

The Influence of UCC Article 8 on Canadian Securities Transfer Law: Is There Room For A Canadian Dialect in Global Commercial Language?

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Introduction

This paper is intended to provide a brief introduction to the effects of globalization on Canadian securities transfer legislation, with particular emphasis on legislative drafting issues and the effect of Revised Article 8 (“Rev8”) of the Uniform Commercial Code (“UCC”) on the drafting of Canadian legislation.²

What Is Securities Transfer Legislation?

Securities transfer legislation, also known as “settlement rules”, is the commercial property-transfer law governing the transfer and holding of securities, and interests in securities.³ Rev8, revised in 1994 and since adopted in 49 states, is generally recognized as the most advanced securities transfer legislation in the world.

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¹ The opinions expressed in this paper are personal, and do not necessarily reflect the views of the Alberta Securities Commission.

² This paper focuses on the effect of Rev8 on legislative drafting in the common law provinces. The unique requirements of the Québec Civil Code in this context are recognized (see note 40, *infra*, and accompanying text), but not addressed in this paper.

³ “Interests in securities” includes security interests in securities, commonly referred to as “pledges”.

Securities transfer legislation is long and complex and its technical details are somewhat arcane. The purpose of this paper is to focus only on how Rev8 impacts our general approach to drafting Canadian legislation, so it will discuss the purpose and function of such legislation in somewhat broad terms that are particularly relevant to drafting issues. Detailed context relating to the history and evolution of securities transfer legislation, and the concepts underlying the reforms reflected by Rev8, have been relegated to the Appendix. The body of this paper is cross-referenced to the Appendix where appropriate.

In order to properly understand the purpose and function of securities transfer legislation like Rev8, we must first recognize the very narrow, but important, role of such legislation within the context of the global securities markets. This may be illustrated by examining the distinction between securities transfer legislation and securities regulatory law.

All major commercial jurisdictions around the world have some form of securities regulatory law. In Canada, it is found in the provincial *Securities Acts*, rules and policies, together with the rules of self-regulatory organizations such as the Toronto Stock Exchange and the Investment Dealers Association. Securities regulatory law covers a vast area, closely regulating many aspects of how securities may be issued and traded. If we consider a typical “trade” in securities—a contract to buy or sell a security made through an exchange—we can see the pervasive effect of securities regulatory law. It governs, sometimes in minute detail, how the security was issued in the first place, the continuous-disclosure obligations on the issuer of the security, the qualifications and duties of the brokers or other intermediaries involved in the trade, and the operation of the stock exchange.

In contrast, securities transfer legislation deals only with one very narrow element of a typical trade in securities—the transfer of property that occurs in the settlement of the trade. That is separate from, and not addressed by, securities regulatory law.

There are two components to settlement: the transfer of property and the payment of money. Securities transfer legislation deals only with the specialized rules governing the transfer of property. The payment

system has its own specialized rules, which is another completely separate topic.⁴

The Relationship Between Securities Transfer Law and the Common Law

We must also recognize that these narrowly-focused commercial property-transfer rules are not merely separate from securities regulatory law, they are a fundamentally different type of law. This difference affects both the drafting and interpretation of such law.

Securities regulatory law is “program legislation”, which “addresses a large social or economic problem by establishing a program of regulation [...] and creating a department or other body to administer it”.⁵ Securities regulation has developed largely as a deliberate and calculated response to inefficiencies or abuses in securities markets.⁶ The current trend towards uniformity in securities regulation is a similarly deliberate and calculated response to the globalization of securities markets. There is a tendency for the regulatory approach of larger and stronger securities markets to set the course for smaller jurisdictions,⁷ but

⁴ See Appendix, footnote 102 and accompanying text.

⁵ See *Driedger on the Construction of Statutes*, 3rd ed. by R. Sullivan (Toronto and Vancouver: Butterworths, 1994) (“*Driedger*”) at pp. 42-3.

⁶ One of the earliest examples of this was the collapse of the South Sea Company, which provoked a somewhat feeble attempt at securities regulation through the English “Bubble Act” of 1720. The first comprehensive licensing system statute was passed in Kansas in 1911, where the term “blue sky law” was coined to describe legislation aimed at promoters who “would sell building lots in the blue sky in fee simple”. The stock market crash of 1929 led to the U.S. Securities Act of 1933 and Securities Exchange Act of 1934. For a full history, see L. Loss and J. Seligman, *Securities Regulation*, 3rd ed. (Boston: Little, Brown and Co., 1989) Vol. 1, at ch. 1; J. Williamson, *Securities Regulation in Canada* (Toronto: University of Toronto Press, 1960) at ch. 1; and D. Johnston and K. Rockwell, *Canadian Securities Regulation*, 2nd ed. (Toronto: Butterworths, 1998) at ch. 2, where the authors note that “The first ‘law’ of securities regulation is that fraud spawns legislative activity.” (at 14, n. 30).

⁷ In 1996, secondary market trading of securities in Canada totaled over \$10 trillion, but this represents only about 3% of the global securities market.

it is important to note that there is no naturally-occurring “model” for uniform securities regulation.

Again, securities transfer law is very different. It is “reform legislation”, which introduces rules to modify or supplement the existing private law regime in, essentially, a common law framework.⁸ When interpreting reform legislation according to the purposive approach, the primary interpretive challenge is, as *Driedger* describes it, “to master the relationship between the new rules and existing law”.⁹

With securities transfer law, the central feature of this relationship has been the fact that commercial practice evolved with a natural tendency towards uniformity within securities markets, with the common law supporting this evolution by recognizing the customs or usages of the securities markets. Commercial practice and the common law provided uniform commercial law in this area prior to any codification, as well as a naturally-occurring model for codification. Codification merely confirmed, and provided a legal foundation for, existing commercial practice.¹⁰

This close relationship with commercial practice and the common law has been evident throughout the history of securities transfer law. The current influence of commercial practice may be stronger than ever because the globalization of securities markets is producing globalization of commercial practices. This, in turn, produces a compelling demand for globalization of uniform commercial law to support such practices,¹¹ which is exactly what is now occurring with securities transfer law.

⁸ See *Driedger*, *supra*, note 5 at pp. 41-2.

⁹ *Ibid.*

¹⁰ See Appendix at pp. 19-25.

¹¹ See R.D. Guynn, “Modernizing Securities Ownership, Transfer and Pledging Laws: A Discussion Paper on the Need for International Harmonization”, International Bar Association Section on Business Law, Capital Markets Forum, February 1996 (“Modernizing Securities Ownership, Transfer and Pledging Laws”).

Fundamental Policy Objectives of Securities Transfer Law

Some of the fundamental policy objectives that have shaped the evolution of commercial practices and securities transfer law also have a powerful effect on legislative drafting. These objectives, which overlap considerably, include *controlling systemic risk*, *achieving finality of settlement* and *avoiding legal risk*.

Controlling Systemic Risk

Systemic risk is “the risk that the inability of one institution to meet its obligations when due will cause other institutions to be unable to meet their obligations when due”.¹² “Put bluntly, the absence of mechanisms for control of systemic risk is why disturbances in the financial system used to be called ‘panics’.”¹³ Securities trading is an inherently risky business and, despite regulatory safeguards, it must be expected that some institutions will fail. The control of systemic risk has been the impetus for the development of various commercial practices and regulatory systems. The 1994 revisions to UCC Article 8 are recognized as playing a critical role in controlling systemic risk.¹⁴

¹² Bank For International Settlements, *Cross-Border Securities Settlements* (Basle: 1995) (“*Cross-Border Securities Settlements*”) at 40. Another source describes systemic risk as “the risk that if a sufficiently broad amount of interdependency risk were realized the financial system as a whole would be threatened”, where “interdependency risk is the risk that one failed transaction will cause other transactions to fail, or that a disruption in the operations of one firm will cause disruptions at other firms”. See *Cross-Border Clearance, Settlement, and Custody: Beyond the G30 Recommendations* (Morgan Guaranty Trust Company of New York, Brussels office, as Operator of the Euroclear System, 1993) (“*Cross-Border Clearance*”) at 12.

¹³ J.S. Rogers, “Policy Perspectives on Revised U.C.C. Article 8”, (1996) 43 U.C.L.A. L. Rev. 1431 (“Policy Perspectives”) at 1437.

¹⁴ Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, said in 1995 that “the greatest risk to the liquidity of our financial markets is the potential for disturbances to the clearance and settlement processes for financial transactions”. He noted that in assessing the adequacy of the clearance and

The importance of controlling systemic risk in the securities settlement system cannot be over-emphasized. Rev8 has aptly been described as part of “Armageddon planning” for the financial system.¹⁵

Achieving Finality of Settlement

Finality of settlement means that the transfer of a security, if performed according to certain rules, cannot be unwound. Without finality of settlement, every securities transaction would remain subject to the risk of an adverse claim from someone earlier in the chain of title. Since securities markets have long been characterized by rapid turnover,¹⁶ the prospect of unwinding trades is obviously antithetical to the needs of the markets and the reduction of systemic risk.

Commercial practices developed to provide some degree of finality of settlement well over 100 years ago.¹⁷ A large part of the evolution of commercial practice and securities transfer law reflects an effort to improve finality of settlement through the application of negotiability principles to security certificates.¹⁸ The main reason for the original UCC Article 8 (developed in the 1940s and 1950s) was to apply the finality principle to all forms of securities, using negotiability principles.¹⁹

settlement system, “the most important set of concerns relates to the legal and institutional foundations of book-entry settlement systems,” and he urged other countries to follow the lead of the United States in eliminating legal uncertainties by modernizing their legal rules as has been done in the Article 8 revision project. See J.S. Rogers, “Policy Perspectives”, *ibid.* at 1438.

¹⁵ J.S. Rogers, “Policy Perspectives”, *ibid.* at 1436.

¹⁶ See Appendix, footnote 90 and accompanying text.

¹⁷ See Alberta Law Reform Institute, *Report No. 67—Transfers of Investment Securities* (June, 1993) (“ALRI Report”) at 14-5.

¹⁸ See Appendix at pp. 19-25.

¹⁹ J.S. Rogers, “Policy Perspectives”, *supra*, note 13 at 1462.

More recently, commercial practice and securities transfer law has evolved beyond negotiability, and away from negotiability principles, into the law of financial accounts.²⁰ This recent evolution does not, however, reflect any change in the underlying policy objectives—Rev8 reflects the continued application of the finality principle.²¹ It is simply that negotiability concepts, which were essential to providing finality within the old paper-based settlement system, were incapable of providing finality within the electronic book-entry settlement system.

