ISDA®

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April 13, 2010

Ministry of Consumer Services
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Toronto, ON M7A 1N3

Attention: Allen Doppelt, Senior Counsel, Legal Services Branch

Land Titles and Personal Properties Registry
Service Alberta
3rd floor, John E Brownlee Building
10365 - 97 Street
Edmonton, AB T5J 3W7

Attention: Mr. Doug Morrison, Executive Director

Dear Sirs/Mesdames:

Re: Proposal for Amendments to the Treatment of Deposit Accounts under the PPSA

Purpose of this Letter

This letter follows up on ISDA's letter of June 8, 2009 regarding a request on behalf of ISDA's Canadian and non-Canadian members that the Ontario and Alberta governments consider amendments to the *Personal Property Security Act* (Ontario) and the *Personal Property Security Act* (Alberta) (together, the **PPSA)** for security arrangements collateralized by deposit accounts. A copy of that earlier letter is attached.

Our earlier letter explained the particular interest participants in global derivatives markets have in reducing risk around cash collateral arrangements and urged you to consider proposing amendments to the PPSA that would permit a secured party to perfect a security interest in a deposit account by obtaining control of the account.

We are writing again to point out that the need for such amendments has become more acute in light of the reasoning of the majority in the Supreme Court of Canada decision released in June of 2009 in *Caisse Desjardins de l'Est du Drummond v. Canada*[1] (***Caisse Drummond***). This case compromises the effectiveness of a deposit account set-off agreement to assure a first claim with respect to credit support in the form of cash. This form of credit support agreement is common not only in the derivatives and securities financing areas, but also in more traditional financing transactions. The result of the case is that market participants increasingly lack confidence in the set-off arrangement as a means of obtaining a first claim to cash credit support. These set-off arrangements are particularly important in the area of derivatives and securities financing transactions such as securities loans. Without a high degree of confidence in the paramountcy of their rights, market participants will simply not accept cash credit support from Canadian participants located in PPSA jurisdictions. Cash collateral is the predominant and most efficient form of credit support in these markets, so the negative consequences of an uncertain legal position are very serious to Canadian participants. As awareness of the implications of the *Caisse Drummond* decision increases, Canadian participants and global participants that deal with Canadian entities are becoming reluctant to accept cash collateral from Canadian participants.

Description of Typical Security Arrangements for Cash

In our previous letter we described the types of arrangements our members typically employ. Parties transfer to their counterparties, by wire or other means, funds in various currencies into specified bank accounts in Canada or other countries. In other words, participants are not usually dealing with security interests over the general operating account of a debtor with its bank. Funds are typically transferred to specific accounts, which may be a general operating account in the name of the credit support taker or a separate account into which the credit support taker receives cash from numerous counterparties or from a particular counterparty. In order to address the fact that Canadian provincial law does not provide for

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[1] [2009] 2 S.C.R. 94.

perfection by control over a deposit account, parties dealing with Canadian entities often rely on an absolute title transfer approach. When the Canadian party wires the cash to its counterparty pursuant to the terms of the credit support document, a debtor-creditor relationship arises between the parties with respect to the cash under the terms of the credit support document. Under the terms of the credit support document the counterparty also has the right to set-off the Canadian party's obligations against its own obligation to repay the transferred cash. Very often the counterparty is itself a deposit taking institution. There is no security interest expressly granted in the cash as it is transferred absolutely to the counterparty. If the right to net the Canadian party's obligations against the counterparty's obligation to repay the transferred cash is enforceable in all circumstances, then for credit assessment and capital requirements the counterparty is able to treat its exposure to the Canadian party as equal to the mark to market value of the contractual obligations[2] less the amount of the cash collateral. If there is no such assurance, then the counterparty must consider its gross exposure to the Canadian party and that renders the transactions more expensive for the Canadian party (if they are even available to it at all).

Put in its simplest terms, the reasoning of the majority in the *Caisse Drummond* case suggests that, if money is placed on deposit with an institution subject to contractual restrictions that are designed to ensure that the institution will be able to set-off against a customer's obligations, then that arrangement creates a security interest in the deposited "fund" and the right of set-off is a means of realizing on that security interest. We attach an article written by our counsel, Margaret Grottenthaler of Stikeman Elliott LLP, which explains the decision and the difficulties with its reasoning in more detail. While the decision dealt with Crown priorities under the *Income Tax Act*, because the definition of "security interest" in the *Income Tax Act* is similar to the PPSA definition, the case may apply in the PPSA context. One absurd result of the case, if it is found to apply in the PPSA context, is

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[2] The mark to market value of a derivatives contract for example is the amount that would be owing to a party if all the transactions under it were terminated as of that day, valued in accordance with the terms of the contract and netted against each other.

that a set-off right that arises comparatively fortuitously (e.g. the parties have mutual obligations at the time of the set-off) will be enforceable, but one that parties have carefully provided for might not.

The upshot of the *Caisse Drummond* decision is that counterparties to transactions with Canadian entities providing cash collateral may be required to rely on registration to perfect their security interests. This means that these counterparties cannot be assured that their rights of set-off will be effective against secured creditors with general security or an assignment of accounts even if the money has been deposited to a deposit account in the counterparty's own name and is clearly subject to their right of set-off. If they are willing to incur the not insubstantial costs involved in conducting searches and obtaining subordination agreements, waivers or estoppels from prior registrants they could obtain some comfort that they have priority over other consensual PPSA governed secured creditors. However, many of the entities that participate in derivatives and securities financing markets are large deposit taking institutions and corporations and they can have many registrations against them. It is therefore rarely practical to take these steps. There is a significant risk that credit support in the form of cash will no longer be acceptable to many international entities that participate in this market. This is, in fact, already happening. Cash collateral is the least costly form of collateral for most Canadian parties, which means that continued uncertainty in this area will lead to increased costs and risks for Canadian market participants.

Further Information on the Proposed Solution

In our earlier letter we recommended adopting an approach for deposit accounts similar to that which applies to securities accounts, namely an ability to perfect a security interest in a deposit account by obtaining control of the account. We attached draft provisions to amend the Ontario PPSA and we have also attached them to this letter with some minor amendments. We have with this letter also attached similar provisions relating to the Alberta PPSA.

We also understand that you might appreciate a general description of how these provisions would work and how competing secured creditors and the debtor would be affected.

Parallel Operation to Securities Accounts

The proposed deposit account provisions would operate in much the same way as the current provisions with respect to investment property and securities accounts in particular. Deposit accounts would not be classed as investment property, but would be treated in essentially the same way. Given that the new rules in both the PPSA, the *Securities Transfer Act* (Ontario), and the *Securities Transfer Act* (Alberta) (together, the **STA**) with respect to securities, security entitlements and securities accounts were adopted at least in part to provide certainty and finality with respect to transfers of such property because of its fungible nature, it arguably makes little sense to have a less certain and less final regime with respect to the most fungible property of all - money. The proposed amendments are based on the provisions of the United States Uniform Commercial Code Revised Article 9 (**Article 9**).

The following concepts are parallel concepts between the securities account, futures account and proposed deposit account provisions.

Securities Accounts (and financial assets credited to them)	**Futures Accounts (and futures contracts)**	**Deposit Accounts**
control agreement	control agreement	authenticated record
securities intermediary	futures intermediary	deposit taking institution
securities account	futures account	deposit account
financial asset	futures contract or option	[no parallel, because a security interest is taken only in the account not individual funds on deposit]
securities intermediary's jurisdiction	futures intermediary's jurisdiction	deposit taking institution's jurisdiction

entitlement holder	n/a	customer

Scope of Application

The proposed revisions would apply to *deposit accounts*. A deposit account would be defined as a demand, time, savings, passbook or similar account maintained with a *deposit taking institution*. A deposit account would not include deposits that are *instruments* or *investment property* (in each case as currently defined in the PPSA).

A deposit taking institution would include not only banks, but other types of entities that are in the business of taking deposits, such as trust companies and credit societies.

One issue to consider is whether there should be an exception for deposit accounts of consumers (i.e. individual's household or personal deposit accounts). Under the proposed revisions no exception has been made for arrangements with consumers. These types of deposit accounts are generally not relevant in the securities financing or derivatives business. A deposit account with respect to a consumer transaction is excluded entirely from the operation of Article 9. This particular approach would probably not be appropriate for PPSA purposes because, unlike the case under Article 9, it is currently possible under the PPSA to perfect a security interest in a consumer's deposit account by registration. However, if there were a compelling policy reason to exclude such accounts they could simply be excluded from the definition of "deposit account" and the existing rules would thereby continue to apply to those accounts. Query however whether there is a compelling policy reason to exclude them. A consumer is not necessarily benefited by such an exclusion given that it does not prevent a valid and perfected security interest from being created or a bank from exercising its rights of set-off and recoupment. We note that a consumer's securities account is not excluded from the parallel regime for securities accounts. Also, deposit taking institutions do take security over the personal accounts of their customers to secure credit lines and other financial product obligations. Consumers are unlikely to secure their accounts in

favour of other secured creditors so allowing the deposit institution to easily perfect and have priority would not change the current position of consumers.

