National Banking Law Review

General Editors: Blair Keefe and Eli Monas, Torys LLP

VOLUME 34, NUMBER 2 | Cited as 34 Nat. B.L. Rev. | APRIL 2015

• CANADIAN FINANCIAL INSTITUTIONS REGULATORY OUTLOOK FOR 2015 •

Jeffrey Graham, Stephen Redican, Gordon Peery, and Jill McCutcheon
Borden Ladner Gervais LLP

• In This Issue •

LexisNexis

The year 2014 was another period of considerable regulatory change for Canadian financial institutions. In recent years Canadian regulators have been focused, to some extent, on adapting the initiatives of international bodies with regulatory responsibilities to the Canadian regulatory environment, and so we start with an outlook into the expected activities of these bodies in 2015.

Financial Stability Board ("FSB")

In a November 2014 communiqué of Mark Carney, the Chairman of the FSB, he noted that the job of agreeing on measures to fix the fault lines that caused the last financial crisis is now substantially complete. He indicated that strengthened international standards are building more resilient financial institutions and more robust markets. This means the FSB will adjust its focus towards addressing new and constantly evolving risks and vulnerabilities. For 2015, areas of work include developing a common international standard on the total loss absorbing capacity of globally systemic banks, an industry agreement to overcome the lack of a global framework to prevent cross-border counterparties taking their money before others when a bank needs to be resolved, and an agreement to prevent cross-border derivative contracts being disruptively terminated in the event of a globally systemic bank entering resolution. Mr. Carney also indicated that in 2015 the FSB will begin an annual reporting process on implementation of reforms by G-20 members. In addition, the FSB will begin the reporting of implementation progress on shadow banking reforms, drawing on monitoring and peer review work undertaken by relevant monitoring bodies.

Bank for International Settlements (Basel Committee on Bank Supervision)

With the backing of the G-20, the Basel Committee on Bank Supervision has a very active program to promote greater consistency in the implementation of global standards and improved transparency of instances where national differences exist. Areas on current consultation leading to potential further reforms include revisions to the standardized approach for credit, capital floors: the design of a framework based on standardized approaches, fundamental review of the trading book, criteria for identifying simple, transparent and comparable securitizations, net stable funding ratio disclosure standards, and reducing excessive variability in banks' regulatory capital ratios.

In the November 2014 speech at the Federal Reserve Bank of Chicago, Mr. Stefan Ingves, Chairman, Basel Committee on Banking Supervision and Governor Sveriges Riksbank noted that a major issue is how to ensure that global systemically important banks have sufficient capacity to absorb losses in resolution, without having to ask taxpayers to foot the bill (total loss absorbing capacity). In addition, he noted that ensuring consistency in the implementation by member countries of risk-based capital standards will therefore be a key factor in restoring confidence in banks, and the Committee is thus assessing bank capital ratios with a view to ensuring that they appropriately reflect the risks that banks face.

International Association of Insurance Supervisors ("IAIS")

The IAIS is currently consulting on a number of issues. First, given an increasing international focus on bribery and corruption, and in view of the risks they pose to the insurance sector, the Financial Crime Working Group of the IAIS considered it timely to explore how this activity affects insurers and insurance intermediaries as well as how insurance supervision can help to ensure that insurers and insurance intermediaries manage such risks effectively. In addition, the IAIS is also consulting on group corporate governance with the objective to create awareness for insurers and supervisors of the challenges of centralized and decentralized governance approaches and possible solutions for these challenges, which should be taken into account when setting up and assessing the corporate governance framework of an insurance group.

The IAIS has concluded development of the first ever global insurance capital standard: the Basic Capital Requirements ("BCR") for global systemically important insurers ("G-SIIs"). Beginning in 2015, the BCR will be reporting on a confidential basis to group-wide supervisors and be shared with the IAIS for purposes of refining the BCR. During this reporting period, the IAIS will review the suitability of the BCR factors to ensure that the

BCR remains fit for its purpose. From 2019, G-SIIs will be required to hold capital no lower than the BCR plus a requirement for Higher Loss Absorption.

