Banking Legislation in Canada

Early Changes in the New Millennium

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INTRODUCTION

In June 1999, Canada's federal government initiated a white paper under the name "Reforming Canada's Financial Services Sector: A Framework for the Future". That white paper was followed in June 2000 by draft legislation in the form of Bill C-38. Bill C-38 set out substantial changes to federal financial institution legislation in Canada, based on the 1999 white paper. Bill C-38 evolved into Bill C-8, which proceeded through the legislative process to initiate changes in late 2001.

This paper comments on some of the significant changes under the amended legislation. It also provides some context to those changes by commenting generally on some legislative provisions outside of those changes. It is only a brief summary, and we invite you to discuss details of the legislation with any member of our Bank Regulatory team.

The federal government Minister responsible for granting certain approvals and consents under the *Bank Act* is the Minister of Finance and is referred to as the "Minister" throughout this paper. The primary supervisor of federal financial institutions in Canada is the Office of the Superintendent of Financial Institutions. Throughout this paper, the Superintendent is referred to as the "Superintendent" and the office of the Superintendent is referred to as "OSFI".

OWNERSHIP AND CONTROL OF BANKS

Traditionally and for historical and political reasons, the ownership and control of Canada's banks have been tightly regulated. The recent *Bank Act* amendments ease the tight restrictions in a number of ways, largely in recognition that Canada's domestic banking industry and its domestic banks, which represent such an important part of the Canadian economy, cannot continue to remain isolated and immune from the factors shaping the global banking industry. Increased shareholdings in Canada's largest banks are now possible and the new regime has introduced new opportunities for investment in and the creation of small and medium-sized banks. The new *Bank Act* also provides for bank holding companies which should facilitate the creation and use of innovative bank and affiliated business ownership structures and joint venture opportunities.

Restriction on Significant Interests

As a general rule, the *Bank Act* provides that no person can own directly or indirectly, more than 10% of any class of shares of a bank or a bank holding company. Any such ownership of more than the 10% of any class of shares of a bank or a bank holding company is defined to constitute a "*significant interest*" under the *Bank Act*. This 10% limit can only be exceeded and a significant interest can only be acquired if:

- the approval of the Minister is obtained, and
- the acquisition is in compliance with any other applicable restrictions on ownership and control contained in the *Bank Act*.

Exceptions to the Restriction on Significant Interests

The ownership rules are structured differently depending on the size of the bank. The extent of the restrictions increases with the overall size of the bank, size being determined based on the equity of the bank. The new regime creates three categories of bank: small, medium and large (without defining them as such).

Small Banks

A "*small bank*" (also commonly called a "millionaire's bank") has equity of less than $1 billion. Small banks enjoy the most relaxed regulatory treatment when compared to other banks. The *Bank Act* creates no size-based restriction precluding the acquisition and holding of a significant interest in a small bank. So long as the approval of the Minister is obtained, a small bank can have any number of shareholders with significant interests, including one shareholder owning all of the shares in the capital of the small bank.

Medium Sized Banks

If the approval of the Minister is obtained, a significant interest in a bank with equity of $1 billion or more, but less than $5 billion (a "*medium sized bank*") is allowed. This is subject to the additional requirement that the medium sized bank have a public float of at least 35% of its voting shares on a stock exchange in Canada.

Public float shares cannot be owned by a major shareholder (see below) of voting shares of a medium sized bank, or any entity that is controlled by such an entity. However, a major shareholder of non-voting shares of a medium sized bank can own public float shares.

Therefore, as long as the Minister approves, a medium sized bank can have one or more shareholders with a significant interest owning up to 65% of the voting shares of the medium sized bank.

An exemption from the requirement that a medium sized bank have public float shares is available if the Minister considers it appropriate to provide such an exemption. Any such exemption will be subject to any terms and conditions imposed by the Minister.

Large Banks

If the approval of the Minister is obtained, a significant interest in a bank with equity of $5 billion or more (a "*large bank*") is allowed, but a large bank must be "widely held". This means that it cannot have a "*major shareholder*" - one which owns, directly or indirectly, more than 20% of the outstanding voting shares of any class of the large bank or more than 30% of the outstanding non-voting shares of any class of the large bank.

Each of Laurentian Bank of Canada, National Bank of Canada and Canadian Western Bank was deemed, under the recent *Bank Act* amendments, to have equity of $5 billion or more (i.e. to be a large bank) notwithstanding that each

bank's equity was in fact and may continue to be less than $5 billion. However, the *Bank Act* reserves to the Minister the power to specify, at any time any of these banks continues to have equity of less than $5 billion, that they are no longer deemed to have equity of $5 billion or more.

The Minister has released a guideline indicating that any application to change the large bank status of any of these banks will need to demonstrate that the change in status is in the public interest and will foster opportunities for the bank to grow and better serve its customers. In considering any application to change the large bank status of any of these banks, the Minister will consider, among other things, the business case and objectives of the proposed transaction, the impact of the proposed transaction on the soundness of the bank, direct and indirect employment, the location of the "directing mind" or management of the bank, the needs of consumers, the best interests of Canadians and, where the bank operates principally in one region, the best interests of those living in that region.

The requirement that a large bank be widely held is subject to a number of exceptions that accommodate holding company structures (and do not cause policy concerns).

The *Bank Act* also contains anti-avoidance rules aimed at ensuring that no one shareholder exerts influence over a large bank. The first anti-avoidance rule, known as the "tainting rule", provides that a widely held bank cannot control another bank that has another major shareholder. If a person becomes a major shareholder of a widely held bank's subsidiary, the widely held bank must take steps either to divest its interest in the subsidiary or have the other major shareholder divest its interest. This tainting rule does not apply to subsidiaries of banks with equity of less than $250 million.

The second anti-avoidance rule, know as the "cumulative voting rule", provides that no person can concurrently own:

- a significant interest in the shares of any class of a widely held bank or bank holding company; and
- a significant interest in the shares of any class of a subsidiary of such a widely held bank or bank holding company.

This prevents a person from having, in substance, two significant interests in a large bank.

