

REFLECTIONS ON THE CANADIAN PAYMENTS SYSTEMS:
FROM MANUAL CLEARING TO ELECTRONIC FUNDS TRANSFERS

by

ALISON L. KIRBY
B.A., McGill University, 1981
LL.B., The University of Ottawa, 1987

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Department of Faculty of Law

The University of British Columbia
Vancouver, Canada

Date December 10, 1996

ABSTRACT

The Canadian payments system encompasses not only those traditional systems which facilitate the processing of paper payment instructions through the Automated Clearing and Settlement System (ACSS) and or the Bank of Canada but those electronic funds transfer (EFT) systems which are capable of processing payment instructions in purely electronic form. Access to the payments system is a key element in the retail and financial services sectors' bid to remain competitive on both national and global scales. Moreover, a complete system of electronic payments will eventually reduce the need for credit cards and, to the extent that it increases the use of deposits for payment purposes, it will reduce the need for currency and cheques as well. In other words, a truly national electronic funds transfer system will act not only as a "payments system" or financial communications system that will carry payment instructions but a "payment mechanism" which will replace payment for goods and services by cash or cheques.

This paper provides an overview of the national payments systems and identifies some of the problems which have arisen as a result of the changes to the largely paper based systems brought about by the electronic banking age. It identifies the technological advances made in the payments area, the traditional right or obligation arising as a result of the bank-customer relationship, if any, which has been effected by the technological advance, it briefly examines how the

technological advance impacts on this right or obligation; and it raises questions about whether the traditional right or obligation needs to be protected, modified or eliminated and, if so, in what matter. In the end, it is hoped that this paper will serve as a wake up call to consumers and academics about the importance of and the need for greater access to information about the national payments system.

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REFLECTIONS ON THE CANADIAN PAYMENTS SYSTEMS: FROM MANUAL CLEARING TO ELECTRONIC FUNDS TRANSFERS

INTRODUCTION

In recent years, there has been an tremendous increase in the use of computers in banking - not only for record keeping and transfer of data but also for the transfer of funds by electronic means (electronic funds transfers or EFT). Automatic Teller machines¹ (ATM's) are now commonplace as are point-of-sale (POS) systems which allow funds to be transferred electronically from the customer's personal account to the account of the retailer to pay for purchases of goods at retail outlets. Home banking is on the increase as is the use of electronic data interchange (EDI) messages. Banking in all electronic fields is growing quickly².

Yet despite their rapid growth, EFT systems have not yet received widespread legal regulation - whether by statute or voluntary codes. While most countries have long standing legislation covering negotiable payment instruments (such as Canada's Bills of Exchange Act³) hardly any nations have generated comprehensive legislative codes for electronic payments⁴. The inter-operability of payment card systems between

¹ In Canada, Automatic Teller Machines are commonly referred to as Automatic Banking Machines (ABM). While most ATMs are owned and operated by banks, many are owned and operated by other financial institutions. Accordingly, I prefer the more generic term.

² H. Rowe, "Legal Issues between Banks Sharing Networks", (1990) 7 Computer Law & Practice 2

³ Bills of Exchange Act, R.S.C. 1970, c. B-5, s.165

⁴ H. Rowe, "Legal Issues between Banks Sharing Networks", (1990) 7 Computer Law & Practice 2

countries is viewed however as an important element in completion of the global market⁵.

Before Canada can contemplate a standardized set of EFT rules which can be used to regulate the exchange of international trans-border data flow, Canada should first consider whether its own national payments system is adequate to deal with EFTs. This consideration in turn leads to the convoluted question of what exactly is Canada's national payments system and what statutory or voluntary codes regulate it.

At its most basic, the Canadian national payments system is a group of services comprising the national clearings and settlement systems under the administration of the Canadian Payments Association⁶. These clearings and settlement systems have evolved from manual cheque clearing to data centre batch cheque processing and are currently in the process of evolving into systems which will be capable of processing payment information in purely electronic form. It is clear however that the national payments system is intended to encompass much more than simply the clearings and settlement systems⁷. Unfortunately its scope has not been defined. Broadly speaking,

⁵ H. Rowe, "Legal Issues between Banks Sharing Networks", (1990) 7 Computer Law & Practice 2

⁶ B. Crawford, "Legal Influences on the Stability of the National Payments System" (1988) 2 Banking & Finance Law Review 183 at 185. Mr. Crawford takes the view that the national payments system does not include all payments systems that now operate in the country or that may be added in the future.

⁷ The Canadian Payments Association's mandate as set out in its enabling legislation is to establish and operate the national clearings and settlement systems and to "plan the evolution of the national payments system". Obviously, the national payments system is viewed as being something greater than the clearing and settlement systems.

it could encompass any and all systems that are used to process payment mechanisms which facilitate the transmission of funds from a depositor/debtor to his or her creditor.

This paper is intended to provide an overview of the evolution of the national payments systems and to identify some of the problems which have arisen or may arise as a result of the changes to the largely paper based systems brought about by the electronic banking age.

Chapter One provides an overview of the historical formation of our modern Canadian clearings and settlement systems. In it, there is a brief summary of the evolution of the clearing systems: from the development of British banking in the 1600's, through the formation of the London Clearing House in the 1700's and the eventual adoption of the clearing houses in Canada in the 1890's as a subcommittee of The Canadian Bankers Association. It then briefly examines how the Canadian clearing system evolved during its first 90 years: from the 1890's to the 1980's when the Canadian Payment Association was formed to take over the operation of the clearing houses in anticipation of the coming electronic banking age. Finally, it examines the mandates, structure, membership, supervision and early history of the Canadian Payments Association through an examination of its governing legislation, policy statements and publications.

Chapter Two provides an overview of the EFTs systems which are in operation in Canada. First, it looks at the difference between a paper-based and an EFT system,

at various definitions of EFTs and at the growth of EFTs in Canada since the 1980s. It then briefly describes the Canadian domestic EFT services and systems which are in existence or in the planning stage. Finally, it briefly looks at international interbank payments systems and the debt and equity clearing services used by the Canadian Depository for Securities Limited.

Chapter Three provides an overview of the nature of the bank-customer relationship. It focuses, through an analysis of the case law and scholarly texts, on the bank's duty to the customer when collecting cheques. It is essential to understand this relationship (and the rights and obligations that the relationship creates) in order to fully analyze the potentially incompatible powers that a deposit-taking financial institution could exercise under an automated clearing system or EFT system. These rights and obligations are also relevant to the question of whether non deposit taking financial institutions and others should be granted direct access to the national payments system (particularly the POS systems) and, if so, what principles and standards should be applied when granting these parties access.

Finally, Chapter Four considers what changes to the Canadian payments system will likely have to be made to accommodate a truly electronic banking age. It examines issues such as whether Canada needs a new payments code, unfair competition by the deposit-taking financial institutions, the use of computer evidence in the courts, how the deposit-taking financial institutions authenticate the customer's mandate in a paperless

transaction, whether a customer can countermand an EFT, cheque truncation and presentment, whether the customer has a right to access information about the payments systems, privacy concerns and allocation of risk between the customer and the financial institution.

Research Methodology

Generally, I conducted my research by reading and analyzing relevant literature of Canadian, British and American scholars, judgments of Canadian, British and American Courts, Canadian and American statutes and by conducting interviews of individuals knowledgeable in the area of the Canadian payments systems⁸.

Unfortunately, I was able to find very little legal or other literature published about the Canadian payments system. I know of no recent study, text or article which provides an overview of Canadian payments system⁹ as a whole or that even provides a comprehensive definition of those individual systems which make up the payments system. Similarly, I have either been unable to find any information or have only been able to find sketchy and disjointed information about the reason why certain services

⁸ I would like to thank in particular Wendy P. Hope, Director of Communications and Education at the Canadian Payments Association, Tony Sorrenti, John Grace and Doug Wyatt of the Department of Finance, Ottawa.

⁹ As will be described in more detail in Chapter One, in my view the Canadian payments system should be defined as those financial communications systems which process payment instructions that are ultimately cleared and settled through the Automated Clearing and Settlement System and or the Bank of Canada.

and accounts can or should not be accessed through the payments system, how much consumers and others are being charged for the use of the systems and what profits the financial institutions are making from that use, what information is being gathered about Canadians through the use of the various systems and how that information is in turn being used, how the services and fees of one bank or trust company compare with those of another, what voluntary codes or contractual arrangements govern the payments system and so on. As a result of this lack of accessible information, any paper in this area, including this one, is more an 'bverview" of the Canadian payments system than a comprehensive analysis of the amendments which should be made to the present system in light of the technological advances being made.

**CHAPTER ONE: HISTORICAL DEVELOPMENT OF PAYMENTS SYSTEMS:
FROM METALLIC MONEY TO THE CANADIAN
PAYMENTS ASSOCIATION**

(a) Introduction and Overview

Once the barter system, the exchange of goods for goods, was replaced by the payment for the goods with coined money, "payment mechanisms" began to be developed as a means to reduce or eliminate the costs and risks associated with the transportation and physical delivery of money in specie in payment. A payment mechanism which facilitates a standard method of payment through a *banking system* has historically been referred to as a "payments system"¹⁰.

The role of modern banking and thus modern "payments systems" did not develop in England until the 17th century. Prior to the Civil War of the mid-17th century, London merchants deposited their surplus money for safekeeping in the King's mint in the Tower of London. After Charles I unilaterally borrowed £200,000 from their deposits in 1640, the merchants increasingly took their business to goldsmiths who offered the service of safekeeping valuables in addition to their trade in gold and silver. During the Cromwellian period, these goldsmiths evolved into the early English bankers. They issued receipts with respect to moneys deposited with them in favour of a payee or bearer. These receipts, which came to be known as a goldsmith's or bank's notes, contained the goldsmith's undertaking to pay on demand when presented with

¹⁰ B. Geva, The Law of Electronic Funds Transfers, (New York: Matthew Bender & Co. Inc., 1992) at 1-11

the receipt and eventually evolved into an early form of promissory note¹¹. The goldsmiths also began to honour orders from their depositors to pay designated persons up to the amount of deposit. Such drafts, payable on demand and made out to a payee or bearer were the first cheques¹². As the goldsmiths began to make arrangements with their depositors for making loans with the money on deposit, their relationship was converted from bailor-bailee to one of creditor-debtor.

Goldsmith's notes and cheques were *payment mechanisms* which facilitated the transmission of funds from a depositor/debtor to his or her creditor. Through the use of such mechanisms, a debtor could avoid the need to physically deliver coined money to the creditor. Payment was made by delivery of the goldsmith's note or cheque and having the account with the goldsmith debited upon the presentation of the instrument¹³. Following the establishment of the Bank of England and its note issuing powers in the late 17th and early 18th century, the Bank of England's notes competed successfully with goldsmith's notes and finally superseded them as paper money¹⁴.

¹¹ B. Geva, "From Commodity to Currency in Ancient History - On Commerce, Tyranny, and the Modern Law of Money", (1987) 25:1-2 Osgoode Hall Law Journal 115 at 145

¹² W.H. Lawrence, Commercial Paper and Payment Systems, Vol. 1, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 1-10; B. Geva, "From Commodity to Currency in Ancient History - On Commerce, Tyranny, and the Modern Law of Money", (1987) 25:1-2 Osgoode Hall Law Journal 115 at 146

¹³ B. Geva, The Law of Electronic Funds Transfers, (New York: Matthew Bender & Co. Inc., 1992) at 1-8

¹⁴ B. Geva, The Law of Electronic Funds Transfers, (New York: Matthew Bender & Co. Inc., 1992) at 1-9

Throughout the 18th century, increasing mercantile activities forced merchants to adopt money substitutes which would facilitate the transmission of funds from a debtor to his creditor¹⁵. Consequently bills of exchange, cheques and bank notes became circulated widely through several hands before ultimately being presented for payment or acceptance¹⁶. The increased mercantile activity led to an increase in payment transactions which in turn led to the need for a more efficient payments system to deal with the paper embodying the payment transactions. As a result, the early clearing houses evolved.

(b) The Formation of the London Clearing House

Traditionally, a clearing house is an organization of member banks which have associated themselves together for the purpose of effecting the exchanges of cheques and the corresponding debits and credits¹⁷. A cheque which is deposited at a branch of a bank and drawn on an account kept at that branch does not require a clearing arrangement. It requires only internal branch bookkeeping to add the amount of the

¹⁵ W.H. Lawrence, Commercial Paper and Payment Systems, Vol. 1, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 1-11. The need for money substitutes in the eighteenth century was also driven by the fact that England did not have any official paper currency and several denominations of gold and silver coins were in short supply. Bank of England notes did not officially become legal tender until 1833.

¹⁶ W.H. Lawrence, Commercial Paper and Payment Systems, Vol 1, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 1-11

¹⁷ F.R. Andrews, "The Operations of the City Clearing House", (1942) 51 *The Yale Law Journal* 582 at 583

cheque to the depositor's account and to deduct the amount from the payor's account. A clearing arrangement is needed, however, when the deposited cheque is drawn on an account located at another branch of the same bank. Each bank, therefore, has to have its own internal system for clearing cheques among its own branches.

The clearing system proper exists for the clearing of cheques that are drawn on the accounts at banks other than those of the negotiating or receiving bank. This is the clearing system that forms the core of the country's payments system, and which is supplemented by a bank's own internal clearing arrangements¹⁸.

The concept of a clearing system or clearing house originated in the middle ages at the great fairs of Europe, particularly that of Lyons. By Ordinance of March 8, 1463, Louis XI of France authorized four fairs per year at stated intervals. Each fair was followed by a day of settlement fixed at the preceding fair. To these days of settlement came the banks, each with their balance sheet of debits and credits. The settlement contemplated three steps: first, acceptance by each drawee of the bills of exchange drawn against them; secondly, a comparison of the accounts; and finally, settlement in money¹⁹.

¹⁸ J.A. Galbraith, Canadian Banking, (Toronto: The Ryerson Press, 1970) at 327

¹⁹ F.R. Andrews, "The Operations of the City Clearing House", (1942) 51 *The Yale Law Journal* 582 at 584

Contemporaneously with the establishment of the clearing houses, merchants' courts were being set up to handle the claims, including those of local people, arising from the sales of merchandise by the travelling traders. These courts (essentially special tribunals of merchants) enforced the rules, customs and usages of merchants and traders instead of those of the local justices. The 'law merchant', based on general convenience and a common sense of justice emanating from those usages of trade, was established to regulate dealings of merchants and mariners in all commercial countries in Europe and the commonwealth. Eventually special English Courts in the sixteenth and seventeenth centuries, applied the 'law merchant' to transactions that came before them. The 'law merchant', which included the law relating to negotiable instruments, thus became part of the common law²⁰.

The events leading to the formation of the London Clearing House had apparently nothing to do with bank management or the waste, risk and stagnation of cash caused by the individual bank clerks having to make their rounds to the various banks. Nor was it apparently modeled on the European clearing houses which, as stated above, had been developing since the middle ages. It was simply based on the desire of the bank clerks themselves to avoid travelling from bank to bank and being

²⁰ J.V. Vergari, and V.V. Shue, Checks, Payments and Electronic Banking, (Practising Law Institute, New York City: 1986) at 4. Since 1882, commercial transactions in England have been governed by the Bills of Exchange Act. The British Bills of Exchange Act served as a model for the United States' National Conference of Commissioners on Uniform State Laws which promulgated the Uniform Negotiable Instruments Law in 1896. In 1952, this law was revised and modernized through Articles 3 and 4 of the Uniform Commercial Code: see W.H. Lawrence, Commercial Paper and Payment Systems, Vol 1, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 1-12. As will be described later, the British Bills of Exchange Act also served as a model for the Canadian Bills of Exchange Act.

forced to wait while each bank verified the cheques drawn on it. By 1770, it became customary for these clerks to meet at a tavern known as the 'Five Bells' where they could exchange one another's cheques in comfort and, at a subsequent meeting, where individual settlements could be made between each pair of banks. In 1773, the London Clearing House was founded but there is no evidence of any formal organization or association at that time and evidently the clerks were left to their own devices, unhampered by any rules²¹.

It was not until 1805, when a committee of banks promulgated a set of rules for the clearing procedure, that the banks themselves become involved with the clearing system. By 1821 a permanent committee was appointed to assume the management of the London Clearing House²² and in 1833, the permanent building known as the London Clearing House was erected at 10 Lombard Street²³. In fact, by 1833, the concept of the clearing had become so well established that one court stated that a

²¹ F.R. Andrews, "The Operations of the City Clearing House", (1942) 51 The Yale Law Journal 582 at 585; J.J. MacLaren, Banks and Banking, 4th ed., (Toronto: Carswell, 1914) at p. 218

²² The manner in which the London Clearing House was operated in 1836 is described in some detail in *Warwick v. Rogers*, (1843) 5 Man. & G. 340 at 348, 134 E.R. 595 at 598 (Common Pleas); J.J. MacLaren, Banks and Banking, 4th ed., (Toronto: Carswell, 1914) at p. 218. Today, the banks comprising the Committee of London and Scottish Bankers (CLSB) (which in 1987 were Barclays, Lloyds, Midland, National Westminster, Bank of Scotland, Royal Bank of Scotland and the Standard Chartered Bank) has replaced the Committee of London Clearing Banks. These banks are colloquially described as the "clearers" - see E.P. Ellinger, Modern Banking Law, (Oxford: Clarendon Press, 1987) at 4

²³ F.R. Andrews, "The Operations of the City Clearing House", (1942) 51 The Yale Law Journal 582 at 585; H. Hart, The Law of Banking, (London: Stevens and Sons, Limited, 1904) at p. 310. The London Clearing House to this day continues to operate at 10 Lombard Street.

presenting banker would be liable to his customer for neglecting the usual clearing practice²⁴.

(c) The Formation of the Canadian Clearing Houses

Canadian Confederation brought the necessity for a general Banking Act to set up the Dominion's financial framework²⁵. By the British North America Act, section 92, subsection 18, the right to legislate respecting currency, coinage, bills of exchange and promissory notes, legal tender, banking and the incorporation of banks and savings banks, and the issue of paper money was assigned exclusively to the Dominion Parliament²⁶. The Bank Act of 1871 set up the banking structure of the country in its permanent mould. It confirmed branch banking as the system for Canada thus making it certain that successful banks, in whatever province they began, could eventually compete across the width of the country²⁷.

²⁴ Boddington v. Schlencker (1833), 4 B. & Ad 752, 110 E.R. 639 (K.B.)

²⁵ J. Schull, 100 Years of Banking in Canada, A History of the Toronto-Dominion Bank, (Toronto: The Copp Clark Publishing Co., 1958) at 34

²⁶ White Paper: Government of Canada, White Paper on the Revision of Banking Legislation: Proposals issued on behalf of the Government of Canada by The Honourable Donald S. Macdonald, Minister of Finance (Ottawa, Minister of Supply and Services, 1976) at 8

²⁷ J. Schull, 100 Years of Banking in Canada, A History of the Toronto-Dominion Bank, (Toronto: The Copp Clark Publishing Co., 1958) at 37

During the first nineteen years of Confederation the power to legislate with respect to the national banking system was exercised so sparingly that when the Statutes were revised and consolidated in 1886, the whole of the Dominion legislation on the subject comprised ten short sections of Chapter 123²⁸. In 1890, however, the Bills of Exchange Act was passed to regulate commercial transactions. It was largely copied from the English Bills of Exchange Act and was essentially a codification of the existing English law relating to negotiable instruments with some amendments to take into account certain provincial enactments that had been passed before Confederation²⁹.

In 1891, The Canadian Bankers' Association was founded as a voluntary organization of banks intended to promote their common interests and in particular to spend time promoting the development of new national clearing houses and in working out common arrangements for their operation. Prior to that time, clearing had been effected through a variety of small regional associations such as the bankers' sections of the Toronto Board of Trade and the first Clearing House established in Halifax in 1887³⁰. By 1897, presumably as a result of The Canadian Bankers' Association's

²⁸ J.J. McLaren, Bills, Notes and Cheques, (Carswell, Toronto 1892) at p. 1

²⁹ Bills of Exchange Act, 1890, 53 Victoria, c. 17, was almost an exact transcript of the Imperial Bills of Exchange Act, 1882, 45 & 46 Vict., cap. 61, the full title of which is "An Act to codify the law relating to Bills of Exchange, Cheques and Promissory Notes"; J.J. McLaren, Bills, Notes and Cheques, (Carswell, Toronto 1892) at p. 2

³⁰ B. Crawford, Crawford and Falconbridge Banking and Bills of Exchange, 8th ed. (Toronto: Canada Law Books, 1986) (hereinafter referred to as "Falconbridge") para 4101

efforts, there were six clearing houses: in Halifax, Saint John, Montreal, Toronto, Hamilton and Winnipeg³¹ and by 1914 there were 20 clearing houses³².

It should be noted that in the 1890's, the use of cheques and their processing through a clearing system was still viewed as being relatively innovative. As stated by J.J. McLaren³³ in his 1892 text Bills, Notes and Cheques, "the system of banking has recently undergone an entire change ...upon this state of things the general course of dealing between banks and their customers has attached incidents previously unknown and these by the decisions of the Courts have become fixed in law ... Besides this, a custom has grown up among banks themselves, of marking cheques as good for the purpose of clearance, by which they become bound to one another."

The Canadian Bankers' Association was formally incorporated in 1900 by a private Act of the Parliament of Canada. Membership was compulsory for those banks named in the Schedule³⁴. By virtue of this new Act, The Canadian Bankers' Association was expressly empowered to establish in any place in Canada a clearing house for banks, and to make rules and regulations for the operations thereof provided

³¹ Falconbridge para 4101; Porter Commission Report: Report on the Royal Commission on Banking and Finance (Ottawa, Queen's Printer, 1964) pp. 106-110; J. Harvey Perry, "Origins of The Canadian Bankers' Association", (1967) 74 Can. Banker 96 at 109

³² J.J. MacLaren, Banks and Banking, 4th ed., (Toronto: Carswell, 1914) at p. 218;

³³ J.J. McLaren, Bills, Notes and Cheques, (Carswell, Toronto 1892) at p.iii

³⁴ S.C. 1900, c. 93; Falconbridge para 4102

that no bank was to be or become a member except with its own consent and that a bank could after becoming a member withdraw at any time therefrom³⁵. In addition, perhaps in an effort to ensure that the government could retain ultimate control over the national clearing system, the by-laws, resolutions, rules and regulations respecting clearing houses for banks which were passed by the executive council of The Canadian Bankers' Association, did not have any force or effect until approved of by the Treasury Board.

In pursuance of the powers contained in the Act, The Canadian Bankers' Association adopted the rules and regulations contained in By-Law No. 16 (the Clearing House Rules) at a general meeting of The Canadian Bankers' Association held in Toronto on November 15, 1900 as amended and approved by the Treasury Board on May 10, 1901³⁶. Eventually, in all large cities where the banking business was large enough to demand such a convenience, clearing houses were established as voluntary associations (rule 1) for the purpose of facilitating daily exchanges and settlements between banks (rule 2).

³⁵ Falconbridge para 4102; M.H Oglivie, Banking The Law in Canada, 3rd ed., (Toronto: Carswell 1985) (hereinafter referred to as "Oglivie") para 361; An Act to Incorporate the Canadian Bankers' Association, 63-64 Vict., c. 93, ss. 7 and 16(3); Bank of B.N.A. v. Haslip; Bank of B.N.A. v. Elliott (1914), 31 O.L.R. 442 (C.A.); J.D. Falconbridge, The Canadian Law of Banks and Banking, 2nd ed., (Toronto: Canada Law Book Company Limited, 1913) at 322

³⁶ J.D. Falconbridge, The Canadian Law of Banks and Banking, 2nd ed., (Toronto: Canada Law Book Company Limited, 1913) at 375

The substantial characteristics of the early manual clearing house in Canada were these: (1) at a set hour every morning, usually ten o'clock, a clerk from each bank attended at a specific room in the clearing house bringing with him all the bank notes, cheques, drafts, bills and other items, usually called "exchanges", upon other banks which have been received by his own bank since the same hour of the preceding day. (2) Each bank had its drawer or box in the room, and the messengers of all the other banks distributed all the cheques which they had in their possession, placing each of them in the drawer or box of the particular bank upon which it is drawn. The exchanges which a bank sends to the clearing house are called "creditor exchanges" and those which it receives from the other banks are called "debtor exchanges". (3) Each bank was then credited on the books of the clearing house with the amount of cheques drawn upon other banks which it had brought in for collection and it was debited with the amount of the cheques drawn upon it which all the other banks had brought. (4) By arrangement with the board of management of the clearing house, one bank acted as clearing bank for the receipt and disbursement of balances due by and to the various banks. At a later hour in the same day, the debtor banks were obliged to bring into the clearing bank the sums which they had respectively lost; and shortly afterwards the creditor banks came and received from the clearing bank out of the funds brought in by the debtors, the amounts of their respective gains. In this manner the business of settling the daily balances and exchanges between the several banks was accomplished with rapidity, accuracy and cheapness. (5) An officer of each bank then took from its drawer or box all the cheques against it which had been placed therein by the other banks, and carried them back to his own bank to be examined, for the

purpose of seeing whether any of them must be dishonoured by reason of insufficient funds or otherwise. (6) Within a specified period of time, the bank on which the rejected cheque was drawn was then able to send it back to the bank which brought it in and to demand repayment³⁷. The omission to comply with the time limits within which the objecting bank was to return the cheque through clearing did not deprive the objecting bank of any rights it would have had if the exchanges had been made directly between the banks concerned instead of through the clearing house. The clearing house was not to be used as a means of obtaining payment of any item, charge or claim, disputed or objected to. Disputed items remained subject to the ordinary rules of law governing recovery by the payer of money paid by mistake to a person who is not entitled to receive payment and who cannot give a discharge³⁸.

