CORPORATE

FINANCE

BULLETIN

October 2002

Activities and Investments in Canada by Foreign Banks and Other Foreign Financial Services Companies

The *Bank Act* of Canada governs the entry into and operations in Canada of all entities that fall within the broad meaning of the term "foreign bank" as defined in the *Bank Act*.

This definition includes any entity that is called a bank or that is regulated as a bank in any jurisdiction in which it carries on business, or that engages in the business of lending money and accepting deposit liabilities transferable by cheque. It also captures any entity that controls a foreign bank and any entity that engages in the business of providing financial services and is affiliated with a foreign bank.

This bulletin discusses, firstly, banking activities and investments in Canada by a foreign bank and, secondly, other financial (i.e., non-banking) and commercial activities and investments in Canada by a foreign bank.

Banking Activities and Investments in Canada by a Foreign Bank

Under the *Bank Act*, a foreign bank may have a banking presence in Canada in different ways.

Ownership of a Bank Subsidiary

A foreign bank may carry on business in Canada through a bank subsidiary (i.e., a bank that is controlled by the foreign bank) incorporated under the *Bank Act*. These banks are referred to as Schedule II banks — so named because they are listed in Schedule II to the *Bank Act*. A Schedule II bank must be separately capitalized (with a minimum capital requirement of Cdn$5 million), and possesses most of the business powers and is subject to the same limitations and restrictions as a Canadian controlled bank (referred to as a Schedule I bank).

These limitations and restrictions include the following prohibitions:

- except as specifically authorized by the *Bank Act*, dealing in goods, wares or merchandise, or engaging in any trade or other business
- acting as a trustee for a trust or engaging in fiduciary activities
- engaging in certain prescribed personal property leasing activities (including the leasing of automobiles)
- engaging in securities activities to the extent prohibited by regulation
- undertaking the business of insurance except to the extent permitted by the *Bank Act* or by regulation

However, a Schedule II bank (like a Schedule I bank) may engage in many of these activities indirectly through subsidiary companies.

Authorized Foreign Bank Branches

Since 1999 foreign banks have been allowed – if authorized by an order made by the Minister of Finance – to establish a branch in Canada to carry on business in Canada under Part XII.1 of the *Bank Act*. These banks are referred to as "authorized foreign banks" and are listed in Schedule III to the *Bank Act*.

The order of the Minister may authorize a foreign bank to carry on business in Canada either through (i) a "lending branch" or (ii) a "full service branch". The main difference between the two is that a lending branch may not accept deposits in Canada or otherwise borrow money in Canada except in limited ways. On the other hand, a full service branch may accept deposits but only in amounts of over $150,000. Subject to these restrictions relating to accepting deposits and borrowing money, an authorized foreign bank may exercise most of the business powers and is subject to most of the same limitations and restrictions as a Schedule I or Schedule II bank.

A foreign bank may have both a full service branch and a Schedule II bank subsidiary, but is not permitted to have both a lending branch and a Schedule II bank.

The branch in Canada of an authorized foreign bank need not be separately capitalized and may rely on the capital of the authorized foreign bank for the purposes of capital adequacy requirements. However, an authorized foreign bank may not commence business in Canada until it has placed on deposit with a Canadian financial institution unencumbered assets with a value of Cdn.$100,000 in the case of a lending branch or Cdn.$5,000,000 in the case of a full service branch.

Representative Office

A foreign bank may also have a presence in Canada through the establishment of a representative office whose activities are limited to promoting the services of the foreign bank or acting as a liaison between the foreign bank and its clients (i.e., a representative office may not engage in banking operations in Canada).

Ownership of Shares in a Schedule I Bank

A foreign bank may also own up to 20% of the voting shares and up to 30% of the non-voting shares of a Schedule I bank with equity of Cdn$5 billion or more. This is an increase from the previous ownership restriction of 10% of any class of shares, and is intended to provide opportunities for foreign banks and Canadian Schedule I banks to enter into strategic alliances and joint ventures through share exchange arrangements. However, ownership of more than 10% of any class of shares of a Schedule I bank would require the approval of the Minister of Finance and is subject to a prohibition against the Schedule I bank being controlled by the foreign bank.

Other Financial and Commercial Activities and Investments in Canada by a Foreign Bank

Other financial (i.e., non-banking) and commercial activities and investments in Canada by a "foreign bank" (broadly defined as described above) are governed by Part XII of the *Bank Act* which has recently undergone extensive amendments. The main provisions and structure of Part XII are outlined below.

