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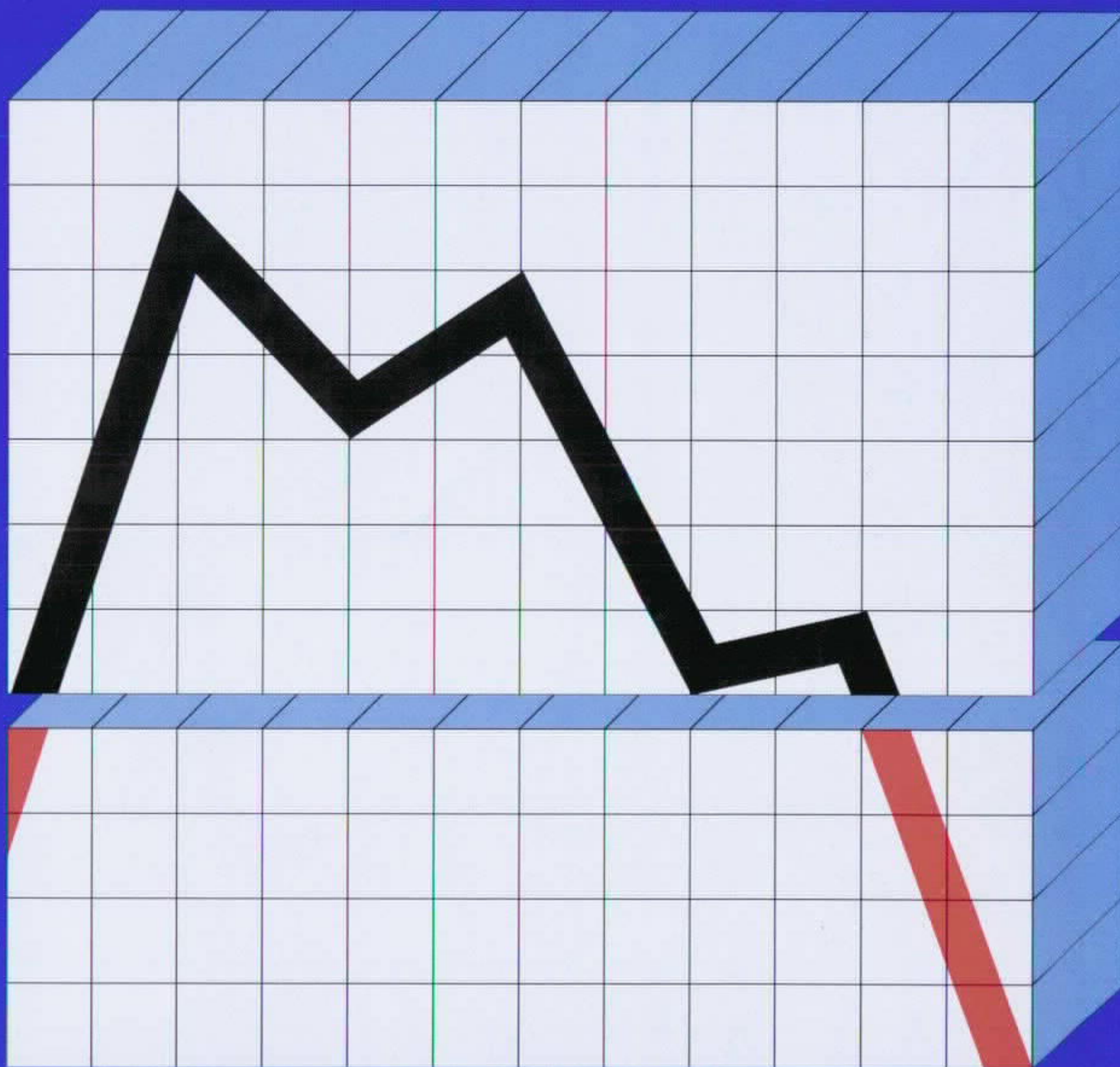

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INSOLVENCY BULLETIN

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The objective of the Insolvency Bulletin is to promote communication and strengthen ties between the Office of the Superintendent of Bankruptcy and insolvency professionals. The Insolvency Bulletin is a free publication which is published four times a year. The Bulletin is aimed particularly at trustees, jurists, registrars, accountants, credit managers and to those with a general interest in bankruptcy and insolvency.

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Coming into Force of the Majority of Sections of Bill C-5

I wish to announce that a large majority of the amendments found in Bill C-5 (now known as Chapter 12 of the Statutes of Canada 1997), *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act and the Income Tax Act* are coming into force on September 30, 1997.

All sections of Bill C-5 are coming into force on September 30, 1997, except for seven sections of the *Bankruptcy and Insolvency Act* (B.I.A.) that will be coming into force in the Spring of 1998. These seven sections are as follows:

1. paragraph 67(1)(b.1)
2. section 68
3. subsection 102(3)
4. paragraph 168.1(1)(e)
5. section 170.1
6. paragraph 173(1)(m)
7. paragraph (n)

These sections either calls for new regulations or refer to mediation which requires that we pursue an ongoing pre-consultation with stakeholders. In the case of section 68 and of paragraph 168.1(1)(e), there is a current version of these which will remain in force until the new version of section 68 and paragraph 168.1(1)(e) comes into force in the Spring of 1998. As for paragraph 67(1)(b.1), subsection 102(3), section 170.1 and paragraphs 173(1)(m) and (n), the new text will have no impact until their coming into force next Spring. For more certainty, you will find attached a copy of the Proclamation order. The Proclamation order's number is SI 97-114 and it will be published in the Canada Gazette on October 1, 1997.

Concerning the amendments brought to the *Companies' Creditors Arrangement Act* (C.C.A.A.), these will all be coming into force on September 30, 1997.

Furthermore, you may remember that on Royal Assent, on April 25, 1997, two sections of Bill C-5 came into force, section 216 of the B.I.A. and section 22 of the C.C.A.A. These two sections provide that the respective Acts will be subjected to a new parliamentary review five years following Royal Assent.

With respect to transitional measures, in general, the new provisions apply to insolvency proceedings commenced after their coming into force. Therefore, the new provisions will apply to bankruptcies and proposals filed on or after September 30, 1997. However, amendments of a technical nature and those dealing with trustee licences and conservatory measures will generally apply to procedures commenced at the time of their coming into force. For an exhaustive list of the transitional measures concerning each new provision, it would be useful to refer to the explanatory guide distributed during the information sessions held in September. The Explanatory guide will be available as of September 30, 1997 from the Office of the Superintendent of Bankruptcy's Web site at: http://strategis.ic.gc.ca/osb.

The Office of the Superintendent of Bankruptcy does not distribute copies of the new legislation but the unconsolidated section of the amendments are available from Canada Communication Group, Publishing, Ottawa, Ontario, K1A 0S9, phone: (819) 956-4802, fax: (819) 994-1498. It is our understanding that consolidated versions of the new B.I.A. and C.C.A.A. can also be purchased form private publishers.

Marc Mayrand
Superintendent of Bankruptcy

His Excellency the Governor General in Council, on the recommendation of the Minister of Industry, pursuant to subsection 129(1) of *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act and the Income Tax Act* (hereinafter referred to as "the Act"), assented to on April 25, 1997, being chapter 12 of the Statutes of Canada, 1997, hereby fixes September 30, 1997 as the day on which sections 1 to 58, section 59, other than paragraph 67(1)(*b.1*) of the *Bankruptcy and Insolvency Act* as enacted by subsection 59(1), sections 61 to 83, section 84, other than subsection 102(3) of the *Bankruptcy and Insolvency Act* as enacted by subsection 84(2), sections 85 to 97, section 98, other than paragraph 168.1(1)(*e*) of the *Bankruptcy and Insolvency Act* as enacted by subsection 98(3), sections 99 and 100, section 102, section 103, other than paragraphs 173(1)(*m*) and (*n*) of the *Bankruptcy and Insolvency Act* as enacted by subsection 103(1), sections 104 to 113, sections 115 to 125, section 21 of the *Companies' Creditors Arrangement Act* as enacted by section 126, and sections 127 and 128 of the Act come into force.

Securities Firm Bankruptcies

by **Benoît Daniel Turcotte, LL.B.**[1]

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1 The author would like to thank Donald A. Leslie, President and Chief Executive Officer of the Canadian Investor Protection Fund for his many insightful and invaluable comments on earlier drafts on this paper. The author would also like to thank Geoffrey Morawetz of the law firm of Borden & Elliott, David I. Richardson of Ernst & Young in Toronto, Craig Bushell of Coopers & Lybrand Ltd. in Vancouver, as well as Professor Aline Grenon of the Faculty of Common Law at the University of Ottawa, Henri Massüe-Monat of the Office of the Superintendent of Bankruptcy and Andrew Kavchak of the Competition Bureau, for their respective contributions. The author is responsible for any errors of observation or interpretation which may be found in the text.

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1.0 Introduction

On April 25th, 1997, Bill C-5 entitled; *An act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act and the Income Tax Act*, received Royal Assent.[2] Bill C-5 was the result of the statutory three year review provision contained in Bill C-22, the previous amending Act to the *Bankruptcy and Insolvency Act* (BIA), introduced on June 23, 1992.

The most notable aspects of the amending legislation of Bill C-5 is the introduction of parts XII (Securities Firm Bankruptcies) and XIII (International Insolvencies) to the BIA. The reasons for their introduction are varied and, according to certain observers, are a reflection of the Liberal Government's current emphasis towards trade and investment initiatives. However, many practical considerations provided the necessary impetus for the introduction of these long overdue measures. Since the late 1960's and early 70's, industry representatives such as the Canadian Investor Protection Fund have been attempting to convince the Federal government to adopt a legislative framework that could rationalize and simplify the administration and liquidation of an insolvent securities firm. Secondly, the recent trend towards globalization of markets and the importance of international trade has made it imperative that our insolvency and bankruptcy laws maintain and even increase the competitiveness of Canadian business both in the domestic and international arena. The rationale for this line of thinking stems from the belief that individuals and corporations wishing to invest in a particular country or jurisdiction will tend to do so where they feel secure in the knowledge that their investments are protected, to a certain degree, in the event of an insolvency or bankruptcy of the company to whom they are creditors or investors. Such provisions, it is hoped, will contribute to maintaining a certain stability in the marketplace while facilitating and lessening the risks associated with investing in a particular country. The amendments also seek to establish a certainty of treatment amongst creditors and investors alike, be they local or foreign.

This paper will argue that the approach of the courts in dealing with the insolvency of a securities firm have provided nothing more than piecemeal solutions to a complex type of administration which requires quick and efficient methods of dealing with the property of such an estate so as to avoid furthering losses to customers and creditors. The discussion will begin with a brief description of the bankruptcy process and elaborate on its role and function in the marketplace. An explanation will then be offered of why the current scheme cannot be expected to remedy the situation by highlighting the particular problems associated with the efficient and fair administration of a bankrupt securities firm. Following an overview of the various common law principles and doctrines applicable to the bankruptcy of a securities firm, we will then briefly touch upon the recommendations of the Bankruptcy and Insolvency Advisory Committee (BIAC).[3]

Finally, the discussion will turn to a brief commentary on the origins of the U.S. and Canadian Customer Compensation Funds, followed by an examination of the newly enacted rules governing the bankruptcy of a securities firm in PART XII of the BIA. This part of our analysis will include a comparison of the more noteworthy provisions of the U.S. scheme. The importance of the U.S. experience cannot be underestimated since the provisions in PART XII are based to significant degree on the U.S. model.

2.0 Historical Overview

Although the 1992 revisions to the BIA did not provide for a legislative scheme dealing with the bankruptcy of a securities firm[4], numerous Government background papers and omnibus bankruptcy bills have for

2 Officals at the Office of the Superintendent of Bankruptcy have indicated that the coming into force of Bill C-5 will likely be sometime in the fall of 1997.

3 In order to prepare for the present legislative phase of these amendments, the Minister established the BIAC consultation mechanism consisting of numerous stakeholders. The committee was comprised of private sector representatives consisting of: Consumer groups, business people and financial institution representatives. Public sector representation included officials both from the federal and provincial jurisdictions. Other members included lawyers and trustees in bankruptcy. More than 100 members were involved representing over 50 organizations and interest groups. The BIAC structure consisted of a directing committee, eight working groups and many sub-committees.

years argued the case for their introduction.[5] Prior to the 1992 revisions, Canadian bankruptcy legislation had not undergone any major reforms since 1949[6], the recommendations of which had been proposed as far back as 1970 by the Tassé Committee.[7] Appointed in 1966 to review bankruptcy and insolvency legislation in Canada, the Tassé Committee undertook an in-depth study of Canadian bankruptcy law recommending the enactment of a completely new bankruptcy and insolvency statute that would establish an integrated and comprehensive bankruptcy system. The Report recommended that special procedures be devised to handle and settle claims made by customers of bankrupt stockbrokers by following as a model, section 60(e) of the *United States Bankruptcy Act*. In fact, south of the border, a U.S. scheme of dealing with the administration of a bankrupt securities firms was only beginning to emerge.[8] It was not until 1975 that government background papers on new bankruptcy legislation even considered that such provisions be included in the BIA.[9] When Bill C-60[10] was tabled in 1975 it set out for the first time a set of rules for dealing with the insolvencies of securities firms in Canada and was in large part due to the dramatic increase in the number of securities firms insolvencies in the U.S. and to a much lesser degree in Canada[11] during the late 60's and early 70's.[12]

4 The 1992 revisions to Canada's insolvency and bankruptcy legislation marked such a complete overhaul of the system that efforts to introduce specific provisions with regards to international insolvencies and the bankruptcy of stockbrokerage firms were delayed until phase two (the current phase) of reform.

