PERFECTING SECURITY INTERESTS IN CASH COLLATERAL

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Submitted to: **The Ministry of Consumer Services;** and **The Ministry of Finance**

Submitted by: **The Ontario Bar Association, Personal Property Security Law Subcommittee**

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The Ontario Bar Association ("OBA") appreciates the opportunity to provide advice to the Government on reforming the law of cash collateral, an important initiative that we believe will both reduce costs for government and further Ontario's *Open for Business* and *Open Ontario* initiatives, particularly in the financial sector. The amendments to the *Personal Property Security Act* ("PPSA") that we are recommending should be effected as soon as possible, before other provinces set the standard on the issue, potentially gaining a competitive advantage and threatening Ontario's historic role as a leader in capital market reform. Quebec has already enacted amendments to its derivatives legislation that accomplish a few of the goals sought to be achieved by the OBA initiative. Given the need for quick action, the alignment with the government's budget objectives and the fact that the proposal is likely to garner a broad consensus, it is ideal for inclusion in the spring budget bill.

Attached you will find a paper outlining the details of this proposal and a backgrounder discussing the shortcomings of the existing legal infrastructure. Below is a summary of the proposal and its basic policy rationale.

The OBA

Established in 1907, the OBA is the largest legal advocacy organization in Ontario, representing 18,000 lawyers, judges, law professors and law students. We advocate both in the interests of the profession, and, as in this case, in the interests of the public. The OBA's Business Law Section has nearly 2000 members and its Personal Property Security Law Subcommittee ("PPSLS") includes the leading experts in the field. The PPSLS members would count among their clients virtually every stakeholder in the personal property security regime and the cash collateral issue, including lenders, borrowers, financial institutions, derivatives counterparties and regulators. The OBA's Business Law Section and PPSLS have assisted government with virtually every reform of the PPSA.

The Recommended Changes

The essential purpose of the recommended changes is to facilitate the use of cash, in the form of bank deposits and other financial accounts, as collateral for loans and other secured obligations. The changes will extend the government's highly successful *Securities Transfer Act, 2006* (the "STA") reforms by giving secured parties holding cash collateral the same degree of legal certainty as to their priority against other creditors that the STA provided to holders of securities as collateral. The proposed amendments to the PPSA take much the same approach to

cash collateral as the STA takes to other financial assets. Both allow security interests in these assets to be perfected through the technique known as "control", which ensures a certainty of priority not available through registration alone.

While it is not the *policy intent* of the PPSA to discourage the use of cash collateral, it is currently an *unintended effect*. The fact that security interests in cash collateral can now be perfected only by registration renders impractical or even impossible the use of this very safe and liquid form of collateral, given the realities of today's financial market transactions. These realities include:

(a) the fact that transactions often must take place in a matter of days or hours rather than weeks, making it impractical to obtain waivers and subordinations from prior creditors; and

(b) the rules governing priority of security interests in collateral perfected by registration are so complex and subject to so many exceptions that few if any law firms can give the priority opinions that secured parties desire.

In a capital market that spans all of North America, we cannot ignore the fact that, since 2001, every state in the U.S. has had legislation in place that extends control to cash deposits, facilitating the use of cash collateral. Rather than endure the delay, uncertainty and transaction costs of Ontario's existing PPSA regime, secured lenders and swap counterparties who require cash collateral in cross border transactions too often elect to export the security to friendlier centres such as New York or Chicago. This competitive disadvantage can only grow worse in the short and long term as the centralized clearing facilities mandated by Dodd-Frank and Basel III come to dominate the North American over-the-counter derivatives market, which will require first priority security interests in cash collateral as the price of admission. Moreover, the market may not be able to supply enough liquid securities to satisfy the massive demand for collateral that will likely result from the new collateralization requirements for central counterparties, with the result that the costs associated with such collateral may rise dramatically. Given these and other market factors, it is critical that Ontario create *now* a legal regime that enables secured parties to have a *clear, certain, automatic and instant* first priority security interest in cash collateral. The legislative changes recommended by the OBA would create such a regime.

Government Policy Goals Furthered by a New Cash Collateralization Regime

Extending control as a means of perfecting security interests in cash collateral has three principal benefits:

1) it will further the government's *Open for Business* and *Open Ontario* plans by reducing unnecessary costs and regulatory burdens for Ontario's current and prospective businesses;

2) it will make Ontario a more competitive jurisdiction for attracting financial services and investment industry jobs and stem the southward flow of such jobs; and

3) it will provide direct cost savings to government.

1) The Government's *Open for Business* and *Open Ontario* Plans

The current PPSA regime makes using cash collateral impractical or at least unduly burdensome and, therefore, increases the costs of secured transactions in several ways. These include the following:

(a) Initial transaction costs increase by virtue of the complicated strategies that must be used to obtain a perfected first priority security interest either in some form of account, if possible, or in a less liquid workaround alternative form of collateral. These costs, which include significant legal and accounting fees, can run to the tens of thousands of dollars per transaction;

(b) Ongoing administrative costs, such as monitoring the fluctuating mark to market value of less fungible collateral to ensure that the obligations remain adequately secured, are also inherent in making cash collateral an impractical option;

(c) Collateral itself becomes more expensive. Collateral in less liquid and safe forms such as marketable securities are typically subject to "haircuts" that reflect the higher credit risk, volatility and illiquidity associated with such collateral in contrast to cash. The result is that the market value of the non-cash collateral posted to secure a given amount of exposure must be higher than the amount of cash that would be needed to secure the same exposure. For example, if $100 worth of collateral is required for a transaction, $100.00 in cash would suffice, but the debtor would need to provide about $105 worth of

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securities if the latter is subject to a 5% “haircut”. Moreover, the market may not be able to supply enough liquid securities to satisfy the massive demand for collateral that will likely result from the new collateralization requirements for central counterparties mandated by Dodd-Frank, Basel III and Canada's G20 commitments, with the result that the costs associated with such collateral may rise dramatically.

(d) Improvements in the personal-property-security regimes in other jurisdictions, most notably the U.S, have made the use of cash collateral a more practical, less expensive and more streamlined option. In today's international market, these more creditor-friendly regimes may motivate secured creditors to export their transactions from Ontario to New York, Chicago or elsewhere. As a result, Ontario's credit market tightens and the cost of credit increases.

Increased costs of credit are visited on businesses looking to finance the building of a new facility, buying plant and equipment, developing new products or expanding or locating operations in Ontario. These costs amount to an unnecessary regulatory and financial burden for current or prospective Ontario businesses and run counter the Government's plan to “create a climate where business can thrive and create jobs.” The current cash collateral regime and the attendant costs could be a strike against Ontario in a company's decisions regarding where to locate and do business.

2) The Financial Services Sector

The Government has recognized the clear importance and value of the province's financial services sector. As outlined in the 2010 Ontario Budget:

> The McGuinty government is supporting the growth and expansion of [the financial services sector] of Ontario's economy by…. establishing a more competitive tax system and a more modern and efficient provincial regulatory climate.

The recommended cash-collateral changes are a critical piece in creating a modern and efficient legal infrastructure for this sector. Increased transaction costs associated with the current regime affect this sector exponentially. For investment firms, mutual funds and insurance companies that would participate on either side of multiple secured transactions a day, transaction costs are critical. Even more significant, though, is the time the current regime adds to the process of perfecting a security interest. The current process simply does not work for financial-sector transactions with very short timeframes, such as over-the counter derivatives, securities loans, repurchase transactions and margin loans. As an ever-growing number of jurisdictions facilitate these transactions through a modernized cash collateral regime, Ontario is losing its competitive advantage in the financial services and investment sector in an increasingly globalized market. Every state in the U.S. has adopted Revised Article 9 of the *Uniform Commercial Code*, which implemented a cash collateralization regime consistent with the changes recommended by this

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proposal. The European Union (under its Directive on Financial Collateral Arrangements) has followed suit. In addition, the proposed changes would further enhance Ontario's role as a market leader on the world stage by helping Canada to comply with its G20 commitments to implementing such systemic safeguards as centralized clearing of derivatives.

The recommended amendments would also be consistent with the leadership and commitment to capital markets efficiency that the Government showed in enacting the STA in 2006. That legislation (and the companion amendments to the PPSA), which has since been adopted almost verbatim by nearly every other common-law province, put the pledge and transfer of securities on a sound legal footing that reflected the modern realities of the marketplace and has achieved its objectives of reducing transaction costs and increasing legal certainty in transactions involving securities. The proposed amendments would do the same for cash collateral, and Ontario could once again lead the way in Canada.

3) Direct Savings to Government

In addition to assisting with the government's private-sector policy priorities, the recommended cash collateral regime will yield transaction cost savings directly to government.

In order to manage a variety of risks, the Province, through the Ontario Financing Authority, is a major player in the over-the-counter derivatives market, entering into interest rate, foreign currency and other swaps with aggregate notional amounts in the billions. The Province generally requires counterparties to post collateral to secure the Province's exposure in these trades. Given the current hurdles to posting cash collateral, counterparties are generally forced to post high-grade securities or other collateral that is more volatile, less liquid and less secure than cash. This increases both the upfront transaction costs and the ongoing monitoring costs, both of which are described above (see p. 4, items (a) and (b)). It would be cheaper and more straightforward if the Province could simply accept cash collateral. Savings in this regard could be in the tens of thousands of dollars per trade.

On the other side of the coin, in light of recent sovereign-debt crises around the world, counterparties increasingly require governments to post collateral to them. In addition to the costs described above, without a practically available cash-collateral regime, the Province must post high-grade securities, which it may be able to acquire only through securities lending or repo transactions, each of which has its own attendant fees and expenses. Again, it would be cheaper if the Province could simply make a cash deposit with the counterparty.

Investor Protection

While the changes recommended reduce unnecessary financial and regulatory barriers and facilitate the flow of capital, it must be understood that they do not jeopardize investor protection. In fact, the contrary is true. Transactions backed with cash collateral soundly secure lenders and other transaction parties and, by extension, their investors and the market as a whole.

In addition, certain market protection mechanisms recently legislated in other jurisdictions, such as the requirement to clear OTC derivatives transitions through central counterparties mandated by the *Dodd-Frank Act* , will require a sound legal infrastructure for cash collateral. The enhanced regulatory capital requirements for financial institutions to which Canada must soon adhere under the Basel III accord, will mandate similar requirements.

The OBA's proposed regime also includes an additional consumer protection element by excluding consumer accounts (i.e. those that are used by individuals for household purposes) from the control regime. This exclusion will ensure that power imbalances between individual consumers and their financial institutions do not become a factor in the new regime and mitigates the perceived risk that banks might regard the new priority regime as an opportunity to further enhance their position in the consumer credit market.

Timing

It is critical for Ontario to adopt this new regime as quickly as possible. Our competitiveness in attracting and maintaining businesses, particularly in the financial services sector, will depend increasingly on reforming the law of cash collateral. Other provinces are discussing similar proposals. There will be considerable pressure for all Canadian jurisdictions to follow the leader in this area on policy choices such as governing law. As it was with the STA, Ontario should be the leader on these choices.

Conclusion

The suggested cash-collateral regime will leverage two important synergies: furthering government private sector policy while yielding direct savings to government, and reducing the regulatory burden in the markets without jeopardizing consumer protection. The attached working paper outlines the proposal in detail and we would be pleased to provide any additional information or answer any questions. Thank you for the opportunity to provide input on this issue.

Cash Collateral –Details of Proposal for Amendments to Ontario PPSA

Part 1 – Discussion
Part 2 – Proposed Amendments
Part 3 – Explanatory Notes

PART 1 – DISCUSSION

The purpose of this document is to set out and explain a proposal (the "**Proposal**") for amendments to the *Personal Property Security Act* (Ontario) ("**PPSA**") that will allow a debtor to provide, and a secured party to obtain, a first priority security interest in certain types of cash collateral perfected by "**control**".

Brief Description of Proposal

The central feature of the proposed amendments is to enable a secured party to perfect a security interest in a new class of collateral known as a "**financial account**" by registration, or by control. If perfection is by control, priority is conferred on the secured creditor that has or first obtains control. If the secured party is the financial institution with which the financial account is maintained or that is obligated under the financial account, then it has automatic control that will perfect any security interest it has in the financial account. That security interest will also automatically rank first unless another secured party is the customer for whom the financial account is maintained or to whom the financial account is owed, or unless the financial institution has expressly subordinated its interest.

