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Canada Adopts Major Revisions to its Financial Institution Legislation

*Blair W. Keefe and Stéphane J. Fournier**

Table of Contents

- I. Introduction
- II. The 1999 Act
- III. The 2001 Act
 - A. FOREIGN BANKS IN CANADA
 - B. CANADIAN BANK AND INSURANCE COMPANY OWNERSHIP REGIMES
 - C. CANADIAN BHCs AND IHCs
 - D. PERMITTED ACTIVITIES AND INVESTMENTS—CANADIAN FRFIs, BHCs, AND IHCs
 - E. CANADIAN BANK AND INSURANCE COMPANY JOINT VENTURES
 - F. LARGE CANADIAN BANK AND BHC MERGER REVIEW
 - G. MEASURES TO EMPOWER AND PROTECT CANADIAN CONSUMERS
 - H. MEASURES TO IMPROVE THE CANADIAN REGULATORY ENVIRONMENT
- IV. Conclusion

I. Introduction

On October 24, 2001, the Canadian government proclaimed in force legislation¹ that made substantial changes to the ownership, investment, business powers, and corporate governance provisions of the federal financial services legislation.² The 2001 Act is the second of a recent two-prong legislative initiative to strengthen Canada's financial services sector. The first part of the initiative took place on June 28, 1999 when the Canadian government proclaimed in force legislation,³ that gave foreign banks greater opportunities with respect to how they provide financial services to Canadians. This legislation also encouraged foreign banks to enter or re-enter the Canadian market.

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1. Financial Consumer Agency of Canada Act, S.C., ch. 9 (2001) (Can.) (hereinafter "2001 Act").
2. The 2001 Act amended the following previous legislation: the Bank Act, S.C., ch. 46 (1991), (Can.); the Insurance Companies Act, S.C., ch. 47, (1991) (Can.); the Trust and Loan Companies Act, S.C., ch. 45 (1991) (Can.); and the Cooperative Credit Associations Act, S.C., ch. 48 (1991) (Can.) (collectively referred to sometimes as the "F.I. Statutes").
3. An Act to amend the Bank Act, the Winding-up and Restructuring Act and other Acts relating to financial institutions, S.C., ch. 28 (1999) (Can.) (the "1999 Act").

The implementation of the 2001 Act is the culmination of a lengthy legislative process dating back to 1996. On December 19, 1996, Canada's Minister of Finance (the Minister) announced the mandate and composition of the Task Force on the Future of the Canadian Financial Services Sector (the Task Force). This Task Force was asked to advise the Canadian government on what needed to be done to ensure that Canada's financial services sector remains strong and dynamic. On September 14, 1998, the Task Force released its report entitled *Change, Challenge, Opportunity*.⁴ Five background papers and eighteen research studies accompanied the Report. Among other recommendations, the Report provided for the allowance of foreign banks to branch directly into Canada, and that large Canadian banks and insurance companies be granted more flexibility to enter into cross-border transactions.⁵ The Canadian government agreed with many of the Report's recommendations. Then, on June 25, 1999, it outlined four primary policy initiatives: (1) promoting efficiency and growth among Canadian Federally Regulated Financial Institutions (FRFI);⁶ (2) fostering domestic competition by facilitating the entry of foreign competitors and removing barriers to entry for new competitors; (3) strengthening consumer bargaining power through increased access to information; and (4) improving the regulatory environment.⁷

Both the 1999 Act and the 2001 Act implement these policy initiatives. Together, these acts create opportunities never before available to domestic and foreign entities seeking to enter or re-enter the Canadian market to engage strategic alliances and joint ventures, or to acquire particular businesses of Canadian financial institutions.

The 1999 Act promotes competition in Canada by allowing foreign banks to offer certain products and services directly through branches, rather than through separate banking subsidiaries. It provides foreign banks greater flexibility, and the possibility of lower costs, in carrying out Canadian operations.

The 2001 Act implements significant changes to the structure of the Canadian financial services sector. For example, it expands in-pillar and cross-pillar access, thereby blurring the distinction between the different types of financial institutions, and essentially eroding what is left of the traditional "four pillars" of the financial services sector.⁸ It also clarifies the Bank Act's foreign bank provisions, without making any substantial changes to Canada's foreign bank policy.

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4. Task Force, *Report of the Task Force: Change Challenge Opportunity* (Sept. 14, 1998), available at <http://finservtaskforce.fin.gc.ca/rpt/report.htm> (last visited Sept. 7, 2002) (hereinafter "Report"). The Report is similar in many respects to Australia's Wallis Inquiry report. The Australian government established the Wallis Inquiry in June 1996 to review the legislative and regulatory framework of the Australian financial system. The report came out in March 1997 (see Financial System Inquiry, *Financial System Inquiry Final Report* (Mar. 18, 1997)).
 5. Report, *supra* note 4, at 99-101.
 6. FRFI that are subject to the 2001 Act amendments are banks, federally incorporated or registered trust and loan companies, insurance companies, and cooperative credit associations.
 7. Department of Finance, *Reforming Canada's Financial Services Sector: a Framework for the Future* at 11 (Jun. 25, 1999), available at http://www/fin.gc.ca/toce/1999/finserv_e.html (hereinafter referred to as the "Policy Paper").
 8. The four pillars of the Canadian financial services marketplace refer to banks, insurance companies, trust companies, and securities dealers.
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Among the most significant changes the 2001 Act makes, are new ownership rules that permit Canadian and foreign entities to increase their interest in Canadian banks and, in certain circumstances, acquire these banks entirely. Rules governing a merger of large domestic banks are also established in guidelines released at the time the 2001 Act was tabled in Parliament. Demutualized Canadian life insurance companies are also permitted to merge with other insurers. Similar to the Canadian banks, domestic and foreign companies are permitted to increase their interest in and, in certain circumstances, acquire these insurers entirely. Moreover, regulated holding company regimes for both Canadian banks and insurance companies are implemented for the first time. Bank holding companies (BHC), and insurance holding companies (IHC) provide their respective financial institutions greater structural flexibility by allowing activities and business to be transferred to an affiliate of the bank or insurance company. New rules also give Canadian FRFIs the opportunity to reposition themselves in a more efficient regulatory environment, while becoming subject to additional consumer protection provisions.