Avoiding Legal Risk

Legal risk is the risk associated with a transaction due to the legal rules applicable to the transaction. Modern securities transactions often involve counterparties or intermediaries in several different jurisdictions.²² The laws of any such jurisdiction (especially the choice of law rules) may create a risk that the transaction will not be considered legally final in that jurisdiction. That risk may cause market participants in other jurisdictions to avoid dealing with counterparties or intermediaries in that jurisdiction.

The adoption of Rev8 in the U.S. and the modernization of securities transfer law in Europe to reduce legal risk has increased the gap between modernized and non-modernized jurisdictions. It has also heightened all market participants' sensitivity to legal risk.²³

The Close Relationship Between Canadian and U.S. Securities Transfer Law

²⁰ See Appendix at pp. 28-37.

²¹ See J.S. Rogers, "Policy Perspectives", *supra* note 13 at 1460-73.

²² See Appendix, note 117 and accompanying text.

²³ See *Cross-Border Clearance*, *supra*, note 12 at 17-35; J.S. Rogers, "Policy Perspectives", *supra*, note 13 at 1436-8; and R.D. Guynn, "Modernizing Securities Ownership, Transfer and Pledging Laws" *supra*, note 11.

As described in the Appendix, Canadian commercial practices and legislation in this area have followed those in the U.S. quite closely. The 1967 Lawrence Report²⁴ and the 1971 Dickerson Report²⁵ both advocated modelling Canadian securities transfer legislation closely upon UCC Article 8 on the basis that doing so would accord with existing commercial practices. In neither case did the resulting legislation (the OBCA and CBCA) come as close to the UCC model as had been recommended and, over time, Canadian legislation has fallen further and further behind commercial practices and UCC Article 8.

As a natural consequence of globalization, current commercial practices in Canada are more similar to those in the U.S., and our securities markets are more highly integrated, than ever before. For example, the links between the Canadian clearing agency/depository, The Canadian Depository for Securities Limited (“CDS”), and its U.S.-equivalent, the Depository Trust and Clearing Corporation (“DTCC”), for processing cross-border transactions are the most extensive bilateral links among clearing agencies in the world.

The Uniform Law Conference of Canada Production Committee’s review of Rev8 did not reveal any areas where major policy changes are required. It found the principles reflected in Rev8 to be appropriate and applicable to Canadian market practices. It concluded that Canadian settlement rules should use the same basic concepts and approach as Rev8.²⁶ In substantive or functional terms, there is no policy reason to change anything about Rev8 in order to have it apply in Canada.

There are, of course, a number of adjustments that will be necessary, but these are relatively minor. Some differences in terminology must be accommodated. For example, an “investment company security” in the U.S. is a “mutual fund security” in Canada, and the U.S. definition

²⁴ See Appendix, note 79 and accompanying text.

²⁵ See Appendix, note 81 and accompanying text.

²⁶ Uniform Law Conference of Canada, Tiered Holding System—Uniform Legislation Project, Report of the Production Committee, Eric Spink—Reporter, April 30, 1997 (“ULCC Production Committee Report”). The Report is available at the ULCC website at <http://www.law.ualberta.ca/alri/ulc/current/etiered.htm>

of “clearing corporation” will have to be modified. It will also be necessary for Canadian legislation to include some additional provisions modeled after those in Article 1 of the UCC, which are used in Rev8. These types of adjustments are evident in existing Canadian law modeled after previous versions of UCC Article 8.

As a practical matter, the historical similarity between Canadian and American law and practice is an enormous advantage for Canada because it allows us to adopt the Rev8 model with few modifications and thereby join the leaders in the quest for international harmonization in this area.²⁷

The Impact of Rev8 on Drafting Canadian Legislation

As noted above, Canada already has a history of patterning its securities transfer legislation closely upon previous versions of UCC Article 8. The following sections will address the impact of Rev8 on the drafting of the next generation of Canadian securities transfer legislation.

Rev8 Works

Rev8 is immensely influential because it works. It has been used for some time in the U.S. to transfer over \$1 trillion worth of property daily, without any significant problems or litigation. Because it works, and because it works in the world’s largest capital market, Rev8 is the natural standard for global securities transfer law. Every commercial jurisdiction²⁸

²⁷ See R.D. Guynn, “Modernizing Securities Ownership, Transfer and Pledging Laws: A Discussion Paper on the Need for International Harmonization”, *supra*, note 11.

²⁸ This includes each state and province in the U.S. and Canada. Following the October 1987 market break, studies in the U.S. identified the lack of uniformity in the various states’ versions of Article 8, and resulting choice of law uncertainties, as a significant problem. Potential and actual non-uniformity among the states was identified as the major problem with the commercial law foundation of the securities clearance and settlement system addressed by the federal Market Reform Act of 1990, which gave the SEC authority to adopt rules overriding state law in this area. The Market Reform Act of 1990 was a major impetus for the 1994 revision to UCC Article 8. See J.S.

wants what Rev8 provides: a reliable legal system that can accommodate modern securities holding and transfers involving tiered intermediaries in multiple jurisdictions. Every commercial jurisdiction wants that because, without it, they are not integrable with the U.S. market, or any other market with similarly-modernized law. Without it, they are marked as a jurisdiction with special *legal risk*, likely to be quarantined by modernized jurisdictions and kept away from the mainstream of the major securities markets.

All market participants naturally want to use a system that provides *finality of settlement* to control *systemic risk*. This motivates market participants in modernized jurisdictions to avoid dealing with anyone in a non-modernized jurisdiction. It also motivates them to avoid dealing with anyone in a modernized jurisdiction who deals with anyone in a non-modernized jurisdiction.²⁹ In effect, the Rev8 standard becomes the

Rogers, “Policy Perspectives”, *supra*, note 13 at 1542, and ALRI Report, *supra*, note 17 at 129.

²⁹ There are indications that this natural inclination will be augmented by regulatory law. The SEC has recently adopted and amended rules under the Investment Company Act (1940) requiring global custodians of U.S. investment funds to analyze and monitor the custody risks of using a foreign depository. This requirement may implicitly include requiring the global custodian to monitor the underlying legal risk in such foreign jurisdiction. Rule 17f-7 and amended Rule 17f-5 under the Investment Company Act (1940) provide for the placement of registered management investment company assets with custodians outside the U.S. The rules establish basic standards for foreign depositories that funds may use and generally require that a fund’s contract with its global custodian obligate the custodian to analyze and monitor the “custody risks of using a depository”. The custodian must also provide information about the risks to the fund or its adviser as well as any information regarding material changes in the risks. Decisions to maintain assets with a depository would be made by the fund or its adviser based upon information provided by the global custodian. Note the following SEC discussion regarding the requirement to analyze and monitor the custody risks of using a depository, “[the] risk analysis requirements of the rule [are written] broadly to provide custodians with flexibility to tailor the risk analysis to the specific risks involved in the use of each particular depository. The rule does not prescribe specific factors or types of risk to be considered in a risk analysis. As a general matter we expect that an analysis will cover a depository’s expertise and market reputation, the quality of its services, its financial strength, any insurance or indemnification arrangements, the extent and quality of regulation and independent examination of the depository, its standing in published ratings, its internal controls and other procedures for safeguarding investments, and any related legal protections” (footnotes omitted). Although there is

admission-ticket to the global securities market, and jurisdictions without that ticket are excluded.

This exclusionary effect may seem sinister, but it is purely motivated by risk control. Securities markets also naturally seek the liquidity that comes with increased participation, so there is no incentive, other than risk control, to exclude jurisdictions from the global market.³⁰

Clarity and Formalism

Joseph Sommer describes how Rev8 achieves an exceptional level of reliability by abolishing almost all disputable facts, and operating on symbols alone.³¹ In this sense, the Rev8 securities transfer system resembles other information systems, like computer systems, that provide a logically determinative output based solely on the data content of the input.³²

In addition to providing exceptional reliability, this characteristic of Rev8 has an important implication for any other jurisdiction that wants to use the Rev8 system: *they should use the same symbols*. The global securities settlement system is becoming very much like a network computer system—you can connect to the global system/network only if your local system is compatible. If it is not compatible, then the global system/network will not recognize or respond to your input.

no mention of underlying securities settlement legal risks in the above enumeration, it seems implicit that such legal risks would constitute a “custody risk”.

³⁰ The same exclusionary phenomenon may be seen in early securities markets, where risk control measures were largely a function of stock exchange membership. Before stock certificates achieved full negotiability, “street certificates” were treated as negotiable provided they were either registered in the name of a stock exchange member and duly endorsed, or otherwise registered and endorsed with the endorsement guaranteed by a stock exchange member. If there was an adverse claim to such a certificate, the stock exchange member was expected to make good the loss or, presumably, face the loss of membership in the exchange.

³¹ See Appendix, footnotes 111 and 112 and accompanying text.

³² See Appendix, footnote 112 and accompanying text.

Again, the effect may be exclusionary but, again, the exclusionary effect is merely a by-product of the risk control mechanisms of the system. The symbolic inputs described by Rev8 are the modern electronic equivalent of the “magic words” that constituted negotiability in paper-based transactions.³³ In both cases, the objective is to produce absolute clarity of legal result.

The symbolic inputs described by Rev8 may be seen as establishing a new common language in this area of commercial law, in much the same way as a common language was established in negotiable instruments law over a century ago with the enactment of the *Bills of Exchange Act, 1882*.³⁴ The spread of the common language of negotiable instruments law was considerable, but ultimately limited by the physical nature of instruments, the communication systems of the day, and the development of electronic funds-transfer systems. The common language of Rev8 faces no such limitations, and may evolve into a form of global commercial law. We can only speculate about such long-term developments, but it seems clear that, for the foreseeable future, Rev8 language appears likely to dominate commercial law in this area.

Clarity for Whom?

Almost everyone who reads Rev8 for the first time finds it daunting. Rev8 is undeniably technical, complex, specialized and formalistic. Lawyers who have studied Rev8, and are familiar with the intricacies of modern securities transfers, are generally quite comfortable with it, but the initial reaction of most lawyers is to wonder whether the law could be drafted in more accessible terms.

³³ See Appendix, footnotes 47 and 54 and accompanying text.

³⁴ In the Introduction to *Chalmers on Bills of Exchange*, 3rd ed. (London: Stevens & Sons Ltd., 1883), the author notes that negotiable instruments are “the most cosmopolitan of all contracts”. He refers to a comment in *Swift v. Tyson* (16 Peters, 1) where Mr. Justice Storey said (citing Cicero and Lord Mansfield): “The law respecting negotiable instruments may be truly declared...not the law of a single country only, but of the whole commercial world.”