Conflict of Laws

As with any type of collateral it is important to have clear conflict of laws rules, otherwise secured parties may find that they need to comply with the substantive law in more than one jurisdiction in order to be certain of perfection. For similar reasons it is also important that there be relative uniformity in conflict of laws rules between jurisdictions, particularly those with which there is significant cross border activity. Currently there is no uniformity with respect to the conflict of laws rules for cash collateral as between the PPSA and Article 9. Consequently, parties must comply with two different personal property regimes. Under the current version of the PPSA, deposit accounts are classified as "intangibles" and validity and perfection are, consequently, governed by the *location of the debtor*. Under Article 9, deposit accounts are in a separate class of property, with its own conflict of laws rule. The relevant law is the *local law* of the *deposit taking institution's jurisdiction*. Under the current PPSA if a debtor located in Ontario wires funds to a USD account of the secured party at its New York based bank, as far as proceedings in an Ontario or Alberta court are concerned, Ontario law governs validity and perfection and registration would be the only means of perfection recognized. If proceedings were commenced in the United States, then the U.S. court would apply New York law as the law of the bank's jurisdiction and control would be the only means of perfection recognized. The secured creditor is required to be satisfied as to validity, perfection and priority under both sets of laws since it cannot assume that proceedings will always take place in one jurisdiction or the other. The proposed amendments, which would bring the PPSA into line with Article 9 on this point, would be more efficient and would ensure uniformity with the United States, the jurisdiction that represents the greatest percentage of international cash collateral flows involving Canadians.

Under the proposed amendments, the validity and priority of a security interest would be governed by the internal law of the *deposit taking institution's jurisdiction*. This jurisdiction would also govern the issue of perfection except where perfection is by means of registration. In the case of perfection by registration perfection would be governed by the location of the debtor as it is now. The deposit taking institution's jurisdiction would be determined by a set of rules set out in the PPSA that are very similar to those that apply to determining a securities intermediary's jurisdiction or a futures intermediary's jurisdiction. These rules will provide certainty and clarity.

A conflict of laws rule that looks to the deposit taking institution's jurisdiction as the relevant connecting factor would also provide consistency between the treatment of securities entitlements and cash collateral. For example, currently, if cash is maintained in a cash only account at a broker, then a different conflict of laws rule could apply to the broker's lien on the account than would apply if the broker maintained the cash in the customer's securities account.[3] Securities regulation in certain jurisdictions and in certain circumstances requires brokers to maintain cash in separate accounts. This leads to the anomalous result in the case of providing collateral to a U.S. broker that the PPSA applies to issues with respect to the cash deposit account and Article 9 applies to any credit balances in the securities account.

Validity/Attachment

The proposed amendments would allow a secured party to obtain and perfect a security interest in funds on deposit in an account with a deposit taking institution as a distinct form of collateral. As mentioned above, there currently is no *deposit account* category of collateral and such collateral would likely be categorized as *intangibles*. As with any other security interest, a secured party would obtain a

[3] Cash accounts in which no securities trading takes place may not be securities accounts and, therefore, not subject to the STA.

valid security interest in a deposit account upon attachment. The security interest would attach to the deposit account when:

- value has been given;
- the debtor has rights to the collateral; and
- either
    - the debtor has signed a security agreement with a sufficient description of the deposit account to enable it to be identified, or
    - the secured party has control of the account pursuant to the security agreement.

The only new part of this would be the last bullet, namely the option to satisfy the attachment requirement by control instead of a description in the security agreement.

Perfection

The PPSA currently permits a secured party to perfect a security interest in any type of collateral, including a deposit account, by registration of a financing statement. We do not propose any change to this. It is the same situation that currently exists with respect to investment property. [4]

The proposed amendments would permit the security interest to be perfected by ***control***. A security interest perfected by control would have a higher priority than a security interest perfected by registration, again as is currently the case with securities accounts, futures accounts and other investment property (see below).

Establishing Control

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[4] Under Article 9 a security interest in a deposit account can be perfected only by control. Unlike the case in PPSA jurisdictions, prior to bringing deposit accounts within the scope of Article 9 it was not possible to perfect a security interest in a deposit account under Article 9 except through a proceeds claim: see M. Livingston, *Livingston on Article 9 Security Interests in Deposit Accounts*, 2010 Emerging Issues 4823, Matthew Bender & Company, Inc. Because of the different historical context, it is appropriate to allow for perfection by registration in PPSA jurisdictions.

A secured party could obtain control over a deposit account by any one of three basic methods:

- If the secured party was also the deposit taking institution maintaining the deposit account, it would automatically have control. No separate control agreement would be needed. This would be the simplest way for a secured party that is a deposit taking institution to fully secure its interest in the deposit account which receives and holds the cash collateral. This is comparable to the position of a securities intermediary or futures intermediary with respect to financial assets, including credit balances, credited to a securities or futures account.
- If the secured party was not the deposit taking institution maintaining the deposit account, control would be achieved when the debtor, secured party and deposit taking institution have agreed in an "authenticated record" (e.g., a deposit account control agreement) stating that the institution will comply with instructions, originated by the secured party, directing disposition of the funds in the account without further consent by the debtor. This would likely become a common method of achieving control over a deposit account in traditional financing transactions and would also be useful with respect to entities that are subject to limits on entering into absolute transfer collateral arrangements (e.g. mutual funds). The account could remain in the name of the debtor, but the secured party would maintain control of the account through the agreement. The degree of control can vary as long as the promise of the institution to comply with instructions in the manner described above is obtained. This is the comparable concept to that of the securities account control agreement, futures account control agreement or issuer control agreement in the context of securities accounts, futures accounts and directly held uncertificated securities, respectively.
- If the secured party is not the deposit taking institution maintaining the deposit account, control can also be achieved by the secured party becoming the customer with respect to the account. In this case the deposit account is in the name of the secured party (or perhaps the joint name of the debtor and

the secured party) and the debtor maintains the amounts required to be maintained as cash collateral in this account. Often in securities financing transactions the debtor wires funds from its own account to an account in the name of the secured party either at the same or a different deposit taking institution, perhaps even to the secured party's own general operating bank account. This current practice would achieve control for the secured party. This is the equivalent position to a secured party that is or becomes an entitlement holder with respect to a securities account.

- A secured party that establishes control has control even if the debtor retains the right to direct the disposition of funds from the deposit account. In other words, the secured party with control may permit the debtor to have access to the account until the deposit taking institution maintaining the account is directed otherwise. This would be of benefit to debtors compared to the current regime. Given the limitations of the current legislation, the best practice in the structured finance and derivatives fields is to transfer the cash to the secured party absolutely allowing the debtor to have no control over the funds in the account. The proposed regime would allow for more flexible arrangements.

Determining Priority

Currently priority over a deposit account is determined by order of registration, except where the moneys deposited are identifiable and traceable as proceeds of property in which a secured creditor has a purchase money security interest (**PMSI**), in which case the PMSI interest has priority.[5] However, a deposit taking institution could exercise a right of banker's or contractual set-off[6] against the account that would trump the PMSI and non-PMSI interest.

The proposed amendments would alter these rules with respect to deposit accounts. A security interest in a deposit account perfected by control would have a

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[5] Sections 30 and 33 of the Ontario PPSA.

[6] Unless the analysis in *Caisse Drummond* applied to the particular arrangement in which case the

higher ranking priority than a security interest in the deposit account held by a secured party that does not have control (e.g. one who has perfected by registration). Again, this is the same position that a secured party with control of a securities account or futures account would enjoy. As between secured creditors that both have control, a *first to control* rule would apply to confer priority.