This paper provides a brief overview of some of the most significant changes brought about by the 1999 Act and the 2001 Act.⁹

II. The 1999 Act

Prior to the 1999 Act, foreign banks wishing to carry on banking business in Canada were generally required to open a representative office, or establish a separate banking subsidiary. The activities of a representative office are limited to promoting the services of the foreign bank, and acting as a liaison with clients of the foreign bank. Banking subsidiaries must be separately capitalized, and must incur the cost of corporate governance structures, which can be extensive and even excessive for institutions doing only a small amount of business in Canada.

The Canadian government viewed such limited entry options as creating unnecessary regulatory barriers to increased competition.¹⁰ Accordingly, it enacted the 1999 Act. This Act maintains the representative office and banking subsidiary options, but gives foreign banks that wish to branch directly into Canada the option of two types of branches—a full-service branch (FSB), and a lending branch (LB).

The procedure to set up a branch is a two-step process. The Minister must authorize, and the Superintendent of Financial Institutions (the Superintendent) must approve, the commencement and carrying on of business in Canada.¹¹ The Office of the Superintendent of Financial Institutions (OSFI), the prudential regulator over Canadian FRFIs, has published the *Guide to Foreign Bank Branching*¹² to assist with this procedure.

9. All references to United States currency are based on the February 15, 2002 opening exchange rate. As of February 15, 2002, C \$1 = U.S. \$0.6287.

10. See Policy Paper, *supra* note 7, at 41. The Task Force criticized the limited options available to foreign banks as being "protectionist barriers." Report, *supra* note 4, at 99.

11. See Bank Act S.C., ch. 46, §§524(1) & 534(1) (amended 1999) (Can.).

12. Office of the Superintendent of Financial Institutions, *Guide to Foreign Bank Branching: Criteria, Information Requirements and Procedures for the Establishment and Commencement of Business of a Foreign Bank Branch in Canada* (updated Sept. 2000) available at <http://www.osfi-bsif.gc.ca/erg/publications/guides/pdf/fbbguide.pdf> (last visited Sept. 7, 2002) (hereinafter referred to as the "*Guide to Foreign Bank Branching*").

Generally, a foreign bank is qualified to establish a FSB if it can satisfy three elements. First, the foreign bank must have at least C \$5 billion (U.S. \$3.14 billion) consolidated assets on a worldwide basis. This criterion, however, does not apply to LBs. Second, it must demonstrate both a favorable financial performance over the past five years, and a proven track record in international banking. Third, the foreign bank's home country must regulate it in an acceptable manner.¹³

A FSB is required to maintain, at all times, capital equivalency unencumbered deposits of acceptable assets with an approved Canadian financial institution equal to the greater of C \$5 million (U.S. \$3.14 million), or 5 percent of the branch liabilities in respect of Canadian business.¹⁴ A LB is required to maintain assets on deposit equal to C \$100,000 (U.S. \$62,870) with an approved Canadian financial institution.¹⁵ These capital requirements are generally considered to be lower than those imposed on banking subsidiaries, which require C \$5 million and compliance with OSFI's assets-to-capital multiple and risk-based capital tests. As part of the initial approval process, or subsequent to the commencement of operations, however, the Superintendent may impose more stringent asset maintenance requirements on a branch.¹⁶ This power is used to safeguard the branch's depositors and creditors by ordering that the branch maintain additional eligible assets in Canada.

A FSB is generally prohibited from taking retail deposits, but is permitted to take wholesale deposits of C \$150,000 (U.S. \$94,310) or more, and deposits from "prescribed entities," such as sophisticated investors.¹⁷ A LB, on the other hand, is prohibited from accepting deposits. It is, however, permitted to borrow on the inter-bank market by means of financial instruments that cannot be sold or traded, and is also permitted to issue guarantees/acceptances that are not intended to be sold or traded except to other financial institutions.¹⁸ In contrast to both types of branches, a banking subsidiary has access to unlimited funding in the inter-bank, wholesale, and retail markets.