U.S. Regulatory Authorities and Derivatives

For Canadian financial institutions and other market participants in Canada executing over-the-counter ("OTC") derivatives within the jurisdiction of U.S. regulators, there will be at least three critical developments in 2015. The U.S. Securities and Exchange Commission ("SEC"), which is the lead securities regulator in the U.S. and the second of two primary U.S. regulators of OTC derivatives, and the lead securities regulator in the U.S., will issue long-awaited, proposed and final rules for most OTC put and call options and other OTC derivatives falling within the definitions of Security-Based Swaps (such as many credit default swaps) and Mixed Swaps (as those capitalized terms are defined in the U.S. *Commodity Exchange Act*, as amended by Title VII of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*). Also in 2015, both the SEC, U.S. banking regulators, and the lead U.S. derivatives regulator, the Commodity Futures Trading Commission ("CFTC"), will have promulgated final collateral rules for un-cleared derivatives which will require substantial operational and legal documentation changes this year; this will be an exceedingly difficult process given differences today in regulatory approaches in this important area. Finally, in addition to having to address capital requirements, Canadian banks (as well as financial services and other firms) triggering the Volcker Rule will need to have standard or enhanced compliance programs up and running and must comply with many other requirements prior to July 21, 2015 (among other key U.S. compliance dates throughout the year). While we also expect to receive, in the first quarter of 2015, guidance from the CFTC on a key residency issue, the foregoing developments this year should be front and centre in the minds of all Canadian market participants executing and settling derivatives within the jurisdiction of these U.S. regulators.

Payments Regulation

The Canadian Government will continue the process of developing a comprehensive risk-based approach to, and framework for, the oversight of the Canadian payments system. To this end, it will strengthen the Code of Conduct for the Credit and Debit Card Industry in Canada to address new developments and mobile payments. In addition, it will continue to advance the development of a comprehensive financial consumer code, and will seek to ensure public confidence in the use of electronic payment methods. This code will streamline the existing and dispersed mix of legislation and regulations. The Canadian Government has made it clear that it is closely watching the new and innovative service delivery channels that are emerging in the use of mobile devices. As such, this will result in a financial consumer protection framework that is technology-neutral in its approach and more adaptable to changes in the marketplace, products, and technology so that no matter how a service is offered to consumers, consumer protections continue to apply.

The Canadian Government will also be taking steps to implement the changes relating to the governance and oversight of the Canadian Payments Association to address accountability and payment system risk, some of which are outlined in Bill C-43, *Economic Action Plan 2014 Act, No. 2*,[1] which received Royal Assent on December 16, 2014.

Office of the Superintendent of Financial Institutions (Canada)

Banking

Having spent the last few years focused on ensuring that Canada has adopted enhancements to its regulatory regime that have been developed in the international fora noted above, in 2015, the Office of the Superindendent of Financial Institutions ("OSFI") appears to be more focused on monitoring the impact of recent reforms and addressing a number of issues that have domestic relevance, with the exceptions noted below. For example, work is being done to update guidance on the incorporation of banks and trust companies and the foreign entry regime, and to provide information and guidance to provincial credit unions seeking to continue federally. OSFI has announced plans to consider consolidation of the various forms of directions provided to regulated entities from the current menu of regulations, guidelines, advisories, and rulings to something that is perhaps less complex. Regulatory review processes that are expected in 2015 include amendments to the Related Party Transactions Regulations[2] and *Assessment of Financial Institutions Regulations. 2001*[3], and Substantial Investment Advisory.

In addition to the domestic focus noted above, OSFI continues to be very much involved in international capital adequacy processes related to the securitization rules and market risk review, and plans to engage in consultations with respect to such issues as credit risk subject to the standardized approach, the interest rate risk in the banking book, and the requirements for use of internal ratings-based ("IRB") methodology and minimum regulatory capital calculations.

Insurance

Changes in approach to capital adequacy assessment and self-assessment will consume the federal prudential regulator and the industry whether it is the full implementation of Own Risk Solvency Assessment ("ORSA") or changes to minimum regulatory capital requirements. Cyber security will remain top of mind for OSFI and the industry will continue to devote resources to this issue, both to address regulatory expectations and reputational risk. Changes to Guideline E-4A with respect to the Role of the Chief Agent and Record Keeping Requirements are expected to be developed; this may have significant implications for the business models of some branches of foreign companies operating in Canada. In addition, the Canadian Government has recently released draft demutualization regulations for the property and casualty insurance sector.

Canada Deposit Insurance Corporation ("CDIC")

The 2014 Budget included an announcement of a planned review of Canada's deposit insurance program to help ensure deposit insurance continues to meet the needs of Canadians. As indicated in the CDIC's Summary of the Corporate Plan 2014/2015 to 2018/2019, building on the corporation's recent and extensive work on developing resolution plans for its largest member institutions, in 2014/2015, CDIC will expand the scope of its resolution planning to include selected mid-sized member institutions. The CDIC has also indicated that it will implement a plan to enhance processes and procedures aimed at further improving the corporation's readiness in the event of the failure of one of its largest member institutions. In 2014/2015, CDIC has indicated that it will develop co-ordination protocols to strengthen its co-operative relationships with resolution authorities in the U.S. and U.K., and potentially other regions where Canadian financial institutions have a significant presence.

Financial Consumer Agency of Canada ("FCAC")

The government is committed to working with stakeholders to develop a National Strategy for Financial Literacy that takes into consideration ways to meet the needs of Canadians at different stages of their lives. FCAC is leading the consultation process. It has been reported that the full National Strategy for Financial Literacy will be released in 2015.