Approval of the Minister

As mentioned above, any person wishing to obtain (or increase) a significant interest in a bank must make application to the Minister. In connection with any such application, the Minister has broad discretion to determine who may own a significant interest. In exercising such discretion, the Minister will take into account all matters that the Minister considers relevant to the application, including, among other things:

- the nature and sufficiency of the financial resources of the applicant as a source of continued financial support for the bank,
- the soundness and feasibility of the plans of the applicant for the future conduct and development of the business of the bank,
- the business record and experience of the applicant,
- the character and integrity of the applicant, or if the applicant is a body corporate, its reputation for being operated in a manner that is consistent with the standards of good character and integrity (the "fit and proper test"),
- the impact of any integration of the businesses and operations of the applicant with those of the bank on the conduct of those businesses and operations,
- the opinion of the Superintendent regarding the extent to which the proposed corporate structure of the applicant and its affiliates may affect the supervision and regulation of the bank, and
- the best interests of the financial system in Canada.

However, the Minister is specifically restricted from considering any of the above-mentioned factors, other than the "fit and proper test", where the application involves a transaction which would result in the applicant becoming a major shareholder of a widely held large bank. The reason for the more limited analysis in this case stems from the fact that no person can control a widely held large bank. As a result, the only relevant factor for the Minister to take into account in such circumstances is whether the applicant is fit and proper to be a major shareholder.

Control

In addition to the provisions relating to ownership, there are provisions in the *Bank Act* relating to the control of banks.

There is an absolute prohibition on any person obtaining control of a large bank (this does not apply if the holding company exceptions apply to the person who controls the large bank). Persons may control small banks and medium sized banks provided the consent of the Minister is first obtained.

The definition of control in the *Bank Act* includes both the concepts of "legal control" and "control in fact". Legal control is the traditional test for determining control based on ownership of a sufficient number of shares to elect the majority of the board or directors. Control in fact is a much broader (and less certain) concept. It captures any person who has any direct or indirect influence that, if exercised, would result in control in fact of the bank in question. Guidelines clarifying what constitutes "control in fact" are contemplated, but have not yet been implemented.

Ownership and control restrictions relating to leasing activity

Banks are prohibited from undertaking any personal property leasing activity, except for the fairly limited financial leasing activities specifically allowed by the *Bank Act*. As a result, the *Bank Act* also provides that no person can control or be a major shareholder of a bank if that person, or a person affiliated with that person, or a person either of them controls or has a significant interest in, carries on leasing activity that a bank is prohibited from carrying on.

BANK HOLDING COMPANIES

The recent amendments to the *Bank Act* permit the creation of bank holding companies ("*holdcos*"). Holdcos are similar in nature to traditional holding companies but the new legislation imposes certain elements of the bank regulatory regime on them. The new rules permitting holdcos are intended to give banks greater flexibility in structuring their operations. For example, the new rules allow banks to move some activities (e.g. those which require lighter regulation) to an affiliated entity, instead of maintaining those activities themselves or moving them to a subsidiary. Although many industry commentators had predicted that the new rules permitting holding companies would be popular and frequently exploited, so far there has not been a significant use of them.

CREATION OF BANK HOLDING COMPANIES

Incorporation

The formal requirements for the incorporation of new holdcos are similar to those for a new bank. There is, however, no requirement for any minimum paid-in capital and no provision for a public inquiry on the desirability of incorporation.

Continuance or Amalgamation

Holdcos may also be created through the continuance of an existing corporation or through the amalgamation of two or more existing corporations.

Holdco Name

The restrictions applicable to bank names will also apply to holdco names. In addition, each approved holdco name must include the letters "bhc" (or, in French, "spb"). A corporation that is not a holdco authorized under the *Bank Act* is prohibited from using those letters in its name.

Corporate Governance

The corporate governance provisions for holdcos are similar to those applicable to banks. Notable exceptions are the absence of related party rules for the holdco itself, and the absence of a requirement for a conduct review committee.

Ownership

The ownership rules applicable to holdcos are identical to those applicable to banks and vary in accordance with the equity capital of the holdco:

- holdcos with equity over $5 billion must be widely-held;
- holdcos with equity between $5 billion and $1 billion must have a 35% public float of their voting shares; and
- holdcos with equity under $1 billion may be wholly-owned by any "fit and proper person".

Holdings of "significant interests" in holdcos are subject to approval by the Minister and a holdco may not have a "major shareholder".

Capital Adequacy Requirements

Holdcos will be required to have "adequate" capital and liquidity. That will be determined on a consolidated basis after a consideration of the type and scope of the holdco's intended activities. OSFI has indicated that the Tier 1 capital requirement for holdcos will be 6% (instead of 7% for banks) and that the total capital requirement (like banks) will be 10% of risk-weighted assets.

Status, Business and Powers

Holdcos are incorporated with all of the powers of a natural person, subject to the provisions of the *Bank Act*. The *Bank Act* provides that holdcos may not engage in or carry on any business other than:

- acquiring, holding and administering permitted investments;
- providing management, advisory, financing, accounting, information processing and other prescribed services to entities in which it has a substantial investment; and
- any other prescribed business.

A newly-formed holdco must acquire a bank subsidiary within a year of its incorporation, and maintain at all times thereafter ownership and control of the bank subsidiary. If a holdco fails to obtain a bank subsidiary within the first year of its existence or at any time thereafter ceases to have a bank subsidiary for a year, it will be forced to discontinue as a holdco under the

Bank Act and continue under one of the federal or provincial corporate statutes, such as the *Canada Business Corporations Act*.

Using a Holdco

An existing bank might become a subsidiary of a holdco in a number of ways including:

- conversion of the bank into a holdco through a process of continuance, followed by the transfer of the operating assets to a newly-formed bank subsidiary;
- by a "take-over and exchange" procedure, in which a newly-incorporated holdco would become the holding body corporate of the bank and all of the shares in the bank held by its existing shareholders would be exchanged for corresponding shares of the holdco; or
- by a newly-incorporated holdco utilizing a "proposal" mechanism to be set forth in the regulations.

Ministerial and shareholder approvals are required to complete any of the foregoing transactions.

Investment Powers

The *Bank Act* provides a permitted investment regime for holdcos which is substantially similar to that provided for banks including:

- substantial investments (10% voting rights or 25% equity) must be in financial service providers, or holding company vehicles;
- investments in financial services providers must be of a controlling interest; others need not be;
- most require Ministerial approval;
- holdcos may own other holdcos or an insurance company holding company together with all their permitted subsidiaries; and
- there are portfolio limits on equity and real estate investments such as apply for banks, although the percentages of regulatory capital that may be invested in each may vary.

