

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

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Background Paper

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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 Acts* (“**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.

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.

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* case⁵, 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.

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 accounts⁹, 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

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 agreement¹⁰, 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 property¹² 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 below¹⁴ is

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.

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 courts²¹, 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

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] 1 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,

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 be 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 collateral²⁷ except in connection with consumer transactions,²⁸ and

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 record³² 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,

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

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”.

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>.