Perhaps it could, but before addressing that possibility (as I do in the next section of this paper) it is important to recognize that the technical complexity and formalism of Rev8 actually improves accessibility for users of the securities settlement system.

The vast majority of users (e.g. investors and intermediaries) simply expect that securities transfers will occur according to their instructions in the normal course of business. As with the payment system, people use the securities settlement system everyday, without the benefit of legal advice, because they assume that the system will operate reliably.³⁵ As Joseph Sommer explains it:

This presupposes simple user rules, which in turn presuppose absolutely reliable system rules. If the underlying system rules are unreliable, then users cannot take them for granted and the user rules cannot be simple. If this seems too abstract, consider ordinary consumer goods, such as a television. A television, with unspeakably complex innards, contains only a few controls on the front panel. A child can use a television because the circuitry within is so reliable that only the front-panel interface is significant. If the circuitry responded unpredictably to the front-panel interface, or if the television broke down frequently, then only technicians would operate televisions, never children.

Payment and securities transfer law, therefore, usually provides simple rules for users. The system rules are transparent to the users. This transparency relies on the extreme clarity of the law. The users, therefore, are under the illusion that they are dealing with “money” or “securities”, not intermediated choses of action. Except in rare cases, such as bank insolvencies, the complex system responds in accordance with the simple user rules. Usually, only the technicians of the system need to poke inside the chassis. [footnotes omitted]³⁶

³⁵ J.H. Sommer, “A Law of Financial Accounts: Modern Payment and Securities Transfer Law” (1998), 53 *Bus. Law.* 1181 (“A Law of Financial Accounts”) at 1197.

³⁶ *Ibid.* at 1197-8.

Rev8 is not perfect but, by providing an unprecedented level of legal clarity to modern securities transfers (an unavoidably arcane subject), it makes itself invisible to most users of the system.

Who are the “technicians” of the securities settlement system? Professor Rogers describes the Article 8 revision as “the product of many years of work, involving a large group of knowledgeable lawyers and business people from all sectors of the securities industry, as well as representatives from all of the securities regulatory agencies and central banking authorities that have responsibility for the securities clearance and settlement system. Perhaps equally, if not more important, the drafting process for revisions of the Uniform Commercial Code is structured in such a fashion that many, if not most, of the key players were not narrowly focused experts but intelligent and dedicated generalist lawyers.”³⁷

From a plain-language perspective, Rev8 is arguably the plainest expression of securities transfer law in existence, simply because it is the most commonly-understood version. One might quibble with whether all users of Rev8 actually understand it at a detailed level, but the fact that they use and rely upon it must imply that they understand it at whatever level they need to. In that sense, Rev8 will remain the plain-language version of this branch of commercial law until some other version becomes more commonly-used.

Could We Improve upon Rev8?

It has been suggested that we could improve on Rev8, either by producing exactly the same substantive effect by using simpler or clearer language, or by producing better substantive law that might give Canada a competitive advantage. Both these suggestions, although well-intended, reveal fundamental misunderstandings about the purpose and function of securities transfer legislation.

Securities transfer legislation is not designed to produce a competitive advantage—its purpose is to remove obstacles and uncertainties that would otherwise impede commercial activity. Its

³⁷ Rogers, “Policy Perspectives”, *supra* note 13 at 1544.

primary function is to support commercial activity without attempting to define or shape that activity. Settlement rules do not dictate how securities settlement systems work—settlement practices dictate what rules are needed. Optimally, the law will also accommodate continuing innovations and the evolution of commercial practice, but it should not attempt to influence the direction of such developments.³⁸

To the extent that existing law does not support existing commercial practices, then reformed securities transfer legislation may be said to remove a competitive disadvantage. That is very different from seeking a unique competitive advantage, because it is in everyone's commercial interests to share the reformed system with their trading partners.

Similarly, there is no advantage to be gained by finding a unique method of expressing the law to produce the same substantive effect as Rev8. For market participants, the pinnacle of achievement for commercial law is *uniform law that works*. Legal innovation that does not address a recognized deficiency in the existing law, and which produces non-uniformity, is highly undesirable. It imposes extra costs (e.g. legal opinions to assess risk) and creates uncertainty that may isolate the jurisdiction with non-uniform commercial law.

One of the most remarkable characteristics of securities transfer law is the lack of case law interpreting it. This may be seen as a tribute to its effectiveness, but it also has important implications for how we assess this law. In the absence of litigation, the assessment must be based on how much *confidence* users have in the system (“system-confidence”). System-confidence becomes a matter of consensus among all the users in the global securities market. For some users, system-confidence is based primarily on exhaustive legal analysis, but for most users, system-confidence is based on more general perceptions, and reliance upon the assessment of others.

Once we recognize the importance of system-confidence in assessing securities transfer law, it becomes difficult to see how or why

³⁸ This has been referred to as the “neutrality principle” reflected in the drafting approach to Rev8. See the Prefatory Note to Revised (1994) Article 8 of the Uniform Commercial Code.

any single jurisdiction (except the U.S.) would attempt to improve upon a system like Rev8, which already enjoys the collective confidence of the global securities market. If we try to make improvements in a Canadian version, and then try to convince the world that our version is actually better than Rev8, would anybody listen? Would market participants in other jurisdictions do an exhaustive legal analysis of Canadian securities transfer law, endorse our version, and spread that confidence throughout the global securities market? Or would we be branded as a jurisdiction with special legal risk?

These are crucial and delicate questions. There is much at stake, and it is impossible to know in advance how much system-confidence unique Canadian legislation would inspire. It seems obvious that the easiest and safest path is for Canada to exploit its historical links with the U.S. and model Canadian settlement rules closely upon Rev8, thereby achieving the same level of system-confidence as the U.S. now enjoys.

Future Developments

Securities markets have evolved more rapidly than most other markets. We must expect that evolution to continue, and anticipate that we will eventually need to revise our securities transfer law again. That prospect points to some of the practical impacts of Rev8, and the benefits of uniformity.

Future developments in securities transfer law will most likely take the form of amendments to Rev8.³⁹ If that is correct, those jurisdictions with existing legislation modeled closely upon Rev8 (“uniform jurisdictions”) will be in the best position to participate in the process, to assess and respond to the amendments.

Mr. Sommer’s analogy between securities transfer systems and computer systems legislation is particularly appropriate in this context—an off-the-shelf system upgrade only works if your existing system is

³⁹ This is because the U.S. has, through the National Conference of Commissioners on Uniform State Laws and the American Law Institute, the most responsive process for developing and enacting such amendments.

compatible. If your existing system is compatible, then your views on its shortcomings, or how it could be improved, are of interest to all other users of that system, and may be addressed during work on the next upgrade. If your existing system is not compatible, then your problems are your own, and you must develop your own system upgrade, which can be prohibitively expensive.

It is also possible that future developments in securities transfer law will occur through litigation and case law interpreting Rev8. In that event, uniform jurisdictions will again be in the best position to participate in the process, to assess and respond to the situation. Assuming that such litigation involves some alleged uncertainty in Rev8, history suggests that the courts will make every effort to interpret Rev8 to support global commercial practices. A positive outcome would immediately restore and confirm system-confidence, but only in uniform jurisdictions. The effect in non-uniform jurisdictions may be just the opposite but would, in any event, likely provoke a re-assessment of legal risk.

If the outcome of the litigation were unfavorable, uniform jurisdictions would presumably turn to the amendment process described above. Non-uniform jurisdictions would have to assess the consequences individually.

Achieving Uniformity

We have a mandate for uniformity within the common-law provinces of Canada, and as-much-uniformity-as-possible with Rev8.⁴⁰

⁴⁰ The Uniform Law Conference of Canada has asked the Canadian Securities Administrators (“CSA”) to prepare a draft Uniform Securities Transfer Act and commentaries, and to publish such draft for comments. The CSA agreed, and approved a proposal by the CSA Settlement Rules Task Force to use a consortium of legislative counsel representing Alberta, BC, Ontario and Quebec to draft the legislation. The general instructions to legislative counsel were to prepare a draft Act suitable for provincial enactment in accordance with the Report of the ULCC Production Committee. More specifically, legislative counsel were instructed to address the following priorities (in this order), using the best ideas and resources available:

Leaving aside the challenges of achieving uniformity within Canada for the time being, this section will identify two challenges to achieving uniformity with Rev8, and the following sections will discuss them in more detail.

The first challenge arises from the fact that the general drafting style of Rev8 is quite different from Canadian legislative drafting. Rev8 uses a different style of numbering and organization. Some of its definitions include more substantive law than is normally found in Canadian definitions. Many of its provisions reflect a considerably more narrative style than is found in Canadian law. Quite simply, Rev8 does not come close to complying with Canadian drafting protocols, and the issue is what to do about that.

The second challenge arises from the significance of the Official Comment⁴¹ to Rev8. The Official Comment is roughly 3 times longer than the actual legislative provisions of Rev8. Although it is not formally a part of the legislation, the Official Comment is a practically indispensable interpretive tool for users of Rev8. The Official Comment presents a challenge because it is needed to ensure that Canadian courts give Canadian law the same substantive effect as Rev8, and that users have the same system-confidence in Canadian law as they do in Rev8.

The Official Comment and General Issues of Interpretation

- 1) The final product must be implementable in each province without amendment. This assumes uniformity in the common law provinces, and as close-to-uniformity-as-possible in Quebec having regard to Quebec's civil code requirements. In other words, we want legislative counsel in the common law provinces to find a way to compromise their individual provincial drafting protocols to the extent necessary to produce an implementable uniform statute.

- 2) The final product should be as uniform and harmonious as possible with Rev8.

⁴¹ Including the Prefatory Note.

If Canadian Courts were ever called upon to interpret Canadian securities transfer legislation that was modeled closely upon Rev8, it appears that they would have access to Rev8, its history, related academic commentary, and the Official Comment.

The purposive interpretation of legislation will include consideration of related legislation.⁴² This review of related legislation also extends to an examination of the policy considerations and other external facts relevant to the legislation of other jurisdictions.⁴³

It could perhaps be argued that the Official Comment is not available to the courts as an interpretive tool because it is an “extrinsic aid”⁴⁴ that falls within either the “partial exclusion rule”,⁴⁵ or the more general “exclusion rule”.⁴⁶ In practice, however, it appears that the “partial” rule is partially ignored, while the general rule is generally ignored.⁴⁷ There are a number of Canadian decisions that refer to the

⁴² In *Barrette v. Crabtree Estate* [1993] 1 S.C.R. 1027, the Supreme Court of Canada was called upon to interpret section 114(1) of the *Canada Business Corporations Act*. The Court considered the background of the provision as the starting point for its interpretation. L’Heureux-Dubé J. examined New York corporate law dating from 1848, and its evolution over time, with reference to law review articles describing the purpose and effect of various amendments during that period. She did the same with Canadian legislation, referring also to Canadian texts, in order to establish the legal context within which to interpret the provision.