Regulation, Examination and Reporting

The Superintendent will examine each holdco annually. Each holdco will have to file annual returns of directors' and auditors' names and interests, and may be required at any time to provide OSFI with any other information that OSFI considers it needs in order to determine whether the holdco is complying with the *Bank Act*. The Superintendent may make compliance orders against, and enter into prudential agreements with, holdcos or entities or individuals in respect of holdcos. The intended focus of these powers appears to be to ensure that OSFI will have the ability to protect the creditors and depositors of the federal financial institutions that are part of the holdco group.

Insolvency

On any insolvency, bankruptcy or proposed winding-up of a holdco, the holdco may be subject to the *Bankruptcy and Insolvency Act*. The *Bank Act* clearly states that the *Winding-up and Restructuring Act* will not apply to a holdco.

BANK MERGERS

In Canada, bank mergers have always been subject to significant political as well as legal considerations. The recent amendments to the *Bank Act* have not changed this reality, but merger review guidelines released by the Minister have made the process, as it relates to large banks, somewhat more transparent.

The amalgamation provisions of the *Bank Act* have been revised to take account of new structures permitted by the amended legislation. For example, bank holding companies are specifically included in the provisions which regulate amalgamations. These amendments to the legislation ensure that amalgamated entities continue to be widely held where a large bank is involved as an amalgamating entity or results from such an amalgamation.

General Rules

The *Bank Act* permits banks to amalgamate (i.e., merge) with other federally-incorporated bodies. Therefore, banks may amalgamate with other banks, federally-incorporated trust and loan companies, federally-incorporated insurance companies and any other federally-incorporated bodies, such as corporations incorporated under the *Canada Business Corporations Act*.

Generally, the process by which amalgamations occur under the *Bank Act* is similar to the process ordinarily found in corporate statutes: the parties enter into an amalgamation agreement and shareholder approval of the amalgamation is obtained. However, in the case of amalgamations under the *Bank Act*, the Minister must approve the amalgamation agreement before shareholder approval is sought. The *Bank Act* also allows "vertical" and "horizontal" short form amalgamations similar to those allowed by corporate statutes. This would allow a bank to merge with one or more of its wholly-owned subsidiaries as well as with one or more of its other affiliated companies (all of which must be controlled by the same entity). A short form amalgamation does not require an amalgamation agreement.

In connection with any amalgamation, including a short form amalgamation, before issuing letters patent of amalgamation, the Minister will take into account all matters that the Minister considers relevant to the application, including the following factors (which criteria are similar to those which the Minister is to consider in connection with certain other approvals under the *Bank Act*):

- the sources of continuing financial support for the amalgamated bank,

- the soundness and feasibility of the plans of the applicants for the future conduct and development of the business of the amalgamated bank,

- the business record and experience of the applicants,

- the reputation of the applicants for being operated in a manner that is consistent with the standards of good character and integrity,

- the impact of any integration of the operations and businesses of the applicants on the conduct of those operations and businesses,

- the opinion of the Superintendent regarding the extent to which the proposed corporate structure of the amalgamated bank and its affiliates may affect the supervision and regulation of the amalgamated bank, and

- the best interests of the financial system in Canada.

If a large bank amalgamates with another body corporate, two large banks amalgamate or two other bodies corporate amalgamate to continue as a large bank, the bank resulting from the amalgamation must continue to be widely held (in other words it must not have a "major shareholder").

<u>Merger Review Guidelines -- Large Banks</u>

The Minister has released merger review guidelines which will apply to any merger involving a large bank. The merger review process reflected in the merger review guidelines has three stages: an examination stage, a decision stage, and, if required, a remedies stage.

<u>Stage One - Examination Stage</u>

In the first stage of the merger review process, the parties wishing to amalgamate will be required to:

- apply to the Competition Bureau, OSFI and the Minister in writing for permission to merge,

- provide any information necessary to assess the merger request, and

- prepare a public interest impact assessment (a "*PIIA*").

In the PIIA, the applicants will need to explain the rationale for the merger and the steps that they could take to mitigate any potential costs or concerns. At a minimum, the parties will need to articulate the following in the PIIA:

- their business case and objectives, that is, why they wish to merge,
- the possible costs and benefits to customers and to small and medium-sized businesses, including the impact on branches, availability of financing, price, quality and availability of services,
- the timing and socio-economic impact of any branch closures or alternative service delivery measures at the regional level, and any alternative service delivery measures that might mitigate the impact,
- how the proposal would contribute to the international competitiveness of the financial services sector,
- how the proposal would affect direct and indirect employment and the quality of the jobs in the sector, distinguishing between transitional and permanent effects,
- how the proposal would increase the banks' ability to develop and adopt new technologies,
- what remedial or mitigating steps in respect of public interest concerns the banks are prepared to take, such as divestitures, service guarantees and other commitments, and what measures to ensure fair treatment of those whose jobs are affected, and
- the impact the transaction may have on the overall structure of the industry.

The merger applicants will be required to make the PIIA widely available to provide a solid basis for public hearings on the proposed merger.

The Competition Bureau (which has released its own detailed guidelines relating to bank mergers) and OSFI will conduct reviews of the proposal from competition and prudential perspectives. Concurrently with such reviews, the House of Commons Standing Committee on Finance and the Standing Senate Committee on Banking, Trade and Commerce will conduct public hearings in

respect of the public interest issues raised by the proposed merger, using the PIIA as a key input.

Once the analyses of the Competition Bureau and OSFI are complete, the Commissioner of Competition and the Superintendent will provide the merger applicants and the Minister with a letter setting out their views on the competition and prudential aspects of the proposed merger. Following receipt of the inputs from the Competition Bureau and OSFI, the Minister will publicly release the documents they provide (with due regard to the need to maintain the confidentiality of commercially sensitive information and information that may affect the stability of the Canadian financial systems).

Upon completion of public hearings and deliberations, the Commons committee and the Senate committee will each report to the Minister on the broad public interest issues that are raised by the proposed merger.

Stage Two - Decision Stage

In the second stage of the merger review process, the Minister, using the reports of the Competition Bureau, OSFI, the Commons committee and the Senate committee as inputs, will render a decision on whether the public interest, prudential and competition concerns that are raised by the proposed merger are capable of being addressed. If the Minister feels that these issues cannot be addressed, the proposed merger will be denied and the merger review process will stop at this stage. If these concerns are capable of being addressed, the merger review process will enter the negotiation of remedies stage.