The proposed amendments would also deal with the situation where both the deposit taking institution and another secured creditor of the account holder has a security interest in the deposit. A deposit taking institution would be deemed to have control and hence a perfected secured interest in the account. If the deposit taking institution, the other secured party and the debtor/customer entered into a deposit account control agreement pursuant to which the deposit taking institution would maintain the account on behalf of the other secured party in order to secure credit extended to the debtor/customer by the other secured party, both the deposit taking institution and the other secured party would have properly perfected their security interests by control over the account. In this situation the security interest of the deposit taking institution would have priority over the other secured party even if the other secured party's interests in the deposit account were perfected before the interest of the deposit taking institution. This rule would be subject to specific subordination terms agreed between the deposit taking institution and the other secured party. In the alternative, the other secured party could establish control of the deposit account by becoming the customer with respect to the account. This would also operate to subordinate the deposit taking institution's security interest as against the debtor to those of the other secured party.

The proposed amendments would also clarify the respective priorities of a secured party with a perfected security interest in the deposit account and a secured party with a security interest in proceeds of inventory that are deposited to the account. The secured party with control would have priority. A party with a PMSI or other security interest in proceeds could protect its position by becoming the

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normal priority rules would apply.

customer with respect to the account, obtaining an agreement from the deposit taking institution to subordinate its security interest or ensuring the proceeds are deposited to a specific cash collateral account with respect to which it is the customer. In practice, inventory financiers concerned with protecting their interest in proceeds of inventory set up consignment arrangements and ensure that the proceeds are paid directly to them. PMSI holders that allow proceeds to be paid to the general operating account of the debtor understand that the proceeds will likely not be traceable or identifiable once that occurs and are subject to the banker's right of set-off in any event. In other words, conferring priority on the party with control of the account will not as a practical matter adversely affect PMSI holders.

In summary, the priority would be as follows:

- As between secured parties with interests in a deposit account or funds in the deposit account that are proceeds of inventory security:
    - First priority would go to the secured party that obtains control by having the debtor's deposit account placed in its name.
    - Second priority would go to the deposit taking institution. The deposit taking institution may ensure first priority by not allowing a secured creditor to have the account placed in its name or by agreement with such secured creditor.
    - Subject to the first and second priority rules above, as between secured parties perfected by control, the first to obtain control would have priority.
    - As between a secured party perfected by control and a secured party perfected otherwise than by control, including a secured party claiming a prior perfected security interest in funds in the deposit account as proceeds of its original collateral

(including PMSI collateral), the secured party with control would have priority.

- As between a secured party claiming a deposit account or funds in a deposit account that are proceeds of inventory and a deposit taking institution exercising set-off or recoupment against the account, the general rule would be that the deposit taking institution has the right to exercise the set-off or recoupment notwithstanding the security interest. An exception would apply if the secured party obtained control over the deposit account by having the account placed in its own name.

Rights of the Secured Party on Default

A secured party with control of a deposit account would have certain specific rights with respect to the account. Current PPSA rules do not apply very easily to funds on deposit in an account. There are rules that deal with power of sale and foreclosure, but this is not how secured parties deal with cash collateral. Therefore, there is little guidance in the PPSA regarding the realization procedures and other rights and obligations parties have with respect to cash collateral.[7]

Under the proposed amendments, it would be made clear that where the secured party is the deposit taking institution it can apply the balance of the cash in the deposit account to the secured obligation upon the occurrence of an event of default of the underlying obligations of the debtor. A secured party that is not the deposit taking institution, and who holds an interest in a deposit account perfected by control (through a deposit account control agreement or by becoming the customer), may upon the occurrence of an event of default instruct the depository institution to pay the balance of the cash in the deposit account to it. As with "money", with respect to funds in a deposit account there is no compelling need to

[7] There is a specific rule that allows a secured party with a security interest in "money" to apply the money to the secured obligations. Since "money" is defined as currency, this provision does not apply to funds in a deposit account.

provide a notice period because there will not be any question as to the value of collateral or any practical benefit to redeeming this collateral.

An Alternative Interim Solution

The discrete problem created by the uncertain effect of the *Caisse Drummond* decision on rights of set-off in the PPSA context could also be addressed by a simple clarification of section 40(1.1) of the PPSA. For ease of reference the Ontario PPSA provision reads as follows and the Alberta PPSA section 40(1) is similar:

> 40. (1) In this section,
>
> "account debtor" means a person obligated on an account or on chattel paper.
>
> (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 equitable set-off and misrepresentation; and
> >
> > (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.[8]

Where cash collateral is placed on deposit with a financial institution as credit support for obligations to the institution, it creates an "account" in favour of the depositor and the financial institution is the account debtor. Section 40(1.1) provides that any defences to payment of that account arising out of the contract apply against an assignee. Defences should include contract rights to set-off the

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[8] Part (b) relates to legal set-off not contractual or equitable set-offs. Legal set-offs are 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).

amount owing against other obligations of the account creditor to the account debtor. This provision codifies the position at common law. If a competing secured creditor has taken security by way of an assignment of accounts, then section 40(1.1) should apply to ensure that creditor takes subject to the right of set-off. However, not all secured creditors are necessarily "assignees". There is some question as to whether a secured creditor who has simply been granted a security interest, for example, would be an assignee. Also, an unsecured creditor representative is not a consensual assignee and may not even be an assignee by operation of law (such as a liquidator).

If it could be clarified that contractual set-off rights relating to the account are effective, not only against legal and equitable assignees pursuant to assignment agreements, but also against any secured creditor with a security interest in the account whether or not the security interest is obtained by way of an express assignment of accounts[9] and against other non-consensual assignees such as trustees in bankruptcy or liquidators. It could be made clear that section 40(1.1) applies notwithstanding the priority rules in the PPSA. With these changes financial institutions and other secured parties that receive cash collateral by way of absolute transfer and that have contractual rights to set-off obligations against their obligations with respect to cash collateral transferred to or deposited with them, can have confidence that those rights are effective even if they were put in place as a form of credit support.

This is only an incomplete solution to the cash collateral issue. There is no clear conflict of laws rule for this provision and, consequently, there would remain some uncertainty as to its effectiveness in all situations. Also, it does not provide debtors with as much flexibility in terms of the security arrangements they can agree to (including ones that give them a greater degree of control). As an interim solution

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[9] Many general security agreements include express assignments of accounts, but others may simply grant a "security interest" in all assets including accounts. As a policy matter the position for the account debtor should not be different as between those two situations in terms of the exercise of set-off rights.

it would, however, be extremely helpful. It would be a helpful clarification even if the deposit account provisions are introduced.

The underlined words are the suggested amendment:

> 40. (1) In this section,
>
> "account debtor" means a person obligated on an account or on chattel paper;
>
> "assignee" includes a secured party, whether or not the security interest of the secured party was granted by way of an assignment of the account;
>
> "assignor" includes a person that has granted a security interest in the account to an assignee whether or not the security interest was granted by way of an assignment of the account;
>
> 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
>
> (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]
>
> (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).

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

If you would like to discuss any matter addressed in this letter further or have any questions please contact me directly or through ISDA's counsel in Canada,

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distinction between (a) and (b).

Margaret Grottenthaler of Stikeman Elliott LLP (mgrottenthaler@stikeman.com – 416-869-5686).

Yours truly,

M. François Bourassa

Chair, ISDACanadian Steering Committee
Senior Vice-President, Trading and Structured products
National Bank Financial Inc.

Draft Provisions for Deposit Accounts
Ontario PPSA

1. Add the following definitions to subsection 1(1):

"authenticated" means:

(A) signed; or

(B) executed or which otherwise adopts a symbol, or is encrypted or similarly processed as a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record.

"deposit taking institution" means an organization that is engaged in the business of taking deposits and includes banks, savings banks, loan companies, savings and loan associations, treasury branches, credit unions, trust companies and other similar deposit taking institutions.

"deposit taking institution's customer" means a person identified in the records of the deposit taking institution as the person for whom the account is maintained;

"deposit account" means a demand, time, savings, passbook, or similar account maintained with a deposit taking institution that is not investment property or an instrument.

"record" means information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form.

2. Amend subsection 1(2) to add a new subparagraph (f) and (g):

(f) a secured party has control of a deposit account if,

(i) the secured party is the deposit taking institution with which the deposit account is maintained;

(ii) the deposit taking institution's customer with respect to the account, secured party, and the deposit taking institution have agreed in an authenticated record that the deposit taking institution will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the deposit taking institution's customer; or

(iii) the secured party becomes the deposit taking institution's customer with respect to the deposit account.

(g) A secured party that has satisfied subsection (f) has control, even if the debtor retains the right to direct the disposition of funds from the deposit account.

3. Amend subparagraph 7.1(5)(a) to add the words "or a deposit account" after "investment property".

4. Amend subsection 7.1(7) to add the words "or a deposit account" after "investment property" and the words ", deposit taking institution's jurisdiction " after the words "securities intermediary's jurisdiction".