"**Financial accounts**" are broadly defined to include any form of deposit account maintained by a financial institution, and any other monetary obligation of a financial institution in respect of funds held or received by that financial institution as security for an obligation, whether or not in the form of a deposit account. The definition of "**financial institution**" too is very broad so as to include every type of participant in financial markets that regularly receives cash collateral, whether or not that person establishes, or holds funds in, a deposit account. For example, if a secured party receives cash collateral and then uses that cash in its business, the secured party may have a monetary obligation to return that cash collateral or to apply it to the debtor's obligations. That monetary obligation would be characterized as a financial account. If the parties (or a court) were to characterize the transaction as creating a security interest in that financial account, the security interest would be automatically perfected and have priority over any other security interest in that financial account, unless subordinated.

"**Consumer accounts**" are excluded from the control regime. "Consumer accounts" are accounts maintained with a financial institution and used by a natural person primarily for personal, family or household purposes. Consumer accounts are excluded partly because the deposit account control regime in Article 9 of the UCC does not apply to consumer accounts and partly to allay some commentators' fears that financial institutions would exploit their dominant position at the expense of consumers. We believe that consumers and financial institutions would actually both benefit if consumer accounts were included within the definition of financial account, and subject to the control regime; but we are concerned that critics of the Proposal may view consumers differently. Therefore, with a view to minimizing controversy, consumer accounts are excluded. But for those concerns (which we do not believe would be justified), we would have included consumer accounts in the control regime.

Operating accounts are not excluded from the regime. We considered the possibility of excluding operating accounts, and we worked on numerous drafts of the Proposal which excluded operating accounts. Those drafts were much more complex than the current draft, largely to deal with the possibility that the exclusion would be too broad or too ambiguous. For example, an operating account could be defined by reference to a customer's ability to access funds in the account without the consent of the secured party. This type of definition is too broad because it is common for customers to be permitted to access funds in a blocked account provided certain conditions are met. Recognizing these drafting difficulties, we concluded that operating accounts should be included in the Proposal. In our view, this decision will not generally be significant in practice because: (a) there are usually no significant funds remaining in an operating account at the time of insolvency proceedings, (b) the financial institution which maintains the operating account typically has rights of set-off against that account, and (c) secured parties generally do not extend credit on the strength of funds held in an operating account, whether by way of proceeds or as cash collateral. The inclusion of operating accounts in the control regime is consistent with the approach taken in the United States in Article 9 of the UCC.

The Forms of Cash Collateral

To aid in assessing how effective the various options for a cash collateral solution may be, this section describes in general terms various types of cash collateral and some typical scenarios where cash collateral might be used.[1]

1. **The 3P FI Scenario.** A debtor grants a security interest to a secured party in a deposit account maintained by a third-party financial institution in the name of the debtor to secure an obligation owed by the debtor to the secured party.

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[1] The Proposal does not addresses credit balances in a securities account because the current legal regime adequately addresses the use of those credit balances as collateral.

2. **The SP FI Scenario.** A debtor grants (or under the reasoning in the *Caisse Drummond* case[2], is deemed to have granted) a security interest in a deposit account in favour of a financial institution that maintains the deposit account in the name of the debtor to secure the debtor's obligations to the financial institution.

3. **The SP Obligation Scenario.** A debtor transfers funds to a financial institution to secure obligations owed by the debtor to the financial institution, giving rise to an account receivable (which may be conditional or contingent) owed by that financial institution to the debtor; but no deposit account is established by the financial institution in the debtor's name. The secured party might hold the funds in its own deposit account at another financial institution; or it might use the funds in its own operations.

4. **The SP Account Scenario.** A debtor transfers funds to a deposit account of the secured party maintained at a third party financial institution. The funds in that account and other funds of the secured party may be transferred back and forth between the debtor and the secured party, depending on margin requirements.[3]

Under the current law, in all of these scenarios the secured party must rely on a PPSA registration to perfect its security interest even though as a practical matter in all but the 3P FI Scenario, its remedy would be to apply the funds in the account to the debtor's obligations by way of set-off or otherwise, rather than to sell, or foreclose on, the collateral.

1. **Possible Objections to the Proposal**

The following summarizes the main concerns that have been expressed in comments on earlier drafts of this Proposal, discusses areas of disagreement and explains how this Proposal addresses those concerns.

Concern: Not all arrangements addressed by this Proposal require a legislative response, at least at this time, and/or a special regime that favours cash collateral secured parties.

We believe that there is currently consensus on the need for reform to provide for a priority for certain cash collateral secured parties to facilitate capital and financial market transactions, including clearing of OTC derivatives transactions and repurchase agreements.

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[2] *Caisse populaire Desjardins de l'Est de Drummond v. Canada*, 2009 SCC 29.

[3] For example, a derivatives counterparty (the debtor) is required to transfer cash collateral to the other counterparty (the secured party) as initial margin or as variation margin to secure the secured party's mark-to-market exposure, which may fluctuate day to day and may require transfers to and from the counterparties.

However, some commentators believe that the case for reform in other contexts, such as commercial lending and business to business arrangements, has not been made and requires further study. According to those commentators, all secured parties who rely on PPSA registrations to perfect their security interests face the same risks and inconvenience associated with registration (*i.e.* the need for searches, subordinations, delays, absence of opinions as to priority). Some commentators argue that there is no policy rationale for a new non temporal priority rule such as exists, for example, for PMSIs or investment property, that would justify special treatment of cash collateral in most cases.

However, in the case of global and domestic capital and financial market transactions (such as derivatives, repo, securities loans and transactions cleared with a central counterparty or clearing house) the certainty of priority with respect to cash collateral is critically important. Additionally, the delays and uncertainty associated with obtaining subordinations and acknowledgments are not acceptable or practical in capital markets and derivatives transactions. Furthermore, a secured party that is a regulated financial institution will not receive regulatory capital relief for collateral it receives from its counterparties if it cannot obtain an opinion as to the first priority of the security interest that secures its exposure. Lawyers do not give priority opinions based on registration. Such an opinion would in any event be impractical to give for many of the financial parties that participate in financial markets given the number of registrations a search report would typically reveal.

Response: The Proposal balances these concerns and goals in several ways:

While the need to provide a solution for financial market transactions is driving the timing of the Proposal and provides the most compelling reasons for reform, it would not be appropriate to design a solution for cash collateral that is specific to these types of transactions (such as a special regime for eligible financial contracts as defined in federal insolvency legislation).[4] PPSA rules typically are not based on the type of transaction or obligation which is secured. For the most part the scheme of the Act does not depend on the nature of the secured obligation.[5] Consequently, it is necessary to formulate a solution around the collateral type and this requires defining a subset of the

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[4] Such a partial solution has (regrettably, in our view) been recently been adopted for derivatives in the Province of Québec. National Assembly, Bill 7, *An Act to amend various legislative provisions concerning the financial sector,* s. 24.2 (assented to on November 30, 2011), which amends the *Derivatives Act* to provide that: "An instrument under which a person is required to pay an amount of money to a party to a derivative, including as a margin or settlement deposit, and which allows that party, in all circumstances described in the instrument, to extinguish or reduce, by means of a set-off, its obligation to repay that amount to the person is enforceable against third persons without further formality."

[5] A PMSI is dependent on the type of transaction, but it is also fundamentally tied to the collateral type.

"account" or "intangible" class of collateral wide enough to cover the types of accounts that are used in the market. That will require a certain over-inclusiveness because the accounts are not readily distinguishable.

The Proposal abandons the concept of the "secured party account" in a previous draft, which was designed to facilitate business-to-business collateral arrangements. While we continue to believe a simpler perfection and priority regime at least for title transfer types of cash collateral arrangements would benefit all commercial parties, in the interests of attempting to reach consensus, this aspect of the former Proposal has been dropped. However, a more limited form of this concept is retained: where the secured party is a financial institution, a transfer of funds to the financial institution for the purpose of securing an obligation to the institution will be covered by the control regime even if no formal deposit account is maintained for an account customer arising from that transfer. This is designed to cover title transfer credit support arrangements, namely the SP Obligation scenario.

The Proposal also excludes consumer accounts, for the reasons explained in the introduction to this Part. We did not exclude operating accounts. Some commentators expressed concern that permitting a secured party to perfect its security interest in an a debtor's operating account through control and thereby gain automatic priority over any other PPSA security interests could give rise to difficult practical and policy issues of tracing, identifiability and priority with respect to PMSI secured parties and receivables financiers. However, we do not believe this concern is so significant that it must be addressed by limiting the Proposal to blocked accounts (i.e. by excluding operating accounts); and for the reasons outlined above and below, we have included operating accounts in the Proposal. Ultimately, this is a question of judgment about which reasonable people could differ; but after considerable debate, drafting and redrafting, we concluded that the exclusion of operating accounts would significantly undermine the commercial and regulatory objectives the Proposal is attempting to address by introducing complexity and uncertainty.

Concern: Depository institutions that are secured parties with respect to the financial account may abuse their priority position.

The Proposal grants the financial institution automatic control and super priority, even over other secured creditors with control other than a secured creditor that is the customer. The deposit bank need not cede this priority to a third party and need not enter into a control agreement. It has been argued that this could result in banks extending their oligopoly over credit and exercising undue market power.

Response*: *The Proposal addresses this concern by excluding consumer accounts from the super-priority regime In addition, the financial institution cedes priority to a secured party that acquires control by becoming the account customer of the financial institution. We also believe that this concern seems misplaced.

The enhanced priority given to financial institutions will not apply to consumer accounts. Also, like section 9-327(4) of the UCC, the Proposal now provides that a secured party that perfects its security interest in a financial account by becoming the account customer has priority over the financial institution with which the financial account is maintained. The concern that Canadian financial institutions will abuse their power by refusing to enter into control agreements or subordinate their security interest with respect to financial accounts maintained with them seems misplaced where clients wish to set up special security arrangements with their other creditors. Competitive pressures of the market will prevent this. Securities intermediaries enjoy a similar privileged status under the STA and PPSA and yet routinely enter into control agreements and subordinate their security interests in securities accounts maintained with them except with respect to a small class of obligations such as fees and overdrafts. Banks also regularly enter into blocked account agreements in favour of lending syndicates or PMSI financiers in which they typically subordinate or waive their rights of set-off with the same limited exceptions.

Concern: Perfection by control allows for secret liens, which is contrary to a fundamental policy of the PPSA.

The concern can be expressed as follows: Perfection by control, whether by control agreement, by virtue of the secured party's status as financial institution with which the account is maintained or by virtue of the secured party becoming the financial institution's account customer, necessarily lacks the element of publicity that is the hallmark of the PPSA registration system. There are no public searches that a third party can do to determine whether the debtor's cash is subject to a first priority security interest perfected by control. The fact that secret liens also exist with respect to perfection by possession or by control under the STA is not a complete answer: a Proposal to make an existing problem worse does not solve the problem.

Response*: *The policy reasons for discouraging secret liens with respect to tangible collateral and receivables do not apply to financial accounts.

The paradigm of the most objectionable form of secret lien is the situation where a debtor appears to own or possess property, such as inventory or the assets which appear on its financial statements, but another person, unknown to creditors, has a lien on the property. Without a registration system, creditors have no means of determining who might have a lien other than requesting that information of the debtor. With a financial account, however, any creditor relying on the balance of the account as a form of security or expression of the assets of the debtor will already know the identity of the financial institution. This is not similar to the case of a general assignment of receivables, where it would not be feasible to determine the identity of every account obligor. With a financial account, the only possible "secret" information is whether or not there is a security interest. A financing statement is not required to give another creditor information as to the identity of potential secured parties. While it might provide some information as to whether the financial institution has a security interest

in accounts, it will not itself provide meaningful information on whether the financial institution has a security interest in a particular account. Inquiries have to be made in any event to determine whether that particular asset has value.