Funding capability is the most significant impediment imposed on branches. FSB's are restricted to wholesale deposits, except for deposits of less than C \$150,000 (U.S. \$94,310) that represent 1 percent or less of total deposit liabilities.¹⁹ Because LBs are restricted to the inter-bank market; they find themselves in precarious situations where they must borrow from Canadian banks, which are their main competitors. Furthermore, LBs must borrow by means of "financial instruments that cannot be sold or traded,"²⁰ which are illiquid assets from the funders' standpoint. FSB and LB credit limits, however, are based on foreign bank capital and not merely on branch assets or capital, whereas banking subsidiaries' credit limits are based on their own capital. If funding issues are

13. See *id.* at 10.

14. See Bank Act, §582(1)(b) (amended 1999).

15. See §582(1)(a).

16. See §617.

17. See §546(1); see also Prescribed Deposits (Authorized Foreign Banks) Regulations, SOR/2000-53 (Can.).

18. See Bank Act, §540.

19. See §545; see also Prescribed Deposits (Authorized Foreign Banks) Regulations, SOR/2000-53 (Can.).

20. Bank Act, §536(1).

overcome, branches are usually the preferred vehicle to carry on business in Canada. As of February 15, 2002, fourteen FSBs and two LBs had been established.²¹

In contrast to banking subsidiaries, branches do not require a board of directors and are not generally required to deal with corporate governance issues. Rather, a Canadian resident employee must be appointed as principal officer of the branch.²² The principal officer is OSFI's contact person and is responsible for maintaining records at the branch, with sufficient detail to identify the branch's business, and enable OSFI to conduct an examination of the branch. While branches are subject to reporting requirements, the requirements are lighter than those imposed on banking subsidiaries. Branches must annually report their conditions and affairs, unclaimed deposits, and unclaimed bills of exchange,²³ as well as other information requested by OSFI.²⁴ OSFI is also required to inspect the business and affairs of branches to ensure compliance with the Bank Act (Canada).²⁵ OSFI must conduct a FSB inspection at least once a year, but it has the discretion as to the frequency of LB inspections,²⁶ which are generally expected to be less frequent.

Like banking subsidiaries, FSBs are entitled to become members of the Canadian Payment Association (CPA) and, subject to the Bank of Canada's approval, a designated clearing and settlement system.²⁷ LBs have access only to the latter, subject to the Bank of Canada's approval.²⁸

Both types of branches, however, are subject to substantially the same annual audit requirements as banking subsidiaries. External auditors are required, and must provide, the principal officer and OSFI²⁹ with a report prepared in accordance with generally accepted Canadian accounting principles, that presents fairly the financial position of the branch's business.³⁰

In the case of branch liquidation, OSFI is authorized to seize all the Canadian assets of the foreign bank to satisfy the claims of the branch's depositors and creditors.³¹ If these assets are insufficient, recourse to the foreign bank's liquidator in its home jurisdiction can be sought.

Foreign banks that choose to operate an LB are prohibited from also operating a banking subsidiary or a FSB.³² Foreign banks, however, may operate both a banking subsidiary and an FSB. Foreign banks that operate a banking subsidiary must, therefore, decide whether to establish an FSB and if so, whether to retain the subsidiary. Funding

21. These figures are posted on OSFI's web site at <http://www.ofsi-bsif.gc.ca> (last visited Sept. 7, 2002).

22. See Bank Act, §536(1).

23. See §§601-603.

24. See §600.

25. See §613.

26. See §613.

27. See §542.

28. See Canadian Payments Act, R.S.C., ch. C-21, §1(2001) (Can.). The definition of "authorized foreign banks" excludes LB's from the application of the Canadian Payments Act. See §2.

29. See Bank Act, §§594(1) & 595(2).

30. See §594(2).

31. See §619.

32. See §540(1).

issues are central to this decision. If the foreign bank cannot accept the funding limitations of an FSB or LB, then it will likely want to maintain its subsidiary. If it can accept the funding limitations, it must decide how to set up the FSB. There are two ways to set up the FSB. The foreign bank can either convert the subsidiary into an FSB, or set up the FSB and maintain the subsidiary either on a temporary or permanent basis. The subsidiary then may carry on less business over time and eventually be wound up or its operation permanently reduced.

III. The 2001 Act

A. FOREIGN BANKS IN CANADA

The 2001 Act amendments to Part XII of the Bank Act bring changes in how foreign banks may operate in Canada. The aim of these Part XII amendments is to clarify the complex rules concerning the role, and permitted, activities of foreign banks in Canada.

Under the new rules, foreign banks fall broadly into three categories: (1) regulated foreign banks that have a financial establishment in Canada³³ (a financial foreign bank); (2) regulated foreign banks that do not have a financial establishment in Canada (a nonfinancial foreign bank); and (3) entities that fall within the definition of a foreign bank but that are not considered to be regulated foreign banks (a near bank). Different rules apply to each of these types of foreign banks.

The first two categories of foreign banks are considered to be regulated, because they meet the designation criteria under the 2001 Act, which distinguishes them from near banks. A foreign bank may be designated if it, or its subordinate entities, carries on business in Canada and:

- It is a real foreign bank according to non-Canadian laws.
- It is regulated as a real foreign bank outside Canada.
- It uses the word "bank," "banking," or its equivalent in its corporate name.
- Its corporate group derives a "prescribed material percentage" (35 percent) of its consolidated total assets or revenues from the activities, of such real foreign banks in the corporate group.³⁴

Foreign banks that are designated under the old rules are deemed to be designated under the new rules.³⁵

The 2001 Act imposes a general prohibition on all foreign banks carrying on business or making investments in Canada. Neither a foreign bank, nor an entity associated with it, may carry on business or make investments in Canada unless authorized or otherwise permitted to do so.³⁶

