

SECURITIES TRANSFER ACT

# Q&A

March 2007

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# SECURITIES TRANSFER ACT Q&A:

## A GENERAL OVERVIEW

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## INTRODUCTION

The *Securities Transfer Act (Ontario)* (the STA)<sup>1</sup> received Royal Assent and was proclaimed in force on January 1, 2007. Alberta's STA came into effect on the same day. British Columbia and Saskatchewan introduced STA legislation in early 2007 and all provinces will hopefully have STA legislation in place within the next few years.

The purpose of the STA is to provide a modern set of rules relating to the holding and transfer of various types of securities and other financial assets. Additionally, consequential amendments to the *Personal Property Security Act (Ontario)* (the PPSA) when combined with the STA, provide rules and procedures for taking security over investment property and determining priority of interests that are more accurately reflective of today's commercial reality. The implementation of these rules and procedures requires the introduction of a number of new concepts and terms relating to the holding and transfer of securities that are held directly, as between the issuer and the security holder, and those that are held indirectly through a securities intermediary. There are also new concepts and terms relating to the taking of security over these types of collateral.

The purpose of this Q&A is to provide an overview of the new STA and PPSA framework and to describe some of the important definitions and concepts employed by the new legislation.

### What is the Securities Transfer Act?

The STA is legislation that, among other things, deals comprehensively with the transfer and holding of securities and interests in securities; in essence it adopts Article 8 of the U.S. *Uniform Commercial Code*. Until now, Canadian statutes have not adequately supported existing commercial practices because they failed to deal appropriately with securities and interests in securities that are indirectly held through securities intermediaries.

The STA provides a new framework to understand the relationships among, and interests held by various parties involved in both the direct and indirect holding of securities and interests in securities. The STA defines and classifies different types of interests in securities, provides rules governing how these interests may be validly acquired and transferred and how different parties may obtain control and priority over these interests. It also sets out obligations, warranties and restrictions that apply to the various parties involved in the holding and transfer of securities in both the direct and indirect systems. These rules apply to issuers of securities and to all parties that hold interests either directly for their own account or indirectly for others, such as clearing agencies, transfer agents and brokers. In order to prioritize and regulate the interests held by various parties involved in both the direct and indirect holding systems, the STA also provides rules governing conflicts of laws, seizure of securities, enforceability of contracts and evidence in legal proceedings.

The purpose of the STA is not to change the manner in which securities are issued, held or transferred, but to clarify the relationships among the various parties involved in holding and transferring securities. In many ways the STA reflects existing rights, obligations and restrictions currently imposed through contract or commercial practice by and among those operating in the indirect holding system.

The changes to the PPSA provide a complementary framework for taking security interests over securities and other types of financial assets in both the direct and indirect holding systems. The new PPSA also provides rules for determining priorities among competing secured creditors and other claimants with

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<sup>1</sup> Introduced as *Bill 41*, now S.O. 2006, c.8.

respect to securities and other financial assets. The changes to the PPSA extend beyond those amendments that are required to implement the STA. For example, there are also new provisions dealing with futures and futures accounts and new conflict of laws rules that make it easier to determine which jurisdiction's laws apply to the taking of security over certain types of property.

### Who is affected by the STA?

Any party that deals with the acquisition, holding or disposition of securities (or interests in securities) in any manner is affected by the STA. Those who are affected include:

- > Issuers of securities (which includes corporate and non-corporate entities)
- > Transfer agents
- > Purchasers and holders of securities (who acquire securities from treasury or by transfer)
- > Transferors of securities
- > Lenders and other secured parties
- > Clearing agencies
- > Participants of clearing agencies (banks, trust companies and investment dealers)
- > Brokers and dealers that have accounts directly with participants of clearing agencies
- > Investors that have accounts with clearing agency participants