Before the establishment of the Central Clearing Fund in 1926 and the Bank of Canada in 1935, settlement was effected at each settlement point by the adjustment of balances held on account of the participating banks by the bank designated under the rules of The Canadian Bankers' Association as the clearing bank for that point³⁹. After

³⁷ J.T. Morse, A Treatise on the Law of Banks and Banking, Volume 1, 3rd ed., (Boston: Little, Brown and Company, 1888) at p. 586; J.J. MacLaren, Banks and Banking, 4th ed., (Toronto: Carswell, 1914) at p. 218; La Banque Nationale v. Merchants Bank, (1891) 7 M.L.R. 336 (S.C.); J.D. Falconbridge, The Canadian Law of Banks and Banking, 2nd ed., (Toronto: Canada Law Book Company Limited, 1913) at 376 and 377

³⁸ J.D. Falconbridge, The Canadian Law of Banks and Banking, 2nd ed., (Toronto: Canada Law Book Company Limited, 1913) at 376 and 377

³⁹ J.D. Falconbridge, The Canadian Law of Banks and Banking, 2nd ed., (Toronto: Canada Law Book Company Limited, 1913) at 377 and 378. In cases of short term financial difficulty, a practice grew in the United States of issuing clearing house certificates as a method of giving each other assistance: upon the deposit with the clearing house of bills receivable and other securities, the banks were issued loan certificates which were used in settling balances at the clearing houses

1926, settlement was made by adjustment of balances held in the Central Clearing Fund. Since 1935, settlement has been by the adjustment of balances on the books of the Bank of Canada⁴⁰.

The Bank of Canada is Canada's central bank. It began operations on March 11, 1935 under the provisions of the Bank of Canada Act of 1934. The Bank of Canada interacts with the payments system in two different ways: it facilitates and effects the final settlement of balances for the national clearings and settlement systems and it acts as the agent of the federal government by clearing government receipts and disbursements⁴¹. Direct Clearers⁴² are required to maintain reserve deposits with the Bank of Canada. Where one Direct Clearer owes money to another as a result of the clearing between them, those debts are settled by the adjustment of their respective reserve accounts with the Bank of Canada⁴³. These statutory reserves are maintained

⁴⁰ Falconbridge para 4102, 4202, 4401

⁴¹ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 46. As of December 1995, more than 30 per cent of the federal government's payroll, pension and socio-economic benefit payments are now effected by electronic credit transfer. Some 70 million federal government payments are made by direct deposit each year - from "CPA Plenary Meeting Updates Payments System Stakeholders", Forum, volume 11, No.4, December, 1995, prepared by the Canadian Payments Association, at 1

⁴² A Direct Clearer is a Canadian Payments Association member that meets the requirements of subsections 10.01 or 10.2 of the CPA Clearing By-Law (No.3); settles for payment items drawn on or payable by it through a settlement account at the Bank of Canada; and is a participant at one or more of the seven regional settlement points prescribed by the CPA Clearing By-Law (no.3). To be a Direct Clearer, the institution must have, inter alia, a payment items volume of not less than ½ of 1 percent of the total national volume of payment items. Clearing By-law s. 17.01 (enacted pursuant to para. 72(1)(d) of the Canadian Payments Association Act); Para 18(1)(l) of the Bank of Canada Act

⁴³ Falconbridge 4202;

on the basis of twice monthly averaging, accordingly, the Direct Clearers can use the reserves in the conduct of their business.

The word "payment" is used when the instrument is honoured by the delivery of cash while "settlement" is used when value is given by the drawee bank by way of set-off of its own similar claims representing cheques it has collected for its own customers or the adjustment of balances on the books of one or the other of them or of a settlement bank. Banks prefer settlements to payments as settlements do not involve dealings with cash away from their own premises. Accordingly, it is common in international banking relations to keep accounts in the name of each other ("Nostro" and "Vostro" Accounts) and simply adjust the balance in the account to reflect the ebb and flow of funds. For domestic transactions, settlement is effected by the adjustment of balances on the books of the Bank of Canada.

As stated above, the clearing houses were intended to facilitate expeditious daily exchanges and settlements between banks. They were not intended to provide for any united action for any business purpose, nor did they contemplate the employment of capital or credit in any enterprise. Incidentally, however, co-operation between the banks brought them in closer relations and opened the way to make them mutually helpful in times of financial stringency⁴⁴.

⁴⁴ J.D. Falconbridge, The Canadian Law of Banks and Banking, 2nd ed., (Toronto: Canada Law Book Company Limited, 1913) at 377

By the 1970's the banks' historic monopoly⁴⁵ of the payments system was being strongly challenged. The Canadian payments system was described in the White Paper that preceded the Banks and Banking Law Revision Act, 1980 as being on the verge of becoming outdated by the development of electronic funds transfer systems⁴⁶. While, The Canadian Bankers' Association had changed its rules in 1971 to permit banks to negotiate their own arrangements for clearing agency relationships with the various non-bank deposit-taking financial intermediaries (NBFIs) and had begun to permit the NBFIs to apply for their own institutional and branch transit numbers, the NBFIs, telecommunications carriers and equipment manufacturers were requesting the right to direct access to the clearing system as a first step to implementing the new automated systems. The government agreed to give them that right and to redress the competitive imbalances that had arisen out of the banks' dominance of the paper-based payments system⁴⁷.

⁴⁵ For example, deposit taking institutions that competed with the banks (such as the Quebec savings banks, the trust and loan companies, credit unions and caisses populaires) were initially only afforded access to the banks' national clearing system through the representation of a bank clearing agent. As a result, in some areas, the credit unions and caisses populaires operated their own regional clearing systems along the lines of the banks' system: from Falconbridge para 4102 and 4301.1.

⁴⁶ Falconbridge para 4301.1; White Paper: Government of Canada, White Paper on the Revision of Banking Legislation: Proposals issued on behalf of the Government of Canada by The Honourable Donald S. Macdonald, Minister of Finance (Ottawa, Minister of Supply and Services, 1976) at 17; The Canadian Payments Systems Standards Group (called for in the Government of Canada's, Statement of Government Policy Concerning Computer/Communications and the Payments System (1975) (the "Blue Book")) reported to the Federal Minister of Finance and of Communications (July 1978)

⁴⁷ Falconbridge para 4301.1; White Paper: Government of Canada, White Paper on the Revision of Banking Legislation: Proposals issued on behalf of the Government of Canada by The Honourable Donald S. Macdonald, Minister of Finance (Ottawa, Minister of Supply and Services, 1976) at 17-19; The Canadian Payments Systems Standards Group (called for in the Government of Canada's, Statement of Government Policy Concerning Computer/Communications and the Payments System (1975) (the "Blue Book")) reported to the Federal Minister of Finance and of Communications (July 1978); In 1976, the Economic Council of Canada recommended that qualified near banks be allowed

The challenge to the banks' historic monopoly over the national payments system (and today's ongoing challenge to the monopoly of the deposit-taking financial institutions) can be partly explained by the change in the type of consumer payment transactions that were taking place. Until the 1960's, consumer payment transactions mainly involved payment in cash, by cheque or by means of a credit contract often accompanied by a promissory note⁴⁸. By 1970, this three part payment structure was radically changed by the introduction of credit cards as the major consumer-payment vehicle⁴⁹. By 1980, it was anticipated that this payment structure would again be radically changed by the wide-spread introduction of electronic funds transfers and paperless-entry payments systems linked to expanded computer and telecommunication technology applicable to consumer financial service products⁵⁰. In

direct access to the clearing system: Falconbridge 4301.1; Economic Council of Canada, Efficiency and Regulation: A Study of Deposit Institutions (Ottawa, Minister of Supply and Services, 1976) - recommendation 17 at p.104; Canadian Life and Health Insurance Association Inc. submission to the Department of Finance, "The Need for Payments System Reform" (December, 1995) at 9

⁴⁸ Bank of Canada notes and coins continue to be the most common and frequently used means of everyday small value transactions. Unfortunately there are no data or other information on either the number or the value of cash payments. It is known that as at December 31, 1992 the total value of outstanding banknotes and coin was \$25,609,234,000 from "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 52 and Table 4

⁴⁹ J.V. Vergari and V.V. Shue, Checks, Payments, and Electronic Banking, (Practising Law Institute, New York City: 1986) at 6-8. As at December, 1992, cheques and other paper payment instruments were the single most important means of payments used by Canadians to effect non-cash payments, accounting for an estimated 98.8% of the total value of all such payments. In terms of volume however, cheques and other paper payment instruments have declined sharply in importance relative to other cashless payment instruments from "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 54.

⁵⁰ J. A. Galbraith foresaw electronic transfer of funds and home computer banking (from his 1970's text Canadian Banking, (Toronto: The Ryerson Press, 1970) at 36

other words, financial institutions and others were anticipating the need for radical changes to the national payments system in anticipation of the wide-spread introduction of ATM and POS terminals⁵¹. If, as anticipated, these systems began to successfully compete with cash and cheques as the major form of consumer payment mechanism, then the transaction fees collected by those institutions who control the systems would increase dramatically and access to the systems for marketing purposes would become more and more important.

In anticipation of the coming electronic banking age, the Act to incorporate The Canadian Bankers' Association was amended in 1980 by s. 90 of the Banks and Banking Law Revision Act most importantly with regard to the transferal of responsibility for the clearing house system to the Canadian Payments Association⁵². The Canadian Payments Association was in turn incorporated by Part IV of the Banks and Banking Law Revision Act⁵³.

⁵¹ The first cash dispenser was installed in Canada by a large chartered bank in 1969, followed in 1972 by the first ATM. As at January 31, 1993 there were 14,576 ATMs installed by deposit taking institutions in Canada, compared with 5,269 at the end of January, 1988 from "Bank for International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993, at 57.

⁵² Oglivie para 378 ; Act to Incorporate the Canadian Bankers' Association, S.C. 1900, c. 93, ss. 7 [repealed 1980-81-82-83, c. 40, s.90(3)], s. 16(2)(d) [repealed 1980-81-82-83, c. 40, s.90(7)], s. 16(3) [repealed 1980-81-82-83, c. 40, s.90(8)]

⁵³ 1980, R.S.C. 1980, c.40: "An Act to revise the Bank Act, to amend the Quebec Savings Banks Act and the Bank of Canada Act, to establish the Canadian Payments Association and to amend other Acts in consequence thereof" (including An Act to Incorporate the Canadian Bankers' Association, An Act to incorporate the Continental Bank of Canada, Bills of Exchange Act (s.165), Canadian Deposit Insurance Corporation Act, Canada and British Insurance Companies Act, Financial Administration Act (s.28), Foreign Insurance Companies Act, Income Tax Act (s.146), Loan Companies Act, Trust Companies Act)

(d) The Canadian Payments Association

(i) Objects: Establish and operate national clearings and settlements systems and plan the evolution of the national payments system

The first meeting of the Board of Directors of the Canadian Payments Association took place at the Bank of Canada in Ottawa on February 24, 1981. The Canadian Payments Association's mandate, as set out in its governing legislation, are to establish and operate national clearings and settlements systems and to plan the evolution of the national payments system⁵⁴. Clearly by the 1980's, Canada's payments system was viewed as encompassing more than simply the clearing and settlement systems. Moreover, the traditional view that the payments system was a payment mechanism that facilitated a method of payment through a *banking system* was also being challenged. As will be set out in more detail below, the scope of Canada's national payments system and who its participants and administrators should be is still very much debated.

In the first 4 to 5 years of its existence, the Canadian Payments Association was occupied with taking over from The Canadian Bankers' Association its responsibilities for the operation and supervision of the existing interbank⁵⁵ clearing and settlement

⁵⁴ Oglivie para 360

⁵⁵ Throughout this paper I have used the term "interbank" and "banking" loosely. It is intended to include all communications and services offered by deposit taking financial institutions.

systems and expanding it to accommodate the non-bank Direct and Indirect Clearers (those NBFIs who had successfully challenged the banks' historic monopoly). Previously, the chartered banks had exchanged between themselves all the cheques and other payment items passing through the system and had settled the resulting balances through their respective reserve accounts at the Bank of Canada. Any other deposit-taking financial institution was required to use the services of one of the chartered banks as its agent in clearing its customer's cheques and other payment items through the system⁵⁶. The first order of business consisted largely of restating the rules and standards developed by The Canadian Bankers' Association over the preceding 80 years⁵⁷. By February 1, 1983, the Canadian Payments Association were ready to take over from The Canadian Bankers' Association the administration of and responsibility for the complex group of systems and services comprising the national clearing and settlement systems.

(ii) Operation of the Automated Clearing and Settlement System (ACSS)

On November 19, 1984, the national clearing and settlement systems was automated as the Automated Clearing Settlement System (ACSS)⁵⁸. The ACSS is a

⁵⁶ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 47

⁵⁷ Falconbridge para 4301.2; Canadian Life and Health Insurance Association Inc. submission to the Department of Finance, "The Need for Payments System Reform" (December, 1995) at 10

⁵⁸ Falconbridge para 4401

restricted access, highly secure computerized service to which the Direct Clearer members of the Canadian Payments Association have access for the purpose of advising each other and the Bank of Canada of the claims that they will have against each other at the end of the day as a result of the exchange of payment items⁵⁹.

Nowadays, each financial institution participating in the exchange and settlement has interconnected computer facilities operated through a network of data centres, each serving branches in an assigned region. The *clearing process* begins when payment items acceptable for clearing are deposited at a branch of a deposit taking financial institution. Each cheque is credited to the payee's account upon its deposit at the depository branch. Such credit is value dated to the day of deposit. At midday, payment items deposited into accounts at each branch are bundled and totaled, collected by courier and delivered to the institution's nearest data centre, if the institution is itself a Direct Clearer, or to its agent, if it is not. The items are then checked, the amounts encoded using magnetic ink, and sorted through high speed reader/sorters according to the institution number in the MICR line⁶⁰ into 'bn-us' items (cheques drawn on the Direct Clearer's own accounts and those of its agency

⁵⁹ Affidavit of Bradley Crawford sworn March 29, 1996 and filed on April 1, 1996 with the Competition Tribunal in action number CT-95/02.

⁶⁰ Magnetic Ink Character Recognition (MICR) technology has been used by Canadian financial institutions for over 35 years. MICR consists of magnetic ink printed characters of a special design that can be recognized by high speed magnetic recognition equipment. MICR encoded documents include cheques, payment orders, credit slips, drafts and remittances. The MICR recognition equipment is sensitive enough to reject documents as unreadable due to incorrect document size or weight, improper ink density or extraneous ink, MICR characters incorrectly positioned or spaced, symbols omitted and the presence of voids in the characters: from "Introduction to MICR", Forum, volume 4, no. 1, March 1988, prepared by the Canadian Payments Association, at p.3

institutions) and those items drawn on other Direct Clearers. At this stage, as many items as possible are microfilmed for tracing and security purposes. Between 6 p.m. and midnight, items drawn on other Direct Clearers are bundled together with control listings, picked up by courier and delivered to the data centres of the other Direct Clearers. Cheques are then sorted by region and transported to regional data centres serving respective drawee branches across the country. There are seven regional "clearing centres" across Canada: Vancouver, Calgary, Regina, Winnipeg, Toronto, Montreal and Halifax. Information from "on-us" items is transmitted electronically to the Direct Clearer's processing centres in other regions and posted to customers' accounts, the physical items are delivered later⁶¹. At the end of each regional exchange, each regional data centre of each Direct Clearer holds all cheques drawn on it, as well as on any other bank represented by it. As each cheque is processed at the drawee financial institution's data centre, the drawer's account is debited at a central or regional computer. Ultimately, cheques may be delivered from each regional data centre of each financial institution to respective drawee branches served by it. Where the branch decides to dishonour a cheque it must return it to the branch of deposit via the clearing system. In general, the operational objective in transporting cheques in the framework of the cheque clearing system is a maximum of three day cycle for out-of-region cheques and a two day cycle for in-region cheques⁶². Physical delivery of the

⁶¹ B. McDougall, "Hidden Highways: Canada's payments clearing and settlement system", January/February 1994 Canadian Banker 27

⁶² B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 304

cheques to respective drawee branches is no longer an indispensable component of the payment process. Under bulk cheque filing, cheques are not delivered by the regional data centre to the respective drawee branches it serves. Rather, an individualized physical examination of each cheque may take place at that data centre⁶³. After each delivery of items is logged on the ACSS terminal of the delivering Direct Clearer, the ACSS logs each Direct Clearer's deliveries of payment items to and receipts from other Direct Clearers and determines the "due-to" and "due-from" balances, as well as confirms these balances with the Bank of Canada by means of an on-line, interactive computer/communications network. The *settlement process* begins at approximately 8:30 a.m. (Ottawa time) on the following day. By 9:30 a.m. the preliminary net clearing gain or loss of each Direct Clearer is available to the institution from the ACSS. Between 9:30 and 11 a.m. bilateral reopenings of clearings may take place to handle corrections. Shortly after 11 a.m., the final net gains and losses are available. At 1:30 p.m. the Bank of Canada obtains from the ACSS each Direct Clearer's national standing in the form of a specialized statement and adjusts the balances on its own books. At approximately, 4 p.m., the Bank of Canada establishes the closing balances of each Direct Clearer as at the end of the previous day⁶⁴.

⁶³ B. Geva., "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 305

⁶⁴ "Bank for International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993 at 60-61

The ACSS also handles a wide range of payment items that are not drawn on accounts maintained at deposit taking institutions. These items include federal government payments, which are cleared and settled for through the Bank of Canada and which account for about 10% by volume of all the items handled by the system, postal and other money orders, grain payment tickets and traveler's cheques⁶⁵.

During a typical weekday evening some 10.6 million payment items, or eighty per cent of the items deposited at the branches of deposit taking institutions, are processed by the data centres of Direct Clearers. The other twenty per cent of the items are drawn on customers' accounts of the deposit taking financial institution itself and can, therefore, be processed internally without being entered into the national clearing and settlement system⁶⁶.

The ACSS has two objectives: to transmit negotiable instruments from the place and institution at which they are deposited to the place and institution on which they are drawn and to facilitate the settlement of the clearing balances generated by the movement of the funds represented by these instruments⁶⁷. By-Law No. 3 of the

⁶⁵ "Bank for International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993 at 59

⁶⁶ "Bank for International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993 at 61

⁶⁷ "Bank for International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993 at 59

Association (the clearing by-law) governs how the members of the Canadian Payments Association are to achieve these objectives. It can be divided into three types of subject matters: (1) the organizational structure at Regional Settlement Points, for example, the formation and management of Regional Clearing Associations; (2) the general procedures for exchanging payment items and settling claims thereby created; and (3) the definition of the rights and obligations of member institutions⁶⁸.

At the third Canadian Payments System Conference held in Montreal on April 15, 1985, Serge Vachon, the Chair, indicated that the Canadian Payments Association was ready to turn its attention to its second mandate (planning the evolution of the national payments system) by (1) the appointment of a Senior Planning Committee of the Board to initiate systems research projects and to liaise with industry and user groups and (2) the appointment of a Technical Committee to study and report on standards applicable to shared ATM networks⁶⁹. The Senior Planning Committee has the general responsibility of advising the Board on all matters that relate to the evolution of the national payments system and acts as the principal channel through which the various sectors of the Canadian economy, not represented within the Canadian Payments Association, may express their views in the planning process⁷⁰.

⁶⁸ "Bank for International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993 at 59

⁶⁹ Falconbridge para 4301.2

⁷⁰ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 48

The Canadian Payments Association released at the second PACE Conference in Toronto on February 24 and 25, 1986 a policy statement entitled "Framework for the Evolution of the Payments System" dated February 10, 1986 on the evolution of point-of-sale electronic funds transfer systems. In the statement, the Canadian Payments Association confirmed that it was solely responsible for the standards and techniques used in the electronic funds transfer⁷¹.

Yet while the Canadian Payments Association has responsibility for the development of the standards and techniques used in the electronic funds transfers systems, it is not mandated to own or operate these systems in the same way that it does the ACSS and the new Large Value Transfer System (LVTS)⁷². Accordingly, a number of payments system "satellites", which are essentially private payments sub-systems under co-operative control, have evolved outside the Canadian Payments Association's formal authority⁷³. These satellites, which have grown up outside any publicly discussed framework, are controlled by the largest Schedule I banks which are

⁷¹ Falconbridge para 4301.2

⁷² The LVTS is discussed in more detail at page 60

⁷³ Canadian Life and Health Insurance Association Inc. submission to the Department of Finance, "The Need for Payments System Reform" (December, 1995) at 10

positioned to control access to, traffic over and the tariff structure for this crucial element of Canada's new economy⁷⁴.

(iii) Interac Association: a Payments system Satellite

The Interac Association (Interac) is one example of such a sub-payments system satellite. It forms the backbone to support retail electronic commerce in this country. It has been estimated that Interac's member institutions account for over ninety-seven per cent of the debit cards issued in Canada⁷⁵ and contribute over ninety-seven per cent of the ATMs deployed in Canada to Interac's shared cash dispensing services⁷⁶.

In the early 1970s, Canadian financial institutions began to offer their customers the ability to obtain access to their funds on deposit through ATMs. Initially, the customer could only access these funds through an ATM owned by the issuing financial institution. In the mid-1980's, Royal Bank of Canada (Royal Bank) and Bank of Montreal arranged connections between their respective proprietary networks and

⁷⁴ Canadian Life and Health Insurance Association Inc. submission to the Department of Finance, "The Need for Payments System Reform" (December, 1995) at 12

⁷⁵ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 48

⁷⁶ As at December, 1993 it has been estimated that more than 18 million debit cards had been issued by Interac member institutions from "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 50

international shared ATM networks. In 1985, Royal Bank acquired exclusive Canadian rights to "Plus", a global ATM cash dispensing service originating in the United States. At the same time, Bank of Montreal acquired membership in "Cirrus" a competing global ATM cash dispensing service. Royal Bank and Bank of Montreal then offered to connect the proprietary networks of other Canadian financial institutions to these networks. Meanwhile, The Bank of Nova Scotia, La Confederation des Caisses Populaires et D'Economie Desjardins du Quebec (Confederation), Canadian Imperial Bank of Commerce (CIBC), Royal Bank and The Toronto-Dominion Bank, the five major Canadian VISA credit card issuing financial institutions, established a shared ATM cash-dispensing service in Canada utilizing the pre-existing VISA credit card authorization network ("VCAN", now "CANNET"⁷⁷) to inter-connect their proprietary ATM networks. This shared network was named Interac in 1985. By the fall of 1985, the four largest MasterCard credit issuing financial institutions, namely Bank of Montreal, Canada Trustco Mortgage Company, Credit Union Central of Canada and National Bank of Canada joined Interac as charter members.

By 1988, Interac was expanded to become the national supplier of shared electronic network services to enable its members to offer a shared Interac Direct Payment service (a POS system) to their cardholders. Charter members of Interac⁷⁸

⁷⁷ CANNET is a private company which until recently was the predominant supplier of electronic credit card authorization services and at present carries all Interac shared cash-dispensing service.

⁷⁸ The charter members of Interac are Bank of Montreal, The Bank of Nova Scotia, Canada Trustco Mortgage Company, Canadian Imperial Bank of Commerce, La Confederation des Caisses-Populaires et D'Economie Desjardins du Quebec, Credit Union Central of Canada, National Bank of Canada, Royal Bank of Canada, The Toronto-Dominion Bank and Interac Inc.. Interac Inc. owns both the Inter-Member Network Software that is used in the operation of the shared electronic financial services

had developed a system to link their respective proprietary terminal networks by installing a switching device at the computer of each institution. The system permitted cardholders of participating Interac member institutions to use their cards and personal identification numbers (PIN) at any participating member's ATM to obtain cash from either their deposit or credit card accounts and at a POS terminal to pay for purchases made at a participating retailer directly from their chequing or savings account. The switching devices acted as communication gateways between the members' network of terminals. Only a charter member was permitted to directly connect with the shared services, a sponsored member had to communicate through its sponsoring charter member in order to send or receive the messages necessary to complete customer transactions⁷⁹. The former could transmit and receive messages only through the latter's gateway⁸⁰. Interac operates on the basis of on-line verification and authorization. An immediate cardholder's account adjustment is not necessarily an indispensable feature of the system. This direct payment service was gradually introduced into Canada between 1992 and 1994⁸¹ so that today, Interac provides customers with two services: shared cash dispensing and Interac direct payment.

network and the Interac Trademarks. The other charter members are the sole shareholders of Interac Inc.