5. Add new subsections 7.1(8), 7.1(9) and 7.1(10):

(8) **Conflict of laws – validity of security interest in deposit accounts -** The validity of a security interest in a deposit account shall be governed by the law, at the time the security interest attaches, of the deposit taking institution's jurisdiction.

(9) **Conflict of laws- perfection and priority of security interest in deposit accounts-** Except as otherwise provided in subsection (5), perfection, the effect of perfection or of nonperfection and the priority of a security interest in a deposit account shall be governed by the law of the deposit taking institution's jurisdiction.

(10) **Determination of deposit taking institution's jurisdiction** – For purposes of this section, the following rules determine a deposit taking institution's jurisdiction:

1. If an agreement between the deposit taking institution and the deposit taking institution's customer governing the deposit account expressly provides that a particular jurisdiction is the deposit taking institution's jurisdiction 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 deposit taking institution's jurisdiction.

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

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

4. If none of the preceding paragraphs applies, the deposit taking institution's jurisdiction is the jurisdiction in which the office identified in an account statement as the office serving the deposit taking institution customer's account is located.

5. If none of the preceding paragraphs applies, the deposit taking institution's jurisdiction is the jurisdiction in which the chief executive office of the deposit taking institution is located.

6. Amend subsection 11(2) to add a new subparagraph (e):

(e) the collateral is a deposit account and the secured party has control under subsection 1(2) pursuant to the debtor's security agreement.

7. Amend section 17.1 to refer to deposit accounts in both subsections (1) and (2).

8. Add a new subsection 22.1(3)

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

(4) A security interest in a deposit account is perfected by control when the secured party obtains control and remains perfected by control only while the secured party retains control.

9. Add as new subsection 17.2:

17.2 **Exercise of deposit taking institution's rights of set-off and recoupment –** (1) (a) **Exercise of recoupment or set-off-** Except as otherwise provided in subsection (c), a deposit taking institution with which a deposit account is maintained may exercise any right of recoupment or set-off against a secured party that holds a security interest in the deposit account.

(b) **Recoupment or setoff not affected by security interest-** Except as otherwise provided in subsection (c), the application of this section to a security interest in a deposit account does not affect a right of recoupment or set-off of the secured party as to a deposit account maintained with the secured party.

(c) **When set-off ineffective**- The exercise by a deposit taking institution of a set-off against a deposit account is ineffective against a secured party that holds a security interest in the deposit account which is perfected by control, if the set-off is based on a claim against the debtor.

(2) **Deposit taking institution's rights and duties with respect to deposit account-**Except as otherwise provided in Section 17.2(1)(c), and unless the deposit taking institution otherwise agrees in an authenticated record, a

deposit taking institution's rights and duties with respect to a deposit account maintained with the deposit taking institution are not terminated, suspended, or modified by:

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

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

(c) the deposit taking institution's receipt of instructions from the secured party.

(3) **Deposit taking institution's right to refuse to enter into or disclose existence of control agreement-** This section does not require a deposit taking institution to enter into an agreement of the kind described in Section 1(2)(f)(ii) even if its customer so requests or directs. A deposit taking institution that has entered into such an agreement is not required to confirm the existence of the agreement to another person unless requested to do so by its customer.

10. Amend subsections 30.1(1), 30.1(2) and 30.1(8) to add the words "or deposit account" after the words "investment property".

11. Add a new subparagraph 30.1(4)(d):

(d) if the collateral is a deposit account carried with a deposit taking institution, the satisfaction of the requirement for control specified in subclause 1(2)(f)(ii) and (iii) with respect to deposit accounts carried or to be carried with the deposit taking institution.

12. Add the following new subsection 30.1(6.1):

(6.1) A security interest held by a deposit taking institution in a deposit account maintained with the deposit taking institution has priority over a conflicting security interest held by another secured party.

13. Replace subsection 30.1(7) with the following (underlying represents the changes to the current provision)

(7) **Interests granted by broker, intermediary <u>or deposit taking institution</u>-** Conflicting security interests granted by a broker, securities intermediary, futures intermediary <u>or deposit taking institution</u> which are perfected without control under subsection 1(2) rank equally.

14. Replace subsection 56(7) with the following (underlying represents the changes to the current provision):

> (7) **No outstanding secured obligation –** Where there is no outstanding security obligation and the secured party is not committed to make advances, incur obligation or otherwise give value, a security 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 a deposit account under subclause 1(2)(f) of this Act shall, within 10 days after receipt of a written demand by the debtor, send to the securities intermediary, futures intermediary or deposit taking institution with which the security entitlement, futures contract or deposit account is maintained a written record that releases the securities intermediary, futures intermediary or deposit taking institution from any further obligation to comply with entitlements orders, directions or instructions originated by the secured party.

15. Amend subsection 61(1) to add the following subparagraphs (c) and (d):

(c) if it holds a security interest in a deposit account perfected by control under Section 1(2)(f)(i), may apply the balance of the deposit account to the obligation secured by the deposit account; and

(d) if it holds a security interest in a deposit account perfected by control under Section 1(2)(f)(ii) or (iii), may instruct the deposit taking institution to pay the balance of the deposit account to or for the benefit of the secured party.

Draft Provisions for Deposit Accounts
Alberta PPSA

16. Add the following definitions to subsection 1(1):

"authenticated" means:

(A) signed; or

(B) executed or which otherwise adopts a symbol, or is encrypted or similarly processed as a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record.

"deposit taking institution" means an organization that is engaged in the business of taking deposits and includes banks, savings banks, loan companies, savings and loan associations, treasury branches, credit unions, trust companies and other similar deposit taking institutions.

"deposit taking institution's customer" means a person identified in the records of the deposit taking institution as the person for whom the account is maintained;

"deposit account" means a demand, time, savings, passbook, or similar account maintained with a deposit taking institution that is not investment property or an instrument.

"record" means information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form.

17. Amend subsection 1.1 to add a new subparagraph (f) and (g):

(f) a secured party has control of a deposit account if,

(i) the secured party is the deposit taking institution with which the deposit account is maintained;

(ii) the deposit taking institution's customer with respect to the account, secured party, and the deposit taking institution have agreed in an authenticated record that the deposit taking institution will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the deposit taking institution's customer; or

(iii) the secured party becomes the deposit taking institution's customer with respect to the deposit account.

(g) A secured party that has satisfied subsection (f) has control, even if the debtor retains the right to direct the disposition of funds from the deposit account.

18. Amend subparagraph 7.1(5)(a) to add the words "or a deposit account" after "investment property".

19. Amend subsection 7.1(7) to add the words "or a deposit account" after "investment property" and the words, "deposit taking institution's jurisdiction" after the words "securities intermediary's jurisdiction".

20. Add new subsections 7.1(8), 7.1(9) and 7.1(10):

(8) **Conflict of laws – validity of security interest in deposit accounts -** The validity of a security interest in a deposit account shall be governed by the law, at the time the security interest attaches, of the deposit taking institution's jurisdiction.

(9) **Conflict of laws- perfection and priority of security interest in deposit accounts-** Except as otherwise provided in subsection (5), perfection, the effect of perfection or of nonperfection and the priority of a security interest in a deposit account shall be governed by the law of the deposit taking institution's jurisdiction.

(10) **Determination of deposit taking institution's jurisdiction** – For purposes of this section, the following rules determine a deposit taking institution's jurisdiction:

1. If an agreement between the deposit taking institution and the deposit taking institution's customer governing the deposit account expressly provides that a particular jurisdiction is the deposit taking institution's jurisdiction 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 deposit taking institution's jurisdiction.

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

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

4. If none of the preceding paragraphs applies, the deposit taking institution's jurisdiction is the jurisdiction in which the office identified in an account statement as the office serving the deposit taking institution customer's account is located.

5. If none of the preceding paragraphs applies, the deposit taking institution's jurisdiction is the jurisdiction in which the chief executive office of the deposit taking institution is located.

21. Amend subsection 10(6) to add a new subparagraph (e):

(e) the collateral is a deposit account and the secured party has control under subsection 1(2) pursuant to the debtor's security agreement.

22. Amend section 17.1 to refer to deposit accounts in both subsections (1) and (2).

23. Add a new subsection 24.1(3)

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

(4) A security interest in a deposit account is perfected by control when the secured party obtains control and remains perfected by control only while the secured party retains control.

24. Add as new subsection 17.2:

17.2 **Exercise of deposit taking institution's rights of set-off and recoupment –** (1) (a) **Exercise of recoupment or set-off-** Except as otherwise provided in subsection (c), a deposit taking institution with which a deposit account is maintained may exercise any right of recoupment or set-off against a secured party that holds a security interest in the deposit account.