The Financial Transactions and Reports Analysis Centre of Canada ("FINTRAC")

Bill C-43[4] included legislative amendments to strengthen Canada's anti-money laundering and anti-terrorist financing regime and improve Canada's compliance with international standards. In 2015 the regulations required to implement the legislative changes enacted in 2014 will be published, including regulations to regulate virtual currencies, such as Bitcoin.

Provincial Insurance Regulation

In the wake of the Supreme Court of Canada decision in *La Souveraine, Compagnie d'assurance générale v. Autorité des marchés financiers,*[5] and an increased focus on market conduct regulation, we expect an increase in both the frequency and severity of administrative monetary penalties imposed on insurers at the provincial level for market conduct and compliance matters. Developments in the forum of the International Association of Insurance Supervisors will continue to impact the regulatory lens and outcomes here in Canada at both the federal and provincial levels of insurance regulation.

Provincial Credit Union Regulation

Ontario is reviewing the *Credit Unions and Caisses Populaires Act, 1994*[6] in a process led by Laura Albanese, the Parliamentary Assistant to the Ontario Minister of Finance. Final recommendations are expected to be provided to the government by the fall of 2015. The review is seeking input from the public on ways to strengthen the regulatory framework, protect consumers, and enable credit unions and caisses populaires to continue to meet the needs of their members.

In November 2014, Central 1 Credit Union, Concentra Financial Services Association, and SaskCentral signed a Memorandum of Understanding to explore opportunities to consolidate their trust services and wholesale financial lines of business. It was reported that these discussions may advance the establishment of a national, credit-union-owned, wholesale financial and trust provider.

Final Comments

There is a tremendous velocity of change in the regulatory requirements for Canada's regulated banking and insurance sectors. The importance of experienced professionals with regulatory compliance responsibilities has never been greater, as are the risks to institutions that fail to adapt to changing requirements. We look forward to supporting the sector in meeting all regulatory requirements in 2015.

[*Editor's note*: **Jeffrey Graham** is the national head of the Financial Services Regulatory Group of Borden Ladner Gervais LLP ("BLG"). Jeff has extensive experience within the financial sector in Canada and the United States.

Stephen Redican is the Toronto regional leader of BLG's Financial Services Regulatory Group. Stephen has many years of experience advising on all aspects of regulatory, compliance, and payments matters on behalf of domestic and international banks and financial services entities.

Gordon Peery is a lecturer, author, and leading authority in over-the-counter derivatives and futures, and works exclusively in this area. As a principal central part of his practice, Gordon advises clients on cross-border, international issues and derivatives.

Jill McCutcheon is a partner in the Toronto office and Chair of the Insurance, Corporate and Regulatory Group. She has more than 20 years of experience in providing counsel to insurers, reinsurers, banks, intermediaries, third-party administrators, marketers, retailers, employers, and associations regarding legal and regulatory issues and on all other aspects of the law.]

1 S.C. 2014, c. 39.

2 *Related Party Transactions (Banks) Regulations, SOR/92-309, the Related Party Transactions (Cooperative Credit Associations) Regulations, SOR/96-275, the Related Party Transactions (Insurance Companies) Regulations, SOR/96-276, and the Related Party Transactions (Trust and Loan Companies) Regulations, SOR/96-277* (collectively, the "Related Party Transactions Regulations").

3 SOR/2001-177.

4 *Supra* note 1.

5 [2013] S.C.J. No. 63, [2013] 3 S.C.R. 756, 2013 SCC 63.

6 S.O. 1994, c. 11.

• SUPREME COURT OF CANADA UPHOLDS SOLICITOR-CLIENT PRIVILEGE, SETTLING A 15-YEAR DISPUTE •

Darcy Ammerman and Pat Forgione
McMillan LLP

On February 13, 2015, the Supreme Court of Canada ("S.C.C.") released a ruling in *Canada (Attorney General) v. Federation of Law Societies of Canada*[1] ending a 15 year battle between Canadian lawyers and the federal government with respect to the ability of the Financial Transactions and Reports Analysis Centre of Canada ("FINTRAC") to, among other things, search and seize files from lawyers' offices without a warrant and hand out penalties to lawyers for non-compliance, such as a fine of up to $500,000 or five years in jail, or both.

FINTRAC is a Canadian administrative financial intelligence unit that operates independently from law enforcement agencies. It is mandated to facilitate the detection, prevention, and deterrence of money laundering and terrorist financing by collecting and analyzing information, and disclosing that information, under certain conditions, to law enforcement agencies. FINTRAC derives its authority from the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*[2] which came into force in 2000 (the "*Act*") and the 2001 *Proceeds of Crime (Money Laundering) and Terrorist Financing Suspicious Transaction Reporting Regulations*[3] (the "Regulations", and together with the *Act*, the "Legislation").