⁷⁹ There are presently nine charter members and 18 sponsored members of Interac. The Laurentian Bank of Canada was the tenth charter member of Interac from May, 1988 to May, 1989. Although it is now a sponsored member, the Laurentian Bank remains directly connected to Interac for shared cash dispensing. Reasons for Consent Order issued June 20, 1996 in Competition Tribunal File No. CT-95/02 at p. 1

⁸⁰ B. Geva, The Law of Electronic Funds Transfers (New York: Matthew Bender & Co. Inc., 1992) at 6-19

⁸¹ Notice of Application filed with the Competition Tribunal by the Director of Investigation and Research on December 14, 1995 as file number CT-95/02

While Interac has evolved outside the Canadian Payments Association's control, its membership criteria and many of its key rules tie directly into the Canadian Payments Association. Its owners or charter members for example must be deposit taking financial institutions that are direct clearing members of the Canadian Payments Association. Further, transactions processed over the network must meet the Canadian Payments Association 'eligible for clearing' criteria⁸². In addition, clearing and settlement of transactions exchanged through Interac take place in the framework of the national clearing and settlement systems. A charter member must have an account at the Bank of Canada. Each charter member debits each other charter member for the daily value of cash dispensed to the latter's customers, including those of its sponsored members, at the ATMs. The debits are entered on the Automated Clearing Settlement System (ACSS) and charter members' accounts are adjusted at the Bank of Canada⁸³.

(iv) Board of Directors, Executive Committee and General Manager

The Canadian Payments Association is governed by a board of directors and is chaired by the director appointed by the Bank of Canada (who must also be an officer

⁸² Canadian Life and Health Insurance Association Inc. submission to the Department of Finance, "The Need for Payments System Reform" (December, 1995) at 13

⁸³ B. Geva, The Law of Electronic Funds Transfers (New York: Matthew Bender & Co. Inc., 1992) at 6-19

of the Bank of Canada). The chair and at least two other directors form the executive committee. The executive committee may exercise those powers and duties of the board that are not expressly reserved to the board. The general manager of the Canadian Payments Association is in turn authorized to direct and manage the Association on behalf of the board in all matters not specifically reserved to the board, chair or executive committee⁸⁴. The board has assigned responsibility for the maintenance of the clearing and settlement system to the National Clearings Committee.

For the purposes of electing representatives to the Canadian Payments Association's board of directors, the Canadian Payments Association members are divided into four classes: (1) banks, (2) credit union centrals, (3) loan and trust companies, and (4) "other" financial institutions. One director is appointed by the Bank of Canada, five are elected from the members of the bank class and five directors are elected to represent the other classes: credit union centrals (two), trust and loan companies (two), and other financial institutions (one)⁸⁵. The bank class members therefore have a significant board presence that is just less than an outright majority.

⁸⁴ sections 69 - 75

⁸⁵ As at March 31, 1996, the Board of Directors was comprised of Serge Vachon, Bank of Canada; Helen K. Sinclair, Canadian Bankers' Association, Lloyd F. Carlington, Bank of Montreal, Jules Gagne, National Bank of Canada, Robert M. Kelly, Canadian Imperial Bank of Canada, Don Beradinucci, Royal Bank of Canada, Michel Jourdain, La Caisse centrale Desjardins du Quebec, Wayne A. Nygren, Credit Union Central of British Columbia, Chris J. Stringer, The Canada Trust Company, Elizabeth Wright, National Trust Company and J.L. Callaghan, Alberta Treasury Branches from Canadian Payments Association Review, 1995-1996 The Board of Directors

With the sale of several trust companies to banks since 1992, there is virtually no offsetting voice on the board⁸⁶.

The board may make by-laws for the conduct of all affairs of the Canadian Payments Association. The by-laws are not effective until approved by the Governor in Council and published in the Canada Gazette and sent to every member. A by-law providing for a penalty must first be approved by the members at a meeting of the members⁸⁷.

Subject to the by-laws, the board may make such rules respecting clearing arrangements and the settlement of payment items as it considers necessary. Rules must be sent by the general manager to every member⁸⁸. These rules would likely be viewed as being contractually binding on banks provided they have been given proper notice. Members of the Canadian Payments Association may present payment items and must accept and arrange for settlement of payment items in accordance with the by-laws and the rules⁸⁹.

⁸⁶ Canadian Life and Health Insurance Association Inc. submission to the Department of Finance, "The Need for Payments System Reform" (December, 1995) at 11

⁸⁷ section 72

⁸⁸ Oglivie para 368; Section 72 and 73

⁸⁹ Oglivie para 372; section 83

It is not clear who is able to bring an action to enforce the duties which the directors owe the Canadian Payments Association, if the directors themselves refuse to act. It is unclear whether members can bring an action similar to those supporting derivative actions in ordinary corporations. There is an indication that those derivative rights might not apply to a quasi-public organization such as the Canadian Payments Association. In the United States, members of the Federal Deposit Insurance Corporation could not sue it for failing to discover irregularities in the affairs of other members having deposits insured with the Corporation or in failing to bring such irregularities to the attention of the other members⁹⁰.

While under no obligation to do so, the board has developed a set of consultative procedures that facilitate discussion and the exchange of information between the Canadian Payments Association and the stakeholders (members, consumers, retailers, non deposit taking financial institutions, governments etc.) in the payments system. The goal of these procedures are to facilitate at an early stage third party input into the payments system planning process⁹¹.

⁹⁰ First State Bank of Hudson County v. United States, 599 F. 2d 558 (3rd Circ., 1979); Federal Deposit Insurance Corp. v. American Bank Trust Shares Inc., 460 F. Supp. 549 (U.S.D.C., S. Car., 1978); see also Baird v. The Queen in Right of Canada (1983), 148 D.L.R. (3d) 1 (Fed.C.A.) re right to bring action to enforce statutory duties owed at large.

⁹¹ Paper entitled "The CPA's Consultative Process" prepared by the Canadian Payments Association on February 27, 1996.

(v) Members⁹².

By statute, the Bank of Canada, all chartered banks and every savings bank to which the Quebec Savings Bank Act applies are required to be members of the Canadian Payments Association. The balance of the members are voluntary. Any financial institution in Canada accepting deposits transferable by order to a third party and which meets the depositor insurance protection and inspection criteria set out in the Act may apply to join the Canadian Payments Association. Canadian deposit taking institutions comprise chartered banks, cooperative credit institutions, trust and loan companies and governmental savings institutions. It is the members who annually approve a budget for the Association and then contribute their proportionate share of the total assessment as dues.

In addition to the Bank of Canada, which is a special member, as at March 31, 1996, the Canadian Payments Association was comprised of the following members:

- (a) sixty-four chartered bank members, the six largest of which operate on a nation-wide basis and internationally while the remaining banks concentrate on serving the financial needs either of a particular region of the country or of a particular sector of the economy. Most of the latter banks are wholly-owned subsidiaries of foreign banks⁹³;

⁹² The requirements of membership are set out in ss. 57 and 84 of the Act and s.8 of the General By-Law, By-Law No.1 Canada Gazette, Part I, Vol. 116, No.5 (January 30, 1982) pp. 864; Falconbridge para 4303.1

⁹³ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 42; see also Canadian Payments Association Review, 1995-1996 Official List of Members

- (b) forty-one trust and loan companies⁹⁴;
- (c) twenty-six cooperative credit institutions, made up of local credit unions and caisses populaires, centrals and federations of centrals⁹⁵. Local credit unions and caisse populaires offering chequing facilities are required to be members of a central or similar body which belongs to the Canadian Payments Association⁹⁶; and
- (d) fifteen "other financial institutions"⁹⁷. This category includes Canada's two governmental savings institutions: the Province of Alberta Treasury Branches and the Province of Ontario Savings Office.

⁹⁴ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 43; see also Canadian Payments Association Review, 1995-1996 Official List of Members

⁹⁵ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 43; see also Canadian Payments Association Review, 1995-1996 Official List of Members

⁹⁶ On November 13, 1983, the Canadian Co-Operative Credit Society Limited, the umbrella organization of the provincial centrals joined the Canadian Payments Association and as of December 1, 1983 acted as the group clearer for eight member centrals. As of June 1, 1984 it acted for British Columbia, Alberta and Saskatchewan centrals. There are also two non-voting member "federations" (incorporation of two or more centrals), namely C.C.C.S. inspected by the Superintendent of Insurance and CCCQ. inspected by his Quebec counterpart. The Alberta Treasury Branch - part of the Alberta government that receives transferable deposits from the public is also a member.

⁹⁷ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 43; see also Canadian Payments Association Review, 1995-1996 Official List of Members

Taken together, the Canadian Payments Association's member institutions account for well over ninety-five per cent of the transferable deposit liabilities of all Canadian deposit-taking institutions⁹⁸. In modern society, deposit accounts with financial institutions on which cheques or other payment orders can be drawn and currency or legal tender consisting of banknotes and coins are viewed as the two principal forms of money. Money in turn is used for making payment in almost all commercial and financial transactions, it is the main vehicle for saving and investing and is the language in which accounts, budgets and financial records are written⁹⁹.

In order to give flexibility to the system, any bank or non-bank member of the Canadian Payments Association can be either a Direct Clearer or an Indirect Clearer or 'non-clearing member'. A Direct Clearer has to keep its reserve account with the Bank of Canada and participate in the clearing at the regional settlement points. A non-clearing member can elect to clear through a Direct Clearer and may keep its reserve account with that member, in which case the Direct Clearer has to match the non-clearing member's reserve account by an equivalent amount in its account at the Bank

⁹⁸ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 47

⁹⁹ Paper entitled "The Framework for the Evolution of the Payments System" prepared by the Canadian Payments Association on February 10, 1986

of Canada¹⁰⁰. To assure all members that their associates are maintaining a sound financial condition, every member (except the Bank of Canada) must be a member of the Canada Deposit Insurance Corporation or the Credit Union Central of Canada or have the deposits made with it insured or guaranteed under a provincial enactment that provides depositors with protection against loss or moneys on deposit with financial institutions¹⁰¹.

As at March 31, 1996, there were 147 members of the Canadian Payments Association but only thirteen Direct Clearers - the Bank of Canada, eight chartered banks (Bank of Montreal, The Bank of Nova Scotia, CIBC, HongKong Bank of Canada, National Bank of Canada, Royal Bank, The Toronto-Dominion Bank and Banque Laurentienne du Canada) and four non-bank deposit-taking institutions (Province of Alberta Treasury Branch, Canada Trustco Mortgage Company, La Caisse Centrale Desjardins du Quebec and Credit Union Central of Canada)¹⁰².

¹⁰⁰ White Paper: Government of Canada, White Paper on the Revision of Banking Legislation: Proposals issued on behalf of the Government of Canada by The Honourable Donald S. Macdonald, Minister of Finance (Ottawa, Minister of Supply and Services, 1976) at 18

¹⁰¹ Oglivie, para. 373; "Bank for International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993 at 60

¹⁰² The number of Direct Clearers is as at March, 1996. The figure is taken from a ACSS Clearing Exchange Report printed April 5, 1996. The number of members is taken from the Canadian Payments Association Review 1995, 1996

(vi) Supervision

Under section 245 of the Bank Act, the Governor in Council is to appoint an Inspector General of Banks¹⁰³. This Inspector is in turn to make or cause to be made the examinations and inquiries pursuant to the Canadian Payments Association Act¹⁰⁴. Thus the affairs or business of the Canadian Payments Association are overseen by the Inspector who reports annually to the Minister of Finance as to whether it is in conformity with its Act and by-laws¹⁰⁵. Apart from this annual review, there is no statutory regulation or supervision of the Canadian payments system¹⁰⁶. However, the Canadian Payments Association, the Canadian Bankers Association and The Canadian Depository for Securities Limited are all incorporated entities and their accounts are therefore subject to an annual financial audit¹⁰⁷.

The actions of the member institutions of the Canadian Payments Association are also internally monitored through a mandatory dispute resolution process. In November, 1995, the Canadian Payments Association's board of directors

¹⁰³ Oglivie para 271

¹⁰⁴ Oglivie para 274

¹⁰⁵ Oglivie para 374

¹⁰⁶ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993, at 42

¹⁰⁷ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 71

strengthened Compliance Rule A11 by granting the general manager the authority to refer a non-compliance complaint to a panel consisting of at least three representatives of member institutions not involved in the complaint¹⁰⁸.

Moreover, since 1871, the federal government has undertaken a complete review of the banking and payments systems at ten year intervals. Its present review is to be completed by 1997. In June, 1996, the Department of Finance announced that it intends to undertake a comprehensive review of the appropriate framework for the financial sector in the 21st century. This review is to include an analysis of the regulatory framework of the payments system given that the "increasing use of technology is changing the payments system landscape"¹⁰⁹.

In summary, the Canadian *clearings and settlement system* has evolved from an interbank system of manual cheque clearing at individual clearing houses to a highly automated and computerized system capable of processing payment information in both paper and purely electronic form. In my view, the national *payments system* is intended to encompass not only this clearings and settlement system (which ultimately clears and settles all accounts with the Bank of Canada) but any and all systems that are used to process payment mechanisms which facilitate the transmission of funds

¹⁰⁸ Canadian Payments Association Review, 1995-1996 at 7

¹⁰⁹ White Paper: Government of Canada, "1997 Review of Financial Sector Legislation: Proposals for Changes" issued on behalf of the Government of Canada by the Honourable Doug Peters, Secretary of State (International Financial Institutions), (Ottawa, Distribution Centre, Department of Finance, June 1996)

from a depositor/debtor to his or her creditor. In other words, the national payments system includes all financial communications systems (including but not limited to POS, ATM and telecommunications systems) which process payment instructions that are ultimately cleared and settled through the ACSS and or the Bank of Canada.

CHAPTER TWO: ELECTRONIC TRANSFERS OF FUNDS

Assuming that the Canadian national payments system includes all financial communications systems which process payment instructions that are ultimately cleared and settled through the ACSS and or the Bank of Canada, the next question is what systems and services presently make up this comprehensive system. This chapter considers the distinction between a paper-based and an EFT system, looks at various definitions of EFTs and looks at the growth of EFTs in Canada since the 1980s. It then briefly describes certain domestic EFT services and systems which are in existence or in the planning stage such as pre-authorized payments by direct debiting, ATMs, POS system, bill payment by telephone, home banking services, the large value transfers system and electronic data interchange. Finally, it briefly looks at international interbank payments systems and the debt and equity clearing services used by the Canadian Depository for Securities Limited.

(a) Distinction between a Paper-based System and Electronic Funds Transfer Systems

Payments systems are classified as either paper-based or electronic, depending on the medium used for interbank communication of payment instructions. In a paper based system, the payor's instruction is embodied in a piece of paper, such as a cheque, either signed by the payor or under the payor's authority. In carrying out the payment, this piece of paper is physically transferred from one financial institution to another. In an electronic system, interbank communication is either off-line, by the

physical delivery of media storage devices such as tapes or disks containing payment instructions, or on-line electronic transmissions over telecommunication lines¹¹⁰.

The dividing line between paper-based and electronic payments systems is the medium used for *interbank* communication. The medium for financial institution-customer communication, in which payment instructions are either delivered by the originating sender to the sending financial institution or advised by the receiving financial institution to the ultimate receiver, is irrelevant for the purposes of characterizing the payments system¹¹¹.

With increasing automation of the paper-based system, the distinction between paper-based and electronic payments systems sometimes becomes blurred. For example, to expedite settlement, clearing and settlement information relating to cheques may be transmitted electronically. However, as long as the process of payment requires the physical transportation of the paper embodying the payment transaction, the system remains classified as paper-based¹¹².

¹¹⁰ B. Geva, The Law of Electronic Funds Transfers (New York: Matthew Bender & Co. Inc., 1992) at 1-24

¹¹¹ B. Geva, The Law of Electronic Funds Transfers (New York: Matthew Bender & Co. Inc., 1992) at 1-24

¹¹² B. Geva, The Law of Electronic Funds Transfers (New York: Matthew Bender & Co. Inc., 1992) at 1-25

The Canadian cheque collection and clearing system is premised on the physical exchange of cheques among financial institutions that settle the resulting balances on their respective accounts at the Bank of Canada¹¹³. As a result the Canadian payments system is considered to be predominantly paper based. Yet while Canada's payments system remains predominantly paper based, its future is as an EFT system.

(b) Definition of an Electronic Funds Transfer and Growth of Same

As previously stated, the financial industry is currently undergoing a revolutionary change involving electronic fund transfer systems. In these systems, the time consuming transfer and processing of paper is replaced by the electronic transmission, processing and storage of data. EFT is defined in the United Nations Commission on International Trade Law's (UNCITRAL) Legal Guide on Electronic Funds Transfers as "a funds transfer in which one or more steps in the process that were previously done by paper-based techniques are now done by electronic techniques"¹¹⁴.

In Regulation E to the U.S. Electronic Fund Transfer Act (the EFTA), an electronic transfer is defined (consumer oriented) as follows:

"Electronic fund transfer means any transfer of funds, other than a transaction originated by check, draft, or similar paper instrument, that is initiated through an

¹¹³ B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 303

¹¹⁴ B. Petre, "Network Providers", (1990) 7 Computer Law & Practice 8

electronic terminal, telephone, or computer or magnetic tape for the purpose of ordering, instructing, or authorizing a financial institution to debit or credit an account. The term includes, but is not limited to, point-of-sale transfers, automated teller machine transfers, direct deposits or withdrawals of funds, and transfers initiated by telephone. It includes all transfers resulting from debit card transactions, including those that do not involve an electronic terminal at the time of the transaction. The term does not include payments made by check, draft, or similar paper instrument at an electronic terminal"¹¹⁵.

An electronic funds transfer is typically initiated by an "access device". The typical access device is a plastic card that not only introduces a consumer to a terminal, but also provides a personal identification number (PIN) that confirms the consumer's identity. The access device also includes telephone transfer codes and bill paying codes that may be established between a financial institution and a consumer to arrange EFTs¹¹⁶. It is assumed that if the card is stolen, the access codes will not also be stolen. In the United States, Regulation E takes steps to insure the safety of the access device. It must be accepted by the consumer, it must be validated by the institution, the institution must verify the consumer's identity by any reasonable means, such as by photograph, fingerprint, personal visit, or signature comparison and it may not be distributed to the consumer other than in response to the consumer's oral or written request or application for the device¹¹⁷. Similarly, the Canadian Payments Association, in association with consumer organizations, financial institutions, retailers

¹¹⁵ 12 CFR § 205.2(g) (1985); C. Felsenfeld, Legal Aspects of Electronic Funds Transfers, (Stoneham, Massachusetts: Butterworths, 1988) at 8

¹¹⁶ Reg. E, § 205.2(a); C. Felsenfeld, Legal Aspects of Electronic Funds Transfers, (Stoneham, Massachusetts: Butterworths, 1988) at 14

¹¹⁷ Reg. E, § 205.2(a); C. Felsenfeld, Legal Aspects of Electronic Funds Transfers, (Stoneham, Massachusetts: Butterworths, 1988) at 15-16

and federal and provincial governments, has developed a voluntary Code of Practice¹¹⁸ with respect to the use of debit card services in Canada. The Code provides, amongst other things, that the debt card service can only be commenced upon written request of the customer, that the applicant can choose which eligible account the card will access and that the issuer must inform the applicant of any associated fees, how to contact the PIN issuer in event of a problem, how to avoid unauthorized use and so on.

Although the flow of paper payment instruments still remains larger in terms of value and volume than the flow of electronic items, the flow of paper items is falling while the flow of electronic items continues to grow rapidly¹¹⁹. For example, the flow of electronic items increased from 8.8% of the volume of all payment items that passed through the ACSS in 1988 to 19.5% during 1992¹²⁰. It is expected that the flow of electronic items will continue to increase as more people use the electronic funds transfer services which are being offered by the financial industry. Eventually this flow

¹¹⁸ Canadian Code of Practice for Consumer Debit Card Services prepared by Electronic Funds Transfer Working Group, revised February, 1996.

¹¹⁹ A look at the number of electronic fund transfers taking place in the United States in the 1980's gives a good indication of the growth which was anticipated to happen in Canada. By 1980, in the United States, the value of transfers over wire had already reached ten times the value transferred by cheque. By 1984, there were 98 million electronic wire transfers of funds with a value of \$250 trillion and 43,000 automated teller machines were being used to process 3.1 billion transactions. In contrast only 36,000 ATMs were in place in 1982 and only 8,000 ATM's were operating in 1978. see C. Felsenfeld, Legal Aspects of Electronic Funds Transfers, (Stoneham, Massachusetts: Butterworths, 1988) at 1 and J.V. Vergari and V.V. Shue, Checks, Payments, and Electronic Banking, (Practising Law Institute, New York City: 1986) at xx and 484

¹²⁰ "Bank for International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993 at 62

will surpass the flow of paper payment instruments, particularly 'small paper times' (essentially cheques under \$50,000.00) which are more directly comparable to ATM and POS transactions¹²¹.

In 1988 there were 6,300 ATMs which processed 656.6 million transactions with a value of \$29.1 billion. By 1992, there were 14,596 ATMs which processed 1,024.8 million transactions with a value of \$53.5 billion. Similarly, in 1988, there were 873 POS terminals which processed 0.4 million transactions of an 'insignificant' value. By 1992, there were 29,699 terminals which processed 30.3 million transactions with a value of \$1.6 billion¹²². The annual flow of payment items through the ACSS for shared ATM networks has increased in value from \$3,594,495,000.00 in 1988, to \$13,432,737,000.00 in 1992 and to \$20,913,319,000.00 in 1995. Similarly, the annual flow of payment items through the ACSS for POS terminals has increased in value from \$insignificant in 1988, to \$335,792,000.00 in 1992 and to \$14,240,678,000.00 in 1995¹²³. In money terms, the increase in electronic banking means that the financial

¹²¹In 1994, the value of all cheque transactions was \$20,953,343,859,000.00. However the value of all small paper items was only \$1,029,533,926,000.00. R. Hayhoe, "Fraud, the Consumer and the Banks: The (Un-) Regulation of Electronic Funds Transfer", (1995) 53 University of Toronto Faculty of Law Review 346 at note 3.

¹²²"Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December 1993 at 81 Table 6. According to an "Automated Banking Machine Survey" reproduced at page 3 in Forum, volume 12, No.1, March, 1996, prepared by the Canadian Payments Association, as of January 31, 1996 there were a total of 17,670 ABMs of which 13,261 were operated by the banks, 1,125 by trust companies, 2,989 by credit unions and caisse populaires and 295 by other members.

¹²³ Annual flow of Payment Items through the Automated Clearing Settlement System (ACSS) prepared by the Canadian Payments Association

institutions are saving a great deal of money which they would otherwise have had to spend processing the paper items. The cost of a customer transaction with a human teller costs more than one dollar. At an ATM the cost drops to seventy-five cents. Telephone banking costs twenty-five to forty cents per transaction depending on whether the customer uses an automated voice-response system or a live operator. On the Internet, the cost of doing a transaction could be as low as a penny¹²⁴.

(c) Canadian Domestic Electronic Funds Transfer Systems

The following EFT banking-related services are currently available in Canada: (a) pre-authorized payments by direct debiting; (b) direct deposit of credit transfers (c) wire transfers of single items (d) ATM services and networks (e) terminal-based cash management services (such as cash concentration and funds flow monitoring, balance reporting, on-us funds applications such as transfers between accounts and into money market investments, and drawing upon established lines of credit) (f) POS and (g) electronic data interchange (EDI)¹²⁵.

Generally the following types of services and systems are encompassed within the term electronic funds transfer:

¹²⁴ G. Arnaut, "The Internet versus private networks", *The Globe and Mail*, Tuesday, November 5, 1996, at p. C6

¹²⁵ B. Crawford, "Legal Influences on the Stability of the National Payments System" (1988) 2 *Banking & Finance Law Review* 183 -

(i) Pre-authorized Payments by Direct Debiting (PAD): In Canada, the development of the pre-authorized debit and direct deposit systems eliminated the need for the establishment of automated clearing houses (ACH) of the type found in many other developed countries¹²⁶. Pre-authorized payment items are the types of debit transfer frequently advertised by mortgage or life insurance corporations as a service to their customers in which the debits are prepared by the payee. Initially, PADs were used exclusively for contractual payments of fixed amounts. They have now been expanded to cover other types of regular payments, sometimes with periodic adjustments in dollar amount. In Canada these payment schemes were originally

¹²⁶ An automated clearing house is a computerized, inter-bank transfer system. It is not designed for direct use by the public but is rather the electronic equivalent to the paper cheque processing system. The ACH system involves the transmittal of funds transfer data, the processing of that data and settlement of those transfers. It is not an on-line, real time system. Processing is done on a batched basis involving multiple transactions. The processing of the ACH transactions is done by computerized facilities referred to as automated clearing houses. Transmittal to and from the ACH facilities may be made either electronically or by physical delivery of a magnetic tape. Regional ACHs were established in the United States in the early 1970's. Several regional ACHs formed the National Automated Clearing House Association (NACHA) in 1974. In the United States, settlement is made through the Federal Reserve System typically on a "next-day basis". The system saves financial institution customers both financial institution costs and internal costs when transactions are not tied to the paper cheque system. It is easier for the financial institutions, and therefore cheaper for the corporation utilizing the ACH system, to process payments that have been transmitted to them electronically. Internally, the costs of reconciling payments made through the ACH system are less than those associated with the reconciliation required for cheques. Instead of clearing cheques, an ACH processes electronic items. Debit and credit entries from originating financial institutions are received by the ACH recorded on magnetic tape or transmitted electronically. The ACH uses data-processing equipment to sort and balance the entries it receives. An ACH greatly increases the efficiency of a program such as direct deposit of payrolls, social security payments and so on. A customer can also give prior authorization for ACH debit transfers for recurring payments in the same amount such as mortgage or insurance payments. The ACH system was adapted for use in connection with a number of other types of transactions including ATM and POS transactions. Transactional data is stored until the end of a day or some other period and put into ACH format applicable to ATM or POS items for transmittal and processing through the ACH system like other ACH items. (see P.E. Homrighausen, "Automated Clearing House System Issues", (1986-87) 1 Banking & Finance Law Review 115 at 116 and 117; B. O'Keefe, "Automated Clearing House Growth in an International Marketplace: The Increased Flexibility of Electronic Funds Transfer and Its Impact on the Minimum Contacts Test", (1994) 15 University of Pennsylvania Journal of International Business Law 105 at 108 and 109; M.R. Katskee and A.I. Wright, "An Overview of the Legal Issues Confronting the Establishment of Electronic Funds Transfer Services", (1980) 2 Computer Law Journal 7 at 8 and W.H. Lawrence, Commercial Paper and Payment Systems, Vol 2, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 16-4 and 16-5).

operated under the aegis of the industry-wide inter-bank agreement in which the financial institutions warrant to each other that PAD items introduced to the clearings for settlement either in paper or magnetic tape format would be fully authorized by the persons on whose accounts they were purported to be drawn. This warranty was necessary by reason of the absence from the PAD item of the signature of the ostensible drawer¹²⁷. Now, Rule H4 of the Clearing Rule governs the exchange of these items. The company initiating the withdrawal from their customer's account must have that customer's written authority to do so and must also have entered into an agreement with its own financial institution to process the PADs. In addition, any unauthorized withdrawal will be reversed by the financial institution if, in the case of a commercial transaction, it is reported within 10 days or, in the case of a consumer transaction, it is reported within 90 days. The reversal process is considered to be automatic in that while the payments are made on the assumption that the consumer's wishes are being carried out they are done without his or her direct instruction.