⁴³ See *Hills v. Canada (A.G.)*, [1988] 1 S.C.R. 513 at 528 and 534-6.

⁴⁴ Extrinsic aids are all materials, other than the text of legislation, that could prove useful in interpreting the legislation. See *Driedger, supra*, note 5 at 427.

⁴⁵ This rule applies to reports of government commissions or other bodies that have investigated a condition or problem and recommended a legislative response. The rule permits such material to be used as evidence of external facts, or to expose the mischief or condition addressed by the legislation addressed, but not as direct evidence of legislative meaning or purpose. *Ibid.* at 432-5.

⁴⁶ This rule applies to other material making up the legislative history of an enactment, with the exception of commission reports as described in the preceding footnote. Such material cannot be used as either direct evidence of legislative intent, not as evidence of external facts or the mischief or condition addressed by the legislation. *Ibid.* at 435-449.

⁴⁷ *Ibid.*

Official Comment to other Articles of the UCC in interpreting related Canadian legislation,⁴⁸ so it seems clear that we can obtain the benefit of the Official Comment to Rev8 provided Canadian legislation, on its face, appears intended to mean the same thing as Rev8. The cases involving cross-jurisdictional comparison demonstrate that differences in wording will be examined carefully to determine whether a different meaning is intended.

In *Morguard Properties Ltd. v. City of Winnipeg*⁴⁹, the Supreme Court of Canada interpreted a provision in Manitoba legislation by contrasting it with similar legislation from two other provinces. The Court observed that it was “not without significance” that the Manitoba legislature had before them the legislation of the other two provinces when they prepared and enacted the Manitoba provisions. The Court concluded that differences in wording between the Manitoba provisions and the legislation of the other two provinces were deliberate and signified a different intention.

In the *Morguard* case, the differences in wording were not particularly subtle. A more troubling Canadian decision involving cross-jurisdictional comparison is *Re Canada Labour Code*⁵⁰, where the Supreme Court of Canada was called upon to interpret a provision in the Canadian *State Immunity Act*. The Court found it useful to consider first the common law antecedents to the *Act*, and then to compare Canada’s

⁴⁸ See *Westpac Banking Corp. v. Duke Group Ltd.* (1994), 20 O.R. (3d) 515 (Ont. Gen. Div.), referring to the Official Comment to UCC ‘5-103; *R.C.L. Operators Ltd. v. National Bank of Canada*, [1995] N.B.J. No. 545 (N.B.C.A.), referring to the Official Comment to UCC Article 3; *Camco Inc. v. Frances Olson Realty (1979) Ltd.*, [1986] S.J. No. 519 (Sask. C.A.), referring to the Official Comment to UCC ‘9-307; *Bank of Nova Scotia v. McIvor* (1986), 57 O.R. (2d) 501 (Ont. D.C.), referring to the Official Comment to UCC Article 9; *Agricultural Credit Corp. of Saskatchewan v. Royal Bank of Canada*, [1994] S.J. No. 313 (Sask. C.A.), referring to the Official Comment to UCC Article 9; and *Spittlehouse v. Northshore Marine Inc.*, [1994] O.J. No. 809 (Ont. C.A.), referring to the Official Comment to UCC Article 9.

⁴⁹ (1983), 3 D.L.R. (4th) 1 (S.C.C.).

⁵⁰ [1992] S.C.R. 50.

codification of the common law with the statutory model in the United States, upon which the *Canadian Act* was patterned.

The relevant provision in the *Canadian Act* said:

“commercial activity” means any particular transaction, act or conduct or any regular course of conduct that by reason of its nature is of a commercial character; [emphasis added]

The equivalent provision in the United States statute said:

A “commercial activity” means either a regular course of commercial conduct or a particular commercial transaction or act. The commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose. [emphasis added]

The issue was whether the definition in the *Canadian Act* was intended to mean something different from the U.S. statute. The Canada Labour Relations Board and the Federal Court of Appeal both found that what is explicit in the U.S. definition—the exclusion of consideration of the purpose of the activity—is implicit in the Canadian definition. The Supreme Court disagreed. La Forest J., for the majority, said:

By excluding the qualifying language found in the American model, Parliament, it seems to me, must have intended that purpose was to have some place in determining the character of the relevant activity.⁵¹

Cory J., dissenting on another point, interpreted the provision the same way, saying:

The material shows that the drafters of the *Canadian Act* were aware of the particular wording of the American legislation. I would infer that they departed from it intentionally.⁵²

⁵¹ *Ibid.* at 74.

⁵² *Ibid.* at 106.

A close examination of this case reveals that the Supreme Court's interpretation probably produced the most uniform interpretation of the Canadian and American legislation.⁵³ That is, however, small comfort for any drafter assigned the task of reproducing the substantive effect of Rev8 in Canadian legislation, because this case clearly illustrates the potential hazards of using non-uniform language to say the same thing.

Drafting Protocols

Drafting protocols are a sensitive subject, because every jurisdiction is naturally somewhat defensive of their own. Also, drafting protocols are an important part of the intellectual capital of legislative drafters, and they are naturally reluctant to part with that, or to see it devalued in any way. Drafting protocols serve a necessary and valuable purpose for most legislation. However, adherence to drafting protocols is problematic with uniform legislation because it has a tendency to introduce non-uniform elements without any intent to produce substantive differences in the legislation.

Drafting protocols are by no means the only, or even the major, obstacle to uniformity in Canada. There is also a very significant political element involved. There are strong arguments for relaxing drafting protocols, and mobilizing political will, in order to produce and enact uniform commercial legislation, such as a Canadian equivalent to Rev8. These are essentially the same arguments that have existed since 1918 when the Uniform Law Conference of Canada was founded to promote uniform legislation in Canada, largely in response to the success of the National Conference of Commissioners on Uniform State Laws. It is unfortunate that these arguments have not been as effective in Canada as

⁵³ Justice La Forest's analysis shows that, notwithstanding the explicit exclusion of any consideration of purpose in the American statute, American courts actually applied a contextual approach to the characterization of state activity, which included some consideration of purpose. See *ibid.* at 74-6 and at 106-7, where Cory J. reaches essentially the same conclusion.

they have in the U.S., as reflected by Canada's relative lack of uniform commercial law.⁵⁴

For the reasons described throughout this paper, Rev8 is an extremely powerful impetus for a uniform, global securities transfer law. In order to produce a uniform Canadian version of Rev8, it will be necessary to bend, break and otherwise abuse our Canadian drafting protocols.

I suggest that we should not hesitate to depart from our drafting protocols when dealing with global uniform law, and that we should anticipate increasing pressures to do so, especially in other branches of commercial law.

Globalization and Language

It may be useful to consider the effects of globalization on legislative language as just one manifestation of a more general effect of globalization—the disappearance of local languages and dialects as young people choose to learn and use more dominant languages.⁵⁵ This process has nothing to do with the inherent value or virtues of any particular language—it has everything to do with the usefulness of particular languages. Languages like English or Spanish dominate, not because they are better, but because they are more ubiquitous and, therefore, more useful than local languages.

⁵⁴ The adoption of Rev8 by the New York legislature illustrates how they valued and preserved uniformity. The legislature identified a lack of clarity in some of the new provisions of Part 5 but, instead of enacting non-uniform provisions, the legislature made a statement of “legislative intent and declaration” describing how it intended the uniform provisions to be interpreted. See L.997, c.566, §1.

⁵⁵ There are approximately 6,000 languages spoken in the world today. As many as 1,000 have died in the past 400 years. Linguists predict that, in the next 100 years, 50-90% of existing languages will die. See D.L. Wheeler, “The Death of Languages” in *The Chronicle of Higher Education*, April 20, 1994, v. 40; M. Brace, “Mind Your Languages” in *Geographical*, November 1999; and E. Shorris, “The Last Word” in *Harper's Magazine*, August 2000.

Rev8 is, in effect, a dominant legislative language. We should recognize that the legislative language in the Canadian version of Rev8 is only useful if it is recognized to say *the same thing* as Rev8. We should not resist using common language for this purpose. It makes sense to do so because it achieves the fundamental objective, even if it may seem to entail a certain loss of individuality or national pride.⁵⁶ It seems odd that we might consider trying to create a “Canadian dialect” of securities transfer law when we can see that globalization is everywhere pushing such dialects towards extinction at the hands of more common language.

⁵⁶ Consider the decision by Air France to order its pilots to speak English to air-traffic controllers at Charles de Gaulle airport in Paris. See *The Globe and Mail*, March 29, 2000, p. 1.

APPENDIX

Proposed Reforms to Canadian Securities Transfer Law: History and Background

Introduction

This appendix is intended to provide some additional context for a discussion of drafting issues. It will briefly examine the evolution of securities transfer law, the relationship between Canadian and American law in this area, and the relationship between commercial practice, securities transfer law and codification. It will also provide a general conceptual description of the proposed reforms to Canadian securities transfer law.⁵⁷

⁵⁷ This Appendix is partially based upon an earlier summary of the policy issues and some of the technical details of the proposed reforms in the ULCC Production Committee Report, *supra*, note 26. That Report draws heavily upon U.S. materials on this subject. The essential U.S. materials on this subject include a series of articles published in Volume 12 of the *Cardozo Law Review* (1990): C. Mooney, "Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries" ("Beyond Negotiability") at 305; M.J. Aronstein, "The New/Old Law of Securities Transfer: Calling a 'Spade' a 'Heart, Diamond, Club or the Like'" at 429; E. Guttman, "Transfer of Securities: State and Federal Interaction" at 437; J.S. Rogers, "Negotiability, Property, and Identity" at 471; M.E. Don and J. Wang, "Stockbroker Liquidations Under the Securities Investor Protections Act and Their Impact on Securities Transfers" at 509; and J.L. Schroeder and D.G. Carlson, "Security Interests Under Article 8 of the Uniform Commercial Code" at 557. See also the Prefatory Note and Official Comments to American Law Institute & National Conference of Commissioners on Uniform State Laws, *Uniform Commercial Code Revised Article 8 Investment Securities (With Conforming and Miscellaneous Amendments to Articles 1, 4, 5, 9, and 10)* (1994 Official Text with Comments). The most current and complete summary of the U.S. material is J.S. Rogers, "Policy Perspectives", *supra*, note 13. Professor Rogers served as Reporter to the Drafting Committee to revise U.C.C. Article 8, and the ULCC Production Committee Report draws particularly heavily upon Professor Rogers' article. The Canadian perspective on this subject is reviewed in the ALRI Report, *supra*, note 17, copies of which are available upon request from the Alberta Law Reform Institute at 402 Law Centre, University of Alberta, Edmonton, Alberta, T6G 2H5; fax (403) 492-1790; email: reform@alri.ualberta.ca.