In 2008, the Legislation was amended to require that certain persons, including lawyers and notaries in the province of Québec, take on obligations including collecting information of clients potentially involved in money laundering or terrorist funding, and providing such information to FINTRAC.

In response, the Federation of Law Societies of Canada launched a constitutional challenge against the Legislation on behalf of the 14 self-governing bodies that oversee lawyers in Canada, arguing that its provisions threaten solicitor-client privilege. In 2010, the Federation and the Attorney General of Canada agreed to a consent order exempting legal counsel and law firms from the amendments, pending determination of the proceedings.

On September 27, 2011, the British Columbia Supreme Court ruled that the portions of the Legislation that applied to lawyers, law firms, and Québec notaries were unconstitutional and granted an order severing and striking down the impugned provisions.

On appeal by the Attorney General, the British Columbia Court of Appeal upheld the trial judge's decision. In reviewing the Legislation, the court found that confidential client information obtained by FINTRAC may be disclosed to law enforcement for the purpose of ensuring lawyer compliance with the Legislation and may then be used by the law enforcement agency for any purpose, including pursuing a criminal charge against the client. The court held that this regime engages the liberty interests of both clients and lawyers in a manner which does not accord with the principles of fundamental justice pursuant to s. 7 of the *Charter of Rights and Freedoms* and cannot be saved by s. 1 of the Charter.

At the S.C.C. level, the analysis focused on the s. 8 Charter right to be free of unreasonable searches and seizures. The S.C.C. held that the search provisions in the Legislation do not provide the constitutionally-required protection for solicitor-client privilege, and that such infringement cannot be saved by s. 1 of the Charter; namely because there are other, less drastic means of pursuing the objectives of combating money laundering and terrorist financing.

In addition, the S.C.C. identified a lawyer's duty of committed representation as a new principle of fundamental justice which was also infringed by the Legislation.

To remedy these infringements, the S.C.C. declared s. 64 of the *Act* of no force or effect and read down ss. 62, 63 and 63.1 so that they do not apply to documents in the possession of legal counsel or in law office premises. Similarly, ss. 33.3, 33.4, 33.5, and 59.4 of the Regulations were declared of no force and effect and s. 11.1 read down so that it does not apply to documents in the possession of legal counsel or in law office premises.

This decision represents a long-awaited victory for lawyers who can continue to represent their clients without fear of being used as an agent of the state. Clients can rest easy knowing that solicitor-client privilege and a lawyer's duty of committed representation is protected by our highest court. However, the legislation will continue to apply to financial institutions, accountants, and real estate firms.

[*Editor's note*: **Darcy Ammerman** is an associate in McMillan's Financial Services Group. Darcy's practice focuses on advising lenders and borrowers with respect to corporate financing transactions, including domestic and international debt financing, syndicated lending, asset-based lending, and project finance. Darcy

also routinely advises federally regulated entities, including financial institutions and insurance companies, with respect to regulatory compliance and licensing requirements.
You can contact Dary at (416) 865-7853 or <darcy.ammerman@mcmillan.ca>.

Pat Forgione is a partner of McMillan in the firm's Financial Services Group. Pat practises in the business law area with a focus on corporate and commercial financing, asset-based lending, syndicated lending, mezzanine financing, private equity, and securitization. Pat routinely acts for major financial institutions on domestic and cross-border transactions. Pat also regularly counsels domestic and foreign financial institutions on the regulatory requirements relating to carrying on business in Canada, including ongoing compliance matters. You can contact Pat at (416) 865-7798 or <pat.forgione@mcmillan.ca>].

[1] [2015] S.C.J. No. 7.
[2] S.C. 2000, c. 17.
[3] SOR/2001-317.

• CANADA'S REGIME FOR DOMESTIC SYSTEMICALLY IMPORTANT BANKS •

John Jason
Norton Rose Fulbright Canada
Canadian Compliance Group Inc.

In November 2010, the Financial Stability Board ("FSB") recommended that all FSB jurisdictions should put in place a policy framework to reduce the risks and externalities associated with global and domestic systemically important financial institutions in their jurisdictions. The FSB recommended five components for the framework:

- a higher loss absorbency capacity to reflect the greater risks that these institutions pose to the global or domestic financial system;
- more intensive supervisory oversight;
- a robust core financial market infrastructure to reduce contagion risk and failure;
- a resolution framework and other measures to ensure that all financial institutions can be resolved safely, quickly, and without destabilising the financial system or exposing taxpayers to the risk of loss; and
- supplementary prudential and other requirements.

How far has Canada come in implementing those recommendations? It appears that Canada has made good progress. Of course, as is typical with respect to financial services regulation in Canada, not all of the measures are transparent. Summarized below are some of the key accomplishments thus far.