(ii) Automated Teller Machines (ATM's): ATMs are part of "an unmanned system that takes deposits, disburses cash and transfers funds from one account to another without processing paper for collection"¹²⁸. In other words, ATM's supplement the cash payments system by disbursing cash to consumers. They also operate as

¹²⁷ B. Crawford, "Does Canada need a Payments Code?", (1982) 7 Canadian Business Law Journal 44 at 49

¹²⁸ Quote from M.R. Katskee and A.I. Wright, "An Overview of the Legal Issues Confronting the Establishment of Electronic Funds Transfer Services", (1980) 2 Computer Law Journal 7 at 8

electronic fund transfer systems by taking deposits, transferring funds between accounts, answering balance inquiries, and making bill payments. They also can be used for credit transactions by disbursing cash for small loans against credit cards or overdraft services on checking accounts¹²⁹. In 1994, there were almost 300 million ATM transactions which cleared through the ACSS. This figure does not include transactions which were performed using the machines provided by the account holder's own institution¹³⁰.

Shared automated teller machine and POS transactions are currently governed separately by CPA Standards 020 and 021, respectively.

(iii) Point of Sale System (POS): A POS system is a system "which simultaneously debits the customer's account and credits the merchant's account for the payment of goods or services"¹³¹. Like the ATM, these systems utilize a debit card issued by the customer's financial institution. Use of the card permits customer to pay

¹²⁹ W.H. Lawrence, Commercial Paper and Payment Systems, Vol 2, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 16-6

¹³⁰ R. Hayhoe, "Fraud, the Consumer and the Banks: The (Un-) Regulation of Electronic Funds Transfer", (1995) 53 *University of Toronto Faculty of Law Review* 346 at note 2. It has been estimated that some one billion transactions were effected at ATMs during 1992, compared with 656.6 million during 1988. Moreover, between 50 and 60% of the customers deposit taking institutions are believed to use the machines currently and of those customers fully a third use the machines at least four times a week from "Bank for International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payments and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993, at 58

¹³¹ Quote from M.R. Katskee, M.R and A.I. Wright, "An Overview of the Legal Issues Confronting the Establishment of Electronic Funds Transfer Services", (1980) 2 *Computer Law Journal* 7 at 8

for retail goods and services through automatic debiting of their accounts, rather than paying cash or by cheque. POS terminals are located at participating merchants' businesses and operated by their employees. Shared POS systems enable several financial institutions to tie into a single network. These systems utilize a switch to route the transaction messages from each participating merchant to the financing institution where the customer maintains an account¹³².

As stated, point of sale systems have been extensively implemented in Canada via the Interac Association in the last few years. In 1988, the value of POS transactions was \$256,000.00. In 1994, the value had increased to \$6,787,306,000.00¹³³. From 1994 to 1995, the growth rate in volumes increased 111 per cent. In December, 1995 alone, 8.2 million persons used Interac Direct Payment services. As at February, 1996, there are more than 170,000 POS terminals in more than 140,000 retailer locations. In 1995, there were approximately 390 million Interac Direct Payment transactions representing an estimated ten per cent of the total cashless payments processed through the clearing system in Canada¹³⁴. The benefits of an POS system for retailers include larger transaction sizes, reduced handling errors

¹³² W.H. Lawrence, Commercial Paper and Payment Systems, Vol 2, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 16-7

¹³³ R. Hayhoe, "Fraud, the Consumer and the Banks: The (Un-) Regulation of Electronic Funds Transfer", (1995) 53 University of Toronto Faculty of Law Review 346 at note 1

¹³⁴ Non-controversial Background Information filed on February 21, 1996 by Retail Council of Canada with the Competition Tribunal in action no. CT-95/02. Retailers pay transaction fees currently ranging up to \$0.18 per transaction. Using a cost of \$0.12, retailers paid financial institutions at least \$48.8 million in transaction fees in 1995.

and cash shortages, reduced losses due to theft, a guaranteed payment device (compared to cheques), reduced overdraft exposure and faster transaction time.

(iv) Bill Payment by Telephone and Home banking Services: The typical Canadian household pays on average nine bills per month. Eighty per cent of these bills are paid by cheque through the mail or over the counter with the remainder being paid by means of ATMs or PAD arrangements. It is estimated that roughly half of the annual clearing volume (about one billion items) is presently accounted for by remittance of household bills and accounts. Accordingly, the question of how to deal with bill payments in a more cost effective way than by the traditional methods of cheques has often been raised¹³⁵.

It is anticipated that home banking services using home computers and the telephone system will be used by the general public to carry thirty per cent of these routine banking transactions by the year 2000¹³⁶. In furtherance of this objective (presumably as a supplement to the ATM and PAD services already offered), the industry has developed telephone transfer systems and home banking services which can be implemented to provide customers with a convenient way to make payments of non-recurring bills. In a telephone transfer system the customer can call his or her

¹³⁵ "New Standards Facilitate Bill Payment Reform", Forum, volume 10, No. 2, June, 1994, prepared by the Canadian Payments Association, at p.1

¹³⁶ D. Wilson, "On-line services will transform banks":, The Globe and Mail, Tuesday, November 5, 1995, at p. C1

financial institution 24 hours a day, 7 days a week with instructions to pay individual payees. With a touch tone phone and the use of a confidential PIN, the information can be transmitted electronically to the payee¹³⁷. Bill payment by telephone allows a financial institution to save the time and expense of processing paper items and enables them to charge their customers a higher transaction fee for use of this new service than that presently charged for cheque processing. From the customer's point of view, he or she saves the combined mailing and cheque processing fees (which together is greater than the automated transaction fee) and has added convenience of home banking.

The industry has also developed programs which allow some banking services (such as checking balances, paying bills, postdating bill payments, transfer of funds between accounts, account statements) to be accessed from the home computer terminal¹³⁸. The home terminals may vary in type from standard personal computers that are programmed to conduct banking functions to small, portable terminals that may be plugged into telephone outlets wherever the consumer may choose to use them. They may be owned by the a financial institution and supplied to the consumer, or they may be owned by the consumer and operated with software supplied by a financial

¹³⁷ W.H. Lawrence, Commercial Paper and Payment Systems, Vol 2, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 16-6

¹³⁸ See for example: Toronto-Dominion Bank's TD Access: PC, CIBC's CIBC PC Banking, Canada Trust Co.'s CTConnect, Vancouver City Savings Credit Union's Van City Direct, Bank of Montreal's Mbanx, Royal Bank's Royal Direct PC Banking and Royal Direct Internet Banking, Bank of Nova Scotia On-Line and National Bank's Computeller

institution. In January, 1994, a consortium of six major corporations¹³⁹ introduced "UBI" one of the first universal, bi-directional and interactive home information highway systems in the world. The system is intended to offer users access to numerous two-way electronic services such as home banking, games, couponing, electricity consumption management, home automation, electronic mail and catalogues. It will use the cable TV network to transmit to and from the consumer's home and will offer consumers the choice of paying for the goods and services by credit card, debit card or an electronic wallet provided on the UBI smart card¹⁴⁰.

Smart Cards or Integrated Circuit Cards are cards containing their own processing capabilities through an embedded microchip. In early 1991, a steering committee was established by the Canadian Payment Association to, inter alia, develop smart-card standards for payment applications. Several smart card applications have been tested by Canadian deposit taking institutions on a limited scale. For example, the stored value Mondex card presently being tested by CIBC and Royal Bank is a "virtual cash card" intended to replace the use of cash for small purchases. It can be "reloaded" at a pay phone equipped with a special card slot or automated teller machine¹⁴¹.

¹³⁹ the Hearst Publishing Group, Hydro Quebec, the National Bank of Canada, Loto-Quebec and Canada Post Corporation

¹⁴⁰ R. Bastien, "UBI Paves Way for Smart Card Payment Applications", Forum, volume 10, No. 1, March, 1994, prepared by the Canadian Payments Association, at p.1

¹⁴¹ D. Wilson, "On-line services will transform banks":, The Globe and Mail, Tuesday, November 5, 1995, at p. C1

(v) Cheque Guarantee: Cheque guarantee systems utilize some of the electronic equipment used in POS but they are designed to facilitate the acceptability of cheques to merchants. The data is transmitted through an ACH to a depositor account database which transmits back an authorization or rejection of the cheque depending on the state of the customers' account¹⁴². Apparently cheque guarantee schemes, so popular in the United States, were phased out in Canada. They were not tied to the POS terminal but rather were operated on the basis of an identification card¹⁴³.

(vi) Wire Transfers - Large Value Transfers System - Canada is currently the only G-10 country without a system that provides finality of payment on the same day for large value payments. International business requires settlement of foreign exchange to be synchronized across borders which in turn requires that the countries of the originator and the receiver have payments systems that provide finality of payment. Canadian financial institutions working through the Canadian Payments Association are in the process of developing a Large Value Transfer System (LVTS) which will be Canada's new wire payment mechanism. It is anticipated that the LVTS will offer intra-day finality of payments for its users and will control systemic risk - the

¹⁴² W.H. Lawrence, Commercial Paper and Payment Systems, volume 2, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 16-7

¹⁴³ B. Crawford, "Does Canada need a Payments Code?", (1982) 7 Canadian Business Law Journal 44 at 50

risk that the failure of one participant to meet its obligations will result in other institutions being unable to meet their obligations¹⁴⁴.

Large value payments account for over ninety per cent of the approximately seventy billion dollars that flows daily through the Canadian Payments Association's existing clearing and settlement system¹⁴⁵. In 1992, large-value payments (\$50,000 and above) averaged some \$68.1 billion per day, representing 93.4% of the value recorded by the ACSS and amounting to 27,500 items per day¹⁴⁶. The large value payments can be divided into three broad categories: (1) international payments which represent approximately one quarter of the total value; (2) payments that reflect transactions in the Canadian securities markets, which account for about 20% of the total value; and (3) commercial and governmental payments¹⁴⁷.

It is proposed that federal legislation be developed to give the Bank of Canada a more explicit role in the oversight of clearing and settlement systems from the point of view of controlling systemic risk. Enhanced powers of the Bank of Canada are

¹⁴⁴ Canadian Payments Association Review 1995-1996 at 2. Trial operation of the LVTS is scheduled to begin in July, 1997 and it is anticipated that the LVTS will be fully operational by early 1997.

¹⁴⁵ Canadian Payments Association Review 1995-1996 at 2

¹⁴⁶ "Bank for International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993 at 59

¹⁴⁷ "Bank for International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993 at 59

consistent with the current focus of central banks around the world on these matters. With respect to the LVTS, the Bank of Canada would have the power to guarantee settlement of transactions on the system in the event that the collateral posted by the financial institution is insufficient to cover losses arising from multiple participant failures at the same time. In other words, the LVTS procedures will guarantee that there is enough collateral available to permit settlement on the books of the Bank of Canada at any time during the day if any participant is declared non-viable. The legislative changes would also permit the Bank of Canada to pay interest on deposit liabilities associated with the LVTS, to open deposit accounts for clearing houses and to act as a settlement agent¹⁴⁸.

On April 9, 1996, the Canadian Payments Association signed a contract with DMR Group Inc. to build and operate the LVTS. The LVTS is essentially the Canadian equivalent of FedWire¹⁴⁹. Payments made via the LVTS will be guaranteed same day

¹⁴⁸ Department of Finance, "Enhancing the Safety and Soundness of the Canadian Financial System" issued on behalf of the Government of Canada by The Honourable Doug Peters, Secretary of State, (International Financial Institutions) (Ottawa: Distribution Centre, Department of Finance, February, 1995) at 19

¹⁴⁹ Prior to developing Canada's LVTS, the Canadian Payments Association reviewed the United State's FedWire and Clearing House Interbank Payment System (CHIPS), the British Clearing House Automated Payment System (CHAPS) and the Swiss Wire Transfer System (S.I.C.): from "Canada-Wide Large Value Transfer System", Forum, volume 5, No. 1, March, 1989, summary of a speech by E.J. Lindwall prepared by the Canadian Payments Association at 1.

FedWire: In the United States, the primary system for transferring large sums of money quickly for payment and settlements of the accounts of financial institutions and commercial enterprises or of the accounts of their customers is through Fedwire (the Federal Reserve Wire Network) operated by the Federal Reserve. The current Federal Reserve System was fully automated in 1973 utilizing a central switch facility located in Culpepper Virginia with additional communications switches in district offices and each Federal Reserve Bank. As a result nearly instantaneous communications and transfer of funds can be made among institutions participating in the network. By the end of 1986, the average daily value transferred over Fedwire was \$700 billion. The system does not collect and store information relating to the customer that originates and receives the funds transferred but merely

finality of settlement and will be backed by the Bank of Canada. DMR Group Inc. in partnership with CDSL Canada Limited is expected to operate the LVTS for the first five years. Is it scheduled for testing in mid-1997 and is expected to be fully operational by the end of that year¹⁵⁰.

debits and credits the member banks involved. Fedwire transfers are settled as the transactions are made. A fund transfer through the Federal Reserve System is considered to be paid on receipt of the communication from Fedwire, and that payment is guaranteed by the full credit of the United States Government. Settlement of the Banks with the Federal Reserve is not accomplished however until the end of the day. The Federal Reserve thus incurs the risk of the failure of a transferor which has incurred "daylight overdrafts" whereby its liability for funds sent exceeds the balance in its account: from W.H. Lawrence, Commercial Paper and Payment Systems, volume 2, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 16-9 and "Canada-Wide Large Value Transfer System", Forum, volume 5, No. 1, March, 1989, summary of a speech by E.J. Lindwall prepared by the Canadian Payments Association at p.1

CHIPS: This system is operated by the New York Clearing House Association. In 1989, there were 21 settling participants, the major U.S. banks and over 100 non-settling participants. Settlement is made at the Federal Reserve Bank of New York by means of FedWire transactions in the evening based on net settlement reports prepared by CHIPS late in the afternoon. The transfers are conditional until the settlement process is completed: from "Canada-Wide Large Value Transfer System", Forum, volume 5, No. 1, March, 1989, summary of a speech by E.J. Lindwall prepared by the Canadian Payments Association at 1.

CHAPS: In England, the existing clearing systems were placed in 1985 under the control of three operating companies governed by an umbrella body named the Association for Payment Clearing Systems. The three companies controlled by this Association were responsible respectively for the paper bulk clearing, for the high value clearing (covering the town clearing and the Clearing House Automated Payment System (CHAPS) which effects the electronic transfer of specific payments of substantial amounts (£10,000 and above)) and for the electronic bulk clearings of the Bankers' Automated Clearing Services (BACS) which effects bank giro transfers including all types of periodic payments and direct debiting arrangements: from E.P. Ellinger, Modern Banking Law (Oxford: Clarendon Press, 1987) at 7 and 8. Under the CHAPS system each of the settlement banks has its own gateway into a national packet switching system. Once a payment is released from a packet switching system to the gateway of the receiving bank, it is guaranteed and may not be revoked under any circumstances: from "Canada-Wide Large Value Transfer System", Forum, volume 5, No. 1, March, 1989, summary of a speech by E.J. Lindwall prepared by the Canadian Payments Association at 1

¹⁵⁰ Canadian Payments Association Review 1995-1996 at 2

Direct access to the LVTS will be limited to those Canadian Payments Association members who can demonstrate sufficient technical competence, who have a settlement account with the Bank of Canada and who have the necessary collateral to enter into the proposed loss-allocation arrangements. It is expected that this group will include all of the major banks, the Caisse, several Schedule II banks, trust companies, Credit Union Central of Canada and Alberta Treasury Branches. Consumers and businesses who wish to send payments through the LVTS will have to do so through a CPA member institution¹⁵¹.

(vii) Electronic Data Interchange (EDI)¹⁵² Financial Electronic Data

Interchange combines the business to business, computer-to-computer transmission of structured business documents such as inventory records, purchase orders, shipping notices and price catalogues with some form of electronic funds transfer thereby allowing the completion of the commercial transaction. On November 18, 1992 the Board of Directors of the Canadian Payments Association approved draft standards and guidelines applicable to EDI relating to the movement of credit-driven electronic funds transfers and the accompanying payments related information between participating deposit taking institutions. The use of EDI is not however increasing as anticipated. As of September 15, 1995, less than one per cent of both the volume and value of electronic transactions in the clearing and settlement system are accounted for

¹⁵¹ Canadian Payments Association Review 1995-1996 at 2

¹⁵² "Developments in Financial EDI", paper presented by Serge Vachon at CPSS Workshop on Retail Payment Systems hosted by the Deutsche BundesBank, Frankfurt, October 13, 1995

by EDI payment transactions. It is anticipated that it will grow as more businesses begin to exchange business data by electronic means.

In 1986, representatives of the Society for Worldwide InterBank Financial Telecommunication (SWIFT)¹⁵³ attending the United Nations Economic Commission meetings agreed to implement joint standards for Electronic Data Interchange for Administration, Commerce and Transport (EDIFACT) in the exchange of business messages between authorized users¹⁵⁴.

(viii) Other Systems: New systems for clearing transactions of government debt securities, known as the Debt Clearing Service (DCS) and a system for clearing and settling foreign exchange transactions are also being developed¹⁵⁵.

¹⁵³ The Society for Worldwide InterBank Financial Telecommunication (SWIFT) is described in more detail at p. 67

¹⁵⁴ B.D. Barclay, "S.W.I.F.T. to Accommodate EDI", Forum, volume 7, no. 1, March, 1991, prepared by the Canadian Payments Association, at p. 2

¹⁵⁵ Department of Finance, "Enhancing the Safety and Soundness of the Canadian Financial System" issued on behalf of the Government of Canada by The Honourable Doug Peters, Secretary of State, (International Financial Institutions) (Ottawa: Distribution Centre, Department of Finance, February, 1995) at 18 and 19

(d) International Interbank Payments systems¹⁵⁶

On the international level, the system carrying out incoming foreign wire payments denominated in Canadian dollars within Canada is the International Interbank Payments System of The Canadian Bankers' Association (IIPS)¹⁵⁷. Its operation is premised on the transmission of Society for Worldwide Interbank Financial Transmission (SWIFT) messages from one Canadian financial institution to another, followed by overnight settlement in the respective clearing accounts of the financial institutions at the Bank of Canada¹⁵⁸.

¹⁵⁶ For a discussion of international interbank payment systems generally see Maduegbuna, S.O., "The Effects of Electronic Banking Techniques on the Use of Paper-based Payment Mechanisms in International trade", (1994) *Journal of Business Law* 338; H. Rowe, "Legal Issues between Banks Sharing Networks", (1990) 7 *Computer Law & Practice* 2; B. Petre, "Network Providers", (1990) 7 *Computer Law & Practice* 8

¹⁵⁷ The two systems that process the bulk of the United States' international transactions are the New York Clearing House Association's Clearing House InterBank Payments System (CHIPS) and the Society for Worldwide InterBank Financial Telecommunication (SWIFT) which were in 1981 transmitting daily transactions totaling well over \$300 billion: from H.F. Lingl, "Risk Allocation in International InterBank Electronic Fund Transfers: CHIPS and SWIFT" (1981) 22 *Harv. Intl' L.J.* 621 at 622

CHIPS is owned by 12 New York Banks that comprise the New York Clearing House. It clears approximately 90% of all international interbank dollar transactions from H.F. Lingl, "Risk Allocation in International InterBank Electronic Fund Transfers: CHIPS and SWIFT" (1981) 22 *Harv. Intl' L.J.* 621 at 626.. As of 1990, nearly 150 additional domestic and foreign banks are participants in CHIPS. While the CHIPS central computer constantly records the transactions and messages as they are made, funds are not moved through any part of this network until the end of the day. At that time, the central computer produces a balance position report showing the daily new debit and credit position of each of the participants. The participants must then settle with each other (by means of an escrow account of CHIPS maintained in the New York Federal Reserve Bank) in the early evening: from W.H. Lawrence, Commercial Paper and Payment Systems, Vol 2, (Salem, New Hampshire: Butterworth Legal Publishers, 1990 at 16-10.

¹⁵⁸ B. Geva, The Law of Electronic Funds Transfers (New York: Matthew Bender & Co. Inc., 1992) at 4-67

The IIPS began operations in October, 1976. Its purpose was to facilitate correspondent banking transactions, third party international transactions, third-party domestic payments of large value and the settlement of domestic transactions in the domestic interbank deposit market. Approximately \$10 trillion is transferred via the system annually¹⁵⁹.

In the case of an international funds transfer, Canadian financial institutions are permitted to use SWIFT for interbank domestic messages. The domestic message passes through one Canadian financial institution to another through a SWIFT Access Point (SAP). There are two SAPs in Canada, one in Montreal and the other in Toronto. In other words, payment is effected from the Foreign financial institution to the Canadian Intermediary financial institution (Direct clearer) via SWIFT and then to the Canadian receiving financial institution (Direct Clearer) via SWIFT or IIPS and then to either an Indirect Clearer via SWIFT or IIPS or to the financial institution branch through its internal network¹⁶⁰.

SWIFT is a privately-operated international communication systems for financial messages¹⁶¹. It was formed in 1973 by 239 European, American and Canadian banks

¹⁵⁹ "Bank for International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993 62

¹⁶⁰ B. Geva, The Law of Electronic Funds Transfers (New York: Matthew Bender & Co. Inc., 1992) at 4-69-4-70

¹⁶¹ W.H. Lawrence, Commercial Paper and Payment Systems, Vol 2, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 16-8

from fifteen countries as a non-profit cooperative company organized under Belgian Law. It is wholly owned by its member banks. All member banks hold shares which are reallocated each year depending on each member's use of SWIFT services¹⁶². The system operates through three main centers, situated respectively in Brussels, Amsterdam and in Culpepper Virginia. Each country in which the banks have joined the system has a national terminal connected primarily to one of these three major centers. All three major centers are interlinked and interchangeable¹⁶³. As of 1991, SWIFT had 1,784 members in 84 countries and exchanged more than 1.3 million messages daily¹⁶⁴. It is solely a message communication system concerning fund transfers among its members. These messages result in debits and credits on bank books but the system does not effect actual transfer of funds or provide any settlement capacity. Settlement is accomplished through bilateral agreements between member institutions¹⁶⁵.

¹⁶² H.F. Lingl, "Risk Allocation in International InterBank Electronic Fund Transfers: CHIPS and SWIFT" (1981) 22 Harv. Intl' L.J. 621 at 622; D. Robinson, "The Structure and Characteristics of the Principal Electronic Banking Systems" in R.M. Goode editor, Electronic Banking The Legal Implications, (London: The Institute of Bankers and Centre for Commercial Law Studies, 1985) 5 at 12

¹⁶³ E.P. Ellinger, Modern Banking Law, (Oxford: Clarendon Press, 1987) at 362

¹⁶⁴ B.D. Barclay, "S.W.I.F.T. to accommodate EDI", Forum, volume 7, No. 1, March, 1991, prepared by the Canadian Payments Association, at p.2

¹⁶⁵ W.H. Lawrence, Commercial Paper and Payment Systems, Vol 2, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 16-10

It is anticipated that the IIPS will cease to operate once the new LVTS is fully operational and that all transactions which are sent over IIPS today will be sent over LVTS regardless of transaction size. LVTS will continue use SWIFT for international transfers.

The Canadian Payments Association is a member of the National Automated Clearing House Association's (NACHA¹⁶⁶) Cross-Border Council which is developing a set of principles, rules and standards to effect cross-border payments including corporate and retail electronic payments between Canada, the United States and Mexico and eventually beyond North America. Currently the majority of these payments are made by cheque which can take up to twenty days for recipients to obtain value for their funds. It also has a seat on the American National Standards Institute (ANSI) committee which considers different versions of ANSI standards and the eventual migration to more global standards¹⁶⁷.