(b) **Recoupment or setoff not affected by security interest-** Except as otherwise provided in subsection (c), the application of this section to a security interest in a deposit account does not affect a right of recoupment or set-off of the secured party as to a deposit account maintained with the secured party.

(c) **When set-off ineffective**- The exercise by a deposit taking institution of a set-off against a deposit account is ineffective against a secured party that holds a security interest in the deposit account which is perfected by control, if the set-off is based on a claim against the debtor.

(2) **Deposit taking institution's rights and duties with respect to deposit account-**Except as otherwise provided in Section 17.2(1)(c), and unless the deposit taking institution otherwise agrees in an authenticated record, a

deposit taking institution's rights and duties with respect to a deposit account maintained with the deposit taking institution are not terminated, suspended, or modified by:

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

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

(c) the deposit taking institution's receipt of instructions from the secured party.

(3) **Deposit taking institution's right to refuse to enter into or disclose existence of control agreement-** This section does not require a deposit taking institution to enter into an agreement of the kind described in Section 1.1(f)(ii) even if its customer so requests or directs. A deposit taking institution that has entered into such an agreement is not required to confirm the existence of the agreement to another person unless requested to do so by its customer.

25. Amend subsections 35.1(1), 35.1(2) and 35.1(8) to add the words "or deposit account" after the words "investment property".

26. Add a new subparagraph 35.1(4)(d):

(d) if the collateral is a deposit account carried with a deposit taking institution, the satisfaction of the requirement for control specified in subclause 1.1(f)(ii) and (iii) with respect to deposit accounts carried or to be carried with the deposit taking institution.

27. Add the following new subsection 35.1(6.1):

(6.1) A security interest held by a deposit taking institution in a deposit account maintained with the deposit taking institution has priority over a conflicting security interest held by another secured party.

28. Replace subsection 30.1(7) with the following (underlining represents the changes to the current provision)

(7) **Interests granted by broker, intermediary <u>or deposit taking institution</u>-** Conflicting security interests granted by a broker, securities intermediary, futures intermediary <u>or deposit taking institution</u> which are perfected without control under subsection 1.1 rank equally.

29. Replace subsection 50(11) with the following (underlying represents the changes to the current provision):

> (7) **No outstanding secured obligation –** Where there is no outstanding security obligation and the secured party is not committed to make advances, incur obligation or otherwise give value, a security party having control of investment property under clause 25(1)(b) of the *Securities Transfer Act, 2006* or subclause 1.1(d)(ii) of this Act or a deposit account under subclause 1.1(f) of this Act shall, within 10 days after receipt of a written demand by the debtor, send to the securities intermediary, futures intermediary or deposit taking institution with which the security entitlement, futures contract or deposit account is maintained a written record that releases the securities intermediary, futures intermediary or deposit taking institution from any further obligation to comply with entitlements orders, directions or instructions originated by the secured party.

30. Amend subsection 57(1) to add the following subparagraphs (c) and (d):

(c) if it holds a security interest in a deposit account perfected by control under Section 1(2)(f)(i), may apply the balance of the deposit account to the obligation secured by the deposit account

(d) if it holds a security interest in a deposit account perfected by control under Section 1.1(f)(ii) or (iii), may instruct the deposit taking institution to pay the balance of the deposit account to or for the benefit of the secured party.

ISDA®

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June 8, 2009

Consumer & Business Services
Ministry of Government Services
77 Wellesley Street West
Ferguson Block, 6th Floor
Toronto, ON M7A 1N3

Attention: Mr. Allen Doppelt, Senior Counsel, Legal Services Branch

Land Titles and Personal Properties Registry
Service Alberta
3rd floor, John E Brownlee Building
10365 - 97 Street
Edmonton, AB T5J 3W7

Attention: Mr. Doug Morrison, Executive Director

Dear Sirs/Mesdames:

Re: Proposal for Amendments to the Treatment of Deposit Accounts under the PPSA

Purpose of this Letter

This letter is a request on behalf of ISDA's Canadian and non-Canadian members that the Ontario and Alberta governments consider amendments to the *Personal Property Security Act* for security arrangements collateralized by deposit accounts.

The International Swaps and Derivatives Association Inc., which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has over 825 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the

Association's web site: www.isda.org. ISDA members include the Canadian chartered banks and other major financial institutions, as well as many other Canadian financial and commodities market participants. ISDA members deal with many Canadian entities that are not themselves ISDA members, but which are nevertheless important players in derivatives and securities lending markets. Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business.

ISDA members have a particular interest in reducing risk around cash collateral arrangements. Cash is received and delivered as credit support for the mark to market exposure on derivatives and securities financing transactions (eg securities loans, securities repurchase agreements, margin loans) at very significant levels. Often both parties are required to post collateral to each other as exposures change during the course of the contractual relationship. This can mean transfers of large amounts of cash collateral on a regular basis, and in many cases on a DAILY basis as the mark to market value of transactions changes. Some significant market participants will accept only cash collateral. While exact statistics are not available for Canada, the ISDA collateral survey for December 2008 indicated that 72% of the collateral posted worldwide at that time to support over-the-counter derivatives transactions was in the form of cash. One Canadian institution reports that it received and delivered in the past six months over $7 billion in cash. The importance of cash collateral in the financial markets makes it imperative to create legal certainty regarding the effectiveness of measures to perfect security interests in cash collateral.

The enactment of the *Securities Transfer Act* and the companion amendments to the PPSA and Ontario *Business Corporations Act* have provided an immense benefit to market participants in reducing risk surrounding the posting of securities collateral for derivatives and securities financing transactions. Canadian market participants would benefit significantly if the same level of legal certainty and efficiency with respect to the posting of cash collateral could be achieved. In this letter we set out what our membership has identified as issues under the PPSA that are impeding collateral relationships with Canadian market participants and

proposals for your consideration as to how these issues could be addressed in the PPSAs.

Description of Typical Security Arrangements for Cash

The types of cash collateral arrangements our members typically have involve the transfer by wire or other means of funds in various currencies into specified bank accounts in Canada or other countries. In other words, participants are not usually dealing with security interests over the general operating account of a debtor with its bank. Funds are transferred typically to specific accounts, which may be a general operating account in the name of the secured party or a separate account in which the secured party holds cash collateral from numerous counterparties or cash collateral from a particular collateral provider. The collateral arrangements vary in terms of documentation. Some involve an absolute title transfer approach without an intention to create a security interest. Others, however, are traditional pledge/security interest agreements. For example, ISDA's form of Credit Support Annex governed by New York law, which is widely used in the Canadian market, creates a security interest in the posted collateral.

The "collateral" is the asset created by the deposit, which is a debt obligation of the deposit institution. Although this deposit account is in the name of the secured party, the secured party still has only been granted a security interest in the transferred funds and, therefore, has only a security interest in the deposit account. For example, Canadian Bank A may deliver cash to US Dealer B by depositing Canadian funds in US Dealer B's account with Canadian custodial Bank C, in which case the collateral is the rights with respect to the account at Bank C. Because the collateral is an "intangible" in PPSA terms, the governing law for validity, perfection and priority is the place where the debtor is located, the only means of perfection possible is registration of a financing statement, and priority as against other consensual secured creditors is determined by order of registration.

ISDA®

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June 8, 2009

Consumer & Business Services
Ministry of Government Services
77 Wellesley Street West
Ferguson Block, 6th Floor
Toronto, ON M7A 1N3

Attention: Mr. Allen Doppelt, Senior Counsel, Legal Services Branch

Land Titles and Personal Properties Registry
Service Alberta
3rd floor, John E Brownlee Building
10365 - 97 Street
Edmonton, AB T5J 3W7

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Uncertainties and Inefficiencies in the Treatment of Cash Collateral

No Assurance of Priority

If secured creditors must rely on registration to perfect their security interest they cannot be assured of a first priority to the cash collateral even if the deposit account is held in their own name. If they are willing to incur the not insubstantial costs involved in conducting searches and obtaining subordination agreements, waivers or estoppels from prior registrants they could obtain some comfort that they have priority over other consensual PPSA governed secured creditors. However, many of the entities that participate in derivatives and securities financing markets are large financial institutions and corporations and they can have many registrations against them. It is rarely practical to conduct this type of process. Even if they did, this does not assure protection against other non-consensual secured creditors (such as deemed trust claimants) or other adverse claimants.

The lack of certainty with respect to priority is a particularly acute problem in the derivatives and securities financing areas, because without it market participants cannot take the collateral fully into account in determining their risk exposure for capital or credit purposes. International bank capital rules, for example, would require that the value of the collateral be significantly discounted if there is not sufficient certainty as to priority.

