately, a very complex question even without considering the effect of securities depositories.

Initially, we must make several important distinctions which are of recurring significance. The most fundamental distinction is one that we have already discussed at some length — the distinction between tangible and intangible property. As stated by Falconbridge:

> A thing must be distinguished from an interest in a thing. Even if the subject of the interest is a tangible thing, a physical object, a person's interest in the thing is itself an intangible legal concept, having no actual existence and no actual *situs*. If the subject of the interest is itself a so-called intangible thing, then the thing, like the interest in the thing, is merely a legal concept. Things may therefore be classified as, (1) tangible things, which may be either (a) movable or (b) immovable, and (2) intangible things. This classification is accurate in so far as it excludes intangibles

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470 Personal Property Security Act, R.S.O. 1990, c. P.10

471 Personal Property Security Act, S.B.C. 1989, c. 36.

472 R.S.A. 1980, c. I-5.

473 R.S.O. 1990, c. I.8

> from the category of movable things, although they are frequently spoken of or thought of as being movable.[474]

This distinction is, in many respects, the key to understanding problems with the *situs* of securities under the existing and proposed legislation. It therefore warrants close examination.

(a) Distinguishing the security certificate from the underlying interest

Securities are generally divisible into two types: 1) equities (usually shares or some other interest in the issuer); and 2) debts (obligations of the issuer, usually to pay money). This dichotomy is clearly reflected in different approaches to the determination of *situs* for each type of security. But with both types of security, we must distinguish between the security certificate and the underlying interest.

Shares are a "personal estate giving the bearer certain rights of proportional participation in the business, the profits, and eventually the partition of the assets of the company itself", and are clearly distinguishable from debts.[475] Both shares and debts are intangible property — choses in action. Both are generally evidenced by security certificates, which are tangible property — choses in possession. We must distinguish between those certificates, which as physical objects have their own *situs*, and the intangible legal concepts represented by those certificates, which may have a different *situs*.

We have seen that share certificates have not traditionally been classed as negotiable instruments. Commercial practices led to legislative provisions (such as the UCC, CBCA, OBCA and ABCA) deeming share certificates to be negotiable instruments. Thus, for the purposes of the transfer or pledge of

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474 J.D. Falconbridge, *Essays on the Conflict of Laws*, 2nd ed. (Toronto: Canada Law Book, 1954) at 487.

475 See J.-G. Castel, *Canadian Conflict of Laws*, Vol. 2 (Toronto: Butterworths, 1977) at 349, citing *Toronto General Trust Corp.* v. *R.*, [1938] 1 D.L.R. 40 (Que. S.C.) at 43. See also *Bradbury* v. *English Sewing Cotton Co. Ltd.*, [1923] A.C. 744 at 767 per Lord Wrenbury. In this chapter we often refer to Professor Castel's 1977 text, even though he has published a second edition in 1986. This is because the earlier edition contains a much more detailed discussion of this area, and the material cited is consistent with the contents of the later edition.

shares under such statutes, the intangible shares are practically fused with the certificates.[476]

With debt securities, the ultimate distinction between the certificate and the underlying intangible interest is essentially the same as for shares. However, the historical legal treatment of debt securities was much different than that of shares, and this difference has had a significant impact on the determination of *situs* for each type of security.

(3) The *Situs* of Debt Securities

The *situs* of debt securities is relatively easy to determine.

Most debt securities have traditionally been classed as negotiable instruments. This was so for centuries before some corporate statutes began specifying that such securities were negotiable instruments. The debt is practically merged in the document which represents it, and the *situs* of the debt is that of the document.[477] The *lex situs* governs the transfer of both the document and the debt. The negotiability of the document is determined according to the *lex rei sitae* at the time of the transfer.[478]

(4) The *Situs* of Shares

Shares have been the subject of much different considerations in the determination of their *situs*, and as compared to debt securities, the *situs* of shares can be extremely difficult to determine.

The rules developed to determine the *situs* of shares vary depending upon the purpose for which such *situs* is being determined. Most of the cases deal with the determination of *situs* with respect to the applicability of succession duties.[479] Although there are currently no provincial succession duties in Canada, these cases and the issues raised by them are by no means

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476 See the discussion of negotiability commencing at p. 39 of this report.

477 J.D. Falconbridge, "Situs And Transfer Of Intangibles In The Conflict Of Laws" (1935) 13 Can. Bar Rev. 265 at 268.

478 *Ibid.* at 488-92. Falconbridge describes registered bonds as "quasi-negotiable instruments" or specialties.

479 See B. Laskin, "Taxation And Situs: Company Shares" (1941) 19 Can. Bar Rev. 617.

irrelevant. Historically, provincial succession duties in Canada have come and gone largely in reaction to federal taxation in this area.[480] The recent constitutional debate in Canada included discussion of the possibility of increased provincial control over taxation, so it would appear that provincial succession duties are dormant, not deceased. The same considerations would be applicable to any provincial taxing measures,[481] and are also fundamentally relevant to determinations of *situs* for certain other purposes.

(a) *Situs* for provincial succession duty purposes

It must be emphasized that the law in this area developed before there were any statutory provisions declaring share certificates to be negotiable instruments. Although the cases acknowledge that share certificates endorsed in blank are negotiable in some sense, certificates were not, strictly speaking, negotiable instruments. Therefore, unlike negotiable instruments, the shares did not merge in the certificates so as to automatically acquire the same *situs* as the certificates, and a separate test developed for determining the *situs* of shares.

It is tempting to simply assume that now, with share certificates being given negotiable instrument status under the Business Corporations Acts, shares have acquired the same *situs* as the certificates. Unfortunately, this conclusion does not necessarily flow from the cases. As we will discuss, the cases have adopted some questionable and confusing positions regarding the nature of the interest held by a person who is not the registered owner of shares, and the effect of a corporation having multiple share registry offices in different jurisdictions. This makes it necessary to examine the cases in some detail. After that, we will specifically address the effect of statutory negotiability on the *situs* of shares.

(i) Early cases

The early cases dealing with succession duty concluded that the notional *situs* of shares is the jurisdiction where, in the ordinary course of business, they may be effectively dealt with as between the shareholder and the

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480 See M.C. Cullity and C.A. Brown, *Taxation And Estate Planning*, 2nd ed. (Toronto: Carswell, 1984) at 9-17.

481 See G.V. LaForest, *The Allocation of Taxing Power Under the Canadian Constitution*, 2nd ed. (Canadian Tax Foundation, 1981) at 111-49.

company, so that the transferee will become legally entitled to all the rights of a member.[482] This meant the location of the share registry office, as this was where the shares would be transferred on the books of the company.[483] The test was originally quite simple and straightforward, because in each case there was only a single share registry office.

(ii) *R. v. Williams*

In 1942, the Privy Council decided the case of *R. v. Williams*,[484] in which the issue was the *situs* of shares for succession duty purposes, where the issuing company kept two share registry offices, one in Ontario and another in New York.

The Privy Council specifically approved three principles formulated by the Supreme Court of Canada[485] applicable to the issue of *situs* in succession duty cases:

1. Property (whether moveable or immovable) can have only one local situation for the purposes of determining *situs* as among the various Canadian provinces' application of succession duties.

2. *Situs* in respect of intangible property must be determined by reference to some principle or coherent system of principles and it is assumed that the British Legislature, in defining the provinces' taxation authority with reference to the local situation of property, must be supposed to have had in view the principles of, or deducible from, the common law.

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482 *Attorney-General* v. *Higgins* (1857), 2 H. & N. 339, 157 E.R. 140 (Ex.); *Colonial Bank* v. *Cady*, *supra*, note 87; *Brassard* v. *Smith*, [1925] 1 D.L.R. 528 (P.C.); *Erie Beach Co. Ltd.* v. *A.G. Ont.*, [1930] 1 D.L.R. 859 (P.C.).

483 *A.G.* v. *Higgins*, *ibid.*

484 [1942] 3 D.L.R. 1.

485 See *R.* v. *National Trust Company*, [1933] S.C.R. 670.

3. Provincial legislatures are not competent to prescribe the conditions fixing the situs of intangible property for the purposes of defining what is taxable under section 92(2) of the BNA Act.[486]

It had been argued that the general test could have no application where two share registries existed in different jurisdictions, but the Privy Council held that the general test remained applicable, and that a choice between the two alternative locations must be made on "a rational ground".[487] The court made special mention of the fact that the certificates in question had been endorsed in blank by the registered owner, so that delivery of the certificates in that form was "a good assignment of the shares, since it passed a title to the assignees both legal and equitable, with the right as against the company to obtain registration and obtain new certificates."[488] It declined to comment on the conclusion it might have reached had the certificates not been endorsed in blank, stating that "there are some obvious distinctions arising in cases where the endorsement on certificates has not been signed by the registered holder".[489] This particular point would become the source of some confusion in subsequent cases, as we shall discuss.

The *Williams* decision also stated very clearly that the certificates are not specialties and the *situs* of certificates is not, taken alone, sufficient to determine the *situs* of shares.[490] Nor did the residence of the late owner influence the *situs* of the shares, since the shares could be sold by an attorney or otherwise.[491] The Privy Council ultimately found that the existence of the endorsed certificates in New York at the date of death was the decisive factor placing the *situs* of the shares in New York.

486 *R.* v. *Williams, supra,* note 484 at 15.

487 *Ibid.* at 15-16.

488 *Ibid.* at 13.

489 *Ibid.* at 16-17.

490 *Ibid.* at 11-13.

491 *Ibid.* at 14.

(iii) *Blonde and Aberdein*

The next major judicial pronouncement on this subject was again by the Privy Council in *Treasurer of Ontario* v. *Blonde; Treasurer of Ontario* v. *Aberdein.*[492] That decision involved two separate cases with similar facts.

In the *Blonde* case the testator was the registered owner of shares in two Michigan companies. Each company had transfer agents in both Michigan and New York. The testator died in Ontario while in possession of the share certificates.

In the *Aberdein* case, the testator was registered owner of shares in two Canadian companies, each of which maintained transfer agents in Toronto and New York. The shares were listed upon the stock exchanges in both cities. The testator died in Massachusetts, where all the share certificates were located.

In neither case were the share certificates endorsed in blank or otherwise by the testator.

The Privy Council held that in neither case were the shares situate in Ontario. It followed and applied test used in the *Williams* decision, stating:

> ... (leaving aside the case of "street certificates") the first matter to be ascertained in an inquiry as to the situs of registered shares is the place in which the shares can be effectively dealt with as between the shareholders and the company so that the transferee will become legally entitled to all the rights of a member.[493]

This reference to street certificates has added to the confusion arising from the *Williams* decision comment on the significance of certificates being endorsed in blank by the owner in that case.

Blonde's case was easily dealt with, since there was no possibility that the shares could be disposed of in Ontario at all. *Aberdein's* case presented more of a challenge, requiring a choice of *situs* as between Ontario and New York. It was found that there were clear advantages to the executors in

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[492] [1946] 4 D.L.R. 785.

[493] *Ibid.* at 686.

choosing New York over Ontario as to the place of transfer, so that the shares were not situate in Ontario.[494]

In examining the reasoning by which the Privy Council selected New York over Ontario, it is remarkable that they refer clearly to the choice of the executors and a registered owner in respect of where the shares might be transferred. It is quite logical to consider the location selected by an executor to register a transfer of shares from the testator to the executor, although such a transfer is often unnecessary. But the Privy Council refers also to the sale of the shares by an owner,[495] and the advantage of receiving U.S. currency on such a sale. This raises an important point not discussed directly in the cases: upon sale of the shares, the seller generally has no effect whatsoever upon the choice of the transfer office used to register the transfer.

The cases clearly recognize that the sale of shares, as between the parties to the sale, is effected by the delivery of a properly endorsed certificate to the purchaser.[496] The purchaser could then register the transfer with the company, or re-sell the shares by endorsing and delivering the certificate. Where the shares are listed on a stock exchange, they will generally be sold through a broker. This would normally involve endorsing the certificate to the broker, who would then register the shares in the name of the broker or a nominee, and then deliver a "street certificate" to the purchaser's broker, or as required by the clearance process. Whether sold directly to a purchaser, or through a broker, the seller does not control, or significantly affect, the selection of the transfer agent used.

It seems illogical, therefore, that the courts have used the circumstances of the seller of shares as a method of determining the location where the registration of transfer is likely to occur. Unfortunately, the courts' misapprehension of this particular aspect of share transfers is not the only area of apparent confusion. It seems linked to the confusion arising from the comment in the *Williams* case about "obvious distinctions" arising in cases where certificates are not endorsed by the registered owner, and the

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494 *Ibid.* at 688.

495 *Ibid.* at 688. The decision refers to *Rex* v. *Globe Indemnity Co. of Canada; Maxwell* v. *Reg.*, [1945] O.R. 190 (C.A.), which also considers both the transfer of shares into the name of the executor, and a sale.

496 See *supra*, note 488 and accompanying text.

qualification in *Blonde's* case to the effect that a different test may be applicable to "street certificates".

(iv) *In re Brookfield Estate*

All these areas were canvassed by the Supreme Court of Canada in *In re Brookfield Estate; Royal Trust Co.* v. *R.*,[497] on appeal from the Supreme Court of Nova Scotia. The court considered the *situs* of shares for succession duty purposes in a situation where the share certificates were held in Nova Scotia by a trust company on behalf of the deceased at the time of his death. The shares were registered in the names of nominees of the trust company, and the certificates were endorsed in blank by those nominees. The shares were in the stock of various U.S. companies, none of which maintained a share transfer office in Nova Scotia.

The Nova Scotia Supreme Court had held that the deceased's interest in the shares was situate in Nova Scotia, basing their decision on *Stern* v. *The Queen.*[498] The *Stern* case found that share certificates located in England, evidencing shares in U.S. companies, endorsed in blank and marketable in England, were subject to probate duty in England.

The Supreme Court of Canada decision comprised four separate judgements.

Kerwin J. assumed without deciding that the case dealt with "street certificates", but he then indicated that the leaving aside of street certificates in the *Blonde* case, and the presence of such certificates in Nova Scotia, did not alter the fact that the test is where the shares may be effectively dealt with as between the company and the owner, not as between transferor and transferee.[499] This fails, however, to recognize any distinction at all between shares registered in the name of the beneficial owner (whether the certificates are endorsed or not) and shares registered in the name of a nominee and represented by street certificates.

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497 [1949] S.C.R. 329.

498 [1896] 1 Q.B. 211.

499 *In Re Brookfield Estate, supra*, note 497 at 333.

In distinguishing the *Stern* decision, Kerwin J. expressed the view that its application should be confined to cases of bearer bonds, which could pass by delivery and were capable of being dealt with for money on the stock exchange.[500] Moreover, he indicated that even if the *Stern* decision operated in England to render share certificates subject to probate duty by reason of their location in England, this should not apply to Canadian constitutional cases as "it would make serious inroads upon the test of the *situs* of shares as being where they may be effectively dealt with as between the company and the owner."[501] Again, this reasoning fails to recognize the real nature of the late Mr. Brookfield's interest in the street certificates. The certificates were as capable of being dealt with for money as if they were bearer bonds, and they would almost certainly be dealt with in their existing form. The question of where they might be dealt with as between the company and the beneficial owner is therefore rather meaningless in these circumstances.

The judgement of Taschereau J. is relatively brief. He stated simply that the shares, in which the deceased had a beneficial interest, cannot be dealt with in Nova Scotia as between the shareholder and the company, but only in the U.S. where the appropriate transfer offices were located.

The judgement of Rand J. began by commenting that, as between transferor and transferee, the established test would be virtually useless since a shareholder could effectively transfer the right to a share in any part of the world.[502] He went on to note that although mere transferability or merchantability of the right to become a shareholder initially have little or no relevance to *situs*, the *situs* of shares may be determined by what the law creating the shares has provided to evidence their characteristics as property. So, if in the case of bearer shares the issuing jurisdiction has in effect embodied in a certain instrument the exclusive symbol of the total rights created, then *situs* will be taken to be the locality of the instrument.[503]

It was argued that street certificates have come to represent a separate unit of property consisting of the beneficial interest in the share coupled with a

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500 *Ibid.* at 334.

501 *Ibid.* at 334-35.

502 *Ibid.* at 338.

503 *Ibid.* at 338-39.

power in the bearer to become a registered shareholder, with the delivery of the certificate concluding the transaction between the parties. Rand J. did not accept this argument because in the case at hand the purchaser could not become a shareholder except by further acts outside of Nova Scotia.[504] He also distinguished *Stern* on the basis that it dealt with a division of interests in or powers over shares so as to allow for more than one *situs* — something not permitted in considerations of provincial taxation powers in Canada.[505]

The judgement of Kellock J. was concurred in by Estey J. He found that the property passing on the death of Mr. Brookfield was the full beneficial ownership of the shares and not merely a chose in action.[506] He went on to find that the fact that the shares were not registered to the deceased did not prevent application of the test set out in the *Williams* case.[507] In addressing the exclusion of street certificates from the Privy Council's decision in *Blonde,* Kellock J. simply indicated that until the Privy Council established a different rule, his view was that shares evidenced by street certificates are subject to the same considerations as shares evidenced by unendorsed certificates registered in the name of the beneficial owner.

In our view, this reasoning is flawed. If the property passing on the death of Mr. Brookfield comprised the shares themselves, it is incorrect to say that such property was not merely a chose in action — shares are a chose in action. But even if that were not so, the property passing could be precisely described as a chose in action exercisable against the trust company which held the shares for Mr. Brookfield. This would include the right to possession of the certificates, the right to dividends received by the trust company, the right to instruct the trust company to vote the shares, etc., which together comprise full beneficial ownership of another chose in action (the shares). Legal ownership of the shares was held by the trust company, but Mr. Brookfield's right to the certificates must be recognized as including the right to acquire legal ownership of the shares.

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504 *Ibid.* at 339. This statement overlooks the fact that, from the standpoint of the U.S. issuers of the shares in question, delivery of the street certificates would have transferred the shares. See *supra,* note 130 and accompanying text. It seems doubtful that this point was ever raised in argument.

505 *Ibid.* at 339-40.

506 *Ibid.* at 341-42.

507 *Ibid.* at 344.

It seems obvious that there is a clear distinction between the property held by Mr. Brookfield and the property held by someone who is the registered owner of shares. In order to complete a transfer of the registered owner's entire property, a purchaser must register the transfer on the books of the issuer.[508] But a transfer of Mr. Brookfield's entire property could be completed in Nova Scotia without registration on the books of the issuer. Mr. Brookfield's administrator (the trust company), in exchange for payment, could simply agree to hold the certificates as agent and trustee for the purchaser, whereupon the purchaser would acquire exactly the same interest as Mr. Brookfield once held.

The Supreme Court's application of the test set out in the *Williams* case places an artificial requirement of registration on the purchaser of Mr. Brookfield's property, without acknowledging that registration would give the purchaser a different (and superior) property interest compared to that held by Mr. Brookfield. The decision advances no explanation for this requirement.

Near the conclusion of his judgement, Kellock J. commented that "Bearer share warrants are subject to different considerations. In such case the legislation usually provides that delivery of the warrant in itself effects a transfer of the shares without more."[509]

Castel asserts that the confusion over the relationship between endorsed share certificates and *situs* was resolved by the *Brookfield Estate* decision.[510] That may be an overstatement. Some confusion persists. In another leading text we find the statement that:

> Where, however, the registered owner of shares is a mere nominee of the beneficial owner and where the nominee has endorsed the share certificate in blank and is holding them to the order of the beneficial owner, then the beneficial owner's interest is situate where the certificate is to be found, for the only property which he possesses is the right to the shares and not the shares themselves: *Stern* v. *The Queen* [1896] 1 Q.B. 211; but see *[Brookfield Estate] Royal Trust Co.* v. *R.* [1949] 2 D.L.R.153. In such

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[508] According to Canadian law at the time.

[509] *Ibid.* at 348.

[510] Castel, *supra*, note 475 at 364 n.165.

> a case the shares continue to have their own situation in accordance with the general principle.[511]

This statement seems to take the analysis considerably further than either of the decisions cited. It directly contradicts the position taken by Castel. The distinction between the property interest of the beneficial owner of street certificates and the interest of a registered shareholder is, in our view, a valid and necessary one. The distinction is, at most, only implicitly recognized by decisions such as *Stern* and *Blonde; Aberdein*. As we have discussed, the *Brookfield Estate* decision essentially denies the distinction by ignoring it.

(v) *Re Canada Trust Co.*

The most recent judicial consideration of the general test involved a fact situation going beyond street certificates, representing circumstances quite similar to those arising with a securities depository. In *Re Canada Trust Co. et al. and the Queen*[512] the issue was whether certain shares forming part of the deceased's estate were liable to B.C. succession duty assessment as property "situate within the Province". The deceased, who died resident in California, had an account with the Victoria, B.C. branch office of a national brokerage firm. That account reflected that the deceased was beneficial owner of certain shares, but the arrangement between the deceased and his broker was such that no shares were registered in the name of the deceased, nor were any certificates segregated for his account. The broker held, on behalf of a number of clients, a quantity of large denomination certificates, registered in the broker's name, at the broker's offices in Toronto and Winnipeg. Transfer offices for the deceased's shares were available in Vancouver, Winnipeg and Toronto.

It is important to note the contrast between this situation and that in the *Brookfield Estate* case, where the trust company was holding specific, earmarked street certificates on behalf of Mr. Brookfield. In *Canada Trust* there was no segregation of certificates as between individual customers of the broker, only the broker's account records to show which customers were entitled to a certain number of shares. Although the case does not use the term "fungible

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511 L. Collins, *Dicey & Morris On The Conflict Of Laws*, 11th ed., vol. 2 (London: Stevens & Sons, 1987) at 911 n.77.

512 (1971), 24 D.L.R. (3d) 753 (B.C.S.C.); aff'd (1972), 30 D.L.R. (3d) 764 (B.C.C.A.).

bulk", it is clear that in fact the deceased's broker held the shares in a fungible bulk.

The B.C. Supreme Court held that the *situs* of the shares was Toronto and Winnipeg, because those were the places where the shares would most likely be transferred as between the purchaser and the company. It rejected the argument that the deceased's property was merely a chose in action exercisable against the broker, holding instead that the "property passing comprised the very shares held for him."[513] It concluded that "the property which passed on the death of the deceased was a proprietary interest in specific and identifiable securities".[514]

On appeal, the B.C. Court of Appeal again rejected the argument that the deceased merely had a creditor-debtor relationship with the broker, holding that the broker held the shares for the deceased on a "custodian" basis, so that the deceased maintained a property interest in the shares. The Court of Appeal referred to a portion of the decision in *Carter* v. *Long & Bisby*[515] implying that the deceased would have legal title to the shares held by the broker, but in this respect the decision is clearly in error. The portion of the *Carter* decision quoted by the Court of Appeal is taken out of context, and the *Carter* decision is authority only for the position that a principal has an equitable title to a portion of intermingled goods purchased by an agent with trust funds.[516]

The *Canada Trust* decision compounded the confusion evident in the earlier cases. Both the B.C. Supreme Court and the Court of Appeal dismissed the suggestion that the deceased's property was a chose of action exercisable against the broker, but did so without a close examination of the question. The Court's finding that a proprietary interest existed in "specific and identifiable" securities is misleading, in that it suggests that particular identifiable certificates were held for the deceased, which was not the case. Moreover, the decision made the same fundamental error as the earlier cases in assuming that, upon a sale of the shares, the location of the certificates in

513 *Ibid.* (B.C.S.C.) at 756.

514 *Ibid.* at 757.

515 *Supra*, note 228.

516 See the discussion of the application of *Carter* v. *Long & Bisby* commencing at p. 86 of this report.

the hands of the vendor will affect the choice of transfer office used by the purchaser. It is regrettable that this point was not addressed, because the deceased's method of holding shares obviously invited an examination of the likely method of transferring them to a purchaser.

The implications of this decision are significant and troubling, and the case was subject to criticism immediately.[517] The broker-customer arrangement considered was commonplace at the time the case arose, and is even more common now, but how many investors know, or care, where their brokers store share certificates? The fact that investors in Alberta may become subject to succession duties in Ontario or Manitoba as a result of their brokers' practice of storing certificates there would certainly discourage Alberta investors from leaving their certificates in the custody of their brokers. It is difficult to say what the result might have been had the broker stored unsegregated certificates in a number of remote locations, or if the broker had surrendered the certificates to the issuer.

(vi) Flaws in the established test

In our view, the cases discussed above, and particularly *Re Canada Trust Co. et al. and the Queen*, demonstrate that the established general test for determining the *situs* of shares is out of step with the realities of modern methods of holding and transferring shares. The test was reasonable when originally formulated in 1857[518] because at that time most companies had but a single share register, and most transfers of shares were registered. This test became problematic when applied to cases where there were transfer agents in more than one jurisdiction,[519] and the courts have struggled unsuccessfully to apply the test rationally to situations involving shares held in marketable form.

We have seen that there has been a great deal of confusion in the cases over the nature of the property interest held by an investor in a fungible bulk of securities.[520] It should now be clear that the property interest of such an

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517 See case comment by J.E. Côté, (1972) 50 Can. Bar Rev. 638.

518 See *Attorney-General* v. *Higgins*, *supra*, note 482.

519 See case comments (apparently) by Bora Laskin in (1942) 20 Can. Bar Rev. 640, and (1944) 22 Can. Bar Rev. 838.

520 See also the discussion of "Where the Broker Holds Securities on Behalf of the Client" commencing at p. 70 of this report.

investor, where the certificates are held by the intermediary in a fungible bulk or otherwise, is a chose in action — a claim against an intermediary including the right to acquire a certificate registered in the investor's name.[521] The transfer of that chose by the investor is generally accomplished without any registration of transfer of shares on the books of the issuer, and it ought to be recognized that the general test is clearly inappropriate to such property.

At present, most companies with publicly-traded shares have transfer agents in several different jurisdictions and, more importantly, only a small fraction of transfers are registered. With the increased involvement of intermediaries, more and more investors vote shares and receive dividends without ever appearing on the corporation's shareholders' list. The ultimate goal of depositories is the immobilization of all share certificates, at which point the share register becomes virtually meaningless. In many ways the share register is an anachronism, and so is the established test for determining the *situs* of publicly-traded shares.

(vii) The effect of statutory negotiability on the established test

How does the specific declaration in the Business Corporations Acts, that share certificates are negotiable instruments, affect the case law positions on *situs*? If share certificates are treated exactly the same as other negotiable instruments, then their *situs* is easily determined: it is the location of the certificates.

If statutory negotiability has no effect, and the courts continue to use the established test to determine the *situs* of shares, it seems likely that the *situs* of the certificates will still be a very important factor. Regardless of whether the certificates are physically held by the investor or an intermediary, or in whose name they are registered, or whether they are endorsed or not, in most cases they would, according to the established test, be dealt with at the nearest available transfer agent to the certificates at the relevant time, bacause that would be the transfer agent most likely to be used to register a transfer. Therefore, the physical location of the certificates would often be the factor most likely to determine the *situs* of the shares, as occurred in *Re Canada Trust Co. et al. and The Queen.* But this seems unacceptable for a number of reasons.

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521 See *supra*, note 287 and accompanying text.

We have discussed in some detail the confusion in the cases dealing with the relationship between endorsed certificates and the *situs* of shares. This confusion appears to have stemmed from the courts' failure to recognize the distinction that existed, before the advent of the Business Corporations Acts, between the interest of a registered owner of shares and that of a beneficial owner where the shares are registered in the name of an intermediary. The registered owner's full interest (legal ownership of the shares) could only be acquired by a purchaser registering the transfer with the issuer, whereas the beneficial owner's full interest (equitable ownership including the right to become legal owner of the shares) could pass merely with the delivery of street certificates, or by book entries made by an intermediary. To some extent, this failure explains why the courts persisted in using registered transfers to determine *situs*, even where this ignored the real nature of the property involved and the method by which it was normally transferred.

With the advent of statutory negotiability, and the resulting ability to transfer any shares without registration, registration should be completely irrelevant to *situs.*

This suggests that the *situs* of shares should be determined by the location of the certificates, which is the position taken by U.S. law.[522] This leaves to be determined the *situs* of an investor's interest in a fungible bulk of securities held by a broker.

In our view, registration requirements should be similarly irrelevant to the determination of *situs* of shares under Canadian law. The *situs* of certificated shares registered in the name of the owner should be determined by the location of the certificates, just as with other negotiable instruments. If the certificates are registered in the name of a nominee, but the certificates are earmarked, then the owner of the certificates is the owner of the shares, the *situs* of which would still be determined by the location of the certificates.