¹⁶⁶ NACHA is an operating rule and standard setting body which from a legal standpoint operates primarily as a private law system - on the basis of a series of contracts among participating financial institutions which fix their respective rights and obligation. In 1986, there were approximately 16,000 participating financial institutions operating through 30 regional associations which were in turn members of NACHA. By 1994, NACHA included more than seventy-five percent of all commercial Banks and over 20,000 depository institutions. In 1978, the Federal Reserve System had made its communications network available to connect NACHA and other institutions. The Federal Reserve interdistrict network is known as the Federal Reserve Communications Systems for the Eighties (FRCS-80) (see W.H. Lawrence, Commercial Paper and Payment Systems, volume 2, (Salem, New Hampshire: Butterworth Legal Publishers, 1990) at 16-3; P.E. Homrighausen, "Automated Clearing House System Issues", (1986-87) 1 Banking & Finance Law Review 115 at 116; B. O'Keefe, "Automated Clearing House Growth in an International Marketplace: The Increased Flexibility of Electronic Funds Transfer and Its Impact on the Minimum Contacts Test", (1994) 15 University of Pennsylvania Journal of International Business Law 105 at 108).

¹⁶⁷ "Financial EDI - A Realistic Assessment", Forum, volume 11, No. 3, September, 1995, prepared by the Canadian Payments Association, at p.4

(e) The Canadian Depository for Securities Limited

The Canadian Depository for Securities Limited (CDS) was incorporated in 1970 under federal law as a private company. It is owned by the major Canadian chartered banks, trust companies members of the Montreal Exchange, The Toronto Stock Exchange and The Investment Dealers Association. Each of the bank, trust and broker-dealer groups hold one-third of the CDS common shares. It provides automated facilities for the clearing and settlement of equity and debt securities transactions through the new Debt Clearing Service (DCS) and Equity Clearing Service (ECS). On average, \$120 billion of Canada bonds and treasury bills and \$400 million of equity securities are settled through CDS daily¹⁶⁸.

As set out, the national payments system encompasses not only those traditional systems which facilitate the processing of paper payment instructions through the ACSS and or the Bank of Canada but those EFT systems which are capable of processing payment instructions in purely electronic form. As computerization becomes more widespread, more and more sectors of the economy will demand access to the payments system on the basis that it is a key element in their bid to remain competitive on both national and global scales. Whoever controls or gains access to

¹⁶⁸ Summary of Non-Controversial Background Information Respecting Midland Walwyn Capital Inc., Richardson Greenshields of Canada Limited, MacKenzie Financial Corporation and Trimark Investment Management Inc. filed with the Competition Tribunal on February 21, 1996 in file number CT 95/02

this financial communications system will be able to offer their customers faster, cheaper and more convenient service. A complete system of electronic payments will eventually reduce the need for credit cards and, to the extent that it increases the use of deposits for payment purposes, it will reduce the need for currency and cheques as well. In other words, a truly national electronic funds transfer system will act not only as a "payments system" or financial communications system that will carry payment instructions but a "payment mechanism" which will replace payment for goods and services by cash or cheques.

Given its dual nature, an EFT system can no longer be viewed as simply an internal bookkeeping matter of the deposit taking financial institutions. Today's reality dictates that the concept of a national payments system must be broadly defined. It must recognize the importance of electronic commerce and the "information highway". Ideally, the national payments system, particularly that component of the system that processes EFT instructions, should be treated as a public utility and should evolve in response to technology-driven change¹⁶⁹.

The present dominance by the largest banks of the Interac system bears no comparison to the vision set out by the federal government in the 1975 document "Toward an Electronic Payments System" in which the government acknowledged that the movement away from a paper-based system would result in the eventual linking of

¹⁶⁹ Canadian Life and Health Insurance Association Inc. submission to the Department of Finance "The Need for Payments System Reform" (December, 1995) at 2

a variety of institutions, financial, retail and government, and ultimately affect the day-to-day transactions of the individual consumer. The government stated that it supported a "common user communications network" for the payments system, which would be nationwide, publicly accessible, a shared facility, and have adequate security. It was intended that the national network would be established under the auspices of the Canadian Payments Association and that this shared service would be openly accessible to all qualified users on a fee-for-use basis. The use of private communications systems for purposes that are entirely internal to the institution and unrelated to payments transactions would not be precluded¹⁷⁰. Presumably, it was anticipated that it would be possible to define sufficiently high standards that would permit the operation of the payments system in an safe and sound manner yet still permit any party capable of meeting the high standards to gain direct access to the system (those same standards would presumably also exclude some of the smaller deposit-taking financial institutions).

Accordingly, how the national payments system will evolve, who will control and operate it and who will have access to it and under what terms must be carefully considered and becomes of increasing importance the closer we get to a fully electronic payments system. Denying a party access to the EFT system or charging

¹⁷⁰ Canadian Life and Health Insurance Association Inc. submission to the Department of Finance, "The Need for Payments System Reform" (December, 1995) at 14-15; "Toward an Electronic Payments System" presented on behalf of the Government of Canada by the Honourable John Turner, Minister of Finance, and Gerard Pelletier, Minister of Communications (1975) at 6

them exorbitant fees for its use will eventually be similar to denying that same party access to paper currency or charging them exorbitant fees for the use of the currency.

CHAPTER THREE: NATURE OF BANK - CUSTOMER RELATIONSHIP

It is essential to understand the historic relationship between a bank and its customer (and the rights and obligations that the relationship creates) in order to fully understand the potentially incompatible powers that a deposit-taking financial institution now exercises or could exercise under the ACSS or EFT system. These rights and obligations are also relevant to the question of whether non deposit taking financial institutions and others should be granted direct access to the national payments system (particularly the POS systems) and, if so, what principles and standards should be applied when granting these parties access. This chapter briefly examines some of the basic rights and obligations of the bank and its customer and raises questions as to whether these rights and obligations should be amended given the electronic funds transfer environment. Questions raised about confidentiality, cheque truncation and presentment, authentication of the customer's mandate, countermand and allocation of risk are addressed in more detail in Chapter Four.

(a) General Principles

A "customer" is someone who has an account with a bank or someone who is in such a relationship with the bank that the relationship of banker and customer exists. The duration of the relationship is not of the essence¹⁷¹. Traditionally, the relationship

¹⁷¹ Oglivie para 391; Woods v. Martins Bank Ltd., [1959] 1 Q.B. 55 (Leeds Assizes); Great Western Ry.Co. v. London & County Banking Co., [1901] A.C. 414 (H.L.); Taxation Commrs. v. English, Scottish & Australian Bank Ltd., [1920] A.C. 683 (P.C.); Ladbroke & Co. v. Todd (1914), 19 Com.Cas. 256 (K.B.)

between the bank and customer is viewed as one of creditor-debtor and the money on deposit with the bank is considered to be a loan to the bank by the customer¹⁷². That being said, the bank is neither the bailee nor trustee of the customer so that the identical res must be returned to the customer nor does the bank have to account for any profit made in the use of the money or be subject to any laws relating to trusts in the manner in which it invests or otherwise uses the money¹⁷³. Subject to the bank's fiduciary duties, described below, the customer has no right to inquire into or question the use of the money by the bank¹⁷⁴.

When a bank agrees to pay any part of the "loan" (money deposited by customer) against the written orders of the customer (cheque), the relationship becomes one of agent and principal, the cheque being the principal's order to his agent to pay out of the principal's money into the agent's hands the amount of the cheque to the payee¹⁷⁵. The exact time when the cheque is cleared or the transfer of the account is actually completed may be decisive in determining whether the bank has become the

¹⁷² Oglivie para 392; J.R. Paget, The Law of Banking, 2nd ed. (London: Butterworth & Co., 1908) at 1; *Foley v. Hill* (1848), 11 H.L.C. 27, 9 E.R. 1002 (H.L.);

¹⁷³ Oglivie para 392; J.R. Paget, The Law of Banking, 2nd ed. (London: Butterworth & Co., 1908) at 1; *Foley v. Hill* (1848), 11 H.L.C. 27, 9 E.R. 1002 (H.L.); *Re Agra & Masterman's Bank* (1866), 36 L.J. (NS) 151 (Ch.); *Sinclair v. Brougham*, [1914] A.C. 398 (H.L.);

¹⁷⁴ Oglivie para 392; *Foley v. Hill* (1848), 11 H.L.C. 27, 9 E.R. 1002 (H.L.); *Re Agra & Masterman's Bank* (1866), 36 L.J. (NS) 151 (Ch.);

¹⁷⁵ Oglivie para 393; *Westminster Bank Ltd. v. Hilton* (1926), 136 L.T. 315 (H.L.); *Selangor United Rubber Estates Ltd. v. Cradock* (No. 3), [1968] 2 All E.R. 1073 (Ch.D.)

debtor of its customer in respect of any amount of the cheque on the account¹⁷⁶. As will be described in more detail below, the traditional rules relating to the presentment of the payment item and the obligation to honour or return a cheque within a certain time period are therefore relevant to the issue of whether the financial institution has become the debtor of its customer. The exact time that a payment instruction is legally considered to have cleared electronically will be of equal importance.

(b) Primary Implied Duties Of The Bank: Duty To Exercise Reasonable Care And Skill, Fiduciary Duty And Duty Of Confidentiality,

The primary implied obligation of a bank in Anglo-Canadian law is to exercise reasonable care and skill in carrying out its customer's business. The failure to make inquiries into an unusual transaction with regard to a customer may constitute a breach of this duty of care where the nature of the transaction is such as to invite inquiry¹⁷⁷. In general, the courts have been reluctant to impose a similar encompassing obligation on the customer to exercise reasonable care in the operation of his or her bank accounts¹⁷⁸. In other words, under ordinary circumstances, a bank is not required to

¹⁷⁶ Oglivie para 395; *Re Farrow's Bank*, [1923] 1 Ch. 41 (C.A.); *White v. Royal Bank* (1923), 53 O.L.R. 543 (C.A.); *Brandon v. Bank of Montreal*, [1926] 4 D.L.R. 182 (Ont. H.C.)

¹⁷⁷ Oglivie para 405; *Groves-Raffin Const. Ltd. v. CIBC*, [1976] 2 W.W.R. 673 (B.C.C.A.); *Royal Bank v. Klip'n Kurl Salon (Lynnwood) Ltd.* (1977), 1 Alta L.R. (2d) 378 (Dist Ct.); *Banque Canadienne Nationale v. Gingras* (1977), 1 B.L.R. 149 (S.C.C.). Compare *Mar-Jac Dev. Ltd. v. CIBC* (1978), 4 B.L.R. 45 (Que Prov. Ct.); *Banque Romande v. Mercantile Bank of Can.*, [1971] 3 O.R. 433 (C.A.) affirmed (1973), 45 D.L.R. (3d) 480 (S.C.C.); *23199 Alberta Ltd. v. Patel* (1992), 1 Alta. L.R. (3d) 215, [1992] 4 W.W.R. 42 (Q.B.); N. Rafferty, "Account Verification Agreements: When Can a Bank Protect Itself Against Its Own Negligence" (1992-93), 8 *Banking & Finance Law Review* 403 at 405

¹⁷⁸ N. Rafferty, "Account Verification Agreements: When Can a Bank Protect Itself Against Its Own Negligence" (1992-93), 8 *Banking & Finance Law Review* 403 at 406

inquire into the source, origin or nature of a customer's deposits in a personal account but a bank should be cautious in accepting for deposit to its customer's account, however broad may be the authority to draw, a cheque drawn by that customer as agent upon his principal's account (usually the account of the customer's employer). If however the court detects circumstances which should arouse suspicion, the bank will be liable to the principal/customer in conversion¹⁷⁹. How is this historic obligation to exercise reasonable care and skill altered by the introduction of EFTs? How can a financial institution be held accountable for even "suspicious transactions" when all instructions have been given electronically? Should their liability be limited? Is their control over the issuing of the access device sufficient to discharge this obligation? If other parties are to be given direct access to the Interac and card issuing rights, should this duty be expanded or eliminated? What types of suspicious circumstances should a financial institution look for in an electronic transfers of funds? These questions are in turn connected to the issue of how the financial institution authenticates the customer's mandate in a paperless transaction to ensure that the payment instruction has been properly authorized.

If person entrusted with a cheque wrongfully deposits it in a bank account to the credit of someone who is not entitled to it, the true owner, if he has given notice to the bank while credit remains in the account, may recover the amount from the bank as

¹⁷⁹ Oglivie para 398; *Reckitt v. Nunburnholme* (1929), 45 T.L.R. 629 (K.B.); *Reckitt v. Barnett, Pembroke & Slater Ltd.*, [1929] A.C. 176 (H.L.); *Midland Bank Ltd. v. Reckitt*, [1933] A.C. 1 (H.L.); compare *Orbit Mining & Trading Co. v. Westminster Bank Ltd.*, [1962] 3 All E.R. 565 (C.A.)

money had and received or as damages in conversion¹⁸⁰. While bank branches have no separate legal identity from the parent bank but are viewed in law as parts of the whole organization of the bank or merely offices of the parent bank¹⁸¹, each bank branch is regarded as a separate endorser for the purposes of the Bills of Exchange Act and is entitled to separate notice of a forged endorsement¹⁸². Likewise, each endorsing branch of a bank is entitled to notice of dishonour¹⁸³. Given the advances of interbank and intra-bank communications, should the notice requirements be changed to permit notice to be given to one centralized location? What happens in an electronic transfer of funds? How are PADs and similar instructions countermanded?

In addition to this general duty to exercise reasonable skill and care, specific obligations have been imposed upon banks by the courts either on the basis of implied contract or principles of equity. Two of these additional obligations are a bank's duty to maintain the confidentiality of its customer's affairs and its duties as a fiduciary¹⁸⁴.

¹⁸⁰ Oglivie para 398; *Calland v. Lloyd* (1840), 6 M. & W. 26, 151 E.R. 307 (Exchequer)

¹⁸¹ Oglivie para 110; *Prince v. Oriental Bank* (1878), 3 App. Cas. 325 (P.C.)

¹⁸² Oglivie para 111; *Bank of Montreal v. Dom. Bank* (1921), 609 D.L.R. 403 (Ont.Co.Ct.)

¹⁸³ Oglivie para 111; *R. v. Lovitt*, [1912] A.C. 212 (P.C.)

¹⁸⁴ J.D. Marshall, "The Relationship Between Bank and Customer: Fiduciary Duties and Confidentiality" (1986-87) 1 *Banking & Finance Law Review* 33 at 34

In most cases, the customer's remedies for the bank's wrongful acts are adequately protected by actions for breach of contract and negligent misstatements. Where, however, a bank's wrongful conduct does not fall neatly into either of those categories, the courts have exercised their equitable jurisdiction to treat the bank as a fiduciary and have set aside the banking transactions or have awarded damages for breach of fiduciary obligations. The substantive difference between a fiduciary duty and a common law duty to exercise reasonable care and skill is that the former generally includes the additional duties of loyalty, good faith, avoidance of conflict of duty and self-interest and full disclosure¹⁸⁵. If non-deposit taking financial institutions or other parties are allowed direct access to the payments system how will this relationship change? Should the banks be entitled to limit their liability? Is it fair to hold them to a higher standard of care?

With respect to the duty of confidentiality, it has long been considered an implied term of the contract between the bank and its customer that the bank will not disclose to third persons, without the consent of the customer, expressed or implied, either the state of the customer's account, or any of his or her transactions with the bank, or any information relating to the customer acquired through the keeping of his or her account, unless the bank is compelled to do so by order of a court, or the circumstances give rise to a public duty of disclosure, or the protection of the bank's own interests requires

¹⁸⁵ Canadian Aero Service Ltd. v. O'Malley, [1974] S.C.R. 592 at 606; J.D. Marshall, "The Relationship Between Bank and Customer: Fiduciary Duties and Confidentiality" (1986-87) 1 Banking & Finance Law Review 33 at 40-41

it¹⁸⁶. The Canada Evidence Act has to some extent codified this duty of confidentiality in that it confirms that a bank is not compellable to produce any book or record or appear as a witness without a court order¹⁸⁷

As will be described in Chapter Four, with the increase of electronic gathering of information, the duty of confidentiality which the financial institutions now owe their customers becomes of increasing importance. How that duty and the duties to exercise reasonable care and skill and fiduciary duty will be applied to other financial institutions who gain access to the national payments system must also be considered.

The financial institution and its customer may also have certain contractual obligations which are set out in the account agreement. These contractual obligations cannot be unilaterally varied in the absence of reasonable notice. No new contract is created every time there is a fresh deposit, rather the account is a continuing one¹⁸⁸. As will be discussed in Chapter Four, the financial institutions use these account agreements to, amongst other things, grant themselves the right to use the confidential

¹⁸⁶ *Tournier; v. National Provincial and Union Bank of England* (1924), 1 K.B. 461 (C.A.); D.H. Flaherty, "Privacy, Confidentiality and Security in a Canadian Electronic Funds Transfer System" Working Paper #5 prepared in connection with a research project designed to identify "Policy and Legislative Responses to Electronic Funds Transfer" from a provincial perspective directed by Professor Richard H. McLaren at 41

¹⁸⁷ Canada Evidence Act, R.S.C. 1970, c. E-10, s.29(5)

¹⁸⁸ Oglivie para 394; *Burnett v. Westminster Bank*, [1966] 1 Q.B. 742 (Q.B.)

information gathered about their customers and to place limits on their liability for unauthorized use of the debit cards.

(c) Presentment for payment

Under the Bills of Exchange Act, the drawer's¹⁸⁹ and each endorser's respective statutory engagement arises only upon the dishonour of the bill "on due presentment". Accordingly, cheques must be presented for payment to charge drawers and endorsers as parties liable thereon¹⁹⁰.

A cheque is normally presented for payment by its holder, usually the payee, through the clearing system. The payee deposits the cheque in the bank where he maintains an account, this bank then presents the cheque to the drawee bank through the cheque clearing and collection system. Balances reflecting the totals of cheques drawn on participating banks are settled among themselves daily. Dishonoured cheques are returned to the holder via the bank with their amounts being reflected in the above-mentioned daily settlement. In the clearing and collection process the drawee bank is known as the payor bank. The bank where the cheque is deposited is

¹⁸⁹ A "drawee" or "payee" is the person to whom the cheque is addressed. The "drawer" or "payor" is the person from whose account the money is to be drawn or paid. Under the Bills of Exchange Act, the drawer of the cheque agrees that "on due presentment", the cheque shall be accepted and paid according to its term. An "endorser" is a payee who endorses the cheque in writing so as to make it payable to a third party (the "endorsee").

¹⁹⁰ Bills of Exchange Act, ss. 1309a) drawer's engagement, 133(a) endorser's engagement, 95(1)(a), and 95(2); B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 296 and 305

the depository or negotiating bank. The depository bank may present the cheque to the payor bank either directly or via intermediary banks. The bank actually presenting the cheque to the payor bank is known as the presenting bank. Except for the payor, each bank, that is to say, the depository and any intermediary, is referred to as the collecting bank¹⁹¹.

Presentment to the paying bank by a collecting bank is central to the payment of cheques through the clearings. Presentment though the clearings may take various forms: (1) payor branch presentment¹⁹² (2) data centre presentment (3) clearing house presentment or (4) remote presentment. In the case of payor branch presentment, no debit even provisional is posted to the drawer's account prior to the physical presentment of the cheque at the drawee branch. In data centre presentment, a debit is posted to the drawer's account either on a provisional or on a memo-posting basis upon the physical presentment of the cheque to a computer facility of the payor bank. The debit may be value-dated to the day of the original deposit of the cheque, day of data centre presentment or to some future date. In the absence of some form of cheque truncation (a procedure whereby only the information contained on the payment item and not the item itself is exchanged or transmitted by electronic means), the cheque is ultimately delivered to the payor branch for a subsequent physical presentment. In the case of clearing house presentment, payor branch presentment

¹⁹¹ B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 296

¹⁹² In electronic banking this practice does not exist.

and data centre presentment is preceded in the clearing system by the actual delivery of cheques by the presenting bank to the paying bank in bulk. No debit is posted to the drawer's account on the basis of clearing house presentment. In remote presentment a drawer's account is debited on the basis of the payment information that is electronically transmitted to the drawee bank, as for example by magnetic tape, prior to the physical presentment of the cheque¹⁹³.

Presentment of a cheque must be made within a reasonable time after its issue or endorsement¹⁹⁴. Where a bank fails to present a cheque within a reasonable time it is liable to the customer for any loss caused by the delay¹⁹⁵. Once a cheque is presented for payment, the bank must either pay or refuse to pay at once since a request to re-present amounts to dishonour¹⁹⁶. This requirement must be read in conjunction with the short turn around time in the clearing house rules.

To present a cheque effectively under the Bills of Exchange Act, the holder must exhibit the cheque to the person from whom he demands payment. In other words,

¹⁹³ B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 297

¹⁹⁴ B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 306

¹⁹⁵ Oglivie para 417; *Lubbock v. Tribe* (1938), 3 M. W. 607, 150 E.R. 1287 (Exchequer)

¹⁹⁶ Oglivie para 399; *Bank of England v. Vagliano Bros.*, [1891] A.C. 107 (H.L.); *Rouxel v. Royal Bank* (1918), 11 Sask. L.R. 218 (K.B.)

presentment has to be made by the physical exposition of the cheque¹⁹⁷. Presentment also has to be made at the proper place of payment which means (1) at the place specified in the cheque (2) at the address of the drawee (3) at the drawee's place of business or residence (4) wherever the drawee can be found or (5) at his latest known place of business or residence¹⁹⁸. Since the standard cheque form does not usually specify a place of payment but rather simply gives the address of the drawee branch, a cheque is presented within the meaning of the Bills of Exchange Act when it is physically presented by the holder, either in person or by a collecting agent, at the payor branch. Presentment for payment may be dispensed with by waiver of presentment, express or implied¹⁹⁹. Accordingly, any payments system which eliminates the need for eventual physical presentment/delivery of the cheque at the payor branch does not comply with the Bills of Exchange Act.

Presentment through a recognized clearing house is considered to be equivalent to presentment to the bank on which the cheque is drawn²⁰⁰. When a bank presents a cheque for collection through a clearing house, it has a duty to exercise reasonable

¹⁹⁷ Bills of Exchange Act, ss.85(3), 87(1); B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 306

¹⁹⁸ Bills of Exchange Act, s.88; B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 307

¹⁹⁹ Bills of Exchange Act, s.92(1)(e); B. B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 307

²⁰⁰ J.J. MacLaren, Bills, Notes and Cheques, (Carswell, Toronto, 1982) at 259; Reynolds v. Chettle, (1811), 2 Camp. 596, 170 E.R. 1263 (Nisi Prius)

diligence for the protection of its customer's interests²⁰¹. In Stanley Works v. Banque Canadienne Nationale²⁰², for example, the court held for the customer where the presenting bank accepted the return through clearing of a cheque and reversed its earlier credit to the customer instead of insisting that the drawee bank honour the cheques as it was entitled to do since the time for the return through clearing had expired.

Traditionally, cheques must be honoured by a bank in order of presentment unless the bank has special instructions from its customer to do otherwise²⁰³. Accordingly, any payments system which fails to keep track of the order of presentment (such as batch processing) would be in breach of this obligation.

(d) Insolvency

Upon learning that a customer is in financial difficulties, a bank is not entitled to refuse to pay cheques properly drawn on the account and to retain in the account the

²⁰¹ Oglivie para 416 and 417; Reynolds v. Chettle (1811), 2 Camp. 596, 170 E.R. 1263 (Nisi Prius); Stanley Works of Can. Ltd. v. Banque Canadienne Nationale (1981), 20 B.L.R. 282 (Que.C.A.); Bank of Van Dieman's Land v. Bank of Victoria (1871), 7 Moore N.S. 401, 17 E.R. 152 (P.C.)

²⁰² Stanley Works of Can. Ltd. v. Banque Canadienne Nationale (1981), 20 B.L.R. 282 (Que.C.A.) but see National Slag v. Canadian Imperial Bank of Commerce et al., (1985) [cite] (Ont. C.A.) where the court held that the account agreement was binding and entitled the presenting bank to debit the customer's account even though the cheque was returned in a manner that was not strictly in accordance with the clearing house rules.

²⁰³ Oglivie para 403; Kilsby v. Williams (1822), 5 B. & Ald. 814, 106 E.R. 1388 (K.B.); Bank of B.N.A. v. Standard Bank (1917), 35 D.L.R. 761 (Ont.C.A.); Sednaoni, Zariffa, Nakes & Co. v. Anglo-Austrian Bank (1909), 2 Legal Decisions Affecting Bankers 208

money necessary to meet liabilities which may thereafter accrue due to the bank from the customer²⁰⁴. If cheques are presented near simultaneously and there are insufficient funds to pay all of them, a bank may refuse to treat them all alike and refuse payment²⁰⁵. Once a bank stamps the cheque "paid" and makes out a credit slip stamped "paid" to the branch from which the cheque has come, there is an appropriation of the moneys of the drawer to the cheque which cannot be revoked on notice of the insolvency of the drawer²⁰⁶.

(e) Countermand

The duty and authority of a bank to honour a cheque drawn by its customer are determined by countermand or stop payment²⁰⁷. How and when a customer can countermand an electronic funds transfer must therefore be considered.

If a bank credits a person's account with a cheque, the bank acquires all the rights and powers of a holder in due course of the cheque. If a cheque is deposited at the payee's bank and the bank has no notice of countermand (which should be made at

²⁰⁴ Oglivie para 404; *Bank of B.N.A. v. Standard Bank* (1917), 35 D.L.R. 761 (Ont.C.A.)

²⁰⁵ Oglivie para 403; *Villiers v. Bank of Montreal*, [1933] O.W.N. 649 (Ont. H.C.)