The Proposal deals with the legitimate interest of other parties in knowing whether a security interest perfected by control exists with respect to a financial account by requiring the financial institution to confirm the existence of its own security interest or a control agreement with another person on inquiry from a person with an interest in the account with the consent of the debtor or on request of the debtor. It also requires the financial institution to seek the consent of the debtor if it does not already have it. In addition the Proposal requires that the security interest be conferred in a written agreement.

In the SP Account scenario and the SP Obligation scenario, the policy objections to secret liens are not engaged because third parties are unlikely to be misled as to whether or not the debtor's assets are subject to security interests. In the SP Account scenario the deposit account is in the name of the secured party, not the debtor, and the financial account is the debtor's right to demand repayment of the funds transferred to the secured party's account. In the SP Obligation scenario, the financial account again is defined by the collateral arrangement itself and there may be no deposit account at all. In neither case would the asset that functions as collateral appear on the books of the debtor as anything other than a contingent receivable, in respect of which the third party will need to make further inquiries of the debtor and the secured party in any event, nor would registration of a financing statement provide any useful information.

We would also note that public filing to perfect security interests in cash collateral is not required under Article 9 of the UCC in the United States, under the Directive on Financial Collateral Arrangements (2002/47/EC, amended 2009/44/EC) in the European Union[6], or under the UNCITRAL Legislative Guide on Secured Transactions.[7]

Concern: Conflict of Laws - Allowing a financial institution to designate the governing jurisdiction in an account agreement gives the institution an unwarranted degree of autonomy in determining the applicable law.

The first version of the Proposal recommended adopting the place of the debtor's location to govern validity, perfection and priority of a security interest in a credit account. Those who commented on this approach believed that it would be preferable to choose an approach consistent with the approach for securities accounts, namely the "law of the financial institution's jurisdiction", which is determined chiefly by the terms

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[6] Available on-line at < http://ec.europa.eu/internal_market/financial-markets/collateral/index_en.htm; http://ec.europa.eu/internal_market/financial-markets/collateral/index_en.htm#amending>.

[7] Available on-line at < http://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670_Ebook-Guide_09-04-10English.pdf>.

of the agreement governing the account. The Proposal adopts the law of the financial institution's jurisdiction as the relevant connecting factor for validity, perfection and priority of a security interest in all financial accounts. The concern expressed with this approach is that using the financial institution's jurisdiction as the connecting factor in effect gives financial institutions the unfettered right to arbitrarily designate any jurisdiction in the account agreement without notice to third parties and without regard to the situs of the transaction or the physical location of either the debtor or the financial institution. This degree of party autonomy puts the secured party (if a bank) in control of the law that governs perfection, which is contrary to the principle that conflicts rules should be objectively based.

Response*: *The potential for abuse (if any) is outweighed by the benefits of the rule.

As with investment property collateral, flows between Canadian and U.S. counterparties are significant. Collateral providers and receivers are, in our experience, quite surprised to learn that security interests that U.S. institutions hold in accounts maintained in the U.S. are governed by Ontario law if the account holder is Canadian. The natural expectation is that the place of the account governs such matters. There are benefits in having a rule which is consistent with UCC Article 9 at least in terms of the conflict of laws rule given the cross-border collateral flows. It will avoid the multiple perfection and sometimes insoluble *renvoi* problems associated with one jurisdiction using debtor location and the other using local law of the bank and this may outweigh any drawbacks.[8] This rule is also consistent with the PPSA/STA rule for securities accounts and futures accounts and will avoid any conflict between those two regimes. For example, security interests in credit balances in a securities account are governed by the securities intermediary's jurisdiction, and if a separate financial account is established with the same intermediary that is not a securities account, it would be governed by the same law.

It seems highly unlikely that Canadian financial institutions will arbitrarily start amending their standard form account agreements to designate foreign laws as their local law in order to gain some marginal advantage over a debtor. This sort of rule arbitrage has not occurred in the context of securities accounts, and in our experience financial institutions will not choose a jurisdiction that is not connected to the location of the financial institution or the account to govern their standard form account agreements.

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[8] For example, where D is located in Ontario for PPSA purposes and the account is governed by New York law for UCC purposes, the security interest must be perfected in both jurisdictions. Conversely, where D is located in New York for PPSA purposes and the account is governed by Ontario law for UCC purposes, Ontario law says that the security interest must be perfected under New York, but New York law says it must be perfected under Ontario law. Since neither jurisdiction recognizes the method of perfection used in the other, neither one works.

There is admittedly the transitional problem of how to deal with multiple PPSA jurisdictions with inconsistent conflicts rules until all of them have been amended. However, that problem will exist regardless of which rule is adopted.

Concern: A solution should be restricted to segregated or blocked accounts to avoid intractable priority disputes, such as disputes over PMSI proceeds.

Comments have been made that the UCC Article 9 approach creates intractable priorities issues with respect to security interests in general operating accounts, such as PMSI proceeds, that have no clear-cut policy driven solution. These problems can be avoided by restricting control to specific, segregated or blocked accounts that can be used for no purpose other than cash collateral. Professor Cuming has proposed a new "blocked account security interest" that would require notice to third parties analogous to that required for inventory PMSIs.

Response*: *Not all agree that there are intractable priorities issues. Blocked account agreements are not feasible in financial markets transactions.

The proponents of this Proposal do not agree that it creates intractable priorities issues. The model appears to operate effectively in the United States. If the Proposal is implemented, PMSI holders can continue to make arrangements with their debtors for segregation of proceeds to designated accounts (as many do now) and thereby themselves take advantage of the clearer priority rules that the Proposal offers them.

Restricting control to segregated or blocked accounts would not provide a workable solution for cash collateral arrangements in capital and financial market transactions. In a typical derivatives transaction the party required to post cash collateral simply transfers the funds to the secured party as directed (e.g., the SP Obligation scenario) without regard to its ultimate destination. Funds will move back and forth between the parties depending on the estimated exposure to each other. At times a party may be a collateral receiver and at others a collateral provider, depending on their respective exposures on the secured transactions. Where excess collateral has been provided, the collateral provider can request its repayment.

A collateral provider will often also have the right to substitute cash collateral with other acceptable forms of collateral, such as a letter of credit or securities, and will be entitled to a repayment of the cash collateral. The collateral provider may require the cash to fund other activities and prefer at various points to post securities or vice- versa. This flexibility increases liquidity and allows parties to make maximum use of their fungible assets. Any requirement that restricts a solution to funds in a third party account that are to remain blocked or segregated and which does not recognize substitution rights will not provide a workable solution and will certain be viewed as no solution at all by market participants.

Also, it is extremely unclear what it means to have a segregated account where the secured party is the financial institution with the obligation that constitutes the financial

account. By its nature, a deposit account creates a debtor/creditor relationship. The transferred funds are by definition used by the receiving financial institution as its own, as are any funds on deposit with a financial institution. Capital requirements (which take into account the right to net against transaction obligations as long as the priority is clear) protect the collateral provider.

A blocked account may be a substitute for the account control agreement where the account is with a third party institution. However, even there it is not a workable general solution for financial market transactions. Say, for example, that a bank-owned dealer, XYZ Securities has received cash into a Canadian customer's financial account to secure securities loans, and pursuant to the account agreement, it has granted a security interest to XYZ Securities to secure securities trading activities and margin requirements as well as to XYZ Bank to secure OTC derivatives transactions and other XYZ affiliates to secure other trading activities such as securities loans. This is a very common arrangement between prime brokers and their customers. The agreement is drafted to be a control agreement in favour of XYZ Bank and the XYZ affiliates with XYZ Securities as the financial institution and allows those entities to give orders on default subject to XYZ Securities' own security interest. Excess collateral in the accounts may also be used to fund settlements of trades. To require the financial account to be blocked and used only to secure the obligations with a particular party or only for purposes of collateral would defeat the efficiency and flexibility of these types of arrangements.

There may very well be policy reasons for requiring certain collateral arrangements to be restricted to segregated accounts. For example, in the context of central counterparties, regulators of those entities with responsibility for regulating so as to reduce systemic risk in the clearing system and protection of clearing clients might determine that a clearing house should maintain cash collateral it receives in a bankruptcy remote custodial institution account. However, these are not the policy imperatives of the PPSA.

The Principles upon which the Proposed Solution is Based

The Proposal is offered as a solution that balances the following principles and interests. Like any compromise solution it may not satisfy every interest. In our view, the optimal solution should:

- ensure that in the context of capital and financial market transactions, such as bi-lateral and cleared OTC derivatives transactions, and securities financing transactions such as securities loans, repurchase transactions and margin loans, the participants are able to provide and receive a security interest in cash collateral that is not subject to competing security of other consensual secured creditors;

- ensure that priority is not dependent on the filing of a financing statement and the order of registration of a financing statement;
- reflect methods of doing business in Canadian and global financial markets and not require adopting any new or special procedures or notice periods to create effective security that do not respond to the constricted time frames of transacting in financial markets. A repo for example, may be entered into and fully performed in the space of a few days;
- allow a debtor the right to substitute cash collateral with other forms of financial collateral, such as investment property, without compromising the effectiveness of the security interest;
- recognize that cash collateral balances may fluctuate on a frequent basis with a debtor being permitted to use those balances to secure a number of different transactions;
- recognize that a secured party receiving cash collateral is not required to segregate cash collateral unless the arrangement with the debtor requires it;
- ensure that active participants in the financial markets, including the Province of Ontario and other Crown participants, pension funds and mutual funds do not have to establish the existence of a deposit account in order to rely on the benefits of perfection by control; and
- clarify the conflict of laws rules applicable to cash collateral arrangements.

In our view the Proposal is an optimal solution which meets all of these criteria.

PART 2 – PROPOSED AMENDMENTS TO THE PPSA

1. Add or amend the following definitions in subsection 1(1):

“**account**” means a monetary obligation not evidenced by chattel paper or an instrument, whether or not it has been earned by performance, but does not include investment property **or a financial account**;

“**consumer account**” means a deposit account that is maintained for a natural person and is used by the natural person primarily for personal, family or household purposes;

“**customer**” means

(a) a person for whom a financial institution maintains a deposit account; or

(b) a person to whom a financial institution owes a monetary obligation of the type described in clause (b) of the definition of financial account;

“**deposit account**” means an account maintained by a financial institution for a person identified in the records of the financial institution as its customer to which deposits to, or funds received or held by, that financial institution are or may be credited, including a deposit account in any form (whether demand, term, cash, chequing or savings, and whether or not evidenced by a certificate of deposit, account agreement, passbook or other document), an investment account, a custody account and a clearing or settlement account, but does not include investment property and a monetary obligation evidenced by chattel paper or an instrument;

“**financial account**” means:

(a) a deposit account other than a consumer account; and

(b) a monetary obligation owed by a financial institution to any person in respect of funds received or held by that financial institution for the purpose of securing an obligation to that financial institution or to another person, but does not include investment property, consumer accounts and any monetary obligation evidenced by chattel paper or by an instrument;

“**financial institution**” means:

(a) a bank;

(b) a savings bank;

(c) a loan company;

(d) a savings and loan association;

(e) a treasury branch;

(f) a trust company;

(g) a caisse populaire, credit union, cooperative credit society or association of credit unions, caisses populaires or cooperative credit societies;

(h) an insurance company;

(i) a clearing or settlement agency or central counterparty;

(j) a central bank;

(k) an entity engaged in:

(i) brokering, dealing in, executing, clearing or settling securities, futures, options on futures or derivatives on behalf of others;

(ii) providing trustee or custodial services; or

(iii) otherwise engaged in the business of providing financial services or maintaining accounts for customers;

(l) a pension fund, including a trustee, manager or administrator of a pension fund;

(m) a trustee or an entity that is a mutual fund or other collective investment vehicle;

(n) a municipal corporation in Canada, the Crown in right of Ontario or any other province, territory or other political sub-division of Canada, the Crown in right of Canada, or any agency thereof; and

(o) such other entity or entity within a class of entities as may be designated by Order in Council to be a financial institution for the purposes of this definition;

regardless of the jurisdiction of organization or incorporation, except as specifically provided in clause (n);

2. Add to subsection 1(2):

(f) a secured party has control of a financial account if:

(i) the secured party is the financial institution that is obligated to the customer under the financial account;

(ii) the customer, the secured party and the financial institution that is obligated to the customer under the financial account have agreed in writing that the financial institution will comply with instructions originated by the secured party directing disposition of funds from the financial account without further consent by the customer; or

(iii) the secured party is the customer with respect to the financial account; and

(g) a secured party that has satisfied the requirements of subparagraph (f) has control of the financial account even if the customer, a debtor or any other person retains the right to direct the disposition of funds from that financial account or substitute other collateral for those funds.