Also, institutions set their policies based on their assessment of legal risk for counterparties generally in the particular jurisdiction. Even if in individual cases a secured creditor may be able to easily obtain priority based on the registration, the fact that there will be situations where they cannot get assurance as to priority based on perfection by registration, essentially results in setting a policy not to take a security interest in cash collateral from Canadian counterparties.

No Clear Right to Use Collateral

Also, the rights that a secured party has with respect to investment property under s.17.1 of the PPSA are not extended to this form of collateral as it is not "investment property". Consequently, it is unclear whether a secured creditor that actually receives cash collateral, even into its own account, could be permitted to use

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it. This distinction between cash and other fungible property does not make much sense from a policy perspective. Collateral providers obtain significantly better terms if the secured party is permitted to use the collateral. This applies not only to securities, but also to cash.

Realization Rights as Against Cash are Unclear

In addition, in terms of realization rights, there is no provision in the PPSA that clearly allows a secured party to simply apply the amount of the cash collateral against the debt, although that is obviously the only sensible course of action when the funds are already being held by the secured party. Doing this could technically be a foreclosure on this collateral. It makes little sense to require the processes for foreclosure to apply to deposit accounts.

Work Arounds Are Not Complete Solutions

Market participants taking cash from Canadian parties to secure derivatives and other financial transactions have for these reasons been avoiding arrangements that create a security interest. For example, under the ISDA form of Credit Support Annex governed by New York law amendments are often made with respect to cash so that no security interest is granted in the cash. Instead cash is transferred absolutely to the secured creditor and a debtor/creditor relationship is created. The amount of the debt can then be set-off against amounts owing under the secured obligation. This set-off arrangement is likely not subject to the PPSA as no security interest is created in any property of the debtor. This arrangement would also allow use of the cash collateral by the transferee and set-off of the amount against the obligations of the debtor.

So given this work around, why do we recommend amendments?

There are a number of reasons, some policy-based and some practical.

First, for regulatory or operational reasons not all debtors are able to provide cash collateral by way of an absolute transfer. For credit reasons, not all debtors want to. Mutual funds and pension funds are examples. So the work around is not always available.

Second, putting in place the required amendments adds substantially to the cost of putting collateral arrangements in place. We have heard from some of our Canadian members that negotiating the amendments to the credit support documents to deal with cash is a key impediment to putting collateral arrangements in place.

Third, there is some risk that, notwithstanding the form of these arrangements, a court would nevertheless characterize them as creating security interests. This possibility, however small, results in many market participants refusing cash collateral from Canadian entities and requiring either securities or letters of credit, which may for a particular entity be a more expensive form of collateral to provide.

Fourth, unlike the case with securities collateral, there is no additional protection as there is in the STA from adverse claims, leaving open the possibility of claims by other lien holders and other non-PPSA interests.

Holders of securities collateral and other investment property now have far more certain and inalienable rights to their collateral than a holder of cash collateral. An entitlement holder of securities has first priority and cannot be subject to proceedings from adverse claimants. As a policy matter, given the fungible nature of both types of property and the importance of finality in the transfer of cash as well as securities, it really does not make sense to treat them so significantly differently.

If the cash was being held in a securities account, it would be classed as investment property and the security interest in it could be perfected by control. It would also have the benefit of the entitlement holder protections from adverse claims that are in the STA. Yet if the same intermediary holds client cash in a cash account separate from the securities trading account, the secured party could lose priority since the cash account is not necessarily a "securities account". For example, in many brokerage arrangements, the client is required to deposit cash to a cash account with the broker to cover margin loans. The broker is perfected by control with respect to cash or securities credited to the client's securities trading account, but arguably not with respect to cash credited to the client's cash account. Requiring

changes to standard form agreements for accounts with Canadians or changing practices regarding the operations of accounts can, practically speaking, impede the development of relationships with Canadian clients. In certain jurisdictions intermediaries are not permitted by regulation or operational constraints to maintain cash in a client's securities account so the separate cash account is a requirement.

It is not only collateral takers that are disadvantaged by the current regime. The collateral provider loses many of the benefits of the PPSA when arrangements are put in place to avoid the creation of security interests and, therefore, the applicability of the PPSA. For example, if an absolute transfer approach is adopted in order to deal with the priority issues, it means by definition that the provider of the cash is taking on the credit risk of the collateral taker and giving up the protections inherent in a retaining at least a right of redemption. With securities on the other hand, there is flexibility to assure the collateral taker has first priority, while allowing the collateral provider to limit the use the collateral taker can make of the collateral and to retain entitlement to the collateral.

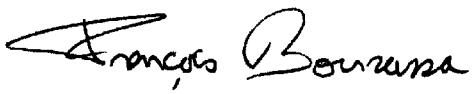
Solutions

The preferable solution would be to adopt similar provisions to those in Article 9 of the Uniform Commercial Code with respect to deposit accounts. These provisions allow for perfection by control either by becoming the customer with respect to the account or entering into an agreement with the deposit taking institution allowing the secured creditor to give directions as to payments from the account. This is a regime similar to that in place for securities entitlements and futures contracts. Pursuant to Article 9 perfection by control is the only method of perfection recognized. We recommend, however, that lenders retain the right to perfect by registration or to use other types of arrangements, such as lock-box arrangements, to protect their interests. Consequently, we believe that our recommendations will give cash collateral lenders maximum confidence with the minimal investigation commercial practice requires, without requiring any change in traditional bank lending processes or practices.

You might also be aware that the United Kingdom Law Reform Commission in its report entitled *Company Security Interests* (August 2005) recommended similar provisions be adopted under U.K. law for perfection of security interests in cash granted by companies. The earlier Consultation Report indicates that the concept of perfection by control for deposit accounts was widely accepted. It is to a certain extent also required by the European Union's Collateral Directive. (You can find a copy of the Commission's reports at http:// www.lawcom.gov.uk/ company_security.htm and the Collateral Directive at http:// ec.europa.eu/ internal_market/financial-markets/collateral/index_en.htm.)

We have attached draft provisions for your consideration. We would be pleased to meet with you to discuss any of the matters addressed in this letter. Please contact me directly or through ISDA's counsel in Canada, Margaret Grottenthaler of Stikeman Elliott LLP (mgrottenthaler@stikeman.com - 416-869-5686).

Yours truly,



Draft Provisions for Deposit Accounts

1. Add the following definitions to subsection 1(1):

"authentic record" means information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form that is:

(A) signed; or

(B) executed or which otherwise adopts a symbol, or is encrypted or similarly processed as a record in whole or in part, with the present intent of the authenticating person to identify the person and adopt or accept a record.

"deposit taking institution" means an organization that is engaged in the business of taking deposits and includes banks, savings banks, loan companies, savings and loan associations, treasury branches, credit unions, trust companies and other similar deposit taking institutions.

"deposit taking institution's customer" means a person identified in the records of the deposit taking institution as the person for whom the account is maintained;

"deposit account" means a demand, time, savings, passbook, or similar account maintained with a deposit taking institution that is not investment property or an instrument.

2. Amend subsection 1(2) to add a new subparagraph (f) and (g):

(f) a secured party has control of a deposit account if,

(i) the secured party is the deposit taking institution with which the deposit account is maintained;

(ii) the deposit taking institution's customer with respect to the account, secured party, and the deposit taking institution have agreed in an authenticated record that the deposit taking institution will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the deposit taking institution's customer; or

(iii) the secured party becomes the deposit taking institution's customer with respect to the deposit account.

(g) A secured party that has satisfied subsection (f) has control, even if the debtor retains the right to direct the disposition of funds from the deposit account.

3. Amend subparagraph 7.1(5)(a) to add the words "or a deposit account" after "investment property".

4. Amend subsection 7.1(7) to add the words "or a deposit account" after "investment property" and the words ", deposit taking institution's jurisdiction " after the words "securities intermediary's jurisdiction".

5. Add new subsections 7.1(8), 7.1(9) and 7.1(10):

(8) **Conflict of laws – validity of security interest in deposit accounts -** The validity of a security interest in a deposit account shall be governed by the law, at the time the security interest attaches, of the deposit taking institution's jurisdiction.

(9) **Conflict of laws- perfection and priority of security interest in deposit accounts-** Except as otherwise provided in subsection (5), perfection, the effect of perfection or of nonperfection and the priority of a security interest in a deposit account shall be governed by the law of the deposit taking institution's jurisdiction.