Where an investor has an interest in a fungible bulk of securities through an intermediary, under the existing law, the *situs* of that person's

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522 See R.A. Leflar, L.L. McDougall and R.L. Felix, *American Conflicts Law*, 4th ed. (Charlottesville: Michie Co., 1986) at §183; and 18 *Corpus Juris Secundum* §126 c. It is important to note that U.S. law does not determine the *situs* of shares for taxation purposes in the same way as Canadian law because U.S. taxes are based on the domicile of taxpayers, not on the *situs* of property.

property interest is probably the place where the investor may bring action against the intermediary. This is, in our view, the most rational approach, consistent with the law determining the *situs* of other negotiable instruments and interests under trusts.[523]

(5) *Situs* of Uncertificated Shares

What is the *situs* of a share for which no certificate has been issued (pursuant to ABCA section 45(1) or its equivalent in the CBCA or OBCA)? There is no authority on point and it is very difficult to speculate on this question. Since no certificate exists, there can be no suggestion that the uncertificated security is a negotiable instrument.

There is no mechanism provided in any Canadian legislation, actual or proposed, for the registered transfer of such a security.[524] The only method provided by statute for these shares to be dealt with, as between the shareholder and the corporation, is for the registered owner to first obtain a certificate. That certificate may be obtained from any of the corporation's transfer agents, so the application of the established test would imply that the *situs* of such shares would be that of the transfer agent most likely to be called upon to issue the certificates. This would probably be the transfer agent in the closest proximity to the registered owner of the shares.

With respect to dematerialized uncertificated shares, it is not surprising that there is again no authority on point. If the established test were to be applied to such shares, it seems most likely that the *situs* would be the transfer agent in the closest proximity to the registered owner of the shares, for the reasons outlined above.

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523 This assumes that the client's interest in a fungible bulk of securities held by an intermediary is trust property. If the interest is viewed as in a debtor-creditor relationship, or bailment, the *situs* of interest is likely the place of the intermediary's residence, as it would be with a simple contract debt.

524 See the discussion of "Transfers of uncertificated securities outside a clearing agency" commencing at p. 140 of this report.

(6) Other Specific Purpose Tests

The *situs* of shares for purposes of income tax is the place of residence of the company.[525] For administration of estates purposes, the test may again involve the determination of the place where the shares can be effectively be dealt with.[526]

With respect to the transfer *inter vivos* of shares, Castel states:

> In the case of shares which are represented by a certificate that must be surrendered in order that the transfer of the shares may be registered on the books of the company, it is necessary to distinguish between the *situs* of the certificate and the *situs* of the shares as well as the effect of the transfer as against the company and as regards the parties to the transfer and the persons claiming under them.
>
> The effect of a transfer of shares as against the company is determined by the *lex situs* of the shares. On the other hand, as regards the parties to the transfer and the persons claiming under them, the effect of the transfer is determined by the proper law of the transaction which in most cases is the place where the certificate has been delivered.[527]

It is clear that the principles used in the determination of *situs* in succession duty cases are not applicable to the determination of *situs* in relation to a dispute over the ownership of the shares.[528] Castel notes that although the cases appear to deal with and turn on the *situs* of shares, they actually rely "either upon the application of the proper law of the contract or on the principle that the condition under which title to its shares may be acquired is exclusively a matter for the law-making authority of the jurisdiction where the corporation has its proper domicile."[529]

With respect to judicial execution, shares may have more than one *situs*: one *situs* will be the domicile or place of incorporation of the corporation; and

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525 Castel, *supra*, note 475 at 365.

526 *Ibid.* at 365-66.

527 *Ibid.* at 404.

528 See *Brown, Gow, Wilson et al.* v. *Beleggings-Societeit N.V.*, *supra*, note 380 at 691-93, and at 695-97, where the decisions in *Braun* v. *The Custodian*, *supra*, note 380, are discussed and applied.

529 Castel, *supra*, note 475 at 368-69.

shares may also be situate wherever they may be effectively dealt with as between the shareholder and the corporation.[530]

(7) The Effect of Depository Operations on *Situs*

Depository operations have a significant effect upon determinations of the *situs* of immobilized securities, particularly when the depository, like CDS, has facilities in a number of different jurisdictions. Once a security certificate is deposited with CDS by a participant, the participant has an interest in the fungible mass of similar certificates held by CDS on behalf of all participants. CDS may store certificates in a number of different locations across Canada, or in one central location, or it may surrender some or, hypothetically, all of the certificates to the issuer. In any case, when one participant sells, and another participant buys a certain quantity of immobilized securities, it is generally impossible to identify any particular certificates which represent the securities being transferred.

If CDS were to store all its certificates within one jurisdiction, this would eliminate uncertainty over the *situs* of the certificates, but practical considerations make this impossible. Centralized depositories such as CDS must have facilities in various jurisdictions in order to provide effective service to their participants, so that, for example, participants in Vancouver or Calgary may deliver and receive certificates there. They also maintain interface arrangements with other depositories so that, for example, securities held by the Depository Trust Company in New York may be "delivered" to CDS in settlement of a trade merely by book entry. The result is that, at any given moment, a centralized depository such as CDS will be in physical possession of certificates located in a number of different jurisdictions, and also be entitled

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530 See *Hunt Estate* v. *R.* (1966), 20 D.T.C. 5322 (Ex.). The court held that the rules established to determine the *situs* of shares relative to the application of succession duties, in so far as they demand that a single *situs* be identified, are inapplicable to a determination of *situs* relative to judicial seizure. Castel appears to overstate this aspect of the decision, suggesting that "the rules relating to *situs* for taxation or succession duty purposes cannot be used to ascertain the *situs* for determining the effect of a judicial seizure" (see Castel, *supra*, note 475 at 369). In fact, the *Hunt Estate* decision suggests that the rule applied in *Brassard* v. *Smith* (*supra*, note 482) may be applicable to determine a *situs* of shares relative to judicial seizure.

to receive certificates from other depositories in other jurisdictions, which certificates may be physically located in still other jurisdictions.[531]

Consequently, to the extent that the *situs* of certificates influences the *situs* of the underlying securities, depository operations present a major problem by making it impossible to determine the *situs* of certificates. This problem is not unique to depositories — it is essentially a magnification of the same problem that occurred when brokers held securities in fungible bulks on behalf of customers, as considered in the case of *Re Canada Trust Co. et al. and the Queen.*[532] In that case the broker happened to store all the certificates comprising a fungible bulk in a specific location, but they might just as easily have been situated in more than one jurisdiction.

If a case such as *Re Canada Trust Co.* were to arise today, we should expect that the broker would be holding the securities in question in an account with CDS. Even if certificates could be clustered in one jurisdiction by CDS, we must recognize that this would only exacerbate the problem of the lack of a rational connection between beneficial owners and the *situs* of certificates, as was demonstrated in the *Re Canada Trust Co.* case. In our view, it is evident that where a person has an interest in a fungible bulk of securities, the *situs* of certificates has no correlation and should be irrelevant to the *situs* of that interest.

For uncertificated securities held by CDS, the same basic considerations apply. If the established test is applied, we may speculate that their *situs* will be the location of the relevant transfer agent nearest to the CDS office which would, in the normal course, request the issuance of certificates. The determination of which CDS office would normally request the issuance of certificates will depend almost entirely upon CDS' internal policies, which would be subject to regulation. Of course, the application of the general test to uncertificated securities held by CDS is just as inappropriate as it is with certificated securities.

531 The Depository Trust Company of New York physically stores many of its certificates with the Midwest Securities Trust Company in Chicago, another depository with which the DTC maintains an interface arrangement. Conversation with Mr. Carl H. Urist, Deputy General Counsel & Vice President, The Depository Trust Company, Dec. 24, 1991.

532 *Supra*, note 512.

The proposed amendments to the ABCA include a provision deeming anyone who deposits a security with CDS, and every book-entry transferee or pledgee of a security, to be in possession of the security for all purposes, identical to OBCA section 85(5). What effect does this provision have on the determination of the *situs* of deposited securities? Probably none, according to the established test, because this deemed possession would have no effect on the actual steps any person would take in order to deal with securities as against the issuer. Deemed possession might affect the applicability of the PPSA, which will be discussed in the next chapter.

(8) Reformed *Situs*

We have recommended reform that would include characterization of interests in fungible bulks as securities entitlements ("SEs"), a special intangible claim against the intermediary, with defined rights. Because the SE is unique, and a creature of statute, we have the luxury of, in effect, specifying its *situs*. The *situs* of an SE should be the place where the investor may bring action against the intermediary — the same jurisdiction specified by a choice of law clause.[533] This should be the location of the intermediary's office, or branch office, where the client deals with the intermediary. This would preserve local regulatory authority, and is consistent with common law principles.

We will now examine particular areas where issues arise from the effects of depository operations on the *situs* of securities.

C. Which Jurisdiction's Laws Apply to the Transfer and Pledge of Securities Held by a Depository?

(1) Scope of Legislative Provisions

If we examine the scope of the transfer provisions found in Part 6 of the ABCA and OBCA, and Part 7 of the CBCA, a significant difference becomes apparent. The OBCA definition of "security", traced through the definitions of "issuer" and "body corporate", leads to the conclusion that "security" includes a security of any body corporate, including federal and extra-provincial corporations. The existing CBCA and ABCA provisions limit the definition of "security" by reference to the definitions of "corporation" and "issuer" so that

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533 Choice of law is discussed in detail in the following section. See also the draft revisions to UCC Art. 8 (April 1, 1993 Draft for Discussion) §8-112.

the CBCA and ABCA transfer provisions apply only to securities issued by corporations incorporated or continued under each respective Act.

The question arises: what is the law governing the transfer in Alberta of securities issued by an Ontario corporation? Assuming that the proper law of the contract of transfer is Alberta, then the answer is that Alberta law applies as between the parties to the transfer, but not Part 6 of the ABCA. This is a puzzling result. There should be no difference between the law applicable to the transfer of Alberta securities in Alberta and the law applicable to the transfer of "foreign" securities in Alberta. Moreover, this lacuna permits a highly undesirable measure of uncertainty with respect to the law applicable to the transfers of such "foreign" securities.

Another gap in the legislation arises from the fact that it applies only to securities issued by corporations. Some investment securities are not issued by corporations,[534] but obviously should be subject to uniform transfer rules. This raises the question: why are these provisions in the ABCA at all? So long as the transfer provisions apply only to securities issued by ABCA corporations, then they are exactly where they belong, but it seems clear that consistent transfer provisions are needed to apply to the transfer of all investment securities under Alberta law.[535]

Should securities transfer provisions of general application be located in the ABCA? We think not. It would be preferable to have a separate statute dealing with the transfer of all publicly traded securities, instead of having such provisions in the ABCA. That separate statute might properly be entitled the "Investment Securities Transfer Act", consistent with the current title of the corresponding article 8 of the UCC.

These same considerations apply to the CBCA.[536]

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534 For example, government securities and limited partnership interests. Section 1(j) of the Alberta Securities Act, *supra*, note 103, defines "issuer" as "a person or company".

535 See also the discussion at p. 174 of this report.

536 Recommendations in this report are often stated in terms of amendments to the ABCA, and occasionally, the CBCA. This is for convenience, and should not be taken to detract from our recommendation for a separate statute to replace the existing ABCA and CBCA provisions.

RECOMMENDATION 8

Alberta legislation governing the transfer of investment securities should not be limited to securities issued by Alberta corporations, but should apply to securities issued by any person.

RECOMMENDATION 9

Provisions dealing with the transfer of publicly traded securities should be removed from the ABCA and placed in a separate statute entitled the "Investment Securities Transfer Act".

(a) Conflicts re: issuers

Provisions such as UCC §8-106, §9-103 and OBCA section 60 provide that the law (including the conflict of laws rules) of the jurisdiction of organization of the issuer will govern the validity of a security, the effectiveness of registration by the issuer, and the rights and duties of the issuer with respect to:

(a) registration of transfer of a certificated security;

(b) registration of transfer, pledge, or release of an uncertificated security;

(c) sending of statements of uncertificated securities; and

(d) the perfection and the effect of perfection or nonperfection of a security interest in an uncertificated security.

These provisions reflect prevailing U.S. case law. No comparable provision exists in the ABCA or the CBCA.

Such a provision is desirable because it provides certainty and clarity with respect to the duties of issuers, who must deal with security holders in various jurisdictions. It is also essential where the statutory provisions accommodate transfers of dematerialized securities, but there are no local laws governing the validity, registration, etc. of such securities. This is the situation that would exist in Alberta.[537]

If we proceed on the assumption that we will not yet introduce amendments that would allow Alberta corporations to issue dematerialized securities, then the only process by which the matters referred to above could be governed by Alberta law would be through the operation of the doctrine of renvoi, where the conflict of laws rules of the jurisdiction of the organization of the issuer provided for the application of Alberta law. This is most unlikely, but not impossible. It could be prevented entirely if we enacted a provision similar to the UCC and OBCA provisions, except that, with respect to items (b), (c) and (d) above, the conflict of laws rules of the jurisdiction of the organization of the issuer would not apply, thus preventing a renvoi back to Alberta law.

With that qualification, it is clear that Alberta legislation should contain a provision to specify which jurisdiction's laws apply to govern validity of securities and the rights and duties relating to the registration of a transfer. We prefer the wording of the pre-1977 UCC §8-106 over section 60 of the OBCA. Both provisions are to the same effect, but the UCC provision is simpler. The OBCA provisions unnecessarily state the specific applications of the same basic principle in two situations: 1) where the issuer is an Ontario corporation; and 2) where the issuer is a "foreign" body corporate. We feel that these applications appear just as clearly from a statement of the basic principle as found in the UCC provision.

RECOMMENDATION 10

Alberta legislation should provide that the laws of the jurisdiction of organization of the issuer govern the validity of a security and the rights and duties of the issuer with respect to registration of transfer.

537 See the discussion of dematerialized securities at p. 141 of this report.

(2) The Proper Law of Transfers and Pledges of Securities

(a) Under existing law

None of the provisions in the current ABCA, OBCA or CBCA determine the proper law governing the contract of transfer or pledge of a security. The methods of determining the proper law can be complex, and often include consideration of the *situs* of the subject matter of the contract. However, the parties to a contract are generally free to specify which law will govern their contract, and the contractual arrangements between CDS participants include such choice of law provisions.

We have examined the provisions of the current Participant Agreement, which has been used by CDS since April 30, 1991, as well as the previous Book Based System Participant Agreement. In comparing these documents we shall refer to them as the "current Agreement" and the "previous Agreement".

Paragraph 17 of the previous Agreement purported to deem transfers and pledges within the book-based system to constitute contracts effected within the jurisdiction in which the transferee's or pledgee's account was located, as identified by the alphabetic prefix of the identification number assigned to that account. This amounted to a contractual election by participants that the proper law governing contracts between participants would be determined by the *situs* of one participant's account. Thus, if a purchaser's account was located in Alberta, a purchase of securities effected through the book-based system would occur in Alberta even if the vendor's account was located in another province, and the laws of Alberta would be the proper law of the contract of purchase and sale.

This seems appropriate because there is a clear rational basis for using the purchaser's account location to determine the proper law of a contract, as long as the account location is tied to the actual location of the beneficial owner of the account and the *situs* of the securities in that account.[538] It

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538 This approach is also potentially compatible with the existing provisions of most Personal PPSAs, which provide that the validity, perfection and effect of perfection or non-perfection of a possessory security interest in a security is governed by the law of the jurisdiction where the collateral is situated at the time the security interest attaches. This would be the location of the pledgee's account, provided that location corresponds with the *situs* of securities held in it. In so far as the location of the pledgee's account corresponds with the physical location of the pledgee, this is compatible with the deemed (continued...)

would appear necessary to have some mechanism (preferably regulation) mandating the manner in which participants maintain accounts with CDS in order to ensure a rational connection between beneficial owners, the location of accounts and the *situs* of securities. This is somewhat analogous to the operation of section 461 of the Bank Act,[539] which deems a deposit account, and any indebtedness arising from such account, to be located at the particular branch of the account.

It might also be necessary to have requirements to control the storage of certificates and the use of available transfer agents to ensure that the *situs* of securities corresponds with the location of the account. This would be a backwards step, because it would interfere with the efficiency of depository operations, but the options are limited by the method of determining *situs* under existing law. Another alternative might be uniform provincial and federal legislation providing a deemed *situs* for depository-held securities.[540]

The current Agreement used by CDS takes a significantly different approach. The new provisions[541] state that all book-entry transactions occur in Ontario and are governed by Ontario law, unless participants enter into separate contracts electing a common jurisdiction whose laws are to govern their transactions. This latter provision for separate contracts is unlikely to be

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538(...continued)
possession provision [proposed ABCA s. 70.2(5)]. See the discussion of "Choice of Law" in Chapter 10 of this report.

539 *Supra*, note 366.

540 Provincial legislation cannot control the *situs* of securities in so far as such *situs* may render the securities subject to provincial taxation powers. See *R.* v. *National Trust Co.*, *supra*, note 485. Arguably, it might be possible to have provincial legislation deeming *situs* of securities for purposes other than taxation, but this would be far less desirable than a single *situs* determined conclusively by federal legislation or the common law.

541 Application For Participation, paras. 12-14 and 16. In the Draft Agreement dated Jan. 31, 1991, there were several provisions dealing with *situs* (draft rules 2.7.5, 3.2.17, and 4.2.16) that were not included in the current Agreement. Those provisions specified that all entries made by CDS effecting its various services were deemed to be made in Ontario and that each parties' rights and obligations shall be determined according to the laws of Ontario and the federal laws of Canada applicable there.

used,[542] so the most probable result is that virtually all participants' transactions will be deemed to occur in Ontario, subject to Ontario law.

This presents some obvious problems. Although the provisions in the current Agreement may have been properly motivated by a desire for uniformity, and the need to apply legislation which specifically recognizes book-entry transactions, the current Ontario legislation is in need of reform and is therefore unlikely to be the model for uniformity. There is also the curious (and politically distasteful) result that a transaction between a participant in B.C. and another in Alberta is subject to and governed by the laws of Ontario. Finally, there is a potential conflict with the operation of proposed ABCA section 70.2(5), which deems the pledgee to be in possession of a security pledged under the PPSA. The natural effect of this deeming provision would be to make the pledge subject to the PPSA of the province where the pledgee is located, whereas CDS' revised contractual provisions appear to make the pledge subject to the Ontario PPSA, regardless of where the pledgee is located.

(b) Under reformed law

With reform and the recognition of the nature of the SE, we must reconsider the nature of the transaction itself. In a reformed environment, it is incorrect to view a purchase or sale by a client, effected through an SE with a broker, as a transfer at all. It is not a transaction with some unidentified "other" party through the mediums of another broker, a stock exchange and a depository: the transaction is strictly as between the client and the broker,

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542 Paragraph 16 of the CDS Application For Participation provides:

> Notwithstanding clauses 12 and 13, if Participants enter into a contract to which CDS is not a party, which creates rights and obligations to transfer securities or money between them through the facilities of CDS and which incorporates the terms of the Legal Documents expressly or by implication or on which the terms of the Legal Documents have an impact, then they may agree that such terms shall be interpreted in accordance with the same laws that govern the contract. An agreement made under this clause 16 shall not be effective with respect to any right or obligation of the Participants that involves or in any way affects any right or obligation of CDS or any other Participant under the Legal Documents.

The final sentence of para. 16 is very broad, and may entirely eliminate any possibility of participants making a choice of law other than Ontario to govern BBS transactions. Even if such choice of law is possible, this provision would not allow participants to enter into a single comprehensive contract specifying various choice of law selections for various types of transactions — the provision allows only a single choice of law per contract.

defined by the SE. Similarly, the broker's transaction is strictly as between it and the depository, defined by the SE. Therefore, we are no longer concerned with the proper law of a transfer between a buyer and seller — we are determining the proper law of transactions that make up the SE between the parties.

This considerably simplifies the situation.

Because these transactions determine the SE, the proper law of such transactions should be the same as that governing the SE itself. The law governing the SE claim against the intermediary should be the law of the jurisdiction where the intermediary does business with its customers.[543] Legislation defining the SE should also specify this choice of law for an action against the intermediary.

As noted above,[544] this choice of law would coincide with the natural *situs* of the SE, and be unrelated to the location of certificates or the operations of the issuer. The *situs*, and choice of law, linked to the location of the intermediary against whom the claim is exercisable, ensures a choice of law selection that is rationally connected with the parties to the transaction.[545]

RECOMMENDATION 11

Reformed legislation should include a choice of law provision specifying that the validity of an SE and the rights and duties of the intermediary with respect to an SE shall be governed by the law of the jurisdiction where the account is maintained.

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543 This is also where the intermediary falls under direct regulatory control. Regulators are thus in a position to dictate the manner in which the intermediary keeps accounts, thereby defining the location of those accounts.

544 See the discussion of "Reformed *Situs*" commencing at p. 207 of this report.

545 See the most recent draft revisions to UCC Art. 8 (April 1, 1993 Draft for Discussion) §8-112.

(3) Legal Relationship Between Participants and CDS

(a) Under existing law

The relationships between participants and CDS are now largely defined by the contracts made between them. The *situs* of securities does not in any way determine which jurisdiction's laws are applicable to the present contracts between participants and CDS. This is specified in the contracts themselves.

Paragraph 17 of the previous Book Based System Participant Agreement included a choice of law clause naming the laws of Ontario as governing the agreement. The current Agreement[546] is to the same effect, except that certain provisions relating to a participant's admission, suspension, termination, fees, charges and confidentiality of information are regarded as a separate contract that may be governed by the laws of a different jurisdiction in Canada.

(b) Under reformed law

The agreements currently in use are acceptable in so far as they apply only to limited administrative matters between participants and CDS. But under a reformed system, they could not apply to in any way affect the SEs between participants and CDS. The validity of SEs, and the rights and duties of CDS with respect to the SEs, would be governed by the statutory choice of law.[547] The statutory choice of law for particpants' SEs as against CDS would probably still be Ontario law.

D. Exigibility of Securities

Even before the advent of depositories in Canada, the law governing the exigibility of securities in Alberta (and most other provinces) was out of step with the realities of modern securities markets. Section 70 of the ABCA provides that no seizure of a security of a distributing corporation is effective until the person making the seizure obtains possession of the security. Similar provisions exist in the OBCA and CBCA. In B.C. the service of notice on the issuing corporation effects a complete seizure.

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546 CDS Application For Participation, paras. 12 and 13.

547 See Recommendation 11.

The problems with these methods are obvious. The B.C. approach undermines the negotiability of security certificates while the Alberta approach ignores the widespread role of intermediaries in the securities industry.

These problems are being addressed and proposals have been made which would appear to cope with seizures of securities held within depositories.[548] These proposals recommend that seizure of a security held by an intermediary be made by service of an appropriate notice of seizure upon the intermediary. This approach would also work under a reformed system where the property being seized is an SE.

But until the laws relating to seizures of securities are changed, depository operations will affect the exigibility of securities by exacerbating the problems which already existed with other intermediaries holding securities on behalf of beneficial owners. One significant problem is, again, that of determining the *situs* of deposited securities. The judicial process can operate only in relation to property situated within the geographical limits of the Court from which it issues.[549] Another problem is that an execution creditor currently has no means of identifying any deposited certificate attributable to a particular judgement debtor, so it is practically impossible for the creditor to obtain possession of the "security" as required by section 70 of the ABCA.

E. Asset Location Requirements

Asset location requirements, such as those of section 43(2) of the Alberta Insurance Act,[550] directly confront the question of the *situs* of deposited securities. At present, the Superintendent of Insurance requires that a security certificate be located in Alberta in order for the security to constitute an "asset in Alberta" for the purposes of the Insurance Act.

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548 See Alberta Law Reform Institute Report No. 61, *Enforcement Of Money Judgments*, vol. 1 (March 1991) at 121-38. See also Law Reform Commission of British Columbia, *Report on Execution Against Securities* (March 1991).

549 *Hunt Estate* v. *R.*, *supra*, note 530.

550 *Supra*, note 472.

The position taken by the Superintendent of Insurance may be seen as a cautious but reasonable reaction to prevailing uncertainty over the *situs* of securities. A more detailed discussion of section 43(2) and related provisions of the Insurance Act is found in Chapter 12, below.

CHAPTER 10 — PERSONAL PROPERTY SECURITY ACTS

A. Introduction

Throughout this report we have focussed mainly on the transfer of investment securities. Although such transfers generally include pledges and the transfer of partial interests,[551] we have not yet dealt specifically with some issues arising out of pledges through depositories. This chapter addresses those issues.

B. Pledges of Securities

Legislation and commentary in this area of the law have almost invariably used the term "pledge" even though it is recognized as problematic. Pledge offers one advantage: it is easier to use than the precise term "security interest in a security", but this is an inadequate justification.

A pledge may be defined as a deposit or bailment of personal property as security for a debt, with an implied power of sale upon default.[552] Thus, the concept of pledge, in the strict sense, is limited in its application to tangible property capable of delivery, or in other words: security certificates.[553] In the past, when movement of certificates was commonplace, pledge concepts worked well. But as we have seen, securities holding practices have for some time tended to involve fungible bulks and at least one level of intermediary. It is therefore surprising that all the legislation in this area still operates on the basis of the pledge.

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551 See the definition of "purchaser" in ABCA s. 44(2)(m), and the reference to a purchaser of a limited interest in s. 56(3).

552 See L. Jones, *Law of Pledges*, 2nd ed. (Indianapolis: Bowen-Merrill Co., 1901) at 1-2; *Coggs* v. *Bernard* (1703), 92 E.R. 107; [1558-1774] All E.R. Reprint 1 (Q.B.) at 5 and 8; and Sir W. Jones, *An Essay on the Law of Bailments* (London: J. Nichols, 1781) at 118.

553 For practical purposes, we might add **negotiable** security certificates. Delivery of non-negotiable share certificates is not a pledge but an equitable mortgage of the shares. See *Harrold* v. *Plenty*, [1901] 2 Ch. 314.

C. Legislation

Canadian Personal Property Securities Acts ("PPSAs") are all based on versions of UCC Article 9.[554] In 1977, revisions to the UCC removed the provisions dealing with investment securities from Article 9 and placed them in Article 8. The revised provisions still used pledge concepts, but substituted "transfer" for "delivery" in order to accommodate uncertificated securities, and to provide a more precise determination of the time when secured interests attach.

No Canadian PPSA has rules similar to the revised UCC Article 8 dealing with pledges of securities, although Ontario and B.C. have added provisions regarding uncertificated securities.

(1) Alberta

The Alberta PPSA[555] defines "security" as a "writing".[556] A "security" cannot be an "intangible".[557] A security interest in a security is perfected when the secured party, or another person (not including the debtor or the debtor's agent), takes possession of the collateral.[558]

It is also possible to perfect a security interest in a security by registering a financing statement, but this is practically useless because a purchaser for value without notice who takes possession of the certificate obtains priority.[559]

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554 See R.H. McLaren, *Secured Transactions in Person Property in Canada*, 2nd ed. (Toronto: Carswell, 1989) at 1-3 to 1-5.

555 *Supra*, note 103.

556 *Ibid.* s. 1(1)(oo).

557 *Ibid.* s. 1(1)(v).

558 *Ibid.* s. 24.

559 *Ibid.* s. 31(3).

The validity and perfection of a possessory security interest in a security is governed by the law, including the conflict of laws rules, of the jurisdiction where the collateral is situated at the time the security interest attaches.[560]

(2) Ontario

The Ontario PPSA[561] defines "security" as "a document" but which includes "an uncertificated security within the meaning of" the OBCA.[562] The definition of "intangible" excludes securities.[563]

Perfection of a security interest in a security is governed by provisions similar to the Alberta PPSA.

(3) British Columbia

The B.C. PPSA[564] uses an innovative definition of security:

> "security" means a share, stock, warrant, bond, debenture or similar record, whether or not in the form of a security certificate, that
>
> (a) is recognized in the jurisdiction in which it is issued or dealt with as evidencing a share, participation or other interest in property or an enterprise, or that evidences an obligation of the issuer, and
>
> (b) in the ordinary course of business is transferred
>
> (i) by delivery with the necessary endorsement, assignment or registration in the records of the issuer or of an agent of the issuer, or by compliance with restrictions on transfer, or
>
> (ii) by an entry in the records of a clearing agency, ...[565]

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560 *Ibid.* s. 5(1).