3. Amend subsection 7.1(5) as follows:

Matters governed by law of debtor's jurisdiction

(5) The law of the jurisdiction in which the debtor is located governs,

(a) perfection of a security interest in investment property **or a financial account** by registration;

(b) perfection of a security interest in investment property granted by a broker or securities intermediary where the secured party relies on attachment of the security interest as perfection; and

(c) perfection of a security interest in a futures contract or futures account granted by a futures intermediary where the secured party relies on attachment of the security interest as perfection.

4. Add to section 7.1:

Conflict of laws – validity of security interest in financial account

(8) The validity of a security interest in a financial account shall be governed by the law, at the time the security interest attaches, of the financial institution's jurisdiction.

Conflict of laws – perfection and priority of security interest in financial account

(9) Except as otherwise provided in subsection (5), perfection, the effect of perfection or non-perfection, and the priority of a security interest in a financial account shall be governed by the law of the financial institution's jurisdiction.

Determination of financial institution's jurisdiction

(10) For purposes of this section, the following rules determine a financial institution's jurisdiction in relation to a financial account:

1. If an agreement between the financial institution and its customer governing a financial account expressly **provides that a particular jurisdiction is the financial institution's jurisdiction in relation to that financial account for purposes of the law of that jurisdiction**, this Act or any provisions of this Act, the jurisdiction expressly provided for in the agreement is the financial institution's jurisdiction.

2. If paragraph 1 does not apply and an agreement between the financial institution and its customer governing the financial account expressly provides that the agreement shall be governed by the law of a particular jurisdiction, that jurisdiction is the financial institution's jurisdiction.

3. If neither paragraph 1 nor paragraph 2 applies and an agreement between the financial institution and its customer governing the financial account expressly provides that the financial account is held or maintained at an office in a particular jurisdiction, that jurisdiction is the financial institution's jurisdiction.

4. If none of the preceding paragraphs applies, the financial institution's jurisdiction is the jurisdiction in which the office identified in statements delivered by the financial institution to the customer is located.

5. If none of the preceding paragraphs applies, the financial institution's jurisdiction is the jurisdiction in which the chief executive office of the financial institution is located or, in the case of the Crown, in which its legislative branch is located.

5. Amend subsection 8(1) as follows:

Procedural and substantive issues

8. (1) Despite sections 5 to 7.3,

(a) procedural issues involved in the enforcement of the rights of a secured party against collateral are governed by the law of the jurisdiction in which the enforcement rights are exercised; ~~and~~

(b) substantive issues involved in the enforcement of the rights of a secured party against collateral are governed by the proper law of the contract between the secured party and the debtor**; and**

(c) other than the rights referred to in subparagraphs (a) and (b), the rights and duties of a secured party with respect to collateral in its possession or control and any rights or obligations arising from a breach of any of such rights and duties is governed by the proper law of the contract between the secured party and the debtor.

6. Amend subsection 11(2) as follows:

When security interest attaches to collateral

(2) Subject to section 11.1, a security interest, including a security interest in the nature of a floating charge, attaches to collateral only when value is given, the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party and,

(a) the debtor has signed a security agreement that contains,

(i) a description of the collateral sufficient to enable it to be identified,

(ii) a description of collateral that is a security entitlement, securities account or futures account, if it describes the collateral by any of those terms or as investment property or if it describes the underlying financial asset or futures contract, or

(b) the collateral is not a certificated security and is in the possession of the secured party or a person on behalf of the secured party other than the debtor or the debtor's agent pursuant to the debtor's security agreement;

(c) the collateral is a certificated security in registered form and the security certificate has been delivered to the secured party under section 68 of the Securities Transfer Act, 2006 pursuant to the debtor's security agreement; ~~or~~

(d) the collateral is investment property and the secured party has control under subsection 1 (2) pursuant to the debtor's security agreement**; or**

(e) the collateral is a financial account, the debtor has signed a security agreement, the secured party has control under subsection 1(2) pursuant to that security agreement and the security agreement contains:

(i) a description of the financial account sufficient to enable it to be identified, or

(ii) a description of the financial account that describes it as such.

7. Add a new section 17.2:

Rights and duties with respect to financial account

17.2 (1) Unless the financial institution otherwise agrees in writing, a financial institution's rights and duties with respect to a financial account are not terminated, suspended, or modified by:

(a) the creation, attachment, or perfection of a security interest in the financial account;

(b) the financial institution's knowledge of the security interest; or

(c) the receipt by the financial institution of instructions from the secured party.

Right to refuse to enter into control agreement

(2) This section does not require a financial institution to enter into an agreement of the kind described in subclause 1(2)(f)(ii) even if the customer so requests or directs.

Obligation to disclose existence of control agreement

(3) A financial institution that has been requested to confirm the existence or non-existence of an agreement of the kind described in subclause 1(2)(f)(ii) by a judgment creditor or other person who has an interest in the collateral shall:

(a) request consent from the customer to confirm the existence or non-existence of the agreement to the person if it has not already obtained that consent as a term of the security agreement or otherwise; and

(b) if it has or obtains the consent of that customer, confirm the existence or non-existence of the agreement to the person making the request.

8. Add to section 22.1:

(3) A security interest in a financial account may be perfected by control of the financial account under subsection 1(2).

(4) A security interest in a financial account is perfected by control from the time the secured party obtains control and remains perfected by control until the secured party does not have control..

9. Amend section 30.1 as follows:

Priority rules for security interests in investment property and financial account

30.1 (1) The rules in this section govern priority among conflicting security interests in the same investment property **or financial account**.

Secured party with control

(2) A security interest of a secured party having control of investment property **or a financial account** under subsection 1(2) has priority over a security interest of a secured party that does not have control of the investment property **or financial account**.

Certificated security perfected by delivery

(3) A security interest in a certificated security in registered form which is perfected by taking delivery under subsection 22 (2) and not by control under section 22.1 has priority over a conflicting security interest perfected by a method other than control.

Rank by priority in time

(4) Except as otherwise provided in subsections (5)**,** ~~and~~ (6), **(6.1) and (6.2),** conflicting security interests of secured parties each of which has control under subsection 1(2) rank according to priority in time of,

(a) if the collateral is a security, obtaining control;

(b) if the collateral is a security entitlement carried in a securities account,

(i) the secured party's becoming the person for which the securities account is maintained, if the secured party obtained control under clause 25(1)(a) of the *Securities Transfer Act, 2006*,

(ii) the securities intermediary's agreement to comply with the secured party's entitlement orders with respect to security entitlements carried or to be carried in the securities account, if the secured party obtained control under clause 25(1)(b) of the *Securities Transfer Act, 2006*, or

(iii) if the secured party obtained control through another person under clause 25(1)(c) of the *Securities Transfer Act, 2006*, when the other person obtained control; ~~or~~

(c) if the collateral is a futures contract carried with a futures intermediary, the satisfaction of the requirement for control specified in subclause 1(2)(d)(ii) with respect to futures contracts carried or to be carried with the futures intermediary~~. or~~

(d) if the collateral is a financial account,

(i) the secured party becoming the customer in relation to the financial account, if the secured party obtained control under subclause 1(2)(f)(iii), or

(ii) the financial institution's agreement to comply with the secured party's instructions with respect to funds in the financial account, if the secured party obtained control under subclause 1(2)(f)(ii).

Securities intermediary

(5) A security interest held by a securities intermediary in a security entitlement or a securities account maintained with the securities intermediary has priority over a conflicting security interest held by another secured party.

Futures intermediary

(6) A security interest held by a futures intermediary in a futures contract or a futures account maintained with the futures intermediary has priority over a conflicting security interest held by another secured party.

Financial institution

(6.1) Subject to subsection (6.2), a security interest held by a financial institution in a financial account that is an obligation of the financial institution has priority over a conflicting security interest in the financial account held by another secured party.

Same

(6.2) A security interest in a financial account in relation to which the secured party has obtained control under subclause 1(2)(f)(iii) has priority over a security interest held by the financial institution that is obligated under that financial account, except for any security interest granted by the secured party in favour of the financial institution.

Interests granted by broker, intermediary

(7) Conflicting security interests granted by a broker, securities intermediary or futures intermediary which are perfected without control under subsection 1 (2) rank equally.

Priority determined under s. 30

(8) In all other cases, priority among conflicting security interests in investment property **and a financial account** shall be governed by section 30.

10. Amend section 40 as follows:

Account debtor

40. (1) In this section,

"account debtor" means a person obligated on an account**, a financial account** or ~~on~~ chattel paper;

"assign" and "assignment" includes the creation of a security interest in any form;[9]

"assignee" includes a secured party with a security interest in an account or a financial account, whether or not the security interest was granted by way of an assignment or otherwise; and

"assignor" includes a person that has granted a security interest in an account or a financial account, to an assignee whether or not the security interest was granted by way of an assignment or otherwise.

Defences available against assignee

(1.1) An account debtor who has not made an enforceable agreement not to assert defences arising out of the contract between the account debtor and the assignor may set up by way of defence against the assignee,

> (a) all defences available to the account debtor against the assignor arising out of the terms of the contract or a related contract, including **contractual rights of set-off,** equitable set-off and misrepresentation; and

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[9] Many (perhaps most) security agreements that create a security interest in accounts do so by way of assignment of the account. There should not, however, be a distinction between the position of a secured creditor to whom an account is assigned and one to whom a security interest is granted. These amendments ensure that the account debtor defences apply to all persons who take an interest in an account regardless of the method of taking that interest.

(b) the right to set off any debt owing to the account debtor by the assignor that was payable to the account debtor before the account debtor received notice of the assignment.[10]

Same

(1.2) For greater certainty, the priority rules in sections 20 and 30 do not affect the defences and rights of the account debtor referred to in subsection (1.1).

Payment by account debtor

(2) An account debtor may pay the assignor until the account debtor receives notice, reasonably identifying the relevant rights, that the account**, financial account** or chattel paper has been assigned, and, if requested by the account debtor, the assignee shall furnish proof within a reasonable time that the assignment has been made, and, if the assignee does not do so, the account debtor may pay the assignor.

Modification, etc., effective against assignee

(3) To the extent that the right to payment or part payment under an assigned contract has not been earned by performance, and despite notice of the assignment, any modification of or substitution for the contract, made in good faith and in accordance with reasonable commercial standards and without material adverse effect upon the assignee's right under or the assignor's ability to perform the contract, is effective against an assignee unless the account debtor has otherwise agreed, but the assignee acquires corresponding rights under the modified or substituted contract.

Prohibition or restriction on assignment

(4) A term in the contract between the account debtor and the assignor that prohibits or restricts the assignment of, or the giving of a security interest in, the whole of the account**, financial account** or chattel paper for money due or to become due or that requires the account debtor's consent to such assignment or such giving of a security interest,

(a) is binding on the assignor only to the extent of making the assignor liable to the account debtor for breach of their contract; and

(b) is unenforceable against third parties.

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[10] Part (b) relates to legal set-off, not contractual or equitable set-offs. Legal set-off is cut-off once notice of assignment is received. That is not true of contractual or equitable set-off. Hence, the distinction between (a) and (b).

11. Amend subsection 56(7) as follows:

No outstanding secured obligation

(7) Where there is no outstanding secured obligation, and the secured party is not committed to make advances, incur obligations or otherwise give value, a secured party having control of investment property under clause 25(1)(b) of the *Securities Transfer Act, 2006* or subclause 1(2)(d)(ii) of this Act **or control of a financial account under subclause 1(2)(f)(ii) of this Act,** shall, within 10 days after receipt of a written demand by the debtor, send to the securities intermediary or futures intermediary with which the security entitlement or futures contract is maintained**, or to the financial institution that is obligated under the financial account,** a written record that releases the securities intermediary**,** ~~or~~ futures intermediary **or financial institution** from any further obligation to comply with entitlement orders**,** ~~or~~ directions **or instructions** originated by the secured party

12. Amend section 61 as follows:

Collection rights of secured party

61. (1) Where so agreed and in any event upon default under a security agreement, a secured party is entitled,

(a) to notify any person obligated on an account**, a financial account** or ~~on~~ chattel paper or any obligor on an instrument to make payment to the secured party whether or not the assignor was theretofore making collections on the collateral; ~~and~~

(b) to take control of any proceeds to which the secured party is entitled under section 25**; and**

(c) to apply the balance of an account or a financial account to the obligation secured by that collateral.