(10) **Determination of deposit taking institution's jurisdiction** – For purposes of this section, the following rules determine a deposit taking institution's jurisdiction:

1. If an agreement between the deposit taking institution and the deposit taking institution's customer governing the deposit account expressly provides that a particular jurisdiction is the deposit taking institution's jurisdiction 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 deposit taking institution's jurisdiction.

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

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

4. If none of the preceding paragraphs applies, the deposit taking institution's jurisdiction is the jurisdiction in which the office

identified in an account statement as the office serving the deposit taking institution customer's account is located.

5. If none of the preceding paragraphs applies, the deposit taking institution's jurisdiction is the jurisdiction in which the chief executive office of the deposit taking institution is located.

6. Amend subsection 11(2) to add a new subparagraph (e):

(e) the collateral is a deposit account and the secured party has control under subsection 1(2) pursuant to the debtor's security agreement.

7. Amend section 17.1 to refer to deposit accounts in both subsections (1) and (2).

8. Add a new subsection 22.1(3)

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

(4) A security interest in a deposit account is perfected by control when the secured party obtains control and remains perfected by control only while the secured party retains control.

9. Add as new subsection 17.2:

17.2 **Exercise of deposit taking institution's rights of set-off and recoupment** – (1) (a) **Exercise of recoupment or set-off-** Except as otherwise provided in subsection (c), a deposit taking institution with which a deposit account is maintained may exercise any right of recoupment or set-off against a secured party that holds a security interest in the deposit account.

(b) **Recoupment or setoff not affected by security interest-** Except as otherwise provided in subsection (c), the application of this section to a security interest in a deposit account does not affect a right of recoupment or set-off of the secured party as to a deposit account maintained with the secured party.

(c) **When set-off ineffective-** The exercise by a deposit taking institution of a set-off against a deposit account is ineffective against a secured party that holds a security interest in the deposit account which is perfected by control, if the set-off is based on a claim against the debtor.

(2) **Deposit taking institution's rights and duties with respect to deposit account-**Except as otherwise provided in Section 17.2(1)(c), and unless the deposit taking institution otherwise agrees in an authenticated record, a deposit taking institution's rights and duties with respect to a deposit account

maintained with the deposit taking institution are not terminated, suspended, or modified by:

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

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

(c) the deposit taking institution's receipt of instructions from the secured party.

(3) **Deposit taking institution's right to refuse to enter into or disclose existence of control agreement-** This section does not require a deposit taking institution to enter into an agreement of the kind described in Section 1(2)(f)(ii) even if its customer so requests or directs. A deposit taking institution that has entered into such an agreement is not required to confirm the existence of the agreement to another person unless requested to do so by its customer.

10. Amend subsections 30.1(1), 30.1(2) and 30.1(8) to add the words "or deposit account" after the words "investment property".

11. Add a new subparagraph 30.1(4)(d):

(d) if the collateral is a deposit account carried with a deposit taking institution, the satisfaction of the requirement for control specified in subclause 1(2)(f)(ii) and (iii) with respect to deposit accounts carried or to be carried with the deposit taking institution.

12. Add the following new subsection 30.1(6.1):

(6.1) A security interest held by a deposit taking institution in a deposit account maintained with the deposit taking institution has priority over a conflicting security interest held by another secured party.

13. Replace subsection 30.1(7) with the following (underlying represents the changes to the current provision)

(7) **Interests granted by broker, intermediary <u>or deposit taking institution</u>-** Conflicting security interests granted by a broker, securities intermediary, futures intermediary <u>or deposit taking institution</u> which are perfected without control under subsection 1(2) rank equally.

14. Replace subsection 56(7) with the following (underlying represents the changes to the current provision):

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

15. Amend subsection 61(1) to add the following subparagraphs (c) and (d):

(c) if it holds a security interest in a deposit account perfected by control under Section 1(2)(f)(i), may apply the balance of the deposit account to the obligation secured by the deposit account; and

(d) if it holds a security interest in a deposit account perfected by control under Section 1(2)(f)(ii) or (iii), may instruct the deposit taking institution to pay the balance of the deposit account to or for the benefit of the secured party.

STIKEMAN ELLIOTT

Supreme Court of Canada decision reveals risk of characterization of cash collateral arrangements as creating security interests

Collateral arrangement relying on set-off held to create a security interest and therefore subject to federal government's priorities for unremitted income tax and employment insurance at-source deductions

Caisse populaire Desjardins de l'Est de Drummond v. Canada, 2009 SCC 29

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On June 19, 2009 the Supreme Court of Canada released its decision in *Caisse populaire Desjardins de l'Est de Drummond v. Canada*. The issue was whether an agreement between a lender and borrower with respect to set-off against a term deposit gave rise to a "security interest" within the meaning of s. 224(1.3) of the federal *Income Tax Act* (ITA). The majority of the court held that it did. Consequently, the lender's right to set-off its term deposit obligation against the borrower's loan obligation was subject to the statutory priority of the federal government with respect to employment insurance (EI) remittances and income tax at-source deductions under s. 227(4.1) of the ITA and s. 86(2.1) of the *Employment Insurance Act* (EIA).

The majority's reasoning is problematic for commercial set-off arrangements, even those that are deliberately drafted to avoid characterization as security agreements, because it suggests that if a set-off opportunity is created for the purpose of providing "security" for a loan or other obligation it gives rise to a security interest in the asset that is subject to the set-off. Many common title transfer collateral arrangements are arguably designed to do just that (such as the cash collateral arrangements under the ISDA Credit Support Annex New York form if using the Canadian recommended amendments, the ISDA Transfer Annex and other industry agreements such as the Global Master Securities Lending Agreement and the Global Master Repurchase Agreement). So too are margin requirements under many forms of securities loan master agreements and securities repurchase agreements.

Background

Concurrently with its extension of a business line of credit to a company called Camvrac, Caisse populaire Desjardins de l'Est de Drummond (Caisse Drummond) and Camvrac entered into a "term savings agreement" (TSA) requiring Camvrac to deposit $200,000. The deposit matured in five years, was not transferrable and could not be hypothecated or given as security in favour of any person other than Caisse Drummond. They also entered into an inadvisably named "Security Given Through Savings" agreement under which it was agreed that Camvrac would maintain the deposit "to secure the repayment of" the line of credit, among other things. Camvrac also consented to Caisse

This newsletter was prepared by members of the Structured Finance and Financial Services Group at Stikeman Elliott.

Drummond withholding the amount of the deposit until the sums due were repaid or the line of credit was in place. In cases of default, Caisse Drummond also had a right to "compensation" (the Quebec equivalent of set-off) between the loan and the amounts deposited. Caisse Drummond kept the certificates of deposit in its possession. In addition as further security, Camvrac hypothecated and pledged to Caisse Drummond the certificates and sums deposited to secure the loan.

The loan went into default in November 2000 but Caisse Drummond did not take any steps as a result until February 21, 2001, two weeks after Camvrac had made an assignment in bankruptcy. Caisse Drummond made a note on its copy of the TSA on February 21: "To be closed on 21/2/2001 to realize on security" (another unfortunate choice of language). In June, the Crown gave notice to Caisse Drummond to pay all of the remittance arrears owing by Camvrac to the Crown.

The majority's reasons

In a judgment authored by Rothstein J., the majority of the court found that the arrangements between Caisse Drummond and Camvrac created a security interest in the deposit or sums on deposit and that the set-off was the means of realizing on this security interest. Consequently, the Crown claims that arose with respect to remittance arrears prior to the date of the set-off had the benefit of the deemed trust.

Definition of "Security Interest"

The ITA and EIA create deemed trusts in favour of the Crown over property of the employer that has deducted income tax and EI premiums at source. The deemed trust also applies to property of the employer held by any secured creditor of the employer that, but for its security interest, would be property of the employer. "Security interest" is defined as:

> any interest in property that secures payment or performance of an obligation and includes an interest created by or arising out of a debenture, mortgage, hypothec, lien, pledge, charge, deemed or actual trust, assignment or encumbrance of any kind whatever, however, or whenever arising, created, deemed to arise or otherwise provided for.

The point of dispute between the majority and minority judgments turned on whether the arrangements created an interest in property of the employer Camvrac.

The argument against set-off being a security interest is that the party seeking to set-off does not by virtue of a set-off right itself have a proprietary claim in property belonging to the other party. The party setting off itself has an obligation (in this case the term deposit obligation) and is entitled to satisfy that obligation by setting off an obligation owed to it by the other party (in this case the loan obligation). Set-off does not have anything to do with realizing on a property interest in one's own obligation. Even if there is a security interest in one's own obligation (as there was in this case), the set-off right can exist quite independently of that (and in a properly drafted agreement that would be clear).