### What is the distinction between the direct and indirect holding systems?

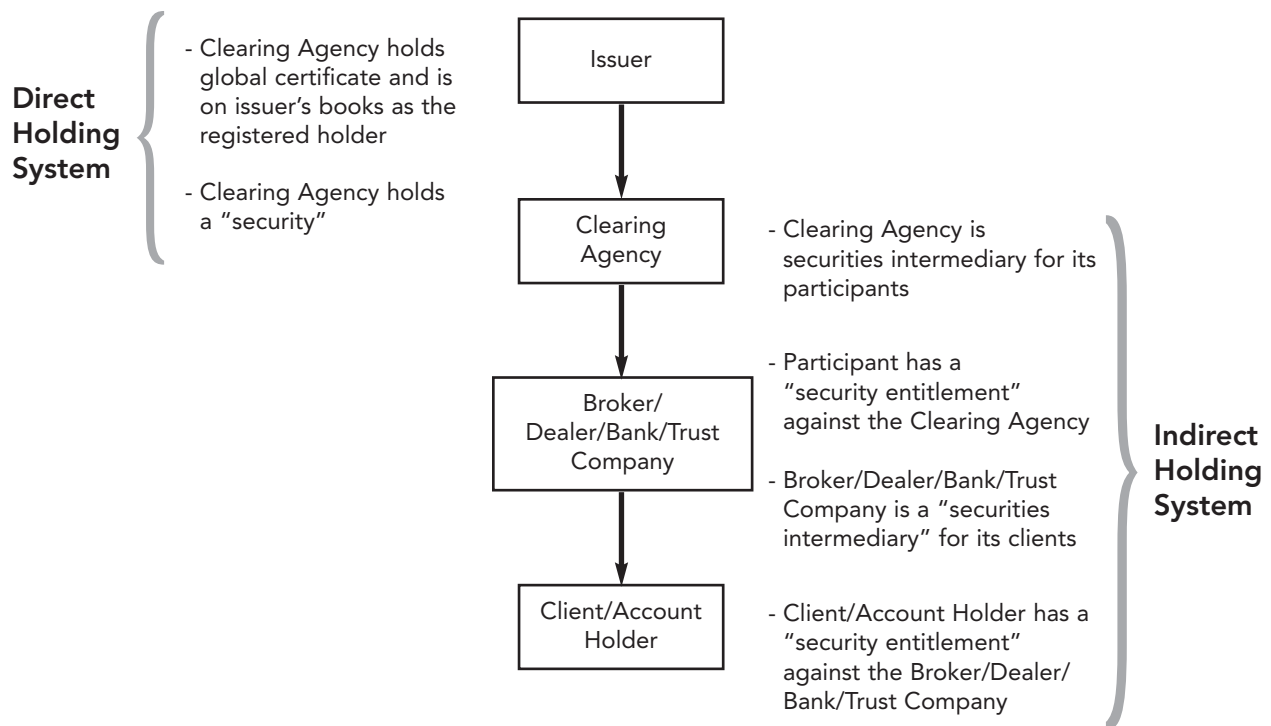
A key to understanding the STA is recognizing that the legislation makes a distinction between the direct and indirect holding systems. A person is a direct holder of securities if the securities have been issued directly to that person by the issuer. For example, lenders who take possession of pledged share certificates and are registered on the books of the issuer are direct holders. The Canadian Depository for Securities Limited (CDS) is a direct holder of the securities and instruments deposited with it. Securities that are directly held may be certificated or uncertificated (or dematerialized).

In contrast, an investor in the indirect holding system is not registered on the books of the issuer and does not physically hold a security certificate. Indirect holders are investors who hold through an account with a clearing house, securities dealer or other intermediary. Those investors hold not a "security" but a "security entitlement". A security entitlement is a bundle of rights against a securities intermediary with respect to a financial asset as opposed to the direct holding of the underlying financial asset.<sup>2</sup> It is, essentially, a different type of asset than the underlying security and indeed a separate asset. The diagram below helps illustrate the distinction between the direct and indirect holding systems.<sup>3</sup>

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<sup>2</sup> Commentary to s.95 of the Uniform Securities Transfer Act, as approved by the Uniform Law Conference of Canada at its Annual Meeting, August 22-26, 2004 (the "STA Commentary").

<sup>3</sup> This illustration shows the clearing agency as the direct holder. A direct holder may also be a broker or other entity that holds the asset directly (e.g. the certificate or is registered holder on the issuer's books as holder of an uncertificated security).