Idem

(1.1) Unless otherwise agreed by the parties, a secured party may exercise a right of recoupment, compensation, set-off or consolidation against an account or a financial account to satisfy an obligation owed to the secured party whether or not the security interest in that collateral has been perfected by control.

Idem

(2) A secured party who by agreement is entitled to charge back uncollected collateral or otherwise to full or limited recourse against the debtor and who

undertakes to collect from a person obligated on an account or on chattel paper or an obligor on an instrument shall proceed in a commercially reasonable manner and the secured party may deduct the reasonable expenses of realization from the collections.

13. Amend section 63(7) as follows:

Notice not required

(7) The notice mentioned in subsection (4) is not required where,

(a) the collateral is perishable;

(b) the secured party believes on reasonable grounds that the collateral will decline speedily in value;

(c) the collateral is of a type customarily sold on a recognized market;

(d) the cost of care and storage of the collateral is disproportionately large relative to its value;

(e) for any reason not otherwise provided for in this subsection, the Superior Court of Justice, on an application made without notice to any other person, is satisfied that a notice is not required;

(f) after default, every person entitled to receive a notice of disposition under subsection (4) consents in writing to the immediate disposition of the collateral; ~~**or**~~

(g) a receiver and manager disposes of collateral in the course of the debtor's business**; or**

(h) the collateral is a financial account.

PART 3 - EXPLANATORY NOTES

New Class of Collateral

The amendments propose creating a new class of collateral – the *financial account*. While "financial accounts" are excluded from the definition of "account", this new class of collateral is in effect a sub-type of that existing broader class of collateral.[11] An account is essentially a monetary obligation, although one that is not within other defined collateral classes, such as investment property, chattel paper or instruments.

A *financial account* is either a deposit account maintained by a financial institution for a customer (other than a consumer account), or a monetary obligation of a financial institution related to any funds received or held by the financial institution as security. The second branch of the definition ensures that all cash collateral arrangements in which a financial institution receives or holds cash can be perfected by control, even if the financial institution does not formally maintain a deposit account and even if the funds received or held by the financial institution are used by it in its business.

Financial institution is defined widely to include any type of financial entity that would maintain deposit accounts for customers, or would otherwise receive or hold cash collateral as security. It is important not to restrict the definition to Canadian regulated institutions because Canadian debtors deal with institutions outside of Canada from their operations outside of Canada, contexts in which Canadian regulatory jurisdiction does not apply. It is not necessary in the case of a financial account that the account be established specifically for the purpose of providing or holding cash collateral.[12] The definition of "financial institution" intends to encompass all of the significant players in Canadian financial markets transactions, including the Crown, pension funds and mutual funds. While these types of entities would not typically maintain deposit accounts for customers, they do receive or hold cash collateral to secure obligations.

Consumer accounts are excluded from the definition of financial account. This exclusion parallels a similar exclusion from the scope of Article 9 of the UCC[13].

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[11] PPSA, s.1(1).

[12] The financial account is a wider class of collateral than the deposit account collateral class defined by Revised Article 9 of the Uniform Commercial Code. It covers a wider class of account and a wider class of financial institution.

[13] UCC §9-109(d)(13) provides that Article 9 does not apply to "an assignment of a deposit account in a consumer transaction".

Attachment

A cash collateral arrangement will usually be provided for in a security agreement that will describe the collateral by reference to the transferred or deposited funds or the financial account itself. Attachment will in those circumstances arise in the normal fashion.

The amendments provide that attachment with respect to a financial account will occur upon the secured party obtaining control.[14] A requirement has been added with respect to a financial account that the security agreement creating the security interest in the account be in writing.[15]

Perfection by Control

The amendments provide that a secured party may perfect a security interest in a financial account in two ways – by registration (as already provided for in the PPSA)[16] and by control.[17] The definition of control with respect to a financial account parallels the definitions of control with respect to a securities account and a futures account.

With respect to a financial account, there will be three means of obtaining control.

Automatic Control. First, the secured party will automatically have control if it is the financial institution that is obligated to a customer to pay the financial account.[18] This parallels the means of control for a securities account in which the securities intermediary maintaining the account has a security interest or a futures account in which the futures intermediary has a security interest.[19]

Control Agreements. Second, if the financial account is with a third party financial institution (or the financial institution is acting in more than one capacity), the secured party, debtor and financial institution may agree in writing that the financial institution will comply with instructions originated by the secured party directing disposition of the funds from the account without further consent of the customer.[20] This parallels a means of control with respect to a securities account and a futures account maintained with a third party securities

[14] New subclause 11(2)(e).

[15] New subclause 11(2)(e).

[16] This requires one minor amendment to section 7.1(5)(a) to add financial accounts.

[17] New subsection 22.1(3).

[18] New subclause 1(2)(f)(i).

[19] STA, s.26; PPSA, s.1(2)(d)(i).

[20] New subparagraph 1(2)(f)(ii).

intermediary and futures intermediary respectively.[21] It will validate blocked account agreements, already in widespread use in Canada, as a means of perfection. Further, this means of perfection will allow, for example, a debtor that has entered into derivatives contracts and securities loans with a Canadian bank to use its financial account balances with the bank's related U.S. subsidiary bank or securities dealer as collateral.

Transfer to the Financial Institution's Account. Third, a secured party will have control if it is the customer with respect to the financial account.[22] This parallels a means of control with respect to a securities account.[23] The secured party will have control if funds are transferred to a financial account of the secured party at a third party financial institution.

In certain circumstances the debtor will have the right to direct the disposition of funds from the financial account or to substitute a different form of collateral. To ensure that conferring or exercising this type of right does not compromise the secured party's control of the financial account, the PPSA would include a provision acknowledging that such actions do not compromise control.[24] This provision would parallel the similar provision with respect to certificated and uncertificated securities and securities accounts.[25]

Priority

A secured party with control of a financial account will have priority over a secured party that does not have control.[26]

If the financial account is an obligation of a financial institution which is itself the secured party, then that financial institution will have priority over a conflicting security interest of any other party,[27] other than a secured party that attains control by becoming the financial institution's customer.[28]

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[21] STA, s.25(1)(b) and PPSA, s.1(2)(d)(ii).

[22] New subclause 1(2)(f)(iii).

[23] STA, s.25(1)(a).

[24] Subparagraph 1(2)(g).

[25] STA, s.23(2), s.24(2) and s.25(2).

[26] Amendment to subsection 30.1(1) and 30.1(2).

[27] New subsection 30.1(6.1).

[28] New subsection 30.1(6.2). The priority over the financial institution given in this subsection to a secured party that obtains control by becoming the financial institution's customer (which follows a corresponding provision in UCC Article a) is included for greater certainty since ordinarily two security interests will be in different accounts if the financial institution has a

Otherwise, the temporal order of obtaining control will determine priority between secured creditors with control of financial accounts.[29]

These provisions substantially parallel the similar provisions with respect to investment property.[30]

Conflict of Laws – Validity, Perfection and Priority

The proposed conflict of laws rule for validity, perfection and priority is that these matters will be governed by the law of the financial institution's jurisdiction, as determined by a cascade of rules that look chiefly to the terms of the agreement that governs the financial account. The advantage of this approach is that the rule parallels that which applies to securities accounts and futures accounts and consequently credit balances in a securities account will be dealt with in a fashion similar to credit balances in a financial account. It may not always be easy to distinguish between a financial account and a securities account that is used primarily to hold cash margin. A consistent conflict of laws rule would therefore be helpful. Also, it is consistent with the Article 9 approach and therefore will not lead to two different applicable jurisdictions with respect to accounts held outside of Canada. These rules will apply to financial accounts generally.

Conflict of Laws – Care and Custody of Collateral

There is no conflict of laws rule in the PPSA to determine the law governing the types of issues referred to in sections 17 and 17.1. Given the importance of rehypothecation rights in international financial markets, particularly with respect to cash collateral and investment property, it would be helpful to have an express conflict of laws rule for these issues. We recommend the proper law of the contract between the secured party and the debtor (which currently applies to substantive issues involved in the enforcement of the security interest against the collateral).

Rights of the Secured Party

The Proposal does not amend section 17.1 to refer to financial accounts because we consider that the secured party would have the right to deal with funds received by it as it sees fit, unless it has otherwise agreed with the debtor.

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security interest in the account of a customer that is also the debtor of another secured party. A new asset is created if the secured party becomes the customer of the financial institution.

[29] New subclause 30.1(4)(d).

[30] PPSA section 30.1.

Financial Institution's Rights and Duties

Unless the financial institution otherwise agrees, its rights and duties with respect to a financial account it maintains or owes should not be affected by a security interest in the financial account.[31] For example, if the financial institution otherwise has a right of set-off against the account, it will be permitted to exercise that right unless it has waived it.

A financial institution would not be obligated to enter into a control agreement with a secured party. This rule parallels the STA approach to securities accounts and futures accounts.[32]

A financial institution will be required to confirm the existence of the control agreement with respect to a financial account to another person if requested to do so by the account customer with respect to the account.[33] It will also be obligated to request that consent from the account customer if it is requested by a judgment creditor or other person with an interest in the financial account. These provisions deviate somewhat from those with respect to a securities intermediary and a securities account in order to address concerns raised regarding secret liens, but they balance that concern against the financial institution's confidentiality obligations.[34]

Enforcement

In the case of a financial account where the financial institution is the secured party, the means of enforcement is to apply the balance of the account to the secured obligations. Although practically speaking this closely resembles the financial institution's right of set-off or consolidation of accounts, it is a conceptually distinct remedy (assuming the *Caisse Drummond* analysis is applied to the right) when applied to realization of a security interest. In the case of a financial account at a third party financial institution, the means of enforcement is to allow the secured party to direct the disposition of the account balance. Amendments will recognize that these are permitted means of enforcement regardless of the method of perfection.[35]

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[31] New subsection 17.2(1).

[32] New subsection 17.2(2).

[33] New subsection 17.2(2).

[34] STA, s.28(2) and (3).

[35] New subclauses 61(1)(c) and (d).

Secured Party's Right of Set-off

New subsection 61(1.1) will recognize that a secured party with an existing right of set-off against a financial account will be entitled to exercise that right without being required to demonstrate that it had a security interest perfected by control. This provision confirms the common-law understanding that rights of set-off, consolidation of accounts and similar rights exist apart from, and are not to be regarded as, security interests; and the amendments are not intended to interfere with such otherwise enforceable rights.

A Proposal to Extend Perfection of Security Interests by Control to Cash Collateral

Cash Collateral Working Group
Personal Property Security Law Subcommittee
Ontario Bar Association – Business Law Section

Background Paper

January, 2012

One of the principal benefits of the *Securities Transfer Act* ("**STA**") legislation that is now in force in almost every province and territory in Canada is that security interests in investment property (including securities and securities accounts) can now be perfected by "control" under the corresponding *Personal Property Security Act*s ("**PPSAs**"). For secured parties, the benefits of perfecting their security interests by control rather than registration are significant: each PPSA in the common-law STA jurisdictions (and the *Civil Code of Quebec* as well) provides that a security interest in investment property perfected by control has priority over every other security interest in the same collateral that has not been perfected by control.[1] Lenders, derivatives counterparties and other secured creditors now have the assurance that a pledge of directly or indirectly held securities perfected by control will automatically take priority over any other PPSA security interest in those securities perfected only by registration, regardless of the order of perfection or attachment. If the only collateral is investment property, it is now no longer necessary to seek subordinations or acknowledgments from prior registrants or even to conduct PPSA searches against the pledgor. In addition, lawyers can now give priority opinions on such security interests – something almost unheard of in the pre-STA world. Although by no means an easy read, the STA has brought legal certainty to an area once plagued by ambiguity.