5 See Bills C-60, S-11, S-14, S-9, C-12 and C-17. Bill C-22 did not provide for such provisions, while Bill C-109 now Bill C-5 once again does so. From 1970 to 1992, a prolonged effort was made to enact a new bankruptcy statute. Six bankruptcy bills, largely inspired by the Tassé Committee report, were introduced into Parliament over that period. It took five years to digest the Tassé report before any legislative action was begun. Government background papers in 1975, 1978, and 1979, culminating with the Colter Report of 1986 have explained the necessity for such provisions.

6 Following the passage of the 1949 Act, complaints began to arise that the Act had become inefficient, obsolete and incapable of coping with fraudulent bankruptcies. The process of reform started in the early sixties when public reports emerging from various authorities revealed many deficiencies in the legislation. As a result, the Act was amended in 1966 expanding the investigatory powers of the Superintendent of bankruptcy, tightening the rules regarding fraudulent preferences, incorporating the concept of "related persons", and enabling trustees to deal more effectively with improper transactions by a debtor, and providing for the orderly payment of debt system in Part X of the Act. These amendments were adopted to remedy flagrant defects, but were originally considered only temporary measures while Parliament waited for the recommendations of a Study Committee.

7 See the: *Report of the Study Committee on Bankruptcy and Insolvency Legislation, Canada 1970* (The Tassé Report), Minister of Consumer and Corporate Affairs, Ottawa, 1970.

8 On December 30, 1970 the President of the United States signed into law the *Securities Investor Protection Act* of 1970 "to provide greater protection for customers of registered brokers and dealers and members of national securities exchange."

9 Consumer and Corporate Affairs. *Background Papers for the Bankruptcy and Insolvency Bill (1979).*

10 *An Act Respecting Bankruptcy And Insolvency,* First Session, Thirtieth Parliament, 23-24 Elizabeth II, 174-75.

11 To date, the Canadian securities industry has not been tremendously burdened with many failures involving losses to the investing public. Over the past forty three years the most notable of these include C.A. MacDonald & Co. Ltd.; Stanbury Investments Limited; Ord, Wallington & Co. Limited; Waite, Reid and Company Limited; Malone Lynch Securities Limited; Andrews & Bélanger Limited; Chartrand, Quinn & Senecal Limitée; Blanchard, O'Connor & Co. Ltd., and L.J. Forget & Company Ltd.. More recently, in 1986 there was the First Commonwealth Securities Corp. failure. Then, in 1987, the Osler Inc. insolvency which represents the most costly failure to date, resulted in payments totalling $15 million, net of recoveries, being made by the Canadian Investor Protection Fund in satisfaction of customer claims. The Osler debacle represents over 50% of CIPF's total payments to customers over its 26 year history. In 1989, R. Drapeau Capital inc. ceased operations and transferred its accounts to another firm. Disputes over certain transactions involving two customers were resolved by litigation with the issue being decided in favour of the customers. At that point Drapeau was insolvent and the customers became eligible for CIPF coverage in the amount of $25,028. The most recent insolvency, that of McConnell & Company Limited in 1991, will likely result in estimated costs of $4.2 million, net of recoveries for the CIPF to fully cover the loss of its customers.

12 Although worthy of analysis and study, the factors that contribute to a securities firm becoming insolvent are multifarious, complex and are far beyond the scope of this paper. For an excellent, though slightly dated discussion of such matters see: John D. Honsberger, "Failures of Securities Dealers and Protective Devices" in P. Anisman *et al.*, *Proposals for a Securities Market Law for Canada* (Ottawa: Minister of Supply and Services, 1979) Vol. 3.

3.0 Bankruptcy Legislation, the Courts and the Bankruptcy of a Brokerage Firm

I) Bankruptcy Legislation Generally

The bankruptcy process and the BIA perform several functions in the marketplace. The basic purpose of the Act is to provide for the orderly and fair distribution of a bankrupt's property amongst creditors on a *pari passu* basis[13] and to permit honest, yet unfortunate debtors to obtain a discharge from their debts, subject to reasonable conditions in order to re-integrate themselves into the business life of the country as useful citizens free from the crushing burden of debt.[14]

Upon being petitioned into bankruptcy or following an assignment, s. 67 provides that all property of the bankrupt wherever situated at the date of bankruptcy, apart from property held in trust by the debtor or property exempt from execution, vests in the trustee to be eventually distributed to the bankrupt's creditors. The definition of "property" therefore becomes very important and determinative of what will vest in the trustee upon bankruptcy. Pursuant to section 2 of the BIA, "property" has a very broad definition and includes money, goods, things in action, land, and every description of property whether real or personal, legal or equitable, whether situated in Canada or elsewhere. Also included are obligations, easements and every description of estate, interest and profit present or future, vested or contingent, in, arising out of, or incident to property.

Following the date of bankruptcy, it is the duty of the trustee, subject to the right of secured creditors, to take possession of the property of the bankrupt as soon as possible. The general approach to the Act by the courts has been that it is a commercial statute, the administration of which is principally in the hands of business people and that technical objections should therefore not be given effect to beyond what is necessary for the proper interpretation of the Act.[15] Litigation and court proceedings are to be avoided in order to maximize returns to creditors[16]. The Act also seeks to promote confidence in the credit system. Credit grantors at all levels need some assurance that the system operates fairly with a means of seeking redress for wrongdoing and treating all persons of a like class in the same manner.[17]

In addition to the above, the BIA serves other functions. Long run economic efficiency requires that resources move from lower to higher value uses. Thus, a firm's assets should be reallocated if they are more valuable in some other use. In this sense, the bankruptcy process and the BIA play an important role in the economy. In any event, bankruptcy is certainly one process by which inefficient firms are eliminated from the market.[18] In keeping these principals and goals of the BIA in mind, the following section explains the complexities of a securities firm bankruptcy and how these complexities render the standard provisions of the Act inadequate and inefficient.

II) The Complexity of a Securities Firm Insolvency

It has been quite accurately observed that "probably no branch of bankruptcy administration presents more troublesome questions of law and administration than does the insolvency of a stock brokerage or investment concern."[19] Nearly seventy three years later, this observation remains accurate in many respects. The bankruptcy of a securities firm seems to frustrate virtually all of the aforementioned goals and principles which the BIA seeks to promote. In many regards, this is due to

13 *Re Neiman* (1953), 33 C.B.R. 230 (Ont. S.C.).

14 *Re Newsome* (1927), 8 C.B.R. 279 (Ont. S.C.).

15 *Re McCourbrey* (1924), 5 C.B.R. 248 (Alta. S.C.).

16 *Royal Bank v. Sefel Geophysical Ltd.* (1989), 76 C.B.R. (N.S.) 29 (Alta. Q.B.).

17 Kavchak, Andrew. *The Reform of Canada's Bankruptcy Act — A Legislative Process Case Study.* Carleton University, Ottawa, 1993. At the time Mr. Kavchak was a policy analyst with the Office of the Superintendent of Bankruptcy.

18 Jocelyn Martel "Bankruptcy Law and the Canadian Experience: An Economic Appraisal" *Canadian Public Policy* XVII, No. 1 March 1991, p. 52-63.

19 *In re Slattery & Co.*, 294 F. 624, 626 (2d Cir. 1923).

the complexity of the securities industry. Presently, securities firm insolvencies are administered in receiverships and under the BIA, despite the absence of any specific reference in the Act to such entities or to any of the particular problems which trustees and lawyers confront in the administration of the affairs of a bankrupt securities firm. The legal issues involved in such insolvencies are complex and centre around the ownership rights of customers with respect to specific securities. The following is an often quoted excerpt from a 1979 Government background paper which highlights the most troublesome aspects of a securities firm insolvency:

> The present Bankruptcy Act contains no special provisions concerning the bankruptcy of securities firms, notwithstanding that such bankruptcies have proved to be especially complicated and problematical.
> These bankruptcies are inherently complicated because a securities firm's business is complicated. It trades securities in large volume on volatile markets on its own behalf and for customers. It pledges its own or customers' securities with banks to secure operating loans and purchase money loans for its customers. It holds securities in various ways for customers. Many are in the name of the securities firm or another securities firm, endorsed, and bear a bank guarantee of signature ("street form"). Some are in the customer's name but endorsed so that the securities firm may trade at its discretion or for the customer's convenience. Some are in the customer's name and endorsed, but segregated and identified as belonging to the named customer. Some are in the customer's name and both unendorsed and segregated. Complicating matters further, the securities firm frequently holds free cash balances for customers that arise from securities sales and dividend receipts.
> Frequently, when a securities firm gets into serious financial difficulty it fails to comply with either the *Securities Act* or regulations, stock exchange or Investment Dealers Association's rules, or even the customer's instructions, and as a result the right of creditors and customers to specific securities and to free cash balances become completely confused. Under the present law, when a bankruptcy occurs, the trustee is required to unravel what is usually a tangled mess in order to identify and distinguish between ownership rights in specific property and mere creditor's claims. To do this he must apply complicated common law rules concerning the identity of the owner of security and even more complicated equitable tracing rules based on the idea that the broker holds securities, if fully paid, as a constructive trustee for his customer, entitling a customer to recover that quantity of securities from the assets of the estate, in effect with priority over other creditors, even where the customer cannot be specifically identified as owner of the securities. **As a result, a particular customer's priority usually is determined as a matter of pure chance, depending on the degree of the securities firm's misconduct, the form of the security, its status on the corporate securities register, the manner in which the securities firm segregated or identified it, or the way the securities firm dealt with it (e.g., permitting recovery of a gift or a preference).**[20] (emphasis added)

Since there are no specific rules under the BIA dealing with the administration of an insolvent or bankrupt investment concern, section 67 provides us with the only useful reference point. Subsection 67(1)(a) provides that the property of a bankrupt which is divisible amongst creditors does not include property held in trust for any third party. The intricacies in applying this principle to the insolvency of an investment concern have been rather convoluted and inconsistent over the years as developed at common law by American and Canadian courts.[21] The following analysis sets forth the current state of the law with regards to this rather complex and esoteric branch of bankruptcy law.

III) The Current Practices

a) *Fungibility of securities*

Before discussing how courts have dealt with the bankruptcy of a securities firm, it is necessary to consider the nature of the property which is always in dispute in any liquidation or bankruptcy of a brokerage firm, namely, securities. Simply put, security certificates are fungible in that every certificate is no more or less

20 *Supra, Consumer and Corporate Affairs*, note 9 at 35.

21 The manner in which the business of stockbrokers is conducted in Canada resembles to a much greater degree the practices and regulations which prevail in the U.S. rather than in England. For this reason, Canadian courts will more readily rely upon American jurisprudence as opposed to English jurisprudence in resolving legal issues of a securities firm insolvency: *Clarke v. Baillie* (1910), 45 S.C.R. 50.

valuable than any other similar certificate. Canadian courts have always supported this concept[22] which is now clearly defined and established by legislation.[23] In *Solloway, Mills v. Blumberger*,[24] the Supreme Court of Canada adopted the following statement from the U.S. Supreme Court decision in *Gorman v. Littlefield*:[25]

> The certificates of stock were not the property itself, but merely the evidence of it . . . . a certificate for the same number of shares . . . . (represents) precisely the same kind and value of property as another certificate for a like number of shares in the same corporation; that the return of a different certificate or the substitution of one certificate for another made no material change in the property right of the customer ... such shares were unlike distinct articles of personal property, differing in kind or value, as a horse, wagon, or harness, and that stock has no earmark which distinguishes one share from another, but is like a grain of a uniform quality in an elevator, one bushel being of the same kind and value as another.[26]

Thus, the "grain in the bin" concept as it was coined became the prevailing characterization of such property. As we will see in section IV, this leads to problems of ownership and identification when a firm becomes bankrupt, often requiring the claimants of shares to resort to the equitable principles of tracing in order to prove their claim.

b) Tracing

The general common law principles applicable to the bankruptcy of a stock broker are those of the law of trusts and of equity.[27] Probably the earliest decision that dealt with the insolvency of a broker dates back to 1815 in *Taylor v. Plumer*.[28] This case dealt with an individual who had entrusted monies to a broker to buy bills of exchange. The broker misapplied the money by buying American stock and bullion. Intending to abscond, the broker was apprehended before leaving England and was forced, shortly thereafter, to make an assignment. It was held that the individual was entitled to withhold the proceeds from the assignee of the broker because it was handed to the broker in a fiduciary character so as not to create the mere relation of debtor and creditor between him and his principal. In *Sinclair v. Brougham*[29] it was held that at common law the right to follow money was not confined to cases where there was a fiduciary relationship, although a fiduciary relationship was usually the basis on which that right was based. At common law, it was to be established if the property in question had passed. If it had not and no relation of debtor and creditor had intervened, the money could be followed and recovered notwithstanding its normal character as currency, provided it could be earmarked or traced into assets acquired with it. In the well known decision of *In Re Hallett's Estate*[30], it was held, overruling existing law, that where a trustee wrongfully or otherwise commingles his own money with monies of his *cestui qui trust* in one account and then makes withdrawals from the mass, the trustee was presumed to make payments for his own purposes out of his own money and not out of the trust money.

c) The nature of the client-broker relationship

In *Re Hallett's Estate,* Jessel, M.R., stating the scope of the equitable right to trace property, uses the

22 Clarkson v. Snider (1886), 10 O.R. 561; *Long v. Smiley* (1913), 12 D.L.R. 61 (Ont. S.C.A.D.); *Cartwright & Crickmore Ltd. v. MacInnes*, [1931] 3 D.L.R. 693; *Soloway, Mills et al. v. Blumberger*, [1933] D.L.R. 693.