However, the majority held that the arrangements were such that Caisse Drummond did have a property interest in the term deposit. It adopted a functional analysis. The deposit was put in place to "secure" the loan, there was a security interest in the deposit and the right of set-off was essentially a "remedy" to enforce the security interest in the term deposit. The truly novel aspect of the majority's reasoning is the conclusion that the contractual "encumbrances" placed on the deposit were what created the lender's property interest in Camvrac's deposit, primarily because those encumbrances ensured that the Caisse would be continuously liable to Camvrac. Rothstein J. noted that, had Camvrac been in a position to shift its funds in and out of the term account, there would have been no security interest.

The majority stressed that they were not saying that a contractual set-off right is *per se* a species of security interest. Rather, they held that, in light of the way the term deposit was put in place and maintained to be available for set-off as long as the credit line continued, the terms of this particular agreement justified the recharacterization of the transaction as a whole as the grant of a security interest.

The dissent

In dissenting reasons, Deschamps J. strongly disagreed with the majority view. Taking a position reflecting that of many in the financial industry and invoking a rather impressive range of academic commentary, she concluded that security interests can only be derived from "real rights" in property and never from the attenuated type of contractual rights to which the majority referred. Not all interests in property are security interests: in this case, she noted, the Caisse had no right to realize on its interest to secure performance of its obligation. The potential to appropriate the underlying property, she maintained, is one of the distinguishing features of a security interest.

Why This Was A Security Interest

The crux of the court's reasoning is captured in the following passage:

> It was the five-year term and the maintenance and retention of the $200,000 deposit, as well as Camvrac's agreement not to transfer or negotiate the deposit and that the deposit could only be used as security with the Caisse, that created the Caisse's interest in Camvrac's property for the purposes of s. 224(1.3) ITA. In the absence of these encumbrances on Camvrac's deposit, Camvrac could have withdrawn the deposit at any time. Should it have done so and still been indebted to the Caisse, the Caisse's right to compensation would be ineffective because it would not be indebted to Camvrac at the time the Caisse had to resort to the remedy of compensation. However, in this case the terms of the agreements provided that Camvrac agreed to the encumbrances on its deposit of $200,000 so that the Caisse would continuously be indebted to Camvrac and that on default there would be effective compensation. It is the fact that the agreements secured the Caisse's right to effective compensation by conferring on the Caisse an interest in Camvrac's property that created a "security interest" for the purposes of s. 224(1.3) ITA.

Analysis

A central problem with the majority's analysis is that it fails to differentiate between a credit support agreement and a security interest. While all security interests provide credit support, the converse is not true: not all credit support arrangements are security interests. For example, guarantees and letters of credit are clearly credit support, but they do not grant an interest in property to secure payment or performance of an obligation. The intention to provide credit support is quite distinct from the intention to confer a security interest. Such distinctions may have been lost on the majority partly because of the drafting of the agreement, which unwisely used "security language". The majority judgment did agree that a property interest must be created in the debtor's property, but its conclusion that there was such a property interest and that the right of set-off was the means to enforce that interest is dubious. One can only hope that this decision will be restricted in any subsequent application to situations where the intention to create a security interest is present on the face of the document and where the set-off rights are not part and parcel of the asset itself (i.e. the terms of the deposit itself do not provide for the set-off).

While there is much to criticize in the judgment, this decision is now a part of Canadian law and may require adjustments to practices. In particular, it is important to note that while the case dealt with the deemed trust provisions of the ITA and EIA, its implications could extend further into the realm of personal property security law. Moreover, it affects not only cash collateral but title transfer arrangements with respect to securities, including industry form agreements such as the GMSLA, the GMRA and the ISDA Transfer Annex. The decision clearly increases recharacterization risk in all of these situations.

Implications for Title Transfer Collateral Arrangements

The Canadian recommended language for cash for the ISDA CSA creates a debtor-creditor relationship with respect to cash and provides for a right of set-off against the cash. Cash is treated as Other Eligible Support and is not subject to the security interest language. On the other hand, there is clearly an obligation to transfer the cash to the collateral taker, there is no right to require repayment except to the extent credit is freed up by changing in exposures, and the purpose of the transfer of the cash is to "secure" the potential obligations under the transactions. The same general analysis applies to credit support transferred pursuant to the Transfer Annex or margin posted for many securities lending and repurchase agreements. While there are certainly features that distinguish these arrangements from the one considered in the *Caisse Drummond* case, there are also these important similarities.

- FEDERAL CROWN CLAIMS

Crown claims that benefit from the statutory deemed trusts (particularly those federal ones that prevail in a bankruptcy) may take priority with respect to the cash. (That would also be the case with respect to any collateral which is clearly subject to a security interest). It is also now a more likely result with respect to the Transfer Annex as it applies to securities or cash. Provincial securities transfer laws that provide protection against adverse claims for transfers of securities do not necessarily apply where the adverse claim is a federal deemed trust. On the other hand, there is a strong argument that the Crown would be subject to the right of set-off in the case of an

agreement such as the Transfer Annex because the "property" is by its defining terms flawed by the set-off right (as opposed to the term deposit in the *Caisse Drummond* case, where the set-off was provided for in a separate agreement and the parties treated the term deposit as an autonomous property).

The decision also makes it clear that a non-defaulting party should not sit on its right to effect the set-off. In this case the lender waited several months from the date of default to note in its records that it was effecting the set-off. It became subject to the remittances in arrears that accrued during that period. Effecting the set-off cut off the Crown's claim from the date of the set-off.

- PPSA

The case deals with the definition of "security interest" in the ITA, and the majority decision made a point of saying that it was not considering the definition under provincial Personal Property Security Acts (PPSA). However, the ITA definition is really not materially different from the PPSA definition. Parties who have cash collateral set-off arrangements should discuss with counsel whether a cautionary filing under the provincial personal property security regime would also be advisable with respect to cash collateral. A security interest in an account (unless the cash is held in a securities account) can only be perfected by the filing of a financing statement.

Normally priority with respect to security interests perfected by filing would be determined by order of registration. However, given the contractual right to set-off, the recognition of the paramountcy of defences in section 40 of the Ontario PPSA (and its equivalent in other common law provinces) should ensure priority over other consensual security interests including those of prior registrants. Section 40(1.1) of the Ontario PPSA provides that an account debtor (e.g. the collateral taker) may set up by way of defence against the assignee (e.g. a competing secured party) all defences available to the account debtor against the assignor arising out of the terms of the contract or a related contract (unless it has contractually waived defences). The "account" in this case is the amount owing by the collateral taker with respect to the cash collateral it has received from the assignor and the defence is the right under the agreement to set-off against the net termination amount. Perfection should not be relevant to priority as against other consensual security interests or other assignees. It is somewhat unclear, however, how section 40 would relate to the rights of a trustee in bankruptcy as representative of the unsecured creditors or other non-consensual lien claimants, so it would be advisable to file a financing statement in any event to preclude any argument that there is an unperfected security interest.

Thankfully, perfection is not an issue with respect to the title transfer of securities (or cash in a securities account) because, regardless of characterization and to the extent the laws of an STA, U.C.C. Revised Article 8 or similar jurisdiction apply, the collateral taker should be perfected by control.

Does the decision affect netting?

The case should not affect netting of transaction losses/gains or values. There is no obligation in the normal course to maintain offsetting transactions for the purpose of protecting the other party against particular transaction defaults.

Contractual language

While perhaps not the decisive factor in the Supreme Court's reasons, the security interest language of the agreements between Caisse Drummond and Camvrac definitely did not help. Furthermore, after Camvrac's default, an official of the Caisse wrote "closed…to realize on security" on the TSA. To a court applying modern "functional analysis" to the question of whether an agreement create a security interest, the attitude suggested by the use of this type of language was obviously significant.

It would therefore be advisable to take special care to avoid "security interest language" in relevant documentation and even to specifically disclaim the intention to create a security interest. The Transfer Annex and the cash collateral language were carefully drafted in this respect. However, if you are putting together a bespoke arrangement it is very important to be rigorous in maintaining the distinction between set-off and security interests.

Contractual set-off works in Quebec

A positive result of the ruling is to make clear that contractual compensation (set-off) is effective under Quebec law. Whether *Bankruptcy and Insolvency Act* provisions permitting set-off in a bankruptcy included contractual compensation in Quebec had been unclear as the result of some previous Supreme Court jurisprudence.

For further information, please contact your Stikeman Elliott representative, the author listed above or any member of our Structured Finance and Financial Products Group listed at www.stikeman.com