General Prohibition and Exceptions/Permissions

The *Bank Act* provides that except as permitted under Part XII, a foreign bank or an entity associated with a foreign bank shall not

- carry on any business in Canada
- maintain a branch in Canada for any purpose
- maintain in Canada any automated banking machine or remote service unit
- have a "substantial investment" (i.e., more than 10% of voting rights or more than 25% of equity) in a Canadian entity

However, this general prohibition is subject to a lengthy and complex set of exceptions and permitted activities and investments (many of them subject to Ministerial approval) that are set out in Part XII. These provisions distinguish between a foreign bank that has no "financial establishment in Canada" and one that does.

Foreign bank with no Financial Establishment in Canada

A foreign bank that has no "financial establishment" in Canada may

- have a substantial investment in a Canadian entity that is not engaged in financial services
- maintain a branch in Canada or carry on business in Canada so long as less than 10% of its business in Canada and outside Canada consists of certain specified financial activities
- engage in leasing activities in Canada provided that (i) it does not engage in any other activity in Canada and (ii) outside Canada it engages only in leasing activities or activities of a non-financial nature

Foreign Bank with a Financial Establishment in Canada

Generally speaking, a foreign bank that does have a "financial establishment" in Canada is entitled to hold a substantial investment in

- various specified kinds of Canadian financial institutions
- other Canadian entities that provide various types of financial services
- a Canadian entity that is a "limited commercial entity"

As well, certain kinds of foreign banks are entitled to engage in certain specified business activities in Canada through a branch including

- insuring risks in Canada
- dealing in securities
- subject to specified conditions, engaging in certain commercial activities

Designated Foreign Banks

Part XII of the *Bank Act* gives the Minister of Finance the authority to "designate" a foreign bank if it meets certain criteria set out in the Act. Entities that satisfy the criteria for "designation" are commonly referred to as "true foreign banks". Generally, a "true foreign bank" is a foreign bank that carries on business as or is regulated like a bank in another jurisdiction, or that is a member of a corporate group in which the assets and/or revenues of the entities in the group that carry on business as or are regulated like a bank exceed a prescribed threshold (currently 35%). A true foreign bank must obtain a "designation order" from the Minister of Finance in order to engage in certain kinds of activities in Canada or to make certain kinds of investments in Canada. The policy intention underlying these provisions is that a true foreign bank should have similar powers and be subject to similar restrictions as a Schedule I bank (i.e., Canadian owned/controlled) bank regarding the conducting of business and the making of investments in Canada.

Ministerial Approvals

In addition, many kinds of activities and investments in Canada by a foreign bank require the specific approval of the Minister of Finance.

Exemption Orders

The *Bank Act* also gives the Minister of Finance the authority to exempt a foreign bank from most of the rules and restrictions contained in Part XII of the *Bank Act* if the foreign bank does not meet the criteria for designation. Entities that qualify for an "exemption order" are commonly referred to as "near foreign banks". A foreign bank that holds an exemption order is free from most of the approval requirements and restrictions contained in Part XII. This is very important because it allows a foreign bank that has obtained an exemption order to establish or make investments in new or existing businesses in Canada without any requirement for approval from the Minister of Finance. However it should be noted that a foreign bank that has obtained an exemption order has a positive obligation under the *Bank Act* to advise the Minister of Finance of any change in circumstances that may affect its eligibility for a designation order.

Transitionally, an exemption order is deemed to have been made if a foreign bank had obtained a consent order under the former section 521 of the *Bank Act* (i.e., prior to the 2001 amendments) provided that the foreign bank had not been designated under the provisions of that section.

Conclusion

The amendments to the *Bank* Act in 1999 that allowed foreign banks to operate in Canada through branches for the first time, and the extensive amendments to the foreign bank regime contained in Part XII of the *Bank* Act that came into effect in 2001, have gone a very long way in levelling the playing field in relation to the operations in Canada of Canadian and foreign banks and other financial services companies. The 2001 amendments to Part XII of the *Bank Act* have also provided greater transparency to approval procedures for activities and investments in Canada by foreign banks. It now remains to be seen the extent to which these changes will have the intended effect of more competition in Canada in the financial services sector through increased activities on the part of foreign banks and other foreign financial services providers.

For further information, please contact your McMillan Binch lawyer or one of the lawyers listed below:

Pat Forgione	416.865.7798	pat.forgione@mcmillanbinch.com
Cheryl Stacey	416.865.7243	cheryl.stacey@mcmillanbinch.com
Ted Weir	416.865.7050	ted.weir@mcmillanbinch.com
Stephanie Robinson	416.865.7204	stephanie.robinson@mcmillanbinch.com

McMillan Binch LLP

Telephone: 416.865.7000
Facsimile: 416.865.7048
Web: www.mcmillanbinch.com

BCE Place, Suite 4400, Bay Wellington Tower, 181 Bay Street, Toronto, Ontario, Canada M5J 2T3