### How does the indirect holding system work?

The indirect holding system applies to a broad range of property or property interests, defined in the STA as "financial assets". Financial assets include securities and security entitlements, as well as other interests, obligations or property that are held through "securities accounts." To determine whether an interest falls under the indirect holding system, and, consequently, Part VI of the STA, it is necessary to consider the definition of "financial asset", together with the definition of "securities account".

The term "financial asset" is generally defined in the STA to include what we would traditionally think of as securities and in this regard the STA offers a broad definition that includes all types of issuers and all types of instruments (e.g. shares, partnership units, trust units). The term is, however, even wider. It includes all kinds of property in a securities account that might not meet the definition of a security:

"any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under [the STA]"

Further, credit balances in a securities account are also financial assets that benefit from the new rules:

"a credit balance in a securities account, unless the securities intermediary has expressly agreed with the person for whom the account is maintained that the credit balance is not to be treated as a financial asset under [the STA]."

The term “securities account” is defined in the STA as “an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that constitute the financial asset.” In this way, a securities account is the arrangement between a securities intermediary and the person or entity (the entitlement holder) on whose behalf the securities intermediary holds a financial asset.

Several significant relationships fall within the definition of a securities account, including the relationship between (a) a clearing agency and its participants, (b) a broker and customers who leave securities with the broker, and (c) a bank or trust company acting as securities custodian and its custodial customers. Under the STA, the determination of whether an arrangement is a “securities account” depends on whether a party has undertaken to treat the other party as entitled to exercise the rights that comprise the security or other financial asset.<sup>4</sup> The arrangement must be consensual in that the securities account must be established by agreement; a formal or written agreement need not be signed.<sup>5</sup> With respect to CDS, the proposed amendments to its Rules will specify that the ledgers maintained by CDS for its participants are “securities accounts” and that the agreements between CDS and its participants are the agreements establishing those securities accounts.

There are many arrangements between institutions and other persons concerning securities or other financial assets which do not fall within the definition of “securities account”. For example, the term “securities account” does not cover the relationship between a bank and its depositors or the relationship between a trustee and the beneficiary of an ordinary trust because the bank and trustee have not undertaken to treat the other persons as entitled to exercise the ordinary rights of an entitlement holder specified under Part VI of the STA.<sup>6</sup>

### What is a security entitlement?

If a financial asset is held in a securities account, the party holding an interest in that financial asset through the securities account has a “security entitlement.” Under the STA the term “security entitlement” is defined as “the rights and property interest of an entitlement holder with respect to a financial asset that are specified in Part VI [of the STA].” “A security entitlement is both a package of personal rights against the securities intermediary and an interest in the property held by the securities intermediary, which interest itself may be a security entitlement. It is not a specific property interest in any financial asset held by the securities intermediary or by a clearing agency through which the securities intermediary holds the financial asset.”<sup>7</sup>

By way of example, referring to the chart above, where the clearing agency (such as CDS) is the registered holder of securities issued by an issuer, the CDS participants have an interest in those securities through the arrangements between the clearing agency and those participants in the form of “security entitlements.” Similarly, through arrangements between the brokers and their clients, security entitlements are also held by those clients with respect their interests in the securities. The clearing agency, as the party registered on the books of the issuer, is the holder of the security and both the broker and the clients are holders of security entitlements, albeit different security entitlements. Each person owns a different asset because each person’s bundle of rights is different.

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<sup>4</sup> Commentary to the definition of “securities account” in the STA Commentary.

<sup>5</sup> *Ibid.*

<sup>6</sup> *Ibid.*

<sup>7</sup> Commentary to the definition of “security entitlement” in the STA Commentary.

## Who is considered a “securities intermediary” under the STA?

The STA defines the term “securities intermediary” to include a clearing agency, or a person that “in the ordinary course of business maintains securities accounts for others and is acting in that capacity.” Examples of securities intermediaries include clearing agencies holding securities for their participants, banks and trust companies acting as custodians, and brokers holding securities for their clients or customers. The STA defines the term “broker” as a dealer under the *Securities Act* (Ontario). As the definition of the term “securities intermediary” requires the intermediary to maintain a securities account for others, determining whether a stockbroker or dealer is a securities intermediary under the STA is a fact-specific exercise that would depend upon the particular arrangements between a broker and its clients.