The First Era in the Evolution of Securities Transfer Law—in Pursuit of Negotiability

Most of Canada and the U.S.⁵⁸ inherited the British common law tradition, and many aspects of British commercial law. Where there are differences between British and U.S. commercial and corporate law, and especially in the area of securities transfers, Canadian law has shown a definite tendency to depart from the British tradition and to follow the U.S. approach. Canadian law governing securities transfers developed more slowly than U.S. law, but in very much the same direction, because the practices in the Canadian securities industry have always tended to follow U.S. practices.⁵⁹ Because Canadian law has always tended to follow U.S. law in this area, it is useful to first examine the evolution of U.S. law, and then examine Canadian law.

Evolution and Codification of U.S. Law up to 1977

Early Anglo-Canadian and Anglo-American law provided that shares were transferable only by registration on the books of the company. This process was too slow and cumbersome to meet the needs of the growing stock market, which required a faster and more reliable method of transferring shares. By the late 1800's, it was common practice for share certificates, endorsed in blank, to be traded on organized markets as though the certificates were the physical embodiment of the shares

⁵⁸ Louisiana and Québec are civil law jurisdictions.

⁵⁹ In *Clarke v. Baillie* (1911), 45 S.C.R. 50, 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.”

themselves.⁶⁰ In other words, the commercial practice was to treat such certificates as if they had certain attributes of negotiability.⁶¹

At that time, the common law was clear that share certificates were not full-fledged negotiable instruments in the sense that bills of exchange and promissory notes were negotiable. However, the common law had evolved to accept and support the commercial practices of the stock market by giving share certificates certain attributes of negotiability.⁶²

⁶⁰ This practice depended on the equitable doctrine of estoppel. See 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.

⁶¹ Negotiability at common law generally means that: an instrument is transferable by delivery (this mode of transfer is known as “negotiation”); and that a transferee who becomes a “holder in due course” or a “*bona fide* purchaser” (by acquiring an instrument that is complete and regular on the face of it, in good faith, for value, and without notice of any defect in the title of the transferee) obtains title free from any defect in (and sometimes the lack of) title of the transferor. See Crawford and Falconbridge, *Banking and Bills of Exchange*, 8th ed. (Toronto: Canada Law Book Inc., 1986) at 1173.

⁶² In *McNeil v. The Tenth National Bank* (1871), 46 N.Y. 325, the New York Court of Appeals said (at p. 331):

“The common practice of passing the title to stock by delivery of the certificate with blank assignment and power, has been repeatedly shown and sanctioned in cases which have come before our courts.”

In *Knox v. Eden Musee Americain Co., Ltd.* (1896), 42 N.E. 988 the New York Court of Appeals said of share certificates (at p. 992):

“They are not negotiable in form, they represent no debt, and are not securities for money. But the courts of this country, in view of the extensive dealing in certificates of shares in corporate enterprises, and the interest both of the public and the corporation which issues them in making them readily transferable and convertible, have given to them some of the elements of negotiability. The owner of shares may transfer his title by delivery of the certificate with a blank power of attorney indorsed thereon, signed by the owner of the shares named in the certificate. Such a delivery transfers the legal title to the shares as between the parties to the transfer, and not a mere equitable right.” [citing *McNeil v. The Tenth National Bank*]

Even so, share certificates had not acquired all the attributes of negotiability. One particular shortcoming in the common law was that, if the properly endorsed share certificate had been lost or stolen, even a *bona fide* purchaser did not obtain good title to it.⁶³ This shortcoming produced an element of risk, however small, in every transaction. Moreover, it was practically impossible to protect against that risk because to do so would require tracing back the chain of ownership of every certificate.

It was recognized in the U.S. that this situation was unacceptable as a matter of policy,⁶⁴ but legislation was required in order to overcome the problem. This came in the first codification of securities transfer law in 1909 when the National Conference of Commissioners on Uniform State

⁶³ See F.L. Dewey, “The Transfer Agent’s Dilemma: Conflicting Claims to Shares of Stock” (1939) 52 Harv. L. Rev. 553 at 555.

⁶⁴ The general attitude was well summarized in *Cook on Corporations*, 6th ed. (Chicago: Callaghan and Co., 1908) Vol. 2 at 1143-4, where the author said:

“Perhaps the most striking industrial feature of modern times is the accumulation of personal property, and the investment of that property, not in landed estates, but in the stocks and bonds of corporations.... It would hardly be an exaggeration to say that the law governing stocks and bonds, in the magnitude of the interests, the number of persons affected, and the variety of legal principles involved, is more important than all other branches of law combined....It is fitting, in these days of the formative period of the law governing corporations and stock, that the principles governing the transfer of certificates should favor the protection and security of the investing public, and should be against secret liens, attachments, claims, and negligence of both the corporation and third persons.”

The author goes on to cite *Masury v. Arkansas Nat. Bank* (1899), 93 Fed. Rep. 603, where the U.S. circuit court of appeals said:

“In the great majority of cases when stock is merely pledged for a loan, no record of the transfer is made on the books of the corporation, and in the judgment of laymen the making of such a record seems to be a needless formality. The trend of modern decisions has been to encourage the free circulation of stock certificates in the mode last indicated, on the theory that they are a valuable aid to commercial transactions, and that the public interest is best subserved by removing all restrictions against their circulation, and by placing them as nearly as possible on the plane of commercial paper.”

Laws introduced the *Uniform Stock Transfer Act*, which was eventually adopted by all 50 states.

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.⁶⁵

The *Uniform Stock Transfer Act*, unlike the common law, protected a *bona fide* purchaser of certificates endorsed in blank by the owner, even where the certificates were stolen from the owner.⁶⁶

The *Uniform Stock Transfer Act* dealt only with transfers of corporate shares because, at that time, the market was truly a "stock market". By the time work began on the UCC in 1942, the market had changed and there was a need for transfer rules governing debt and non-corporate securities, as well as shares.

The UCC was first introduced in 1952.⁶⁷ UCC Article 8 was described as "a negotiable instruments law dealing with securities".⁶⁸

⁶⁵ 6 U.L.A. at 2.

⁶⁶ *Turnbull v. Longacre Bank* (1928), 163 N.E. 135 (Court of Appeals of New York).

⁶⁷ Significant revisions to the original Article 8 were made in 1958, 1962, 1977 and 1994. The first state to adopt the UCC was Pennsylvania in 1953, but most states did not adopt the UCC until after the 1958 revision. All 50 states have adopted that version or later versions. 49 states (plus Puerto Rico and the District of Columbia)

Article 8 was generally “intended to codify the better case law and commercial practice in the securities field rather than to change the law”.⁶⁹

Article 8 provided that securities certificates were negotiable instruments,⁷⁰ which provided an effective legal foundation for the practice of settling securities transactions by delivering physical certificates. That practice worked well enough until the late 1960s, when a sharp increase in trading volumes overwhelmed the paper-based system.⁷¹ This provided the impetus for a number of legal and operational innovations to clearance and settlement systems.

The major legal innovation was the 1977 revision to UCC Article 8, which introduced a new set of provisions designed to permit the use of uncertificated securities. At that time, it was thought that a certificateless system might evolve where issuers would not issue certificates at all. Transfers would be settled by registration on the books of the issuer according to an “instruction” provided to the issuer by the previous registered owner. The 1977 revision was not entirely successful because, as it turned out, the system evolved in quite a different direction, which eventually led to the need for the 1994 revision to UCC Article 8.

Before examining the developments leading up to the 1994 revision to UCC Article 8, it is convenient to pause here to review the evolution and existing state of Canadian securities transfer law because Canadian law is currently at approximately the stage of development as U.S. law was with the 1977 revision.

have adopted the 1994 revision. It has been introduced to the legislature in the remaining state, South Carolina, in 2000.

⁶⁸ Uniform Code Comment to §8-101, 1958 Official Text.

⁶⁹ C. Israels, “Investment Securities as Negotiable Paper—Article 8 of the Uniform Commercial Code” (1958) 13 Bus. Law. 676 at 679.

⁷⁰ §8-105.

⁷¹ This event, known as the “back-office crisis”, “paperwork crunch” or “paperwork crisis”, is described in some detail in the ALRI Report, *supra*, note 17 at 20-23.

Evolution of Canadian Securities Transfer Law Prior to Codification

Canada does not have a Uniform Commercial Code.⁷² Because of this, securities transfer legislation has generally been located in corporate statutes. Prior to the 1970's, the securities transfer provisions in Canadian corporate statutes were very brief, and could not be described as any kind of comprehensive codification.

Prior to codification, there were a number of Canadian cases dealing with the question of whether share certificates endorsed in blank were negotiable instruments. These cases generally followed the same path as U.S. common law prior to the Uniform Stock Transfer Act of 1909, holding that such certificates were not negotiable instruments. If the owner delivered such certificates to a broker, and the broker fraudulently sold or pledged them, then the owner was estopped from asserting any claim as against a *bona fide* purchaser for value.⁷³ But if such 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.⁷⁴

⁷² The Uniform Law Conference of Canada is working towards a "Commercial Law Strategy" that would produce more uniform commercial legislation in Canada. See "Towards a Commercial Law Framework for Canada" at www.law.ualberta.ca/alri/ulc. Information about the project is available from the National Coordinator of the Commercial Law Strategy, Hélène Yaremko-Jarvis, email: hmyj@hotmail.com. See also J. Babe "Uniform commercial law—an impossible dream?" in *The Lawyers Weekly*, September 15, 2000 at p. 9.

⁷³ 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 *Melanson v. McCleave*, the Court suggests that perhaps the certificates were negotiable instruments, but stops short of deciding that they were (see p. 590).

⁷⁴ See *Chartered Trust & Executor Co. v. Pagon*, [1950] 4 D.L.R. 761 (Ont. H.C.); *Whitehead v. Bridger, Hevenor & Co.*, [1936] 3 D.L.R. 408 (Ont. C.A.); *Aitken v. Gardiner and Watson et al.* (1956), 4 D.L.R. (2d) 119 (Ont. H.C.); and *Goodbody v. Bank of Montreal* (1974), 4 O.R. (2d) 147 (H.C.J.). In *Aitken v. Gardiner and Watson*, the Court notes that its position is the same as the common law position

The British Columbia Court of Appeal was the only Canadian court to hold that share certificates endorsed in blank were negotiable instruments at common law. In *Patrick v. Royal Bank of Canada*,⁷⁵ Mr. Patrick endorsed share certificates in blank and gave them to his broker, who wrongfully pledged the certificates to the bank. The Court held that the bank was entitled to the shares on the basis that the certificates were negotiable instruments, taken by the bank in good faith.