23 See the *Business Corporations Act*, R.S.O. 1990, c-B.16, ss 53(1) and 61(1), and the *Canadian Business Corporations Act*, R.S.C. 1985 C-44, ss 48(2) and 54.

24 *Supra* note 22.

25 (1913), 229 U.S. 19 at 23.

26 *Supra*, note 22 at 95.

27 Use of the terms "securities firm", "stockbroker" and "brokerage firm" will be used interchangeably throughout this paper, the two latter terms being the terms of preference in decisions at common law, whereas the former seems to be the modern equivalent used in various legislation, including Bill C-5.

28 M. & S. 562, 2 Rose 457.

29 [1914] A.C. 398, 83 L.J. Ch. 465.

30 (1880), 13Ch. D. 696 (C.A.).

word "trustee" as including all persons in a fiduciary relation such as express trustees, agents and bailees.[31] This is significant since the relationship between client and broker has been characterized as that of principal and agent, giving rise to a fiduciary obligation on the part of the broker.[32] However, depending on the circumstances of a customer's dealing with a broker:

> In any given situation there may be customers who have deposited securities with the broker for safekeeping or on an order to sell; others who have given the broker cash with which to buy certain securities, paying for them in full, which order may or may not have been executed. Then too, there are always margin customers who have deposited their own stock as security for their trading accounts, and some for whom the broker has bought securities on margin, which he is carrying for them subject to their indebtedness to him on account of the purchase. Between these different groups who have claims on bankruptcy, the legal relationship of the broker varies; so that he is at once a creditor, bailee, agent, trustee; in executing orders for purchase or sale he acts as agent, while in advancing the credit with which to buy on margin he becomes a creditor who holds on pledge the securities bought. When money is put up by a customer to buy particular stocks, the broker has been held a trustee under the duty of carrying out his instructions.[33]

To complicate matters further, in certain transactions such as margin purchases the broker is said to acts in a threefold manner. In an early Ontario case, Ferguson J.A. quoted *inter alia* from Jones on Pledges:

> The broker acts in a threefold relation: first in purchasing the stock he is an agent; then, in advancing money for the purchase, he becomes a creditor; and, finally, in holding the stock to secure the advances made, he becomes a pledgee of it. It does not matter that the actual possession of the stock was never in the customer. The form of a delivery of the stock to the customer, and a redelivery by him to the broker, would have constituted a strict, formal pledge. But this delivery and redelivery would leave the parties in precisely the same situation they are in when, waiving this formality, the broker retains the certificates as security for the advance. The contract is in spirit and effect, if not technically and in form, a contract of pledge, and is governed by the law of pledges.[34]

It has also been held that as an agent, a broker does not acquire any rights on the securities which were purchased for a customer and they must be returned to that client.[35]

However, in *Re Stobie-Forlong-Matthews*[36] the Manitoba Court of Appeal also drew an important distinction between the rights of customers who entrust their money to a broker for the purpose of purchasing shares on their behalf, thereby creating a relationship of agent and principal, and the situation where the customer purchased directly from the broker shares owned by that broker or securities firm, which merely created a vendor-purchaser relationship. In the first situation, a fiduciary obligation was created and in the latter case, such a relationship relegated the claim of the purchaser-customer to that of a creditor until such time as the certificates were set apart and clearly earmarked or appropriated to the contract.[37]

31 *Ibid.* at 709.

32 *Re Bryant Isard & Co.* (1922), 3 C.B.R. 49, affirmed 4 C.B.R. 537 (Ont. C.A.); see also: *Re C.A. MacDonald & Co.* (1958), 37 C.B.R. 119, which held that there exists a fiduciary relationship between a principal and agent, reversed on other grounds 2 C.B.R. (N.S.) 326, (1959).

33 *The Bankrupt Stockbroker: section 60(e) of the Chandler Act*, 39 Colum. L. Rev. 485 (1939), as quoted John D. Honsberger in, *Failures of Securities Dealers and Protective Devices*, *supra* note 12 at 1506.

34 *Re Stout and City of Toronto*, 60 O.L.R. 313, [1927] 2 D.L.R. 1100 (C.A.). The quotation from L. Jones, Law of Pledges (2ed. 1901) was also approved in the U.S. Supreme Court decision of *Richardson v. Shaw*, (1908), 209 U.S. 365.; and also in *Re Bryant Isard & Co.*, 3 C.B.R. 49, 22 O.W.N. 537 (S.C. 1922), affirmed in 4 C.B.R. 537, 23 O.W.N. 113 (C.A. 1922).

35 *Kern Agencies, Ltd.* (No.3), 13 C.B.R 333, [1932] 1 W.W.R. 585 (Sask. S.C.).

36 (1931), 12 C.B.R. 313 (Man. C.A.).

37 It is interesting to note that brokers have always resisted any attempt at characterizing their relationship vis-à-vis clients as one of *cestui que trust*, as do, for example, solicitors, insurance and real estate agents and trustees. As an illustration, we need only consider how, until recently customers' "free credit" balances were used to finance a firm's day to day operations but which could be repaid on demand because of the magnitude of the capital base that most securities firms have access to. A free credit

Presently, under both the common law and subpara. 67(1)(a) of the BIA, property held by the debtor in trust for any other person is excluded from the property divisible amongst creditors generally in the trustee's administration of an estate. The trust may be either an express or constructive trust[38]; but it is essential that the property is capable of being traced or identified.[39]

d) The identification of securities

1) Securities generally

As a general rule, all stocks or bonds that can be traced to the bankrupt firm and to a particular client are to be returned to that client regardless of whether they have been paid for. If monies are still due on the purchase price the client will be entitled to the certificates upon payment of the balance due. The same rule applies to any dividends or interest paid on a customer's free credit balance. If an unfortunate customer is unable to identify or trace his securities he will then rank as a general creditor who must share on a *pari passu* basis once all of the other customer claims have been satisfied. The fact that the stock is held as security for margin accounts is also irrelevant as long as the amount owing is satisfied.[40] Furthermore, the fact that the securities have not been specially marked or that identification by serial number is impossible does not invalidate the claim.[41] In other words, the customer need only trace the securities *in kind* and is not required to do so *in specie*.

The central issue then becomes whether the customer can trace his property and prove to the trustee that particular securities are actually his own. If at the date of bankruptcy the broker does not have sufficient securities to satisfy all of the claims for a particular kind of security, the customers must share on a *pro rata* basis. In many cases, not only will a bankrupt securities firm not have sufficient securities of a particular kind to satisfy all other customer claims, but some of these securities will have been pledged to banks and other financial institution and suppliers, as security for loans made to the firm to finance its day to day operations.

2) Pledged securities

In an ideal world, securities bought on behalf of customers would be in the possession of the broker or firm at the date of bankruptcy and would be traceable. In practice this is seldom the case. When loans for the benefit of customers are made and the securities of those customers are pledged to secure those loans and bankruptcy ensues, the lender will sell only what is necessary to discharge the debt owed to it. Thus, the lender will decide which securities are to be sold and which securities will be returned upon satisfaction of the amount owed.[42] Securities found in margin accounts[43]

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balance is an amount of cash owed by a broker-dealer to a customer which is not subject to any unfulfilled commitments of the customer to the broker, and which the customer has an unrestricted and immediate right to withdraw on demand. These balances are created by one of three ways:

1. by the deposit of cash by the customer with the broker-dealer in anticipation of placing an order;
2. by the broker selling securities for the customer and holding the proceeds of the sale pending reinvestment or the client's instructions; or
3. by the broker receiving for the customer interest or dividends received on securities owned by him or her.

First introduced in 1968 by the IDA as conditions of registration, Section 118 of the *Ontario Securities Act Regulations*, R.R.O. 1990, Regulation 1015, now provides that:

> **118.** Clients' free credit balances, where satisfactory arrangement concerning bonding or insurance have not been made and approved by the Commission, shall be deposited in a client's trust account and properly identified forthwith upon their receipt by the registrant. R.R.O. 1990, Reg. 910, s. 106.

38 A.H. Oosterhoff & E.E. Gillese, *Test, Commentary and Cases on Trusts, Fourth Edition,* (Scarborough: Carswell, 1992), at 17; "a constructive trust is based on the idea that when a person transfers property to, or purchases property but directs title to be taken in the name of another and the latter pays no consideration, it must be presumed that the grantor or purchaser did not intend to give the grantee the beneficial interest, but rather to retain it."

39 *King v. Hutton* [1900] 2 Q.B. 504.

40 *Re Bryant Isard & Co.* (1922), 3 C.B.R. 49, affirmed 4 C.B.R. 537 (Ont. C.A.).

41 *Re C.A. MacDonald & Co. Ltd.* (No. 2) (1961), 35 W.W.R. 565 (Alta. S.C.A.D.).

42 Michael E. Don & Josephine Wang, *Stockbroker Liquidations Under The Securities Investor Protection Act and Their Impact On Securities Transfers,* 12 Cardozo L.Rev. 509 (1990), at 521.

and those held in bulk segregation or "in the box" are usually the types of securities which are most often pledged.

In *Kern Agencies, Limited (No.3)*[44]the Manitoba Court of Appeal held that where securities have been pledged and the pledgee has sold sufficient stock to pay off the brokers's indebtedness, purchasers need only be able to trace their claims to a type of stock, and not to specific certificates.

Occasionally, "customer name securities" or those securities which are registered under the customer's name will also be pledged pursuant to a written agreement between broker and client giving the broker a power of attorney to sell the securities, or simply because they were wrongly pledged due to error or wrongdoing. As Don & Wang have explained:

> Even when fully paid for by the customer, securities could be misappropriated. Caught in the throes of financial failure, the desperate broker-dealer might misuse customer securities to stave off bankruptcy, perhaps by selling them and converting the proceeds, or unlawfully pledging fully paid-for securities. Third, the broker could have "bucketed" orders, by reporting as completed, customer orders for securities that in fact had never been executed. Consequently, when the trustee assumed control, some securities would be present and others would not.[45]

With regards to securities which have been wrongly pledged, Canadian courts have not, as a general rule, made any differentiation to customers' claims on this basis. However, the pledgee must have acted in good faith when the securities were accepted, and no knowledge of impropriety can be evidenced.[46] If wrongly pledged customer securities have been sold by the pledgee and no surplus remains, the customer will only rank as an unsecured customer.[47]

3) "Sharing the burden of the loan"

When a pledgee has sold only a portion of the shares, then returned some shares and excess cash to a trustee in bankruptcy, Canadian courts have adopted the U.S. doctrine of "sharing the burden of the loan" whereby the remaining shares and monies are shared *pro rata* among customers claiming the same kind of shares, and no customer whose shares are returned has a greater claim than those customers whose securities were sold. This doctrine has been held to apply equally to all claimants regardless of whether certain customers can specifically trace their securities by certificate number.[48] It is also irrelevant that the securities were overpledged.[49]Nor has any distinction been made where the securities were sold prior to the bankruptcy,[50]the doctrine will still apply if the claimants can trace their securities to the fund held by the pledgee. When applying this doctrine, it is common practice for the court to order that the shares be sold and that the proceeds be distributed *pro rata* in order to facilitate the administration of the estate.

It is interesting to point out that Canadian courts have applied this equitable doctrine in a "more equitable" manner. In applying the doctrine, Canadian decisions have not differentiated between pledges by brokers which were done properly and improperly, or between overpledging and outright conversion.[51] The underlying

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43 Margin accounts are those accounts for which the client is allowed to buy securities on credit, borrowing a portion of the purchase price form the broker. "Margin" refers to the amount the client must personally provide. This deposit is security only. It does not represent satisfaction of any portion of the customer's debt to the broker. Ownership of these securities remains vested with the broker. In fact, the reason that many margin accounts are often pledged is to enable the broker to finance the margin transaction.

44 *Supra*, note 35.

45 Supra, note 42 at 522.

46 Haggart v. Trustee of Heron, 11 C.B.R. 163 (Ont. S.C.).

47 Re H.S. Shannon & Co.; Ex parte Milne (1932), 13 C.B.R. 437.

48 *Re Carroll & Wright, Ex parte Bain* [1932] 14 C.B.R. 36 (Ont. S.C.).

49 *Re Nakashidze*, [1948] 1 D.L.R. 346 (Ont. H.C.).

50 *Re C.A. MacDonald & Co.* (No.2), *supra*, note 41.