Roadmap for Action

The Federal Budget for 2013 announced that steps would be taken to "implement a comprehensive risk management framework" for domestic systemically important banks ("D-SIBs"). These steps were to include the introduction of a higher capital requirement, the implementation of a bail-in regime in the event that a D-SIB depletes its capital, enhanced supervision, and a requirement for recovery and resolution plans.

Designating the D-SIBs

Roughly coincident with the release of the Budget, the Office of the Superintendent of Financial Institutions ("OSFI") announced that the six largest Canadian banks had been designated as D-SIBs. A description of the designation criteria that OSFI used to make the designations is now found as an Appendix to Chapter 1 of the OSFI Capital Adequacy Requirements Guideline ("CAR Guideline"). Based on the methodology described in the Appendix, OSFI designated the five largest banks "without further distinction between them". According to OSFI, The National Bank of Canada was also designated because of its importance relative to other less prominent banks and in the interest of prudence, given the inherent challenges in identifying ahead of time which banks are likely to be systemic in times of stress.

Additional Capital

At the time that the D-SIBs were designated, OSFI also announced that an additional capital requirement would be imposed on D-SIBs beginning on January 1, 2016. The additional capital requirement or "Higher Loss Absorbency Target" was implemented in the form of a common equity surcharge of 1 per cent of Risk Weighted Assets ("RWA"). Accordingly, D-SIBs will be required to meet an all-in Pillar 1 target common equity Tier 1 ratio of 8 per cent RWA commencing January 1, 2016.

Bail-in Regime

In August 2014, the federal Minister of Finance launched a consultation on a possible bail-in structure for D-SIBs. Under the proposal, certain types of debt would be converted to equity if a D-SIB depletes its capital. The comment period for the consultation closed last September. There has been no indication of the timing for the release of the final details of this bail-in regime.

More Disclosure

The Appendix to the CAR Guideline states that D-SIBs are expected to adopt the recommendations of the FSB's Enhanced Disclosure Task Force and any future disclosure recommendations that are endorsed by international standard setters and the FSB, as well as evolving domestic and international bank risk disclosure best practices. The FSB recommendations were developed for large international banks rather than specifically for D-SIBs.

Additionally, OSFI Advisory – *Public Capital Disclosure Requirements related to Basel III Pillar 3*, prescribes a set of capital-related disclosure requirements that are unique to D-SIBs.

Further, OSFI Advisory – Public Disclosure Requirements for Domestic Systemically Important Banks on Liquidity Coverage Ratio implements the Liquidity Coverage Ratio Disclosure Standards developed by the Basel Committee on Banking Supervision that apply to internationally active banks. In this case, OSFI has substituted D-SIB for internationally active.

Closer Supervision

The Appendix to the CAR Guideline also discusses the additional supervisory measures that have been implemented in respect of D-SIBs. Although OSFI notes that it has always applied a risk-based approach to determining the intensity of its supervision, OSFI noted that it had implemented the following additional measures:

- greater frequency and intensity of on- and off-site monitoring of activities, including more granular forms of risk management reporting to OSFI, and more structured interactions with boards and senior managements;

- more extensive use of specialist expertise relating to credit risk, market risk, operational risk, corporate governance, and AML/compliance;
- stronger control expectations for important businesses, including the use of "advanced" approaches for Pillar 1 reporting of credit, market, and operational risks;
- greater use of cross-institution reviews, both domestically and internationally, in order to confirm the use of good risk management, corporate governance and disclosure practices;
- selective use of external reviews to benchmark leading risk-control practices, especially for instances where best practices may reside outside Canada; and
- regular use of stress tests to inform capital and liquidity assessments.

Of course, most of these measure would not be transparent outside of the D-SIBs.

Resolution and Recovery Plans

The CAR Guideline notes that OSFI is leading on recovery planning and the Canada Deposit Insurance Corporation ("CDIC") is leading on resolution planning. Indeed, the CDIC Deposit Insurance Policy By-law was recently amended to permit the CDIC to request information from a CDIC member for the purpose of designing and maintaining a resolution plan. According to OSFI, CDIC has committed significant new resources to the resolution planning process.

Conclusion

All in all, it appears that significant steps have been taken to implement the FSB recommendations. While OSFI certainly would have devoted more attention to the large banks, even prior to the financial crisis, developing a framework for a distinct portion of the financial services industry marks a departure from the traditional approach to bank regulation in Canada. It will be interesting to see how this approach will be carried forward in the future.

[*Editor's note*: **John Jason** practises law at Norton Rose Fulbright Canada LLP in the financial services regulatory practice group. He is also president of Canadian Compliance Group Inc., which provides regulatory compliance solutions to for the Canadian financial institutions. You can contact John at (416) 216-2964 or <john.jason@nortonrosefulbright.com>.]