²⁰⁶ Oglivie para 408; *White v. Royal Bank* (1923), 53 O.L.R. 543 (C.A.)

²⁰⁷ Oglivie para 411; Bills of Exchange Act, s. 167(a); *M'Lean v. Clydesdale Banking Co.* (1883), 9 App. Cas. 95 (H.L.)

the branch on which the cheque is drawn) it becomes a holder in due course as against the drawer²⁰⁸

As stated above, bank branches have no separate legal identity from the parent bank but are viewed merely as offices of the parent bank²⁰⁹. Accordingly, a drawer of a cheque who countermands payment of it at the branch where his account is located does all that is required of him²¹⁰. However, even where the drawer of a cheque stops payment by notice to the branch upon which it is drawn, if another branch advances the money in good faith and without notice that payment has been stopped, the bank is entitled to recover against the drawer²¹¹.

The duty and authority of bank to pay a cheque drawn by a customer is also determined by a writ or legal proceeding or order or injunction or notice by any person purporting to assign, perfect or otherwise dispose of any interest in any deposit

²⁰⁸ Oglivie para 411; Bills of Exchange Act, s. 165(3); see also *Bank of N.S. v. Gould* (1977), 79 D.L.R. (3d) 473 (Ont.Co.Ct.); *Bank of N.S. v. Taylor* (1979), 27 N.B.R. (2d) 14, 60 A.P.R. 14 (Co.Ct.); *Bank of N.S. v. Archo Indus. Ltd.* (1970), 11 D.L.R. (3d) 593 (Sask. Q.B.); *William Ciurluini Ltd. v. Royal Bank* (1972), 26 D.L.R. (3d) 552 (Ont.H.C.); *Royal Bank v. Wild* (1974), 51 D.L.R. (3d) 188 (Ont.C.A.); *Caisse Populaire (St-Jean Baptiste) Belle Riviere Ltd. v. A. & L. Auto Wreckers Ltd.* (1978), 82 D.L.R. (3d) 766 (Ont.Div.Ct.)

²⁰⁹ Oglivie para 110; *Prince v. Oriental Bank* (1878), 3 App. Cas. 325 (P.C.)

²¹⁰ Oglivie para 111; *Royal Bank v. Royce*; *Royal Bank v. Wildman* (1966), 57 D.L.R. (2d) 683 (Ont. Co.Ct) Compare *Bank of N.S. v. Gould* (1977), 17 O.R. (2d) 96 (Co.Ct.)

²¹¹ Oglivie para 110; *London, Prov. & South Western Bank Ltd. v. Buszard* (1918), 35 T.L.R. 142 (K.B.); *Garrloch v. Canadian Bank of Commerce*, [1919] 3 W.W.R. 185 (Alta.S.C.)

account. Notice must be served on branch of the account in respect of the deposit account²¹²

(f) Collection of Cheques and Bills

Where a bank collects cheques and other negotiable instruments for a customer, it acts as an agent or conduit pipe to receive payment from the bank on which they are drawn and to hold the proceeds at the disposal of the customer. In such cases, the bank may be a mere collecting agent or a holder for value or in due course²¹³. When a collecting bank employs an agent for collection it becomes the debtor of the customer when payment of the item is actually received by the agent²¹⁴. The bank as a collecting agent will be liable to its principal for negligence in the performance of that duty. The bank cannot exclude by notice responsibility for liability in collecting²¹⁵. Where the bank becomes holder for value then, in the absence of forgery, it can sue upon the

²¹² Oglivie para 413; Bank Act s. 212(1); see also *Rogers v. Whiteley* (1889), 23 Q.B.D. 236 (C.A.); *Yates v. Terry* [1901] 1 K.B. 102 reversed on other grounds [1902] 1 K.B. 527 (C.A.); *Retstin v. Severo Sibirsko Co.*, [1933] 1 K.B. 47 (C.A.); *Plunkett v. Barclays Bank Ltd.* [1936] 2 K.B. 107 (K.B.)

²¹³ Oglivie para 414; *Capital & Counties Bank Ltd. v. Gordon*, [1903] A.C. 240 (H.L.) see also *Home Bank; Ex parte McLeod* (1924), 4 C.B.R. 695 (Ont S.C.)

²¹⁴ Oglivie para 395; *MacKersy v. Ramsays Bonars & Co.* (1843), 9 Clark & Finnelly 818, 8 E.R. 628 (H.L.); *Re Home Bank and Winding Up Act, Ex parte Dearborn Chem. Co.* (1929), 10 C.B.R. 582 (Ont.S.C.)

²¹⁵ Oglivie para 414; *Nelson v. Union Bank* (1923), 33 Man. R. 508 (C.A.); *Browne v. Commercial Bank* (1853), 10 U.C.Q.B. 438 (C.A.); see also *Bank of Montreal v. Dom. Bank* (1921), 60 D.L.R. 403 (Ont.Co.Ct.); see also Bills of Exchange Act

cheque in its own name as holder in due course and it can debit the customer's account if the cheque is dishonoured²¹⁶. In an electronic funds transfer it will therefore be important to know when the funds are considered to be "collected" by the financial institution.

(g) Forgery, Repayment of Deposits and Honouring Cheques

Under the Bills of Exchange Act, the general rule is that the bank bears the risk of fraud. Section 49(1) of the Act is designed to protect the purported drawer from forgery and provides that a forged signature is wholly inoperative. Later sections modify this slightly by requiring notice of forgery within one year and by permitting ratification of an unauthorized signature which does not amount to forgery. Thus, when a customer's signature is forged on a cheque, subject to the requirement of reasonable notice and the common law doctrine of estoppel, the bank bears the risk and is not entitled to debit the customer's account²¹⁷. In other words, the bank will be liable if it pays a cheque which is irregularly endorsed²¹⁸. A customer has a corresponding duty to refrain from drawing a cheque in such a manner as to facilitate fraud or forgery and

²¹⁶ Oglivie para 419; *Royal Bank of Scotland v. Tottenham*, [1894] 2 Q.B. 715 (C.A.); *R. v. Bank of Montreal* (1886), 1 Ex.C.R. 154; *Owens v. Que. Bank* (1870), 30 U.C.Q.B. 382 (C.A.); *Capital Assoc. Ltd. v. Royal Bank* (1973), 36 D.L.R. (3d) 579 (Que C.A.) affirmed (1976), 65 D.L.R. (3d) 384 (S.C.C.)

²¹⁷ R. Hayhoe, "Fraud, the Consumer and the Banks: The (Un-) Regulation of Electronic Funds Transfer", (1995) 53 *University of Toronto Faculty of Law Review* 346 at 347; *Falconbridge* (8th ed.) at 1362-1400

²¹⁸ Oglivie para 401; *Slingsby v. Dist. Bank Ltd.*, [1932] 1 K.B. 544 (C.A.); *Arab Bank Ltd. v. Ross*, [1952] 1 All E.R. 709 (C.A.)

to inform the bank immediately after learning of some forgery²¹⁹. When a drawee bank pays a cheque it represents to the cashing or receiving bank that the signature of the drawer is genuine²²⁰. However, the drawee bank makes no representation as to the genuineness of a cheque beyond this fact²²¹. When a bank dishonours a cheque even though there is sufficient balance or without justification, it is in breach of contract and liable to the customer in damages for injury to credit²²².

What are the corresponding duties in an electronic funds transfer system? When money is obtained fraudulently who should bear the risks? Should the financial institutions be permitted to limit their liability for unauthorized use of the PIN, for the fraud of their employees?

(h) Clearing House Rules

The usages sanctioned as between banks with regard to the clearing are not binding on a person dealing with the bank until it can be assumed or proved that such

²¹⁹ N. Rafferty, "Account Verification Agreements: When Can a Bank Protect Itself Against Its Own Negligence" (1992-93), 8 *Banking & Finance Law Review* 403 at 406; *London Joint Stock Bank Ltd. v. MacMillan*, [1918] A.C. 777 (H.L.); *Greenwood v. Martins Bank Ltd.*, [1933] A.C. 51 (H.L.);

²²⁰ *R. v. Bank of Montreal* (1906), 38 S.C.R. 258

²²¹ *Dominion Bank v. Union Bank of Canada* (1908), 40 S.C.R. 366 at p. 371; *CIBC v. Bank of Credit and Commerce Canada*, [1989] A.J. No. 150 (Alta. Q.B.)

²²² Oglivie para 400; *Marzetti v. Williams* (1830), 1 B. & Ad. 415, 109 E.R. 842 (K.B.)

person's dealings with the bank have been entered into subject to such usages²²³. Any custom of trade or banking in derogation of the common law must be strictly proved²²⁴.

The delivery of items to a bank through the clearing house is provisional and such items are held by the receiving bank as trustee until such bank pays to the clearing bank at the proper time the balance, if any, found against it as a result of the clearings of the day²²⁵. The fact that money is deposited into a customer's account does not necessarily entitle the customer to draw on it at once unless there is an express or implied agreement that customer may draw prior to clearing²²⁶.

In Dominion Bank v. Union Bank, the Supreme Court of Canada considered a situation where a drawee attempted to recover money it had paid to a collecting bank on a cheque which had been fraudulently altered. It was held that the drawee bank

²²³ Sterling Bank v. Laughlin (1912), 3 O.W.N. 643 (C.A.); For discussions of clearing houses - See also Bank of Toronto v. Pickering (1919), 46 O.L.R. 289 (H.C.); Bank of B.N.A. v. Standard Bank (1917), 38 O.L.R. 570 (C.A.)

²²⁴ In Banque Nationale v. Merchants Bank, (1891) 7 M.L.R. 336 (S.C.) a cheque was returned on the afternoon of the day of its receipt, and therefore with sufficient diligence according to the common law standard but too late according to the temporary rule adopted by the then newly formed Montreal clearing house. It appeared in evidence that this rule was not generally observed by the banks belonging to the clearing house and it was held that the objecting bank had the right to return the cheque.

²²⁵ J.D. Falconbridge, The Canadian Law of Banks and Banking, 2nd ed. (Toronto: Canada Law Book Company Limited, 1913) at 381

²²⁶ Oglivie para 419; Akrokerri (Atl.) Mines Ltd. v. Economic Bank, [1904] 2 K.B. 465 (Commercial Court); Bevan v. Nat. Bank Ltd. (1906), 23 T.L.R. 65 (K.B.); Jones & Co. v. Coventry, [1909] 2 K.B. 1029 (K.B.); Re Farrow's Bank [1923] 1 Ch. 41 (C.A.); A.L. Underwood Ltd. v. Bank of Liverpool, [1924] 1 K.B. 775 (C.A.); Re Pac Mobile Corp; Robitaille c. Amer. Bilrite (Can.) Ltd. (1979), 34 C.B.R. (N.S. 8 (C.S.Que.)) compare Union Bank v. Tattersall (1920), 15 Alta L.R. 350 (C.A.)

could collect. In considering the actions of the collecting bank, MacLennan J. said at p. 381:

. . . When it presented the cheque for payment, it did so as owner of it and vouched for its genuineness by its stamp, as provided by rule 6 of the Clearing House respecting indorsements.

Similarly, in Number 10 Management v. Royal Bank (1976), 69 D.L.R.(3d) 99 at 105 (Man.C.A.), Monnin J.A. noted that:

. . . A collecting bank guarantees the endorsement of all properly issued bills of exchange. If the endorsement is forged, and it pays out money, it is liable.

His Lordship held that "a properly issued bill" is one where the signature of the drawer is genuine²²⁷.

²²⁷ In Crawford and Falconbridge, Banking and Bills of Exchange, Vol. 2 (8th ed., 1986) at 1493, the authors state that the stamp of a collecting bank is not an endorsement since the necessary animus indorsandi or intention to negotiate or to transfer is absent. The stamp merely identifies the cheque in the clearing process. The case of R. v. Bank of Montreal (1905), 10 O.L.R. 117 (H.C.J.) at p. 135, affirmed 11 O.L.R. 595 (C.A.), affirmed (1907), 38 S.C.R. 258, is given as authority for this. In that case the trial judge, Anglin J., said that the collecting bank's stamp was not an endorsement. At p. 135 he said:

Upon the evidence I find that the third party banks were not indorsers. They did not become parties to the cheques to pass title thereto. They did not place their names upon them with intent to assume liability, or for any other purpose than to identify as their property such cheques as they had respectively sent to the clearing house, and to signify to the officer there in charge to what bank he should credit such cheques.

In the Court of Appeal, Moss C.J.O. also found that the collecting banks "did not endorse the cheques or become parties to them so as to render themselves liable" as an endorser (p. 600). However, in the Supreme Court of Canada, the majority decided the case on the basis that the drawee bank must be taken to know the signature of its customer and so cannot recover if it pays out on a forged signature. Duff J. agreed with the decision of Moss C.J.O. in the court below.

Thus, the stamp of the financial institution may do more than merely identify the collecting financial institution in the clearing process if the stamp is intended to vouch for the payment item's genuineness²²⁸.

In summary, it is essential to understand the historic relationship between a bank and its customer (and the rights and obligations that the relationship creates) in order to fully analyze how these rights and obligations have been affected by the introduction of the ACSS and/or EFT systems. It is only after this analysis has been completed that suggestions can be made as to how these rights and obligations can be protected or whether they should be eliminated in light of the technological changes being made in the financial services industry. These rights and obligations are also relevant to the question of whether non deposit taking financial institutions and others should be granted direct access to the national payments system (particularly the POS systems) and, if so, what principles and standards should be applied when granting these parties access. In other words, when considering the impact of a technological advance or proposed change to the payments system, the following test should be applied: (1) identify the technological advance or proposed change to the payments system; (2) identify the traditional right or obligation, if any, which will be affected by the technological advance or proposed change; (3) identify how the technological advance or proposed change to the system impacts on this right or obligation; and (4) consider

²²⁸ see also *CIBC v. Bank of Credit and Commerce Canada* [1989] A.J. No. 150, Alta Q.B., February 24, 1989

whether the traditional right or obligation needs to be protected, modified or eliminated and, if so, in what matter.

CHAPTER FOUR: FUTURE DIRECTIONS

This Chapter is intended to provide an outline of issues that should be considered in planning the evolution of the national payments system. It considers issues such as whether Canada needs a new payments code, unfair competition by the deposit-taking financial institutions, the use of computer evidence in the courts, payment matters such as how the deposit-taking financial institutions authenticate the customer's mandate in a paperless transaction, how a customer can countermand an EFT, cheque truncation and presentment, whether the customer has a right to access information about the payments system, privacy and security concerns and the allocation of risk between the customer and the financial institution. As part of this analysis, the historic relationship between a bank and its customer and the rights and obligations which this relationship creates are also examined. These rights and obligations are relevant not only to the question of whether financial institutions are exercising incompatible powers under the ACSS or EFT systems but whether non deposit taking financial institutions and others should be granted direct access to the national payments system (particularly the POS systems) and, if so, what principles and standards should be applied when granting these parties access.

(a) Does Canada need a new payments code?

The need to standardize the electronic payments area and find common elements in the law and banking practice have led various jurisdictions to produce EFT rules. In addition to the United States' EFTA, for example, New Zealand has a "Code of Practice to Cover the Issue and Use of Electronic Funds Transfer Cards within New Zealand" (published May 1987) and the Secretariat of the United Nations Commission on International Trade Law produced the "UNCITRAL Legal Guide on Electronic Funds Transfers" in 1987²²⁹. A Canadian EFT system which is operable not only between Canadian provinces and Canadian financial institutions but between different countries is an important element in completion of the global market²³⁰. Yet except for the federal Currency Act, the federal Bills of Exchange Act, the federal Canadian Payments Association Act and certain provisions of provincial legislation (which are largely concerned with procedural matters), the legal framework for the Canadian payments system has been established principally through contract and private agreement²³¹.

²²⁹ The Canadian Payments Association was involved in Canada's participation in the UNCITRAL working group whose purpose was to devise a model law on international EFT.

²³⁰ The EC commission has stated that it regards the inter-operability of payment card systems between member states as an important element in the completion of an internal market providing concrete evidence that People's Europe is for real. H. Rowe, "Legal Issues between Banks Sharing Networks", (1990) 7 Computer Law & Practice 2

²³¹ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993, at 41

The Bills of Exchange Act is the only rudimentary payments code in existence in Canada. Except for bills of exchange and promissory notes (which are of declining importance and can generally be said to be adequately served by the Bills of Exchange Act), the Bills of Exchange Act does not adequately deal with the payment mechanisms currently available to Canadians let alone EFTs. In the case of cheques, individual attention and handling of items cleared in the old-fashioned way (the exchange of cheques by messengers at pre-arranged time at specified location) permit straightforward application of the rules of the Bills of Exchange Act and the case law interpreting the holder's duties²³². However, the Bills of Exchange Act does not cover many modern banking practices such as batch processing instead of single item processing, data center presentment instead of drawee branch presentment and full or partial truncation and presentment through electronic means. Only the common law appears to govern many aspects of modern cheque collecting practices²³³. In the case of credit cards, while the financial institutions are authorized to operate credit and debit card schemes²³⁴ and their operations are governed to a certain extent by the disclosure requirements of the Cost of Borrowing Disclosure Regulations²³⁵, there is no federal law

²³² Falconbridge para 4401.5

²³³ B. Crawford, "Does Canada need a Payments Code?", (1982) 7 Canadian Business Law Journal 44 at 47

²³⁴ Bank Act, S.C. 1980, c.40, s. 173(1)(k); B. Crawford, "Does Canada need a Payments Code?", (1982) 7 Canadian Business Law Journal 44 at 48;

²³⁵ As of 1982, it was not available in definitive form - see disclosure draft Can. Gaz. Part I, December 20, 1989, p.7756, B. Crawford, "Does Canada need a Payments Code?", (1982) 7 Canadian Business Law Journal 44 at 47

of general application. In the case of debit cards, there is no legislation currently in place which is directed to regulating the rights of parties. Similarly, no laws of general application apply to ATM's except section 302 of the Bank Act which limits their number for foreign banks. Albeit the federal Department of Consumer and Corporate Affairs did issue the voluntary Canadian Code of Practice for Consumer Debit Card Services prepared by the Electronic Funds Transfer Working Group which covers the issuing of debit cards and PINs, debit cardholder agreements, debit card transactions, liability for loss and the resolution of disputes²³⁶. In addition, the Criminal Code prohibits abuse of credit and debit cards and the interruption of payments system messages²³⁷.

The new EFT systems raise a number of issues which could be addressed by legislation. Issues such as authorization, responsibility, payment matters (such as countermand, when is the payment beyond the control of the payor and his creditors, when does the payment become available to the payee as his property, when is the payment final, is the payment reversible), records, privacy and security of data, minimum contract terms or standards which should be imposed, access for users to the service, free market entry by competitors, problems relating to consumer protection

²³⁶ "Bank of International Settlements: Payment Systems in the Group of Ten Countries" prepared by the Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, Basle, December, 1993, at 42

²³⁷ Section 33 of the Competition Act, S.C. 1986, c. 26 made special provision for agreements between Bank Act banks with respect to the services provided to customers and de-criminalizes any anti-competitive content where the agreement's real purpose is the development and utilization of systems, methods, procedures and standards and of common facilities. S.C. 1985, c. 19, ss. 301.2, 387(1.1); B. Crawford, "Legal Influences on the Stability of the National Payments System" (1988) 2 Banking & Finance Law Review 183 at 200

involving disclosure rights and remedies, special documentation requirements, error resolution procedures and special liability allocation and cost allocation provisions for consumer transactions²³⁸.

Do we need government intervention to protect consumer interests and to offset the deposit taking financial institutions' overwhelming control of the payments system or is it sufficient that legal and banking scholars, retailers, consumers and other interested parties review and criticize banking practices? Theoretically, in the absence of a legislative scheme, the legal maxim that the law is never silent - that the law will provide guidance for business and society no matter how novel the questions may appear to be when they first arise - will always be sufficient to protect any injured party who has had to seek the court's assistance to redress a payments problem²³⁹. Moreover, the clearing rules and standards drafted by the financial institutions which are now used to process payments are under review more or less continuously by the financial institutions themselves and may be adjusted five or six times a year to respond to the perceived needs of the operations of the financial institutions' data centers or to sustain the accustomed levels of performance for the public or to introduce new systems as quickly as a market for the services of the available

²³⁸ B. Crawford, "Does Canada need a Payments Code?", (1982) 7 Canadian Business Law Journal 44 at 54

²³⁹ B. Crawford, "Does Canada need a Payments Code?", (1982) 7 Canadian Business Law Journal 44 at 61

technology can be identified²⁴⁰. These privately made rules are then subject to review by federal regulatory authorities. Given the flexibility of our current system, the financial institutions' apparent willingness to enter into voluntary codes and the Canadian Payments Association's mandate of setting the standards for the national payments system, an argument can be made that there is no need for a formal legislative framework for EFTs. In my view however, EFT legislation designed to protect consumer interests should be drafted to deal with issues relating to the use of the confidential information gathered by the financial institutions and risk allocation. In these areas the interests of the consumer and those of the financial institution are directly in conflict. It appears to me to be illogical to rely on the financial institutions themselves to adequately protect the consumer in ways which will decrease their profitability.

In 1995, as part of the 1997 financial services review, the Government of Canada proposed to improve the supervisory and regulatory systems for federally regulated financial institutions, including proposals to reduce systemic risk in major clearing and settlement systems which would enhance the safety and competitiveness of Canada's clearing and settlement systems for financial transactions²⁴¹. As

²⁴⁰ B. Crawford, "Does Canada need a Payments Code?", (1982) 7 Canadian Business Law Journal 44 at 61

²⁴¹ Department of Finance, "Enhancing the Safety and Soundness of the Canadian Financial System" issued on behalf of the Government of Canada by The Honourable Doug Peters, Secretary of State, (International Financial Institutions) (Ottawa: Distribution Centre, Department of Finance, February, 1995) at 1

previously stated, the government also intends to undertake a review of the payments system in light of the technological advances which have occurred and the increased demand by non-deposit taking institutions for access to the system²⁴². Presumably the first questions which will have to be addressed, after the difficult task of defining Canada's national payments system, is whether the legislation and standards which presently apply to the national payments system's different components are adequate to protect the interests of all parties and are compatible with the way it is expected that the payments system will evolve.

(b) Should Control of the Payments System rest solely with Deposit-Taking Financial Institutions

Now that EFTs are beginning to replace the physical use of currency for the payment of goods and services, consumers and commercial entities need a convenient, comprehensive and speedy method of communicating instructions to carry out various financial services. A shared electronic financial service such as Interac would satisfy this need. While Interac was developed by participants in the Canadian payments system (which historically required its participants to be capable of performing three core functions: holding demand accounts, processing/network operations and clearing/settlement), the question arises as to whether non-deposit taking financial institutions, retailers and others should now be able to participate directly in these

²⁴² White Paper: Government of Canada, "1997 Review of Financial Sector Legislation: Proposals for Changes" issued on behalf of the Government of Canada by the Honourable Doug Peters, Secretary of State (International Financial Institutions), (Ottawa, Distribution Centre, Department of Finance, June 1996)

networks and whether Interac charter members have such an effective monopoly over their financial services network as to preclude any competitive alternative to Interac services²⁴³.

In December, 1995, the Competition Bureau filed an application against Interac Inc. and its charter or founding members alleging that the member financial institutions, through their control over Interac and the enactment of exclusionary by-laws governing membership in and operation of the network, were engaged in a joint abuse of dominance contrary to the Competition Act.²⁴⁴ Specifically, the Director alleged that Interac was engaged in a practice of anti-competitive acts which was likely to continue to have the effect of preventing or substantially lessening competition in Canada in the intermediate market for the supply of shared electronic network services and in the retail market for the supply of shared electronic financial services²⁴⁵. As of 1994, banks owned seventy per cent of the total assets of investment dealers, forty-five per cent of the total assets of trust companies and seventy-six per cent of the total assets of loan companies. Moreover, the five largest banks, all charter members of Interac, held

²⁴³ Notice of Application filed with the Competition Tribunal by The Director of Investigation and Research on December 14, 1995 as file number CT-95/02.

²⁴⁴ Notice of Application filed with the Competition Tribunal by The Director of Investigation and Research on December 14, 1995 as file number CT-95/02. Reasons for Consent Order issued by the Competition Tribunal on June 20, 1996 in file number CT-95/02.

²⁴⁵ Reasons for Consent Order issued by the Competition Tribunal on June 20, 1996 in file number CT-95/02 at p.7

eighty-five per cent of total bank assets²⁴⁶. Interac handles more than 90 percent of the shared cash dispensing transactions in Canada. There is no shared electronic funds transfer at POS service available in Canada other than through Interac²⁴⁷.

The respondents and the Competition Bureau reached a settlement which theoretically would enable any commercial entity that is capable of providing a shared service or facilitating the provision of a shared service to become a member of Interac. The settlement was also intended to allow non-members from indirectly gaining access to the Interac system through the use of sweep accounts. "Sweep accounts" also known as "zero-balance" or "pass-through" accounts allow a cardholder of a member of Interac to gain access through ATMs to funds held in their account with non-deposit taking financial institutions, such as insurance companies, brokerage firms and investment dealers. Using their Interac access card, the customer accesses the zero balance account at a specified financial institution and is authorized to withdraw cash from the empty account after the financial institution's computer has ascertained that there are funds in the non-deposit taking financial institution's account. That financial institution and the Interac member would settle as between themselves. Interac had amended its by-laws to prohibit the use of such accounts in connection with the Interac

²⁴⁶ see Summary of Non-Controversial Background Information Canadian Life and Health Insurance Association filed on February 21, 1996 with the Competition Tribunal in action number CT-95/02.