Yet ironically, this same degree of certainty does not extend to a type of collateral that one might intuitively think is the best there is – cash. Cash may be king in most spheres of commerce, but under Canadian personal property security law, cash is the poor relation with "issues" that no one wants to invite to the party.

Collateral in the form of "cash" (which is usually understood to mean funds on deposit in a deposit account or funds transferred to the secured party to serve as collateral) is commonly used to secure a wide variety of obligations – revolving credit facilities, letters of credit, and large value derivatives transactions, to name a few. The 2010 ISDA Margin Survey reported that cash used as collateral represents around 82% of collateral received and 83% of collateral delivered in 2009 as margin for derivatives transactions worldwide.[2] Assuming the existence of an adequate legal infrastructure, cash would be the most widely accepted form of collateral under the central counterparty arrangements that will in effect be mandated by Dodd-Frank, Canada's G20 commitments and Basel III.

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[1] E.g., s. 30.1(2) of the Ontario PPSA ("**OPPSA**").

[2] ISDA Margin Survey 2010, <http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2010.pdf>.

Cash also has obvious advantages over less liquid forms of collateral such as securities. It is fully liquid and readily available. Its value is always known and not subject to dispute and no "haircuts" are needed to offset liquidity, credit and market risks. Realization on security interests in cash entails no incremental formalities.

Yet in Canada, despite these advantages, the same cash that the debtor can use to satisfy any other monetary obligations is often not accepted as collateral for those same obligations because of the legal uncertainties that surround security interests in cash. Cash as collateral, or the deposit account to which it is credited, has no special status under the PPSAs. What is generally meant by "cash"[3] is simply an "intangible" or "account", a security interest in which can be perfected only by registration. Since the priority rules relating to security interests perfected by registration are much less straightforward than those for control, the result is that secured parties accepting cash collateral are unable to obtain a "clean" – or often, any – legal opinion as to the priority of their security interest or even as to where that security interest needs to be perfected.

In this regard, Canada is a decade behind our trading partner to the south. July 1, 2011 marked the tenth anniversary of the date on which Revised Article 9 of the U.S. Uniform Commercial Code ("**Revised Article 9**") took effect in most states. Among its many other reforms, Revised Article 9 extended perfection by control to "deposit accounts", which formerly had been excluded from the scope of Article 9 altogether.[4] It now became possible to perfect a security interest in cash collateral on deposit in a bank account by entering into a control agreement with the deposit bank, by becoming the bank's customer with respect to the deposit or by being the deposit bank itself. Despite the fact the Revised Article 9 deals only with "deposit accounts" and not "cash collateral" as such, it appears to be working quite well.

The Cash Collateral Working Group of the Personal Property Security Law Subcommittee of the Ontario Bar Association – Business Law Section was formed about two years ago to explore the possibility of extending control to cash collateral either by importing the Revised Article 9 approach or producing a "made in Canada" solution. The process has proved to be more difficult and time consuming than originally anticipated. In an effort to obtain the benefit of a diversity of views, the working group invited comments from a number of academics, many of whom expressed significant reservations about adopting the Revised Article 9 regime, which are discussed in more detail below. The working group's proposal that accompanies this paper (the "**Proposal**") attempts to address these concerns while preserving most of the benefits of the control regime. This paper discusses some of the background behind the Proposal and its basic concepts, which are explained in greater detail in the explanatory notes and introduction to the draft legislation.

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[3] There is no statutory definition of "cash" in the PPSA. "Money" is defined in effect as physical currency such as bank notes and coin. Under section 22, a security interest in money may be perfected by possession, but this method is impracticable for large value transactions that may require millions of dollars in cash collateral that can fluctuate day to day depending on the secured party's mark to market exposure, not to mention anti-money laundering legislation.

[4] Under Revised Article 9 (§9-102(29)), "deposit account" is defined as follows: ""Deposit account" means a demand, time, savings, passbook, or similar account maintained with a bank. The term does not include investment property or accounts evidenced by an instrument." A deposit account is in effect a *sui generis* type of property. It is neither an "account" nor a "general intangible" and the depository bank is not an "account debtor" of the depositor. This differs from the approach taken in the Proposal, which is to assimilate "financial accounts" as a subset of "accounts", which in turn is a subset of "intangibles".

Types of Transactions Involving Cash Collateral

As explained in greater detail in the Proposal, security interests in what is commonly referred to as cash collateral typically arise under one of four scenarios:

1. **The 3P FI Scenario.** The debtor grants a security interest to a secured party in a deposit maintained with a third-party financial institution to secure an obligation owed to the secured party. For example, the debtor grants a security interest in all present and after acquired property under a general security agreement, which includes "accounts" in the charging language and so catches all deposit accounts, including operating accounts and personal accounts.

2. **The SP FI Scenario.** The debtor grants (or under the reasoning in the *Caisse Drummond* case[5], is deemed to have granted) a security interest to the financial institution with which it maintains a deposit account to secure its obligations to the financial institution. For example, the financial institution grants a line of credit to the debtor secured by, among other things, the balance in the debtor's various operating accounts.

3. **The SP Obligation Scenario.** The debtor transfers funds to a financial institution secured party to secure obligations owed to the secured party, giving rise to a receivable owed by the financial institution secured party to the debtor but not under a particular deposit account of the debtor. For example, the debtor is required to post cash collateral to secure the reimbursement obligations of the debtor as applicant under a letter of credit issued by the financial institution.

4. **The SP Account Scenario.** The debtor transfers funds to an account of the secured party maintained at a third party financial institution. The secured party may or may not require the funds to remain credited to that account. For example, a derivatives counterparty (the debtor) is required to transfer cash collateral to the other counterparty (the secured party) as initial margin or as variation margin to secure the secured party's mark-to-market exposure, which may fluctuate day to day and may require transfers to and from the counterparties.

In all of these scenarios the secured party would have to rely on registration to perfect its security interest even though as a practical matter in all but the 3P FI Scenario, its remedy would be set-off rather than sale or foreclosure.

Problems with the Current Registration Regime for Cash Collateral

Registration under the PPSA as the sole method of perfecting security interests in cash is beset by manifold difficulties that make many lenders, derivatives counterparties and other secured parties reluctant to rely on this form of collateral once they become aware of the legal issues.

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[5] See discussion under paragraph 10 below.

1. *Priority*

As noted above, the security interest of a secured party having control of investment property automatically enjoys priority over a security interest of a secured party that does not have control.[6] Perfection of a security interest in cash in a deposit account by registration offers no such assurance of priority. The priority rules set out in section 30 of the OPPSA are complex and subject to numerous exceptions. No opinions can be given with respect to security interests in cash collateral or deposit accounts where the debtor is located in a PPSA jurisdiction.

2. *Need for Searches and Subordination*

To mitigate the risk of subordination to other secured parties having prior perfected security interests in the cash collateral, the cash-collateral secured party will typically require PPSA searches against the collateral giver to disclose prior registrations and seek subordinations, creditor acknowledgments, waivers or estoppel letters from those secured parties whose registrations could suffice to perfect a security interest in the cash collateral and so take priority. However, taking these precautions often proves to be impractical or undesirable. Obtaining such assurances is time consuming, and other secured parties often have no incentive to respond to such requests in a timely fashion. The tight time frames for most capital markets transactions often make this exercise a practical impossibility.

3. *Competition with Proceeds Secured Parties*

Cash on deposit in an operating account may represent proceeds of collateral subject to higher-ranking security interests that would follow the proceeds to the extent they are identifiable or traceable.[7] For example, a purchase-money security interest (PMSI) in inventory that is sold and gives rise to proceeds deposited to the debtor's deposit account would continue to enjoy the same priority over the holder of a security interest in the deposit account to the extent the proceeds are traceable, regardless of time of registration.[8] Although the OPPSA now requires that inventory PMSI notices be given to any secured party that has registered a financing statement that describes the collateral as including accounts[9], such a notice may afford little practical benefit to a cash-collateral secured party that has advanced a term loan to the debtor on the security of cash in the deposit account.

4. *Increased Transaction Costs*

To mitigate some or all of these risks, lenders and counterparties may require that the cash collateral be deposited in segregated blocked accounts, increasing transaction costs and reducing the secured party's ability to utilize the cash collateral productively. Alternatively, the secured

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[6] OPPSA, s. 30.1(2).

[7] In OPPSA s. 1(1), "proceeds" is defined as "identifiable or traceable personal property in any form derived directly or indirectly from any dealing with collateral or the proceeds therefrom"; s. 25(1)(b) extends security interests in original collateral to proceeds.

[8] OPPSA s. 33(1).

[9] OPPSA s. 33(1)(b)(iii).

parties may refuse to accept cash collateral at all and require other, more expensive forms of security such as letters of credit or credit insurance.

5. *Public Disclosure*

Registration requires public disclosure of at least the parties' names and entitles a party having an interest in the collateral to a true copy of the security agreement[10], which may disclose deal terms that the parties have a legitimate interest in keeping confidential.

6. *Possibility of Invalidating Errors*

Registration requires additional care and due diligence to ensure that the debtor's name is set out accurately since even a minor error can invalidate the registration.[11]

7. *Re-use or re-hypothecation rights*

Re-use or re-hypothecation rights with respect to cash collateral are unclear. New section 17.1(2) of the OPPSA makes it clear that a secured party having control of investment property as collateral may sell, transfer, use or otherwise deal with the collateral in the manner and to the extent provided in the security agreement. However, this right of re-use does not apply to cash collateral, which is not investment property[12] unless it represents the credit balance in a securities account.[13] Section 17(2)(e) provides that unless otherwise agreed, where collateral is in the secured party's possession the secured party may create a security interest in the collateral upon terms that do not impair the debtor's right to redeem it. However, it is not clear that this provision has application to cash collateral in the form of a bank deposit.

8. *Unclear Realization rights*

Rights of realization against cash under the PPSA are unclear. Somewhat surprisingly, the realization provisions of the PPSA do not provide clear authority for the common practice of simply applying funds on deposit with the secured party in satisfaction of the secured obligations as a means of realization. The provisions in Part V relating to the rights and duties of a secured party on realization seem to contemplate only sales (or "dispositions") of collateral or foreclosure (accepting the collateral in satisfaction of the debt), neither of which accurately describes the process whereby a secured party with which the cash collateral is on deposit debits the account to repay the obligation. Of course this process is typically described as the exercise of a right of set-off, but if the reasoning in the *Caisse Drummond* case discussed below[14] is

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[10] OPPSA s. 18(1)(d).

[11] For a recent example see the Ontario Court of Appeal's decision in *Fairbanx Corp. v. Royal Bank of Canada* 2010 ONCA 385, where the "misspelling" of the debtor's name as "Friction Technology" instead of "Friction Tecnology" (the name in its articles) was held to invalidate the financing statement.

[12] Section 17(4)(a) does provide that a secured party may use the collateral in the manner and to the extent provided in the security agreement. However, where the collateral is cash, does "use" extend to spending the cash or transferring it to a third party? In context, "use" would appear to apply best to tangible goods (such as equipment) that can be used without depleting them.

[13] STA, s.1(1), "financial asset," clause (d).

[14] See discussion at paragraph 10 below.

applied to such rights, they will be characterized as remedies of a secured party under the PPSA. As such there is no statutory scheme that governs the extent of those remedies. A bank's appropriation for its own account of funds on deposit with it as collateral could arguably be regarded as a form of foreclosure that would need to be governed by the detailed notice and objection provisions of s. 65, which makes little commercial sense. A strained interpretation of s. 61(1)[15] might be used to justify a third party holding security over a deposit account (which now is an "account" for PPSA purposes) giving notice to the deposit bank requiring it to honour withdrawal instructions from the secured party; but aside from the fact that practically speaking banks would likely not comply with such requests unless received from taxation authorities, consented to by the depositor or previously agreed to in a negotiated blocked account agreement, they have no application to the deposit bank itself applying funds on deposit to obligations owed to it by its depositor.