561 *Supra*, note 470.

562 *Ibid.* s. 1(1).

563 *Ibid.*

564 *Supra*, note 471.

565 *Ibid.* s. 1(1).

There is also a definition of "security with a clearing agency".[566] Securities cannot be intangibles.[567]

Perfection provisions are similar to those in Alberta except that sections 5, 24 and 31, corresponding to the same sections in the Alberta PPSA, all make specific allowance for securities with a clearing agency. For the purpose of determining the location of the collateral, securities with a clearing agency are situated where the records of the clearing agency are kept. To perfect a possessory security interest, or to achieve priority over a mere registered interest, entries in the records of the clearing agency have the same effect as taking possession of a certificate.

(4) Operation of the Legislation

The law in this area is even more out of step with modern securities holding practices than the law dealing with outright transfers. It has all the same problems that we discussed in the context of transfers. A secured party may receive deemed possession and delivery, and may acquire *bona fide* purchaser status, but their perfected possessory security interest is actually only an intangible claim against a fungible bulk. These problems are particularly acute for lenders because lenders do not enjoy the protection afforded to customers under the Canadian Investor Protection Fund. Lenders may be unwilling to extend credit secured by a security interest in a fungible bulk in circumstances where there is any question about the adequacy of the fungible bulk.[568]

When the 1977 revisions to UCC Article 8 continued the application of pledge concepts to security interests in uncertificated securities, this had the effect of expressly creating a "pledge" of an intangible right.[569] Even under the less sophisticated provisions of the Ontario PPSA, the effect is much the same. Where one depository participant "pledges" securities to another, this is effected by book-entries and the pledgee is deemed by OBCA section 85 to be a holder in possession of the pledged securities. In fact, if we ignore the legal

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566 *Ibid.*

567 *Ibid.*

568 See *infra*, note 571 and accompanying text.

569 E. Guttman, "Transfer of Securities: State and Federal Interaction", *supra*, note 369 at 439, referring to UCC §8-108.

fictions created by section 85, we see that the property interest being pledged is the intangible claim against the fungible bulk in the depository.

Complex financing arrangements are used in the securities industry, and the existing system has difficulty coping with them. For example, "repo transactions" are a common method of short-term securities financing, often used by securities dealers to finance their inventory. The borrower "sells" a security to a lending "buyer" pursuant to an agreement whereby the buyer agrees to sell back the same security at a specified time and price. Although there are no Canadian cases dealing with such transactions, U.S. cases have never clearly decided whether such transactions are actually sales or secured loans.[570] In the U.S., uncertainty over perfection and priority of security interests has caused liquidity problems at critical moments, such as during the October 1987 "Market Break" and just prior to the bankruptcy of Drexel, Burnham, Lambert.[571]

It is now widely recognized in the U.S. that the use of pledge concepts in existing legislation is inappropriate,[572] and the current revisions to UCC Article 8 propose to abandon the notion "that a security interest in a security can be created only by a method akin to the traditional possessory pledge."[573]

Very similar considerations apply to the Canadian laws governing this area. Although we are not aware of cases where disputes have arisen over the application of the PPSAs to securities, the same legal uncertainties exist and, with them, the potential for the same problems that have occurred in the U.S. Because these uncertainties originate with the inherent incompatibility of pledge concepts with intangible property, they need to be addressed by

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570 See the ABA "Interim Report of the Advisory Committee on Settlement of Market Transactions" *supra*, note 348 at 31-32; E.M. Osenton, "The Need for a Uniform Classification of Repurchase Agreements: Reconciling Investor Protection with Economic Reality" (1987) 36 Am. U.L Rev. 669; and W.F. Hagerty, "Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities" (1984) 37 Vand. L. Rev. 401.

571 See Mooney, "Beyond Negotiability", *supra*, note 283 at 315 n.13.

572 See J.L. Schroeder and D.G. Carlson, "Security Interests Under Article 8 of the Uniform Commercial Code" (1990) 12 Cardozo L.R. 557; M.J. Aronstein, "The New/Old Law of Securities Transfer", *supra*, note 267 at 435-36; and ABA "Interim Report of the Advisory Committee on Settlement of Market Transactions", *supra*, note 348.

573 Draft revisions to UCC Art. 8 (July 1992 Draft for Discussion) at 15.

fundamental reforms. There is nothing to recommend keeping the existing system.

We will briefly review some particular issues arising from existing PPSA provisions.

(a) Pledges to non-participants

In B.C. or Ontario, a depository participant can obtain a perfected possessory security interest in a deposited security, because the pledgee participant is deemed to have taken possession of the pledged certificate. But a non-participant seems unable to obtain a perfected security interest in a security held by a depository. The non-participant must deal through a participant, say, a broker. Assuming that the pledgor is also a participant, the pledgor could cause the depository to record the pledge to the pledgee's broker. Is this perfection of the possessory security interest?

In B.C. it clearly is not, because the depository book-entry can only have the effect of taking possession by the secured party.[574] Thus, it can operate only if the secured party is shown on the records of the depository.

In Ontario, OBCA section 85 deems the pledgee's broker to have possession, so the question is whether this is possession "on the secured party's behalf by a person other than the debtor or the debtor's agent".[575] In our view, it is not. Deemed possession is a difficult concept, but even if we imagine that the pledgee's broker has possession of a security, we cannot escape the fact that the pledgee's claim against the broker is in a fungible bulk, just like other clients' claims. As we have seen, the pledgee and the broker's other clients do not actually have tangible property interests in specific securities, so it is impossible to say that the broker's deemed possession of any particular security is on behalf of any particular client.

This point is addressed by R.H. McLaren in the course of his discussion of perfection by possession and section 85(5) of the OBCA:

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574 B.C. PPSA, *supra*, note 471, s. 24(3).

575 Ontario PPSA, *supra*, note 470, s. 22.

> The result is that pledges made through CDS or VSESC are perfected security interests under the Act. Non-participants in these systems cannot avail themselves of this method of perfection. This would also be the case even if the non-participants lodged the shares with a participating broker because the system records will show a net holding, in the relevant broker's account, of uncertificated amounts of various shares some of which are pledged collateral.[576]

Presumably the "system records" referred to are the records of the depository. If so, it is not the depository's records that are a critical factor, since by virtue of section 85(5) the broker is deemed to be in possession of the securities shown in the broker's account. In our view, it is the customer-broker relationship that is inadequate to support the concept of possession by agent. In any event, we agree with Mr. McLaren's conclusion.

Consider a situation under the OBCA where a client/creditor is willing to operate through a broker, so that the debtor/pledgor, in effect, pledges securities through a depository to the creditor's broker. Although the client/creditor has probably not perfected the security interest, the broker has. The client is then in almost exactly the same position as we discussed above in the context of transfers.[577] The client may, under certain circumstances, be left with only an unsecured claim against the broker in bankruptcy.

There are other awkward aspects of perfection through the fiction of deemed possession that may be mentioned briefly. The PPSA provisions limit perfection by possession to the period "while it is actually held as collateral".[578] On a plain reading, this could be interpreted to preclude perfection by deemed possession. Similarly, the PPSAs prohibit perfection by possession where the collateral remains in the possession of the debtor or the debtor's agent.[579] With pledges through a depository, actual possession never changes, and the depository is arguably the agent for both parties to the transaction.

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576 *Secured Transactions In Personal Property In Canada*, vol. 1, *supra*, note 554 at 3-11.

577 See the discussion of "The Transfer Mechanism Under the OBCA" commencing at p. 109 of this report.

578 See for example Alberta PPSA, *supra*, note 103, s. 24(1).

579 *Ibid.*

(b) Choice of law

The B.C., Alberta and Ontario PPSAs all rely upon the location of the collateral at the time the security interest attaches to determine which jurisdiction's laws apply to the transaction. These provisions pose serious problems.

Under the Alberta or Ontario PPSAs, there is no mechanism to ascertain the location of securities. Since the existing Alberta PPSA specifies that a security is an instrument, the collateral is clearly the instrument. Under the Ontario PPSA, "security" means a document, except that it also includes an "uncertificated security" within the meaning of the OBCA, which would include dematerialized securities issued outside Canada or, more likely, securities issued in Canada where the depository has surrendered the certificate to the issuer in exchange for a non-transferable written acknowledgement ("NOTWRACK").

With an "uncertificated security" under the OBCA, we are dealing with the *situs* of an intangible — the share interest in the issuing corporation. There are no case authorities determining the *situs* of an intangible share interest for this purpose under the PPSA. Most authorities arise in the context of succession duty legislation, and these authorities suggest clearly that the shares are located in the jurisdiction where they would most likely be dealt with as against the company.

With a certificated security, the *situs* of the certificate is determined by its physical location. Unfortunately, there is no straightforward method of determining the *situs* of immobilized certificated securities. Although the *situs* of a particular certificate is easily determined, because CDS holds securities as a fungible bulk, there is no way to associate a participant's interest with any specific certificate or any particular location. This problem might be overcome if CDS stored all certificates in one location, but this is impractical. Certificates are delivered to CDS and held at its various offices and through arrangements with other depositories, so that certificates of any given issue will be located in several different jurisdictions. Accordingly, we cannot use the simple technique of merely locating certificates.

In the result, there is no practical or reliable means of determining which jurisdiction's laws apply to the pledge of securities held by a depository under the Alberta or Ontario PPSAs.

The B.C. PPSA includes a provision that "... a security with a clearing agency is situated where the records of the clearing agency are kept."[580] This provision is at least an attempt to deal with the problem, but in our view it is inadequate because the test used to establish *situs* is imprecise. CDS, for example, maintains its data processing facilities in Ontario, but access to its computer records is available in each jurisdiction where CDS operates. One would expect some duplication of records kept by CDS at its branch offices with those kept at its main office in Ontario. This makes it somewhat difficult to say exactly where CDS' records are "kept".

D. The Direction of Reform

As noted earlier, it would be premature to treat any part of the Draft revised UCC Article 8 as being settled, but certain aspects of the approach taken in the Draft are important.

The revisions currently being developed for UCC Article 8 would continue to use existing rules with respect to the perfection by possession of a security interest in certificated securities. This would not include an interest in securities held in fungible bulks through intermediaries, because such interests are defined as securities entitlements ("SE") — a special form of intangible claim against the intermediary. Perfection of a security interest in an SE is perfected by obtaining "control" over it. Control generally involves the secured party being designated as the account holder of the SE on the records of the intermediary.

This approach represents a vast improvement over existing law because it properly characterizes the property in which a security interest is granted, and it does not rely upon fictional delivery or possession for perfection of a security interest in the intangible SE. We endorse this approach and recommend that Alberta, in consultation with other provinces, develop uniform amendments to the PPSA compatible with the UCC.

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580 B.C. PPSA, *supra*, note 471, s. 5(2).

RECOMMENDATION 12

The provisions of the Alberta PPSA governing security interests in investment securities should be amended and patterned after pending revisions to Article 8 and 9 of the Uniform Commercial Code. Alberta legislation should, if possible, be uniform with other Canadian PPSAs.

CHAPTER 11 — SHAREHOLDER ISSUES

A. Introduction

We have seen that one of the consequences of modern securities trading and holding practices is that shares are often registered in the names of intermediaries or depositories who have no beneficial interest in those shares. This reflects a trend that began before the advent of depositories,[581] but the growing use of depositories has accelerated the trend dramatically.

This chapter examines some of the issues that arise from this trend.

B. Who is a Shareholder?

There is no meaningful definition of "shareholder" in the ABCA.[582] For most purposes, it seems that a shareholder must be the registered owner of shares as shown on the securities register of the corporation, kept pursuant to section 46. But a close examination of the various provisions reveals some uncertainty concerning who is a shareholder.

(1) The Securities Register

For investment securities, the traditional securities register mandated by section 46 of the ABCA is an anachronism. We have seen that the growing use of intermediaries has significantly changed the content of the securities register of publicly-traded corporations. It no longer reflects information about many of the beneficial owners of shares, but lists intermediaries and depositories in their stead. This change in content has altered the use of the securities register to the point where it may be suggested that it no longer functions in the manner originally intended.

Although we can only surmise the intended function of the securities register, it is clear that the securities register is to provide a record of

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581 See the discussion of "Alternative Methods of Holding Securities" commencing at p. 70 of this report.

582 Section 219(1) includes an unhelpful definition for the purposes of that section: "'shareholder' includes the legal representatives of a shareholder".

registered security holders, together with some history of past holders.[583] Beyond this, we encounter problems in determining the exact function of the securities register.

For example, the latest known address of each current and past security holder is to be included in the securities register. This information may trigger consequences under other legislation, such as where constraints exist upon shares "held" by non-residents, where such "shareholding" is clearly dependant upon the securities register.[584] Similarly, compliance with certain requirements of the Securities Act[585] is required only if security holders, or a certain number of security holders, are shown "on the books of" the issuer as having their latest address in Alberta. Assuming that "the books" refers to the securities register, the obvious question is whether there is any rational connection between these provisions and the information that appears on the securities register.

Often there is no rational connection. Given that the registered owner of shares is likely not the beneficial owner, and that the address of the registered owner may bear no relation to the address of the beneficial owner, such provisions are based on an incorrect assumption about the operation of the securities register.

(2) The List of Shareholders

Sections 21 and 132 refer to a list of shareholders. These provisions operate rather awkwardly, but they do offer some evidence about the legislative intent behind the provisions.

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583 The information in the securities register must be kept for "at least 7 years after the security holder ceases to be a security holder" according to s. 46(1.1) and Alta Reg. 408/87, s. 12. Cancelled security certificates in registered form must be kept for 6 years after the date of cancellation, as per ABCA s. 46(6)(a).

584 See for example the Alberta Energy Company Act, *supra*, note 103, ss 1(1)(l) and 26.

585 *Supra*, note 103. See for example ss 122, 125, 127, 128, 131(1)(i) and consequential provisions regarding take-over and issuer bids in Part 13 [ss 132(1)(e), 133(h), 135(a) and 135(b)].

(a) Unregistered transferees

As we have already seen,[586] section 47(1) permits, but does not require, a corporation to treat the registered owner of a security as the person exclusively entitled to vote, receive notices, dividends, etc., subject to sections 128, 129 and 132.

Section 128 deals with record dates for the purpose of determining "shareholders" entitled to receive dividends, participate in a liquidation distribution, or receive notice of a meeting. Section 129 deals with sending notice of a meeting of shareholders. Section 129(1)(a) requires that such notice shall be sent to "each shareholder entitled to vote at the meeting". Section 129(3) provides that a notice is not required to be sent to "shareholders who were not registered on the records of the corporation ... on the record date ... but failure to receive a notice does not deprive a shareholder of the right to vote at the meeting."

Section 132 requires that a corporation having more than 15 shareholders entitled to vote at a meeting shall prepare "a list of shareholders entitled to receive notice of a meeting". Those named on the list are entitled to vote the shares attributed to them by the list unless: 1) the person named on the list transferred the ownership of some shares after the record date; and 2) the transferee of those shares proves ownership and demands to be included on the list. In that event, the transferee becomes entitled to vote those shares and, presumably, the transferee's name is included on the list in substitution for the name of the previous owner.

These provisions almost seem to assume that such a transferee would move promptly to have the transfer registered, because the transferee's rights begin to unravel if the transfer is not registered. Is the unregistered transferee a "shareholder"? The answer seems to be yes, because the transferee's name now appears on the "list of shareholders" and the transferee is entitled to vote the shares at the "meeting of shareholders".[587] The transferee could even advance a shareholder proposal under section 131. But on a strict reading of these sections, the transferee may lose the ability to vote or advance proposals at the next meeting of shareholders. When the corporation sets the record date

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586 See the discussion at p. 51 of this report.

587 See s. 134(1) regarding the right to vote.

for the next meeting, if the transferee is not "registered on the records of the corporation" according to section 129(3), then the corporation is not required to send the transferee notice of the meeting, and the transferee's name will not appear on the "list of shareholders entitled to receive notice of a meeting" under section 132(1). The transferee cannot use the provisions of section 132 to get back on the list of shareholders, because the transferee no longer meets the requirement of having acquired shares from a person on the list after the record date.[588] In fact, if the transferee does not become the registered owner of the shares prior to the next record date, then it seems that the previous owner's name will reappear on the list of shareholders and the previous owner will be entitled to vote the shares and advance proposals.

How can this result be reconciled with section 47(1), which is specifically made subject to sections 128, 129 and 132? The key provision is section 129(3), but reading that provision subject to section 47(1) does not change its operation. It seems that the "subject to" refers only to the fact that, by establishing a record date, and sending notices to shareholders, the corporation must ignore subsequent registered transfers for purposes of voting, unless the transferee asserts the right to vote under section 132.

Could the transferee argue that the status of "shareholder" acquired under section 132 is sufficient to be "registered on the records of the corporation" under section 129(3)? There is no doubt that the transferee is "on the records of the corporation", but it seems impossible to argue successfully that this also means "registered" because registration can only be associated with the securities register.

It seems odd that the transferee can become a shareholder, with the right to vote and advance proposals at the meeting of shareholders, and then have those rights disappear automatically. Does the transferee remain a "shareholder", even though the right to vote and advance proposals has been lost? There is no clear answer. The transferee remains the owner of the shares, but disappears from the list of shareholders under section 132. It is then surprising to find that the transferee's name may still appear on a different "list of shareholders" — that prepared under section 21.

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588 Sections 132(2) and 132(3) also allow no method whereby a transferee who purchased shares say, on the day before the record date, could acquire the right to vote the shares, even if the transfer was registered on the day after the record date.

This list contains the names, addresses and number of shares owned by each shareholder "as shown on the records of the corporation". According to section 47(1), the corporation has the option to include the transferee on this list, or it may choose to rely solely on the securities register. If the corporation chose to include the transferee on the list prepared under section 21, it still could not include the transferee on the list prepared for the next meeting of shareholders under section 132,[589] nor could the transferee vote there.

This creates the possibility of two different lists of shareholders: a list prepared under section 21 (which is accessible to anyone who pays a reasonable fee and provides a statutory declaration regarding their use of the list);[590] and a list prepared under section 132 (which is accessible only to "shareholders" according to section 132(4)).

The existence of two different lists is obviously undesirable, yet that situation could also arise in a different way. The corporation has no choice regarding the list prepared under section 132, or changes made to that list as a result of demands made by transferees who acquired shares after the record date. But the corporation has some choice in how it prepares the list under section 21. It could choose to rely upon section 47(1) and prepare the list strictly on the basis of the securities register, even though this may mean that the list is substantially inaccurate, and intentionally misleading.

The unregistered transferee, therefore, may be named on one, both or neither list of shareholders, depending on the circumstances. Even if named on both lists, there is still some doubt as to whether the transferee is the "security holder" referred to in various sections of the Securities Act.[591]

Is the unregistered transferee entitled to receive payment of a dividend, or to participate in a liquidation distribution? This is also unclear. The transferee is a shareholder, known to the corporation, but it is possible, perhaps even likely, that the corporation may rely upon section 47(1) and ignore the transferee.

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589 This is because the transferee is not entitled to receive notice of the meeting according to s. 129(3), and such entitlement defines the list prepared under s. 132(1).

590 Provisions similar to those found in ABCA s. 21 regarding the entitlement to a list of shareholders were considered in *Re MacMillan Bloedel Limited*, [1976] 6 W.W.R. 475 (B.C.S.C.).

591 See *supra*, note 585 and accompanying text.

(b) Purpose of the list of shareholders

We shall here focus upon the list of shareholders prepared under section 21. The possible differences between the list prepared under section 21 and that prepared under section 132 appear to be a matter of improvident drafting, not legislative intent. Also, the list under section 21 is more widely available, and therefore likely to be more widely used.

Section 21 is based upon the CBCA, and it is significant that the CBCA provision and a similar provisions in the 1970 OBCA were both intended to facilitate communication with and among shareholders in connection with the affairs of the corporation.[592] This is reflected in section 21(11), which prohibits any use of a shareholders list except in connection with:

> (a) an effort to influence the voting of shareholders of the corporation,
>
> (b) an offer to acquire shares of the corporation, or
>
> (c) any other matter relating to the affairs of the corporation.

"Affairs" is defined by section 1(a) to mean "the relationships among a corporation, its affiliates and the shareholders, directors and officers of those bodies corporate but does not include the business carried on by those bodies corporate".

Some shareholders prefer to be anonymous. If they are serious about maintaining their anonymity, it is easily accomplished by the use of nominees. No statutory provision exists which would allow a corporate issuer to refuse to disclose those shareholders who have merely requested anonymity, nor does it appear that such requests for anonymity would have prevented disclosure under the common law.[593]

Section 21 not been the subject of any judicial consideration in Canada which would elaborate upon the uses set out in the ABCA. In the U.S., entitlement to shareholders lists has in some instances been quite restricted by

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592 See the *Dickerson Report*, *supra*, note 97, vol. 1 at 32-33; and Report of the Attorney General's Committee on Securities Legislation in Ontario, 1965, (The Kimber Report) at 25-26.

593 *Brunet et al.* v. *Prince County Hospital* (1983), 23 B.L.R. 168 (P.E.I. Sup. Ct.).

requirement of a "proper purpose" for the inspection,[594] but the more recent trend has been towards broader entitlement to such lists,[595] including the entitlement to names of beneficial owners whose nominees are registered shareholders.[596] The basis for entitlement to names of beneficial owners is stated by the Court of Chancery of Delaware in the *Shamrock*[597] decision at page 661:

> This Court has repeatedly recognized that, in effectuating the purpose of §220, the stocklist materials provided to a stockholder should include all of those forms of stockholder data readily available to the corporation. This approach promotes the interests of all stockholders by providing them the most prompt and complete information concerning the corporate decision at hand:
>
> > Once having established a proper purpose, a stockholder is entitled to the same lists and data relating to stockholders as is available to the corporation. [Citation omitted] To hold otherwise would be to give the corporation an unfair advantage in a proxy solicitation battle. The best interest of the stockholders requires that they quickly receive all the information generated by the competing interests. *Hatleigh Corporation v. Lane Bryant, Inc.*, 428 A.2d at 354-355.

In the *Hatleigh* case, the scope of inspection was held to include an obligation upon the issuer to provide a breakdown of the listings of stockholdings by "Cede & Co.", the nominee for the Depository Trust Company.[598]

The U.S. decisions appear to be completely consistent with the general intent of section 21, but they go considerably further than a plain reading of the provision might suggest is possible. Until a similar issue is considered by a Canadian court, it is not clear whether section 21 needs to be amended. It does seem clear that the list of shareholders should not be restricted to merely a list of registered holders.

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594 *State Ex Rel. Pillsbury* v. *Honeywell Inc.*, 191 N.W.2d 406 (1971).

595 *Credit Bureau of St. Paul, Inc.* v. *Credit Bureau Reports, Inc.* (1972), 290 A.2d 689 (Del. Ch.), aff'd (1972), 290 A.2d 691 (Del. Supr.); *Skouras* v. *Admiralty Enterprises, Inc.* (1978), 386 A.2d 674 (Del. Ch.); *CM&M Group, Inc.* v. *Carroll* (1982), 453 A.2d 788 (Del. Supr.).

596 *Scott* v. *Multi-Amp Corporation* (1974), 386 F.Supp. 44 (D. N.J.); *Hatleigh Corp.* v. *Lane Bryant, Inc.* (1981), 428 A.2d 350 (Del. Ch.); *Shamrock Associates* v. *Texas American Energy Corp.* (1986), 517 A.2d 658 (Del. Ch.); *Cenergy Corp.* v. *Bryson Oil & Gas P.L.C.* (1987), 662 F.Supp. 1144 (D. Nev.).

597 *Ibid.*

598 *Hatleigh Corporation v. Lane Bryant, Inc.*, *supra*, note 596 at 353-54.

C. Nominee Registration and Shareholders' Rights

(1) Nominee Registration[599]

The unregistered transferee discussed above is not a common phenomenon, but nominee registration is.[600]

Some provisions in the ABCA do contemplate the fact that the securities register will reflect nominee holders,[601] but there is still a large disparity between the rights of a beneficial owner and a registered owner. In one instance, a beneficial owner is given exactly the same rights as a registered owner,[602] but more often statutory rights are granted to "shareholders" with no allowance for beneficial owners.[603]

Where the provisions do make some allowance for beneficial owners, this does not always put a beneficial owner on an equal footing with a registered owner, even where it seems clear that equal rights are intended.

One important example of this is found in the provisions dealing with the rights of a dissenting shareholder. Section 184(4) reads:

> A dissenting shareholder may only claim under this section with respect to all the shares of a class held by him or on behalf of any one beneficial owner and registered in the name of the dissenting shareholder.

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599 Nominee registration refers to the registration of shares in the name of someone who is not the beneficial owner. This would include brokers holding shares on behalf of others, and depositories. See also the discussion of "Alternative Methods of Holding Securities" commencing at p. 70 of this report.

600 It is not unusual for listed corporations to show more than 50% of their voting securities held by depositories. A much smaller, but still significant, proportion of shares would normally be registered to various brokers and other intermediaries, representing street certificates in circulation.

601 See the definition of "beneficial ownership" in ABCA s. 1(d.1).

602 The ability to apply under Part 19 to the court as a "complainant", defined by s. 231(b).

603 See for example s. 131 (the right to advance proposals at a meeting of shareholders), s. 132(4) (the right to examine the list of shareholders), s. 189(1)(c)(ii) (the right of a dissenting offeree in a take-over bid to elect to apply to the court to fix the fair value of shares), and s. 223 (the right to apply to the court for an order directing an investigation of a corporation).

Case law indicates clearly that only a registered shareholder may exercise the statutory right to dissent.[604] The provision allows for dissent by a registered shareholder on behalf of a beneficial owner, and even seems to have anticipated the fact that a registered shareholder may hold shares on behalf of more than one beneficial owner.

But the provision has not anticipated the possibility of two or more levels of intermediaries. If we assume a common situation where CDS is the registered holder of shares, held on behalf of various broker/participants, each of whom holds on behalf of various clients, it is evident that section 184(4) poses a serious problem. Only CDS can exercise the right to dissent. CDS holds shares on behalf of brokers, not beneficial owners, but even if we call the brokers beneficial owners, section 184(4) will require that CDS exercise dissenting rights with respect to all the shares held on behalf of any broker. This won't work, because the broker holds shares on behalf of a number of clients, and some of them won't want to dissent.

Section 184(4) is an example of a provision that attempts to provide beneficial owners with rights equivalent to those of a registered owner, but which fails because it does not cope adequately with the extra intermediary layer that exists between beneficial owners and registered holders in situations involving securities depositories.

(2) Shareholder Communications

With large-scale nominee registration of shares, it becomes difficult to ensure that beneficial owners of shares can effectively exercise the voting or other rights that attach to their shares. Ensuring that beneficial owners have the actual ability to vote (or to exercise the right to dissent, advance a proposal, etc.) is only a small part of the task. The Business Corporations Acts give shareholders certain rights to express their views on the affairs of the corporation, and rights to receive information[605] regarding those affairs and the views of other shareholders. Such shareholder communication must be recognized as essential to the full exercise of shareholders rights.

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604 See *The Manitoba Securities Commission* v. *Versatile Cornat Corporation and Mesman*, and *Westmin Resources Limited* v. *Hamilton*, *supra*, note 127.

605 The form and content of that information is strictly regulated. See for example the requirements in the Securities Regulation, Alta. Reg. 46/87, regarding financial statements, Information Circulars, Take-over Bid Circulars, etc..

ABCA section 147 provides that shares registered in the name of a registrant[606] or his nominee, and not beneficially owned by the registrant, shall not be voted unless the registrant forwards copies of documents (notice of meeting, financial statements, proxy circular, etc.) to the beneficial owner. The registrant may not vote such shares except in accordance with the instructions of the beneficial owner,[607] and must appoint the beneficial owner proxyholder upon request. Section 79 of the Securities Act is similar.

National Policy Statement No. 41 — Shareholder Communication ("NP41") was adopted by the Canadian Securities Administrators[608] effective March 1. 1988. It sets out procedures for the conveyance to beneficial owners of proxy-related materials delivered on behalf of issuers.

Considered together, these provisions still leave some gaps in the shareholder communication process. ABCA section 147 and Securities Act section 79 apply only to "registrants", and so do not apply to depositories. NP41 applies to depositories, but only operates with respect to proxy-related materials delivered on behalf of issuers. It does not apply to other proxy-related materials (such as a dissident's proxy circular), take-over bid materials, issuer bids, rights offerings or other matters.