• *RAZA KAYANI*: ONTARIO COURT OF APPEAL ADDRESSES SCOPE OF FICTITIOUS PAYEE DEFENCE UNDER CANADA'S *BILLS OF EXCHANGE ACT* •

David S. Wilson and Chris McKibbin
Blaney McMurtry LLP

In the recent decision of *Raza Kayani LLP v. Toronto-Dominion Bank* [*Raza Kayani*],[1] the Ontario Court of Appeal addressed the scope of the "fictitious payee" defence available to banks and other financial institutions under Canada's *Bills of Exchange Act*.[2] The decision has important implications for entities seeking to recover against financial institutions in cheque fraud cases.

The plaintiffs were a law firm and another individual lawyer who fell victim to essentially identical counterfeit cheque scams. The plaintiffs were each retained by a purported purchaser in connection with a commercial transaction involving a vendor known as Nithiyakalyaani Jewellers. As part of the closing of each transaction, the plaintiffs were provided with counterfeit certified cheques representing the purchase funds, which they deposited into their trust accounts. The plaintiffs then provided a trust cheque and a bank draft (the "instruments") payable to "Nithiyakalyaani Jewellers" to a representative of the purported vendor.

The fraudsters' use of the name "Nithiyakalyaani Jewellers" was a form of corporate identity theft. There had been a valid Ontario corporation, Nithiyakalyaani Jewellers Ltd., which had previously carried on business at the address used by the fraudsters, but which no longer did so at the time of the fraud. One of the plaintiffs had even performed a Canada411 search on "Nithiyakalyaani Jewellers" to satisfy himself that the entity existed and was located at the address provided.

An individual, Shaik, had opened an account in the name of Nithiyakalyaani Jewellers with TD Bank. Shaik provided TD Bank with an Ontario Master Business Licence indicating that he had registered "Nithiyakalyaani Jewellers" as a sole proprietorship. The instruments were deposited into this account. By the time the plaintiffs learned that the certified cheques were counterfeit, the fraudsters and the money were long gone.

The plaintiffs alleged that TD Bank, as collecting bank, was liable in conversion because it credited the instruments to someone other than the intended payee. As conversion is a strict liability tort, TD Bank had no defence, other than the statutory defence afforded to collecting banks by subs. 20(5) of the *Bills of Exchange Act*. This provides that where a named payee is a fictitious or non-existing person, a cheque may be treated as payable to bearer (*i.e.*, whoever presents the cheque to the collecting bank) and the bank will have no liability for negotiating it on the bearer's instructions.

The law in this area is not always easy to apply. If the payee is not the name of any real person known to the drawer, but is merely that of a creature of the imagination, the payee is non-existing, and is probably also fictitious. However, if the payee is the name of a real person, intended by the drawer to receive payment, the payee is neither fictitious nor non-existing, even if the drawer has been induced to draw the instrument by a fraudster's representation that there is a transaction in respect of which the payee is entitled to the sum mentioned in the instrument.

TD Bank contended that "Nithiyakalyaani Jewellers" was a fictitious and non-existing entity – a figment of the fraudsters' imaginations. As such, TD Bank validly negotiated the instruments and was not liable.

Relying on the Court of Appeal's 2012 decision in *Rouge Valley Health System*,[3] the plaintiffs countered that a payee will not be found to be non-existing if the payee name is similar to the name of an actual person, such that the drawer of an instrument might plausibly maintain that it believed it was paying a real entity. This is sometimes referred to as the "plausibility doctrine".

The trial judge had held that the plaintiffs believed that an entity called Nithiyakalyaani Jewellers (with or without the "Ltd.") existed, and that it was located at the address where Nithiyakalyaani Jewellers Ltd. had previously operated. On this basis, she held that Nithiyakalyaani Jewellers Ltd. was the entity the plaintiffs intended to pay. Consequently, the payee was neither fictitious, nor non-existing, and TD Bank had no defence under subs. 20(5).

The Court of Appeal disagreed, holding that the plausibility doctrine still requires that the drawer of the instrument must have knowledge of the payee, *i.e.*, the name must be similar to the name of an actual person or entity with which the drawer has previously done business. Here, the plaintiffs acknowledged that they had had no prior dealings with Nithiyakalyaani Jewellers Ltd., and that they had not turned their minds to the incorporation status of Nithiyakalyaani Jewellers when they drew the instruments.

Consequently, the Court of Appeal held that the plaintiffs could not establish that "Nithiyakalyaani Jewellers" was the name of a real entity, intended by the plaintiffs to receive payment. As such, subs. 20(5) applied to afford TD Bank with a defence to the conversion claim.

The Court of Appeal appears to have narrowly applied the plausibility doctrine in *Raza Kayani*. The court's decision demonstrates the need for careful analysis of the factual context under which a drawer has been induced to prepare and part with a cheque. Where a drawer can adduce evidence demonstrating that the drawer thought it was paying an entity with which it had some prior relationship, the drawer may be able to recover in conversion against the collecting bank.