51 See L. Houlden and C. Morawetz, *Bankruptcy Law of Canada*, 3rd ed., Vol. 1 (Scarborough: Carswell, 1989) at 3-22 to 3-22.1,

principle and rationale for this doctrine has been that "equality is equity". The Alberta Law Reform Commission (ALRI), while recognizing this fact, has nevertheless strongly criticized the doctrine, and has commented thus:

> ... the doctrine of "sharing the burden of the loan", like the decision allowing customers to trace their securities in kind, is contrary to traditional trust tracing principles, and was strongly criticized for being so. **A particularly difficult aspect to reconcile with trust principles is the loss of rights by those who can trace to a specific certificate. The Canadian cases are not entirely clear on this point, and several have upheld the rights of clients who can trace to a particular certificate on the basis that such a certificate remains the property of the client and cannot be affected by other claimants.** The conflict between the doctrine of "sharing the burden of the loan" and traditional trust tracing principles may be seen as a conflict between established trust and property concepts and practical considerations necessitated by the unique nature of the broker-client relationship.[52] (emphasis added)

IV) The Inadequacy of Current Practices

> "Any reasonable man ought to know that a broker's office is no place to leave money or securities for safekeeping."
>
> McLauglin, *Aspects of the Candler Bill to Amend the Bankruptcy Act*, 4 U. Chi. L. rev. 369, 398 (1937) (*quoting* Garrard Glenn).

Although this quote does not necessarily ring true today, it is obvious from the foregoing discussion that the reclamation process under current practices as established by the courts has proven to be quite complicated, time consuming and uneven in its treatment of claimants. First, whether a customer can reclaim depends upon fortuitous factors such as whether the securities sought are still in the possession of the broker. In other words, whether a customer obtains delivery of his securities or is a general unsecured creditor for cash depends as much on luck as anything else.

For example, let us suppose that customers A and B both own 100 shares of ABC Co. stock. Customer A's shares were earmarked and registered in A's name the day before bankruptcy, while B's broker failed to do so before the firm was petitioned into bankruptcy. Customer A will be able to claim her stock outright. However, B will have to trace his shares and then, if fortunate enough to have done so *in specie*, case law **seems**[53] to suggest that he too is entitled to the return of his 100 shares of ABC Co. stock regardless of whether they were registered. Alternatively, assuming that customer B was only capable of tracing *in kind*, he will be obliged to share *pro rata* with other claimants of ABC Co. shares if an insufficient amount of that particular stock remains.

A further distinction is also made with regards to the claims of customers whose securities have been pledged. Yet again, the element of chance is determinative of the success of a customer's claim. When applying the doctrine of "sharing the burden of the loan" it is immaterial if a customer shares were registered in her name or can be specifically identified, all customers must share in the loss if insufficient shares are on hand once the loan has been repaid. As mentioned above, this approach has been highly criticized. The ALRI has argued that:

> The situation is even more difficult to understand if we ask the question: who owned the traceable non-earmarked certificate? According to the cases, the certificate was owned at all times by the unfortunate client. The pledgee acquired a special property in the certificate for the duration of the pledge, but once the broker's loan was paid, the pledgee's interest ended.

citing *Re Clark Martin & Co.* (1933), 15 C.B.R. 89 (Man. C.A.) and *Re Naskashidze*, [1948] 1 D.L.R. 346 (Ont. H.C.) See also *Re C.A. Macdonald and Co. Ltd.* (1958), 26 W.W.R. 116 (Alta. S.C., rev'd on other grounds (1959), 28 W.W.R. 231 (A.D.); *Re C.A. Macdonald and Co. Ltd.* (No. 2) (1961), 35 W.W.R. 565 (Alta. S.C.A.D.); and *Re Waite, Reid & Co. Ltd.* (1969), 5 D.L.R. (3d) 229 (Ont. S.C.) aff'd (1969), 13 C.B.R. (N.S.) 330n (C.A.).

52 Alberta Law Reform Commission, *Transfers of Investment Securities*, Report No. 67, (June 1993), at 89.

53 See Houlden & Morawetz citing *Re C.A. MacDonald & Co., supra,* note 51. In tracing shares or bonds, it is not necessary that the identification be by serial number or by inscription of the customer's name upon the share certificates or the bonds, it is sufficient if securities are found of the same description as those purchased by the bankrupt with the customer's money; see also ALRI Report no. 67 at *ibid.* at 92: *"Earmarking facilitates tracing, but where a non-earmarked certificate can also be traced in specie there seems to be no rational distinction between the two situations."*. Case law does not provide us with an answer on this point.

> Somehow, the client's property, which on a classic trust tracing analysis should not even be subject to the bankruptcy proceedings, gets divided amongst the brokers's creditors.
>
> *The final result may be fair, or at least more fair than* the result of strict adherence to property and tracing principles. But the cases fall short of providing any alternative principle that explains and justifies the result.[54]

In addition, the 1986 Colter Report[55] also identified other inequities and inefficient results which, in large measure, are a direct result of the problematic applications of common law methods of tracing and of "sharing the burden of the loan". The Report criticized the current approach for the following reasons:

- Complex analysis is required to determine whether sufficient securities of a class and type are available in the estate. This involves delay and uncertainty as to whether customers have completed transactions or whether they should process the transaction in question through another securities firm.
- Substantial liquidations of securities are involved, creating significant costs for commissions and administrative expenses and causing exposure to market fluctuations. The customer, not the estate, should be exposed to the risk of market fluctuations.
- Suppliers of goods and services and judgement creditors should not share in the assets that rightfully belong to the securities customers. They should look to the general assets of the firm, such as furniture and fixtures.
- Self-regulatory bodies cannot petition for the appointment of a trustee unless they are a creditor.[56]

Lastly, as the above analysis has shown, it can be convincingly argued that the common law principles of trust and equity lead to results which cannot be considered practical or equitable by today's standards. Moreover, in light of modern technological advances, the segregation of share certificates on a customer basis is no longer possible in a computerized environment.

4.0 Industry Driven Attempts to Provide Increased Protection for Investing Public

I) Recommendations of the Bankruptcy and Insolvency Advisory Committee (BIAC) Working Group #4

In the early stages of discussion, the BIAC Working Group on securities firm insolvencies concluded that the scheme for administering stockbroker insolvencies as set out in Bill C-17, the last of the omnibus bankruptcy bills introduced in 1984, could perhaps provide a suitable framework. The subcommittee noted that the Bill C-17 scheme was based on preliminary experience in the U.S. under the *Security Investor Protection Act*[57] (SIPA), which was promulgated in 1970 but extensively amended in 1978 following the first 100 bankruptcies administered under the scheme. The C-17 proposal with respect to securities firms was substantially unchanged from previous proposals as set out in Bills S-9 and C-60 which were also based on previous SIPA legislation.

The subcommittee noted that the Bill C-17 scheme *would reduce the need to trace customer rights to* securities in possession of the broker by providing for pooling of securities and distributing them amongst customers *pro rata*. However, it would create a very wide category of property, called "specifically identifiable property" which would not be pooled and would

54 *Ibid.*

55 Supply and Services Canada, *Report of the Advisory Committee on Bankruptcy and Insolvency* (Chairman: Gary F. Colter; 1986), at 91.

56 Self-Regulatory bodies such as the Stock Exchanges, the Investment Dealers Association and the Canadian Investors Protection Fund argue that since they establish most industry practices and standards, set capital adequacy requirements and conduct audits of securities firms on a regular basis, that they are in an ideal position to judge the solvency and financial viability of such entities. Furthermore, many customers and trade creditors often are not privy to the necessary telltale signs that indicate a securities firm is in financial difficulty. This will be discussed further in section 5.0 of this paper.

57 The *Securities Investor Protection Act of 1970*, Pub. L. No. 91-598, 84 Stat. 1636 (Codified as amended at 15 U.S.C. §§78aaa-*lll* (1988)). Hereinafter: SIPA.

allow individual investors the right to trace and identify.[58] The use of specifically identifiable property would still require the trustee to scrutinize each individual transaction in order to ascertain whether customers could trace their property. In addition, securities in a depository, which now represents the predominant method of segregation of securities, would qualify as specifically identifiable property and would not be included into the pool of customer securities or "customer fund". On the surface this definition seemed to allow for a greater number of customers to successfully claim their property, yet, as with common law principles, the success of a customer's claim remained dependent more on luck than on prudence or law. The need to trace one's securities would be avoided only if the trustee elected to provide all of the securities claimed by customers with funds provided by a customer compensation fund such as the Canadian Investor Protection Fund (CIPF). If such were the case, the insurer would have to commit to providing the full amount or value of securities claimed, which the CIPF would not do since it does not compensate investors above the set $500,000 maximum. The end result being that tracing would remain a troublesome remnant of the common law under this system. Therefore, in light of the 1978 amendments to SIPA, the subcommittee recommended that it would be more efficient to work directly from the current SIPA legislation.

II) Customer Compensation Funds — a Brief Description

a) The U.S. Model — the Securities Investor Protection Act and the Securities Investor Protection Corporation[59]

During the high volume of trading that arose in the 1960's, the securities industry found itself unprepared and unable to deal with the large "paperwork crunch". As well, the lack of a centralized clearing agency led to a failure to complete trades, serious accounting and reporting mistakes and eventually to theft of securities at brokerage houses.[60] This in turn led to rising costs by having to expand sales staff while the hiring of back office staff was neglected. When the "paperwork crunch" occurred many firms developed severe capital shortages. Many liquidations, mergers and bankruptcies ensued.

Towards the end of 1968, each major stock exchange had instituted voluntary trust funds whereupon assessments were made on member firms. However, the funds soon proved to be inadequate, due to their relatively small size, their discretionary nature and the absence of coverage for customers of firms who were not members of an exchange.[61] In response to these and other problems, the U.S. Congress enacted SIPA[62]

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58 The definition of "specifically identified property" was based in large measure, both under SIPA and Bill C-17, on section 60(e) of the *United States Bankruptcy Act*. This provision was added to the Bankruptcy Act by the *Chandler Act of 1938*, Pub. L. No. 696, 52 Stat. 840-940 (1938). The general policy of section 60(e) is that customers who are the owners of specifically identified property (The "cash customer") are entitled to preferred treatment while the margin customers who permit the broker to have wide powers over their securities should be subject to the risk of the brokers's failure but with some priority over general creditors. Accordingly, three classes of claims were established: 1) "cash customer" who are able to identify "specifically" their securities; 2) all other customers, and 3) general creditors.
...."The first level of priority established by section 60(e) are cash customers who have paid in full for securities that are specifically identifiable. These customers are permitted to reclaim such identifiable securities and thereby gain priority over other customers, presumably on the theory that they are believed to be still owners of the specific property. Securities are regarded to be not specifically identified unless they remained in their identifiable form in the broker's possession until the date of the bankruptcy, or unless such securities or any substitutes therefor or the proceeds thereof were more than four months before bankruptcy or at a time while the stockbroker was solvent, allocated to or physically set aside for such customer, and remained so allocated or set aside at the date of bankruptcy. ... The express intent of the draftsmen was that unless the certificate was specifically allocated or physically set aside, it must be thrown into the fund for distribution to all customer of the single class."
...."This provision eventually proved problematic since the ordinary manner of operating the bulk segregation system makes it impossible for securities to remain in their identical form since shares in bulk segregation are regarded as fungible." quoted from: John D. Honsberger *supra,* note 12 at 15358-9.
Today, s.60(e) is only relied upon for the liquidation of government bond dealers. Since membership to the SIPC is mandatory all other stockbroker liquidations are handled by SIPC pursuant to SIPA.

59 The following will provide a general structural overview of the U.S. regime. For an in-depth analysis of stockbroker liquidations in the U.S. see: Don & Wang, *Supra* note 42.

60 *Ibid.,* at 510-11.

whose most important feature was to establish the Securities Investor Protection Corporation (SIPC):

> . . . to protect individual investors from financial hardship, to insulate the economy from the disruption which can follow the failure of major financial institutions; and to achieve a general upgrading of financial responsibility requirements of brokers and dealers to eliminate, to the maximum extent possible, the risks which lead to customer loss.[63]

The SIPC is a private non-profit corporation and is not designed to be an agency of the United States Government. In theory the SIPC is an independent body. In practice, however, this corporate entity is subordinated to the discretionary power of the Securities and Exchange Commission.

> The SIPC's role is primarily one of consultation and cooperation with the self-regulatory organizations which remain subject to the federal security terms and the rules of the SEC. By mandating membership in the SIPC for certain members of the securities industry and by granting the SIPC general assessment authority over the members in order to establish a SIPC fund, Congress accomplished its intentions that the cost of providing protection to customers under SIPC be borne by the securities industry itself.[64]

Membership in SIPC is mandatory, under SIPA §78ccc(a)(2)(a), all persons registered as brokers or dealers under §15(b) of the Securities Exchange Act of 1934 are members[65]. The members of SIPC are obligated to pay assessments upon all of their revenues specified in §78ddd(c).[66] These levies are used to fund operating expenses and to provide for the customer protection fund. In the event that the fund should become inadequate to fulfill the purposes of SIPA, SIPC may borrow through the SEC and against the United States Treasury, up to $1 billion as authorized under §78ddd(f),(g),and (h).

The most notable aspect of the U.S. model is that SIPA will protect the investments of customers who qualify as "customers" as defined at §78*lll*(2). Once a claimant meets the criteria required to be deemed a customer under the Act, he or she is entitled to compensation. For any customer account SIPA may advance up to $500,000, of which $100,000 can be for cash. The trustee under a SIPA liquidation also has the option of restoring a customer's account by either transferring the account to another SIPC member firm or simply forwarding the monies advanced by SIPC directly to that customer. Gone is "specifically identifiable property" which is replaced by "customer name securities" as defined at §78*lll*(3), and includes only securities which are registered in the name of the customer in non-negotiable form or in the process of being so registered pursuant to the customer's instructions. Customer name securities are not viewed as part of the debtor's estate, but as being held in trust. Under this definition a customer can now only reclaim if the securities were in the debtor's possession and in non-negotiable form. All other securities and cash received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property, become part of the "customer property" fund — §78*lll*(4). The customer property is eventually shared on a *pro rata* basis, among customers to the extent of their net equities.[67]

b) The Canadian Model — the Canadian Investor Protection Fund

Unlike the U.S. model, the CIPF is not a creation of statute, though its relevance is in no way diminished by

61 Don & Wang, *Supra* note 42at 512.

62 15 U.S.C. 2. 78 aacc., Pub. L. No. 91-598, 84 Stat. 1636-1757 (1970).