In a situation where shares are registered in the name of a depository, the operation of section 128 of the Securities Act exemplifies the range of inconsonance between these various provisions. This section governs the solicitation of proxies from security holders whose latest address as shown on the books of the reporting issuer is in Alberta. It provides that no proxy shall be solicited from a security holder unless such solicitation is accompanied by an appropriate circular, with the exceptions that no circular is necessary where the solicitation is: 1) by a registrant pursuant to section 79; 2) by the beneficial owner of the securities; or 3) where the solicitation is not by or on behalf of management and the total number of security holders whose proxies are

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606 "Registrant" is defined in ABCA s. 141(c) as "a person required to be registered to trade or deal in securities under the laws of any jurisdiction".

607 Section 141(1)(d)(viii) gives beneficial owners a proxy solicitation exemption protecting them from committing a breach of the Act by instructing the voting of their own shares.

608 The Canadian Securities Administrators is an association of Canadian securities regulators, including all the major provincial securities Commissions. NP41 therefore represents the policy of all such Commissions and is binding upon all issuers subject to regulation by those Commissions.

solicited is not more than 15 persons or companies. If every registered security holder was also a beneficial owner, this section would operate logically.

Exceptions 1) and 2) above are obviously intended to accommodate nominee holders, but they fail to do so in several respects. If we consider the situation where a group of dissident shareholders wish to solicit proxies, the following anomalies occur:

1. Under section 79, ABCA section 147 and NP41, a depository is under no legal obligation to forward a dissident's proxy circular.[609] A nominee holder who is a registrant is under such obligation.

2. Dissident shareholders have no mechanism giving them access to the names or addresses of the beneficial owners of shares held by nominees, and so have no means of contacting such owners directly.

3. If the dissident shareholders choose to solicit nominees notwithstanding the problems outlined in 1) above, they may do so without using a circular as long they solicit not more than 15 persons or companies. But since each nominee may hold securities on behalf of hundreds or even thousands of different beneficial owners, solicitation through 15 nominees may be a massive solicitation, vastly wider than solicitation of any 15 registered beneficial shareholders.

D. Constrained Shares

Constrained shares refer generally to any shares subject to legal or regulatory restrictions on their transferability. In Alberta, examples include shares of Alberta Energy Company,[610] Pacific Western Airlines Corporation,[611] and Nova Alberta Corporation.[612] In each case, legislation limits the proportion of voting shares that may be held by any one shareholder or beneficial owner. The Alberta Energy Company Act also restricts the proportion of voting shares that may be held by non-residents of Alberta.

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609 Part IX of NP41 provides that use of NP41 procedures is encouraged, but not mandatory, in this situation.

610 Alberta Energy Company Act, *supra*, note 103, ss 26 and 27.

611 Pacific Western Airlines Act, *supra*, note 374, s. 4.

612 Nova Corporation Of Alberta Act, R.S.A. 1980, c. N-12, s. 10.

Such constraints present a definite problem for intermediaries, particularly depositories. As shares accumulate, registered in their name, breaches of the constraints may occur. Depositories may use a series of different nominees to avoid any breach of constraints, but this is awkward, and in light of the fact that depositories act only on behalf of participants, and do not beneficially own securities themselves, it seems absurd that constraints force such machinations to occur.

This problem is recognized by the Group of Thirty Working Committee for Canada. In their July, 1990 report, one of the Committee's recommendations relating to the operations of a central securities depository identifies a need for amendments to legislation relating to constrained shares:

> 3.4 **Legislation governing the issuance and ownership of constrained shares should be changed to recognize the realities of nominee ownership through financial institutions and securities depositories.**
>
> Rationale:
>
> Currently, the book-entry eligibility of constrained shares is inhibited. Such issues as Air Canada, Videotron and other industry sector restraints imposed by regulators cause undue risk in the settlement of securities trades, the re-registration of certificates, ownership rate reporting and entitlements distribution. Accordingly, the Working Committee recommends that steps be taken to accommodate these restraints within a nominee/depository environment. Such initiatives could be as simple as dual listings for domestic vs. foreign investors, or other means.[613]

One approach to this problem is found in the Air Canada Public Participation Act.[614] It contains provisions imposing residency and proportionate ceiling constraints on the issue, transfer and ownership of voting shares of Air Canada, but the application of these constraints is limited by section 6(3):

> (3) No provision imposing constraints pursuant to paragraphs (1)(a) and (b) and no regulation referred to in subsection (2) applies in respect of voting shares of the Corporation that are held
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> ...

613 "Report of G30 Working Committee" July 1990 at 7.

614 R.S.C. 1985, c. 35 (4th Supp.).

(c) by any person that is acting in relation to the shares solely in its capacity as an intermediary in the payment of funds or the delivery of securities, or both, in connection with trades in securities and that provides centralized facilities for the clearing of trades in securities.

This limitation might avoid the application of constraints to a clearing agency or depository but would not shield any other intermediaries (such as brokers) from those constraints. Even so, such a provision is a step in the right direction. In our view, the provision might go further, and exempt any intermediary from the application of constraints except where the intermediary holds the security as beneficial owner.

RECOMMENDATION 13

Legislation imposing constraints on investment securities should not apply to intermediaries who hold securities other than for their own account.

But whether or not the application of the constraints is subject to such a limitation, constraint provisions still create problems for the issuer of constrained shares, intermediaries and any beneficial owner whose shares are held by an intermediary. As we have seen, it is virtually impossible to determine, at any given time, the true proportion of outstanding shares held by non-residents because the bulk of all shareholdings are held in the name of nominees. The issuer has no reliable means of determining whether the constraints are being observed. A broker cannot reliably advise a non-resident client that it is safe to purchase constrained shares, because the issuer cannot provide such information. If the non-resident did purchase constrained shares, there would be a risk that the shares might not have voting rights, or might be redeemed by the issuer at a price lower than the purchaser paid for them.

In order for constraints to be meaningful, an issuer must have access to information about shareholders extending past the registered nominees. This problem may be seen as part of the overall problem that exists with shareholder communication.

E. Conclusion

It seems fair to conclude that the mechanisms in the ABCA and the Securities Act for shareholder communication and corporate governance were designed to operate on the basis of a securities register and a list of shareholders that reflect beneficial ownership. Even with the introduction of NP41, the overall system has not evolved to cope adequately with the growing use of nominee ownership.

Securities depositories are not the cause of this problem — their operations have made the pre-existing problem much larger. But depositories also offer a possible vehicle for reform. Depositories are generally more efficient in conveying information than other intermediaries. In any reformed system for shareholder communication, depositories will be in the best position to collect and distribute information between issuers and shareholders. Policy considerations aside,[615] it would be possible for the depository to maintain computer records providing issuers with the names and addresses of every account holder of the issuer's securities.[616]

We emphasize that our discussion here deals only with some basic issues arising out of shareholder communications.[617] The goals reflected by

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615 Intermediaries are very reluctant to disclose information that amounts to their list of customers. Law enforcement would prefer more accessible and complete records of securities transactions. See M.E. Beare and S. Schneider, "Tracing of Illicit Funds: Money Laundering in Canada", Solicitor General of Canada User Report, 1990 at 120-51.

616 There are parallels between this idea and the current role of depositories in respect of BEO securities. See the discussion commencing at p. 147 of this report.

617 See also: "Report of the Joint Regulatory Task Force on Shareholder Communication to The Canadian Securities Administrators" July, 1987; "Report of the Industry Implementation and Monitoring Committee Re: National Policy Statement No. 41" (1988) 11 OSCB 3326; K. Kanzaki, "Immobilization of Stock Certificates: The Position of the Beneficial Shareholder" (1981) 3 J. of Comp. Corp. Law and Sec. Reg. 115; J.R. Brown Jr., "The Shareholder Communication Rules and the Securities and Exchange Commission: An Exercise in Regulatory Utility or Futility?" (1988) 14 J. Corp. L. 683; J.W. Barnard, "Institutional Investors and the New Corporate Governance" (1991) 69 N.C.L. Rev. 1135; (1991) 17 J. Corp. L., No.1; J.H. Matheson and B.A. Olson, "Corporate Law and the Longterm Shareholder Model of Corporate Governance" (1992) 76 Minn. L.R. 1313; K.R. Lehman, "Revising Federal Securityholder Communication Rules to Respond to Pension Funds' Increasing Market Presence" (1992) 19 Pepp. L.R. 1163; "Securities and Exchange Commission, Report of the Advisory Committee on Shareholder Communications, Improving Communications Between Issuers and Beneficial Owners of Nominee Held Securities" (1982) Fed. Sec. L. Rep. (CCH) ¶ 83,244; L.J. Milken, "Comprehensive Securities Depository Systems and the Beneficial Owner" (1972) 20 UCLA L. Rev. 348; "Securities

(continued...)

the existing mechanisms, as they operate with registered beneficial owners, may not accurately represent the best, or even current, views on shareholder communications and corporate governance. The important point is that the various aspects of existing law in this area are in conflict. The existing provisions dealing with the rights of shareholders clearly contemplate that shareholders may exercise certain powers in relation to the affairs of the corporation, but the fact of increasing nominee ownership and the failure of existing mechanisms to cope with it effectively disenfranchise many shareholders. The consideration of any specific reforms in this area is beyond the scope of this project, but there is a clear need: first, to define precisely who is a shareholder and what are the rights of shareholders (including the rights of those who hold through intermediaries, if there is any difference); and second, to provide the means for shareholders to effectively exercise those rights.

It is essential to recognize the close connection between securities transfer mechanisms, securities holding practices, shareholder communication procedures and corporate governance. We have recommended reform of the securities transfer mechanisms to provide a rational basis for existing securities holding practices. There is an equally pressing need to simultaneously address broad issues of shareholder communication and corporate governance.

RECOMMENDATION 14

Recognizing that registered ownership of securities is no longer usual, the term "shareholder" in the ABCA should be defined to clarify who is entitled to the rights of a shareholder, possibly including persons who hold SEs in respect of corporate shares. This should be done concurrently with the reform of securities transfer legislation.

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[617](...continued)
and Exchange Commission, Staff Report on Corporate Accountability" September 4, 1980 at 327-77. This last report includes a 21 page "Selected Bibliography".

RECOMMENDATION 15

ABCA section 147 and Securities Act section 79 should be amended, in conjunction with revisions to National Policy No. 41, to provide for a level of shareholder communication commensurate with shareholder rights under the ABCA.

RECOMMENDATION 16

Securities Act provisions such as sections 122, 125, 127, 128, 131 and consequential provisions in Part 13, triggered by the existence or number of security holders whose latest known address as shown on the books of the issuer is in Alberta, should be amended to accord with a clarified definition of shareholder in the ABCA.

CHAPTER 12 — OTHER STATUTES AFFECTED

A. Introduction

We have dealt specifically with recommended changes to the ABCA, the Alberta Securities Act and the Alberta PPSA. In the course of our discussion, we have sometimes touched related provisions in other statutes. This Chapter will review those other statutes affected by the operation of depositories.

It should be noted again that the need for reform of these statutes is not due solely to the operation of securities depositories, but is often the result of the statutes not dealing adequately with the practice of holding securities through intermediaries. The growth of depository operations has merely exacerbated existing problems.

It will be evident that the detailed reform of these statutes will often depend upon the specific provisions of a reformed Investment Securities Act. Consequently, our recommendations are sometimes made in general terms.

B. Insurance Act[618]

We have already mentioned the asset location requirement of section 43(2) of the Insurance Act, in the context of *situs* of securities.[619] At present, the Superintendent of Insurance requires that a security certificate be located in Alberta in order for the security to constitute an "asset in Alberta" of an insurer for the purposes of this provision. This requirement effectively prohibits insurers from holding securities through a depository under current law.

But it is not only the asset location requirements of the Insurance Act that would require modification in order to allow insurers' assets to be held by a depository. Section 94(12), dealing with permitted investments for Alberta-incorporated insurers, requires that "All investments and deposits of a company shall be made in its corporate name ...". Section 94(12) is primarily a requirement as to the nature of the permitted investment, although we have seen that the nature of the asset may influence the test used to determine the

618 *Supra,* note 472.

619 At p. 216 of this report.

situs of the asset. Currently, an interest in a fungible bulk purports to be a property interest in securities which are held in the name of nominees, so they are not allowed.

Reform would explicitly recognize that an interest in a fungible bulk is a special claim against an intermediary (SE). The SE would be located where the intermediary operates. If an SE were to become a permitted investment, its location would be clear.

Obviously, any decision to amend these requirements must be based upon an assessment of the rights of an insurer holding an SE. The apparent intent of the legislation is to keep the risk of loss to policyholders at an absolute minimum, so we may assume that amendments to allow insurers to hold an SE would only be considered if the additional risk arising through the involvement of intermediaries was negligible.[620]

Even so, insurers and policyholders have an interest in the efficient handling of an insurers' assets. Insurers should not be unfairly deprived of the ability to use intermediaries to handle securities transactions, provided adequate safeguards are in place.

RECOMMENDATION 17

We recommend that changes to the asset location and permitted investment requirements of the Insurance Act be considered, once reformed securities transfer and holding provisions are in place.

C. Trustee Act[621]

Section 9(1) of the Trustee Act currently requires a trustee who invests in securities to have the securities "registered in his name as the trustee for the particular trust for which the securities are held, and the securities may be transferred only on the books of the corporation in his name as trustee for that

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620 See the discussion of possible changes to the CIPF at p. 133 of this report.

621 *Supra*, note 103.

trust estate." It effectively forbids any trustee, other than a trust corporation, from holding securities through an intermediary in a fungible bulk.

The same considerations apply to any possible amendment of this section as with section 94(12) of the Insurance Act, discussed above.

RECOMMENDATION 18

We recommend that changes to section 9 of the Trustee Act be considered, once reformed securities transfer and holding provisions are in place.

D. Alberta Evidence Act[622]

The Alberta Evidence Act does not contain any provisions to facilitate the admission in evidence of "business documents", although such provisions do exist in section 30 of the Canada Evidence Act[623] and certain other provincial Evidence Acts.[624]

The prospect of having to prove every component of a securities transaction (or, more likely, a large number of transactions) in a legal proceeding is daunting. The task would involve an enormous amount of work for the parties to the proceeding and for CDS. Yet there is certainly a need to have such evidence available for use in civil, regulatory and judicial proceedings.[625] The desirability of adding "business documents" provisions to the Alberta Evidence Act is clear, for much the same reasons as provided the impetus for introduction of "bank records" provisions now found in all Canadian Evidence Acts.

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622 R.S.A. 1980, c. A-21.

623 R.S.C. 1985, c. C-5.

624 See for example the Ontario Evidence Act, R.S.O. 1990, c. E.23, s. 35.

625 See for example the discussion of money laundering and the Canadian securities industry in "Tracing of Illicit Funds: Money Laundering in Canada", *supra*, note 615. It is noted that the laundering of proceeds of provincial Securities Act infractions occurs in the same manner as for proceeds of criminal activities, and that the maintenance and availability of detailed records is a vital component in detection and enforcement.

There is no need to await the completion of other reforms to address this particular issue.

RECOMMENDATION 19

We recommend that the Alberta Evidence Act be amended to include provisions, similar to those in section 30 of the Canada Evidence Act, to facilitate the admission in evidence of business records, including the records of a clearing agency or depository.

CHAPTER 13 — REGULATION OF SECURITIES DEPOSITORIES

A. Introduction

There is an obvious need for regulation of securities depositories in Canada. They are an integral component of our securities markets, performing a vital function. They hold astronomical amounts of other people's property.

Regulation of the securities markets in Canada is performed by provincial Securities Commissions. Many aspects of depository operations raise issues that are a matter of regulation, not law. The distinction between the two is not always clear, in that regulatory requirements will very often impact upon legal rights.[626] In fact, the power to legislate cuts across the entire field now dealt with by regulation, but there is a trend away from detailed legislation because regulation is better suited to deal with the rapidly changing details of the securities markets. We therefore distinguish between regulatory and legal issues simply as a matter of jurisdiction: whatever issues now fall within the control of regulators are regulatory issues.

This Chapter will discuss some of the issues relating to the regulation of securities depositories.

B. The Current Regulatory Structure

At the present time, the only two provinces that exercise any direct regulatory control over securities depositories are Quebec and Ontario. CDS is a "clearing house approved by the Commission" within the meaning of section 10.2 of the Quebec Securities Act.[627] Ontario's Securities Act includes Part

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626 We have seen this in the context of the broker-client relationship, where regulatory requirements govern many of the arrangements that can be made between the parties, and where those arrangements largely determine the parties legal rights and obligations to one another.

627 R.S.Q. 1977, c. V-1.1, as am. by S.Q. 1984, c. 41. The full text of the provision reads:

> The transfer or pledge of a security entered in the book entry system of a clearing house approved by the Commission may be made by book entries in the accounts maintained by such clearing house. Such book entries in the accounts may show merely a quantity or the amount of the securities transferred or pledged or the balance of the securities after clearing.

IX[628], which gives the Ontario Securities Commission the power to designate a person or company as a "recognized clearing agency", and to exert substantial control over their operations. CDS is a "recognized clearing agency" in Ontario.

The B.C. Securities Act[629] includes a definition of "clearing agency" in section 1(1), and provisions allowing the B.C. Securities Commission to recognize and regulate "self regulatory bodies and stock exchanges" in sections 10-18. The B.C. Securities Commission does not recognize or directly regulate either the West Canada Clearing Corporation or the West Canada Depository Trust Company. It does recognize and regulate the Vancouver Stock Exchange, which owns 100% of WCDTC and 75% of WCCC.

The Alberta Securities Commission regulates the Alberta Stock Exchange, which owns 25% of WCCC, but does not otherwise regulate WCCC or WCDTC.

(1) A Gap in the Alberta Regulatory Structure

At present, the only provisions under the Alberta Securities Act[630] dealing with clearing agencies are found in the Regulation[631] at Part 17, sections 193-195. These provisions are, in our view, inadequate to regulate either a pure depository such as WCDTC, or a combined clearing agency/depository such as CDS.

The definition of "clearing agency" in section 193 of the Regulation does not include depository functions, and so would not apply to WCDTC. This is a minor problem. Amending the definition to add wording similar to that in section 1(1) of the B.C. Securities Act would solve it.

A more significant problem is whether there is any authority under the Securities Act to make appropriate regulations. The authority to make regulations on this subject is found in section 196(z.3) of the Securities Act,

628 See R.S.O. 1990, c. S.5, s. 22.

629 S.B.C. 1985, c. 83.

630 *Supra*, note 103.

631 Alta. Reg. 46/87.

which merely states that the Lieutenant Governor in Council may make regulations "governing self-regulating bodies". The term "self-regulating body" is defined in Part 17 of the Act in section 176 as "an association or organization recognized by the Board under this Part as a self-regulating body". Thus, the term "self-regulating body" actually means a self-regulating body recognized by the Board as such.

Section 177 of the Act deals with recognition by the Board, stating "The Board may in writing recognize an association or organization representing registrants, whether incorporated or unincorporated, as a self-regulating body ...". The obvious question arises whether a clearing agency is "an association or organization representing registrants". Probably not, in which case clearing agencies can not be self-regulating bodies as that term is used in the Act.[632] It then follows that section 196(z.3) does not provide a sufficient basis to allow regulations governing the operation of clearing agencies.

RECOMMENDATION 20

In order to provide statutory authority to regulate depositories in Alberta, we recommend that the definition of "clearing agency" in section 193 of the Regulation to the Alberta Securities Act be amended to specifically include depository activities and that sections 193-195 be moved from the Regulation into the Securities Act.

C. Memoranda of Understanding

Since before the submission of the *CDS Proposal,* there have been negotiations regarding Memoranda of Understanding ("MOUs") dealing with the regulation of CDS. These negotiations have involved CDS and securities regulators (the federal Office of the Superintendent of Financial Institutions and various provincial Securities Commissions). Initially there were to be two MOUs: one was to be entered into between CDS and the regulators involved to formalize the submission of CDS to regulation; the second was to be between the various regulators to determine precisely how CDS' operations would be regulated.

632 A similar result appears under s. 11 of the B.C. Securities Act.

It was originally anticipated that the final versions of the MOUs would be available before the end of 1989, and that the MOUs might provide answers to some of the regulatory issues that arose in the course of our examination. Unfortunately, there are still no final versions of the MOUs. It appears that negotiations are continuing and that the parties are working towards a single MOU encompassing all aspects of the regulation of CDS.

The latest draft MOU that we have seen does not attempt to address specific regulatory issues. Instead, it establishes a regulatory framework and procedures for co-ordinating the regulation of CDS' operations. It seems safe to assume that the final version of the MOU will not deal specifically with any regulatory issues.

D. Regulatory Issues

It is not our function to tell securities regulators how to do their jobs, so we won't. It is necessary, however, to recognize certain areas where regulatory requirements have direct impact upon some of the legal issues raised in this report. It does not purport to be an exhaustive list of regulatory issues arising with respect to depository operations.

(1) Contractual Arrangements

Depositories make contractual arrangements with their participants, with other depositories and with their nominees. These arrangements will often have far-reaching implications upon legal rights of the contracting parties and others.

(a) With participants

The contractual arrangements between the depository and its participants are critical.

These arrangements determine exactly how the depository will hold securities on behalf of its participants. Under existing law, the holding arrangements may determine the *situs* of securities or of interests in a fungible bulk of securities.[633] They may also determine the law applicable to a pledge

633 See the discussion of *situs* of securities held in fungible bulks commencing at p. 198 of this report.

of securities.[634] The address given by the depository to the issuer when shares are registered will affect which jurisdiction's laws apply in respect of shareholder communications.[635]

Most importantly, the contractual arrangements between the depository and participants currently determine the choice of law for the transactions between them,[636] as well as certain rights and duties of the parties in the event of a default by a participant or a shortfall in the quantity of securities held by the depository.[637] Under a reformed regime, the choice of law and essential aspects of any intermediary's rights and duties under an SE would be determined by legislation,[638] but the contractual arrangements would still be subject to regulation. These arrangements could continue to determine details of obligations regarding shareholder communications, including disclosure with respect to holdings of constrained shares.[639]

(b) With other depositories

With globalization of securities markets, interface agreements between depositories are a necessity. Depositories may hold increasing numbers of securities through foreign depositories as a consequence of the settlement of inter-jurisdictional transactions. This indirectly affects the legal rights of participants and their customers by placing securities, in respect of which they have claims against one depository, in the actual control of another depository and usually in a foreign jurisdiction. Regulation of the interface agreements is therefore important to ensure that each depository's rights against another are protected. This issue relates to the general issue of the integrity of depository operations, discussed below.

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634 See the discussion of choice of law under the PPSA commencing at p. 226 of this report.

635 See *supra*, note 585 and accompanying text.

636 See the discussion of "The Proper Law of Transfers and Pledges of Securities" commencing at p. 211 of this report.

637 See for example CDS Participant Agreement and Service Rule 1.16 (CDS Insurance, Liability and Indemnity), Rule 1.18 (Participant Funds), Rule 1.19 (Participant Fund Credit Ring), and Rule 2.9 (CDS Liability and Indemnity).

638 See the discussions of the proper law of transfers and pledges under reformed law at p. 213, and of the legal relationship between participants and CDS under reformed law at p. 215 of this report.

639 See Chapter 11.

(2) Integrity of Depository Operations

There has not been a failure of a modern depository/clearing agency, and hopefully there never will be. As noted earlier, such a failure is not impossible, but it is only likely in the context of a major market disruption such as the October 1987 "Market Break".[640] To be precise, the risk of failure arises with the clearing and settlement function,[641] not with the depository function, although in the case of CDS these are connected. Considering the large and ever-increasing role of securities depositories in modern markets, the integrity of depositories is practically a cornerstone of securities trading.

From the standpoint of most investors, the concern is not so much over what legal rights they may have against a depository in the event of a failure, but that regulators should never allow such a failure to occur. So, the integrity of depository operations is primarily a matter of regulation, with secondary legal issues that we will briefly review.

(a) Legal status and control

The rights of claimants against any depository, and control over the depository's operations, are to some extent determined by the depository's legal status. Some depositories are limited-purpose trust corporations, others are ordinary corporations. Corporate structure, control, not-for-profit status and other matters are determined by regulation.

(b) Insurance and internal security

Depositories may maintain insurance,[642] but rely primarily upon elaborate and extensive internal security procedures to guard against losses. Regulation of internal security procedures will always be of vital importance.

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640 See *supra*, note 325.

641 Under the CNS system, the clearing agency takes the position of counterparty to each side of the transaction. If large numbers of parties fail to settle their transactions, this places the clearing agency in an imbalanced position. See the discussion of the CNS system commencing at p. 26 of this report and *supra*, note 325.

642 See for example CDS Participant Agreement and Service Rules 1.16, 1.6.3 and 2.9.3.

CDS currently limits its liability to participants to the amount recoverable by CDS from its insurers.[643] Although recommended reforms would define by statute the nature and extent of a depository's liability to its participants, the review and regulation of insurance requirements is obviously very significant under current law.

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643 *Ibid.*

CHAPTER 14 — CONCLUSION

The overall reform of the law applicable to transfers of investment securities is clearly a daunting task. It is significant that our recommendations are, in principle, consistent with CDS' efforts to establish uniform Canadian legislation, compatible with the UCC. Although the *CDS Proposal* is now dated, it did represent a notable attempt at law reform in this area. The fact that so much time has passed since the *CDS Proposal* was first advanced reflects the extent to which this area of law has been neglected.

The need for reform of the Canadian law of securities transfers will become acute once the revisions to UCC Article 8 are in place. The reforms recommended in this report, and especially the call for uniform, integrated federal and provincial legislation, may seem overly ambitious when viewed against the current state of Canadian law. We believe that these reforms will, in the relatively near future, be indispensable.

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CHAIRMAN

DIRECTOR

June 1993

PART III — LIST OF RECOMMENDATIONS

RECOMMENDATION 1 (page 38)

Alberta should introduce legislation to accommodate the operation of securities depositories.

RECOMMENDATION 2 (page 129)

Amendments to the existing security transfer provisions of Part 6 of the ABCA are required. Such amendments should not follow the approach suggested in the *CDS Proposal* because that approach contains the same basic conceptual flaw as the existing provisions. The conceptual flaw is the characterization of the property interest of a claimant against a fungible bulk of securities as a property interest in the underlying securities that comprise the fungible bulk.

RECOMMENDATION 3 (page 133)

Amendments to Alberta legislation governing securities transfers should be patterned after pending revisions to Article 8 of the Uniform Commercial Code, using the concept of a Securities Entitlement in substitution for the proportionate property interest in securities held in fungible bulk. Alberta legislation should, if possible, be uniform with federal and provincial legislation in this area.

RECOMMENDATION 4 (page 142)

The amended legislation should include provisions dealing with the transfer of dematerialized securities.

RECOMMENDATION 5 (page 145)

ABCA section 45(1) should be repealed or amended.

RECOMMENDATION 6 (page 158)

The federal government should be asked to amend the securities transfer provisions of the CBCA to provide specifically that they prevail over the Bills of Exchange Act in the event of conflict. The Bills of Exchange Act should also be amended to defer to the CBCA in the event of conflict.

RECOMMENDATION 7 (page 172)

Federal and provincial legislation governing securities transfers should specifically provide that it is binding on Her Majesty.

RECOMMENDATION 8 (page 209)

Alberta legislation governing the transfer of investment securities should not be limited to securities issued by Alberta corporations, but should apply to securities issued by any person.

RECOMMENDATION 9 (page 209)

Provisions dealing with the transfer of publicly traded securities should be removed from the ABCA and placed in a separate statute entitled the "Investment Securities Transfer Act".

RECOMMENDATION 10 (page 210)

Alberta legislation should provide that the laws of the jurisdiction of organization of the issuer govern the validity of a security and the rights and duties of the issuer with respect to registration of transfer.

RECOMMENDATION 11 (page 214)

Reformed legislation should include a choice of law provision specifying that the validity of an SE and the rights and duties of the intermediary with respect to an SE shall be governed by the law of the jurisdiction where the account is maintained.

RECOMMENDATION 12 (page 228)

The provisions of the Alberta PPSA governing security interests in investment securities should be amended and patterned after pending revisions to Article 8 and 9 of the Uniform Commercial Code. Alberta legislation should, if possible, be uniform with other Canadian PPSAs.

RECOMMENDATION 13 (page 241)

Legislation imposing constraints on investment securities should not apply to intermediaries who hold securities other than for their own account.