The most significant aspect of the *Patrick* decision was the way the Court reached the conclusion that the share certificates were negotiable instruments. The Court noted that this particular transaction was made in the ordinary course of business, like thousands of others that occur daily. The Court adopted the commercial practice, custom or usage regarding the negotiability of certificates and the use of signature guarantees.⁷⁶ In accepting the evidence of usage or custom as establishing negotiability, the Court referred⁷⁷ to *Goodwin v. Roberts*⁷⁸, the leading decision on how the English courts accepted the evolving customs or usages of merchants and traders (the “law merchant”) as part of the common law.

Codification of Canadian Securities Transfer Law

The first comprehensive codifications of securities transfer law in Canada arose from corporate law reform initiatives in the late 1960’s. These codifications had two consistent objectives: 1) to make the law consistent with prevailing commercial practices; and 2) to achieve uniformity with the UCC.

taken in U.S. courts, aside from the operation of the Uniform Stock Transfer Act (see pp. 132-3).

⁷⁵ [1932] 2 W.W.R. 257, reversing [1931] 3 W.W.R. 100 (B.C.S.C.).

⁷⁶ *Ibid.* at 269-70.

⁷⁷ *Ibid.* at 262-3.

⁷⁸ (1876), 1 App. Cas. 476 (H.L.); affirming (1875), L.R. 10 Exch. 337; affirming (1875), L.R. 10 Exch. 76.

In 1967, the Interim Report of the Select Committee on Company Law in Ontario made a number of recommendations regarding share transfer legislation.⁷⁹ It concluded that existing law was incompatible with existing commercial practices, and that the law should be changed by deleting the existing provisions and “substituting therefore a corporate securities transfer code modelled closely after Article 8 of the UCC with appropriate changes in terminology”. The Report went on to say:

The adoption of such a securities transfer code should not, if it is submitted, interfere adversely with the developed practices of Canadian stock exchanges and the financial community generally. In fact, one of the effects of the adoption of such a code would be to bring the statutory law in line with such practices and, in the opinion of the Committee, would significantly upgrade the prevailing practices to the mutual benefit and advantage of the investing public, the stock exchanges, and transfer agents and brokers. The code would broadly define the “securities” to which it applies and would state that such securities would be negotiable instruments.⁸⁰

The Report led to the *Ontario Business Corporations Act, 1970* (“OBCA”) but, unfortunately, the securities transfer provisions in that Act fell considerably short of the expectations described in the Report. It did not, for example, specify that security certificates were negotiable instruments, and it made a number of modifications to the Article 8 model.

At this same time, the federal government was re-examining the *Canada Corporations Act*. A task force was appointed in 1967 which produced the 1971 *Dickerson Report*.⁸¹ It criticized the modifications of the UCC model made by the OBCA, and advocated the advantages of uniformity with Article 8. The *Dickerson Report* says:

⁷⁹ *Interim Report of the Select Committee on Company Law*, Chairman A.F. Lawrence, Ontario Legislative Assembly: 1967 at pp. 40-45; paras. 6.1.1 to 6.2.3.

⁸⁰ *Ibid.* at 44.

⁸¹ 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).

Given the inherent complexity of security transfer problems—and the obvious need for uniform laws within the North American securities markets—it is unfortunate that the provisions of the [OBCA] depart in substance from the Uniform Commercial Code model which its draftsmen purported to adopt.... Some have deprecated the adoption of the U.C.C. model. For the above reasons we think that such adoption is obviously justified. And even if the language of the U.C.C. is frequently inelegant or the system sometimes lacks logical symmetry, U.C.C. Article 8 has two unassailable advantages: first, it is written in the language of transfer agents, reflecting business reality; second, it has worked for a considerable time in many jurisdictions without the need for substantial judicial interpretation. In the light of this experience, tampering with a demonstrably good model hardly appears warranted.⁸²

The *Dickerson Report* formed the basis for *The Canada Business Corporations Act* (“CBCA”).⁸³ The securities transfer provisions in the CBCA are very similar to the pre-1977 version of Article 8.

The CBCA was used as a model by several provincial corporate statutes, including the *Alberta Business Corporations Act*.⁸⁴ In 1982, the *OBCA* was amended to conform quite closely with the securities transfer provisions of the *CBCA*. Since then, the *OBCA* has been amended twice (in 1986 and 1995) in an effort to keep its securities transfer provisions compatible with current commercial practices relating to book-entry settlement of securities transactions. Those amendments incorporate some aspects of the 1977 amendments to *UCC* Article 8 relating to uncertificated securities, but still rely upon the concepts of possession and delivery of negotiable security certificates to complete a transfer or to perfect a pledge.

⁸² *Ibid.* vol. I at 59-60.

⁸³ *Canada Business Corporations Act*, originally enacted as S.C. 1974-75-76, c. 33, now R.S.C. 1985, c. C-44.

⁸⁴ S.A. 1981, c. B-15.

Book-entry Settlement and the Indirect Holding System

As noted earlier, the 1977 amendments to *UCC* Article 8 were “based upon the assumption that changes in ownership of securities would still be effected either by delivery of physical certificates or by registration of transfer on the books of the issuer.”⁸⁵ That assumption proved to be wrong. Although some issuers have started using a book-entry-only or certificateless system, most securities are still issued in traditional certificated form. To date, the problems with the physical handling of certificates have been alleviated mainly by the increased use of intermediaries to hold securities on behalf of others. Although some investors still take actual possession of security certificates and are registered with the issuer, most investors now hold securities through intermediaries, and securities settlement is handled by “accounting entries on the books of a multi-tiered pyramid of securities intermediaries.”⁸⁶

At the lower tier, the intermediaries are brokers, banks or trust companies holding securities on behalf of their customers. These brokers, banks and trust companies are typically participants in the upper-tier intermediary—a securities depository/clearing agency such as the Canadian Depository for Securities Limited (“CDS”).

CDS receives securities from its participants and holds them in fungible bulks.⁸⁷ CDS registers these securities in the name of a CDS

⁸⁵ See the Prefatory Note to Revised (1994) Article 8.

⁸⁶ *Ibid.* In this Appendix, the discussion is limited to a basic two-tier system: e.g. a customer deals with a broker (lower tier); the broker deals with the depository (upper tier). There may be more than two tiers. For example, in the context of what were formerly called “service arrangements”, now “introducing and carrying broker arrangements”, the customer may deal with an introducing broker (lower tier), who deals with a carrying broker (middle tier), who deals with the depository (upper tier). See Investment Dealers Association of Canada Compliance Interpretation Bulletin C-111, March 4, 1997. See also the definition of “multi-tiered securities holding system” in *Cross-Border Clearance*, *supra*, note 12 at 55. The additional tier (or tiers) do not significantly affect the system.

⁸⁷ Current Canadian law, which is based on *UCC* 1-201(17), defines fungible to mean “...in relation to securities, securities of which any unit is, by nature or usage of trade, the equivalent of any other like unit”. See for example *CBCA* s. 48(2), where

nominee, and maintains accounts showing the entitlements of each participant. Securities market transactions are reported to CDS, which then performs two separate functions: clearance and settlement. Clearance involves the calculation of each participant's net obligations, which greatly improves the efficiency of processing. Settlement is the actual transfer of money and securities to satisfy those net obligations.

Since most transactions occur between CDS participants, settlement of the security-transfer obligations can be done 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 is called "book-entry" settlement.

Currently, CDS holds nearly \$2 trillion worth of securities on deposit. The gross value of trades reported to CDS ranges between \$100 and \$150 billion daily, exceeding \$350 billion on busy days. The efficient clearing process distills the total down to about \$5 to \$10 billion in actual settlement obligations daily. Less than 1% of the trades reported to CDS result in withdrawals of certificates from the depository, with the balance settled electronically by book-entry.

Book-entry settlement only operates with securities positions held by intermediaries who are participants in the depository/clearing agency. This practice of holding securities through intermediaries is called the "indirect holding" system.⁸⁸ In the indirect holding system, persons holding securities positions through an intermediary are not shown on the issuer's records (in the case of registered securities), nor do they have actual possession of negotiable certificates (in the case of unregistered securities such as bearer bonds). Instead, the securities are registered to, or

"securities" refers to certificates, and *OBCA* s. 53(1), where "securities" refers to the underlying intangible interest. Because securities of the same issue are fungible there is normally no need to keep them separately identifiable and they are held in bulk. The use of such "fungible bulks" is a significant contributor to the efficiency of depository operations.

⁸⁸ The Prefatory Note to Revised (1994) Article 8 of the Uniform Commercial Code noted that, in the U.S., the nominee of The Depository Trust Company (the predecessor to DTCC) held 60-80% of the outstanding shares of all publicly-traded companies.

in the actual possession of, CDS. The records of CDS show the securities held on behalf of its various participant brokers, banks and trust companies. The records of each such participant show the securities held on behalf of their individual customers.

The indirect holding system contrasts with the “direct holding” system, where such individual customers are registered on the records of the issuer, or in actual possession of unregistered negotiable certificates.

Book-entry settlement, combined with improved clearance techniques, provides an extremely efficient system for processing securities transactions. Where 10-million-share-daily-trading-volumes on the New York Stock Exchange paralyzed the securities settlement system in the late 1960s, the book-entry system handled over 600-million-share-daily volume during the October 1987 “market break”.⁸⁹ It would be impossible to settle the current daily volume of transactions by actual delivery of certificates.

Because many securities trades occur “back-to-back”, reducing the time lag between trading and settlement reduces risk in the settlement system.⁹⁰ In June 1995 the settlement period for most securities transactions was shortened from 5 days to 3 days (“T+3”).⁹¹ In addition to reducing risk, this effectively forced all actively-traded securities into the indirect holding system.⁹²

⁸⁹ J.S. Rogers, “Policy Perspectives”, *supra*, note 13 at 1445. On October 26, 2000 the combined trading volume of the NYSE and NASDAQ exceeded 3.5 billion shares.

⁹⁰ J.S. Rogers, “Policy Perspectives”, *supra*, note 13 at 1438-41.

⁹¹ The SEC has asked the markets to move to T+1 settlement by June 2002, but implementation of this change may be delayed.