Stage Three - Negotiation of Remedies Stage

In the third and final stage of the merger review process, the Competition Bureau will negotiate any competition remedies and OSFI will negotiate any prudential remedies required in connection with the proposed merger. Both the Competition Bureau and OSFI will work with the Minister in coordinating an overall set of public interest remedies (including possible divestitures). These remedies will address the concerns that have been raised during the merger review process.

The upshot of the foregoing is that mergers of large banks, while being technically possible under the *Bank Act*, will be politically difficult and exceptionally expensive transactions to complete.

CORPORATE GOVERNANCE

The recent amendments to the *Bank Act* introduced some flexibility and brought a number of principles of corporate governance under the old *Bank Act* more in line with the treatment afforded non-bank, federally-incorporated corporations under the *Canada Business Corporations Act*. The rules of corporate governance under the new *Bank Act* remain extensive, and given the recent concerns about and focus on corporate governance, they are not likely to be relaxed or reduced in the near future.

Directors

The obligation of directors of a bank to manage or supervise the management of the business and affairs of the bank continues unchanged. Also unchanged are requirements to establish an audit committee, a conduct review committee and other board committees, to establish procedures relating to conflicts of interest, customer disclosures and customer complaints, and to establish investment and lending policies, standards and procedures. Director and officer duties to act honestly and in good faith with a view to the best interests of the bank, and to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances, also continue.

However, the recent amendments added some flexibility to the residency requirements of directors. Now only two thirds of the directors of any domestic bank, rather than three quarters, must be resident Canadians. For foreign bank subsidiaries, the requirement that at least one-half of the directors be resident Canadians continues in effect. The requirement that no more than two-thirds of the directors be affiliated with the bank also continues.

The *Bank Act* continues to require that a majority of directors present at a meeting of the board be resident Canadians (at least one-half in the case of a foreign bank subsidiary). The recent amendments have, however, introduced a new requirement: that at least one director not affiliated with the bank be present at each meeting. There is some allowance in both cases for a director not able to be present to approve the business transacted at the meeting.

The duties of the audit committee and conduct review committee continue to be outlined in the *Bank Act* as amended. Duties of the conduct review committee have been adjusted slightly to take into account new structures permitted in the updated legislation.

Directors remain personally liable if they vote for or consent to certain transactions (including certain share and subordinated debt issues and

redemptions, certain dividend payments and certain other transactions) made contrary to the *Bank Act*. There continue to be due diligence defences for alleged violations by directors.

Corporate Records

There have been no significant changes to the requirements to hold corporate and customer records at the head office of the bank or otherwise in Canada. The Superintendent's order continues to be required if information or data relating to those records is to be maintained or processed outside of Canada.

Self-Dealing

The amended *Bank Act* continues its broad prohibition on material transactions with related parties. A "transaction" can include a guarantee, an investment, an acquisition of a loan or a taking of a security interest. Exemptions continue for nominal or immaterial transactions, certain guaranteed transactions, ordinary course of business service transactions and certain other transactions.

A set of rules with respect to bank transactions with holding companies has been added in the recent amendments. Subject to a few restrictions noted below, the rules permit any transactions between a bank and its widely held holding company or any related party in which the holding company has a substantial investment. These transactions are subject to the bank's established policies and procedures, certain restrictions on specific transactions (based on regulatory capital) where the related party is not a federal financial institution, and restrictions on asset acquisitions (based on value of assets acquired) from a related party that is not a federal financial institution.

Transactions with related parties continue to be required to be on terms and conditions that are at least as favourable to the bank as market terms and conditions. The meaning of "market terms and conditions" has been refined for transactions that would not reasonably be expected to occur in an open market between arms-length parties. The focus in that respect is on terms and conditions that would reasonably be expected to provide the bank with fair value, having regard to all the circumstances of the transaction, and that would be consistent with the parties to the transaction acting prudently, knowledgeably and willingly.

INVESTMENTS

Investment powers of banks have always been restricted with the intention that banks remain prudent in their financial dealings. The new legislation introduces few substantive changes in this regard. Among the changes offering a certain degree of flexibility are the rules that permit banks to maintain a separation of lines of permitted businesses among two or more affiliated entities and that allow a bank to invest where the target entity provides services and carry on activities that the bank itself is permitted to provide or carry on.

General Restrictions

As is the case with other parts of the *Bank Act*, the investment restrictions begin with a broad prohibition that restricts a bank from controlling or holding, or acquiring or increasing, a "*substantial investment*" (generally shares holding more than 10% of the total votes or more than 25% of shareholders equity) in any entity other than a "*permitted entity*". Exceptions to the general prohibition allow for temporary investments, including those made in the context of loan workouts and realization of security.

A "*permitted entity*" includes financial institutions such as banks, trust companies, insurance companies and securities dealers, and related holding companies. It also includes other entities whose businesses are limited to one or more of:

- engaging in any activity that a bank is permitted to engage in under the general business section of the *Bank Act*;
- owning entities that a bank can own;
- providing services exclusively to a member of the bank's group (or others including a member of the bank's group);
- engaging in activities that relate to promotion, sale, delivery or distribution of financial products or services; and
- engaging in mutual funds or real property brokerage activities.

In the listed cases, the entity in which the investment is made cannot be one that accepts deposit liabilities, or engages in certain activities or investments that are prohibited to the bank.

Control Requirements

The bank must control any financial institution or related holding company in which it has a substantial investment. It must also control certain other financial service and investment entities. "*Control*" includes control in fact. The legislation indicates the Minister may issue guidelines as to what constitutes control in fact, and those guidelines will be used to determine how the concept is applied in practice.

Minister's and Superintendent's Approvals

The Minister's approval is required for the acquisition of control of, and sometimes the acquisition or increase of a substantial investment in, certain entities including certain non-federal financial institutions, finance/factoring/financial leasing entities, promotions/distribution entities and data collection and information management advisory entities. The recent amendments to the legislation introduced some increased flexibility by providing that some acquisition approvals may be given by the Superintendent instead of the Minister. Those approvals include acquisition of a non-federal financial institution or a securities dealer from within the bank's group, and acquisition of a factoring entity or financial leasing entity.