RECOMMENDATION 14 (page 243)

Recognizing that registered ownership of securities is no longer usual, the term "shareholder" in the ABCA should be defined to clarify who is entitled to the rights of a shareholder, possibly including persons who hold SEs in respect of corporate shares. This should be done concurrently with the reform of securities transfer legislation.

RECOMMENDATION 15 (page 244)

ABCA section 147 and Securities Act section 79 should be amended, in conjunction with revisions to National Policy No. 41, to provide for a level of shareholder communication commensurate with shareholder rights under the ABCA.

RECOMMENDATION 16 (page 244)

Securities Act provisions such as sections 122, 125, 127, 128, 131 and consequential provisions in Part 13, triggered by the existence or number of security holders whose latest known address as shown on the books of the issuer is in Alberta, should be amended to accord with a clarified definition of shareholder in the ABCA.

RECOMMENDATION 17 (page 246)

We recommend that changes to the asset location and permitted investment requirements of the Insurance Act be considered, once reformed securities transfer and holding provisions are in place.

RECOMMENDATION 18 (page 247)

We recommend that changes to section 9 of the Trustee Act be considered, once reformed securities transfer and holding provisions are in place.

RECOMMENDATION 19 (page 248)

We recommend that the Alberta Evidence Act be amended to include provisions, similar to those in section 30 of the Canada Evidence Act, to facilitate the admission in evidence of business records, including the records of a clearing agency or depository.

RECOMMENDATION 20 (page 251)

In order to provide statutory authority to regulate depositories in Alberta, we recommend that the definition of "clearing agency" in section 193 of the Regulation to the Alberta Securities Act be amended to specifically include depository activities and that sections 193-195 be moved from the Regulation into the Securities Act.

APPENDIX A

Submission of The Canadian Depository for
Securities Limited
To
the Minister of Consumer and Corporate Affairs
For
the Province of Alberta
With Respect to Amendments
To the
Business Corporations Act

January, 1989

I. Introduction

This submission is made by The Canadian Depository for Securities Limited ("CDS") in support of certain proposed amendments to the Business Corporations Act (Alberta) (the "ABCA"). The amendments are designed for the purpose of establishing a statutory basis for transfers and pledges of securities made by book entries in the records of the depositories and clearing corporations such as CDS. Part II of this submission contains a brief description of CDS and of its operations. Part III sets out the proposed amendments with a brief explanation of the reasons for each proposal.

The proposed amendments are not addressed to general policy matters; they deal only with sections of the ABCA as necessary to expressly validate the operations of CDS. CDS' board of directors, which includes representatives of CDS' three major participant groups (banks, trust companies and investment dealers), has endorsed the proposal to seek statutory amendments to the substantive laws of each Province applicable to CDS' operations.

We note that the participants which utilize CDS' services also have a substantial interest in the suggested amendments to the ABCA, and may wish to make additional representations. It is hoped that Alberta Consumer and Corporate Affairs will accept submissions on these amendments from these groups once they have had an opportunity to review this submission. As noted below, the bank participants in particular have demonstrated an active interest in comparable prior proposals.

The West Canada Depository Trust Corporation or its predecessor Vancouver Stock Exchange Service Corp. ("WCDTC") has, of course, been operating in Alberta for some ten years without statutory provisions of the kind proposed in this submission. The WCDTC, however, deals principally with persons who are members of the Alberta Stock Exchange, and subject to its bylaws and rules and proper contractual arrangements. It deals in transfers of corporate equity securities among Exchange members, but not with pledges to chartered banks and other creditors. CDS differs from the WCDTC in a number of respects. CDS' membership is diverse, drawn from a number of constituent groups not subject to the rules of a common self-regulatory organization. CDS handles trades among all types of financial institutions and is not limited to members of a stock exchange, deals with a variety of financial instruments and not merely corporate equity securities, and provides facilities for pledging securities and the creation of third party interests in them.

CDS is proposing the amendments at this time in order to provide a statutory foundation for all its services which have been offered through its Calgary office since February, 1988. CDS also notes that it previously made a submission in February 1985 to the then Minister of Consumer and Corporate Affairs (Alberta) with a view to obtaining statutory amendments in effect identical to those proposed by this present submission, although no amendments resulted from such earlier submission.

II. Description of CDS and its Facilities

CDS is a securities depository and clearing corporation. It was incorporated as a federal corporation on June 9, 1970 and continued under section 181 of the Canada Business Corporations Act on July 30, 1980. It is a private company owned by six major Canadian chartered banks, five major trust companies, and the members of the Montreal Exchange, the

Toronto Stock Exchange and the Investment Dealers' Association of Canada. Representatives of the banks, trust companies and investment dealers each hold one-third of CDS' common shares. Currently, CDS' principal customers are its owners, although deposits of securities and transactions handled through CDS are often for the accounts of others. CDS has approximately 105 participant customers, all of whom with the exception of other foreign depositories, clearing corporations or stock exchanges, are regulated financial institutions or members of self-regulating organizations, and CDS does not deal with member of the public.

The services and facilities provided by CDS are designed to provide for the efficient settlement of securities transactions. CDS is recognized as a clearing agency by the Ontario Securities Commission and by the Quebec Securities Commission. In addition, as the custodian of large security holdings for the account of its bank and the trust company participants, CDS must, as a practical matter, satisfy the Office of the Superintendent of Financial Institutions ("OSFI") as to the security of its operations and of its computer-based systems.

Operations of CDS

CDS presently provides two primary services and a number of related subsidiary services to financial institutions and investment dealers who trade in and hold securities in Canada. Of the primary services, one is clearing and settlement, and the other is custodial. The subsidiary services relate to the physical movement of certificates and transaction documents between Montreal Toronto, Calgary and Vancouver and a number of other financial centres in Canada and the United States.

CDS is the clearing corporation for all trades on the Montreal Exchange and on the Toronto Stock Exchange. In addition, it clears an increasing volume of bonds and unlisted equities traded in the over-the-counter markets. Further, through arrangements with a similar organization, it facilitates clearing for transactions of Canadian brokers made in New York.

CDS provides a means whereby securities held by its participants may be held in custody, transferred and pledged through the centralized facility offered by CDS, known as the Securities Settlement Service ("SSS"). CDS receives and processes information on securities transactions, reports to its participants on up-coming delivery and payment obligations and facilitates deliveries and payments. Payments are calculated by CDS on a net basis, and each active participant makes a payment to or receives a payment from CDS in each settlement cycle. Deliveries between participants can be made on a certificated basis, in which case CDS acts essentially as a central clearing house for physically receiving and delivering envelopes containing security certificates. Participants may also utilize the Book Based System ("BBS"), one of the services offered as part of the SSS, to make uncertificated securities deliveries. The proposed amendments are designed to recognize and reflect the development of the BBS and facilitate its operations.

The BBS relieves CDS participants of the need to vault their securities. Even more important, it is the basis for a simple but significant improvement in the efficiency with which securities transactions are settled, whether they involve sale and delivery, or lending. In effect, electronic ledger entries replace the physical movement and possession of securities.

The BBS puts CDS in a close relationship with the issuers of securities and their transfer agents. An essential element in the system is that CDS becomes the nominee registered holder of securities deposited with it, although it has no beneficial interest in them. As most of the trade settlement involving such deposited securities takes place though electronic ledger entries in CDS records, the number of new certificates issued upon registration of transfer tends to decline and the use of street certificates is reduced. In the process, CDS assumes and discharges important responsibilities as a conduit for information, proxy distributions, dividends and interest from issuers to beneficial owners in compliance with National Policy Statement No. 41 - Shareholder Communications, adopted by the Canadian Securities Administrators.

Under the BBS, participants deposit securities with CDS. The securities are registered in the name of a CDS nominee, and CDS credits the new balance to an account maintained for the participant. A BBS participant with a credit balance can transfer or pledge those securities to another BBS participant by giving the appropriate instructions to CDS. CDS implements those instructions by making corresponding entries in the BBS accounts maintained for each of the participants involved. The BBS contributes significantly to the efficiency of participant operations by reducing the participant's need to keep a large inventory of physical security certificates and reducing associated costs of safekeeping, record keeping and delivery.

CDS presently has full service offices in Montreal, Toronto, Calgary and Vancouver providing its participants with the full range of securities clearing and settlement (SSS) and depository (BBS) services, security information services, courier services and international services. As CDS' services are highly computerized, participants can elect to control their operations from any convenient office, which may be within or outside Alberta. The importance of the BBS to its users is apparent from the fact that the value of securities held in the BBS on December 30, 1988 was $93 billion.

CDS intends to extend its BBS and SSS services to include Canadian federal marketable bonds ("Bond Bring-On") and thereafter to introduce a new service called the Money Market Service ("MMS").

The MMS will provide a centralized facility to clear and settle transactions involving same-day settlement instruments. Custodial services will be provided for the instruments traded in the growing Canadian Money Market. This on-line real time computerized system will link CDS customers acting as buyers, sellers, agents, lenders, borrowers and issuers with the service. Securities of same day settlement will be included in the MMS in the following order: treasury bills (issued by governments and which constitute in this category the greater part of the money market) bearer deposit notes, commercial paper (short term promissory notes), provincial and municipal notes, term deposits, guaranteed investment certificates, short-term Canada bonds. The ultimate objective is to replace the current physical movement in money market operations with efficient and secure data flows.

The phased implementation of the Bond Bring-On and the MMS remains subject to CDS securing an appropriate framework of federal and provincial regulation. For this purpose CDS is, and has been for some time, actively involved in discussions with representatives of OSFI and the securities commissions or similar authorities in the Provinces of Quebec, Ontario, Alberta and British Columbia. CDS expects to achieve the required regulation to permit the successive implementations of such services as planned.

The cost efficiencies and simplified record keeping offered by the BBS are of prime importance to participants, and there is a consequent interest in expanding the BBS to permit the inclusion of all types of securities. A major factor in such expansion is the assurance that the operations of the BBS have an appropriate legal foundation. The high volume and value of securities transfers and pledges and anticipated growth thereof in the BBS make it vital that the BBS be recognized as a legally effective alternative to the conventional market in physical security certificates which it replaces with efficiency cost improvements to the marketplace.

Statutory Basis for the BBS

As noted above, the BBS service is offered to participants through CDS' offices in Montreal, Toronto, Calgary and Vancouver. Although CDS was regulated as a clearing house under section 174 of the Quebec Securities Act, until 1984 there was no specific legislative recognition in Quebec of the BBS. Amendments to that Act in 1984 provided a statutory basis for transfers and pledges of securities through the BBS in Quebec. These amendments were proposed by CDS with the active support of the Quebec Securities Commission, the Montreal Exchange and the Canadian Bankers' Association.

The Business Corporations Act, 1982 (Ontario) (the "OBCA") has contained for some time provisions permitting book entry systems for the transfer and pledge of investment securities. These are drawn from provisions included in Part 8 of the Uniform Commercial Code which has been adopted in all 50 states in the United States. CDS has worked closely with the Ministry of Consumer and Commercial Relations in Ontario and in 1985 proposed a variety of technical amendments to the Ontario statute which have since been enacted. CDS' activities in this connection had the support of the Ontario Securities Commission, the Investment Dealers' Association of Canada and the Canadian Bankers' Association.

In Alberta no statutory basis exists for the book entry operations of depositories and clearing corporations. While other general principles of law may offer some support they leave serious questions and uncertainties especially in relation to pledges. Hence, the proposal for one express statutory basis. The proposed amendments are intended to provide such a basis.

The amendments have three primary objectives:

1. to establish in a form common in Canadian jurisdictions a proper statutory foundation for the validity of transfers and pledges of securities made through book entries in a clearing corporation;

2. to ensure that clearing corporation systems, which are now a primary settlement mechanism for security trades, may appropriately deal with all forms of publicly traded securities whether issued by governments, corporations or other entities; and

3. to enable development of systems in which securities can be issued and transferred without any certificate being produced, with a view to effecting considerable cost savings, reducing risks and simplifying record keeping.

The intent of the suggested amendments is to equate a book-based transaction with certificated methods of effecting transactions in the securities market so that the legal effect of a book entry in the records of a clearing corporation (whether the intention of the transaction is a transfer or pledge of the security) is the same as the legal effect of a physical delivery of a certificate evidencing the same security in like circumstances.

III. Suggested Amendments to the Business Corporations Act (Alberta)

Section 44(2)(c)

"*bona fide* purchaser" means a purchaser for value, in good faith and without notice of any adverse claim,

(i) who takes delivery of a security certificate in bearer form or order form or of a security certificate in registered form issued to him or endorsed to him or endorsed in blank,

(ii) in whose name an uncertificated security is registered or recorded in records maintained by or on behalf of the issuer as a result of the issue or transfer of the security to him, or

(iii) who is a transferee or pledgee as provided in section 70.2.

Explanation

Subsection (iii) in the definition of "bona fide purchaser" would make it clear that a participant taking a transfer or pledge of a security through the BBS qualifies as a bona fide purchaser, if the participant satisfied the other elements of the definition by giving value in good faith and without notice of any adverse claims. The status of bona fide purchaser is important since Part 6 provides that bona fide purchaser is entitled to a number of important rights protecting title to the securities purchased (see, for example, sections 51(4), 53, 56(2), 59, 64 and 68).

Non-certificated securities, the subject of proposed subsection (ii), are discussed in detail below, with reference to the proposed amendment to the definition of security in subsection 44(2)(n). Subsection (ii) is intended to ensure that a person who holds a security, but does not request the issuer to provide a certificate evidencing that security, will not be deprived of the benefits of bona fide purchaser status. The amendment would not directly affect BBS participants, as they are not the registered holders of the securities held in the BBS. It would affect CDS, insofar as CDS operates on a non-certificates basis, as discussed below, and any other person who chooses to take advantage of holding uncertificated securities (as permitted by section 45 in respect of ABCA corporations, for instance).

Section 44(2)(dd)

"clearing agency" means a person designated as a recognized clearing agency by the Commission pursuant to section 194 of the Regulations under the Securities Act.

Explanation

This definition is required because the term appears in proposed section 70.2. Part 17 of the Regulations under the Securities Act governs the recognition of clearing agencies.

Section 44(2)(ddd)

"custodian" means a person acting as a custodian for a clearing agency or for any such custodian;

Explanation

The proposed section 70.2 contemplates that a clearing corporation may itself hold the certificates evidencing the securities deposited with it or may request another entity to hold such certificates in safekeeping on its behalf. Securities must be held in safekeeping by an institution falling within the definition of "custodian" in subsection 44(2)(ddd) or transactions in such securities through the BBS will not be within the ambit of section 70.2. It is currently the practice of CDS to keep the bulk of its securities in large denomination certificates lodged in bank vaults in Montreal, Toronto, Calgary and Vancouver and to keep a 'float' of small denomination certificates in bank safe deposit boxes or on its premises to cope with the daily demand for withdrawals of securities from the BBS.

Sections 44(2)(n), 44(2)(nn) and 44(2)(qq)

> "security" means a share, participation or other interest in property, rights or an enterprise of an issuer, or an obligation of an issuer, or any right to acquire such a share, participation, interest or obligation, of a type commonly dealt in upon securities exchanges or markets or commonly recognized as a medium for investment in any area in which it is issued or dealt in;
>
> "security certificate" means an instrument in bearer, order or registered form, issued by an issuer evidencing a security;
>
> "uncertificated security" means a security, not evidenced by a security certificate, the issue and any transfer of which is registered or recorded in records maintained for that purpose by or on behalf of the issuer.

Explanation

At the present time, subsection 44(2)(n) does not differentiate between the security itself (for instance, a share of a corporation) and the instrument which evidences that security (the share certificate). It is important that the distinction be made, in order to facilitate the use of non-certificated securities. Part 6 anticipates non-certificated operations. For instance, the current subsection 45(1) clearly implies that securities may be issued and the holder exercise rights in respect of the security although no instrument evidencing the security is produced; the ABCA does not require the issue of share certificates. Non-certificated operation has been recognized in the OBCA and the Securities Act (Quebec).

CDS' expressed objective is to convert its operations to a non-certificated basis as soon as legal and operational issues have been resolved. In such a system, CDS or its nominee would be registered on the books of the issuer as the holder of a security but no security certificate would be issued unless CDS specifically so requested. The issuer or its transfer agent would from time to time verify CDS' holdings of the security. Non-certificated operation would eliminate the possibility of security certificates being lost or misappropriated and would substantially reduce safekeeping costs incurred by CDS. These risks and costs are incurred not only while CDS holds securities on deposit but also during the course of transfers and withdrawals which in a certificated environment require physical delivery of security certificates between CDS and the transfer agents. Audit verification of holdings and recordkeeping by CDS would also be greatly simplified in a non-certificated environment. In a sense, by holding securities on a non-certificated basis CDS would itself obtain benefits similar to those offered to its participants in using the BBS. CDS has been engaged in discussions with transfer agents to determine appropriate procedures for instituting non-certificated operations. The amendment to subsection 44(2)(n) and the proposed subsections 44(2)(nn) and 44(2)(qq) are requested to ensure that the non-certificated operations can proceed if other issues are resolved, and that implementation of the system will not be inhibited by a technical problem with the definitions in Part 6.

The new definitions eliminate the requirement that the security be "one of a class or series or by its terms divisible into a class or series of instruments". A number of securities likely to be made eligible for the BBS would not necessarily conform to this definition. For instance, we have indicated that CDS is creating a system for the clearing of transactions in money market instruments. In some cases, these instruments are issued individually and it would be difficult to argue that they are one of a class or series. It appears that the important part of the definition is the functional one requiring that the security be of a type dealt in upon securities, exchanges or markets. The proposed change would emphasize the fact that the definition of a security is functional.

Section 70.2

Transfer through clearing house.

(1) If a security shown in the records of a clearing agency is evidenced by,

(a) a security certificate in the custody of the clearing agency or a custodian or of a nominee of either, subject to the instructions of the clearing agency, and is in bearer form or endorsed in blank by an appropriate person or registered in the name of the clearing agency or a custodian or of a nominee of either; or

(b) an uncertificated security registered or recorded in records maintained by or on behalf of the issuer in the name of the clearing agency or a custodian or of a nominee of either, subject to the instructions of the clearing agency.

Then, in addition to other methods, a transfer or pledge of the security or any interest therein may be effected by the making of an appropriate entry in the records of the clearing agency.

(2) *Interest in fungible bulk.* Under this section, entries may be in respect of like securities or interests therein as part of a fungible bulk and may refer merely to a quantity or value of a particular security without reference to the name of the registered owner, certificate or bond number or the like and, in appropriate cases, may be on a net basis taking into account other transfers or pledges of the same security.

(3) *Constructive endorsement and delivery.* A transfer or pledge under this section has the effect of delivery of a security in bearer form or duly endorsed in blank representing the amount of the obligation or the number of shares or rights transferred or pledged.

(4) *Idem.* If a pledge or the creation of a security interest is intended, the making of entries has the effect of a taking of delivery by the pledgee or a secured party and the pledgee or secured party shall be deemed to have taken possession for all purposes including the purposes of the Personal Property Security Act.

(5) *Holder.* A person depositing a security certificate or an uncertificated security with a clearing agency, or a transferee or pledgee of a security under this section, is a holder of the security and shall be deemed to have possession of the security so deposited, transferred or pledged, as the case may be, for all purposes, including, if a pledge or the creation of a security interest is intended for the purposes of the Personal Property Security Act.

(6) *Not registration.* A transfer or pledge under this section does not constitute a registration of transfer under sections 71 to 75.

(7) *Error in Records.* Entries made in the records of the clearing corporation as provided in subsection (1) which are not appropriate do not affect the validity or effect of the entries nor the liabilities or obligations of the clearing corporation to any person adversely affected thereby.

(8) *Definitions.* In this section "issuer" includes a person, other than an individual, and a government or agency thereof,

(a) that is required by this Act to maintain a securities register,

(b) that directly or indirectly creates fractional interests in its rights or property and issues security certificates or uncertificated securities as evidence of the fractional interests,

(c) that places or authorizes the placing of its name on a security certificate, otherwise than as an authenticating trustee, registrar or transfer agent, or that otherwise authorizes the issue of a security certificate or an uncertificated security evidencing a share, participation or other interest in its property or in an enterprise or evidencing its duty to perform an obligation, or

(d) that becomes responsible for or in place of any other person described as an issuer in this section; and

"security", "security certificate" and "uncertificated security", in addition to the meaning each has for the purposes of Part 6, are extended to include a security, security certificate or uncertificated security, as the case may be, of an issuer within the meaning of this section.

Explanation

The foregoing provisions in section 70.2 are designed to establish a proper statutory foundation for the activities of clearing corporations such as CDS. The provisions themselves represent an adaptation of certain provisions now found in Part VI of the OBCA. They do not, however, involve the wholesale adoption of Part VI of the OBCA, for that involves issues of policy that go far beyond the limited objects of the present proposals. Nothing in the present proposals forecloses the question whether provisions similar to those contained in Part VI of the OBCA (and in Part VI of the Canada Business Corporation Act) should be adopted in Alberta.

The heart of the present proposed amendments is contained in paragraph (1), and its effect may be succinctly summarized by saying that it provides for the effective transfer or pledge of securities or interests in securities, through the making of entries in the records of the clearing corporation. This, in essence, is the book entry system, and this provision, accordingly, establishes the statutory foundation for the system, and validates transactions effected through it.

It should be noted, first, that paragraph (1) applies to both security certificates and uncertificated securities. "Security" is defined in subsections 44(2)(n), (nn) and (qq) to include both, and each is defined in subsection 70.2(8). There is a distinction between the underlying security itself, which in law is a chose in action, such as a share of a corporation, and the instrument which evidences that security (the share certificate). The ABCA, as mentioned earlier, does not mandate the issue of share certificates.

The provisions proposed contemplate that a clearing corporation may itself hold the certificates evidencing the securities deposited with it or may request another entity to hold such certificates in safekeeping on its behalf. Hence the reference to a "custodian", as defined in subsection 44(2)(ddd).

In many instances, participants are acting on behalf of third parties, and therefore securities held in the BBS may be held on behalf of a pledgor which is not itself a participant. The non-participant may instruct the participant acting on its behalf to effect a pledge. For instance, a broker may be instructed by its client to deliver securities purchased for the client to a bank. The bank may be holding such securities as collateral for a loan to the client. The broker cannot in such circumstances be said to be the "pledgor" of the securities, but acts as the agent of the client, making delivery of the securities to the bank on behalf of the client. Nonetheless, it is intended that such delivery effect a pledge pursuant to the Personal Property Security Act which has been enacted but not yet proclaimed in force. It is of great importance to participants and their clients that such pledges should be recognized; any doubt as to the legal effectiveness of the pledge might force participants to revert to the holding of security certificates, with resulting inefficiencies and costs. Recent amendments to the Securities Act (Quebec) and to the OBCA do not require the transferor or pledgor to be a participant but simply state that a pledge of a security entered in the book entry system of the clearing agency may be made by book entries in the accounts maintained by such clearing agency. This adds considerable flexibility to the BBS and significantly increases its utility to participants. CDS' systems and procedures must be uniform in all jurisdictions, and therefore it is appropriate that the legislation validating BBS transactions in different jurisdictions should be as uniform as possible.

Paragraph 1(a) deals with security certificates, which are either "in bearer form" or "endorsed in blank by an appropriate person", or are "registered in the name of the clearing agency or a custodian or a nominee of either".

The OBCA contains a definition of "bearer form" but this has been omitted from the current proposal. The omission is based upon the belief that "bearer form" is a well understood expression which does not call for specific definition. An "appropriate person" is also a defined term (section 61 of the ABCA).

Paragraph (2) of the proposal does not call for explanation. The word "fungible" is defined in section 44(2)(g) of the ABCA.

Paragraph (3) of the proposal is self-explanatory.

Paragraph (4) is drafted in such a way as to apply to participants in the BBS who create a credit balance either through a deposit of securities with CDS or by accepting a transfer or pledge of securities. Each is deemed to be in possession of those securities for all purposes. The point of this provision is to make it clear that a participant is not considered to have lost any rights by changing its holding of a security from the holding of a physical security certificate to the holding of a security through the facilities of BBS.

Paragraphs (1) and (4) of the proposal both refer to the making of a pledge or the creation of a security interest through entries in the records of the clearing corporation. This is satisfactory with respect to a pledge made by one BBS participant to another BBS participant. In such cases, CDS records the transaction as a delivery of the security for the purpose of pledge and a special record is maintained for both the pledgor and the pledgee. But securities held in the BBS may be held in pledge, although the pledge was not itself effected through the facilities of the BBS and indeed one of the parties to the pledge may not itself be a participant in CDS. For instance, many participants hold securities on behalf of customers. A bank may for instance hold securities for a customer in safekeeping. Provided appropriate arrangements are made with the customer, such securities may be deposited by the bank in its BBS account. The bank obtains the advantages of having CDS perform the safekeeping and record keeping functions of the BBS and holding the securities on the BBS facilitates any transfers which may be made on the instructions of the customer, for instance, a transfer to a broker who may be acting on behalf of the same customer. A participant may also hold securities pledged to it by its customers. The bank may for instance receive securities in pledge from a customer, or may be holding securities in safe keeping for a customer and the nature of that holding may be changed to a holding for the purposes of pledge when appropriate arrangements are entered into with the customer. It is vital to participants that in such circumstances the participant have a perfected security interest in the securities of its customer, and it is therefore important that a holding of securities through the BBS be deemed to give the participant possession of such securities for purposes of any provincial law requiring possession to create and perfect a security interest. Paragraph (5) which deems a BBS participant to have possession of the security for all purposes is intended to ensure that participants will be deemed to have possession of all securities held for their account in the BBS, regardless of how the credit balance was obtained, and to ensure that this possession is sufficient to perfect a security interest event though the security interest may have been outside of the BBS.

Paragraphs (6) and (7) are self-explanatory.

Paragraph (8) proposes to amend the definition of "issuer" but only for the purpose of section 70.2. The amendment is intended to make it clear beyond doubt that securities issued by governments and their agencies, are included. The diversity of investments available in the Alberta securities market is immense. The book entry system will become an increasingly vital settlement mechanism for security trades in Alberta, and it is important to all participants that all forms of securities in which they may trade may be made eligible for such a system.

It is CDS' plan to make government debt securities as well as debt securities issued by government agencies and municipalities eligible for book-based transactions in the near future. Recently, certain provincial government bond issues have been made eligible for the BBS. In the very near future CDS will be offering a clearing system similar to the BBS for all forms of money market securities, including federal treasury bills. In addition, it is recognized that the securities market is inventive and new forms of securities may be introduced, the precise form of which cannot be anticipated at this time, as new forms of securities are limited only by the ingenuity of the market place. For instance, precious metal certificates are traded on the Montreal Exchange and are eligible for BBS settlement. Similarly, zero coupon or strip bonds (marketed as Term Investment Growth Receipts and Sentinels) representing fractional interests in underlying government securities, have recently been made eligible for the BBS. Therefore, it is suggested that the definition of issuers be as broad as possible to ensure that the section has an equally broad ambit and gives a statutory validation to BBS transactions in all possible forms of securities.

Addendum To The
Submission Of The Canadian Depository For Securities Limited
To
The Minister Of Consumer And Corporate Affairs
For
The Province Of Alberta
With Respect To Amendments
To The
Business Corporations Act

January, 1993

Introduction

This addendum to the previous submission of CDS made in January 1989 is intended to provide an update in respect of developments at CDS and in Canadian securities markets generally in order to renew our request for certain amendments to the Alberta legislation dealing with transfer and pledges of securities by book entry through the facilities of a clearing agency such as CDS.

As the relevant provisions of the Alberta legislation have not been updated since 1989, the substance of the previous submission remains applicable. It is submitted that the need for the amendments has increased due to increased utilization of the book entry services of CDS and the heightened awareness of securities clearing and custodial risks in certificated environments.

Growth in Depository and Clearing Services

The most notable development since January 1989 is the growth in the values and volumes of securities processed at CDS. Whereas the value on deposit at that time was approximately $93 billion, that number has grown to in excess of $465 billion at the present time. Daily gross values of securities settlements exceed $20 billion with net settlement payment obligations in the range of $3 to $4 billion daily. Approximately $4 billion of entitlement payments are processed through CDS on a monthly basis.

The primary factor in driving this growth has been the successful completion of the Canada Bond Bring-on Project which is referenced in the submission. During 1990, all long-term Canada Bond (currently 113 issues) were made eligible for deposit and recent statistics indicate that approximately 75% of the total outstanding issue of these bonds has been deposited with CDS. Settlement of the trades in Canada Bonds represents a large portion of the growth in settlement values also.