²⁴⁷ Reasons for Consent Order issued by the Competition Tribunal on June 20, 1996 in file number CT-95/02 at p.10

shared services²⁴⁸ and then, following the Competition Tribunal application, agreed to allow non-deposit taking financial institutions indirect access to Interac through the use of such accounts. Under the terms of the consent order, only Interac members who were also members of the Canadian Payments Association were permitted to directly 'issue' their own encoded debit cards. Accordingly, non-deposit taking financial institutions were still prohibited from issuing debit cards that could be used by their customers to access funds electronically via the Interac which were held in an account at the non-deposit taking financial institution. As an 'acquirer' rather than an 'issuer', the non-deposit taking financial institution could deploy ATMs and POS terminals but still had to transmit the request for authorization through the network to the member that issued the card being used. In other words, the customer and the non-deposit taking financial institution would have to have an account with an 'issuer'²⁴⁹. The banking industry took the position that allowing non-deposit taking financial institutions, retailers or others to participate directly in the flow of funds within the inter-member network of Interac was not a viable option, since doing so would entail allowing such parties to participate in the clearing and settlement process²⁵⁰. In essence, Interac took

²⁴⁸ Royal Trust had entered into a number of sweep account arrangements with insurance and brokerage firms (such as Midland Walwyn and London Life). These arrangements were terminated when Royal Trust was acquired by Royal Bank. Reasons for Consent Order issued by the Competition Tribunal on June 20, 1996 in file number CT-95/02 at p.55.

²⁴⁹ Reasons for Consent Order issued by the Competition Tribunal on June 20, 1996 in file number CT-95/02.

²⁵⁰ Quote from "Banking Industry Views on Access to the National Payment System: Balancing Rights and Responsibilities" Canadian Bankers' Association, October 1995, at page 28, as reproduced in Summary of Non-Controversial Background Information Canadian Life and Health Insurance Association filed on February 21, 1996 with the Competition Tribunal in action number CT-95/02.

the position that membership should be restricted to deposit taking financial institutions of undoubted credit and reputation in order to maintain public confidence in the payments system. In concluding that an electronic payments system could not operate in a safe and sound manner with non-deposit taking financial institutions as direct members, they assessed a number of risk factors including counterparty risk, liquidity risk, finality risk, regulatory risk and operations risk. Counterparty risk involves monitoring the extent of the participants mutual credit exposure during any given period as a result of the payments messages being exchanged. (To offset the risk each member has to be able to establish a figure representing the maximum credit that it is prepared to extend during the day to the other participant.) Liquidity risk is the risk that a participant in a payments system will not be able to settle its net obligations at the material time. Finality risk is the risk that payments may have to be reversed if a participant is unable to settle its net aggregate obligation to all other participants at the end of the day. Regulatory risk is the risk that a business entity may not be subject to the same rigorous regulatory regime as that imposed on the majority of the participants in a payments system. Finally, operations risk are those that an inexperienced participant may bring to the other participants by reason of its lower operating standards, inexperience or lack of vigilance in administering secure and confidential systems²⁵¹.

²⁵¹ Affidavit of Bradley Crawford sworn March 29, 1996 and filed on April 1, 1996 with the Competition Tribunal in action number CT-95/02, paras. 44 to 52

The settlement reached was not satisfactory to a number of interested parties who were granted leave to intervene in the case. The argument of the life and health insurance providers are representative of the arguments made by the interveners. They argued that the 1992 reforms to the financial services sector were intended to foster competition and to create a level playing field in that sector. The reforms gave life and health insurers the power to issue payment cards and to belong to payment card networks²⁵². Federally incorporated insurance companies were able to retain or receive back for segregated investment, funds payable by them to policyholders as dividends, bonuses or proceeds of policies they had issued. They argued that numerous payments system barriers have denied this open competition. Competitors are excluded from the Canadian Payments Association through bank controls of the rules, such as Rule H4 which governs pre-authorized debits. In addition, insurers are not permitted to provide their customers with direct access to insurance proceeds payouts thus giving deposit takers, to which the proceeds must be transferred, unfair competitive advantages to build market shares including the opportunity to cross-sell their own wealth management products²⁵³. Each week insurance companies make payments to their customers in excess of half a billion dollars. As stated, these assets flow mostly to the banks since, without access to Interac, the customers cannot

²⁵² There are more than 140 life and health insurance firms operating in Canada. By virtue of section 440(2)(c) of the Insurance Companies Act, S.C. 1991, c.47, insurance companies are granted the statutory power to issue payment, credit or charge cards and in cooperation with others including other financial institutions, to operate a payment, credit or charge card plan: from Summary of Non-Controversial Background Information Canadian Life and Health Insurance Association filed on February 21, 1996 with the Competition Tribunal in action number CT-95/02.

²⁵³ News Release issued by the Canadian Life and Health Insurance Association Inc. "Canadian Life and Health Insurance Industry Calls for Full and Direct Access to the National Payments System" (December 20, 1995) at 5 and 6

conveniently leave their funds with insurers²⁵⁴. In short, the banks' control of the payments system allows them to (1) exclude potential competitors, (2) limit consumer choices (3) reap windfall profits (as a result of the transfer of the insurance benefits from the insurers' accounts to the banks and related cross-selling of financial service products) and (4) gain access to competitively sensitive information²⁵⁵. The insurers also argued that the payments system "satellites" such as Interac had been purposely kept out of the Canadian Payments Association jurisdiction to avoid even its limited form of oversight and that the Association had not been urged by its board to pursue aggressively its "second mandate" for the same reason²⁵⁶.

In its Reasons for Consent Order, the Competition Tribunal, while ultimately approving the settlement reached, criticized the scope of the application as it related to the Director's decision not to challenge the continued use of the Canadian Payments Association clearing and settlement mechanism by Interac as an anti-competitive act

²⁵⁴ Life and health insurance firms have collective worldwide assets of some \$267 billion and Canadian assets of \$176 billion. Each year Canadian life and health insurers pay out more than \$28 billion in funds to customers or beneficiaries (in excess of \$540 million/week on average) from Summary of Non-Controversial Background Information Canadian Life and Health Insurance Association filed on February 21, 1996 with the Competition Tribunal in action number CT-95/02.

²⁵⁵ Canadian Life and Health Insurance Association Inc. submission to the Department of Finance "The Need for Payments System Reform" (December, 1995) at 16-21. For example life insurance payouts amount to approximately \$80 million per day yet despite legislation which permits life insurance companies to manage these proceeds on behalf of their customers, the rules that govern the payments system do not allow these customers quick, easy, periodic access to such funds. Instead, the funds must be transferred to a deposit taker.

²⁵⁶ Canadian Life and Health Insurance Association Inc. submission to the Department of Finance, "The Need for Payments System Reform" (December, 1995) at 10

and as it related to Interac's prohibition on direct card issuance by non-deposit taking financial institutions. The director had agreed with the banking industry that card issuance and indirect arrangements were matters of access to the ACSS which raised questions going to the integrity and security of that system and were beyond the scope of the application. As a result, two of the proposed remedial measures - the admission of non-financial institution members as acquirers-only into Interac and the removal of the prohibition on sweeps and other arrangements providing non-financial institutions with indirect access to Interac in lieu of direct access as card issuers - were largely illusory since they could not be implemented without the approval of the Canadian Payments Association which was not an arm's length or neutral third party given that members of Interac have the votes to appoint the majority of the board of the Canadian Payments Association. The Tribunal concluded that in making the decision to clear and settle Interac transactions under the umbrella of the CPA, and thus incorporate CPA restrictions into the network, the respondents may have had several motivations²⁵⁷. The Tribunal also pointed out that Interac could create an alternative settlement mechanisms in which all Interac members could participate outside the ACSS and that arguments presented as a justification for maintaining Interac within the Canadian Payments Association on the basis of cost were unconvincing. Even the right of commercial entities to become "acquirers" was unlikely to be commercially viable since the banks' established market position created a disadvantage for new entrants (Canada already has the highest number of ATMs per capita of any country in

²⁵⁷ Only deposit taking financial institutions can be members of the Canadian Payments Association and only member may present items eligible for clearing through the ACSS. Whether an item is eligible for clearing is also determined by the Canadian Payments Association. Reasons for Consent Order issued by the Competition Tribunal on June 20, 1996 in file number CT-95/02 at pp.32 and 37

the world besides Japan²⁵⁸) and since they could not handle the whole transaction, they must still enter into an additional agreement with a deposit taking financial institution to process and settle each credit to the retailer's account²⁵⁹. With respect to the removal of the prohibition against sweep accounts from Interac, the Tribunal concluded that it 'would have no effect' until the Canadian Payments Association chooses to act and that the Association has indicated that it will only consider sweep accounts with a high degree of presence by the deposit taking financial institution²⁶⁰. In the Tribunal's view such a high degree of visibility would not make the sweep account a viable substitute for direct access to the Interac network²⁶¹.

Obviously, the concessions made by the respondents as a result of the Interac Application are not broad enough. In my view, the Canadian Payments Association Act ultimately will have to be radically amended to allow commercial entities to clear and settle payment items through the ACSS. These amendments will be necessary to accommodate the financial transactions of the future: transactions using one 'smart

²⁵⁸ Reasons for Consent Order issued by the Competition Tribunal on June 20, 1996 in file number CT-95/02 at p.47

²⁵⁹ The Tribunal concluded: "In the end, while removing the prohibition [re acquirers] does no harm and may, although we are not convinced that it is likely, do some good, it is hardly an essential part of the order". Reasons for Consent Order issued by the Competition Tribunal on June 20, 1996 in file number CT-95/02 at pp.51 and 52

²⁶⁰ Reasons for Consent Order issued by the Competition Tribunal on June 20, 1996 in file number CT-95/02 at pp.63-67

²⁶¹ Reasons for Consent Order issued by the Competition Tribunal on June 20, 1996 in file number CT-95/02 at p.62

card" which will serve as both debit and credit card and be able to directly access accounts in a variety of financial institutions.

(c) The Use of Computer Evidence

The federal and provincial Evidence Acts were revised in 1987 to ensure that data from financial institution computer systems was readily admissible in court proceedings to prove payment or default or related facts affecting the rights of customers and others²⁶². The Acts do not however provide guidance as to whose testimony is to be preferred or what presumptions are to be applied when this computer data is contradicted by a witness²⁶³. Traditionally, the evidence preferred by the Courts is live testimony given by witnesses who have personal knowledge of the facts in issue since the witness is under oath and his or her veracity, memory, ability to communicate and perception can be tested by cross-examination²⁶⁴. On the other hand, financial

²⁶² B. Crawford, "Legal Influences on the Stability of the National Payments System" (1988) 2 *Banking & Finance Law Review* 183 at 200; see Crawford and Falconbridge, *Banking and Bills of Exchange*, 8th ed. (Toronto: Canada Law Book, 1986) at s.3809.3

²⁶³ In *Judd v. Citibank*, 435 NYS 2d 210 (1980), a cardholder disputed the debiting of her account which was shown on her statement as having been withdrawn by the use of her access card. The teller machine involved was programmed to effect a withdrawal only if the card was verified and the numbers on it matched with the personal identification number (PIN) keyed in. It was a case in which the judge had to decide between the testimony of the cardholder and the evidence of the computer printout. The Court was "not prepared to go so far as to rule that where a credible witness is faced with the adverse 'testimony' of a machine, he is as a matter of law faced also with an unmeetable burden of proof". The Court preferred the card-holders' testimony to the evidence based on computer printouts. E.P. Ellinger, *Modern Banking Law*, (Oxford: Clarendon Press, 1987) at 400

²⁶⁴ A.W. Bryant, "Proof of Payment and Evidentiary Problems: A Comparison of Today's Payment System to the Computer Payment System of the Future" Working Paper #7 prepared in connection with a research project designed to identify "Policy and Legislative Responses to Electronic Funds Transfer" from a provincial perspective directed by Professor Richard H. McLaren at 3

institutions will often include a clause in their account agreements which provides that the financial institution's records are deemed conclusive proof of transactions effected through the use of the teller machine²⁶⁵. Should such clauses be contrary to public policy or unreasonable under relevant consumer protection legislation? Is there need for legislation to outline the Canadian position on the presumptions to be applied to the use of computer evidence? Section 909(b) of the U.S. EFTA provided that, if a consumer claimed an unauthorized transfer and a limitation of liability, the burden was on the financial institution to show that the transfer was authorized. This provision was not carried forward into Regulation E²⁶⁶. In Canada, as the use of electronic banking increases, the only party with a organized, itemized and centralized record of the daily transactions which the customer has "authorized" will be the financial institution. Moreover, the financial institution has the duty to ensure that it transfers the customer's funds only if properly "authorized". Should Canada legislate with respect to the burden of proof? In my view, consumer protection legislation making the financial institution bear the burden of proof that the transfer was authorized is not unreasonable.

²⁶⁵ For example, clause 11 of the Scotiacard Cardholder Agreement provides that their records "as to whether any Automated Banking Services transaction or an ABB transaction has been performed and our count or determination of the details of any such transaction, will be considered to be correct and will be binding upon you in the absence of evidence to the contrary satisfactory to us." Similarly, clause 6 of CIBC's Instant Banking Service Agreement provides that "CIBC's records with respect to all Instant Banking Transactions and the contents of any envelope placed in an automated banking machine are conclusive and binding upon me ... I agree that CIBC's records will be admissible evidence in any legal proceeding."

²⁶⁶ C. Felsenfeld, Legal Aspects of Electronic Funds Transfers, (Stoneham, Massachusetts: Butterworths, 1988) at 21;

(d) Payment Matters**(i) Cheque Truncation and Presentment**

As previously discussed, under the Bills of Exchange Act, the drawer's and each endorser's respective statutory engagement arises only upon the dishonour of the bill on 'due presentment'. Accordingly, the presenting bank has an obligation to its customer to properly present a cheque for payment to the payor bank. This obligation to present the physical cheque is however at odds with the technological advances (such as batch processing or data center presentment and cheque truncation) being made to speed up cheque exchange and processing.

The sufficiency of clearing house presentment was considered in the English case of Barclays Bank, plc. v. Bank of England²⁶⁷. In that case, the Court concluded that the presenting bank's responsibility to its customer in respect of the collection of the cheque is only discharged when the cheque is physically delivered to the paying branch for decision as to whether it should be paid or not. The Court rejected the argument that a customer of a participating bank is bound by the usage of the banks (in England as in Canada the established usage and practice of banks participating in the clearing was to treat delivery of the cheques at the clearing house as the effective presentment to the paying bank) and that for all practical purposes the customer has waived the presentment requirement. The Court held that in order to establish such a

²⁶⁷ [1985] 1 All E.R. 385 at 387

waiver, it would need evidence showing (1) that the participating banks have expressly or impliedly agreed to treat delivery at the clearing house as equivalent to presentation and (2) that the customer knows and expressly or impliedly assents to this arrangement. The Court declined to find an applicable agreement on the first point. The Court did note however that since the drawer is discharged upon the holder's failure to duly make presentment, the customer cannot be regarded as losing the right to require proper presentment solely as a result of a private agreement made between the banks for their own convenience unless the very strongest proof of his or her knowledge and assent is demonstrated. Similarly, the Canadian position indicates that the dealings sanctioned as between the banks by voluntary association in the clearing system is a matter not binding per se on the public unless it can be assumed or proved that the party sought to be charged has been dealing with the bank subject to the usage of the clearing house²⁶⁸. However, there are also some very old cases which hold that there could be sufficient presentment of the cheque to the officials of the drawee bank at the clearing house²⁶⁹. Arguably then, clearing house presentment and data centre presentment could meet the statutory standard set out in the Act provided an individualized banking decision is made by the drawee bank pertaining to the cheque at that clearing house or data centre²⁷⁰. Yet if the physical cheque is

²⁶⁸ Sterling Bank v. Laughlin (1912), 1 D.L.R. 383 at 384 (Ont.Div.Ct.); B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 333

²⁶⁹ Reynolds v. Chettle (1811), 2 Camp. 596, 170 E.R. 1263 (Nisi Prius); Falconbridge, p. 1131 text at note 1, p1128 text at note 30

²⁷⁰ B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 319

presented for payment at the data centre, how is the customer's signature verified? And when will the payment be deemed to be irreversible through clearing? And what about the goal of remote cheque truncation at the point of deposit where the banking decision to pay or dishonour a cheque is made by the payor financial institution, usually at a data centre, on the basis of payment information captured at and transmitted from the point of truncation without resort to the physical paper²⁷¹. Currently, any form of cheque truncation would have to be followed by subsequent payor branch physical presentment²⁷².

Cheque truncation is a practice directed at reducing or eliminating paper movement in the collection and payment process. It involves the separation or capturing of the payment information embodied on the physical cheque itself and the transmittal of this information onward from that "point of truncation" through high-speed telecommunications equipment detached from the physical cheque²⁷³. In the absence of computer interface among participating financial institutions, an interbank flow of this information is interrupted by the preparation of computer tapes, each capturing payment information pertaining to the cheques drawn on a particular drawee financial

²⁷¹ B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 321

²⁷² B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 300

²⁷³ B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 299

institution. Each tape is then delivered to a central or regional processing facility of the respective drawee financial institution for further transmission. In general, the physical cheque is either retained at the point of truncation or transported onward in a less time-critical and less expensive procedure than a system premised on the movement of paper²⁷⁴. The highest form of truncation is remote truncation at the point of deposit. In remote truncation, the banking decision to pay or dishonour a cheque is made by the payor financial institution, usually at a data centre, on the basis of payment information captured at and transmitted from the point of truncation without resort to the physical paper²⁷⁵.

Full cheque truncation would satisfy the goal of complete elimination of paper, yet it can not be undertaken without revisions to the presentment related sections of the Bills of Exchange Act²⁷⁶. In addition, with regard to the law of evidence, it may be difficult to prove payment if a subsequent dispute arises requiring the production of the item as evidence. Currently, electronic cheque presentment is being evaluated as a means of speeding up cheque exchange and processing. It involves the presentment of MICR information on the cheque from one financial institution to another electronically with paper documents following some time later. Another possible means

²⁷⁴ B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 299-300

²⁷⁵ B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 Banking & Finance Law Review 295 at 300

²⁷⁶ "CPA Plenary Meeting Updates Payments System Stakeholders", Forum, volume 11, No.4, December, 1995, prepared by the Canadian Payments Association, at p.3

of resolving the problem of presentment may be to implement truncation through image processing which would permit a negotiating institution to present a cheque for payment by merely transmitting the image of the cheque to the drawee institution. The negotiating institution would become the stopping place for all cheques while the drawee institution could make visual verification of the instrument and actually compare the account customer's digitized signature with a specimen on file. Costs would be cut in several areas such as branch services, data centre operations, courier services and labour²⁷⁷. In practice the physical presentment of paper items at the branch office is no longer carried out unless the customer requests and pays a fee for the return of the physical cheque with his or her monthly statement.

(ii) Paperless Transactions - how do financial institutions authenticate the customer's mandate

The drawer's signature on the cheque authenticates the customer's mandate. That mandate is fundamental to the financial institution-customer relationship since without the customer's consent, the bank has no authority to pay out funds deposited in the customer's account. With the move towards cheque truncation and other forms of electronic transfer of funds questions such as how the customer's signature can be effectively verified and how a customer's mandate can be authenticated without a

²⁷⁷ "Cheque Truncation and the Canadian Clearing and Settlement System", Forum, volume 7, No.4, December, 1991, prepared by the Legal Department of the Canadian Payments Association, at p.2

signature are raised²⁷⁸. For instance, without presentment of the physical cheque at the branch office, how can the signature be compared to the sample in order to detect possible forgeries. In paperless transactions, how can the signature be effectively verified in an electronic transmission and will such transmissions make it harder to detect forgeries. Does the PIN legally replace the signature and if so is it fair to make financial institutions bear the risk of unauthorized use of the PIN when, unlike in the case of a forged signature on a cheque, a forged or unauthorized use of the PIN will appear identical to an unauthorized use. Risk sharing may be a possible answer.

(iii) Countermand and EFT

As stated, the duty and authority of a bank to honour a cheque drawn by its customer are determined by countermand or stop payment. When payment is by physical cheque passed through clearing, the rule is that the payor bank becomes committed to the presenting bank when the latter is informed, whether before or after presentation of the cheque, that the cheque will be paid or when the payor bank fails to return the cheque within the time laid down by the Clearing Rules²⁷⁹. Prior to that time, the customer can countermand the cheque and the payor bank may become liable to

²⁷⁸ E. Smart, "Electronic Banking An Overview of the Legal Implications" in R.M. Goode editor, Electronic Banking The Legal Implications, (London: The Institute of Bankers and Centre for Commercial Law Studies, 1985) 1 at 4

²⁷⁹ R. Goode, "Electronic Funds Transfer as an Immediate Payment System" in R.M. Goode editor, Electronic Banking The Legal Implications, (London: The Institute of Bankers and Centre for Commercial Law Studies, 1985) 15 at 20

the customer for acting contrary to the customer's instructions if it transfers the funds to the drawee's account. In the case of an EFT, the payment becomes irrevocable as soon as the payee settlement bank sends the payor settlement bank a logical acknowledgment (although what exactly constitutes a logical acknowledgment is unclear). The effect is to bind the payor bank to transfer the funds and the payee bank to give same-day value to its payee customer²⁸⁰.

Unfortunately, there is a lack of clear rules for determining the time of commitment and payment through any mechanism other than negotiable and non-negotiable instruments. Yet whether a customer should be permitted to countermand an electronic funds transfer and if so, how and when such a countermand should be communicated should be considered. Questions such as whether it matters what type of EFT is involved (for example should electronic bill payment instructions using the ATM be capable of automatic reversal but not POS transactions) or what party is initiating the EFT on behalf of the customer (i.e. should instructions originating through a non-deposit taking financial institution be capable of reversal but not those originating through a Direct Clearer) or the type of system used (on line real time) or the timing of the countermand instructions, must all be addressed. In the absence of legislation, the financial institutions have established their own guidelines as to how an EFT can be

²⁸⁰ R. Goode, "Electronic Funds Transfer as an Immediate Payment System" in R.M. Goode editor, Electronic Banking The Legal Implications, (London: The Institute of Bankers and Centre for Commercial Law Studies, 1985) 15 at 23; *Momm v. Barclays Bank International Ltd.*, [1977] Q.B. 790 (Q.B.) in which Barclays Bank believing that Herstatt's account was in credit, initiated a substantial in-house transfer of funds to another customer at Herstatt's request, only to discover the following morning that Herstatt's account was substantially in debit. It then reversed the entries, a step held by Kerr J. to be ineffective since payment was complete from the moment the computer process to effect the transfer was set in motion.

countermanded: in the case of POS transactions, once the debit card has been accepted by the merchant and the PIN entered, accepted and verified by the Bank, the customer may not revoke or stop the transaction²⁸¹.

Another question which must be addressed is whether a financial institution's customer is even entitled to learn about a countermanded transfer. The transferor and transferee financial institutions may not be concerned that there are no general rules as to commitment and payment in EFT since no real problems have arisen and they are usually able to reach an amicable agreement on the recall of payment instructions without the need for any guiding principles or legal rules but such lack of concern may depend on the customer remaining unaware that his or her financial institution held in its hands a credit transfer for the customer's account or that it had received an electronic signal notifying an amount to be paid. Should the financial institutions be under an obligation to keep their customers informed of countermanded EFTs? Are the customers taken to contract with reference to reasonable custom and usage of the banking industry, including the custom and usage codified in the clearing house rules? Can a customer complain if two financial institutions agree to relax or waive the rules and, if there are no rules, should the two financial institutions be permitted to decide amongst themselves whether a payment item should be recalled²⁸²? Does the

²⁸¹ See for example clause 18 of Scotiacard Cardholder Agreement

²⁸² R. Goode, "Electronic Funds Transfer as an Immediate Payment System" in R.M. Goode editor, Electronic Banking The Legal Implications, (London: The Institute of Bankers and Centre for Commercial Law Studies, 1985) 15 at 26;

monetary size of the transaction or the identity of the customer make a difference? Without knowing how often such countermanded transfers occur it is impossible to determine whether this is a serious problem, however, any action taken by the collecting bank which is incompatible with its obligation to its customer should be viewed with wariness.

(e) Privacy and Security Concerns

The gathering of financial information about banking customers raises questions of privacy and security. Privacy involves questions of what personal data should be collected, stored and disseminated and security involves questions of the procedures to assure confidentiality or the protection of information from improper disclosure, modification or destruction²⁸³.

In California Bankers Association v. Shultz²⁸⁴ (a case upholding the U.S. Bank Secrecy Act), Mr. Justice Douglas wrote in his dissenting opinion:

'In a sense a person is defined by the checks he writes. By examining them the agents get to know his doctors, lawyers, creditors, political allies, social connections, religious

²⁸³ D.H. Flaherty, "Privacy, Confidentiality and Security in a Canadian Electronic Funds Transfer System" Working Paper #5 prepared in connection with a research project designed to identify "Policy and Legislative Responses to Electronic Funds Transfer" from a provincial perspective directed by Professor Richard H. McLaren at 1

²⁸⁴ 94 S.Ct. 1494 (1974) at 1529, 416 U.S. 21, 85 (1974); D.H. Flaherty, "Privacy, Confidentiality and Security in a Canadian Electronic Funds Transfer System" Working Paper #5 prepared in connection with a research project designed to identify "Policy and Legislative Responses to Electronic Funds Transfer" from a provincial perspective directed by Professor Richard H. McLaren at 4

affiliation, educational interests, the papers and magazines he reads and so on ad infinitum. These are all tied to one's social security number; and now that we have the data banks, these other items will enrich that storehouse and make it possible for a bureaucrat - by pushing one button - to get in an instant the names of 190 million Americans who are subversives or potential and likely candidates."