[*Editor's note*: **David S. Wilson** and **Chris McKibbin** are partners with Blaney McMurtry LLP in Toronto. Their fidelity insurance practice encompasses all aspects of coverage analysis and litigation involving fidelity bonds, commercial crime policies, and financial institution bonds, as well as fraud subrogation work against employees, co-conspirators, auditors, and financial institutions.

You can contact David at (416) 593-3970 or <dwilson@blaney.com> and Chris at (416) 596-2899 or <cmckibbin@blaney.com>.]

1 [2014] O.J. No. 5784, 2014 ONCA 862.

2 R.S.C. 1985, c. B-4.

3 *Rouge Valley Health System v. TD Canada Trust*, [2012] O.J. No. 81, 2012 ONCA 17.

• ONTARIO SUBSEQUENT MORTGAGEE LOSES PRIORITY FOR FRAUDULENT PRIOR DISCHARGE •

Jordan Deering, Mark Evans, Renée Brosseau, and Jon Pinkus
Dentons Canada

In *CIBC Mortgages Inc. v. Computershare Trust Co. of Canada*,[1] the Ontario Superior Court of Justice considered applications from competing mortgagees to a property where the first charge had been discharged by fraud and subsequent mortgages were obtained. The court decided that although the subsequent mortgagees were innocent parties, unaware of the fraudulent discharge on the first mortgage, the first mortgagee was entitled to retain priority.

Facts

In 2008, two homeowners, Dhanraj and Sumatie Lowtan ("the Owners") applied for a loan from Computershare Trust Company of Canada ("Computershare") secured by a first charge on the property. In 2009, unbeknownst to Computershare, its mortgage was discharged by someone fraudulently claiming to have authority to bind the company. In March 2011, the Owners granted a mortgage to Maria Giovanni and Darlene Geraci. Meanwhile, the Owners continued to make payments to Computershare.

In July 2011, the Owners approached CIBC to obtain a new mortgage. Despite the fact that the Owners were still making monthly payments to Computershare, they told CIBC that the only charge they had was the mortgage with Giovanni and Geraci. CIBC granted a "first" mortgage, on the condition of payout and discharge of the Giovanni/Geraci mortgage. In December 2012, the Owners then approached Secure Capital MIC Inc. ("Secure Capital") to register a "second" mortgage. This time, the Owners told Secure Capital about the CIBC "first" mortgage, but still did not disclose the original mortgage with Computershare.

Payments on the Computershare mortgage continued until January 4, 2013, after which time the mortgage went into default. Less than a month later, the Owners defaulted on both the CIBC and Secure Capital mortgages. On April 9, 2013, Secure Capital issued a notice of sale.

On April 12, 2013, Computershare discovered that its mortgage had been fraudulently discharged. Shortly thereafter, the Owners filed for bankruptcy and vacated the property. Towards the end of May 2013, a caution was registered against the property, indicating that the discharge of the Computershare mortgage may be fraudulent.

While CIBC sold the property with all parties' consent, the proceeds were insufficient to satisfy all three debts. As a result, CIBC and Computershare each brought an application seeking a declaration that it had first charge on the property. Computershare also applied to have the discharge declared void. Secure Capital sought a declaration that its mortgage ranked second behind CIBC.

Decision

The court made a factual finding that the Owners knew about the fraudulent discharge.[2]

In the circumstances, CIBC and Secure Capital unsuccessfully attempted to argue that the charges granted by the Owners to them were not fraudulent within the meaning of s. 78 of the *Land Titles Act* [*LTA*],[3] which confirms that an instrument is effective according to its nature and intent once it is registered. However, subs. (4.1) excludes fraudulent instruments and subs. (4.2) preserves non-fraudulent instruments, including those registered subsequent to a fraudulent one.

The court found that since the Owners knew about the fraudulent discharge, they did not own the interest in the property which they purported to have secured to the benefit of CIBC and Secure Capital. The subsequent mortgages were therefore fraudulent instruments under s. 78(4.2) of the *LTA*, and their priority had to give way to Computershare's prior (though "discharged") security.[4]

Legal Principles

Although the purpose of the *LTA* is to save those dealing with registered properties from having to check behind the register to investigate the title,[5] that reliance on the registry is "not a one-way street".[6] In this case, Computershare legitimately expected that it was enough to register its charge on title, which would act as notice to anyone who obtained charge on title in the future.[7]

The court was ultimately guided by the "theory of deferred indefeasibility", citing the decision in *Lawrence v. Wright* [*Lawrence*].[8] *Lawrence* effectively did away with the "immediate indefeasibility" theory, which held that the fact that a transfer was obtained by fraud is irrelevant and the subsequent party is entitled to rely on the register.[9] In contrast, the "theory of deferred indefeasibility" sets out three types of parties for the purpose of determining title when there has been fraud on a property: (i) the original owner, (ii) the intermediate owner (the one who deals with the fraudster), and (iii) the deferred owner (a *bona fide* purchaser or encumbrance for value without notice who takes from the intermediate owner). Recognizing that the intermediate owner has the opportunity to avoid the fraud, only a deferred owner can defeat the original owner's title.[10] In this case, CIBC was the intermediate owner, since it acquired an interest from a fraudster, and had the opportunity to investigate the transaction and avoid the fraud. There was no deferred owner, which left Computershare with priority.