The definition of securities intermediary includes the requirement that the person be “acting in the capacity” of maintaining securities accounts for others. This aspect of the definition takes into account the fact that a particular entity (i.e. a bank or trust company) may act in many different capacities: as transfer agent for issuers; as trustee of a fund; as a dealer in government securities; as a lender taking securities as collateral; and as a provider of general payment and collection services. For example, where a financial institution maintains securities accounts for its customers, in that capacity it would be a securities intermediary; however, if it takes a pledge of securities from a borrower to secure a loan it is not acting as a securities intermediary with respect to the pledged securities, since it holds them for its own account rather than for a customer.<sup>8</sup>

## What are the obligations of securities intermediaries?

The STA sets out the obligations of a securities intermediary and provides that an entitlement holder’s property interest in a particular financial asset may be enforced against the securities intermediary only by the exercise of an entitlement holder’s rights under the STA. These rights (and conversely the duties of the securities intermediary) are set out in Part VI of the STA. The Part VI rules, among other things, require the securities intermediary to:

- > obtain and maintain the financial assets in a quantity corresponding to the aggregate security entitlements established in favour of entitlement holders with respect to that financial asset, either directly or through one or more financial intermediaries,
- > take action to obtain a payment or distribution made by the issuer of a financial asset (which obligation is triggered if the payment or distribution is received by the securities intermediary),
- > exercise rights with respect to a financial asset as directed by an entitlement holder,
- > comply with entitlement orders (provided the entitlement order is originated by the appropriate person and the securities intermediary has a reasonable opportunity to comply with it and to assure itself that it is genuine and authorized), and
- > act at the direction of an entitlement holder.

These are some of the statutory rules imposed by the STA. There are other rights that an entitlement holder may have against a securities intermediary arising from the contractual agreement between the securities intermediary and the entitlement holder as well as other laws that the relationship may be subject to. The STA provides that a securities intermediary satisfies its STA statutory duties if it acts with respect to the duty as agreed to with the entitlement holder or, in the absence of such an agreement, it exercises due care in accordance with reasonable commercial standards.

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<sup>8</sup> Commentary to the definition of “securities intermediary” in the STA Commentary.

A securities intermediary who deals with certificated and uncertificated securities that are directly held is required to give warranties in various circumstances relating to those securities. The STA warranty provisions replace the broker warranty provisions previously found in the *Business Corporations Act (Ontario)* (OBCA). Although the new provisions in the STA are comparable to the old law, there are some differences. For example, the warranties that are required to be given on transfer now include warranties that there are no “adverse claims” to the securities, that the transfer does not violate any restriction on transfer and that if the transfer is by endorsement that the endorsement is made by the appropriate person. There are also new warranty provisions to specifically address uncertificated securities which have not previously been dealt with in the OBCA. The warranty provisions in the STA are very specific depending upon the action being taken, so any securities intermediary dealing with directly held securities should refer to the various specific sections.

### **What are some rights and obligations of entitlement holders?**

Once a security entitlement is established under the STA, Part VI confers certain rights, benefits and obligations on the entitlement holder. For example, section 97 of the STA provides that to the extent necessary to satisfy all security entitlements in a particular financial asset, all interests in a financial asset held by a securities intermediary are held for entitlement holders, are not property of the securities intermediary and are generally not subject to the claims of creditors of the securities intermediary. Section 96 of the STA protects entitlement holders from “adverse claims” by prohibiting a third party from bringing a legal proceeding based on an adverse claim to a financial asset against a person who acquires a security entitlement for value and without notice of the adverse claim.