63 S. Rep. No. 1218, 91st Cong., 2d Sess. 6 (1970); H.R. Rep. No. 1613, 91st Cong., 2d Sess. 14.

64 Gates, *The Securities Investor Protection Act of 1970: A new Federal role in Investor Protection, 24* Vand. L . Rev. 586, 606, 607 (1971); *S.E.C. v. Guaranty Bond and Sec. Corp.*, 496 F. 2d 145 (6th Cir. 1974).

65 15 U.S.C. §780(b) (1988).

66 The SIPC Board of Directors has agreed to set the assessment rate each year so as to achieve an annual fund growth of ten percent. Under this program, the SIPC fund should have achieved the $1 billion level by April, 1997. For fiscal years beginning in 1995, this formula resulted in an assessment rate of .00095% of gross revenues.

67 For an illustration of how the distribution scheme functions in practice, refer to Don & Wang, supra note 42, at pp. 543-6.

the absence of such a formally created mandate. The CIPF was created in 1969 by an Agreement and Declaration of Trust by the founding parties. This fund was truly an industry driven initiative, the founding members, referred to as Sponsoring Self-Regulatory Organizations (SSRO's) being the Toronto, Montreal, Vancouver and Canadian Stock Exchange (which has now merged with the Montreal Stock Exchange) along with the Investment Dealers Association of Canada. More recently, in 1981, the Alberta Stock Exchange and in 1992 the Toronto Futures Exchange have joined as SSROs. Membership to the fund is not mandatory.

The CIPF is funded in a manner similar to the SIPC in that funding is contributed by the securities industry through;

(i) regular quarterly assessments and risk premiums (based on capital deficiencies), levied against Member firms and collected by the SSROs, and;

(ii) contributions by the SSROs consisting of their respective shares from the net income of CIPF for the immediately preceding year.[68]

The Agreement and Declaration of Trust states that a limit of no more than 1% of a member's aggregate gross revenue shall be assessed in any calender year subject to any amount owing for repayment of obligations under the bank line of credit resulting from the failure of a member firm. In such circumstances the 1% assessment can be increased to repay any such obligation if the Fund is depleted.

It is important to point out that unlike the SIPC, the CIPF still remains, in theory, a discretionary trust/protection fund. However, in practice any customer with a legitimate claim will not be denied coverage. This discretion is exercised according to policies adopted in the CIPF brochure. In a nutshell, the CIPF will cover customer losses of securities and cash balances provided that the customers were dealing at arm's length with the insolvent firm and their dealings did not contribute to the insolvency of the firm. The coverage available for a customer's general accounts is limited to a total of $500,000 of which cash balances may not exceed $60,000. As of June 30, 1997, the Fund balance had exceeded $135 million, while maintaining a $40 million line of credit with a Canadian Chartered Bank.

Apart from the aforementioned differences between the two regimes, the CIPF cannot petition a Member Firm into liquidation proceedings, let alone a non member firm. Regardless, the CIPF has been extremely effective in protecting customer investments since its creation.[69] However, even with such extensive coverage afforded to the investing public the industry has recognized the need for comprehensive insolvency legislation. Leslie, Morawetz & Richardson have noted that:

> Recently, insolvencies have been administered under provincial receivership legislation. This alternate approach has been available largely because no creditor has objected. The receivership vehicle was administered in a manner which permitted the CIPF the opportunity to fulfil its mandate. However, we must be mindful that this alternative may not always be available. If certain creditors take exception to the use of provincial legislation in the administration of insolvent securities firms, the liquidation would likely have to be administered under the Act which would likely result in the application of common law principles.[70]

5.0 The New Rules Governing Securities Firm Bankruptcies — Part XII of BIA

The provisions of Part XII of the BIA provide an exhaustive scheme for the administration of a bankrupt securities firm. These provisions are significant for two reasons. First, they establish what can be called "customer-creditors", namely customers who would normally not be included under the definition of "creditor" under the BIA, but who are, for the purposes of Part XII, entitled to participate in the administration of the estate of the brokerage firm. Secondly, the scheme introduces the concept of non-creditor petitioning, allowing non-

68 Canadian Investor Protection Fund 1994 Annual Report at 11.

69 Over the past 28 years the CIPF has covered all customer losses of every member firm liquidation since its creation. Total claims, to date, have amounted to $25 million, net of recoveries.

70 Donald A. Leslie, David A. Richardson, and Geoffrey B. Morawetz. *Insolvency Reform: The Next Generation, Securities Firm Insolvency*, presented to the Canadian Bar Association, Continuing Legal Education, Toronto, Ontario, March 20, 1996, at 5.

creditors to petition a member firm into bankruptcy. The following is a section-by-section analysis of this regime.

I) Section 253 — Some Key Definitions[71]

a) "customer"

Perhaps no other term in part XII is as important as the definition of "customer" under s.253, since it clarifies how customers are to be treated and distinguished. It is important to note however, that the definition is not given its everyday ordinary meaning, rather, it is used as a "term of art". The language of the definition seems to indicate the presence of an intention to protect individuals who have entrusted cash or securities for the purpose of investing including situations connected with participation in the securities markets. "Customer" is defined as (a) a person who deals with and who has a claim against a firm for securities acquired or held for that person in various forms; (i) for safekeeping or in segregation, (ii) with a view to a sale, (iii) to cover a completed sale, (iv) pursuant to a purchase, (v) to secure performance of an obligation of that person, or (vi) for the purpose of effecting a transfer. The term customer also includes a person who has a claim against the firm arising out of a sale or wrongful conversion by the securities firm of a security mentioned above. As well, customer includes a person who may have other types of property held by the firm, placed there with a view to buying securities, or received into a *customer account as proceeds of a sale of securities.* Presumably, this would include free credit balances and stock dividends. Excluded from the definition are persons with a claim for cash or securities that constitute part of the capital of the firm, or a claim that is subordinated to creditors's claims.[72] The definition also includes corporations to the extent that they are dealing *at arms length with the firm.*

b) "customer name securities"

Adopted from SIPA legislation, "customer name securities" is defined as securities held by a firm for a customer and registered in the customer's name or alternatively, in the process of being registered, provided they are not in negotiable form. Unlike previous draft legislation, this definition clearly demarcates which securities will be kept out of the general customer pool and greatly simplifies the trustee's task of establishing which securities are pooled in the customer fund.

c) "deferred customer"

A deferred customer is one who, by dishonest management of an employee of the firm, misconduct, or by speculating massively, caused or materially contributed to the firm's insolvency. Such customers will be the last to share in the assets of the firm once all of the general creditors' claims have been met.

d) "open contractual commitment" (OCC)

An OCC is *an enforceable* but *uncompleted contract* of the securities firm to buy or sell securities. An example might be an unsettled securities transaction, an uncompleted securities loan or repurchase position, or a commodities or financial futures contract, (which are more commonly considered as being derivative products) where the firm, acting for the customer undertakes to *take or make delivery of a commodity or financial instru*ment on a specified future date.

e) "securities firm"

Included in the scope of this definition will be a person involved in the business of buying and selling securities and includes any person required to be registered to enter into securities transactions with the public under the relevant provincial securities legislation. The definition does not, however, include other financial institutions such as a bank, trust company or

71 The following definitions are not a complete listing to be found in s.253, though they include, in the author's opinion, the key terms fixing the scope of the Part XII.

72 "For example, principals of a firm or a lender may have made a loan of cash or securities to the firm under a uniform form of subordination agreement, approved by regulators, by which they agree that the loan is subordinated to claims of general creditors. (Rules of regulators and self-regulatory organizations in the securities industry allow such loans as a means of contributing capital to a firm which may be taken into account in calculating the firm's capital for purposes of assessing capital adequacy." Industry Canada, *Briefing Document, Prepared for the Parliamentary Committee to Study Bill C-5,* March, 1996 at 121.

insurance company, excluded from the definition of "corporation" under section 2.

f) "security"

Security is defined as any document, instrument or written or electronic record evidencing a share that is commonly known as a security, and includes such investment instruments as stocks, equity shares, debt instruments, mutual fund units and any other instruments as prescribed. Specific instruments which are identified under this definition include shares, a participation right or other right or interest in property or in an enterprise, debentures, mortgages, certificates of deposit, commercial paper or mortgage backed instruments and, derivative instruments such as a right, option, warrant or subscription, or under a commodity future, financial future, or exchange or other forward contract, including an eligible financial contract under subsection 65.1(8).

II) General Provisions

a) Customer-creditors

Subsection 254(1) is said to provide certainty with regards to the treatment of customers. It is declaratory in nature and provides that in respect **of claims by customers for securities or customer name securities, all of the provisions of the BIA apply as if customers were creditors in respect of such claims.** The subsection provides that although customers are not creditors in the usual sense, they will be treated as if they were for the purposes of liquidating a securities firm. This in turn will entitle them to receive notices, file proofs of claim, and the like. Another consequence of being treated as creditors will be the applicability of sections 91-101 concerning settlement, preferences and reviewable transactions to customer-creditors (subsection 254(2)). The reasoning underlying this provision holds that preferential payments by a firm to customers are considered to be unfair to other customers-creditors in the same way as preferential payments to ordinary creditors. However, the operation of Part XII is still subject to the rights of secured creditors (subs.254(5)).

Since this scheme interferes substantially with the traditional ownership principles of customer property, subsection 254(3) stipulates that the scope of part XII is restricted to liquidations or bankruptcies only and does not apply to reorganizations in Part III of the BIA. The reason for this is quite simple, if the CIPF will cover all customer losses subject to the $500,000 limit, it would be ridiculous to ask customers to agree to accept less than one hundred cents on the dollar under a proposal. Even if it is assumed that a proposal was to be accepted, this would not solve the firm's inability to trade due to its suspension for not meeting capital adequacy requirements.

Finally s. 255 stipulates that if a conflict arises between the application of the provisions of Part XII, in so far as they are applicable, and the other provisions of the Act, the provisions of Part XII will be deemed to prevail.

b) Who may petition?

As with SIPA and Bill C-17, Bill C-5 introduces the concept of "non-creditor petitioning" to Canadian bankruptcy legislation. This is accomplished by authorizing certain persons who would otherwise not meet the requirements of "creditor" as set out under s.2 and s.43 to 45 of the Act, as well as for reasons that would normally not constitute an act of bankruptcy under s.42, to petition a securities firm into bankruptcy. In addition to any creditor who may petition in accordance with sections 43 to 45, subsections 256(1)(a), (b), (c) and (d) would allow a Securities Commission established under an enactment of a province which licensed or registered a firm or broker, a Securities Exchange recognized by a provincial securities commission, a Customer Compensation Body or a receiver, receiver manager or liquidator of the firm's assets appointed under securities legislation, to file a petition. The petitioner would have to show that the firm had committed an act of bankruptcy referred to in section 42 **or that it had been suspended for failing to meet capital adequacy requirements under subsection 256(2), within the six months before the filing of the petition and remained suspended at the time of filing the said petition.** However, a securities commission would only be so authorized if the firm was licensed or registered by that securities commission to carry on business in Canada or if it was established that the firm should have been registered as such. Likewise, a securities exchange could petition only if the securities firm was a member of the exchange, and a customer compensation body (CIPF) could only be so authorized if the firm's accounts were protected by the said body, in whole or in part.

c) Trustee powers and responsibilities

Under s.257, the trustee has a role to play in assisting customers in preparing their proofs of claim. The section requires the trustee to send customers a statement of their accounts along with the notice of the bankruptcy. The trustee will take possession of the broker's files and computer records and will be able to assist customers by sending a print out of the most recent state of their accounts.

The trustee is also vested with the power, if need be, of applying to the bankruptcy court for a determination of whether a customer has caused or materially contributed to the insolvency of the firm and therefore should be treated as a deferred customer (subs. 258(1)). In such a case, the trustee will inform the customer forthwith of his or her decision including the reasons for the decision and a copy of the application, and shall apply for a court ruling on the matter. The CIPF is also vested with this authority under subsection 258(2) where the accounts of customers are protected by the said fund.

Section 259 enumerates powers which the trustee may exercise without the permission of inspectors until inspectors are appointed and thereafter with their permission. The trustee may;

(a) exercise a power of attorney in respect of and transfer any security vested in the trustee;

(b) sell securities, other than customer name securities;

(c) purchase securities;

(d) discharge any security interests on securities vested in the trustee;

(e) complete open contractual commitments;

(f) maintain customers' securities accounts and meet margin calls;

(g) distribute cash and securities to customers;

(h) transfer securities accounts to another firm and consider customer requests for disposal or transfer of open contractual commitments and indemnify a transferee firm against shortages of cash or securities in transferred accounts;

(i) liquidate any securities account without notice and;

(j) to sell, without tender, assets of the firm essential to the carrying on of its business.