Implications of the Decision

This decision arguably places the burden of guarding against fraud with the mortgagee closest to the act of fraud itself. Here, the court suggested that CIBC could have found out by asking the right questions, such as how the homeowners were able to pay off the Computershare mortgage despite their financial difficulties.[11] Mortgagees should therefore be mindful of the need to make inquiries to ensure their priority is not negatively impacted by fraud perpetrated on an earlier mortgagee where circumstances (such as the prior discharge of a significant mortgage) suggest it is reasonable to do so.

Mortgagees must also be diligent in following up on any information they receive after granting a loan to a party, even if secured by a first charge. In this case, the evidence did not suggest that Computershare should have been aware of the fraudulent discharge.[12] However, the fact that payments were continuing would not have been enough to relieve Computershare of their obligation to be vigilant. As the court observed, a party's willingness to continue mortgage payments may be a part of the fraudulent scheme itself.[13]

[*Editor's note*: **Jordan Deering** is a partner and co-lead of Dentons Canada Fraud and Asset Recovery practice group. She represents a variety of clients, respecting a broad range of matters, including fraud prevention, investigation, and recovery mandates.
You can contact Jordan at (403) 268-3110 or <jordan.deering@dentons.com>.

Mark Evans is a partner and co-lead of Dentons Global Fraud, Corruption and Asset Recovery Group. Mark represents clients in the co-ordination and prosecution of banking and securities-related frauds and in the recovery of assets. In 2013, Mark was recognized by the International Who's Who of Business Lawyers as a leading asset recovery lawyer in Canada.
You can contact Mark at (416) 863-4453 or <mark.evans@dentons.com>.

Renée Brosseau is a member of the Litigation and Dispute Resolution group of Dentons' Toronto office. Renée advises on all aspects of restructuring, insolvency, and bankruptcy, including commercial reorganizations, distressed acquisitions, fraudulent transactions, forbearance arrangements, security enforcement, leasing, and real estate.
You can contact Renée at (416) 863-4650 or <renee.brosseau@dentons.com>.

Jon Pinkus, an articling student at Dentons Canada, assisted with the writing of this article. Prior to his articles, Jon completed his JD at the University of Ottawa.

You can contact Jon at (416) 367-7756 or <jonathan.pinkus@dentons.com>.]

1 [2015] O.J. No. 403, 2015 ONSC 543 [*Computershare*].
2 *Ibid.* at paras. 30-36.
3 RSO 1990, c. L.5.
4 *Computershare*, *supra* note 1 at paras. 51, 62.
5 *Ibid.* at para. 53.
6 *Ibid.* at para. 43.
7 *Ibid.*
8 [2007] O.J. No. 381, 2007 ONCA 74.
9 *Ibid.* at para. 36.
10 *Ibid.* at para. 21; *Computershare*, *supra* note 1 at para. 58.
11 *Computershare*, *supra* note 1 at para. 58.
12 *Ibid.* at paras. 25-29.
13 *Ibid.* at para. 35.

INVITATION TO OUR READERS

Have you written an article on a current issue that you think would be appropriate for *National Banking Law Review*?

Do you have any suggestions for topics you would like to see featured in future issues of *National Banking Law Review*?

If so, please feel free to contact us at nblr@lexisnexis.ca

National Banking Law Review is published six times per year by LexisNexis Canada Inc.
This issue is cited as 34 Nat. B.L. Rev.

You can contact the LexisNexis Editor at:

Telephone (905) 479-2665, ext. 308 Toll-Free Telephone 1-800-668-6481
Fax (905) 479-2826 Toll-Free Fax: 1-800-461-3275
Internet e-mail: nblr@lexisnexis.ca

Price: $465 for six issues and annual index. Binder available at $20 upon request.
$535 for Print & PDF

The articles included in the *National Banking Law Review* reflect the views of the individual authors. The *National Banking Law Review* is not intended to provide legal or other professional advice and readers should not act on information contained in this publication without seeking specific advice on the particular matters with which they are concerned.

ISBN 0-409-91076-7 ISSN 0822-1081
ISBN 0-433-44389-8 (Print & PDF)
ISBN 0-433-44684-6 (PDF)

The Journal is indexed in the *Index of Canadian Periodical Literature*
and in *the Index to Canadian Legal Literature*.
Publications Mail Registration No. 180858