He would have undoubtedly been even more concerned if he had foreseen that use of POS and other EFT transactions would rapidly replace the use of cash and cheques. EFT generates new kinds of records, increase the amount of information collected, make the data easier to retrieve and increase the number of institutions with access to the data. The type of data collected might include the name, address, account number, account balance, debit and credit amounts, debit and credit payees or payors, and the location, date and time where the transaction took place²⁸⁵. Before EFTs, information about purchases gathered from payments in cash, by cheques and credit cards were so diffuse that few patterns were evident, now the information generated by the electronic system can be easily manipulated and sold or used as invaluable purchasing information. Marketing firms desire direct, objective and unbiased information on individual buying habits since the customer's spending patterns give clues to their lifestyle and future purchases. With the proliferation of computers and the purchase and sale of marketing lists, customer information has become a huge industry²⁸⁶. Yet how is this industry regulated? Do financial institutions

²⁸⁵ D.H. Flaherty, "Privacy, Confidentiality and Security in a Canadian Electronic Funds Transfer System" Working Paper #5 prepared in connection with a research project designed to identify "Policy and Legislative Responses to Electronic Funds Transfer" from a provincial perspective directed by Professor Richard H. McLaren at 10

²⁸⁶ D.A. Doheny and G.J. Forrer, "Electronic Access to Account Information and Financial Privacy", (1992) 109 No. 5 The Banking Law Journal 436

directly or indirectly sell consumer records or information gathered through the payments system to defray the cost of their acquisition and maintenance? Is this practice disclosed to the customer? Do financial institutions themselves use this information for target marketing purposes to the detriment of their competitors²⁸⁷? Every bit of collected data increasingly opens personal lives to outside scrutiny and increases the likelihood that this personal information will flow into the hands of unanticipated parties. The growing international trade in information is in effect virtually unregulated in North America.

In Canada, in addition to the common law duty of confidentiality and the individual's Charter right to a reasonable expectation of privacy²⁸⁸, many provinces have enacted Privacy Acts in an attempt to balance the computer's power to collect, store and manipulate personal data with the controlled disclosure of this data. Privacy Acts establish information codes of conduct or practices relating to the collection, use, disclosure, disposal and security of the personal information which government bodies have claimed they require to administer their programs²⁸⁹.

²⁸⁷ For example, the Canadian Life and Health Insurance Industry is very concerned that there appears to be nothing in the Bank Act, the Insurance Business Regulations or the Canadian Payments Association rules that would prevent a financial institution from accessing the information it has obtained through the payment system (especially with respect to pre-authorized debits) about the life and health insurance industry's customer lists and from potentially using this information for target marketing purposes: see Canadian Life and Health Insurance Association Inc. submission to the Department of Finance "The Need for Payments System Reform" (December, 1995) at 21

²⁸⁸ Section 8 of the Canadian Charter of Rights and Freedoms protects an individual's right to a reasonable expectation of privacy including privacy of information about them.

²⁸⁹ In the United States, the Right to Financial Privacy Act was enacted in response to the decision of the Supreme Court in United States v. Miller, 425 U.S. 435 (1976), the leading case on the constitutional

Privacy Acts do not however govern the use of electronic data gathered by the private sector. Accordingly, in the absence of express legislation designed to protect the confidentiality of the electronic data gathered by financial institutions, is self regulation by these financial institutions sufficient? Should legislation comparable to the Privacy Acts be enacted to regulate the private sector's use of the personal data, to confirm that this data belongs to the customer and not to the financial institution and to confirm that any use of the information must be undertaken with fiduciary care? Should legislation be drafted to require that only the minimum personally-identifiable information needed to complete the transaction may be collected? Should the EFT system have built in controls against unrelated uses of the information (including unauthorized use by the collector itself) or the matching and blending of purchase information? Should financial institutions and others be expressly prohibited from disclosing or selling this information to others without the express consent of the

protections against the disclosure of bank depositor records to government agencies. In that case, the majority of the Supreme Court held that bank records were the property of both the bank and the depositor and that the bank had the same authority to disclose as the depositor. The Court held that Miller had no right or interest in protecting his financial records from subpoena, nor any expectation of privacy for his cheques and deposit slips. The Fourth Amendment was therefore not violated when the financial institution allowed government authorities to examine and copy the record. In response to the Miller decision and the growing concerns over the government's access to individuals' deposit records, Congress passed the Right to Financial Privacy Act of 1978 which prohibits federal agencies from obtaining access to the account records of financial institutions without: customer authorization, administrative subpoena and summons; search warrant; judicial subpoena; formal written request by a government agency lacking summons or subpoena power; and grand jury subpoena. Generally the customer has the right to receive predisclosure notice and the opportunity to contest the pending access. The Federal Reserve itself has been criticized for being in a conflict of interest position of both regulating and operating the Automated Clearing House. The Privacy Protection Study Commission in 1974 felt this dual role presented "an unparalleled threat to personal privacy" see D.A. Doheny and G.J. Forrer, "Electronic Access to Account Information and Financial Privacy", (1992) 109 No. 5 *The Banking Law Journal* 436 at 443 and C. Felsenfeld, Legal Aspects of Electronic Funds Transfers (Butterworths, Stoneham, Massachusetts: 1988) at 175, 176, 184 and 194

customer? If not, should the financial institutions be required to offset the service charges imposed on the customer with at least a portion of the profits generated from the sale of this customer information? Should they be required to provide their customer's with rights of access and correction of the electronically gathered data? In the absence of legislation, the financial institutions rely on clauses in their account agreement which expressly authorizes them to collect information from the customer for the purposes of marketing services, to give and exchange credit and other information with others and to use information about the customer for marketing purposes after the bank-customer relationship has ended²⁹⁰.

Technical measures have been instituted to protect the security of the current domestic and international systems in the hope that the risks of fraud and error remains acceptable and containable. These measures act both to restrict the access and use of the network (login, select codes, access sequence numbers, authentication keys, acknowledgment receipts and physical access control) and to protect the data during

²⁹⁰ see for example Scotiabank's "Application for Deposit Services" which provides as follows:

"Scotiabank collects information from you for the purposes of establishing and maintaining a relationship, ... marketing services ... and for any other compatible purpose.

By signing on the front of this Application, you confirm that the information you have given is true and complete. You authorize us to give to, obtain, verify, share and exchange credit and other information about you with others, including credit bureaux and any subsidiary of the Bank ... You authorize us to send you information about products of the Bank and its subsidiaries and agree that we may use the information about you for marketing purposes after the relationship created by this agreement has ended."

Similarly, CIBC's pamphlet entitled "Your Right to Privacy" provides that the "information is used only in your interests - for your banking relationship with us and to offer products and services which we believe would be suitable to you. No other use is made without your approval."

transmission (error checking controls, encryption)²⁹¹. These security concerns will only become larger as the use of electronic banking becomes more common place.

(f) Allocation of Risk - Liability for Unauthorized Transfers

Despite the security measures taken by the financial institutions to prevent unauthorized transfers, these transfers may still occur. Accordingly, the question of who should bear the risk of such transfers and whether there should be any limits on liability must be addressed.

In British Columbia, liability for theft or loss of credit card is limited under section 31 of the Consumer Protection Act²⁹² to fifty dollars for any unauthorized transactions prior to notification of the issuer. The Act excuses the holder entirely from liability for any unauthorized transactions entered into after the issuer has been notified. ATM or debit cards on the other hand are not covered by the Consumer Protection legislation²⁹³. Constitutionally, debit cards should be regulated federally. Yet despite the growth of ATM and POS networks, there is currently no federal legislation governing their operation or limiting liability for their unauthorized use (although the Bank Act arguably

²⁹¹ B. Petre, "Network Providers", (1990) 7 Computer Law & Practice 8 at 12-13

²⁹² R.S.B.C. 1979, c. 65

²⁹³ *Plater v. Bank of Montreal*, [1988] B.C.J. No. 139 (B.C.Co.Ct.); *Villemure v. Master Card* (Division Banque de Montreal) C.P. District de Montreal 505-32-001620-864 (unreported)

contains authority under its general provisions for the Minister of Finance to regulate the relationship between the card-holder and the bank²⁹⁴).

In the absence of legislation, the issuers of debit cards have worked with consumer organizations, financial institutions, retailers and federal and provincial governments to develop the voluntary "Canadian Code of Practice for Consumer Debit Card Services". This Code outlines industry practice and consumer and industry responsibilities. It provides that an card issuer must provide a copy of the cardholder agreement to the customer and that the agreement inter alia must contain a heading relating to liability. The Code provides that cardholders are responsible for all authorized use of valid cards and all unauthorized use when the cardholder has contributed to that use by voluntarily disclosing the PIN²⁹⁵ or keeping a poorly disguised written record of the PIN or by failing to notify the issuer of the unauthorized use or disclosure of the PIN within a reasonable time. The cardholder is not responsible for unauthorized use where the issuer was responsible for preventing such use or when, although the cardholder has unintentionally contributed to the unauthorized use, he or

²⁹⁴ Banks and Banking Law Revision Act, S.C. 1980, c.40, s.315(1); A.D. Chant, "The Automated Teller Machine - A New Consumer Bank Relationship", (1986-87) 1 Banking & Finance Law Review 99 at 100

²⁹⁵ Scotiacard Carholder Agreement provides that the customer will be considered as contributing to the unauthorized use of the Card and or PIN where the PIN selected "is the same as or similar to an obvious number combination such as (but not limited to) his or her date of birth, bank account number(s) or telephone number(s). Similarly, CIBC Instant Banking Service Agreement provides that the customer will be deemed to have intentionally contributed to unauthorized use if he or she selects a PIN which is based on the number on the debit card, birth date, phone number or address, or the birth date, phone number or address of any close relative. or if the same PIN is selected for telephone banking and ATM terminal access.

she co-operates in any subsequent investigation. Thus usually, the customer will be liable to the financial institution for all unauthorized withdrawals, without limitation, made before notification to the financial institution²⁹⁶.

In contrast, in the United States, Regulation R of the EFTA²⁹⁷ places limits on liabilities for transfers made without the consumer's consent²⁹⁸. The degree of consumer liability in the case of unauthorized transfer of funds through the use of a debit card will depend on the length of time it takes the consumer to report the loss of the card or the unauthorized transfer that appears on the financial institution statement. Liability is only limited for unauthorized transfers. EFTs will not be deemed unauthorized (even if the consumer may not have given actual authority for the transfer) where (1) the EFT is initiated by a person who was furnished with the access device (including PIN) by the consumer; (2) the EFT is initiated with fraudulent intent by the consumer or any person acting in concert with the consumer and (3) the EFT is

²⁹⁶ R. Hayhoe, "Fraud, the Consumer and the Banks: The (Un-) Regulation of Electronic Funds Transfer", (1995) 53 University of Toronto Faculty of Law Review 346 at 351

²⁹⁷ Regulation R of the EFTA is the result of pressure from American consumer advocates who stressed the need for protection against the power of financial institutions to contractually limit their risk exposure. The American financial industry representatives had taken the position that regulation was unnecessary and that unauthorized use was always the result of negligence on the customer's part: see R. Hayhoe, "Fraud, the Consumer and the Banks: The (Un-) Regulation of Electronic Funds Transfer", (1995) 53 University of Toronto Faculty of Law Review 346 at 354; L. Taffer, "The Making of the Electronic Fund Transfer Act: A Look at Consumer Liability and Error Resolution" (1979), 13 U. San Fran. L.R. 231

²⁹⁸ As do the Truth in Lending Act (TILA), P.L., 90-321, § 103(H), and Regulation Z for credit transactions. The provisions for debit cards are however extremely different from the credit card consumer liability limits. In the former, there may be in some circumstances no limit to the consumer's liability. For credit cards, liability is considerably more restricted: see C. Felsenfeld, Legal Aspects of Electronic Funds Transfers, (Stoneham, Massachusetts: Butterworths, 1988) at 17, n.35;

initiated by a financial institution (in the latter case, the EFT is considered neither authorized nor unauthorized, the loss falls entirely upon the financial institution)²⁹⁹. In cases, where a thief has demanded and has been furnished with the access device from the customer, the Courts have held that the use the card should not be deemed to have been authorized. This finding was later supported by additions to the Federal Reserve Board's Official Commentary³⁰⁰. The American Courts have interpreted the EFTA and regulation liberally to give wide protection to the consumer³⁰¹.

From the Canadian perspective, Regulation R provides a useful example of a compromise between the interests of the card-holders and the issuing financial institutions, a relationship which in Canada is now covered only by contract between the financial institution and the card-holder³⁰². In determining whether legislation similar to the EFTA should be enacted or whether the financial institution should be permitted to unilaterally impose contractual limits on the cardholder's liability (in accordance with whatever voluntary codes they may agree to) the following questions,

²⁹⁹ C. Felsenfeld, Legal Aspects of Electronic Funds Transfers, (Stoneham, Massachusetts: Butterworths, 1988) at 25

³⁰⁰ Judd v. CitiBank, 107 Misc.2d 526, 435 N.Y.S.2d 210 (N.Y.Civ.Ct. 1980); Re New York v. CitiBank, N.A., 537 F. Supp 1192 (S.D.N.Y. 1982); Federal Reserve Board's Official Commentary, Q2-27 and Q2-28; C. Felsenfeld, Legal Aspects of Electronic Funds Transfers, (Stoneham, Massachusetts: Butterworths, 1988) at 26;

³⁰¹ Russell v. First American Bank- Mich., N.A., [1988-1989] Fed. Banking L. Rep. (CCH) §87,524 (W.D. Mich. 1988) - the Court held that the Bank could not contractually expand the customer's liability beyond the EFTA

³⁰² A.D. Chant, "The Automated Teller Machine - A New Consumer Bank Relationship", (1986-87) 1 Banking & Finance Law Review 99 at 101

amongst others, will have to be considered: Is the contract explicit about keeping the PIN separate from the card? Is liability under the contract affected by failure to keep the PIN separate or is the cardholder simply responsible for all unauthorized transfers until the financial institution has been notified and has had an opportunity to cancel access of the card to the machine? Should the combination of the PIN stored with the debit card be regarded as the equivalent of a blank, signed cheque? Should the customer owe a duty to the financial institution to secure the PIN and the card in the same way that the customer has a common law duty not to draw a cheque in such a manner as will facilitate forgery³⁰³? It is estimated that in over 50 per cent of the cases the unauthorized user of the card is known to the cardholder (e.g. larcenous housekeeper, dishonest child or dishonest friend of the child or an aggrieved ex-spouse)³⁰⁴, do these statistics support the view that the customer rather than the financial institution should be liable for the unauthorized use? Should the unauthorized transaction be viewed as being equivalent to a forged cheque (and thus a nullity) so that the financial institution in turn is viewed as having no authority, expressed or implied, to pay the funds out of the account³⁰⁵. If the customer's liability is to be limited should a duty be imposed on the customer to examine financial institution statements

³⁰³ see for instance, *London Joint Stock Bank v. MacMillan*, [1918] A.C. 777; A.D. Chant, "The Automated Teller Machine - A New Consumer Bank Relationship", (1986-87) 1 *Banking & Finance Law Review* 99 at 106

³⁰⁴ A.D. Chant, "The Automated Teller Machine - A New Consumer Bank Relationship", (1986-87) 1 *Banking & Finance Law Review* 99 at 105

³⁰⁵ A.D. Chant, "The Automated Teller Machine - A New Consumer Bank Relationship", (1986-87) 1 *Banking & Finance Law Review* 99 at 106

or to balance his or her cheque book³⁰⁶ in order to report such transfers in a more timely manner? What are the financial institutions' obligations concerning periodic statement disclosures? If they are obliged to provide information about term identification and location disclosure in order to permit easy identification of unauthorized use how will they accommodate the customer's privacy concerns? Should a financial institution be permitted to raise an account verification agreement which requires the customer to examine financial institution statements and report any discrepancies as a contractual defence to its own negligence³⁰⁷? If the PIN is obtained by an unauthorized user due to deficiencies in the design of the ATM system or negligence on the part of the financial institution (for example with regard to the layout of the ATM location or hand held access device) should the customer still be liable³⁰⁸? Do not the millions of dollars in transactions fees charged by the financial institutions for the use of the system more than compensate the financial institutions for the losses they might suffer due to unauthorized use?

³⁰⁶ A.D. Chant, "The Automated Teller Machine - A New Consumer Bank Relationship", (1986-87) 1 Banking & Finance Law Review 99 at 107; *Canadian Pacific Hotels Ltd. v. Bank of Montreal* (1987), 40 D.L.R. (4th) 385 (S.C.C.) and *Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd.*, [1986] A.C. 80 (P.C.) (U.K.) but see *Arrow Transfer Co. v. Royal Bank*, [1972] S.C.R. 858, 27 D.L.R. (3d) 81; N. Rafferty, "Account Verification Agreements: When Can a Bank Protect Itself Against Its Own Negligence" (1992-93), 8 Banking & Finance Law Review 403 at 409

³⁰⁷ *239199 Alberta Ltd. v. Patel* (1992), 1 Alta.L.R. (3d) 215, [1992] 4 W.W.R. 42 (Q.B.); *Cavell Developments Ltd. v. Royal Bank of Canada* (1991), 54 B.C.L.R. (2d) 1, [1991] 4 W.W.R. 266 (C.A.); for cases to the contrary see N. Rafferty, "Account Verification Agreements: When Can a Bank Protect Itself Against Its Own Negligence" (1992-93), 8 Banking & Finance Law Review 403 at 412-418

³⁰⁸ *Ognibene v. CitiBank*, 112 Misc. 2d 219 (NY Cir.Ct. 1981); A.D. Chant, "The Automated Teller Machine - A New Consumer Bank Relationship", (1986-87) 1 Banking & Finance Law Review 99 at 107

In addition to unauthorized use which might occur at an ATM owned or operated by the customer's own financial institution, what happens when the unauthorized transactions occurs at an ATM owned by other than the customer's financial institution? A shared ATM system brings into effect a three way relationship between the customer, the financial institution owning the ATM and the home financial institution of the customer. In most cases, the relationship is of little concern to the customer. Members of a shared system would usually become members of an association whose major assets would be electronic switching equipment which would provide the mechanism for linking the proprietary systems of the various members and the trade mark (e.g. Interac) for the system. The member financial institutions through transaction fees or some form of cost sharing would agree to pay an appropriate share of the association's fees. The member financial institutions would also agree to pay another member financial institution a fee whenever a customer uses an ATM of that financial institution to access an account. In any ATM related law suit between the customer and a financial institution the fact that a disputed transaction took place at an ATM owned by a second organization will only be of significance where the critical issue in the dispute involves the method of operation of the particular machine in question³⁰⁹. In such a case how will liability be shared?

³⁰⁹ A.D. Chant, "The Automated Teller Machine - A New Consumer Bank Relationship", (1986-87) 1 Banking & Finance Law Review 99 at 109

(g) Allocation of Risk - Liability for Fraud / Forgery

Under the Bills of Exchange Act, the general rule is that the financial institution bears the risk of fraud. Section 49(1) of the Act is designed to protect the purported drawer from forgery and provides that a forged signature is wholly inoperative. Later sections modify this slightly by requiring notice of forgery within one year and by permitting ratification of an unauthorized signature which does not amount to forgery. Thus, when a customer's signature is forged on a cheque, subject to the requirement of reasonable notice and the common law doctrine of estoppel, the financial institution bears the risk and is not entitled to debit the customer's account³¹⁰.

Apparently, a practice has developed of not checking signatures on small amount cheques³¹¹, so loss of right to verify the customer's signature due to cheque truncation may not be of any concern to financial institutions. Moreover, new technology, such as the ability to transmit the signature image electronically or fingerprint, eyeprint and body image scans may replace the need to verify the customer's signature on the cheque or debit slip. But what about EFTs that have occurred due to fraud? How should the liability currently imposed under the Bills of Exchange Act be modified to take into account cheque truncation, EFTs and these new

³¹⁰ R. Hayhoe, "Fraud, the Consumer and the Banks: The (Un-) Regulation of Electronic Funds Transfer", (1995) 53 *University of Toronto Faculty of Law Review* 346 at 347; Falconbridge (8th ed.) at 1362-1400

³¹¹ B. Geva, "Off-Premises Presentment and Cheque Truncation under the Bills of Exchange Act", (1986-87) 1 *Banking & Finance Law Review* 295 at 302

methods of authenticating the customer's mandate? Credit card companies lost more than \$74 million to fraudulent transactions in Canada in 1994³¹². Presumably, debit cards, smart cards and other advanced card technologies are similarly at risk.

(h) Allocation of Risk - Interest and Principal Losses and Losses Caused by Computer Malfunctions

Whatever network is used to transmit financial data, there is always the risk of destruction of the data (deliberately by means of a software virus or accidentally through systems malfunction or failure) with the result that the data may never reach the recipient or that it will be delayed. There is also the risk of unauthorized access to and use of the network (such as through line tapping) which may result in the data never reaching the recipient or being delayed or reaching the recipient with a different content or with leakage on the way. The events mentioned can cause different types of damages: direct loss such as loss of the principal amount which is the subject of the transaction (for example if the money is withdrawn from the account to which it was wrongly directed), loss of interest or loss of foreign exchange rate and indirect damages³¹³.

³¹² "Advanced Card Technologies", Forum, volume 11, no. 3, September, 1995, prepared by the Canadian Payments Association, at p.5

³¹³ B. Petre, "Network Providers", (1990) 7 Computer Law & Practice 8 at 10

In the absence of rules to the contrary, the general legal principles of liability should apply. Accordingly, the damages should be borne by the person who behaved faultily: For example, if the system failure was due to the fault or negligence of the network provider, the network provider should be responsible for the losses³¹⁴.

Should that liability be limited? What is each financial institution's liability where customers of one financial institution can withdraw money at ATM's of other financial institutions under agreements between the financial institutions? Who is liable for malfunctions causing loss to customers and other financial institutions arising from system sharing. Should financial institutions or carriers be permitted to limit their liability for losses caused by system or personnel failure or an negligent act, error or omission and, if so what limits on their liability should be permitted³¹⁵?

³¹⁴ B. Petre, "Network Providers", (1990) 7 Computer Law & Practice 8 at 11

³¹⁵ For example, SWIFT may be liable for interest losses arising out of a late payment and it may be liable for "direct loss or damage" which is limited to nonrecoverable loss of funds representing the principal amount of authenticated messages and loss interest on such amounts. SWIFT's liability for direct loss or damage is subject to a floor limit of BEF 2 million (approximately \$64,000.00 U.S.) and a ceiling of BEF 3 billion for any one loss or series of losses arising out of the same event. There is also an annual ceiling for each claimant, thus making a maximum liability of BEF 6 billion in the aggregate for each annual period for direct loss or damage through any fraudulent or dishonest act committed by SWIFT employees as well as for direct loss or damage through errors or omissions and fraud. Similarly, CHIPS assumes liability only for dishonest or fraudulent acts committed by a Clearing House employee alone or in collusion with others. The losses are covered by a financial institution bond with aggregate and single loss limits of \$2.5 million provided they are discovered within the bond period. Participants are also to indemnify the Clearing House for loss arising by virtue of liability being attached to it in proportion to their share in the preceding month's CHIPS payment activity: see H.F. Lingl, "Risk Allocation in International InterBank Electronic Fund Transfers: CHIPS and SWIFT" (1981) 22 Harv. Intl' L.J. 621 at 634; SWIFT User Handbook; "New SWIFT Rules on the Liability of Financial Institutions for Interest Losses", 13 Cornell Intl' L.J. 311 (1980); B. Geva, The Law of Electronic Funds Transfers, (New York: Mathew Bender & Company, 1992) at 3-27 and 4-57

CONCLUSION

The payments system has evolved considerably since its inception as a straightforward system for the clearing and settlement of interbank payment items. The old view that the payments system is simply an internal bookkeeping matter of the financial institutions is clearly no longer appropriate. The payments system is no longer used to simply connect the computer networks of the deposit-taking financial institutions for clearing and settlement purposes. It now connects retailers and customers and serves as a financial communications network. Its growth is comparable to that of the Internet which evolved from a means for governments and university researchers to communicate with one another to a global system capable of connecting personal computers at local area networks with those in other local area networks³¹⁶. Since the nature of the participants has changed, the payments system must also change. Yet the direction which the Canadian payments system will take in the future, particularly as it relates to electronic funds transfers, is extremely complex. There must be a balance between the right of the retailer and non-deposit taking financial institutions to gain access to the system in order to be able to successfully compete and service their customers in the electronic age with the need to safeguard the stability of the Canadian monetary system. There must also be substantial changes to the existing legislation to accommodate EFTs. Until information about the payments system becomes more readily accessible, however, it will be virtually impossible to make recommendations about the types of detailed changes which should be made to the payments system.

³¹⁶ A.S. Grove, "Is the Internet overhyped?" *Forbes*, September 23, 1996, at p. 110

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