The STA includes clear provisions dealing with the acquisition and transfer of security entitlements. Under s. 95 of the STA, a person acquires a security entitlement if a securities intermediary: (a) indicates by book entry that a financial asset has been credited to that person’s securities account, (b) receives a financial asset from the person or acquires a financial asset for that person, and in either case, accepts it for credit to the person’s securities account, or (c) becomes obligated under another statute, law, regulation or rule to credit a financial asset to the person’s securities account. The transfer of security entitlements is accomplished under the STA through “entitlement orders”. To accommodate the manner in which instructions are currently communicated in the indirect system, the concept of “communication” under the STA encompasses a signed writing or transmission of information by any other means agreed to by the transmitting party and the recipient of the information. For example, the trade instructions entered into the CDS system for settlement in accordance with the CDS Rules are entitlement orders for purposes of the STA.

A person who originates an entitlement order to a securities intermediary to transfer a security entitlement makes certain warranties to the intermediary. Some of the warranties mandated by the STA include that the order is made by the appropriate person, or if made by an agent that the agent has actual authority to act on behalf of the appropriate person, and that there is no adverse claim to the security entitlement. Accordingly, when a customer instructs its broker to make a trade, the customer is making these warranties to the broker; the broker in turn makes the same warranties to CDS when the broker enters the trade instructions into the CDS system.

The proposed amendments to the CDS Rules clarify that participants will look to the Ontario STA with respect to their roles as entitlement holders with CDS. Under the proposed amendments, CDS is choosing and requiring its participants to acknowledge that Ontario is its jurisdiction for purposes of the STA. The proposed amendments to the CDS Rules also introduce a new provision clarifying that CDS’ legal documentation governing the rights and obligations between CDS and its participants are effective even if they conflict with the STA or the PPSA. This “paramountcy” provision is sanctioned by Section 7 of the STA which provides that a rule adopted by a clearing agency is effective even if it conflicts with

the STA or the PPSA. This provision is arguably supported from a policy perspective as it will allow CDS to keep pace with international standards regarding clearing and settlement, which is the primary purpose behind the implementation of the legislation.

### **How does a secured creditor perfect a security interest over financial assets and security entitlements?**

The implementation of the STA and amendments to the PPSA have forced secured creditors to revisit their approach to taking a security interest over securities-type property. The PPSA introduces the key concept of “investment property”, which includes certificated securities, uncertificated securities, security entitlements, securities accounts, futures contracts and futures accounts. A secured party may perfect a security interest in various types of investment property in different ways. “Control” is a fundamental concept under the new legislation and perfection by control is the best assurance of a first priority. Ultimately, the method of perfection of a security interest will be driven by (i) the type of collateral (investment property) over which the secured creditor is taking security, and (ii) the level of protection the secured creditor wishes to obtain.

As discussed above, financial assets held by a borrower in a securities account are security entitlements. Control is the best method of perfecting a security interest over this type of collateral and a secured party can achieve control in multiple ways. A secured party that becomes the entitlement holder with respect to a securities account will achieve control of the financial assets and the highest level of protection. Essentially, this process creates a new security entitlement that belongs to the secured party. As the STA protects entitlement holders from “adverse claims”, a secured party that takes control by this method will be able to avail itself of this entitlement holder protection.

However, allowing the secured party to become entitlement holder is not always an acceptable arrangement to the borrower. Another way in which a secured party can obtain control over a security entitlement is by entering into a control agreement with the securities intermediary and the borrower that allows the secured party to give “entitlement orders” to the securities intermediary in certain circumstances. It is important to note that there are other ways to get control and that more than one person can have control of a security entitlement at the same time. It is crucial that control agreements be carefully drafted to ensure that the secured creditor maintains the priority it bargained for.

Certain provisions of the STA restrict the ability of a securities intermediary to grant a security interest in a financial asset that it is required to maintain in favour of an entitlement holder, except as otherwise agreed to by the entitlement holder. Typically, agreements that securities intermediaries have with their clients specifically contain an acknowledgement by the client that the securities intermediary may take security over the assets held by the securities intermediary in the client’s account. The STA specifically states that, to the extent an entitlement holder grants an interest in a security entitlement to the holder’s own securities intermediary, the securities intermediary has control of the security entitlement. The PPSA priority rules give priority to a securities intermediary who holds a security interest in a security entitlement or a securities account maintained with that intermediary over a conflicting security interest held by another secured party.