Paragraphs (a) to (c) give the trustee the necessary powers to buy and sell securities since the value of securities can often be quite volatile and must be read in conjunction with subsection 262(2.1) which provides *that a trustee may satisfy all or part of a customer's claim* to securities of a particular type by delivering to the customer securities of that type to which the customer was entitled at the date of bankruptcy. Given the frequent volatility of certain securities and of securities markets in general, to limit or even eliminate the fallout from the failure of a broker, these trustee powers seek to restore customers to the positions in which they were in at the date the petition was filed in as little time as possible. This section does not, however, clearly demarcate under what circumstances a trustee would be justified in doing so.

Presumably the powers enumerated at paragraphs (a) to (c) and 262(2.1) may be exercised in two ways. First, we have what can be called the "pro-estate/pro-compensation fund approach." If a customer is owed securities and only some of which can be identified in the possession or control of the firm, the customer will receive his pro-rata share of the securities with the remainder of the claim being satisfied either in cash or in kind depending on the value of the securities and on the date of the filing of the petition. Therefore, if the trustee sees that the value of the securities claimed by the customer has dropped between the filing date and the date for which the customer files his or her proof of *claim or the date for which the trustee is able and willing* to satisfy the claim, the trustee may elect to purchase the amount of shares still owing on the open market instead of satisfying the amount owed in cash, thereby choosing the more economical route and leaving more funds available to the estate while lightening the burden of customer compensation to the CIPF. The reverse would apply if the value of the securities had risen between the date of petitioning and the date the proofs of claim were filed or the date the trustee elected to satisfy the claim. This is essentially a variation on the method of satisfying customer claims under SIPA prior to the 1978 amendments.[73] Using this second approach, the trustee could elect to exercise his or her powers in a more equitable manner by adopting the approach currently relied upon under SIPA §78fff-2(d). By following this approach, the trustee would be author-

ized to purchase missing securities to the extent that a "fair and orderly market" existed, meaning that if the markets are not overly volatile or if the securities are not unique, thinly traded, or possibly manipulated, the customer would be compensated for the amount of shares still owed.[74] Paragraph (d) which is also modelled on SIPA §78fff-3(c)(1) legislation enables the trustee to use CIPF advances to satisfy loans in order to recover customer securities that have been pledged as collateral. This is a welcomed provision that will certainly eliminate many of the aforementioned problems associated with having to apply the doctrine of "sharing the burden of the loan".

Industry representatives have seemed to indicate that when the CIPF will be involved, it's aim will be to provide customers with securities to the extent they are obtainable in a fair and orderly market and it will grant the authority to a trustee to do so. Consequently, it will pay the excess where share values have risen since the date of bankruptcy. This decision will of course be discretionary. If the CIPF is not involved, the trustee's only source of funds and securities will be what is on hand in the estate. Subs. 262(2) requires the trustee to distribute shares on hand to the extent they are available. The trustee will not be able to sell shares that will have risen in value and distribute the proceeds in cash. It would appear, however that the trustee will be able to buy and distribute securities whose value has fallen, as the CIPF would likely do. Therefore, in cases where the CIPF will not be involved the burden of the rise in share prices will be placed upon customers. Since there are no provisions related to this issue in Part XII, it is difficult to assess how the issue of fluctuations in the value of securities between the date of bankruptcy and the date for which customer claims are satisfied would be dealt with.

Paragraphs (e), (f), (h) and (i) enable the trustee to carry out or close executory contracts as circumstances may dictate. With regards to paragraph (e), an open contractual commitment involves an agreement by one broker to deliver securities to another broker, against the payment of cash on a specified date. Under SIPA[75] this date must precede the filing date of the petition. The commitment remains "open" since on the filing date, neither party has performed their respective parts of the contract.[76] The goal of these provisions, presumably, is to alleviate the potential hardships for customers waiting to have their claims satisfied. These provisions are similar to §78fff-2(f) which allows a trustee to transfer accounts in bulk to another broker if such a transfer will expedite matters in terms of satisfying customers claims and the liquidation of the debtor securities firm. Don & Wang explain this process under SIPA legislation as follows:

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73 SEC v. S.J. Salmon & Co., Case No. 72 Civ. 560 (SDNY June 19 1973) (Decision on Claims of Kalika, Greenstein, Miller, Kars, Vernick and Sanders at 3-5); H.R. Rep. No. 746, 95th Cong. 1st. Sess. 21 (1977); cited in Don & Wang supra, note 42 at 533-4. Prior to the 1978 amendments if a customer was owed securities after receiving his or her pro-rata share, the customer would receive the balance in cash, based on the filing date value of the securities. As to the portion of the securities claim satisfied in cash, the customer would have to absorb any loss resulting from an increase in value in the securities between the filing date and the satisfaction of the claim. By the same token, the customer would reap the benefit of a downturn in the market value of the securities during the same period.

74 Under the SIPA regime, the court sets an initial period for claims to be filed, which may not be more than 60 days after publication of the liquidation notice — § 78fff-2(a)(3). Claims for securities that are filed after the initial period, and that require a SIPC advance, may be satisfied in kind or in cash, depending upon which is the most economical. The purpose of the provision is to discourage customers from delaying the filing of their claims, while they see if a market change takes place that will allow them to improve their positions. Don & Wang supra note 42 at 543.

75 17 C.F.R. § 300.300(c) (1990).

76 Don & Wang *supra*, note 38 at 547, explain that under SIPC rule, *ibid.* § 300.301., "the non-debtor broker must complete or close out the transaction, if (1) it was acting on behalf of a customer eligible for SIPA protection; (2) the settlement date of the transaction (that is, the date of the delivery of securities versus payment of cash) was on or within thirty days of the filing date or up to five days after the filing date; and (3) the trade date of the transaction was on or within five business days of the settlement date". The burden is on the broker to demonstrate his customer's interest in the transaction: § 300.301(b).
In closing out or completing the transaction, the broker will buy the security owed to his customer or sell the security owned by his customer, whatever the case may be, within thirty days after the settlement date: § 300.302(a)(1). If a profit is realized by the customer of the other broker upon the resale or repurchase, it is remitted to the trustee. If a loss is sustained by the customer, it is compensated by the trustee, but only in an amount up to $40,000: § 300.301(b).

Whether a transfer is feasible depends upon such factors as the condition of the debtor's books and records, the nature of the customer accounts, and the availability of a SIPC member able to handle a transfer and service new accounts. If an acceptable buyer is found and an agreement reached, customer accounts eligible for SIPA protection are transferred to the broker. Where feasible, a tape-to-tape transfer between brokers of account information and positions may expedite the transfer. Transferred with the accounts are securities and cash to which the customers in question are entitled, provided that the amounts do not exceed the limits of SIPA protection. If a dispute develops with respect to a transferred account, the account may be reconveyed to the trustee for resolution.

Upon acceptance of an account, the transferee broker undertakes to pay any debit balance, and deliver any short position in the account, to the trustee, and to assume all of the debtor's obligations to the customer, to the extent supported by the debtor's books and records. Typically, the trustee indemnifies the transferee broker against losses resulting from errors in the debtor's books and records, or against the trustee's failure to deliver, in accordance with the transfer agreement, any cash credit balance or security. SIPC funds may be used for the indemnification, provided that the amount would not exceed that of satisfying the account in the normal course.

The transfer agreement is contingent upon approval by SIPC. However, once the agreement is approved, the customer has the option of obtaining the release of cash and securities owed to him or of having the new broker service his account.[77]

In addition, paragraph (h) is in part based on the *U.S. Bankruptcy Code 1978*[78] which requires the trustee of a bankrupt commodities futures broker to comply with a customer's request to the extent practicable, for the transfer of futures accounts whenever there are resources available to cover the customer's equity. Generally, another commodity firm will not accept the transfer of accounts and the liability to customers for their equity unless it receives adequate cash and securities to cover that liability. The BIAC working Group #4 on stockbroker insolvencies decided early on that if fair treatment of the investing public was the most important basis for these provisions, then there were no compelling arguments that could be identified other than an all inclusive approach towards investment instruments to be covered under the scheme.

Paragraph (g) merely confirms the trustee's obligation to distribute securities quickly and paragraph (j) confirms the trustee's right to make a block sale of the firm's securities inventory where appropriate.

Once these matters have been rectified, the trustee must determine which of the securities are to be dealt with as customer name securities and those which will not be dealt with as such (subs. 260(a)). The trustee must then notify the customers of this determination as soon as possible (subs. 260(b)).

d) Distribution of the estate

Once a broker makes an assignment or is petitioned into bankruptcy, subsection 261(1) provides that all the securities and cash held by the firm either for itself or for its customers with the exception of "customer name securities", vests in the trustee (whereas the BIA provides at subs. 71(2) that only the property of the bankrupt vests in the trustee). This enables the trustee to place all remaining customer securities in the "customer pool fund" (subs. 261(2)).

Subsection 261(2) determines how the property of the estate is to be allocated. It requires the trustee to establish a "customer pool fund" containing securities held for the account of customers, together with securities held for the securities firm's own accounts in addition to any investments of the securities firm in its subsidiaries. Property which is excluded consists of customer name securities and eligible financial contracts to which the firm is a party, that are held by or for the account of the firm. Also included in this fund are monies from customer accounts or monies obtained through settlement of transactions after the bankruptcy, including dividends and any interest accrued or other income.

77 *Ibid.*, at 546-7. With regards to this issue, the CIPF considers this to be an overly conservative method and does not contemplate such a strict application of this approach in the Canadian context.

78 (Public Law 95-598)

All of the remaining property is allocated to the "general fund" to be divided between creditors.

Thus, pursuant to s. 262(1), cash and securities in the customer pool are then allocated on the following basis:

(a) for costs of administration pursuant to paragraph 136(1)(b), yet only to the extent that such funds **are not available in the general fund**;[79]

(b) to customers, other than deferred customers, in proportion to their net equity; and

(c) to the general fund.

Subsection 262(1.1)(a)(b) allows a person that has deposited property with a securities firm to assure performance of an obligation under the terms of an eligible financial contract to also benefit from the proceeds of this fund in the same way as if they were a customer of the firm with a claim for net equity subject to any amounts which may be owing.

Subsection 262(2) then provides that where there are securities in the pool of the same type as are claimed by customers, the trustee will distribute those securities to those customers in proportion to their claims for those specific securities, up to the allotted proportion of net equity owed to them. This confirms the trustee's duty to distribute securities in kind to the extent they are available. Thus, if there are enough securities of ABC Co. to compensate the claimants of ABC Co. in full, but no XYZ Co. securities available, then in the absence of contributions from a compensation body, securities of ABC Co. would be distributed to ABC Co. claimants in proportion to their claims for ABC, but not in full, as some ABC shares would have to be sold to obtain cash to compensate claimants of XYZ securities. However, if the customer pool is inadequate, customers will share in the distribution of the general fund with creditors. The rationale being that customer's securities were used by the firm in building up its own assets.

If any surplus remains after the initial distribution of the customer fund, the remainder is to be allocated to the benefit of claimants of the general fund.

Subsection 262(3) sets out the order of priority for claimants of the general fund which is identical to the way a bankrupt's property is allocated under the Act. The only variance is that customers and a compensation body (if it compensated customers) will share pro-rata with creditors.

(a) First, preferred creditors, **in their order of priority** as set out under s.136(1);

It is important to note that the next three groups would then share equally in the remainder of the estate.

(b) followed by customers with claims for net equity remaining after property in the customer pool has been depleted;

(c) where applicable, to a customer compensation body — if it has compensated customers;

(d) ordinary creditors, in proportion to their claims for net equity;

The two remaining groups would then share *by order of priority*.

(e) deferred creditors referred to in section 137; and

(f) deferred customers, again in proportion to their claims for net equity.

Section 263 provides the authority for the trustee to distribute customer name securities to customers who own them, subject to payment of any amount owing. In situations where a customer neglects or refuses to discharge their indebtedness in full, the trustee may, on notice to the customer, sell a sufficient number of cus-

79 The trustee's administrative costs will be applicable to the "general fund"exclusively and then, if there are insufficient assets in the "general fund", to the "customer pool fund". It has been suggested that creditors might object to the "general fund" having to bear the brunt of paying for these fees. A more equitable approach might have been achieved by providing for the spliting of these fees between the funds in proportion to the costs associated with the administration of each. Practical considerations would justify such an approach. It might be that significant fees will be generated by the time and resources necessary to properly administer and distribute the proceeds of the customer pool fund. By the same token, less time and resources might be spent on the general fund, or vice versa.

tomer name securities to discharge the indebtedness and then deliver any remaining customer name securities to the customer.

Section 264 stipulates that where the accounts of customers are protected by a customer compensation body, the trustee will be required to consult the said body. The customer compensation body will also be allowed to designate an inspector to act on its behalf.

Analogous to s.150 of the Act, s.265 will allow a customer to prove his or her claim after the distribution of cash and securities in the customer pool fund. However, it is important to note that such a claim will not affect the previous distribution of the customer pool fund or the general fund. This will allow the trustee to act quickly and still permit customers to file claims even if they are late in doing so.

It is interesting to note that although these provisions do provide an exhaustive scheme for the distribution of assets, they do not give trustees any means by which to deal with customer name securities which are not claimed. These securities cannot be included into the customer pool fund since they are registered in someone's name and are non-negotiable. It has been the case in past that unclaimed shares are left in the possession of trustees who cannot dispose of them in any manner. Perhaps it would have been prudent to provide for a mechanism that would have the effect of allowing a transfer of these shares in the customer pool fund after a certain period of time has elapsed.