Under the 2001 Act, financial foreign banks are generally permitted to carry on the same financial activities as Canadian banks. In particular, the investments permitted of Financial foreign banks are designed to place them on a level playing field with Canadian

33. The term "financial establishment in Canada" is defined in sections 507(15) and 507(16). See §§507(15) & 507(16).

34. See §§508(1) & 508(2).

35. See §508(3).

36. See §510.

banks. Financial Foreign Banks may acquire, control, or make substantial investments in, among others, the following Canadian entities:

- A FRFI, BHC, or IHC,³⁷ if the Minister grants approval under the ownership provisions of the relevant F.I. Statute.
- A provincially regulated financial institution (PRFI) such as a securities dealer, a trust, loan, or insurance company, or a cooperative credit society,³⁸ if the Financial Foreign Bank is designated³⁹ and, in certain circumstances, if the Minister grants approval.⁴⁰
- Other financial intermediaries such as a factoring, financial leasing, or finance entity,⁴¹ if the Financial Foreign Bank is designated⁴² and, in certain circumstances, if the Minister grants approval.⁴³
- A financial agent, including a mutual fund entity or a mutual fund distribution entity, either acting as financial agent or providing investment counseling services, portfolio management services, networking of financial services,⁴⁴ if the Financial Foreign Bank is designated.⁴⁵
- An investment holding entity, including a specialized finance entity,⁴⁶ if the Financial Foreign Bank is designated.⁴⁷

Recognizing that many countries allow banks to own commercial enterprises, the 2001 Act grants the Minister with the power to allow a Financial Foreign Bank to invest in certain limited commercial businesses in Canada. The business must be the same as, similar to, related to, or incidental to the business outside of Canada of the Financial Foreign Bank, or an entity associated with it.⁴⁸ However, no Financial Foreign Bank or its associated entities may carry on or invest in automobile leasing activities, which are prohibited to Canadian banks.⁴⁹

Nonfinancial foreign banks are essentially permitted to only engage in commercial activities, and have unlimited commercial holdings in Canada.⁵⁰ They and their associated entities, may not control or be a person, or associated group, that owns more than twenty percent of any class of voting shares, or thirty percent of any class of nonvoting shares (a Major shareholder⁵¹) of a Canadian FRFI, PRFI, BHC, IHC, or financial services provider.⁵² They may, however, acquire any other Canadian entity.

37. See §522.07.

38. See §522.07.

39. See §§522.21(1)(a)(i), 522.21(2)(a)(i), 522.21(3)(a)(i), or 522.21(4)(a)(i).

40. See §522.22(1)(b).

41. See §522.08(1)(a).

42. See §§522.21(1)(a)(ii), 522.21(2)(a)(ii), 522.21(3)(a)(ii), or 522.21(4)(a)(ii).

43. See §522.22(1)(b).

44. See §§522.08(1)(a) & 522.08(1)(e).

45. See §§522.21(1)(a)(ii), 522.21(2)(a)(ii), 522.21(3)(a)(ii), or 522.21(4)(a)(ii).

46. See §522.08(1)(b); see also Specialized Financing (Foreign Banks) Regulations, SOR/2001-432 (Can.).

47. See Bank Act, §§522.21(1)(a)(ii), 522.21(2)(a)(ii), 522.21(3)(a)(ii), or 522.21(4)(a)(ii).

48. See §522.09.

49. See §522.08(2).

50. See §522.05.

51. See §2.2; see also Insurance Companies Act, §2(3).

52. See Bank Act, §522.04.

Finally, Near banks may apply for an exemption order from the Minister relieving them from the application of most of the Part XII requirements, including the general prohibition on foreign banks carrying on business in Canada.⁵³ Near banks that have section 521 consent orders under the old rules, are deemed to have an exemption order under the new rules.⁵⁴ With proper exemption orders, Near banks may therefore carry on unregulated activities in Canada, including asset-based lending, wholesale finance, and automobile leasing.

Unless an exemption is granted, all foreign banks and entities associated with them, in which a Ministerial decision has been made, must provide annual financial statements, a list of their activities and businesses, and other prescribed information to OSFI.⁵⁵ In addition, if foreign banks or entities associated with them contravene a particular section of the 2001 Act, or fail to comply with any terms and conditions of an order, the Minister may require them to divest their investment.⁵⁶

The 2001 Act establishes a number of transitional or grandfathering provisions focusing on investments that may no longer be permitted to designated foreign banks and entities associated with them.⁵⁷ Designated foreign banks with existing Ministerial orders may continue to hold investments, so long as they disclose to the Minister the nature of the entities' businesses, and those activities do not change.⁵⁸

B. CANADIAN BANK AND INSURANCE COMPANY OWNERSHIP REGIMES

The 2001 Act implements new ownership regimes in the Bank Act (Canada), and the Insurance Companies Act (Canada), that are based on shareholder equity as reported in financial statements. Canadian banks and insurance companies are generally placed in the following categories:⁵⁹

- Large banks and large demutualized insurance companies with equity of C \$5 billion (U.S. \$3.14 billion) or more.
- Medium-sized banks and medium-sized insurance companies with equity of C \$1 billion (U.S. \$628,700) or more, but less than C \$5 billion (U.S. \$3.14 billion).
- Small banks and small insurance companies with equity of less than C \$1 billion (U.S. \$628,700).