Real Property and Equity Limits

Limits on holdings and improvements in real property, and on equity acquisitions below substantial investments, continue to exist in relation to prescribed percentages of the regulatory capital of banks other than large, widely held banks. The prescribed percentages are 70% in the case of real property, 70% in the case of equity purchases and 100% in the aggregate for purchases of equity interests and real property interests.

Divestment Orders and Asset Transfers

The Superintendent continues to have the power under the amended legislation to require divestments where the legislation's restrictions on investments are contravened. Also, limits on acquiring assets from, or transferring assets to, a person continue in the amended legislation, based on transactions within the then previous 12 months and 10% of the total value of the assets of the bank.

FOREIGN BANKS IN CANADA

For some time now, Canada has been gradually easing its restrictions on foreign banks operating here. This has been part of the federal government's policy of increasing competition for the domestic banks while at the same time increasing their flexibility. The new foreign bank rules under the recent revisions to the *Bank Act* are designed to make foreign bank entry into Canada even easier.

Generally, in the recent amendments, there has been no fundamental shift in the policies for controlling the entry by foreign banks into Canada. However, they refine the foreign bank entry regime in several important areas. These include:

- broadening the scope of activities in Canada that a foreign bank is prohibited from undertaking without obtaining regulatory approval or exemption;
- sharpening the distinction between "near" banks and "real" banks and the regulatory implications under the *Bank Act* of being in one or other of those categories;
- detailing the alternative entry option of establishing a Canadian branch (as opposed to incorporating a Canadian subsidiary) and permitting the foreign bank to use its consolidated balance sheet for Canadian capital adequacy purposes; a branch can be either a "full service" or "lending" branch; and
- permitting a certain level of "non-financial" activity by a foreign bank in Canada without regulation.

Prohibited Activities of a Foreign Bank in Canada

Prior to the recent amendments, the *Bank Act* prevented a foreign bank from (among other things) directly or indirectly in Canada undertaking any "*banking business*" (which was not a defined term) without obtaining regulatory consent. The revised prohibition applies not only to a foreign bank but also to any entity associated with the foreign bank.

The revised prohibition does not refer to "*banking business*". Instead, subject to a number of somewhat complicated exceptions, it prohibits a foreign bank from engaging in Canada in <u>any</u> business (whether it is a business that a bank is permitted to carry on under the *Bank Act* or otherwise); from maintaining a branch in Canada for any purpose; from establishing, maintaining or acquiring for use in Canada an automated banking machine, a remote service unit or a

similar automated service or in Canada accepting data from such a machine, unit or service; or acquiring or holding control of or a "*substantial investment*" in any Canadian entity. The definition of *substantial investment* has not been revised. It means any investment in a Canadian corporation which results in the foreign bank holding more than 10% of its votes or more than 25% of its total equity.

After setting out the broad prohibitions, the *Bank Act* then sets out a somewhat byzantine scheme of exemptions. These ultimately lead to the positions described below, and the general policy of permitting large, reputable foreign banks to operate in Canada on an equitable basis with Canadian banks.

Foreign Banks

It is important to remember that for purposes of the *Bank Act*, and the way in which OSFI interprets the scope of its mandate, the term "*foreign bank*" is given a very broad meaning. It includes not only financial institutions that are regulated as banks in their home jurisdiction but also any entity that engages directly or indirectly in the business of providing any financial service. For example, a multinational manufacturing conglomerate that does not have a regulated bank or trust company or other financial institution within its corporate family will nevertheless be viewed by OSFI as being a "foreign bank" if it provides financial services to customers anywhere in the world (such as for example, lending money, financial leasing, or having a financing subsidiary that provides credit to or for the benefit of customers).

The most recent amendments to the *Bank Act* appear to be intended to clarify the distinction between entities that OSFI will consider to be a "near" bank as opposed to a "real" bank. The distinction makes a difference in terms of the degree of regulation and supervision within Canada. The revised *Bank Act* continues the earlier approach of allowing near banks to establish or maintain a Canadian business without any material degree of regulation or oversight by OSFI once the original consent or exemption order is obtained.

The general rule remains that a foreign bank that wants to do business in Canada must either establish a branch or a subsidiary. Foreign banks are, however, given the option of establishing various kinds of presence and will be permitted to establish multiple subsidiaries and a branch simultaneously, should they wish to do so.

Near Banks

Foreign banks that are near banks are now permitted to apply to the Minister through OSFI for an order declaring that (with a few exceptions) the foreign bank rules and restrictions in Part XII of the *Bank Act* will not apply to that foreign bank. The foreign bank will still be subject to the ongoing applicability of certain provisions in Part XII of the *Bank Act*. These include the possibility of being designated as a real bank, being subject to any orders for divestiture or divestment for contraventions of the *Bank Act*, and potential application of the *Investment Canada Act*.

There are many near banks already operating corporate subsidiaries in Canada. The revisions to the *Bank Act* provide them with some grandfathering protection. An exemption order (of the sort described above) is deemed to have been made in respect of that foreign bank if immediately before the amendments to the *Bank Act* came into force (i.e. October 24, 2001) the foreign bank had already received regulatory consent under the former provisions of the *Bank Act* (namely a consent under section 521 of the old Act), that consent had not been revoked and the foreign bank, or any entity associated with it, had not been "designated" under the *Bank Act*.

Designated Foreign ("Real") Banks

The Minister, acting on the recommendation of OSFI, may designate any foreign bank that, in their view, should be considered as a real bank. A foreign bank may also be designated if it is regulated as a bank in its home jurisdiction (or in any other jurisdiction in which it carries on business); or if it directly or indirectly engages in providing financial services and describes itself as a bank abroad; or if more than a prescribed proportion (currently 35%) of its global business (using both an asset and total revenue test) is regulated as such.

Although a designation order means that the foreign bank will not be exempt from the application of Part XII, designation may be desirable or necessary. A designation order opens up a broad range of powers to the foreign bank. These range from holding financial institutions to providing many types of services (but not services in which a Canadian bank cannot engage). The revisions to the *Bank Act* require a foreign bank to be "designated" if it wishes to establish or acquire a financial services business in Canada (as summarized below).

A foreign bank wishing to operate a business in Canada must determine whether it proposes to engage in commercial (trade or business but not

financial service) activities in Canada or whether it proposes to carry on financial services activities. With very restricted exceptions, it cannot do both. If it chooses to carry on financial services activities in Canada, it can do so either by way of a subsidiary or by way of a branch or both.