⁹² Shortly before the change to T+3, it was stated that:

“Today, if the security is held in certificated form, sufficient time exists for the intermediary to deposit it to the book-based depository. When T+3 is implemented, this option will not be practical, so securities must be in book-entry form before they are traded.”

Problems with Existing Canadian Law

As noted above, current Canadian law and pre-1994 versions of UCC Article 8 rely upon the concepts of possession and delivery of negotiable certificates to complete a transfer or to perfect a pledge. This works very well for transfers or pledges within the direct holding system, because the direct holding system is supported by what is, essentially, a specialized negotiable instruments code that has been evolving ever since the 1909 Uniform Stock Transfer Act. Similar rules have been operating reliably for transfer or pledges within the direct holding system in Canada since the 1976 CBCA. The 1994 revision to Article 8 makes few changes to the direct holding system rules because few are needed.

The negotiability-based concepts of actual or deemed possession and delivery work less well when applied to the modern indirect holding system. This is not surprising, since they were not originally designed to describe indirect holding, but were pressed into service as the system evolved. They are essentially fictions, since there can be no actual possession or delivery of the intangible aspects of the property interest in the indirect holding system. They also rely upon equitable tracing rules that may be sound in theory, but very difficult to apply in practice, especially under the extreme conditions that arise during market disturbance or participant failure.

Uncertainties about the application of the old rules arose during the October 1987 stock market break. Details of this are complex and tedious,⁹³ but the problem was serious enough to prompt U.S. federal legislation and a major law reform project culminating in the 1994 revisions to Article 8.

⁹³ The most thorough analysis is by C.W. Mooney in “Beyond Negotiability”, *supra*, note 57. A more general discussion in the Canadian context is found in Chapter 6 of the ALRI Report, *supra*, note 17.

Revised Article 8—Evolving Beyond Negotiability

The objective of Rev8 was not to change securities holding practices, but to provide a clear and certain legal foundation for the practices that already dominated the market (the indirect holding system). The approach was to reform the rules to more accurately describe the special property interest of one who holds a book-entry security position through an intermediary, without the artificial constraints of negotiability-based concepts.

The Article 8 drafting technique was simple: first describe the special property interest, then name it.

Rev8 describes the relationship between the intermediary and the “entitlement holder” as follows:⁹⁴

- the entitlement holder does not take credit risk of the intermediary’s other business activities; that is, property held by the intermediary is not subject to the claims of the intermediary’s general creditors;
- the intermediary will maintain a one-to-one match between the assets that it itself holds and all of the claims of its entitlement holders;
- the intermediary will pass through to the entitlement holder payments or distribution made with respect to the securities;
- the intermediary will exercise voting rights and other rights and privileges of ownership of the securities in the fashion directed by the entitlement holder;
- the intermediary will transfer or otherwise dispose of the positions at the direction of the entitlement holder; and
- the intermediary will act at the direction of the entitlement holder to convert the position into any other available form of securities holding, e.g. obtain and deliver a certificate.

⁹⁴ J.S. Rogers, “Policy Perspectives”, *supra*, note 13 at 1450-1.

This package of rights and duties is called a “security entitlement”. It should be noted that the security entitlement is itself a unique form of property interest, not merely a personal claim against an intermediary.

The introduction of the security entitlement concept in Rev8 was a major evolutionary step in commercial law away from negotiability⁹⁵ This retreat from negotiability merely reflects the fact that the securities market has evolved past the point where the negotiability system can serve its needs.⁹⁶ The security entitlement cannot be properly understood or analyzed in terms of physical objects such as negotiable certificates.⁹⁷ The security entitlement represents a different legal paradigm, which has been described as the *law of financial accounts*.⁹⁸ This financial accounts paradigm is also incorporated in electronic funds transfers (Article 4A of the UCC) and the United Nations Commission on International Trade Law (UNCITRAL) Model Payment Law.⁹⁹

Advantages of the Security Entitlement Concept

⁹⁵ See C. Mooney, “Beyond Negotiability”, *supra*, note 57; and J.S. Rogers “Negotiability, Property, and Identity”, *supra*, note 57 at 478-84.

⁹⁶ “The demise of negotiability in the world of investment securities nicely illustrates the various causes that are gradually but surely leading to the extinction of the doctrine in all of its applications. First, negotiability doctrine rests on the assumption that the best way to transfer abstract rights is to embody them in pieces of paper and then physically deliver the papers from person to person. As the volume and velocity of trading increases, the requirement of physical delivery becomes an intolerable burden; once we pass from paper to electronic recording of financial relationships, delivery becomes a metaphysical absurdity.” J.S. Rogers, *ibid.* at 480.

⁹⁷ See J.S. Rogers, “An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons From the Article 8 Revision” (1995), 31 Idaho Law Rev. 689.

⁹⁸ See J.H. Sommer, “A Law of Financial Accounts”, *supra*, note 35.

⁹⁹ *Ibid.* at 1191-2.

The security entitlement concept provides a number of advantages over existing law. The advantages of the security entitlement concept derive from the simple fact that it is a more rational description of the unique property interest that is central to the indirect holding system. This produces clearer and more certain legal rules. What follows are specific examples of these advantages.

Distinguishing Direct vs. Indirect Instead of Certificated vs. Uncertificated

The format of the old rules was confusing because there was no clear distinction between the rules governing the direct vs. indirect holding systems. There was a definite distinction between the rules governing certificated vs. uncertificated securities. The revised rules recognize that the much more important distinction is between the direct and indirect systems, so these rules are clearly separated.

The distinction between certificated and uncertificated securities is retained, but to a lesser extent. The distinction is relevant only to the relationship between the issuer and the registered owner. Uncertificated securities may be held in either the direct or indirect holding systems, so both systems include rules dealing with them.

This produces a number of organizational changes to the legislation which should make it easier to understand.

The Entitlement Holder's Rights Are Only Against Its Own Intermediary

This is not a change in the law. It merely clarifies a reality of current practice that was obscured by the old rules.

Conceptually, the old rules define the property interest of an entitlement holder in terms of physical objects (certificates) that were normally held by an upper-tier intermediary (depository). This provides a legal foundation for the notion that the entitlement holder, or someone claiming through or against them, might be able to trace that property interest all the way to the depository. That notion is, however, impractical and inconsistent with the need for certainty in the settlement system.

The revised rules make it clear that the entitlement holder's rights may only be asserted against its own intermediary. This greatly simplifies the situation by identifying and locating the entitlement holder's property interest with their intermediary. So, for example, it becomes clear that a creditor wishing to seize the entitlement holder's property must deal with that intermediary.

Coherent Choice of Law Rules

Choice of law rules are extremely important because, like other industrialized countries, Canada has experienced explosive growth in cross-border securities trading (transactions between residents and non-residents).

Cross-border Trading of Bonds and Equities in Canada.¹⁰⁰

(as a percentage of GDP)

1970	1975	1980	1985	1990	1993
5.7	3.3	9.6	26.7	64.1	152.7

The old choice of law rules, using property-tracing concepts, cannot cope with the indirect holding system. For example, Canada's current pledging rules generally purport to apply the law of the jurisdiction where the collateral is located. For indirectly-held securities, that location

¹⁰⁰ Source: Bank For International Settlements, *Cross-Border Securities Settlements*, *supra*, note 12, Table 1, p. 9.

is difficult to determine, and often has no meaningful connection to the transacting parties. This adds uncertainty and risk to transactions.

Rev8 provides much clearer choice of law rules. As described above, the security entitlement is identified and located with a particular intermediary. There are detailed rules, but generally speaking the entitlement is located where the securities intermediary and its customer specify that it is located. In the absence of a specific agreement, the rules provide that it is located where the securities account is served, which will ordinarily be the same place where the entitlement holder deals with the securities intermediary. This makes it easy to determine the location of the property and applicable law in advance.

Finality of Settlement and the Reduction of Systemic Risk

Finality of settlement means that the transfer of a security, if performed according to certain rules, cannot be unwound. Finality has been a key objective of settlement rules since long before the indirect holding system. The early transfer rules applied negotiable instruments principles to stock certificates, so that a bona fide purchaser for value without notice acquired shares free from all adverse claims.

Over the years, revisions to the transfer rules were designed, successfully, to extend the finality principle to other types of certificated securities. However, there were difficulties in both concept and practice arising from the old rules' application of negotiable instruments concepts to the indirect holding system.

Rev8 abandons the terms “bona fide purchaser” and “good faith” in favour of rules that more clearly state when a purchaser does (or does not) obtain protection against adverse claims. The new term used is “protected purchaser”. Rev8 narrows, and thereby clarifies, the method of effectively asserting adverse claims and the rights and duties of intermediaries and issuers in respect of such claims.

Finality of settlement is just one component of a larger effort to control systemic risk throughout the financial system. Systemic risk is “the risk that the inability of one institution to meet its obligations when due

will cause other institutions to be unable to meet their obligations when due".¹⁰¹ In 1996, Canada enacted legislation designed to reduce systemic risk in the payment system.¹⁰² The reform of settlement rules is intended to reduce systemic risk in the securities settlement system.¹⁰³

Improved Rules Governing Secured Transactions

The old rules apply pledge concepts that relied upon deemed delivery and possession to perfect a security interest in indirectly-held securities. Pledge concepts are inherently incompatible with the intangible rights of entitlement holders in the indirect holding system. This produces uncertainty. Using the security entitlement concept to precisely describe the property interest permits the revised rules to operate more clearly.

Under the revised rules, a security interest in "investment property" may be perfected by "control". "Investment property" includes most anything that might be held through a securities account: securities, interests in securities, interests in commodity contracts, and money. This is intended to facilitate the common practice of granting a creditor a charge against the entire contents of such an account.

"Control" means that the creditor has taken whatever steps are necessary to be in a position to sell the collateral without any further action by the debtor. This does not change the normal method of perfecting a pledge of directly-held certificated securities: possession is control. For security entitlements, the creditor may obtain control by

¹⁰¹ See footnote 12, *supra*.

¹⁰² See the *Payment Clearing and Settlement Act*, enacted by S.C. 1996, c.6, s.162. The payment system has been described as "essentially a part of the banking system"; see B. Crawford, "The Payment Clearing and Settlement Act, 1996" (1997), 28 C.B.L.J. 1, at 20.

¹⁰³ For a comprehensive analysis of systemic, legal and other risk in cross-border securities trading see *Clearance and Settlement Systems in the World's Securities Markets* (New York: Group of Thirty, 1989); *Cross-Border Clearance*, *supra*, note 12 at 14-24; *Cross-Border Securities Settlements*, *supra*, note 12 at 17-30; and J.S. Rogers, "Policy Perspectives", *supra*, note 13 at 1436-8.

agreement with the debtor's intermediary to act on the creditor's instructions, or by having the security entitlements transferred into the creditor's own account.