Ownership rules that distinguished between widely-held Schedule I Canadian banks, and closely-held Schedule II Canadian and foreign-owned banks have disappeared. All Canadian banks are now listed in Schedule I, all foreign-owned banking subsidiaries

53. See §509.

54. See §509(3).

55. See §522.27.

56. See §522.25.

57. See §§522.29-522.33.

58. See §§522.29-522.33.

59. Stock insurance companies that have not come into existence as a result of a demutualization will generally be treated as a mid-sized company regardless of the size of their shareholder's equity.

are now listed in Schedule II, and all foreign bank branches continue to be listed in Schedule III.

Large banks and large demutualized insurance companies⁶⁰ are required to be widely-held. Previously, this widely-held rule restricted any shareholder from having more than a ten percent interest in any class of shares. With a view to accommodate significant transactions in both the Canadian and cross-border markets, the Task Force recommended that this widely-held rule be relaxed. The Task Force agreed that a more flexible widely-held rule would facilitate acquisitions of and alliances with foreign financial institutions and corporations.⁶¹ Such transactions could lead to innovative products and delivery channels for the Canadian market, platforms from which to offer services to Canadian customers doing business abroad, and expansion into foreign markets.⁶²

The 2001 Act provides this flexibility. If the Minister is now satisfied with the character and integrity of the applicant or, in the case of a body corporate, is satisfied that it is operated by individuals with suitable reputations, a widely held bank or insurance company is now one that does not have a Major shareholder. No one, however, through investment or otherwise, may be in a position to exercise control over the institution.⁶³

The legislation does not clearly define what is meant by control. For the purposes of the 2001 Act, a person has control⁶⁴ if a person has any direct or indirect influence that, if exercised, would result in that person having control of the institution in fact. For greater certainty, the 2001 Act provides that the Minister may issue guidelines outlining what constitutes control, including a description of policy objectives, and the relevant provisions of the 2001 Act are meant to achieve.⁶⁵ Such guidelines are expected to be released by the spring of 2002.

Widely-held banks and certain other eligible financial institutions that control other banks, that has less than the C \$5 billion (U.S. \$3.14 billion) in equity, are allowed to retain shares in the bank's equity if it later exceeds the C \$5 billion threshold.⁶⁶ Generally, a bank that becomes large through growth or acquisition may meet the widely held requirement through a widely held Canadian or foreign financial institution parent, or regulated BHC or IHC.⁶⁷ Other widely held entities cannot be a Major shareholder in such a bank.⁶⁸

Although a public float of 35 percent of voting shares is required, medium-sized banks and insurance companies are allowed to be closely held⁶⁹ with prior approval

60. The Minister, however, by order may provide that the widely held regime no longer applies to a large demutualized insurance company. See Insurance Companies Act, §467(8).

61. See Report, *supra* note 4, at 84.

62. See *id.*

63. See Bank Act, §377(1); see also Insurance Companies Act, §407.2.

64. Section 3(1) of the F.I. Statutes also defines control to include other circumstances such as ownership if more than 50 percent of the voting shares of the entity. See the F.I. Statutes, §3(1).

65. See §3(4).

66. See Bank Act, §374.

67. See §374.

68. See §374.

69. See §396; see also Insurance Companies Act, §420. In addition, the Minister is prohibited from granting approval for the acquisition of more than 10 percent of the shares of a bank to any person or entity which carries on (or whose affiliate carries on) automobile or certain other leasing activities in Canada. See Bank Act, §378.2.

from the Minister.⁷⁰ The public float requirement means that thirty-five percent of the voting shares must be publicly traded on a Canadian stock exchange.⁷¹ As a result, a Major shareholder, including a commercial enterprise, is allowed to hold up to 65 percent of the outstanding voting shares, and indeed 100 percent of the common shares (if a class of voting preferred shares was issued) of a medium sized bank or insurance company. In certain circumstances, including where the Minister approves, the public float requirement can be satisfied by an upstream holding company.⁷² Small banks and insurance companies are not subject to any ownership restrictions other than to receive prior approval from the Minister for an acquisition of greater than 10 percent of the shares.⁷³

Although the National Bank of Canada, the Laurentian Bank of Canada, and the Canadian Western Bank, all have equity of less than C \$5 billion (U.S. \$3.14 billion), the 2001 Act deems these banks to be entities with equity of more than C \$5 billion.⁷⁴ Consequently, these medium and small-sized banks cannot be acquired, as they must be widely held. The Minister, however, has the power to revoke this treatment and recategorize these banks as medium-sized (or small banks as the case may be), so long as the banks' equity remains below the C \$5 billion level. As a matter of policy, the Minister will consider regional interests when deciding whether to recategorize these entities.⁷⁵ Furthermore, a recategorization of a medium-sized bank (namely, the National Bank of Canada) that results in the acquisition or control of the institution, is subject to a public review process similar to that for mergers of large banks, which will be discussed later.⁷⁶

C. CANADIAN BHCs AND IHCs

The 2001 Act permits, for the first time, Canadian widely held banks and insurance companies to be owned by regulated, nonoperating Canadian holding companies.⁷⁷ Ownership restrictions on the new holding companies are essentially the same as those on banks and insurance companies—based on shareholder equity.⁷⁸ For example, BHCs are divided into the same three categories as banks, depending on their equity. The same investment restrictions apply within each category.⁷⁹ Therefore, it is possible for BHCs, with equity under C \$5 billion (U.S. \$3.14 billion), to be, like banks, owned and controlled by a commercial enterprise.⁸⁰ It also remains true that a BHC that controls a current Schedule I bank with equity under C \$5 billion is deemed to be a large BHC.⁸¹

70. See §384–92; see also, Insurance Companies Act, §§411–18.

71. See Bank Act, §385; see also Insurance Companies Act, §411.

72. See Bank Act, §388; see also Insurance Companies Act, §411.

73. See Bank Act, §373.

74. See §378.

75. See *Recategorization Guidelines for Former Schedule I Banks With Equity of Less Than \$5 Billion*, Ottawa: Dept. of Fin. News Release 01-014 (Feb. 7, 2001).