Permitted Investments in Commercial Operations

A foreign bank that wishes to acquire or establish a business in Canada that is not a financial service activity may not need any approval to do so. A foreign bank that does not have a "*financial establishment*" in Canada may acquire, or hold control of, or make a "*substantial investment*" in, a Canadian entity so long as the foreign bank, or any entity associated with it, does not end up controlling or becoming a "*major owner*" of a regulated Canadian entity (including a bank, a trust and loan company, a co-operative credit association, an insurance company, a securities dealer, etc.) or a "*financial services entity*". A foreign bank would become a "*major owner*" of any entity if, in the case of an unincorporated Canadian entity, it beneficially owns, directly or indirectly, more than 35% of the ownership interests in that entity or, in the case of an incorporated Canadian entity, it holds more than 20% of the voting shares or holds more than 30% of the outstanding shares of any class of non-voting shares in that Canadian entity.

Unfortunately, one definitional difficulty that remains in the revised *Bank Act* is that the phrase "*financial service*" is not defined. This was problematic for clients and practitioners in the earlier versions of the *Bank Act* and remains so. The revised *Bank Act* defines a "*financial services entity*" as an entity that provides, among other things, a "financial service". To that extent, the definition of a financial services entity is somewhat circular and not entirely clear. As a policy matter, it appears that the Minister and OSFI continue to prefer to retain the discretion to determine what types of evolving activities in the financial services industry generally are or are not financial services. It will sometimes be difficult, without consulting with OSFI, or obtaining advance rulings, to determine whether or not a proposed activity in Canada is or is not a "financial service". That would have an impact on whether or not the foreign bank has or would have a financial establishment in Canada.

Also, a foreign bank, or an entity associated with it, without a financial establishment in Canada will be permitted, subject to some prescribed conditions, to: (i) operate a commercial branch operation here, so long as no more than 10% of its business here and abroad (or some other proportion to be set by regulation) is in financial services; or (ii) engage in the activities of a leasing entity so long as it does not engage in any other activity in Canada.

Permitted Investments in Financial Services Subsidiaries

A foreign bank will, subject to the designation requirements, and with the Minister's approval, be permitted to own one or more subsidiary financial services businesses in Canada or make substantial investments in Canadian financial services businesses. The range of permitted investments will be the same as those that Canadian banks are permitted to make. Significantly, the same restrictions will also apply.

Designated foreign banks that establish or invest substantially in Canadian financial services entities will not, for example, be permitted to undertake personal property leasing business or engage in the business of insurance agency. They will, however, be permitted to invest in Canadian non-bank financial service entities such as securities dealers, insurance and trust companies. They will also be permitted to invest in information technology businesses that are ancillary to financial services. Similarly, designated foreign banks will be permitted to engage in other non-financial service businesses that are ancillary to financial businesses so long as those services are provided to financial services businesses only and to the bank itself or a member of its group.

The revised *Bank Act* allows considerable flexibility in the structure of these investments. A new holding company regime is established under the revised *Bank Act*. (This regime is summarized separately in this paper). Foreign banks will be permitted to take advantage of this holding company option as well as structuring their investments through tiered subsidiaries.

Foreign Bank Branches in Canada

It is useful to remember that, aside from the branching option, a foreign bank still has the options of establishing a presence in Canada by (depending upon the nature of the business planned for Canada) incorporating a non-bank affiliate or a Canadian bank or loan/trust subsidiary, or establishing a representative office. Generally speaking, if regulatory requirements permit, a non-bank affiliate is the simplest form for substantial operations, followed by lending branches and full service branches, and then by bank and loan/trust subsidiaries. The extent of the need or desire on the part of the foreign bank to be able to take deposits in Canada has much to do with the choice of operating entity.

The rules for the establishment of foreign bank branches were legislated in 1999 and are incorporated into the revised *Bank Act*. They have not been substantially changed, except to make the rules more similar to those that

apply to domestic banks. This includes the addition of a prohibition on personal property leasing by branches of foreign banks.

Foreign banks are permitted, again with the Minister's authorization and OSFI's consent, to establish either "full service branches" or "lending branches". Only qualified foreign banks (generally, those that are widely-held and have established track records in international banking) will be authorized.

Lending branches, as the name implies, are not permitted to take deposits. Full service branches are permitted to take deposits of $150,000 or more. Those deposits are not CDIC insured and the branch is required to warn customers in a notice posted in each of its branches and in its advertisements to that effect. The branch must also warn customers at the time each client opens an account.

Foreign banks are generally authorized to establish full service branches only if they are considered to be well regulated in their home jurisdiction, have favourable five-year track records and have at least $5 billion in consolidated world-wide assets. The minimum capital equivalency deposit for a full service branch is the greater of $5 million in unencumbered assets (reduced from the previous $10 million) or 5% of Canadian liabilities. A foreign bank wishing to establish a lending branch (as opposed to a full service branch) is required to deposit in Canada $100,000 of unencumbered assets.

The foreign bank applicant must also demonstrate that its risk based capital ratio meets the minimum international standards established by the Bank for International Settlements.

It is possible for a foreign bank to establish a lending branch or a full service branch while at the same time maintaining a deposit-taking banking subsidiary in Canada. Several (but not all) of the foreign banks which have been carrying on business in Canada through a regulated Canadian banking subsidiary have recently converted that banking subsidiary to a branch.

CONSUMER MATTERS

An eighteenth century French economist once wrote "To suppose all consumers to be dupes, and all merchants to be cheats, has the effect of authorizing them to be so, and of degrading all the working members of a community". Canada's federal government obviously does not subscribe to that theory, or perhaps finds the political benefits of consumer protection too appealing to ignore. The *Bank Act* has always had substantial consumer protection provisions. The new legislation expands consumer protection in a number of areas, and banks can look forward to additional costs as a result.

Financial Consumer Agency of Canada

The Minister is responsible for a new agency, the Financial Consumer Agency of Canada (FCAC). The FCAC is established under a new piece of legislation, the *Financial Consumer Agency of Canada Act.*

The objects of the FCAC include supervising compliance with "consumer provisions" and promoting their adoption, monitoring implementation of voluntary codes of conduct and other commitments to consumers, and promoting consumer awareness and understanding of financial services and related issues. *"Consumer provisions"* include legislative provisions relating to disclosure of interest charges and other matters, some related board of director duties, low fee deposit accounts, customer complaints and the new Ombudsman, government cheque cashing, tied selling and deposit insurance.