6.0 Conclusion

In this author's opinion, these long overdue measures will function adequately in rectifying many of the inequities and inefficiencies which have, to date, plagued the administration of securities firm bankruptcies. Under this approach, the normal principles and rules respecting property held by a bankrupt belonging to a third party, or which is held in trust for another, will not operate. However, it is felt that the disadvantages will be trivial compared to the benefits which will accrue under this system. First, the scheme will establish more certainty and have clearly defined rules for differentiating between only two types of customer property, namely "customer name securities" and "customer securities". This will facilitate tracing and virtually eliminate the need to do so where customer accounts are protected by the CIPF, as the CIPF compensates customers for any shortfalls of up to $500,000[80]. The CIPF will then be allowed to rank as a single creditor under the "general fund" for the claims of all customers which it would have paid out. Firms whose customer accounts will not be protected by the CIPF will at least benefit from the more equitable, efficient and simpler regime offered under Part XII. Furthermore, recourse to the doctrine of "sharing the burden of the loan" will be virtually eliminated, based on the aforementioned reasons, but also because the trustee will be able to discharge any security interest thereby reclaiming pledged securities. The doctrine will only be applied where the market value of pledged securities exceeded the amount of the loan. Second, any investor who wants to ensure that his or her shares would not be subject to distribution amongst other claimants in the event of a bankruptcy can simply make arrangements with a broker to qualify them as "customer name securities" or by obtaining them and holding the certificates of ownership themselves. Thirdly, the more extensive pooling of securities under the new scheme should lead to higher *pro rata* distributions before having to rely on the CIPF, which in turn will put customers in a position where they will be less likely to run up against the $500,000 ceiling for CIPF compensation. This more simplified approach is likely to lower costs related to the administration of the estate, which in turn will require less litigation to resolve disputes and ultimately result in quicker liquidations. This is of particular importance in the securities industry where markets can often be quite volatile. Consequently, more property will remain for distribution amongst customers and creditors.

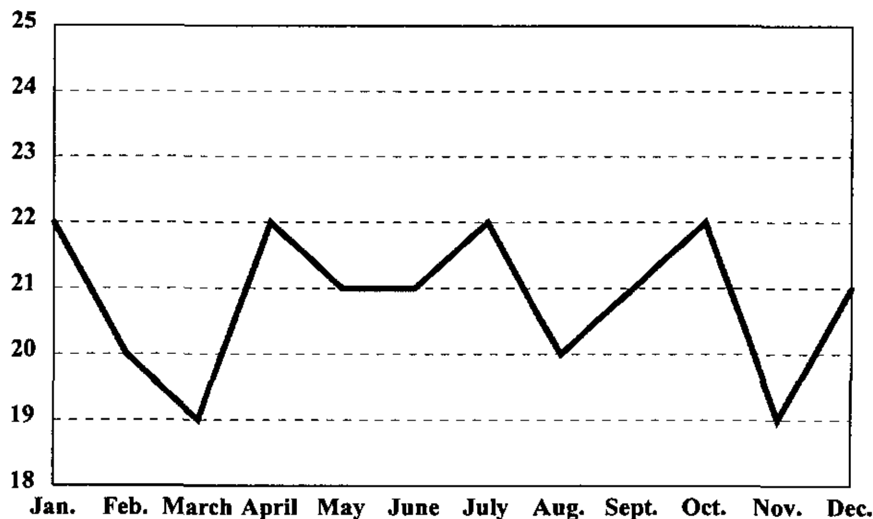
It is often difficult to judge the practical success of any legislative endeavour, regardless of the discipline or industry which is being regulated. The securities industry remains complex and ever-changing, while the economy and market fluctuations continue to affect how a securities firm conducts its business. It is therefore difficult to evaluate the success of these recent amend-

80 To date, the CIPF has not received a customer claim which has exceeded the $500,000 coverage limit.

ments to the BIA. Yet, a good indication can be had by examining how our neighbours south of the border have benefited from SIPA and the SIPC for almost 26 years. One can only hope that this system will function as adequately in Canada. In the writer's opinion, the drafters of this legislation have, in a competent and far-sighted manner, incorporated the finer points of the American regime, while adapting it to the unique aspects of the Canadian securities industry.

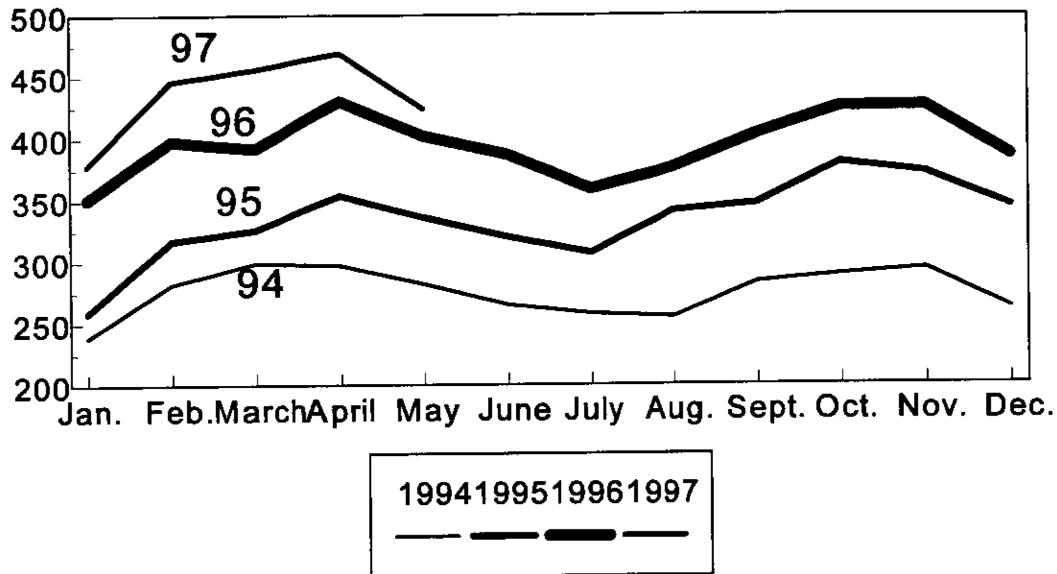
Bankruptcy Filings per Trading Day

Many analysts compare the number of bankruptcy filings in a month to the number of bankruptcy filings in the previous month or the same month of the previous year. These types of comparisons can be misleading. The number of trading days (or business days) can be affected by statutory holidays, the number of weekend days and by the varying number of days in a month. Also, bankruptcy filings experience a seasonal effect. i.e. bankruptcy filings will naturally be higher in certain months and lower in others. Calculating average filings per trading day for each month helps to clarify comparisons.



The graph above illustrates the number of trading days per month in 1997 in Hamilton, Ontario as statutory holidays differ from province to province. The Hamilton figures use statutory holidays for Hamilton. The number of trading days can vary between 19 and 22 which is a 14% difference. Some statutory holidays, such as Easter, can occur in different months in different years. For these reasons, comparisons between months for total bankruptcy filings can be misleading.

Filings per Trading Day
National

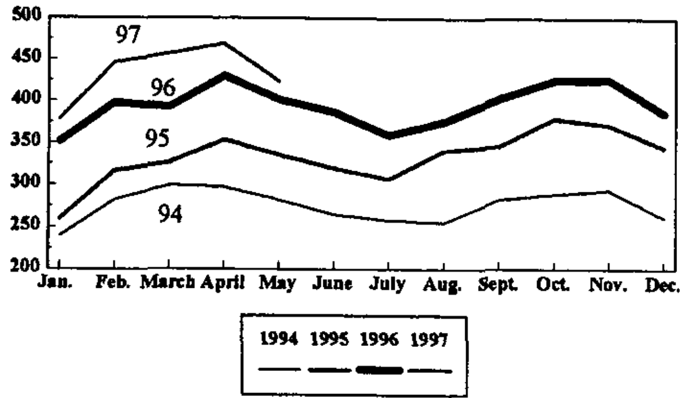


The graph above illustrates the number of bankruptcy filings per trading day on a monthly basis from January 1994 to May 1997. The graph illustrates the seasonal effect. Bankruptcy filings per trading day behave in a reasonably consistent manner. They experience seasonal lows in the winter and summer and seasonal highs in the spring and fall.

The graphs on the following pages show filings per trading day for each of the district bankruptcy offices of the Office of the Superintendent of Bankruptcy. Similar seasonal patterns can be identified in each case, although this effect is more pronounced in some districts than in others.

Thus, the combination of the seasonal effect and the number of trading days in a month can cause misleading monthly comparisons of total bankruptcy filings. By using filings per trading day and by taking the seasonal effect into account, more meaningful comparisons can be made.

Should you require any further information on filings per trading day please do not hesitate to contact Trent Craddock at (613) 941-2858.


Filings per Trading Day
National
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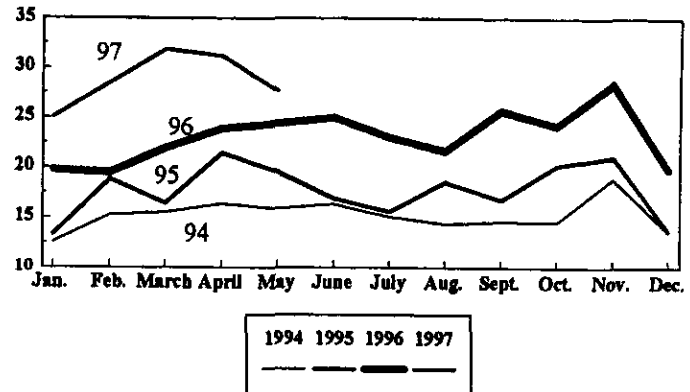
Filings per Trading Day
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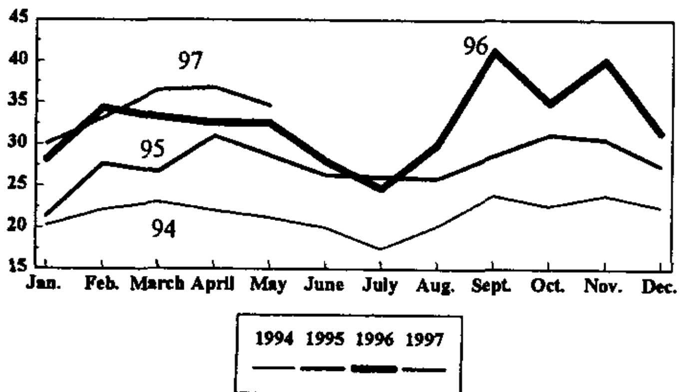
Filings per Trading Day
Québec City
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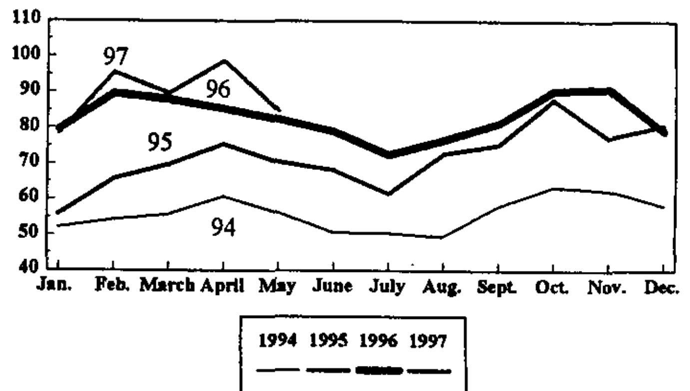
Filings per Trading Day
Montréal
110
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90
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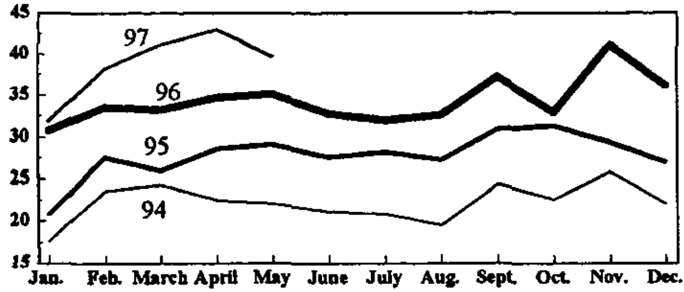
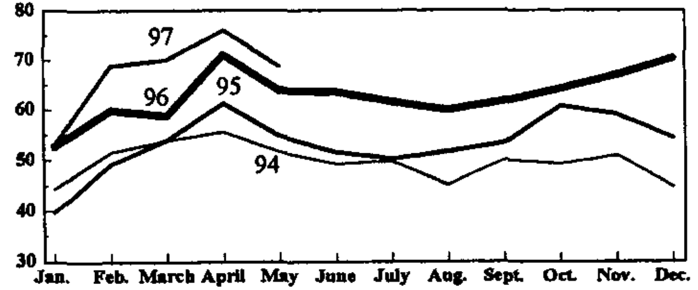
1996
1997