76. See *id.*

77. See Bank Act, §662; see also Insurance Companies Act, §699.

78. See Bank Act, §876.

79. See §§873–904.

80. See §§893 & 906.

81. See §884.

Demutualized companies that established nonoperating insurance companies under the Insurance Companies Act at the time they demutualized, may continue those companies as an IHC.⁸²

However, differences exist between the widely held rule applicable to BHCs and IHCs. In particular, an IHC, with equity of less than C \$5 billion (U.S. \$3.14 billion), is permitted to grow beyond C \$5 billion in equity without any other ownership restrictions except the 35 percent public float requirement.⁸³

The holding company structure allows banks and insurance companies to engage in activities that they presently conduct in-house, either through a subsidiary or through a "sister corporation" or affiliate. Depending on the particular activity, an affiliate of a bank or insurance company owned by a BHC or IHC, respectively, may be subject to less regulation and supervision, than the bank or insurance company itself. The holding company feature provides greater structural flexibility to compete with unregulated entities, such as Near banks that obtain exemptions from Part XII requirements of the Bank Act (Canada). The flexibility also facilitates the raising of external capital, and creation of alliances with both Canadian and foreign business partners. The 2001 Act also recognizes other ways to create a holding company, other than by incorporation. These methods include the continuation of an existing company as a holding company, or the amalgamation of two or more entities to form the holding company.⁸⁴

D. PERMITTED ACTIVITIES AND INVESTMENTS—CANADIAN FRFIs, BHCs, AND IHCs

Permitted activities of BHCs and IHCs include acquiring, holding, and administering permitted investments, as well as providing management, advisory, financing, accounting, and information processing services to entities in which they have substantial investments.⁸⁵ BHCs and IHCs, however, are not permitted to undertake any core financial services functions.⁸⁶

Permitted investments of BHCs and IHCs are the same as for banks and insurance companies, and include investments in entities defined as financial services providers formed, and regulated, under federal or provincial legislatures of Canada. Such financial services providers include banks, BHCs, insurance companies, IHCs, trust corporations, loan companies, co-operative credit societies, investment dealers, and foreign entities primarily engaged outside Canada in a business that, if conducted in Canada, would be the business of one of the entities referred to above.⁸⁷

A FRFI, BHC, or IHC is permitted to invest in any entity that provides a service that an FRFI itself could provide.⁸⁸ This policy is reflected through three new categories

82. See Insurance Companies Act, §719.

83. See §938.

84. See Bank Act, §§682–8 §803–12; see also Insurance Companies Act, §§719–25 & 857–66.

85. See Bank Act, §922; see also Insurance Companies Act, §963.

86. Bank Act §922.

87. See Bank Act, §§468(1) & 930(1); see also Insurance Companies Act, §§495(1) & 971(1).

88. See Bank Act, §§468(2) & 930(2); see also Insurance Companies Act, §§495(2) & 971(2); Trust and Loan Companies Act, §453(2); Cooperative Credit Associations Act, §390(2).

of investments. The first category includes entities that limit their activities to providing financial services that an FRFI is permitted to provide under the 2001 Act, other than deposit-taking, fiduciary services, certain leasing activities, high ratio mortgages on residential properties, underwriting insurance, and certain securities dealing activities.⁸⁹ This enables FRFIs to, for the first time, establish separate legal entities to engage in consumer or commercial lending activities that are not directly subject to any licensing or capital requirements under the F.I. Statutes.⁹⁰

The second new category, includes entities that engage in activities related to the promotion, sale, delivery, or distribution of a financial product, but that do not themselves provide a financial service.⁹¹ This category also includes entities that do provide a financial service, but that offer a significant portion of such business to the FRFI, or another member of the FRFI's group of companies. Such an ability to invest in entities that offer services to customers outside the FRFI's group, represents a relaxation of the current permitted investment regime.

The third category of investments is service entities. Under this category, a FRFI, BHC, or IHC may invest in an entity that provides services to financial institutions, other financial service providers, and their affiliates.⁹² This category is a somewhat more flexible elaboration of the permitted investment rules, with respect to service corporations.

In addition to these three categories of investments, the legislation continues to permit a FRFI, BHC, or IHC to invest in mutual funds and their related distribution corporations, real property brokerage entities, downstream holding entities, specialized financing entities, and information services entities.⁹³ Permitted activities of FRFIs have also been clarified, if not expanded, to include the operation of data transmission systems, information sites, communication devices, and information platforms or portals.⁹⁴

These new investment categories are subject to limitations, as FRFIs, BHCs, and IHCs must control certain investments of theirs. Such investments include those in other financial institutions, and entities that engage in financial intermediary activities that expose the entity to material market or credit risk.⁹⁵ The Minority Investment Regulations made under each of the F.I. Statutes, however, continue to apply and now apply

89. See Bank Act, §§468(2)(a), 468(3), 930(2)(a), & 930(3); see also Insurance Companies Act, §§495(2)(a), 495(3), 971(2)(a), & 971(3); Trust and Loan Companies Act, §§453(2)(a) & 453(3); Cooperative Credit Associations Act, §§390(2)(a) & 390(3).