In addition to the Canada Bonds, CDS has made eligible the publicly-traded bonds of all of the provinces, most of their hydro-utilities and many other government-guaranteed securities. A number of provincial and hydro-utility "global bond" issues have also been processed by CDS permitting such issues to be marketed globally, but settled by book entry in local markets without securities certificates being delivered overseas.

Finally, strip bonds representing the coupons and principal residue portions of marketable bonds have been made eligible and deposited in increasing numbers. Strip bonds have been made eligible in both physical and book entry form. Physical strip bonds are held by a financial institution as custodian for CDS, while book entry strips are created by allocating separate security identification numbers to each interest and principal payment for an underlying fully registered bond. The face value of strip bonds currently on deposit with CDS is in excess of $83 billion, with book entry strips representing $57 billion of that total.

Money Market Service/Debt Clearing Service

In the January 1989 submission, reference is made to the planned implementation of a real-time, on-line Money Market Service for the clearing and custody of treasury bills, commercial paper. bankers' acceptances and other discount instruments traded for same-day settlement in the Canadian money markets. Due to a number of obstacles, primarily of a regulatory and policy nature, the MMS has not been implemented to date. Instead, enhancements to the underlying system have been developed such that the service can accommodate interest-bearing debt securities settling in longer time frames than same-day, five business days being the norm.

The regulatory issues delaying the implementation of the Debt Clearing Service have been specifically identified and intensive efforts are on-going between the participant financial institutions and their regulatory authorities to seek resolution. The issues deal mainly with the processes required for dealing with default in the payment of settlement obligations to the system, in particular due to the lack of finality of payment in the Canadian payments system. We are confident that these issues will be resolved in the near future and that the newly-developed technology for the debt and money market instruments can be implemented in due course.

Participant Agreement and Service Rules

In order to process the increased values of securities of recent years, CDS' risk containment mechanisms have undergone a thorough review and enhancement. These risk containment mechanisms include rules relating to the delivery of certified cheques, CDS' security interest in unpaid securities as collateral for a participant's obligations, the implementation of participants' funds and "credit rings" underpinning the continued operation of each service, the elimination of risk spillover between services, and the enhancement of risk prevention and recovery procedures for each major service.

During 1990-91, the risk containment mechanisms were consolidated with other contractual provisions of CDS' previous participant agreements within the "Contractual Restructuring" project. The revised and fully updated Participant Agreement and Service Rules were reviewed and received the non-disapproval of the Securities Commissions in the four provinces in which CDS maintains clearing and depository operations as well as the federal regulatory authorities. The final package became effective on April 30, 1991.

Non-Certificated Inventory Project

During the past year, CDS and the financial institutions which offer transfer agency services for equity securities have been working on the Non-Certificated Inventory Project. A pilot project involving one of the transfer agents is scheduled to commence in the middle of November; if all goes well, we expect that all Canadian equities eligible for CDS will be operating in an NCI mode by the end of the first quarter of next year.

In this NCI operation, participants will deposit securities certificates through CDS to the transfer agent for re-registration into the nominee name CDS & Co. Instead of issuing a new certificate to CDS, however, the registration of CDS & Co. on the shareholders' register will be communicated electronically to CDS in order to update the depositing participants' ledgers. No certificates will be issued to CDS, but the total of the participants' ledgers will be reconciled on a daily basis to the transfer agent's records.

Accordingly, it is important that the concept of an "uncertificated security" be included in the Alberta legislation.

Regulation of CDS

The 1989 submission indicates that CDS is recognized as a clearing agency under the respective provisions of the Ontario and Quebec Securities Acts. In addition, the submission states that CDS has been seeking the establishment of an appropriate framework of federal and provincial regulation involving the four provincial securities commissions and the federal Office of Superintendent of Financial Institutions. This statement refers to a Memorandum of Understanding which has been under negotiation since 1988, but has not been formally executed due to differences among the regulatory authorities. An alternative arrangement which is being considered is the execution of an MOU involving only the four provincial securities commissions and CDS, without federal involvement. CDS has been seeking to comply with the spirit of the draft MOU through regular monthly reporting to the regulators, including the Alberta Securities Commission and the seeking of their non-disapproval to various CDS' initiatives such as rule changes and new service introductions.

Part 17 of the Alberta Securities Act governs the recognition of "clearing agencies" in your province. If the proposed amendments are implemented as recommended in the submission, CDS will apply for such recognition as required by the terms of the proposed amendments.

Statutory Amendments in Other Provinces

As indicated in the previous submission, substantive law provisions similar to those recommended for the ABCA have already been in force in Ontario and Quebec for some time. In 1990, the Province of British Columbia enacted legislation (Bill 56, the Securities Amendment Act, 1990, which amended the Personal Property Security Act, sections 52 and 57) which provides for book entry transfers and pledges of securities through a clearing agency.

Accordingly, Alberta is the only province in which CDS operates which does not have a statutory foundation for such book entry transfers and pledges.

Alberta Personal Property Security Act

Since 1989, the Personal Property Security Act of Alberta has been amended, but without provisions which would conform to the book entry transfer and pledge sections recommended in our submission. In particular, we understand that some financial institution participants of CDS are hesitant to take pledges of securities through the services of CDS because of the deficiencies of the PPSA. It would appear that a pledgee taking a security interest in securities held in a clearing agency would have to register a financial statement in order to perfect its security interest. Such a process is not realistic in the securities markets.

The problem arises in the first place from the definition of "security" in section 1(1)(oo) of the PPSA to mean "a writing" and the lack of recognition of "uncertificated securities". Accordingly, it is recommended that the definition of "security" in the PPSA be amended to conform to the definitions that are set out in the CDS submission.

Secondly, the terms of section 25 providing that "registration of a financing statement perfects a security interest in collateral" would appear to prejudice the position of a bona fide purchaser of a security for value and without notice of the prior interest perfected by financial statement. No purchaser (or pledgee) could take delivery of a security without having first conducted a search of the PPSA registry. Again, this situation would be unrealistic in the high turnover environment of the securities markets.

In order to give priority to the bona fide purchaser, an additional sub-section should be added to section 30:

> **(Section 30 - Buyer or lessee takes free of security interest.)**
>
> A bona fide purchaser of a security, whether in the form of a security certificate or an uncertificated security, who has taken possession of it, has priority over any security interest in it perfected by registration or temporarily perfected under section 25 or 26.

Such a provision would mesh well with the recommended section 7.02(5) of the ABCA which provides, in essence that a participant with a book entry in the records of a clearing agency shall be deemed to have possession of the security for all purposes including the PPSA. Since no other person can have "possession" of such a security, there is no need for a financing statement to be registered by a pledgee of securities through a book entry.

Conclusion

The amendments which CDS is seeking have been adopted in the other provinces in which CDS operates and, indeed, are modeled after legislation in the United States of America. The legislation is intended to update the laws of Alberta to recognize and protect the legal validity of book entry transfers and pledges of certificated and uncertificated securities. As the proposed amendments are quite technical, they have not proven to be controversial in the other jurisdictions in which CDS has been successful in obtaining their enactment. The amendments have, however, provided considerable comfort to participants using the system and their clients.

CDS management and legal counsel will be pleased to provide further assistance as may be required for the enactment of this important legislation.

APPENDIX B

Alberta Business Corporations Act
S.A. 1981, c. B-15

Part 6

ALBERTA BUSINESS CORPORATIONS ACT
S.A. 1981, c. B-15

PART 6

SECURITY CERTIFICATES, REGISTERS AND TRANSFERS

Division 1
Interpretation and General

Definitions and interpretation
44(1) The transfer or transmission of a security shall be governed by this Part.

(2) In this Part,

(a) "adverse claim" includes a claim that a transfer was or would be wrongful or that a particular adverse person is the owner of or has an interest in the security;

(b) "bearer" means the person in possession of a security payable to bearer or endorsed in blank;

(c) "bona fide purchaser" means a purchaser for value in good faith and without notice of any adverse claim who takes delivery of a security in bearer form or order form or of a security in registered form

(i) issued to him, or

(ii) endorsed to him or endorsed in blank by an appropriate person as defined in section 61;

(d) "broker" means a person who is engaged for all or part of his time in the business of buying and selling securities and who, in the transaction concerned, acts for, or buys a security from, or sells a security to, a customer;

(e) "delivery" means voluntary transfer of possession;

(f) "fiduciary" means

(i) a trustee, guardian, committee, curator or tutor,

(ii) an executor, administrator or representative of a deceased person, and

(iii) any other person acting in a fiduciary capacity;

(g) "fungible" means, in relation to securities, securities of which any unit is, by nature or usage of trade, the equivalent of any other like unit;

(h) "genuine" means free of forgery or counterfeiting;

(i) "good faith" means honesty in fact in the conduct of the transaction concerned;

(j) "holder" means a person in possession of a security issued or endorsed to him or to bearer or in blank;

(k) "issuer" includes a corporation

(i) that is required by this Act to maintain a securities register, or

(ii) that directly or indirectly creates fractional interests in its rights or property and that issues securities as evidence of those fractional interests;

(l) "overissue" means the issue of securities in excess of any maximum number of securities that the issuer is authorized by its articles or a trust indenture to issue;

(m) "purchaser" means a person who takes by sale, mortgage, hypothec, pledge, issue, reissue, gift or any other voluntary transaction creating an interest in a security;

(n) "security" or "security certificate" means an instrument issued by a corporation that is

(i) in bearer, order or registered form,

(ii) of a type commonly dealt in on securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment,

(iii) one of a class or series or by its terms divisible into a class or series of instruments, and

(iv) evidence of a share, participation or other interest in or obligation of a corporation;

(o) "transfer" includes transmission by operation of law;

(p) "trust indenture" means a trust indenture as defined in section 77;

(q) "unauthorized" in relation to a signature or an endorsement means one made without actual, implied or apparent authority and includes a forgery;

(r) "valid" means issued in accordance with the applicable law and the articles of the issuer or validated under section 48.

(3) A security is a negotiable instrument except when

(a) its transfer is restricted and noted on the security in accordance with section 45(8), or

(b) it is stated conspicuously on the security certificate that it is non-negotiable.

(4) A security is in registered form if

(a) it specifies a person entitled to the security or to the rights it evidences, and

(b) either its transfer is capable of being recorded in a securities register or the security so states.

(5) A debt obligation is in order form if by its terms it is payable to the order or assigns of any person specified in it with reasonable certainty or to him or his order.

(6) A security is in bearer form if it is payable to bearer according to its terms and not by reason of any endorsement.

(7) A guarantor for an issuer is deemed to be an issuer to the extent of his guarantee whether or not his obligation is noted on the security.

Security certificates

45(1) A security holder is entitled at his option to a security certificate that complies with this Act or a non-transferable written acknowledgment of his right to obtain a security certificate from a corporation in respect of the securities of that corporation held by him.

(2) A corporation may charge a fee in an amount not exceeding the maximum amount prescribed in the regulations for a security certificate issued in respect of a transfer.

(3) A corporation is not required to issue more than one security certificate in respect of securities held jointly by several persons, and delivery of a certificate to one of several joint holders is sufficient delivery to all.

(4) A security certificate shall be signed by at least 1 director or officer of the corporation or by or on behalf of a registrar, transfer agent or branch transfer agent of the corporation or by a trustee who certifies it in accordance with a trust indenture.

(5) Any signatures required on a security certificate may be printed or otherwise mechanically reproduced on it.

(6) If a security certificate contains a printed or mechanically reproduced signature of a person, the corporation may issue the security certificate, notwithstanding that the person has ceased to be a director or an officer of the corporation, and the security certificate is as valid as if he were a director or an officer at the date of its issue.

(7) There shall be stated on the face of each share certificate issued by a corporation

(a) the name of the corporation,

(b) the words "Incorporated under the Business Corporations Act",

(c) the name of the person to whom it was issued, and

(d) the number and class of shares and the designation of any series that the certificate represents.

(8) If a security certificate issued by a corporation or by a body corporate before the body corporate was continued under this Act is or becomes subject to

(a) a restriction on its transfer other than a constraint under section 168, or

(b) a lien in favour of the corporation,

the restriction or lien is ineffective against a transferee of the security who has no actual knowledge of it unless

(c) it or a reference to it is noted conspicuously on the security certificate,

(d) the security certificate contains a conspicuous statement that it is non-negotiable, or

(e) the transferee is not

(i) a bona fide purchaser, or

(ii) a purchaser against whom the owner of the security may not assert the ineffectiveness of an endorsement under section 64.

(9) A distributing corporation shall not restrict the transfer of its shares except by way of a constraint permitted under section 168.

(10) There shall be stated legibly on a share certificate issued by a corporation that is authorized to issue shares of more than one class or series

(a) the rights, privileges, restrictions and conditions attached to the shares of each class and series that exists when the share certificate is issued, or

(b) that the class or series of shares that it represents has rights, privileges, restrictions or conditions attached to it and that the corporation will furnish to a shareholder, on demand and without charge, a full copy of the text of

(i) the rights, privileges, restrictions and conditions attached to each class authorized to be issued and to each series in so far as they have been fixed by the directors, and

(ii) the authority of the directors to fix the rights, privileges, restrictions and conditions of subsequent series.

(11) If a share certificate issued by a corporation contains the statement mentioned in subsection (10)(b), the corporation shall furnish to a shareholder on demand and without charge a full copy of the text of

(a) the rights, privileges, restrictions and conditions attached to each class authorized to be issued and to each series in so far as they have been fixed by the directors, and

(b) the authority of the directors to fix the rights, privileges, restrictions and conditions of subsequent series.

(12) A corporation may issue a certificate for a fractional share or may issue in its place scrip certificates in a form that entitles the holder to receive a certificate for a full share by exchanging scrip certificates aggregating a full share.

(13) The directors may attach conditions to any scrip certificates issued by a corporation, including conditions that

(a) the scrip certificates become void if they are not exchanged for a share certificate representing a full share before a specified date, and

(b) any shares for which those scrip certificates are exchangeable may, notwithstanding any pre-emptive right, be issued by the corporation to any person and the proceeds of those shares distributed rateably to the holders of the scrip certificates.

(14) A holder of a fractional share issued by a corporation is not entitled to exercise voting rights or to receive a dividend in respect of the fractional share, unless

(a) the fractional share results from a consolidation of shares, or

(b) the articles of the corporation otherwise provide.

(15) A holder of a scrip certificate is not entitled to exercise voting rights or to receive a dividend in respect of the scrip certificate.

1981 cB-15 s45;1987 c15 s7

Securities records

46(1) A corporation shall maintain a securities register in which it records the securities issued by it in registered form, showing with respect to each class or series of securities

(a) the names, alphabetically arranged, and the latest known address of each person who is or has been a security holder,

(b) the number of securities held by each security holder, and

(c) the date and particulars of the issue and transfer of each security.

(1.1) A corporation shall keep the information entered in the register referred to in subsection (1) for the period of time prescribed in the regulations.

(2) A corporation may appoint

(a) one or more trust corporations as its agent or agents to maintain a central securities register or registers, and

(b) an agent or agents to maintain a branch securities register or registers.

(3) Registration of the issue or transfer of a security in the central securities register or in a branch securities register is complete and valid registration for all purposes.

(4) A branch securities register shall contain particulars of securities issued or transferred at that branch.

(5) Particulars of each issue or transfer of a security registered in a branch securities register shall also be kept in the corresponding central securities register.

(6) Neither a corporation, nor its agent nor a trustee defined in section 77(1) is required to produce

(a) a cancelled security certificate in registered form, an instrument referred to in section 29(1) that is cancelled or a like cancelled instrument in registered form 6 years after the date of its cancellation,

(b) a cancelled security certificate in bearer form or an instrument referred to in section 29(1) that is cancelled or a like cancelled instrument in bearer form after the date of its cancellation, or

(c) an instrument referred to in section 29(1) or a like instrument, irrespective of its form, after the date of its expiry.

1981 cB-15 s46;1987 c15 s8;1991 cL-26.5 s335(7)

Dealings with registered holders and transmission on death

47(1) A corporation or a trustee as defined in section 77(1) may, subject to sections 128, 129 and 132, treat the registered owner of a security as the person exclusively entitled to vote, to receive notices, to receive any interest, dividend or other payments in respect of the security, and otherwise to exercise all the rights and powers of an owner of the security.

(2) Notwithstanding subsection (1), but subject to a unanimous shareholder agreement, a corporation whose articles restrict the right to transfer its securities shall, and any other corporation may, treat a person as a registered security holder entitled to exercise all the rights of the security holder he represents if that person furnishes evidence as described in section 72(4) to the corporation that he is

(a) the executor, administrator, heir or legal representative of the heirs of the estate of a deceased security holder,

(b) a guardian, committee, trustee, curator or tutor representing a registered security holder who is an infant, an incompetent person or a missing person, or

(c) a liquidator of, or a trustee in bankruptcy for, a registered security holder.

(3) If a person on whom the ownership of a security devolves by operation of law, other than a person described in subsection (2), furnishes proof of his authority to exercise rights or privileges in respect of a security of the corporation that is not registered in his name, the corporation shall treat that person as entitled to exercise those rights or privileges.

(4) A corporation is not required to inquire into the existence of, or see to the performance or observance of, any duty owed to a 3rd person by a registered holder of any of its securities or by anyone whom it treats, as permitted or required by this section, as the owner or registered holder of the securities.

(5) If an infant exercises any rights of ownership in the securities of a corporation, no subsequent repudiation or avoidance is effective against the corporation.

(6) A corporation shall treat as owner of a security the survivors of persons to whom the security was issued if

(a) it receives proof satisfactory to it of the death of any joint holder of the security, and

(b) the security provides that the persons to whom the security was issued are joint holders with right of survivorship.

(7) Subject to any applicable law relating to the collection of taxes, a person referred to in subsection (2)(a) is entitled to become a registered holder or to designate a registered holder, if he deposits with the corporation or its transfer agent

(a) the original grant of probate or of letters of administration, or a copy of it certified to be a true copy by

(i) the court that granted the probate or letters of administration,

(ii) a trust company incorporated under the laws of Canada or a province, or

(iii) a lawyer or notary acting on behalf of the person referred to in subsection (2)(a),

or

(b) in the case of transmission by notarial will in the Province of Quebec, a copy of the will authenticated pursuant to the laws of that province,

together with

(c) an affidavit, statutory declaration or declaration of transmission made by a person referred to in subsection (2)(a), stating the particulars of the transmission, and

(d) the security certificate that was owned by the deceased holder

(i) in the case of a transfer to a person referred to in subsection (2)(a), with or without the endorsement of that person, and

(ii) in the case of a transfer to any other person, endorsed in accordance with section 61,

and accompanied by any assurance the corporation may require under section 72.

(8) Notwithstanding subsection (7), if the laws of the jurisdiction governing the transmission of a security of a deceased holder do not require a grant of probate or of letters of administration in respect of the transmission, a legal representative of the deceased holder is entitled, subject to any applicable law relating to the collection of taxes, to become a registered holder or to designate a registered holder, if he deposits with the corporation or its transfer agent

(a) the security certificate that was owned by the deceased holder, and

(b) reasonable proof of the governing laws, of the deceased holder's interest in the security and of the right of the legal representative or the person he designates to become the registered holder.

(9) Deposit of the documents required by subsection (7) or (8) empowers a corporation or its transfer agent to record in a securities register the transmission of a security from the deceased holder to a person referred to in subsection (2)(a) or to any person that the person referred to in subsection (2)(a) may designate and, thereafter, to treat the person who thus becomes a registered holder as the owner of the security.

Overissue

48(1) The provisions of this Part that validate a security or compel its issue or reissue do not apply to the extent that validation, issue or reissue would result in overissue, but

(a) if a valid security, similar in all respects to the security involved in the overissue, is reasonably available for purchase, the person entitled to the validation or issue may compel the issuer to purchase and deliver such a security to him against surrender of the security that he holds, or

(b) if a valid security, similar in all respects to the security involved in the overissue, is not reasonably available for purchase, the person entitled to the validation or issue may recover from the issuer an amount equal to the price the last purchaser for value paid for the invalid security.

(2) When an issuer subsequently amends its articles, or a trust indenture to which it is a party, to increase its authorized securities to a number equal to or in excess of the number of securities previously authorized plus the amount of the securities overissued, the securities so overissued are valid from the date of their issue.

(3) Subsection (2) does not apply if the issuer has purchased and delivered a security in accordance with subsection (1)(a) or paid the amount referred to in subsection (1)(b).

(4) A purchase or payment by an issuer under subsection (1) is not a purchase or payment to which section 32, 33, 34 or 37 applies.

Burden of proof in actions

49 In an action on a security,

(a) unless specifically denied in the pleadings, each signature on the security or in a necessary endorsement is admitted,

(b) a signature on the security is presumed to be genuine and authorized but, if the effectiveness of the signature is put in issue, the burden of establishing that it is genuine and authorized is on the party claiming under the signature,

(c) if a signature is admitted or established, production of the instrument entitles a holder to recover on it unless the defendant establishes a defence or a defect going to the validity of the security, and

(d) if the defendant establishes that a defence or defect exists, the plaintiff has the burden of establishing that the defence or defect is ineffective against him or some person under whom he claims.

Securities are fungible
50 Unless otherwise agreed, and subject to any applicable law, regulation or stock exchange rule, a person required to deliver securities may deliver any security of the specified issue in bearer form or registered in the name of the transferee or endorsed to him or in blank.

Division 2
Issue - Issuer

Notice of defects
51**(1)** Even against a purchaser for value and without notice of a defect going to the validity of a security, the terms of the security include those stated on the security and those incorporated in it by reference to another instrument, statute, rule, regulation or order to the extent that the terms so referenced do not conflict with the stated terms, but such a reference is not of itself notice to a purchaser for value of a defect going to the validity of the security, notwithstanding that the security expressly states that a person accepting it admits such notice.

(2) A security is valid in the hands of a purchaser for value without notice of any defect going to its validity.

(3) Except as provided in section 53, the fact that a security is not genuine is a complete defence even against a purchaser for value and without notice.

(4) All other defences of an issuer, including non-delivery and conditional delivery of a security, are ineffective against a purchaser for value without notice of the particular defence.

Staleness is notice of defect
52 After an event that creates a right to immediate performance of the principal obligation evidenced by a security, or that sets a date on or after which a security is to be presented or surrendered for redemption or exchange, a purchaser is deemed to have notice of any defect in its issue or of any defence of the issuer,

(a) if the event requires the payment of money or the delivery of securities, or both, on presentation or surrender of the security, and such funds or securities are available on the date set for payment or exchange, and the purchaser takes the security more than one year after that date, or

(b) if the purchaser takes the security more than 2 years after the date set for surrender or presentation or the date on which such performance became due.

Unauthorized signature
53 An unauthorized signature on a security before or in the course of issue is ineffective, except that the signature is effective in favour of a purchaser for value and without notice of the lack of authority, if the signing has been done by

(a) an authenticating trustee, registrar, transfer agent or other person entrusted by the issuer with the signing of the security, or of similar securities, or their immediate preparation for signing, or

(b) an employee of the issuer or of a person referred to in clause (a) who in the ordinary course of his duties handles the security.

Completion or alteration
54(1) If a security contains the signatures necessary to its issue or transfer but is incomplete in any other respect,

(a) any person may complete it by filling in the blanks in accordance with his authority, and

(b) notwithstanding that the blanks are incorrectly filled in, the security as completed is enforceable by a purchaser who took it for value and without notice of the incorrectness.

(2) A completed security that has been improperly altered, even if fraudulently altered, remains enforceable, but only according to its original terms.

Warranties of agents
55(1) A person signing a security as authenticating trustee, registrar, transfer agent or other person entrusted by the issuer with the signing of the security, warrants to a purchaser for value without notice that

(a) the security is genuine,

(b) his acts in connection with the issue of the security are within his authority, and

(c) he has reasonable grounds for believing that the security is in the form and within the amount the issuer is authorized to issue.

(2) Unless otherwise agreed, a person referred to in subsection (1) does not assume any further liability for the validity of a security.

Division 3
Purchase

Title of purchaser
56(1) On delivery of a security, the purchaser acquires the rights in the security that his transferor had or had authority to convey, except that a purchaser who has been a party to any fraud or illegality affecting the security or who as a prior holder had notice of an adverse claim does not improve his position by taking from a later bona fide purchaser.

(2) A bona fide purchaser, in addition to acquiring the rights of a purchaser, also acquires the security free from any adverse claim.

(3) A purchaser of a limited interest acquires rights only to the extent of the interest purchased.

(4) Nothing in subsection (2) confers any rights on a purchaser unless all necessary endorsements are made by an appropriate person as defined in section 61.

Deemed notice of adverse claims
57**(1)** A purchaser of a security, or any broker for a seller or purchaser, is deemed to have notice of all adverse claims if

(a) the security, whether in bearer or registered form, has been endorsed "for collection" or "for surrender" or for some other purpose not involving transfer, or

(b) the security is in bearer form and has on it a statement that it is the property of a person other than the transferor, except that the mere writing of a name on a security is not such a statement.

(2) Notwithstanding that a purchaser or any broker for a seller or purchaser has notice that a security is held for a 3rd person or is registered in the name of or endorsed by a fiduciary, he has no duty to inquire into the rightfulness of the transfer and has no notice of an adverse claim, except that if a purchaser knows that the consideration is to be used for, or that the transaction is for, the personal benefit of the fiduciary or is otherwise in breach of the fiduciary's duty, the purchaser is deemed to have notice of an adverse claim.

Staleness as notice of adverse claims
58 An event that creates a right to immediate performance of the principal obligation evidenced by a security or that sets a date on or after which the security is to be presented or surrendered for redemption or exchange is not of itself notice of an adverse claim, except in the case of a purchase

(a) after one year from any date set for such presentation or surrender for redemption or exchange, or

(b) after 6 months from any date set for payment of money against presentation or surrender of the security if funds are available for payment on that date.

Warranties
59**(1)** A person who presents a security for registration of transfer or for payment or exchange warrants to the issuer that he is entitled to the registration, payment or exchange, except that a purchaser for value without notice of an adverse claim who receives a new, reissued or re-registered security on registration of transfer warrants only that he has no knowledge of any unauthorized signature in a necessary endorsement.

(2) A person by transferring a security to a purchaser for value warrants only that

(a) the transfer is effective and rightful,

(b) the security is genuine and has not been materially altered, and

(c) he knows of nothing that might impair the validity of the security.

(3) If a security is delivered by an intermediary known by the purchaser to be entrusted with delivery of the security on behalf of another or with collection of a draft or other claim to be collected against such delivery, the intermediary by such delivery warrants only his own good faith and authority even if he has purchased or made advances against the draft or other claim to be collected against the delivery.

(4) A pledgee or other holder for purposes of security who redelivers a security received, or after payment and on order of the debtor delivers that security to a 3rd person, gives only the warranties of an intermediary under subsection (3).

(5) A broker gives

(a) to his customer and to a purchaser the warranties provided in subsection (2), and

(b) to the issuer the warranties provided in subsection (1).

(6) A broker has the rights and privileges of a purchaser under this section.

(7) The warranties of and in favour of a broker acting as an agent are in addition to warranties given by his customer and warranties given in favour of his customer.

Right to compel endorsement

60 If a security in registered form is delivered to a purchaser without a necessary endorsement, he may become a bona fide purchaser only as of the time the endorsement is supplied, but against the transferor the transfer is complete on delivery and the purchaser has a specifically enforceable right to have any necessary endorsement supplied.

Endorsement

61**(1)** In this section, "appropriate person" means

(a) the person specified by the security or by special endorsement to be entitled to the security,

(b) if a person described in clause (a) is described as a fiduciary but is no longer serving in the described capacity, either that person or his successor,

(c) if the security or endorsement mentioned in clause (a) specifies more than one person as fiduciaries and one or more are no longer serving in the described capacity, the remaining fiduciary or fiduciaries, whether or not a successor has been appointed or qualified,

(d) if a person described in clause (a) is an individual and is without capacity to act by reason of death, incompetence, minority, or otherwise, his fiduciary,

(e) if the security or endorsement mentioned in clause (a) specifies more than one person with right of survivorship and by reason of death all cannot sign, the survivor or survivors,

(f) a person having power to sign under applicable law or a power of attorney, or

(g) to the extent that a person described in clauses (a) to (f) may act through an agent, his authorized agent.