Filings per Trading Day Ottawa



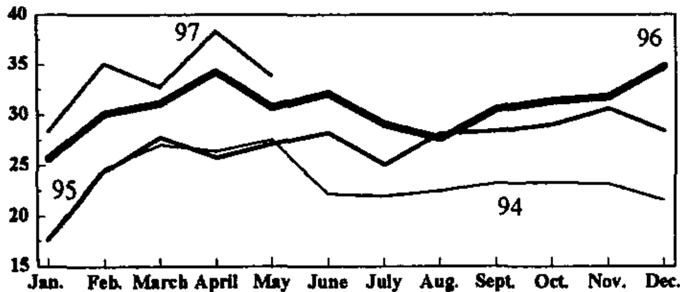
1994 1995 1996 1997

Filings per Trading Day Toronto



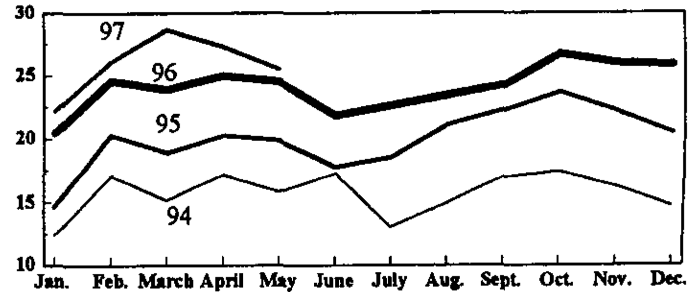
1994 1995 1996 1997

Filings per Trading Day Hamilton



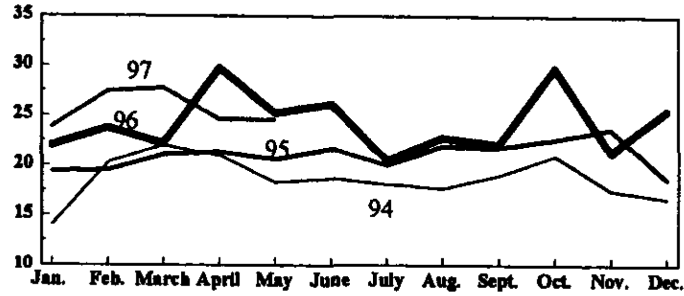
1994 1995 1996 1997

Filings per Trading Day London

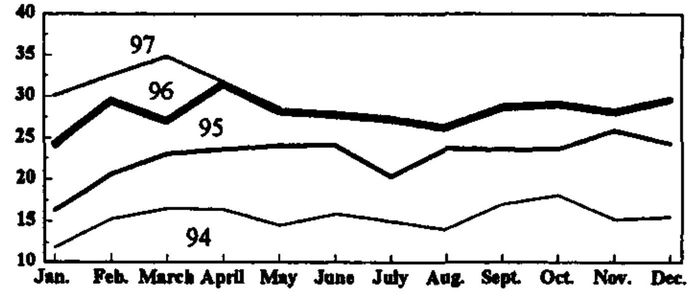


1994 1995 1996 1997

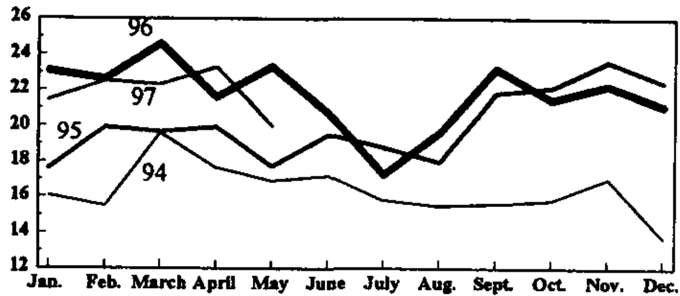
Filings per Trading Day
Winnipeg



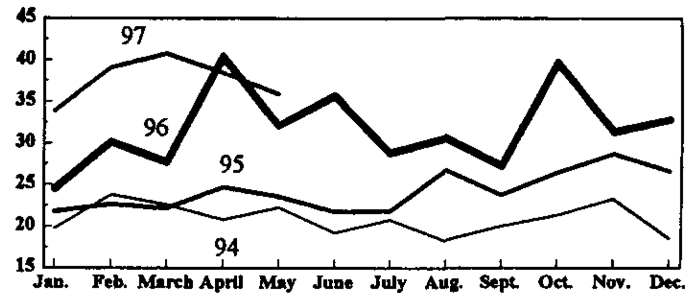
Filings per Trading Day
Edmonton



Filings per Trading Day
Calgary



Filings per Trading Day
Vancouver



Bankruptcy Statistics Available on Industry Canada's Strategis Internet Site

1. Current Availability

The Office of the Superintendent of Bankruptcy currently publishes statistics on the Internet on a monthly basis (http://strategis.ic.gc.ca/osb). These statistics include the following as represented in the table below.

Current State of Bankruptcy Statistics on Strategis		
	Start Date	**End Date**
Summary of Bankruptcy and Proposal Statistics by Month	January 1992	May 1997
Business Bankruptcies by Industry Type Grouped by Province	January 1992	May 1997
Receivership Statistics	January 1993	May 1997

The Summary of Bankruptcy and Proposal Statistics by Month provides users with an overview of statistics for a specific month. Consumer and business bankruptcy filing volumes for the current month and for the year to date are provided. The total number of bankruptcies for the current month are compared to the same month last year. Total bankruptcies are also compared for the year to date with the year to date last year. Proposal statistics are available for the current month and the year to date for division I, division II and total proposals.

Business Bankruptcies by Industry Type Grouped by Province provides users with provincial and national statistics on business bankruptcies for a specific month. For each province and for Canada the user is able to view statistics on the number of business bankruptcies and the amount of liabilities by standard industrial classification major group. These statistics are produced for the current month and for the year to date.

Receivership Statistics provides users with information on receivership filing volumes. Statistics are provided for private receiverships, for court receiverships and for total receiverships for both the current month and for the year to date.

2. Future Availability

The Office of the Superintendent of Bankruptcy is currently preparing an expanded version of it's bankruptcy statistics available on Industry Canada's Strategis Internet site. This expansion reflects stakeholder interest in bankruptcy statistics.

The expanded bankruptcy statistics will have two components: published statistics and enhanced statistics. These expanded bankruptcy statistics are summarized in the table below.

Future State of Bankruptcy Statistics on Strategis			
		Start Date	**End Date**
Published Statistics:			
Consumer and Business Bankruptcies by Province		January 1987	May 1997
Bankruptcies and Proposals by Urban Centre		January 1995	May 1997
Business Bankruptcies by Province and by SIC		January 1990	May 1997
Receiverships, Private and Court by Province		January 1993	May 1997
Proposals, Division I and II by Province		January 1993	May 1997
Enhanced Statistics:			
Annual Bankruptcy Rates by Urban Centre		1991	1996
Trend Analysis:	Consumer and Business Bankruptcy(Counts)	January 1987	May 1997
	Industrial Sectors(Counts & Liabilities)	January 1990	May 1997
	Receivership	January 1993	May 1997
	Proposals	January 1993	May 1997
Compare Years:	Consumer and Business Bankruptcy(Counts)	January 1987	May 1997
	Industrial Sectors(Counts & Liabilities)	January 1990	May 1997
	Receivership	January 1993	May 1997
	Proposals:	January 1993	May 1997
Country Profile:	Consumer and Business Bankruptcy(Counts)	January 1987	May 1997
	Industrial Sectors(Counts & Liabilities)	January 1990	May 1997
	Receivership	January 1993	May 1997
	Proposals	January 1993	May 1997

Under published statistics we have added more depth by adding five more years of data to the consumer and business bankruptcies by province and two more years to the business bankruptcies by province and by SIC. Also we have added more breadth by the addition of bankruptcies and proposals by urban centre. The statistics by urban centre provide details on filing volumes for all of the census metropolitan areas and census agglomerations in Canada. The major urban centre statistics will include statistics for the component census subdivisions of Vancouver, Montreal, Toronto and Hamilton.

The enhanced statistics provide value added statistics to the user. In particular, they provide consumer and business bankruptcy rates for each of the urban centres as well as for the census subdivisions of Vancouver, Montreal, Toronto, and Hamilton. These bankruptcy rates are available from 1991 to 1996 on an annual basis. The enhanced statistics will also allow users to undertake trend analysis, to compare years and to obtain a country profile.

Newly Licensed Trustees 1997

Newfoundland

Howe, David Alexander

New Brunswick

Francheville, Henry M.

Québec

Aberback, Sheri Lee

Auclair, Andrée

Bouthillier, Denis

Brault, Nathalie

Bresse, Charles

Chiasson, Jean

Chorel, Danielle

Denis, Mario

Farmer, Robert

Fillion, Jeannot

Gagnon, Martin

Gauvin, Stéphane

Jordan, Philippe

Landry, Michel

Lapointe, Sylvain

Lessard, Stéphane

Nicolini, Isabella

Palus, Allan Stephan

Pesant, Jacques

Pronovost, Éric

Renaud, Jocelyn

Ontario

Boulay, Daniel Ronald

Chow, Mark Goodfellow

Covent, Warren R.

Dhingra, Subhash C.

Edgar, Brock J.

Evans, Sherri Lee

Gaertner, Jerrard B.

Gray, Phyllis Marie

Haralovich, John Pierre

Jones, Douglas Owen

Judd, Gregory

Kerbel, Jeffrey Daniel

Kofman, Robert David

Mathew, Joseph

Meghji, Mohsin Yusufali

Meilach, Jeffrey Shawn

Morgenroth, Donna Marie

Murray, Janet Victoria

MacRae, Dana

McKinley, Rebecca Diane

Pellarin, Jeff P.

Rodrigues, Jervis Cyril

Rudichuk, Bruce Edward

Salyzyn, Leanne Elizabeth

Sutter, Richard John

Thatcher, Kevin James

Tremblay, Solange (extended to Ontario)

Manitoba

Neudorf, Gordon Victor

Saskatchewan

Hopkins, Stanley Ward

Aberta

Bailey, Senga

Brennan, Kevin B.

Kelly, Marc Edward

Klaray, C. Thomas

McDicken, Daniel William

British Columbia

Kwasnicky, Debora V.

McNeill, David Bruce

Newly Licensed Trustees
1997
Statistics

	Candidates	Licence					
		Full	%	Restricted	%	No	%
1. Canada	87	46	53	13	15	28	32
2. Province							
a) Nfld.	2	1	50			1	50
b) N.B.	1	1	100				
c) Qué.	28	15	54	6	21	7	25
d) Ont.	43	21	49	6	14	16	37
e) Man.	2	1	50			1	50
f) Sask.	1	1	100				
g) Alb.	7	4	57	1	14	2	29
h) B.C.	3	2	67			1	33
3. Total	87	46	53	13	15	28	32
4. Restricted				Cons.- 7* Corp.- 6**			

* Licence restricted to consumer insolvencies only.
** Licence restricted to corporate insolvencies only.

Property Exempt from Attachment or Seizure

Rules Respecting the Exemption of Property from Attachment or Seizure — Addendum

by **Mark Winkler**

Earlier this year, in the first trimester issue of the *Insolvency Bulletin* (Vol. 17), we published a report on the principal exemptions provided by provincial and federal legislation, with regard to the seizure of property entitled "*Property Exempt from Attachment or Seizure*". Along with a notice that our report was not to be construed as an exhaustive list of such exemptions, we invited our readers to inform us of any errors, omissions or inaccuracies that they might come across, or any comments they might have regarding the report. The following are noteworthy additions, which have been brought to our attention thanks to comments received from our readers. We have also added several references to federal statutes which were not included in the report published this year.

Ontario

Pension Benefits Act, R.S.O. 1990, c. P.8.

- Subsections 66(2) and (3) provide that both money transferred from a pension fund to an RRSP or RRIF, and money payable from an RRSP or RRIF, are exempt from execution, seizure or attachment.

Québec

Ministère du Revenu Act, R.S.Q. 1990, c. M-31.

- Section 33 provides that every amount owing by the Crown in respect of a fiscal law as a refund is inalienable and unseizable, except where such a fiscal law expressly provides otherwise.

Federal Exemptions

1. ***Financial Administration Act,*** R.S.C 1985, c. F-11, s. 67: a Crown debt is not assignable.
2. The following federal statutes provide exemptions for various types of benefits, pensions and allowances:
   - ***Labour Adjustment Benefits Act,*** R.S.C. 1985, c. L-1, s. 23;
   - ***Members of Parliament Retiring Allowances Act,*** R.S.C. 1985, c. M-5, s. 60;
   - ***Pension Act,*** R.S.C. 1985, c. P-6, s. 30 para. 1 and para. 1.1;
   - ***Pension Benefits Division Act,*** R.S.C. 1992, c. 46, sch. II, s. 12 para. 2;
   - ***Public Service Superannuation Act,*** R.S.C. 1985, c. P-36, s. 10 para. 10(c) and s. 58 para. (b);
   - ***Royal Canadian Mounted Police Superannuation Act,*** R.S.C. 1985, c. R-11, s. 9 para. 7(c); and
   - ***Special Retirement Arrangements Act,*** R.S.C. 1992, c. 46, sch. I, s. 22 para. c.

Erratum

In the first trimester of the 1997 *Insolvency Bulletin* (Vol. 17), there was an error in the text by Mr. Benoit Mario Papillon entitled "*Reflections on the Origins of Business Bankruptcies*". In the first column of the second paragraph of page 18, the text should be as follows:

> Canada's business bankruptcy regime is the product of bankruptcy legislation and other relevant laws[9], business practices, the financial system and government programs for access to credit, and the industrial structure. Taken together, they place Canada somewhere between the extreme "centralization" where the probability of bankruptcy is nonexistent, and the extreme "market" in which the firm has no justification[10]. Any modification of the bankruptcy regime through changes is one of its determining components can be interpreted as the search for a compromise between these two extremes.