Overseeing of consumer issues is centralized in a single agency, rather than having several regulators oversee those issues. The annual cost of the FCAC is assessed to the various financial institutions.

A Commissioner, appointed for five years, has powers assigned by the various pieces of legislation. The Commissioner monitors and reports to the Minister in respect of all matters connected with the *FCAC Act* and the "consumer provisions" in the various pieces of financial services legislation. The Commissioner may also monitor compliance with financial institutions' voluntary codes of conduct and other commitments to consumers, and generally carry on activities to promote consumer awareness.

There are interesting enforcement provisions in the *FCAC Act*. The regulations designate "violations" that may be dealt with under the scheme set out in the *FCAC Act*. A contravention of any consumer provision is a violation, as is non-compliance with any agreement with the Commissioner as to compliance with consumer provisions.

Violations are not "offences" and will be dealt with separately from offences. Violations have a maximum penalty of $50,000 for a natural person and $100,000 for a financial institution.

If the Commissioner believes on reasonable grounds that a person has committed a violation, the Commissioner may issue a notice of violation, which will include a proposed penalty. If the proposed penalty is paid, the person is deemed to have committed the violation and the proceedings end. A person not either paying the penalty or making representations to the Commissioner with respect to the violation within thirty days after service will be deemed to have committed the violation, and the Commissioner will decide whether to impose the proposed penalty, a lesser penalty or no penalty. If representations are made, the Commissioner will decide whether the violation has been committed, and decide on whether to impose the proposed penalty, a lesser penalty or no penalty.

There is a right of appeal to the Federal Court. The *FCAC Act* provides that due diligence is a defence to a violation. It also makes common-law rules and principles justifying or excusing an offence applicable to violations, to the extent not inconsistent with the *FCAC Act*.

The Minister must report annually to the House on the operations of the FCAC and its conclusions on compliance of financial institutions with consumer provisions.

Complaint Procedures

These provisions of the *Bank Act* have been expanded beyond former procedures relating to complaints by customers as to disclosures or application of charges. Procedures now have to be established for dealing with complaints not only by customers, but also by persons having requested products or services. The type of complaint is no longer limited. The procedures are to be filed with the Commissioner of the FCAC, rather than with OSFI.

An Ombudsman corporation has also been established to deal with complaints that have not been satisfactorily resolved by the financial institution involved. All banks have to be members of the Ombudsman corporation. It will be interesting to see the type of complaints with which the new corporation will deal. No doubt service levels will be dealt with. However, many current publicized complaints deal with credit availability, particularly with respect to small business. Dealing with those types of issues will be a challenge (to say the least) for an Ombudsman.

The annual report of the Minister to Parliament will include references to complaint procedures and the number and nature of complaints brought to the FCAC. The previous version of the *Bank Act* required banks to provide customers who have complaints on certain specific matters with information as to how to contact OSFI. The contact has now been changed to the FCAC, and contact information will have to be provided not only to customers with complaints, but to any person requesting or receiving a product or service and having a complaint as to certain specific matters.

Disclosures

As part of the recent *Bank Act* amendments, the cost of borrowing calculations have been broadened in terms of what is to be included in disclosures. *"Cost of borrowing"* now includes not only interest, discounts and prescribed charges as previously, but also "any amount charged in connection with the loan that is payable by the borrower to the bank". The regulations have also expanded the list of items to be specifically included in the cost of borrowing.

A few changes have been made to deposit account disclosure requirements. Increasing the amount of the minimum opening deposit to $150,000 from $100,000 has narrowed disclosure exemptions. Where a customer already has an account, some flexibility has been added by permitting oral disclosure of prescribed information. Written disclosure must follow within seven business days of the account opening, and the customer has fourteen business days from that date to close the account without charge and with a rebate of non-interest charges.

Disclosure and other requirements have also been imposed to a certain extent on bank affiliates that are "finance entities" or other prescribed entities. The bank will not be able to enter into an arrangement or otherwise co-operate with the affiliate to sell products or services unless the affiliate complies with cost of borrowing disclosure requirements, complaint procedure requirements, Ombudsman membership requirements, prepayment protection requirements and tied selling requirements as if it were a bank.

The new legislation includes broad regulation-making powers respecting disclosure of information by banks generally. The government has recently passed regulations for disclosure of risk on index-linked deposits and relating to hold periods on deposits.

Finally, where a deposit will not be insured by the Canada Deposit Insurance Corporation due to an exemption from the CDIC membership normally required, disclosure of that fact is also required.

Mandatory Accounts and Services

The new legislation effectively provides a right to a bank account (and in some circumstances a low fee account) for certain individuals who meet prescribed conditions. It also requires the cashing of Receiver General and certain other cheques by CDIC-insured deposit-taking banks for individuals meeting prescribed conditions. The keys to these provisions will be the prescribed conditions, which have not yet been released. Initial indications are that they will relate simply to identification requirements, except in the case of low fee accounts. For those, the government will first try to implement requirements through memoranda of understanding with the banks, rather than through regulations.

The legislation also protects availability of services to a certain extent. Certain notices (four to six months', depending on location, according to current indications) will have to be given where a bank plans to close a retail deposit account branch or cease providing retail deposit accounts or cash disbursement services. The Commissioner of the FCAC will be able to require the bank to hold a meeting with interested parties about the closure or cessation of those services. Some exemptions will be available.

Tied Selling

The previously imposed restrictions on undue pressure or coercion as a condition for obtaining a loan have been expanded to apply to conditions for obtaining a product or service. The prohibition on tied selling will have to be disclosed in a plain statement displayed at all of the banks' branches.

Public Accountability Statements

Banks with equity of $1 billion or more now have to publish an annual statement describing the contribution of the bank and its prescribed affiliates to the Canadian economy and society. The statement must be filed with the Commissioner under the *FCAC Act* and disclosed to bank customers and the public. There are no specific requirements that the Commissioner do any particular analysis of the annual statements, although that could be done within the Commissioner's terms of reference. It seems more likely that the public will be left to do its own analysis and comparisons.