90. Some of these entities, however, may be subject to provincial regulation or licensing.

91. See Bank Act, §§468(2)(d) & 930(2)(d); see also Insurance Companies Act, §§495(2)(d) & 971(2)(d); Trust and Loan Companies Act, §453(2)(d); Cooperative Credit Associations Act, §390(2)(d).

92. See Bank Act, §§468(2)(c) & 930(2)(c); see also Insurance Companies Act, §§495(2)(c) & 971(2)(c); Trust and Loan Companies Act, §453(2)(c); Cooperative Credit Associations Act, §390(2)(c).

93. See, Bank Act, §§468(2)(e) & 930(2)(e); see also Insurance Companies Act, §§495(2)(e) & 971(2)(e); Trust and Loan Companies Act, §453(2)(e); Cooperative Credit Associations Act, *supra* §390(2)(e).

94. See Bank Act, §410(1)(c.1); see also Insurance Companies Act, §441(1)(d.1); Trust and Loan Companies Act, §410(1)(c.1); Cooperative Credit Associations Act, §376(1)(h).

95. See Bank Act, §468(4); see also Insurance Companies Act, §495(6); Trust and Loan Companies Act, §453(4); Cooperative Credit Associations Act, §390(4).

to BHCs and IHCs, permitting the FRFI, BHC, and IHC, under certain terms and conditions, to make minority investments in entities that the FRFI, BHC, or IHC would otherwise be required to control.⁹⁶

E. CANADIAN BANK AND INSURANCE COMPANY JOINT VENTURES

Both the Bank Act and the Insurance Companies Act, contain what is referred to as the "tainting rule." This rule prohibits anyone from being a Major shareholder of any Canadian bank that is a subsidiary of any large bank. It also prohibits anyone from being a Major shareholder of any Canadian insurance company that is a subsidiary of a large insurance company. If this situation were to present itself and not be eliminated within one year, the bank or the insurance company would be required to divest its interest in the subsidiary. To provide additional latitude, the restriction is waived for bank and insurance company subsidiaries, as long as the subsidiaries have less than C \$250 million (U.S. \$157,175) of equity.⁹⁷

F. LARGE CANADIAN BANK AND BHC MERGER REVIEW

One of the goals of the 2001 Act is to allow Canadian-based financial institutions to become large enough to compete internationally, while maintaining a reasonable degree of domestic competition. Large banks and large BHCs, are permitted to merge with any other federally incorporated bank or institution (including BHCs, insurance companies, IHCs, trust or loan companies, and nonregulated business corporations), and continue as one bank or BHC. However, as a matter of policy, large banks are not permitted to merge with large demutualized insurance companies and *vice versa*.⁹⁸ This policy rule also applies to large BHCs and large IHCs.⁹⁹

The new ownership restrictions also apply in the context of mergers. If a large bank or large BHC were to merge with another institution, the new merged entity would be required to be widely-held.¹⁰⁰ Rules governing such mergers require the reviews of competition issues by the Competition Bureau, and prudential issues by OSFI.¹⁰¹ They also require the parties to the proposed merger to prepare a Public Interest Impact Assessment (PIIS).

96. See Minority Investment (Banks) Regulations, 2001 C.R.C. SOR/2001-402; Minority Investment (Bank Holding Companies) Regulations, 2001 C.R.C. SOR/2001-401; Minority Investment (Insurance Companies) Regulations, 2001 C.R.C. SOR/2001-404; Minority Investment (Insurance Holding Companies) Regulations, 2001 C.R.C. SOR/2001-405; Minority Investment (Trust and Loan Companies) Regulations, 2001 C.R.C. SOR/2001-406; Minority Investment (Cooperative Credit Associations) Regulations, 2001 C.R.C. SOR/2001-403.

97. See, Bank Act, §376.01; see also Insurance Companies Act, §407.02.

98. Department of Finance, News Release 2001-014, *Summary of Key Legislative Measures and Statements of Government Policy* (Ottawa: Department of Finance, February 7, 2001) (hereinafter Press Release).

99. *Id.*

100. *Id.*

101. Department of Finance, News Release 01-014, *Merger Review Guidelines* (Ottawa: Department of Finance, February 7, 2001).

The PIIS must outline the costs and benefits of the proposed merger. This can include external considerations, such as the impact on sources of financing for individuals, and for small to medium-sized business, as well as regional impacts of branch closures.¹⁰² This can also include internal considerations, such as impact on employment, and on abilities to develop and adopt new technologies.¹⁰³

The House of Commons Standing Committee on Finance, and the Standing Senate Committee on Banking, Trade, and Commerce (the Parliamentary Committees) will be asked to review the PIIS, and conduct public hearings into the public interest issues related to the proposed merger. The Competition Bureau, OSFI, and the Parliamentary Committees will then report to the Minister. The decision whether to approve, and on what terms, is ultimately up to the Minister, who will consider prudential, competition, and public interest concerns when coming to a decision.¹⁰⁴ If the concerns are not capable of being addressed, the Minister will deny the proposed merger. If the concerns can be addressed, the Competition Bureau and OSFI will negotiate competition and prudential remedies, as the case may be, and will assist the Department of Finance in negotiating public interest remedies. Following the successful negotiation of remedies, the Minister will approve the proposed merger with undertakings reflecting the remedies.¹⁰⁵

G. MEASURES TO EMPOWER AND PROTECT CANADIAN CONSUMERS

With an emphasis on facilitating competitiveness and organizational change, the Task Force recommended a number of provisions designed to ensure the continued protection of Canadian consumers. The 2001 Act includes a number of provisions that deal with preserving the best interests of consumers.