As part of the revision, the secured transaction rules were moved from Article 8 to Article 9, which also deals with secured transaction rules for other types of property. In Canada, comparable rules have generally been kept separate from security transfer rules, which is consistent with the current U.S. approach.

The Law of Financial Accounts

As noted earlier, the security entitlement concept used in Rev8 represents the abandonment of negotiability concepts in favour of a new and different legal paradigm: the law of financial accounts. Joseph Sommer describes the laws of payment and securities transfer "as part of a unified commercial law of financial accounts, mostly contained in U.C.C. Articles 4A, 8 and 9", and outlines two "call and response themes" characteristic of this new law.¹⁰⁴

First, this law calls for unparalleled legal clarity; the response is unparalleled legal formalism. Second, payment and securities holding systems are rife with intermediating institutions. The law of financial accounts responds with careful compartmentalization of legal responsibility.¹⁰⁵

Because Mr. Sommer's two themes provide what may be the most generally-accessible framework for understanding Rev8 concepts, this section will briefly review these two themes with particular emphasis on their drafting implications.¹⁰⁶

¹⁰⁴ J.H. Sommer, "A Law of Financial Accounts", *supra*, note 35 at 1182.

¹⁰⁵ *Ibid.*

¹⁰⁶ This entire section draws very heavily from Mr. Sommer's article, *ibid.* Wherever possible, I have punctuated and footnoted direct quotes from the article. Some of the material here consists of slight re-organization and re-phrasing of Mr. Sommer's material, to the extent that complete punctuation and footnoting would be distracting.

Clarity and Formalism

The new law of financial accounts is extremely formalistic because it needs tremendous clarity of result. This is true of the predecessor to the new law, the law of negotiable paper. It is even more true of the new law, however, for at least two reasons. First, accounts have no physical reality, so their governing law can ultimately refer to nothing other than the symbolic content of communications. Paper, at least, has some physical basis. Therefore, the physical relationship of the parties to the paper can—and does—have legal significance. But the new world of financial accounts is a world of symbolic communications alone. Symbols have no tangible existence. Therefore, all consequences in this new law must derive from the transmission, authenticity, and symbolic content of the communications. Second, the old paper-based law of negotiable instruments served two masters. It was not only a law of payments and securities transfer, it was also a law of commercial obligations. The same clarity required by payment a securities transfer law could be injustice in the enforcement of an ordinary debt. The clear edges of negotiable instruments law were, therefore, blunted by cases adjudicating the conjoint law of negotiable obligations. By sharing the same doctrine, both bodies of law suffered. In contrast, the new law does nothing but hold and transfer funds and securities. It, therefore, can be more clear that the old law of negotiable instruments. [footnotes omitted]¹⁰⁷

Mr. Sommer draws an excellent analogy between payment and securities transfer law and plumbing.¹⁰⁸ He points out that commercial law has an essential, usually invisible, role in ensuring that money and

In those instances, the footnotes refer to the portions of Mr. Sommer's article so treated.

¹⁰⁷ *Ibid.* at 1182-3.

¹⁰⁸ *Ibid.* at 1194-7.

securities remain liquid (i.e. fully usable without delay), and that we can view payments and securities settlements as a flow through a pipe.

Mr. Sommer points out that the commercial law governing payments and securities transfers is not invisible because it is unimportant—it is invisible because it works so well. Users only notice plumbing, or this law, when they break down (i.e. when the pipe leaks). Leakage of 0.001% of total flow (as a result of litigation costs, the wrong party winning, preventive law, etc.), which would be unbelievably good for ordinary law, would be disastrous for the law governing payments and securities transfers because the value and volume of transactions is so high.¹⁰⁹

Mr. Sommer notes that the legal system has a limited ability to process disputed facts, and explains how the law of financial accounts provides an exceptional level of reliability by abolishing almost all disputable facts.¹¹⁰

The law of financial accounts is so formalistic that it does not operate on the ordinary sort of facts, but on symbols alone (this approach could more properly be called “nominalism”). If these symbols are appropriately communicated, authenticated, and preserved, then there is absolutely no room for ordinary factual disputes. This statement is as true for the old law of negotiable instruments as it is for the new law of accounts. The new electronic systems, however, are even better than paper. They provide for much stronger authentication, more reliable communication, and more stable record-keeping. [footnotes omitted]¹¹¹

¹⁰⁹ Mr. Sommer uses the U.S. Federal Reserve’s Fedwire system as an example. 1998 data showed that it clears about \$1.1 trillion in cash and \$650 billion in securities daily, so that leakage of 0.001% annually would amount to \$4.4 billion. The Fedwire is the single largest securities settlement system in terms of value, but other systems operating in industrialized countries collectively handle a larger daily volume of securities settlements than Fedwire. See J.H. Sommer, *ibid.* at 1195 and *Cross-Border Securities Settlements, supra*, note 12 at Table 3.

¹¹⁰ Sommer, *ibid.* at 1198.

¹¹¹ *Ibid.*

Mr. Sommer points out an important characteristic of the law of financial accounts by comparing it to other information systems:

If all the legally relevant “facts” are symbols, payment and securities transfer systems resemble other information systems, such as computer programs. Payment and securities transfer systems adapt well to computerization, but this is not quite the point. More to the point is that these systems, like computer systems, rely on symbolic inputs. These systems all provide a logically determinative output based solely on the data content of the input. To reliably operate such a system, the inputs must be carefully controlled. This is, of course, accomplished operationally. Most payment and securities transfer systems are “closed”; the information flow is under bank or brokerage control from beginning to end. [footnotes omitted]¹¹²

Mr. Sommer notes that the theme of clarity and formalism explains as much about the old negotiability-based law of securities transfers as it does about the new law of financial accounts.¹¹³ He points out that negotiability “is almost purely a question of magic words, not external facts”.¹¹⁴ In other words, the law of financial accounts uses the same basic technique (formalism) to pursue the same fundamental policy objective (clarity) as the previous law.

Intermediation, Internationalization, and Privity

The second theme of the modern law of financial accounts arises from intermediation. The U.C.C. contains a dazzling list of intermediaries.... Most transactions involve multiple intermediaries, often in multiple jurisdictions. The payment and securities transfer systems are *systems*—composed of many parties. If these systems are to work, the relations between these parties

¹¹² *Ibid.* at 1199.

¹¹³ *Ibid.* at 1200.

¹¹⁴ *Ibid.* at 1198.

must be as clear as the underlying legal rules of the system. The law of financial accounts has a characteristic device for ensuring clarity in the midst of diversity: careful compartmentalization of obligations. Just as formalism is the primary response to the need for clarity, compartmentalization is the response to intermediation.¹¹⁵

Mr. Sommer notes that the “old law did not formally recognize intermediation and ensured compartmentalization primarily through the property rights embedded in negotiable paper. The new law expressly provides for intermediaries and insists on strictly regulated privity.”¹¹⁶

We have already seen that intermediation is central to the indirect holding system and book-entry settlement system, and that the vast bulk of securities are held through a multi-tiered pyramid of securities intermediaries. Mr. Sommer points out that “Apart from prevalence and tiering, intermediation has a third key dimension—internationalization. Banks and brokers are increasingly global firms. A single transaction, or holding, may span several borders.”¹¹⁷

We have also already noted that each entitlement holder’s rights are only against its own intermediary. This reflects the fact that the entitlement is an account between two parties, based on privity.¹¹⁸ Mr. Sommer points out that:

¹¹⁵ *Ibid.* at 1183-4.

¹¹⁶ *Ibid.* at 1200. See also at 1184, n.17, referring to UCC §8-320 (1978). It might be more accurate to say that §8-320 and its counterpart in Canadian law (OBCA s. 85) provide for intermediation, but do so inadequately because of their failure to achieve sufficient compartmentalization of obligations.

¹¹⁷ *Ibid.* at 1201. See also at 1208-09, where he describes an international securities holding system example involving eight different jurisdictions. Such examples are not extreme. See R.D. Guynn, “Modernizing Securities Ownership, Transfer and Pledging Laws”, *supra*, note 11; and *The Oxford Colloquium on Collateral and Conflict of Laws*, Special Supplement to Butterworths Journal of International banking and Financial law, September 1998, Richard Potok—Rapporteur.

¹¹⁸ *Ibid.* at 1202, citing J.S. Rogers, “Policy Perspectives”, *supra*, note 13 at 1455-7.

[P]rivity is not a dyadic relation between two parties. Rather, privity is a triad: two parties and a system of law. Clear roles and rules are not enough in a world of international business and national borders. Each role must uniquely correspond to a precise rule, governed by the law of a precisely defined sovereign. In other words, the law of financial accounts demands determinate conflict-of-laws rules.¹¹⁹

Mr. Sommer explains the importance of privity in terms of risk management:

Payment and securities transfer systems are just that—systems of many entities, some of which are intermediaries and some of which are end-users. The behaviour of each entity generates risks such as insolvency, operational failure, and security. These risks must be managed both locally and globally. Global risk management comes from regulators, clearing houses, and the like. This kind of risk management, although necessary for externalities such as systemic risk, is by itself inadequate. Intermediaries must practice their own risk management, for most of the reasons that decentralized markets work better than command economies. Third parties have neither adequate information nor the sharp incentive of a bottom line. To provide adequate information and incentives to the parties at interest, risk must be clearly defined, clearly allocated, and clearly transferred. To do so, privity is essential, virtually as a matter of mathematics.

Strict privity ensures that most (but not all) risk within a system decomposes into a set of bilateral legal relations. This permits most of the risk in the system to be based on bilateral risk assessments, modified by the standard tools of bilateral contract and credit limits. [footnote omitted]¹²⁰

Summary and Conclusion

¹¹⁹ *Ibid.* at 1205.

¹²⁰ *Ibid.* at 1205.

We have seen that the entire history and evolution of securities transfer law has been marked by efforts to reduce or manage the risks associated with securities settlements. The securities settlement system is, increasingly, a global system. Modern securities holding and transfer practices are characterized by the involvement of a tiered system of intermediaries, and it is common for securities transactions or securities holdings involve several different jurisdictions.

The law of financial accounts responds to the fundamental needs of modern securities holding and transfer systems for clarity and certainty by using two techniques: formalism and privity. Through extreme formalism, the law provides extreme clarity, which not only minimizes risk but also permits market participants to more accurately assess and manage the risks that still exist. Through privity, including conflict-of-laws rules that clearly designate the legal system applicable to each transaction or relationship, the law enables market participants to reliably determine what jurisdiction's law will apply to any transaction or relationship within the system.