### **How does a secured creditor perfect a security interest over directly held securities?**

With the STA in force, a secured creditor can continue to make a PPSA registration to perfect its security interest in directly held certificated securities. A secured creditor can also continue to (i) obtain a blank stock transfer executed by the borrower and take possession of the share certificate in the name of the

borrower, or (ii) take possession of a new share certificate registered in the secured creditor's name. Under the STA and revised PPSA, taking possession of the share certificate is referred to as "delivery" and the additional step of obtaining the blank stock transfer or registration in its own name will give the secured creditor control.

The STA has codified the concept of an uncertificated security. With the rules for transferring uncertificated securities more certain under the STA, uncertificated securities may become more common. Once again, with respect to these types of securities, control constitutes perfection and will result in a first priority.

### **How are priorities determined under the new legislation?**

The amended PPSA establishes basic priority rules as between competing secured creditors who have security interests in the same investment property. As stated above, control is usually the best method of perfection. A security interest in investment property perfected by control has priority over a security interest perfected by any other means (i.e. by registration, delivery or attachment). Perfection by delivery without control is second best as it trumps perfection by attachment or registration. If more than one secured creditor has control, then priority as between them is by the order of obtaining control. If a secured party has control by becoming the entitlement holder with respect to a securities account, these priority rules do not really apply because there is no competing interest in that same investment property. In such a situation, different rules in the STA must be examined.

The STA and amended PPSA include priority provisions for secured parties in relation to persons other than competing secured creditors. The STA introduces the concept of a "protected purchaser" (which only applies to "securities", i.e. to holders in the direct holding system). A protected purchaser is a purchaser of a certificated or uncertificated security, or of an interest in the security who (a) gives value, (b) does not have notice of any adverse claim to the security, and (c) obtains control of the security. A "purchaser" includes a secured creditor. The protected purchaser concept essentially protects the secured creditor from adverse claims asserted by third parties other than secured creditors. If a secured creditor has control of a certificated or uncertificated security and meets the definition of "protected purchaser" under the STA it will obtain the highest level of protection and priority.

### **What is the impact on issuers in the direct holding system?**

The STA replaces most of the share transfer provisions previously contained in the OBCA. Although the provisions in the STA are substantially similar to those previously found in the OBCA, subtle differences do exist. Any issuer that is subject to the new legislation should be cognizant of the new transfer provisions and the obligations imposed on it under the STA. Some examples include the following: validity of a security is now determined based on the law of the jurisdiction of incorporation and the constating provisions governing the issuer, not just the issuer's articles; there are new rules regarding uncertificated securities and how those types of securities are transferred; and the STA sets out all of an issuer's obligations and liabilities with respect to registering a transfer of securities.

The STA does not necessarily apply to all issuers and there are new conflict of laws provisions to guide issuers in making this determination. This is somewhat complex for federally incorporated entities so a case-by-case analysis will be required to determine what provisions of applicable STA legislation will apply.

## CONCLUSION

As stated in the explanatory note to the legislation, the STA establishes a “comprehensive system of rules for the transfer of investment securities that reflects current international commercial practices.” The implementation of these rules brings Canadian capital markets closer to their international counterparts with respect to the rules and relationships that govern the direct and indirect holding and transfer of securities. As articulated in the CSA Consultation Paper,<sup>9</sup> modern uniform legislation was urgently needed to “improve the efficiency and safety of the Canadian securities settlement system.” For players in the indirect system, these rules will clarify the rights and obligations of different parties involved in the chain of ownership in securities and interests in securities and the taking of security over such collateral. This clarification is long awaited and has lagged behind the evolution of sophisticated and creative capital market products that are indirectly held and transferred through electronic entitlements. While many of these relationships may have been adopted through commercial practice or by contract, imposition of a statutory regime will help to improve uniformity and predictability in these relationships, ensuring the better operation of the indirect holding system and of the regulations and rules that govern it.

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<sup>9</sup> Consultation Paper of the Canadian Securities Administrators’ Uniform Securities Act Task Force, “Proposal for a Modernized Uniform Law in Canada Governing the Holding, Transfer and Pledging of Securities” dated May 28, 2004 at p.7.

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