The 2001 Act establishes the Financial Consumer Agency of Canada (FCAC) to enforce the consumer-oriented provisions of the F.I. Statutes, and monitor the industry's self-regulatory initiatives. The FCAC is designed to protect the interests of consumers and small businesses, promote consumer awareness, and respond to general consumer inquiries.¹⁰⁶

Subject to any regulations made by the Governor in Council, banks, federal trust and loan companies, and federal co-operative credit associations in Canada are required to give notice of a branch closure.¹⁰⁷ After notice is given, but before the branch is closed, the FCAC's Commissioner (the Commissioner) can, in prescribed situations, require a bank to meet with him or her, and any interested parties, to exchange views about the closing or cessation of activities.¹⁰⁸ This is the extent of the Commissioner's powers, however. He or she has no power to enforce or prohibit a closure, or change a closure schedule.

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.*

106. Financial Consumer Agency of Canada Act, S.C., ch. 9, §§3-6 (2001) (Can.).

107. See Bank Act, §459.2; see also Trust and Loan Companies Act, §444.1; Cooperative Credit Associations Act, §385.27.

108. See Bank Act, §459.2; see also Trust and Loan Companies Act, §444.1; Cooperative Credit Associations Act, §385.27.

Banks, trust and loan companies, and insurance companies with C \$1 billion (U.S. \$628,700) or greater in equity, now have to publish annual statements describing their contribution, and that of their prescribed affiliates, to the Canadian economy and society.¹⁰⁹ These statements must be filed with the Commissioner and be disclosed to customers and the public.¹¹⁰

Banks are now required to allow individuals to open a retail account without a minimum deposit or the maintenance of a minimum deposit.¹¹¹ Eight banks have also signed memoranda of understanding with the Canadian government, in which they agree to offer low-cost accounts to their customers.¹¹² In addition, the current Bank Act restrictions on coercive tied selling are broadened to cover the purchase of any financial product, as a condition of obtaining another product, not just loans.¹¹³

H. MEASURES TO IMPROVE THE CANADIAN REGULATORY ENVIRONMENT

The 2001 Act changes the mandate of the CPA to better define its role in the payment system and clarify its objectives.¹¹⁴ The 2001 Act also increases the size of the CPA board, allowing the appointment of three independent directors by the Minister.¹¹⁵

In support of initiatives to further competition in the financial services sector, the 2001 Act provides the Superintendent with increased supervisory powers to deal with the possibility for additional risk in the system.¹¹⁶ To reduce regulatory compliance obligations on federal financial institutions, the 2001 Act first converts a number of applications formerly requiring Ministerial approval to the Superintendent, thus expediting the approval process.¹¹⁷ Second, it establishes a new notice-based approval system for many of the applications that require the Superintendent's approval.¹¹⁸

IV. Conclusion

The 1999 Act is designed to encourage a stronger foreign bank presence in Canada. Such a presence will hopefully lead to a wider range of financing sources for all types of Canadian businesses, as well as to a greater choice for some types of consumer lending.¹¹⁹

109. See Bank Act, §459.3; see also Trust and Loan Companies Act, §444.2; Insurance Companies Act, §489.1.

110. See Bank Act, §459.3; see also Trust and Loan Companies Act, §444.2; Insurance Companies Act, §489.1.

111. See Bank Act, §448.1.

112. Department of Finance, News Release 01-014, *Low-Cost Accounts Memoranda of Understanding* (Ottawa: Department of Finance, February 7, 2001).

113. See Bank Act, §459.2.

114. See Canadian Payments Act, R.S.C., ch. 21, §5 (1989) (Can.).

115. See §§8 & 9(1.1).

116. See Office of the Superintendent of Financial Institutions Act, R.S.C., ch.18, §6 (1985) (Can.).

117. See Bank Act, §976; see also Trust and Loan Companies Act, §529.1; Insurance Companies Act, §1019; Cooperative Credit Associations Act, §461.1.

118. See Bank Act, §976; see also Trust and Loan Companies Act, §529.1; Insurance Companies Act, §1019; Cooperative Credit Associations Act, §461.1.

119. Policy Paper, *supra* note 7, at 42.

The 2001 Act will hopefully provide FRFIs with the latitude to adapt to, and thrive in, an era of change and global competition.¹²⁰ In addition to the measures discussed above, the new financial services framework: (1) maintains the practice of mandatory five-year review of the F.I. Statutes; (2) demonstrates flexibility on the part of the Canadian government to revisit the F.I. Statutes prior to the five-year review, when necessary, to keep up with the changing marketplace; and (3) increases the Canadian Government's ability to adjust the framework as needed between legislative initiatives.¹²¹

120. Press Release, *supra* note 97.

121. *Id.*