9. *Conflict of Laws Issues*

Aside from the inherent drawbacks of registration as a means of perfecting security interests in deposit accounts, the PPSA conflict of laws rules applicable to accounts and other intangibles can give rise to anomalous and unexpected results in multi-jurisdictional transactions. For example, assume that a New York-based subsidiary of an Ontario borrower is required to secure the borrower's obligations by granting a security interest in funds on deposit in a Toronto bank account. This not uncommon fact situation can give rise to some difficult legal and practical conflict of laws issues.

If perfection of the security interest were in issue before an Ontario court, the court would apply the conflict rules in s. 7(1)(a)(i) of the OPPSA, which look to the location of the debtor as the jurisdiction governing validity, perfection, and the effect of perfection or non-perfection of a security interest in an intangible. Assuming the subsidiary's chief executive office is in New York state, perfection of the security interest would therefore be governed by New York state law. Under the New York version of Revised Article 9, perfection of a security interest in a deposit account can be effected only through control, which may be achieved in one of the three ways discussed below.[16] Now the Revised Article 9 conflicts rule applicable to security interest in deposit accounts would point to the local law of the bank's jurisdiction,[17] which in this case would likely take us back to Ontario. At this point the Ontario court would decline to re-assume jurisdiction on the basis that section 8.1 of the OPPSA provides that a reference to the local law of a jurisdiction is a reference to its internal laws, excluding its conflict of laws rules. However, excluding the doctrine of *renvoi* in such a case does not solve the practical and legal question of where and how to perfect the security interest.

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[15] "Where so agreed and in any event upon default under a security agreement, a secured party is entitled,

> (a) to notify any person obligated on an account or on chattel paper or any obligor on an instrument to make payment to the secured party whether or not the assignor was theretofore making collections on the collateral; and
>
> (b) to take control of any proceeds to which the secured party is entitled under section 25."

[16] See UCC § 9-104(a), 9-314.

[17] See UCC § 9-304.

For the security interest to be validly perfected from an Ontario perspective, the secured party (ironically) would need to enter into a U.S. style deposit account control agreement with the Toronto bank, despite the fact that Ontario law does not recognize control as a means of perfecting a security interest in a deposit account. Conversely, if proceedings were brought in New York, the New York court, applying the UCC rules, would hold that the laws of Ontario apply to perfection of the security interest. Therefore, from a New York perspective, the secured party would (ironically) need to register a PPSA financing statement against the debtor in Ontario, despite the fact that New York law does not recognize filing as a means of perfecting a security interest in a deposit account.

But the oddity of this result goes beyond being merely being counter-intuitive and requiring the expense and inefficiency of having to perfect in both jurisdictions. Having gone through the trouble and expense of negotiating a U.S. style deposit account control opinion with a Toronto bank and registering an Ontario PPSA financing statement against a New York debtor, the secured party would undoubtedly expect to get an opinion of New York counsel that its security interest has been perfected under New York law and an opinion of Ontario counsel that its security interest has been perfected under Ontario law. It would probably get neither. New York counsel would say, yes, a control agreement with the Toronto bank would perfect the security interest in the deposit account *if New York law governed perfection*; but unfortunately the UCC tells us, no, perfection is governed by Ontario law, as to which New York counsel expresses no opinion. By the same token Ontario counsel would say, yes, registration under the PPSA would perfect the security interest in the intangible that is the deposit account, *if Ontario law governed perfection;* but unfortunately, the PPSA tells us that perfection is governed by New York law, as to which Ontario counsel expresses no opinion. So excluding *renvoi* may save an Ontario judge the nuisance of having the matter come back to her like a bad penny; but it does nothing to give the secured party the assurance that the security interest has been perfected in the appropriate jurisdiction by the appropriate means.

The simplest solution to these unnecessarily complex problems would be to align the PPSA conflict of laws relating to deposit accounts to those of Revised Article 9. In the above scenario, Ontario law would govern, assuming that the operation of account agreement with the Toronto bank is governed by Ontario law or specifies Ontario as its jurisdiction for the purposes of the PPSA.

10. *Issues Raised by Caisse Populaire Desjardins de l'est de Drummond v. Canada*

As a means of circumventing these problems, secured parties developed a number of workarounds over the years. Standard form bank cash collateral agreements typically include what has been referred to as the "triple cocktail" of security interest, set-off and "flawed asset". (The latter term is used to describe an agreement whereby the debtor/depositor's right to withdraw funds from a pledged deposit account is suspended or subject to a minimum balance so long as the obligations to the secured party/deposit bank are outstanding – hence the deposit account asset in the depositor's hands (which is in law an account receivable from the bank) is "flawed".) The theory behind using this three-pronged approach was that if for some reason the bank's security interest is held to be unperfected or unenforceable, the bank could rely in the alternative on its right of set-off against the deposit obligation, and the "flaw" in the asset would ensure that the credit balance in the account would be sufficient to satisfy the debt owing to the bank.

In addition, recognizing the manifold difficulties associated with registration of a security interest in cash collateral under the PPSAs was not practicable for most derivatives transactions, swap counterparties some years ago developed a workaround using set-off as the security device rather than a security interest per se. Under the Ontario Annex to the ISDA Credit Support Annex,[18] cash collateral, recharacterized as "posted Credit Support", is transferred absolutely to the secured party, creating a debtor-creditor relationship. On termination of the swap, the secured party is required to pay back the posted cash credit support, but this debt can be set off against any net termination payment owed to the secured party by the pledgor.

However, the efficacy of these workarounds was brought into question by the Supreme Court of Canada's decision in *Caisse populaire Desjardins de l'Est de Drummond v. Canada*[19] (released June 19, 2009). In brief, the majority reasons, written by Mr. Justice Rothstein, held that an agreement between a deposit-taking lender and its borrower/depositor that combined a right of set-off (or "*compensation*" in Québec parlance) against a term deposit with restrictions on withdrawing the funds on deposit gave rise to a "security interest" within the meaning of section 224(1.3) of the *Income Tax Act* and other federal tax legislation.

The reasoning of the case may be criticized as giving insufficient weight to the threshold requirement under both the federal and provincial definitions of security interest that there must exist some *in rem* interest in *property* and not simply *in personam* contractual rights. However, its effects may be far reaching. While the *ratio* of the decision deals only with the federal definition of "security interest", that definition closely resembles that used in provincial PPSAs, namely "an interest in personal property that secures payment or performance of an obligation..." Moreover, even though a consideration of provincial law was not necessary for the decision, Mr. Justice Rothstein took some pains to repudiate the minority's view that provincial personal property security legislation excluded contractual set-off from the scope of security interests and suggested that the "functional approach" of common-law personal property legislation would characterize a right of set-off against a deposit combined with a right to restrict access to would give rise to a security interest.[20] Since even *obiter dicta* of the Supreme Court of Canada have been interpreted as binding on lower courts[21], these somewhat unfortunate forays into provincial personal property security law open the door to attempts by competing creditors and trustees in bankruptcy to recharacterize rights of set-off coupled with "flawed asset" restrictions (whereby the depositor's rights to withdraw funds from or otherwise deal in the account are restricted or suspended until the obligations to the bank are discharged) as giving rise to security interests that must be perfected as such to be effective against third parties.

These concerns are especially acute with respect to cash posted as credit support for derivatives contracts since one reason for the alternative debtor-creditor/set-off arrangement was to avoid the need for PPSA registrations, which accordingly are not commonly done. Banks holding cash collateral as part of a broader security package may have a PPSA registration in place, but derivatives counterparties historically have not done so. As a result of *Caisse Drummond,* the

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[18] See <http://www.isda.org/c_and_a/pdf/ISDA-Schedule_Canada.pdf> for the Ontario amendments and <http://www.isda.org/c_and_a/pdf/ISDACSAGuide.pdf> for instructions as to their use.

[19] [2009] 2 S.C.R. 94 ("***Caisse Drummond***").

[20] *Caisse Drummond,* para. 41-42.

[21] See *Sellars v. R.* [1980] l S.C.R. 527.

ISDA Canadian Legal and Regulatory Affairs Committee recommends that counterparties using the Ontario amendments register under the PPSA as well.[22]

If security interests in deposit accounts and cash collateral generally could be perfected by control, the risk that rights of set-off will be recharacterized as security interests would be much less worrying. Even if the right of set-off were recharacterized as a security interest, the secured party would take precautions to ensure that it has a perfected first priority security interest.

Cash as a Financial Asset Under the STA: An Imperfect Solution

When the STA amendments were first enacted, it was widely believed that the drawbacks of not having control apply to cash could be circumvented by simply depositing the cash to a securities account, where it would be treated as a financial asset, a security interest in which could then be perfected by control under the STA regime. Under the STA (unlike Revised Article 8 of the UCC)[23], "a credit balance in a securities account" is a financial asset unless the parties otherwise agree.[24] So rather than have the cash collateral deposited to a bank account, why not simply have the debtor open a securities account with a securities intermediary, deposit the cash there and then perfect through control? In practice, however, this simple solution has proved more difficult to implement than an abstract description would suggest.

A threshold difficulty arises because of the circularity of the definitions in the STA of "securities account" and of "financial asset" as it relates to "cash". The first step in the analysis is to confirm that the account to which cash (or a "credit balance") is credited is a "securities account". However, "securities account" is itself defined as:

> an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that constitute the financial asset.[25]

This definition presupposes that the issue of whether the asset in question is a "financial asset" for the purposes of the STA has already been decided. However, if the asset in question is one whose characterization as a financial asset is in issue (such as a credit balance) and the only asset credited to that account is cash, there is no basis on which to conclude that the account is a securities account, and the asset a financial asset, because the analysis soon becomes hopelessly circular: cash is a financial asset only if it represents the credit balance in a securities account,

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[22] See <http://www.isda.org/c_and_a/pdf/ISDA-Memorandum-refiling-statements-May-2010.pdf>.

[23] Although the UCC does not expressly characterize credit balances in securities accounts as financial assets, the Official Comment to § 9-115, s. 4 suggests that a security interest in a securities account would also attach to any credit balance: "[a] security interest in a securities account would also include all other rights of the debtor against the securities intermediary arising out of the securities account. For example, as security interest in a securities account would include credit balances due to the debtor from the securities intermediary, whether or not they are proceeds of a security entitlement".

[24] STA s. 1(1), "financial asset", clause (e).

[25] STA s. 1(1).

but an account is a securities account only because it is an account to which a financial asset is or may be credited.

Even if the characterization of the account as a securities account is assured, there may be other practical difficulties associated with perfecting a security interest in the credit balance of a securities account by control. What is referred to as the "free credit balance" in a securities account often takes the form of investments in money-market mutual funds and as such may not satisfy the definition of cash in the applicable security agreement or credit support annex. The credit balance may also be subject to withdrawal restrictions in favour of the securities intermediary. The securities intermediary may also need to comply with regulatory restrictions imposed on free credit balances such as those contained in Rule 1200 of the Ontario Dealer Member Rules of IIROC, which may be inconsistent with characterizing the credit balance as being "in" the securities account, since it may need to be segregated in a cash or near-cash account.[26] Even if the securities intermediary does not object to keeping cash "in" the securities account, the "cash" may in practice be credited to a segregated deposit account maintained with a bank or other deposit taking institution, either for regulatory compliance as noted above or internal tracking purposes. If the cash balance appears on the securities account statement, one could still argue that it is "in" the securities account, although the intermediary holds it through another intermediary, just as it might hold securities with a sub-custodian. But if the securities intermediary is simply holding the cash balance as agent or trustee for the client, then arguably the client is holding a deposit account, not a securities account. There may also practical difficulties associated with withdrawing cash from a securities account that do not arise with a demand deposit account that might make it difficult to meet variation margin calls under a derivatives contract.

As a result of these difficulties, perfecting security interests in the credit balance of securities accounts by control is rarely practical as a stand-alone solution to the cash collateral problem.

The Revised Article 9 Regime

Since its adoption in 2001, Revised Article 9 has permitted security interests to be granted in deposit accounts as original collateral[27] except in connection with consumer transactions,[28] and

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[26] Investment Industry Regulatory Organization of Canada, Dealer Member Rules, available on the IIROC website at http://iiroc.knotia.ca/. Rule 1200.3 provides that each Dealer Member shall hold an amount at least equal to the amount of clients' free credit balances in excess of eight times the net allowable assets of the Dealer Member plus four times the early warning reserve of the Dealer Member either (a) in cash segregated in trust for clients in a separate account or accounts with an acceptable institution; or (b) segregated and separate and apart as the Dealer Member's property in bonds, debentures, treasury bills and other securities with a maturity of less than one year of or guaranteed by the Government of Canada, a province of Canada, the United Kingdom, the United States of America and any other national foreign government (provided such other foreign government is a member of the Basel Accord).