OTHER MATTERS

The recent changes to the *Bank Act* included some administrative changes, and were accompanied by changes to other legislation, the most significant of which are described below.

New Payments System Access

The *Canadian Payments Association Act*, pursuant to which the Canadian Payments Association is established, was renamed the *Canadian Payments Act*.

Pursuant to section 4 of the *Canadian Payments Act*, the potential members of the Association were expanded to include (i) life insurance companies, (ii) securities dealers, (iii) cooperative credit associations, (iv) trustees of qualified trusts and (v) qualified corporations on behalf of their money market mutual funds. Once they have obtained access to the payments system, these types of organizations will be able to offer their customers bank-like payment services such as chequing accounts and debit cards.

In addition to its existing mandate to operate the national clearings and settlements system, the objects of the Association have been expanded to include (i) seeking out other arrangements for the clearing and settlement of payments, (ii) facilitating the interaction between its clearing and settlement systems and other systems involved in the exchange, clearing or settlement of payments and (iii) facilitating the development of new payment technologies.

The size of the board of directors of the Association has been increased from 11 members to 16 members. The Bank of Canada appoints one of its officers as a director. In addition, the Minister appoints three independent directors, while the members of the Association elect the remaining 12 directors. Whereas the members of the Association were previously grouped into 4 categories for the purpose of electing directors, members are now placed into 7 classes (i) banks, (ii) credit unions, (iii) trust companies, (iv) mutual fund entities, (v) securities dealers, (vi) life insurance companies and (vii) other members.

The new legislation requires that all rules of the Association be sent to the Minister within 10 days after having been approved by its Board. A rule will not come into effect until the 30th day following the receipt of the rule by the Minster, unless the Minister proclaims it into force prior to that date. The Minister has the power to disallow a rule or any part thereof and to direct the Association to make, amend or repeal a rule.

The new legislation also establishes the Stakeholder Advisory Council, consisting of no more than 20 persons, to provide counsel and advice to the Board on any matter relating to the objects of the Association. The Board may appoint two of its directors as members of the Council, with the remaining members are to be chosen by the Board in consultation with the Minister. As a group, the Council's membership must be representative of the users and service providers to the payment systems.

Finally, the new legislation provides the Minister with the power, when it is in the public interest to do so, to designate a payment system that is:

- national or substantially national in its scope; or
- that plays a major role in supporting transactions in Canadian financial markets or the Canadian economy.

Whether it is in the public interest to designate a payment system shall depend on:

- the level of financial safety provided by the payment system to its participants and users;
- the efficiency and competitiveness of the payment system in Canada; and
- the best interests of the financial system in Canada.

The Minister has the power to issue guidelines in respect of any matter relating to the administration or enforcement of the designated payments system.

Regulatory Streamlining

In an attempt to streamline the regulatory process contained in all federal financial services legislation, the Department of Finance and OSFI have reviewed each instance within the legislation where the approval of the Minister or the Superintendent is required. To the extent possible, unnecessary or duplicate approvals have been eliminated. Also, where possible, responsibility for certain Ministerial approvals has been transferred from the Minister to the Superintendent to expedite the approval process.

In addition, a new notice-based or deemed approval system has been created with respect to applications for approval made to the Superintendent. Under this system, the Superintendent is required to issue a receipt to an applicant

immediately upon receipt of an application for approval. The Superintendent then has 30 days to respond by issuing:

- a notice approving the application subject to such terms and conditions as the Superintendent may deem necessary; or
- a notice indicating that the application is not approved.

The Superintendent may also extend the period for considering the application by issuing a notice stating that it is unable to consider the application during the prescribed 30-day period. Where the applicant does not receive a notice from the Superintendent regarding a decision on the application or an extension of the period for making such a decision, the application is deemed to have been approved regardless of whether the approval is to be in writing or not.

Credit Union Developments

The new legislation contemplates the creation of a National Service Entity. It will permit credit unions to reduce costs, eliminate duplication, promote stronger co-ordination and create national brands. The intent is to establish credit unions as a stronger national presence and permit them to compete more effectively with larger institutions in Canada and abroad.

Additional OSFI Supervisory Powers

The supervisory powers of the Superintendent have been enhanced as a result of certain amendments to the *Office of the Superintendent of Financial Institutions Act*. Under the new legislation, an administrative monetary penalties regime has been established whereby a violation of specified provisions of financial institutions legislation or non-compliance with an order issued by the Superintendent may result in a penalty of up to $100,000 for a natural person and up to $500,000 for an entity. Those violations and con-compliances include:

- failing to comply with a direction to cease or refrain from committing an act or pursuing a course of conduct;
- failing to comply with an undertaking given to the Superintendent; or
- failing to comply with the terms of a prudential agreement entered into with the Superintendent.

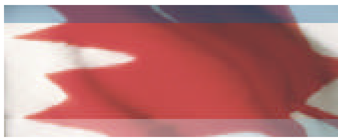
Where the Superintendent has reasonable grounds to believe that a violation has occurred, he/she shall issue and serve a notice of violation on the suspected offender. The notice must:

- identify the violation;
- set forth the penalty that the Superintendent proposes to impose;
- set out the right of the person to make representations to the Superintendent regarding the violation and/or the proposed penalty (such representations to be made within 30 days after receipt of the notice); and
- indicate that should the person fail to pay the penalty or make the representations within the prescribed period, the person shall be deemed to have committed the specified violation. If a person makes representations in respect of the notice, the Superintendent will decide on a balance of probabilities whether the person committed the violation and, if so, may impose the proposed penalty, a lesser penalty or no penalty.

There are three categories of violations under the new regime:

- minor violations;
- serious violations; and
- very serious violations.

The quantum of the proposed penalty is determined based upon the classification of the offence. Where a person has been served with respect to a serious or very serious violation, that person has the right to appeal the decision of the Superintendent to the Federal Court, which has the power to confirm, set aside, or vary the Superintendent's decision.



CONCLUSION

The recent changes initiated by Bill C-8 made some things easier for Canadian banks, and some things more difficult. In particular, the federal government's gradual easing of restrictions on foreign banks operating in Canada has continued. On the other hand, regulation in respect of consumer matters has increased yet again. There are continued efforts by the larger banks in Canada to get a better indication of the real ground rules for bank mergers in Canada.

As with any legislative change, the next few years will prove interesting as federal financial institutions deal with the changes.

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