(2) Whether the person signing is an appropriate person is determined as of the time of signing and an endorsement by such a person does not become unauthorized for the purposes of this Part by reason of any subsequent change of circumstances.

(3) An endorsement of a security in registered form is made when an appropriate person signs, either on the security or on a separate document, an assignment or transfer of the security or a power to assign or transfer it, or when the signature of an appropriate person is written without more on the back of the security.

(4) An endorsement may be special or in blank.

(5) An endorsement in blank includes an endorsement to bearer.

(6) A special endorsement specifies the person to whom the security is to be transferred, or who has power to transfer it.

(7) A holder may convert an endorsement in blank into a special endorsement.

(8) Unless otherwise agreed, the endorser by his endorsement assumes no obligation that the security will be honoured by the issuer.

(9) An endorsement purporting to be only of part of a security representing units intended by the issuer to be separately transferable is effective to the extent of the endorsement.

(10) Failure of a fiduciary to comply with a controlling instrument or with the law of the jurisdiction governing the fiduciary relationship, including any law requiring the fiduciary to obtain court approval of a transfer, does not render his endorsement unauthorized for the purposes of this Part.

Effect of endorsement without delivery
62 An endorsement of a security, whether special or in blank, does not constitute a transfer until delivery of the security on which it appears or, if the endorsement is on a separate document, until delivery of both the security and that document.

Endorsement in bearer form
63 An endorsement of a security in bearer form may give notice of an adverse claim under section 57 but does not otherwise affect any right to registration that the holder has.

Effect of unauthorized endorsement
64 Unless the owner has ratified an unauthorized endorsement or is otherwise precluded from asserting its ineffectiveness, he may assert its ineffectiveness against the issuer or any purchaser, other than a purchaser for value and without notice of adverse claims, who has in good faith received a new, reissued or re-registered security on registration of transfer.

Warranties of guarantees of signatures or endorsements
65**(1)** A person who guarantees a signature of an endorser of a security warrants that at the time of signing

(a) the signature was genuine,

(b) the signer was an appropriate person as defined in section 61 to endorse, and

(c) the signer had legal capacity to sign.

(2) A person who guarantees a signature of an endorser does not otherwise warrant the rightfulness of the particular transfer.

(3) A person who guarantees an endorsement of a security warrants both the signature and the rightfulness of the transfer in all respects, but an issuer may not require a guarantee of endorsement as a condition to registration of transfer.

(4) The warranties referred to in this section are made to any person taking or dealing with the security relying on the guarantee and the guarantor is liable to that person for any loss resulting from breach of warranty.

Constructive delivery and constructive ownership
66**(1)** Delivery to a purchaser occurs when

(a) he or a person designated by him acquires possession of a security,

(b) his broker acquires possession of a security specially endorsed to or issued in the name of the purchaser,

(c) his broker sends him confirmation of the purchase and the broker in his records identifies a specific security as belonging to the purchaser, or

(d) with respect to an identified security to be delivered while still in the possession of a 3rd person, that person acknowledges that he holds it for the purchaser.

(2) A purchaser is the owner of a security held for him by his broker, but a purchaser is not a holder except in the cases referred to in subsection (1)(b) and (c).

(3) If a security is part of a fungible bulk a purchaser of the security is the owner of a proportionate interest in the fungible bulk.

(4) Notice of an adverse claim received by a broker or by a purchaser after the broker takes delivery as a holder for value is not effective against the broker or the purchaser, except that, as between the broker and the purchaser, the purchaser may demand delivery of an equivalent security in relation to which no notice of an adverse claim has been received.

Delivery of security
67(1) Unless otherwise agreed, if a sale of a security is made on an exchange or otherwise through brokers,

(a) the selling customer fulfils his duty to deliver when

(i) he delivers the security to the selling broker or to a person designated by the selling broker, or

(ii) he causes an acknowledgement to be made to the selling broker that the security is held for him,

and

(b) the selling broker, including a correspondent broker, acting for a selling customer fulfils his duty to deliver

(i) by delivering the security or a like security to the buying broker or to a person designated by the buying broker, or

(ii) by effecting clearance of the sale in accordance with the rules of the exchange on which the transaction took place.

(2) Except as otherwise provided in this section and unless otherwise agreed, a transferor's duty to deliver a security under a contract of purchase is not fulfilled until he

(a) delivers the security in negotiable form to a purchaser or to a person designated by the purchaser, or

(b) causes an acknowledgement to be made to the purchaser that the security is held for him.

(3) A sale to a broker purchasing for his own account is subject to subsection (2) and not subsection (1), unless the sale is made on a stock exchange.

Right to reclaim possession of security

68**(1)** A person against whom the transfer of a security is wrongful for any reason, including his incapacity but not including an unauthorized endorsement, may against any person except a bona fide purchaser reclaim possession of the security or obtain possession of any new security evidencing all or part of the same rights or claim damages.

(2) If the transfer of a security is wrongful by reason of an unauthorized endorsement, the owner may reclaim possession of the security or obtain possession of a new security even from a purchaser for value and without notice of an adverse claim if the ineffectiveness of the purported endorsement may be asserted against such purchaser under section 64.

(3) The right to reclaim possession of a security may be specifically enforced, its transfer may be restrained and the security may be impounded pending litigation.

Right to requisites of transfer

69**(1)** Unless otherwise agreed, a transferor shall on demand supply a purchaser with proof of his authority to transfer or with any other requisite that is necessary to obtain registration of the transfer of a security, but if the transfer is not for value a transferor need not do so unless the purchaser pays the reasonable and necessary costs of the proof and transfer.

(2) If the transferor fails to comply with a demand under subsection (1) within a reasonable time, the purchaser may reject or rescind the transfer.

Seizure of security

70 No seizure of a security of a distributing corporation or other interest evidenced by a security is effective until the person making the seizure obtains possession of the security.

No conversion if good faith delivery by agent

70.1 An agent or bailee who in good faith, including observance of reasonable commercial standards if he is in the business of buying, selling or otherwise dealing with securities, has received securities and sold, pledged or delivered them according to the instructions of his principal is not liable for conversion or for participation in breach of fiduciary duty although the principal has no right to dispose of them.

Duty to register transfer

71**(1)** If a security in registered form is presented for registration of transfer, the issuer shall register the transfer if

(a) the security is endorsed by an appropriate person, as defined in section 61,

(b) reasonable assurance is given that that endorsement is genuine and effective,

(c) the issuer has no duty to inquire into adverse claims or has discharged any such duty,

(d) any applicable law relating to the collection of taxes has been complied with,

(e) the transfer is rightful or is to a bona fide purchaser, and

(f) any fee referred to in section 45(2) has been paid.

(2) If an issuer has a duty to register a transfer of a security, the issuer is liable to the person presenting it for registration for loss resulting from any unreasonable delay in registration or from failure or refusal to register the transfer.

Assurance that endorsement is effective

72**(1)** An issuer may require an assurance that each necessary endorsement on a security is genuine and effective by requiring a guarantee of the signature of the person endorsing and by requiring

(a) if the endorsement is by an agent, reasonable assurance of the agent's authority to sign,

(b) if the endorsement is by a fiduciary, evidence of his appointment or incumbency,

(c) if there is more than one fiduciary, reasonable assurance that all who are required to sign have done so, and

(d) in any other case, assurance that corresponds as closely as practicable to the foregoing.

(2) In subsection (1), "guarantee of the signature" means a guarantee signed by or on behalf of a person reasonably believed by the issuer to be a responsible person.

(3) An issuer may adopt reasonable standards to determine responsible persons for the purpose of subsection (2).

(4) In subsection (1)(b), "evidence of appointment or incumbency" means

(a) in the case of a fiduciary appointed by a court, a copy of the order certified in accordance with section 47(7), and dated not earlier than 60 days before the date a security is presented for transfer, or

(b) in any other case, a copy of a document showing the appointment or other evidence believed by the issuer to be appropriate.

(5) An issuer may adopt reasonable standards with respect to evidence for the purposes of subsection (4)(b).

(6) An issuer is not deemed to have notice of the contents of any document obtained pursuant to subsection (4) except to the extent that the contents relate directly to appointment or incumbency.

(7) If an issuer demands assurance additional to that specified in this section for a purpose other than that specified in subsection (4) and obtains a copy of a will, trust or partnership agreement, by-law or similar document, the issuer is deemed to have notice of all matters contained therein affecting the transfer.

Limited duty of inquiry as to adverse claims

73**(1)** An issuer to whom a security is presented for registration of transfer has a duty to inquire into adverse claims if

(a) written notice of an adverse claim is received at a time and in a manner that affords the issuer a reasonable opportunity to act on it before the issue of a new, reissued or re-registered security and the notice discloses the name and address of the claimant, the registered owner and the issue of which the security is a part, or

(b) the issuer is deemed to have notice of an adverse claim from a document that is obtained under section 72(7).

(2) An issuer may discharge a duty of inquiry by any reasonable means, including notifying an adverse claimant by registered mail sent to the address furnished by him or, if no such address has been furnished, to his residence or regular place of business, that a security has been presented for registration of transfer by a named person, and that the transfer will be registered unless within 30 days from the date of mailing the notice either

(a) the issuer is served with a restraining order or other order of the Court, or

(b) the issuer is provided with an indemnity bond sufficient in the issuer's judgment to protect the issuer and any registrar, transfer agent or other agent of the issuer from any loss that may be incurred by any of them as a result of complying with the adverse claim.

(3) Unless an issuer is deemed to have notice of an adverse claim from a document that it obtained under section 72(7) or has received notice of an adverse claim under subsection (1), if a security presented for registration is endorsed by the appropriate person as defined in section 61 the issuer has no duty to inquire into adverse claims, and in particular,

(a) an issuer registering a security in the name of a person who is a fiduciary or who is described as a fiduciary is not bound to inquire into the existence, extent or correct description of the fiduciary relationship, and thereafter the issuer may assume without inquiry that the fiduciary is no longer acting as such with respect to the particular security,

(b) an issuer registering a transfer on an endorsement by a fiduciary has no duty to inquire whether the transfer is made in compliance with the document or with the law of the jurisdiction governing the fiduciary relationship, and

(c) an issuer is not deemed to have notice of the contents of any court record or any registered document even if the record or document is in the issuer's possession and even if the transfer is made on the endorsement of a fiduciary to the fiduciary himself or to his nominee.

(4) A written notice of adverse claim received by an issuer is effective for 12 months from the date when it was received and thereon ceases to be effective unless the notice is renewed in writing.

(5) An issuer who registers the transfer of a security on an unauthorized endorsement is liable for improper registration.

Limitation of issuer's liability

74(1) Except as otherwise provided in any applicable law relating to the collection of taxes, the issuer is not liable to the owner or any other person who incurs a loss as a result of the registration of a transfer of a security if

(a) the necessary endorsements were on or with the security, and

(b) the issuer had no duty to inquire into adverse claims or had discharged any such duty.

(2) If an issuer has registered a transfer of a security to a person not entitled to it, the issuer shall on demand deliver a like security to the owner unless

(a) subsection (1) applies,

(b) the owner is precluded by section 75(1) from asserting any claim, or

(c) the delivery would result in overissue, in which case the issuer's liability is governed by section 48.

Rights and obligations on loss or theft
75(1) If

(a) a security has been lost, apparently destroyed or wrongfully taken, and the owner fails to notify the issuer of that fact by giving the issuer written notice of his adverse claim within a reasonable time after he knows of the loss, destruction or taking, and

(b) the issuer has registered a transfer of the security before receiving such notice,

the owner is precluded from asserting against the issuer any claim to a new security.

(2) If the owner of a security claims that the security has been lost, destroyed or wrongfully taken, the issuer shall issue a new security in place of the original security if the owner

(a) so requests before the issuer has notice that the security has been acquired by a bona fide purchaser and before a purchaser described in section 64 has received a new, reissued or re-registered security,

(b) furnishes the issuer with a sufficient indemnity bond, and

(c) satisfies any other reasonable requirements imposed by the issuer.

(3) If, after the issue of a new security under subsection (2), a bona fide purchaser of the original security presents the original security for registration of transfer, the issuer shall register the transfer unless registration would result in overissue, in which case the issuer's liability is governed by section 48.

(4) In addition to any rights on an indemnity bond, the issuer may recover a new security issued under subsection (2) from the person to whom it was issued or any person taking under him other than a bona fide purchaser.

Rights, duties, etc. of issuer's agent
76(1) An authenticating trustee, registrar, transfer agent or other agent of an issuer has, in respect of the issue, registration of transfer and cancellation of a security of the issuer,

(a) a duty to the issuer to exercise good faith and reasonable diligence, and

(b) the same obligations to the holder or owner of a security and the same rights, privileges and immunities as the issuer.

(2) Notice to an authenticating trustee, registrar, transfer agent or other agent of an issuer is notice to the issuer with respect to the functions performed by the agent.

APPENDIX C

Ontario Business Corporations Act
R.S.O. 1990, c. B.16

Part VI

ONTARIO BUSINESS CORPORATIONS ACT
R.S.O. 1990, c. B.16

PART VI
INVESTMENT SECURITIES

Definitions

53.—(1) In this Part,

"adverse claim" includes a claim that a transfer is or would be unauthorized or wrongful or that a particular adverse person is the owner of or has an interest in the security; ("opposition")

"appropriate person", when used to refer to a person endorsing a security, means,

(a) the person specified by the security or by special endorsement to be entitled to the security,

(b) where the person so specified is described as a trustee or other fiduciary but is no longer serving in that capacity and even though a successor has been appointed or qualified,

(i) where only one person is so described, that person or that person's successor, or

(ii) where more than one person is so described, the remaining persons,

(c) where the person so specified is an individual and is without capacity to act by virtue of death, incompetence, infancy or otherwise, the individual's executor, administrator, committee, guardian or like fiduciary,

(d) where the security or endorsement specified more than one person as joint tenants or with right of survivorship and by reason of death all cannot sign, the survivor or survivors,

(e) a person having the power to sign under the applicable law or controlling instrument, or

(f) to the extent any of the foregoing persons may act through an agent, the person's authorized agent; ("personne compétente")

"bearer form" when applied to a security means a security that is payable to bearer according to its terms and not by reason of any endorsement; ("au porteur")

"broker" means a person engaged full-time or part-time in the business of buying and selling securities and who, in the transaction concerned, acts for or buys a security from or sells a security to a customer; ("courtier")

"clearing agency" means a person designated as a recognized clearing agency by the Commission; ("agence de compensation")

"custodian" means a person acting as a custodian for a clearing agency; ("dépositaire")

"delivery" means voluntary transfer of possession; ("livraison")

"fiduciary" means a trustee, guardian, committee, curator, tutor, executor, administrator or representative of a deceased person, or any other person acting in a fiduciary capacity; ("représentant") "fungible" in relation to securities means securities of which any unit is, by nature or usage of trade, the equivalent of any other like unit; ("fongibles")

"genuine" means free of forgery or counterfeiting; ("authentique")

"good faith" means honesty in fact in the conduct of the transaction concerned; (bonne foi")

"good faith purchaser" means a purchaser for value, in good faith and without notice of any adverse claim,

(a) who takes delivery of a security certificate in bearer form or order form or of a security certificate in registered form issued to the purchaser or endorsed to the purchaser or endorsed in blank,

(b) in whose name an uncertificated security is registered or recorded in records maintained by or on behalf of the issuer as a result of the issue or transfer of the security to the purchaser, or

(c) who is a transferee or pledgee as provided in section 85; ("acheteur de bonne foi")

"holder" means a person in possession of a security issued or endorsed to the person or to bearer or in blank; ("détenteur")

"issuer" means a body corporate,

(a) that is required by this Act to maintain a securities register,

(b) that directly or indirectly creates fractional interests in its rights or property and issues security certificates or uncertificated securities as evidence of the fractional interests,

(c) that places or authorizes the placing of its name on a security certificate, otherwise than as an authenticating trustee, registrar or transfer agent, or that otherwise authorizes the issue of a security certificate or an uncertificated security evidencing a share, participation or other interest in its property or in an enterprise or evidencing its duty to perform an obligation, or

(d) that becomes responsible for or in place of any other person described as an issuer in this Part; ("émetteur")

"noted conspicuously" and "appearing conspicuously" mean written in such a way that the person against whom words so noted or appearing are to operate ought reasonably to notice them; ("indiqué visiblement", "apparaissant visiblement")

"order form" when applied to a security means a security that is payable to the order or assigns of any person therein specified with reasonable certainty or to such a person or such person's order; ("à ordre")

"overissue" means the issue of securities in excess of any maximum number of securities that the issuer is authorized by its articles or a trust indenture to issue; ("émission excédentaire")

"proper form" means regular on its face with regard to all formal matters; ("en bonne et due forme")

"purchaser" means a person who takes by sale, mortgage, hypothec, pledge, issue, reissue, gift or any other voluntary transaction creating an interest in a security; ("acquéreur") "registered form" when applied to a security means a security that,

(a) specifies a person entitled to the security or to the rights it evidences, and the transfer of which is capable of being recorded in a securities register, or

(b) bears a statement that it is in registered form; (nominative")

"security" means a share, participation or other interest in property, rights or an enterprise of an issuer, or an obligation of an issuer, or any right to acquire such a share, participation, interest or obligation, of a type commonly dealt in upon securities exchanges or markets or commonly recognized as a medium for investment in any area in which it is issued or dealt in; ("valeur mobilière")

"security certificate" means an instrument in bearer, order or registered form, issued by an issuer evidencing a security; ("certificat de valeur mobilière")

"transfer" includes transmission by operation of law; ("transfert")

"trust indenture" means a trust indenture as defined in Part V; ("acte de fiducie")

"unauthorized", when used with reference to a signature or an endorsement, means one made without authority, actual, apparent or of any other type and includes a forgery; ("non autorisé")

"uncertificated security" means a security, not evidenced by a security certificate, the issue and any transfer of which is registered or recorded in records maintained for that purpose by or on behalf of the issuer; ("valeur mobilière non constatée par un certificat")

"valid" means issued in accordance with the applicable law and the articles of the issuer or validated under section 58. ("valide") 1982, c. 4, s. 53 (1); 1986, c. 57, s. 7.

Application of this Part

(2) This Part does not apply to a promissory note or bill of exchange to which the *Bills of Exchange Act* (Canada) applies.

Security as negotiable instrument

(3) Except where its transfer is restricted and noted on a security in accordance with subsection 56 (3), a security is a negotiable instrument. 1982, c. 4, s. 53 (2, 3).

Share certificates

54.—(1) Every security holder is entitled upon request to a security certificate in respect of the securities held by the security holder that complies with this Act or to a non-transferable written acknowledgement of the security holder's right to obtain a security certificate from a corporation in respect of the securities of the corporation held by the security holder, but the corporation is not bound to issue more than one security certificate in respect of a security or securities held jointly by several persons, and delivery of a security certificate to one of several joint security holders is sufficient delivery to all.

Fee

(2) A corporation may charge a fee of not more than $3 for a security certificate issued in respect of a transfer. 1982, c. 4, s. 54.

Signing of share certificates

55.—(1) A security certificate shall be signed manually by at least one director or officer of the corporation or by or on behalf of a registrar, transfer agent, branch transfer agent or issuing or other authenticating agent of the corporation, or by a trustee who certifies it in accordance with a trust indenture, and any additional signatures required on a security certificate may be printed or otherwise mechanically reproduced thereon.

Idem

(2) If a security certificate contains a printed or mechanically reproduced signature of a person, the corporation may issue the security certificate even though the person has ceased to be a director or an officer of the corporation, and the security certificate is as valid as if the person were a director or an officer at the date of its issue.

Where manual signature not required

(3) Despite subsection (1), a manual signature is not required on,

(a) a promissory note that is not issued under a trust indenture;

(b) a scrip certificate;

(c) a security certificate representing a fractional share; or

(d) a warrant. 1982, c. 4, s. 55.

Contents of share certificate

56.—(1) A corporation shall state upon the face of each share certificate issued by it,

(a) the name of the corporation and the words "Incorporated under the law of the Province of Ontario" or words of like effect;

(b) the name of the person to whom it was issued; and

(c) the number and class of shares and the designation of any series that the certificate represents.

Idem

(2) Where a corporation is authorized to issue shares of more than one class or series, the corporation shall legibly state on each share certificate issued by it,

(a) the rights, privileges, restrictions and conditions attached to the shares of each class and series that exists when the share certificate is issued; or

(b) that the class or series of shares that it represents has rights, privileges, restrictions or conditions attached thereto and that the corporation will furnish to a shareholder, on demand and without charge, a full copy of the text of,

   (i) the rights, privileges, restrictions and conditions attached to that share and to each class authorized to be issued and to each series in so far as the same have been fixed by the directors, and

   (ii) the authority of the directors to fix the rights, privileges, restrictions and conditions of subsequent series, if applicable.

Where restriction, lien, etc., ineffective

(3) Where a share certificate issued by a corporation or by a body corporate before the body corporate was continued under section 180 is, or becomes, subject to,

(a) a restriction on its transfer other than a restriction referred to in subsection (8);

(b) a lien in favour of the corporation;

(c) a unanimous shareholder agreement; or

(d) an endorsement under subsection 185 (13),

the restriction, lien, agreement or endorsement is ineffective against a transferee of the share who has no actual knowledge of it, unless it or a reference to it is noted conspicuously on the share certificate. 1982, c. 4, s. 56 (1-3).

Notice of restriction

(4) If a body corporate continued under section 180 has outstanding a share certificate issued prior to the date of the certificate of continuance and if the words "private company" or "compagnie fermée" appear on the certificate, those words are deemed to be a notice of a restriction, lien, agreement or endorsement for the purpose of subsection (3).

Idem

(5) Where a corporation was incorporated as a private company under *The Corporations Act*, being chapter 89 of the Revised Statutes of Ontario, 1970, or any predecessor thereof, before the 1st day of January, 1971, the words "private company" or "compagnie fermée" appearing conspicuously on the face of a share certificate issued before the 1st day of January, 1971 shall be deemed to be notice of a restriction on the transfer of the share for the purpose of subsection (3). 1982, c. 4, s. 56 (4, 5), *revised.*

Par value share certificate

(6) A share certificate issued,

(a) prior to the 29th day of July, 1983 by a corporation; or

(b) prior to the date of the certificate of continuance by a body corporate continued under section 180,

does not contravene this Act merely because the certificate refers to the share or shares represented thereby as having a nominal or par value.

Information to be furnished by corporation

(7) Where a share certificate issued by a corporation contains the statement mentioned in clause (2) (b), the corporation shall furnish to a shareholder on demand and without charge a full copy of the text of,

(a) the rights, privileges, restrictions and conditions attached to that class authorized to be issued and to that series in so far as the same have been fixed by the directors; and

(b) the authority of the directors to fix the rights, privileges, restrictions and conditions of subsequent series, if applicable. 1982, c. 4, s. 56 (6, 7).

Notice of restrictions

(8) Where the articles of a corporation restrict the issue, transfer or ownership of shares of any class or series for a purpose set out in clause 42 (2) (c) or (d), the restriction or a reference to it shall be noted conspicuously on every share certificate of the corporation evidencing a share that is subject to the restriction if the certificate is issued after the day on which the share becomes subject to the restriction under this Act and any reference to the restriction shall include a statement that the corporation will furnish to a shareholder, on demand and without charge, a full copy of the text of the restriction. 1986, c. 57, s. 8.

Furnishing text of restrictions

(9) Where a share certificate of a corporation contains a reference to a restriction under subsection (8), the corporation shall furnish to a shareholder, on demand and without charge, a full copy of the text of the restriction.

Omission to note restrictions

(10) The omission to note a restriction or a reference to it under subsection (8) shall not invalidate any share or share certificate and shall not render the restriction ineffective against an owner, holder or transferee of the share or share certificate. 1982, c. 4, s. 56 (9, 10).

Certificate for fractional share or scrip certificates

57.—(1) A corporation may issue a certificate for a fractional share or may issue in place thereof scrip certificates in bearer form that entitle the holder to receive a certificate for a full share by exchanging scrip certificates aggregating a full share.

Scrip certificates

(2) The directors may attach conditions to any scrip certificates issued by a corporation, including conditions that,

(a) the scrip certificates become void if not exchanged for a certificate representing a full share before a specified date; and

(b) any shares for which such scrip certificates are exchangeable may, despite any pre-emptive right, be issued by the corporation to any person and the proceeds thereof distributed rateably to the holders of the scrip certificates.

Rights of holder of fractional share

(3) A holder of a fractional share issued by a corporation is not entitled to exercise voting rights or to receive a dividend in respect of the fractional share unless,

(a) the fractional share results from a consolidation of shares; or

(b) the articles of the corporation otherwise provide.

Rights of holder of scrip certificate

(4) A holder of a scrip certificate is not entitled to exercise voting rights or to receive a dividend in respect of the scrip certificate. 1982, c. 4, s. 57.

Overissue

58.—(1) The provisions of this Act that validate a security or compel its issue or reissue do not apply to the extent that validation, issue or reissue would result in overissue, but,

(a) if an identical security that does not constitute an overissue is reasonably available for purchase, the person entitled to issue or validation may compel the issuer to purchase and deliver such a security to the person against surrender of the security, if any, that the person holds; or

(b) if a security is not so available for purchase, the person entitled to issue or validation may recover from the issuer the price that the person or the last purchaser for value paid for it with interest from the date of the person's demand.

Validation of overissue

(2) When an issuer subsequently amends its articles or a trust indenture to which it is a party to increase any maximum number of securities to a number equal to or in excess of the maximum number of securities previously authorized plus the amount of the securities overissued, the securities so overissued, and any act taken by any person in reliance upon the validity of such overissued securities, are valid from the date of their issue.

Non-application of ss 30, 31, 32, 35

(3) A purchase or payment by an issuer under subsection (1) is not a purchase or payment to which section 30, 31, 32 or 35 applies. 1982, c. 4, s. 58.

Evidence

59. In an action on a security,

(a) unless specifically denied in the pleadings, each signature on the security or in a necessary endorsement is admitted;

(b) a signature on the security is presumed to be genuine and authorized but, if the effectiveness of the signature is put in issue, the burden of establishing that it is genuine and authorized is on the party claiming under the signature;

(c) if a signature is admitted or established, production of the instrument entitles a holder to recover on it unless the defendant establishes a defence or a defect going to the validity of the security; and

(d) if the defendant establishes that a defence or defect exists, the plaintiff has the burden of establishing that the defence or defect is ineffective against the plaintiff or some person under whom the plaintiff claims. 1982, c. 4, s. 59.

Selection of laws

60.—(1) The validity of a security and the rights and duties with respect to the registration of a transfer of a security of an issuer that is a corporation or a body corporate incorporated under the laws of Ontario are governed by this Act and the laws of Ontario.

Idem

(2) The validity of a security and the rights and duties with respect to the registration of a transfer of a security of an issuer that is a body corporate other than a corporation or a body corporate incorporated under the laws of Ontario are governed by the law, including the conflict of law rules, of the jurisdiction in which the body corporate was incorporated. 1982, c. 4, s. 60.

Form of transfer

61.—(1) Unless otherwise agreed and subject to any applicable law, regulation or stock exchange rule, a person required to deliver securities may deliver any security of the specified issue in bearer form or registered in the name of the transferee or endorsed to the transferee or in blank.

Default in payment

(2) Where the buyer fails to pay the price as it comes due under a contract of sale, the seller may recover the price,

(a) of any security accepted by the buyer; and

(b) of any security not accepted by the buyer if its resale would be unduly burdensome or there is no readily available market,

but resort to the remedy herein provided for shall not be construed so as to affect or limit any rights or remedies under applicable law. 1982, c. 4, s. 61.

Position of issuer re guarantor

62.—(1) The obligations and defences of an issuer apply to a guarantor of a security to the extent of the guarantee whether or not such an obligation is noted on the security.

Issuer

(2) The person on whose behalf a register of transfers is maintained is an issuer for the purposes of the registration of a transfer under sections 86 to 89. 1982, c. 4, s. 62.

Notice of terms of security

63.—(1) Even against a purchaser for value and without notice of a defect going to the validity of a security, the terms of a security include those stated on the security and those incorporated therein by reference to another instrument, statute, rule, regulation or order to the extent that the terms so referred to do not conflict with the stated terms, but such a reference is not of itself notice to a purchaser for value of a defect going to the validity of the security, even if the security expressly states that a person accepting it admits such notice.

Validity of security

(2) A security is valid in the hands of a purchaser for value without notice of any defect going to its validity.