[27] See UCC § 9-109(a)(1) (2003). The term "deposit account" is defined in UCC § 9-102(a)(29). Former Article 9 of the Uniform Commercial Code, as reflected in the 1995 and earlier Official Texts, excluded from its scope security interests in deposit accounts as original collateral. See former UCC § 9-104(*l*) (1995).

[28] See UCC § 9-109(d)(13); see also Official Comment 16 to UCC § 9-109. For useful discussion of the Article 9 deposit account control regime, see Ingrid Michelson Hillinger, David Line Batty and Richard K. Brown, "Deposit Accounts under the New World Order", 6 N.C. Banking Inst. 1 (2002) (providing a detailed discussion of the treatment of deposit accounts under Article 9); Ben Carpenter, "Security Interests in Deposit Accounts and Certificates of Deposit Under Revised UCC Article 9", 55 Consumer Fin. L.Q. Rep. 133 (2001) (outlining mechanics of how to obtain control of deposit account in order to perfect a security interest in that deposit account as original collateral); G. Ray Warner, "Deposit

such security interests may be perfected only by control in a manner analogous to that used for investment property under Revised Article 8 and the STAs. The salient provisions can be summarized as follows:

1. *Perfection Only by Control*

Control under UCC §9-314 is the only method available for perfecting security interests in deposit accounts as original collateral.[29] The filing of a UCC financing statement would be ineffective. However, filing still perfects a security interest in deposit accounts that constitute "proceeds" of collateral perfected by filing.[30]

2. *Methods of Obtaining Control*

A secured party has "control" of a deposit account if:

(a) the secured party is the bank with which the deposit account is maintained;[31]

(b) the debtor, secured party, and bank have agreed in an authenticated record[32] that the bank will comply with instructions originated by the secured party directing disposition of the funds in the account without further consent by the debtor;[33] or

(c) the secured party becomes the bank's customer with respect to the deposit account.[34]

It will be apparent that these provisions are modeled on the control provisions of Revised Article 8 relating to securities accounts and security entitlements, now incorporated in sections 25 and 26 of the STA. The first provision parallels section 26 of the STA, whereby a securities intermediary has control of a security entitlement if an interest therein is granted to it by its client, the entitlement holder. The second of these provisions parallels section 25(1)(b) of the STA, where the purchaser obtains control if the securities intermediary agrees, in what is commonly called a securities account control agreement, to comply with entitlement orders originated by the purchaser without the further consent of the entitlement holder. The third provision parallels STA s. 25(1)(c), which grants control to a purchaser that becomes the entitlement holder.

Accounts as Collateral Under Revised Article 9", 19 Am. Bankr. Inst. J. 18 (2000) (briefly describing procedure of attachment, perfection, and priority of security interest in deposit account as original collateral); Bruce A. Markell, "From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9", 74 Chi.-Kent L. Rev. 963 (1999) (discussing history behind and structure of Article 9 as it pertains to deposit accounts).

[29] UCC § 9-312(b)(1).

[30] UCC § 9-312(b) excepts proceeds from the rule in § 9-312(b)(1).

[31] UCC § 9-104(a)(1).

[32] An "authenticated record" would include a signed or otherwise authenticated agreement in physical or electronic form.

[33] UCC § 9-104(a)(2).

[34] UCC § 9-104(a)(3).

3. *Favourable Position of Depositary Banks*

Similar to the position of a securities intermediary under the Revised Article 8/STA regime, a depositary bank that holds a security interest in a deposit account maintained with it enjoys a favoured status as against competing secured parties having security interests in the same deposit account:

(a) The depositary bank automatically has control over the deposit account for purposes of perfection.[35]

(b) In general, a security interest held by the bank with which the deposit account is maintained has priority over a conflicting security interest held by another secured party; the only exception is where the competing secured party obtains control by actually becoming the bank's customer with respect to the account. [36]

(c) The depositary bank may enforce its security interest in its own deposit account by applying the balance of the deposit account to the obligation secured by the deposit.[37] In practice this would be indistinguishable from the right of set-off or consolidation of accounts that the bank would have in any event, but since it is not characterized as right of set-off, presumably it would not be subject to the same constraints as legal or equitable set-off, but it could be subject to other statutory limitations on enforcement of security interests.

(d) The depositary bank is not required to enter into a control agreement with a third party creditor having a security interest in a deposit account maintained with it, even if the customer so requests or directs, and is not required to confirm the existence of such an agreement unless requested to do so by its customer.[38]

4. *Priorities.*

UCC § 9-327 sets out the special priority rules governing conflicting security interests in the same deposit account, which again parallel those pertaining to investment property under the PPSA:

(a) A security interest held by a secured party having control of the deposit account has priority over a conflicting security interest held by a secured party that does not have control.

(b) Security interests perfected by control generally rank according to priority in time of obtaining control.

(c) As noted above,

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[35] UCC § 9-104(a)(1).

[36] UCC § 9-327(3), (4).

[37] UCC § 9-607(a)(4).

[38] UCC § 9-342.

(i) except as otherwise provided in UCC § 9-327(4), a security interest held by the bank with which the deposit account is maintained has priority over a conflicting security interest held by another secured party;

(ii) under UCC § 9-327(4), a security interest perfected by control under Section 9-104(a)(3) (i.e., by becoming the bank's customer) has priority over a security interest held by the bank with which the deposit account is maintained.

5. *Conflict of Laws.*

Under the conflict of laws provisions of Revised Article 9, perfection, the effect of perfection or non-perfection, and the priority of a security interest in a deposit account maintained with a bank is governed by the "local law of the bank's jurisdiction", which is determined by a "cascade" of rules analogous to those used to determine the jurisdiction of a securities intermediary.[39] For example, if an agreement governing the deposit account expressly provides that a particular jurisdiction is the bank's jurisdiction for the purposes of the UCC provisions, that jurisdiction is the bank's jurisdiction. If this rule does not apply then the governing law of the account agreement will determine the bank's jurisdiction. Such rules would be a change from the existing rule in OPPSA s. 7(1) under which these matters are governed by the location of the debtor, which may or may not be the jurisdiction of the bank. As with the rules for determining the "securities intermediary's jurisdiction" under s. 45(1) of the STA, the bank and the debtor thus have some party autonomy in contractually determining the local law that will govern perfection by control of the deposit account and are not constrained by common law rules governing the *situs* of a deposit account.

Benefits of Adopting the Article 9 Model

In light of the foregoing discussion, extending perfection by control to deposit accounts would have a number of benefits.

1. *Consistency with Treatment of Other Financial Assets*

It would be consistent with the treatment of perfection of security interests in investment property (such as security entitlements and futures contracts) under the PPSA, as amended by the STA. Arguably, there is no compelling reason in principle to treat deposit accounts and cash differently from other financial assets, broadly defined, for the purposes of perfection since cash is used as collateral in circumstances that are no different in principle from those applicable to investment property. It is true that legally and structurally a deposit account differs from a security account in a number of significant respects. Whereas a securities account is essentially an agency relationship in which the securities intermediary holds underlying financial assets that represent claims against third parties for the benefit of its customer, the entitlement holder, a deposit account creates a debtor-creditor relationship in which the bank is indebted to the customer for a monetary amount equal to the credit balance and does not hold any underlying assets as agent or bailee for the customer. Although in a sense a state's money represents a claim

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[39] UCC § 9-304 (a), (b). Since deposit accounts are neither general intangibles nor accounts under UCC 9, the conflict of laws rules relating to those forms of collateral need not apply to deposit accounts.

against the state, that claim is no different from the monetary obligation itself. A bank account balance of Cdn$100 gives the depositor the right to demand Cdn$100 from the bank; it does not give the depositor a right or cause of action, even indirectly, against Her Majesty the Queen in right of Canada. However, despite these differences, both securities accounts and bank accounts have now been assimilated to what has been called the general "law of financial accounts".[40]

2. *Harmonization with UCC*

The Proposal adopts a conceptual framework for perfecting security interests in cash collateral that closely resembles that taken for deposit accounts in Revised Article 9. As explained in more detail in the introduction and explanatory notes, it deviates from that paradigm in some respects. For example, it is not restricted to deposit accounts as such but instead extends to a broader class of "financial accounts" which do not necessarily require an identifiable deposit account; and the definition of "financial institutions" is broader than the UCC definition of "bank". That said, the approaches taken to cash collateral in the Proposal and Revised Article are sufficiently similar that adopting the former would further harmonize the PPSA with the UCC and Ontario banking and opinion practice with that in the U.S., promoting greater volumes of cross-border financing and reducing transaction costs and time spent negotiating opinions and documentation. It would lead to greater uniformity in security documentation and perfection methods used in cross-border secured transactions between Canadian and U.S. parties. If a Canadian affiliate of a U.S. parent borrower is required to give security for a U.S. credit facility, the U.S. documentation even now commonly includes deposit account control agreements for both U.S. and Canadian credit parties even though they have no effect on perfection of the lender's security interest in deposit accounts under Ontario law if the debtor is located in Ontario. Blocked account agreements, which achieve some of the same practical benefits as a control agreement, are often used in addition to U.S.-style control agreements, resulting in increased transaction costs and delay.

3. *Conflict of laws issues*

It would eliminate the anomalies and duplication resulting from the differing conflict of laws rules under Article 9 and the PPSA relating to security interests in deposit accounts discussed above and facilitate delivery of legal opinions as to perfection that are not vitiated by extensive qualifications and disclaimers.

4. *Derivatives collateralization and Central Counterparty Requirements*

It would allay the concerns of derivatives counterparties regarding the use and re-use of cash collateral noted above and would make it unnecessary to resort to awkward and possibly ineffective workarounds. Equally important, it would enable Canadian counterparties to participate in the central counterparty arrangements that in effect become mandatory for most cross border and possibly even domestic OTC derivatives transactions as a result of Dodd-Frank,

[40] See, Joseph Sommer, " Law of Financial Accounts: Modern Payment and Securities Transfer Law", 53 Bus. Law. 1181 (1997-1998).

Canada's compliance with its G20 commitments and the punitive capital charges associated with derivatives trades that are not centrally cleared.[41]

5. *Caisse Drummond issues*

It would address many of the issues raised by the *Caisse Drummond* case in that even if a court held that a right of set-off coupled with a security interest gave rise to a security interest, that security interest if perfected by control would take priority over those perfected by registration.

Going Forward

It is hoped that the Proposal will receive serious and timely consideration by the current Ontario Government and form the basis for amendments to the PPSA that will address many of the problems associated with perfecting security interests in cash collateral and will level the playing field with markets where these problems have long been resolved.

The need for action is urgent. If the PPSA provinces in Canada do not take this opportunity to create a legal infrastructure that enables secured parties to accept cash collateral with confidence and legal certainty, we may find ourselves increasingly marginalized in markets where "cash is king".

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[41] On December 16, 2010, the Basel Committee on Banking Supervision ("BCBS") released the final text of the Basel III package, which were endorsed by the G20 leaders (including Canada) in November 2010. On February 1, 2011, the Office of the Superintendent of Financial Institutions (Canada) published a statement alerting federally regulated financial institutions to the BCBS' substantial completion of the international agreement on capital rules, to be implemented starting January 1, 2013, indicating that the reforms will also be implemented in Canada by January 2013. Among other consequences, the heightened capital requirements applicable under the new framework will increase incentives to move OTC derivative exposures to central counterparties (CCPs). The new framework will impose a "modest" 2 percent risk-weight on exposures to "qualifying CCPs" – generally those subject to standards set by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions (IOSCO) – as opposed to the zero percent risk-weight permitted under the current Basel II framework. An exposure to a non-qualifying CCP, like any other bilateral OTC derivative exposure, would attract the significantly higher capital charges applicable under Basel III – possibly as high as 1200%. The original proposal is available at http://www.bis.org/publ/bcbs190.htm.