Defence of issuer

(3) Except as provided in section 65, the fact that a security is not genuine is a complete defence even against a good faith purchaser.

Idem

(4) All other defences of the issuer including non-delivery and conditional delivery of the security are ineffective against a good faith purchaser.

Idem

(5) Nothing in this section shall be construed to affect the right of a party to a "when, as and if issued" or a "when distributed" contract to cancel the contract in the event of a material change in the character of the security that is the subject of the contract or in the plan or arrangement under which such security is to be issued or distributed. 1982, c. 4, s. 63.

Notice of defect

64.—(1) After an act or event that creates a right to immediate performance of the principal obligation evidenced by the security or that sets a date on or after which the security is to be presented or surrendered for redemption or exchange, a purchaser is deemed to have notice of any defect in its issue or any defence of the issuer,

(a) if the act or event requires the payment of money or the delivery of securities or both on presentation or surrender of the security and such funds or securities are available on the date set for payment or exchange and the purchaser takes the security more than one year after that date; and

(b) if the act or event is not one to which clause (a) applies and the purchaser takes the security more than two years after the date set for surrender or presentation or the date on which such performance became due.

Revoked call for redemption excepted

(2) Subsection (1) does not apply to a call for redemption that has been revoked. 1982, c. 4, s. 64.

Unauthorized signatures on issue

65. An unauthorized signature placed on a security before or in the course of issue is ineffective, except that the signature is effective in favour of a good faith purchaser if the signing has been done by,

(a) an authenticating trustee, registrar, transfer agent or other person entrusted by the issuer with the signing of the security or of similar securities, or their immediate preparation for signing; or

(b) an employee of the issuer or of a person referred to in clause (a) who in the ordinary course of the employee's duties handles the security. 1982, c. 4, s. 65.

Completion of blanks

66.—(1) Where a security contains the signatures necessary to its issue or transfer but is incomplete in any other respect,

(a) any person may complete it by filling in the blanks in accordance with the person's authority; and

(b) even if the blanks are incorrectly filled in, the security as completed is enforceable by a purchaser who took it for value and without notice of such incorrectness.

Improper alteration

(2) A completed security that has been improperly altered, even if fraudulently altered, remains enforceable but only according to its original terms. 1982, c. 4, s. 66.

Effect of registration

67.—(1) An issuer or a trustee defined in subsection 46 (1) may, subject to sections 95, 96 and 100, treat the registered holder of a security as the person exclusively entitled to vote, to receive notices, to receive any interest, dividend or other payments in respect of the security, and otherwise to exercise all the rights and powers of a holder of the security.

Representatives, etc., may exercise rights of security holder

(2) Despite subsection (1), an issuer whose articles restrict the right to transfer its securities shall, and any other issuer may, treat a person referred to in clause (a), (b) or (c) as a registered security holder entitled to exercise all the rights of the security holder that the person represents, if that person furnishes evidence as described in subsection 87 (3) to the issuer that the person is,

(a) the executor, administrator, heir or legal representative of the heirs, of the estate of a deceased security holder;

(b) a guardian, committee, trustee, curator or tutor representing a registered security holder who is a minor, an incompetent person or a missing person; or

(c) a liquidator of, or a trustee in bankruptcy for, a registered security holder.

Rights where ownership devolves by operation of law

(3) If a person upon whom the ownership of a security devolves by operation of law, other than a person referred to in subsection (2), furnishes proof of the person's authority to exercise rights or privileges in respect of a security of the issuer that is not registered in the person's name, the issuer shall treat the person as entitled to exercise those rights or privileges.

Corporation has no duty to enforce performance

(4) An issuer is not required to inquire into the existence of, or see to the performance or observance of, any duty owed to a third person by a registered holder of any of its securities or by anyone whom it treats, as permitted or required by this section, as the owner or registered holder thereof.

Repudiation by minor

(5) If a minor exercises any rights of ownership in the securities of an issuer, no subsequent repudiation or avoidance is effective against the issuer.

Joint holders

(6) Where a security is issued to several persons as joint holders, upon satisfactory proof of the death of one joint holder, the issuer may treat the surviving joint holders as owner of the security.

Registration of executor, etc.

(7) Subject to any applicable law of Canada or a province of Canada relating to the collection of taxes, a person referred to in clause (2) (a) is entitled to become a registered holder or to designate a registered holder, if the person deposits with the issuer or its transfer agent,

(a) the original grant of probate or of letters of administration, or a copy thereof certified to be a true copy by

(i) the court that granted the probate or letters of administration,

(ii) a trust corporation incorporated under the laws of Canada or a province, or

(iii) a lawyer or notary acting on behalf of the person; or

(b) in the case of transmission by notarial will in the Province of Quebec, a copy thereof authenticated under the laws of that Province,

together with,

(c) an affidavit or declaration of transmission made by the person stating the particulars of the transmission;

(d) the security certificate that was owned by the deceased holder,

(i) in case of a transfer to the person, with or without the endorsement of that person, and

(ii) in case of a transfer to any other person, endorsed in accordance with section 73; and

(e) any assurance the issuer may require under section 87.

Idem

(8) Despite subsection (7), if the laws of the jurisdiction governing the transmission of a security of a deceased holder do not require a grant of probate or of letters of administration in respect of the transmission, a legal representative of the deceased holder is entitled, subject to any applicable law of Canada or a province of Canada relating to the collection of taxes, to become a registered holder or to designate a registered holder, if the legal representative deposits with the issuer or its transfer agent,

(a) the security certificate that was owned by the deceased holder; and

(b) reasonable proof of the governing laws, the deceased holder's interest in the security and the right of the legal representative or the person the legal representative designates to become the registered holder.

Recording in security register

(9) Deposit of the documents required by subsection (7) or (8) empowers an issuer or its transfer agent to record in a securities register the transmission of a security from the deceased holder to a person referred to in clause (2) (a) or to such person as that person may designate and, thereafter, to treat the person who thus becomes a registered holder as the owner of those securities. 1982, c. 4, s. 67.

Warranties in issue

68.—(1) A person signing a security as authenticating trustee, registrar or transfer agent warrants to a purchaser for value without notice of the particular defect that,

(a) the security is genuine and in proper form;

(b) the person's own participation in the issue of the security is within the person's capacity and within the scope of the authorization received by the person from the issuer; and

(c) the person has reasonable grounds to believe that the security is in the form and within the amount the issuer is authorized to issue.

Idem

(2) Unless otherwise agreed, a person referred to in subsection (1) does not assume any further liability for the validity of a security. 1982, c. 4, s. 68.

Rights acquired by purchasers

69.—(1) Upon delivery of a security, the purchaser acquires the rights in the security that the transferor had or had actual authority to convey except that a purchaser who has been a party to any fraud or illegality affecting the security or who as a prior holder had notice of an adverse claim cannot improve the purchaser's position by taking from a later good faith purchaser.

Good faith purchaser

(2) A good faith purchaser in addition to acquiring the rights of a purchaser also acquires the security free of any adverse claim.

Limited interest

(3) A purchaser of a limited interest acquires rights only to the extent of the interest purchased. 1982, c. 4, s. 69.

Notice of adverse claim

70.—(1) A purchaser, including a broker for a seller or purchaser, of a security is deemed to have notice of an adverse claim if,

(a) the security has been endorsed "for collection" or "for surrender" or for some other purpose not involving transfer; or

(b) the security has on it an unambiguous statement that it is the property of a person other than the transferor, but the mere writing of a name on a security is not such a statement.

Idem

(2) Even if a purchaser, including a broker for a seller or purchaser, has notice that a security is held for a third person or is registered in the name of or endorsed by a fiduciary, the purchaser has no duty to inquire into the rightfulness of the transfer and has no notice of an adverse claim, except that where a purchaser knows that the consideration is to be used for, or that the transaction is for, the personal benefit of the fiduciary or is otherwise in breach of the fiduciary's duty, the purchaser is deemed to have notice of an adverse claim.

Idem

(3) An event that creates a right to immediate performance of the principal obligation evidenced by a security or that sets a date on or after which the security is to be presented or surrendered for redemption or exchange is not of itself notice of an adverse claim, except in the case of a purchase,

(a) after one year from any date set for such presentation or surrender for redemption or exchange; or

(b) after six months from any date for payment of money against presentation or surrender of the security if funds are available for payment on that date. 1982, c. 4, s. 70.

Warranties on presentment

71.—(1) A person who presents a security for registration of transfer or for payment or exchange warrants to the issuer that the person is entitled to the registration, payment or exchange, except that a good faith purchaser who receives a new, reissued or reregistered security on registration of transfer warrants only that the purchaser has no knowledge of any unauthorized signature in a necessary endorsement.

Warranties on transfer

(2) A person by transferring a security to a purchaser for value warrants only that,

(a) the transfer is effective and rightful;

(b) the security is genuine and has not been materially altered; and

(c) the person knows of nothing that might impair the validity of the security.

Warranties by intermediary

(3) Where a security is delivered by an intermediary known by the purchaser to be entrusted with delivery of the security on behalf of another or with collection of a draft or other claim to be collected against such delivery, the intermediary by such delivery warrants only the intermediary's own good faith and authority even if the intermediary has purchased or made advances against the draft or other claim to be collected against the delivery.

Warranties of pledgee

(4) A pledgee or other holder for purposes of security who redelivers a security received, or after payment and on order of the debtor delivers that security to a third person, gives only the warranties of an intermediary under subsection (3).

Warranties of broker

(5) A broker gives to a customer, to the issuer or to a purchaser, as the case may be, the warranties provided in this section and has the rights and privileges of a purchaser under this section, and those warranties of and in favour of the broker acting as an agent are in addition to warranties given by the customer and warranties given in favour of the customer. 1982, c. 4, s. 71.

Absence of endorsement

72. Where a security in registered form has been delivered to a purchaser without a necessary endorsement, the purchaser may become a good faith purchaser only as of the time the endorsement is supplied, but against the transferor the transfer is complete upon delivery and the purchaser has a specifically enforceable right to have any necessary endorsement supplied. 1982, c. 4, s. 72.

Endorsement

73.—(1) An endorsement of a security in registered form is made when an appropriate person signs on the security or on a separate document an assignment or transfer of the security or a power to assign or transfer it or when the signature of the person is written without more upon the back of the security.

Idem

(2) An endorsement of a security may be,

(a) in blank, including to bearer; or

(b) a special endorsement, specifying the person to whom the security is to be transferred or who has the power to transfer it,

and a holder may convert an endorsement in blank into a special endorsement.

Obligation of endorser

(3) Unless otherwise agreed, the endorser by making an endorsement assumes no obligation that the security will be honoured by the issuer.

Partial endorsement

(4) An endorsement purporting to be only of part of a security representing units intended by the issuer to be separately transferable is effective to the extent of the endorsement.

Appropriate person

(5) Whether the person who has made an endorsement is appropriate shall be determined as of the date the endorsement was made and an endorsement by such person does not become unauthorized for the purposes of this Act by virtue of any subsequent change of circumstances.

Improper endorsement by fiduciary

(6) Failure of a fiduciary to comply with a controlling instrument or with the law applicable to the fiduciary relationship, including any law requiring the fiduciary to obtain court approval of the transfer, does not render the fiduciary's endorsement unauthorized for the purposes of this Act. 1982, c. 4, s. 73.

Delivery necessary

74. An endorsement of a security whether special or in blank does not constitute a transfer until delivery of the security on which it appears, or if the endorsement is on a separate document until the delivery of both the document and the security. 1982, c. 4, s. 74.

Endorsement of security in bearer form

75. An endorsement of a security in bearer form may give notice of an adverse claim under section 70 but does not otherwise affect any right to registration that the holder has. 1982, c. 4, s. 75.

Effect of unauthorized endorsement

76.—(1) The owner of a security may assert the ineffectiveness of an endorsement against the issuer or any purchaser, other than a good faith purchaser who received a new, reissued or reregistered security on registration of transfer, unless the owner,

(a) has ratified an unauthorized endorsement of the security; or

(b) is otherwise precluded from impugning the effectiveness of an unauthorized endorsement.

Idem

(2) An issuer who registers the transfer of a security upon an unauthorized endorsement is liable for improper registration. 1982, c. 4, s. 76.

Guarantee of signature

77.—(1) Every person who guarantees a signature of an endorser of a security warrants that at the time of signing,

(a) the signature was genuine;

(b) the signer was an appropriate person to endorse; and

(c) the signer had legal capacity to sign,

but the guarantor does not otherwise warrant the rightfulness of the particular transfer.

Guarantee of endorsement

(2) Any person may guarantee an endorsement of a security and by so doing warrants not only the signature but also the rightfulness of the particular transfer in all respects.

Idem

(3) No issuer may require a guarantee of endorsement as a condition to registration of transfer.

Liability of guarantor

(4) The warranties referred to in this section are made to any person taking or dealing with the security in reliance on the guarantee and the guarantor is liable to such person for any loss resulting from breach of warranty. 1982, c. 4, s. 77.

What constitutes delivery

78.—(1) Delivery to a purchaser occurs when,

(a) the purchaser or a person designated by the purchaser acquires possession of a security;

(b) the purchaser's broker acquires possession of a security specially endorsed or issued in the name of the purchaser;

(c) the purchaser's broker sends the purchaser confirmation of the purchase and the broker in the broker's records identifies a specific security in the broker's possession as belonging to the purchaser;

(d) with respect to an identified security to be delivered while still in the possession of a third person, that person acknowledges that it is being held for the purchaser; or

(e) appropriate entries in the records of a clearing agency are made under section 85.

What constitutes ownership

(2) A purchaser is the owner of a security held for the purchaser by a broker, but is not the holder except as specified in clauses (1) (b), (c) and (e).

Idem

(3) If a security is part of a fungible bulk, the purchaser is the owner of a proportionate property interest in the fungible bulk.

Notice of adverse claim after delivery

(4) Notice of an adverse claim received by a broker or by a purchaser after the broker takes delivery as a holder for value is not effective against the broker or the purchaser except that as between the broker and the purchaser, the purchaser may demand delivery of an equivalent security as to which no notice of an adverse claim has been received. 1982, c. 4, s. 78.

Duty of seller to deliver

79.—(1) Unless otherwise agreed where a sale of a security is made on a stock exchange recognized for the purposes of this Part by the Commission or otherwise through brokers,

(a) the selling customer fulfils the duty to deliver by placing such a security in the possession of the selling broker or of a person designated by the broker or, if requested, causes an acknowledgement to be made to the selling broker that the security is held for the selling broker; and

(b) the selling broker including a correspondent broker acting for a selling customer fulfils the duty to deliver by placing the security or a like security in the possession of the buying broker or a person designated by the buying broker or by effecting clearance of the sale in accordance with the rules of the recognized stock exchange on which the transaction took place.

Idem

(2) Except as otherwise provided in this section and unless otherwise agreed, a transferor's duty to deliver a security under a contract of purchase is not fulfilled until the transferor places the security in form to be negotiated by the purchaser in the possession of the purchaser or of a person designated by the purchaser or at the purchaser's request causes an acknowledgement to be made to the purchaser that it is held for the purchaser.

Idem

(3) A sale to a broker purchasing for the broker's own account is subject to subsection (2) and not subsection (1), unless the sale is made on a recognized stock exchange. 1982, c. 4, s. 79.

Action for wrongful transfer

80.—(1) A person against whom the transfer of a security is wrongful for any reason, including the person's incapacity, may against anyone except a good faith purchaser reclaim possession of the security or obtain possession of any new security evidencing all or part of the sale rights or claim damages.

Idem

(2) If the transfer of a security is wrongful by reason of an unauthorized endorsement, the owner may reclaim possession of the security or a replacing security from a good faith purchaser if the ineffectiveness of the purported endorsement may be asserted against such purchaser under section 76.

Specific performance and injunction

(3) The right to reclaim possession of a security may be specifically enforced, its transfer may be restrained and the security may be impounded pending litigation. 1982, c. 4, s. 80.

Transferor's duty to provide requisites for registration of transfer

81.—(1) Unless otherwise agreed, a transferor shall on demand supply a purchaser with proof of the transferor's authority to transfer or with any other requisite that is necessary to obtain registration of the transfer of a security, but if the transfer is not for value a transferor need not do so unless the purchaser pays the reasonable and necessary costs of the proof and transfer.

Effect of failure

(2) If the transferor fails to comply with a demand under subsection (1) within a reasonable time, the purchaser may reject or rescind the transfer. 1982, c. 4, s. 81.

When seizure effective

82. No seizure of a security or other interest evidenced thereby is effective until the person making the seizure obtains possession of the security. 1982, c. 4, s. 82.

Transfer by agent in good faith not conversion

83. An agent or bailee who in good faith, including observance of reasonable commercial standards if the agent or bailee is in the business of buying, selling or otherwise dealing with securities, has received securities and sold, pledged or delivered them according to the instructions of his, her or its principal is not liable for conversion or for participation in breach of fiduciary duty although the principal has no right to dispose of them. 1982, c. 4, s. 83.

Contract for sale

84. A contract for the sale of securities is not enforceable by way of action or defence unless,

(a) there is some writing signed by the party against whom enforcement is sought or by the party's authorized agent or broker sufficient to indicate that a contract has been made for sale of a stated quantity of described securities at a defined or stated price;

(b) delivery of the security has been accepted or payment has been made, but the contract is enforceable under this provision only to the extent of such delivery or payment;

(c) within a reasonable time a writing in confirmation of the sale or purchase and sufficient against the sender under clause (a) has been received by the party against whom enforcement is sought and the party has failed to send written objection to its contents within a reasonable time after its receipt; or

(d) the party against whom enforcement is sought admits in the party's pleading, testimony or otherwise in court that a contract was made for sale of a stated quantity of described securities at a defined or stated price. 1982, c. 4, s. 84.

Transfer through clearing agency

85.—(1) If a security shown in the records of a clearing agency is evidenced by,

(a) a security certificate in the custody of the clearing agency or a custodian or of a nominee of either, subject to the instructions of the clearing agency, and is in bearer form or endorsed in blank by an appropriate person or registered in the name of the clearing agency or a custodian or of a nominee of either; or

(b) an uncertificated security registered or recorded in records maintained by or on behalf of the issuer in the name of the clearing agency or a custodian or of a nominee of either, subject to the instructions of the clearing agency,

then, in addition to other methods, a transfer of pledge of the security or any interest therein may be effected by the making of an appropriate entry in the records of the clearing agency. 1986, c. 57, s. 9 (1).

Interest in fungible bulk

(2) Under this section, entries may be in respect of like securities or interests therein as part of a fungible bulk and may refer merely to a quantity of a particular security without reference to the name of the registered owner, certificate or bond number or the like and, in appropriate cases, may be on a net basis taking into account other transfers or pledges of the same security.

Constructive endorsement and delivery

(3) A transfer or pledge under this section has the effect of a delivery of a security in bearer form or duly endorsed in blank representing the amount of the obligation or the number of shares or rights transferred or pledged.

Idem

(4) If a pledge or the creation of a security interest is intended, the making of entries has the effect of a taking of delivery by the pledgee or a secured party and the pledgee or secured party shall be deemed to have taken possession for all purposes including the purposes of the *Personal Property Security Act*. 1982, c. 4, s. 85 (2-4).

Holder

(5) A person depositing a security certificate or an uncertificated security with a clearing agency, or a transferee or pledgee of a security under this section, is a holder of the security and shall be deemed to have possession of the security so deposited, transferred or pledged, as the case may be, for all purposes, including, if a pledge or the creation of a security interest is intended, for the purposes of the *Personal Property Security Act*. 1986, c. 57, s. 9 (2).

Not registration

(6) A transfer or pledge under this section does not constitute a registration of transfer under sections 86 to 90.

Error in records

(7) That entries made in the records of the clearing agency as provided in subsection (1) are not appropriate does not affect the validity or effect of the entries nor the liabilities or obligations of the clearing corporation to any person adversely affected thereby. 1982, c. 4, s. 85 (6, 7).

Definitions

(8) In this section,

"issuer" includes a person, other than an individual, and a government or agency thereof,

(a) that is required by this Act to maintain a securities register,

(b) that directly or indirectly creates fractional interests in its rights or property and issues security certificates or uncertificated securities as evidence of the fractional interests,

(c) that places or authorizes the placing of its name on a security certificate, otherwise than as an authenticating trustee, registrar or transfer agent, or that otherwise authorizes the issue of a security certificate or an uncertificated security evidencing a share, participation or other interest in its property or in an enterprise or evidencing its duty to perform an obligation, or

(d) that becomes responsible for or in place of any other person described as an issuer in this section; ("émetteur") and

"security", "security certificate" and "uncertificated security", in addition to the meaning each has for the purposes of this Part, are extended to include a security, security certificate or uncertificated security, as the case may be, of an issuer within the meaning of this section. ("valeur mobilière", "certificat de valeur mobilière", "valeur mobilière non constatée par un certificat") 1986, c. 57, s. 9 (3).

Duty of issuer to register transfer

86.—(1) Where a security in registered form is presented for transfer, the issuer shall register the transfer if,

(a) the security is endorsed by the appropriate person;

(b) reasonable assurance is given that that endorsement is genuine and effective;

(c) the issuer has no duty to inquire into adverse claims or has discharged any such duty;

(d) any applicable law of Canada or a province of Canada relating to the collection of taxes has been complied with;

(e) the transfer is rightful or is to a good faith purchaser; and

(f) any fee referred to in subsection 54 (2) has been paid.

Liability for undue delay

(2) Where an issuer has a duty to register a transfer of a security, the issuer is liable to the person presenting it for registration or the person's principal for loss resulting from any unreasonable delay in registration or from failure or refusal to register the transfer. 1982, c. 4, s. 86.

Assurances required by issuer

87.—(1) For the purpose of obtaining reasonable assurance that each necessary endorsement required by section 73 is genuine and effective, the issuer may require a guarantee of the signature of the person endorsing or, where such guarantee is lacking,

(a) if the endorsement is by an agent, reasonable assurance of authority to sign;

(b) if the endorsement is by a fiduciary or a successor on whom title or control vests on the death of the holder, appropriate evidence of appointment or incumbency;

(c) if there is more than one fiduciary or successor, reasonable assurance that all who are required to sign have done so; and

(d) if the endorsement is by a person other than by a person mentioned in this section, assurance appropriate to the case equivalent as nearly as may be to those required by this section.

Sufficiency of guarantee

(2) A "guarantee of the signature" in subsection (1) means a guarantee signed by or on behalf of a person reasonably believed by the issuer to be responsible, and the issuer may adopt reasonable standards with respect to responsibility.

Appropriate evidence of appointment or incumbency

(3) For the purposes of subsection (1), "appropriate evidence of appointment or incumbency" means,

(a) in the case of a fiduciary appointed by a court, a copy, certified in accordance with subsection 67 (7) not more than sixty days before the date the security is presented for transfer, of the order of the court;

(b) in the case of an estate of the deceased holder of net value less than $3,000 or if the market value of the securities is less than $600, proof thereof to the reasonable satisfaction of the issuer; or

(c) in any other case, a copy of a document showing the appointment or other evidence believed by the issuer to be appropriate.

Where contents not notice

(4) An issuer is not deemed to have notice of the contents of any document obtained under subsection (3) except to the extent that the contents relate directly to appointment or incumbency.

Notice of additional assurances

(5) If an issuer demands assurance additional to that specified in this section for a purpose other than that specified in subsection (3) and obtains a copy of a will, trust or partnership agreement, by-law or similar document, the issuer shall be deemed to have notice of all matters contained therein affecting the transfer. 1982, c. 4, s. 87.

Notice to issuer of adverse claim

88.—(1) An issuer to whom a security is presented for registration has a duty to inquire into adverse claims if,

(a) written notice of an adverse claim is received at a time and in a manner that affords the issuer a reasonable opportunity to act on it before the issue of a new, reissued or reregistered security and the notice discloses the name and address of the claimant, the registered owner and the issue of which the security is a part;

(b) the issuer is deemed to have notice of an adverse claim from a document that is obtained under subsection 87 (5); or

(c) the issuer is given written notice by the registered owner that the security is lost, apparently destroyed or wrongfully taken.

Discharge of duty of inquiry

(2) An issuer may discharge a duty of inquiry by any reasonable means, including notifying an adverse claimant by registered mail sent to the address furnished by the adverse claimant or, if no such address has been furnished, to the adverse claimant's residence or regular place of business, that a security has been presented for registration of transfer by a named person, and that the transfer will be registered unless within thirty days from the date of mailing the notice either,

(a) the issuer is served with a restraining order or other order of a court; or

(b) the issuer is provided with an indemnity bond sufficient in the issuer's judgment to protect the issuer and any registrar, transfer agent or other agent of the issuer from any loss that may be incurred by any of them as a result of complying with the adverse claim.

Where no duty to inquire

(3) Unless an issuer is deemed to have notice of an adverse claim from a document that is obtained under subsection 87 (5) or has received notice of an adverse claim under subsection (1), if a security presented for registration is endorsed by the appropriate person, the issuer has no duty to inquire into adverse claims and in particular,

(a) an issuer registering a security in the name of a person who is a fiduciary or who is described as a fiduciary is not bound to inquire into the existence, extent or correct description of the fiduciary relationship and thereafter the issuer may assume without inquiry that the newly registered owner continues to be the fiduciary until the issuer receives written notice that the fiduciary is no longer acting as such with respect to the particular security;

(b) an issuer registering transfer on an endorsement by a fiduciary has no duty to inquire whether the transfer is made in compliance with the document or with the law of the jurisdiction governing the fiduciary relationship; and

(c) an issuer is deemed not to have notice of the contents of any court record or any registered document even if the record or document is in the issuer's possession and even if the transfer is made on the endorsement of a fiduciary to that fiduciary or to that fiduciary's nominee.

Limitation for notice

(4) A written notice of adverse claim received by an issuer is effective for twelve months from the date when it was received unless the notice is renewed in writing. 1982, c. 4, s. 88.

Liability of issuer

89.—(1) Except as otherwise provided in any applicable law of Canada or any province of Canada relating to the collection of taxes, the issuer is not liable to the owner or any other person who incurs a loss as a result of the registration of a transfer of a security if,

(a) the necessary endorsements were on or with the security; and

(b) the issuer had no duty to inquire into adverse claims or had discharged any such duty.

Idem

(2) If an issuer has registered a transfer of a security to a person not entitled to it, the issuer shall deliver on demand a like security to the owner unless,

(a) subsection (1) applies;

(b) the owner is precluded by subsection 90 (1) from asserting any claim; or

(c) the delivery would result in overissue, in which case the issuer's liability is governed by section 58. 1982, c. 4, s. 89.

Loss, etc., of securities

90.—(1) Where a security has been lost, apparently destroyed or wrongfully taken, and the owner fails to notify the issuer of that fact by giving the issuer written notice of the owner's adverse claim within a reasonable time after the owner knows of the loss, destruction or taking and if the issuer has registered a transfer of the security before receiving such notice, the owner is precluded from asserting against the issuer any claim to a new security.

Replacing loss, etc., of securities

(2) Where the owner of a security claims that the security has been lost, apparently destroyed or wrongfully taken, the issuer shall issue a new security in place of the original security if the owner,

(a) so requests before the issuer has notice that the security has been acquired by a good faith purchaser;

(b) files with the issuer an indemnity bond sufficient in the issuer's opinion to protect the issuer and any transfer agent, registrar or other agent of the issuer from any loss that it or any of them may suffer by complying with the request to issue a new security; and

(c) satisfies any other reasonable requirements imposed by the issuer.

Rights of good faith purchaser

(3) If, after the issue of a new security under subsection (2), a good faith purchaser of the original security presents the original security for registration of transfer, the issuer shall register the transfer unless registration would result in overissue, in which case the issuer's liability is governed by section 58.

Rights of issuer

(4) In addition to any rights on an indemnity bond, the issuer may recover a new security issued under subsection (2) from the person to whom it was issued or any person taking under that person other than a good faith purchaser. 1982, c. 4, s. 90.

Duty of agents for issuer

91.—(1) An authenticating trustee, transfer agent, registrar or other agent for an issuer has in respect of the issue, registration of transfer, and cancellation of a security of the issuer,

(a) a duty to the issuer and to the holder or owner to exercise good faith and due diligence; and

(b) the same obligations to the holder or owner of a security and the same rights, privileges and immunities as the issuer.

Notice to agents for issuer

(2) Notice to an authenticating trustee, transfer agent, registrar or other such agent is notice to the issuer with respect to the functions performed by the agent. 1982, c. 4, s. 91.