Law Society of Ontario | Barreau de l'Ontario

Tab 7.5

Professional Regulation Committee

Proposed Amendments to the Rules of Professional Conduct – Finance Company

April 25, 2019

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Introduction

The Law Society is seeking input on the following proposed amendments to Rule 3.4-13 of the *Rules of Professional Conduct*:

> In Rules 3.4-14 to 3.4-16 a 'lending client' is any of the following:
>
> a) a bank, trust company, insurance company, or credit union;
> b) a finance company that is a corporation or partnership :
> i) whose material business involves making or refinancing loans, or entering into other similar arrangements for advancing funds or credit; and,
> ii) whose shares or ownership interests (or another person or entity with which it is affiliated) are listed on a stock exchange within or outside Canada that is a Designated Stock exchange for the purposes of the *Income Tax Act* (Canada); or
> c) a person designated as an approved lender under the *National Housing Act (Canada)*.

Executive Summary

In 2018, the Law Society received submissions from the Ontario Bar Association ("OBA") identifying certain ambiguities in the definition of the term "lending client" provided in Rules 3.4-13 to 3.4-16. These rules provide an exception to the conflict of interest rules by specifying that a lawyer may act for both a lender and borrower where the lender is a lending client. Rule 3.4-13 defines lending client as "a client that is a bank, trust company, insurance company, credit union or finance company that lends money in the ordinary course of its business". According to the OBA, the inclusion of the term "finance company", without further definition leaves lawyers without sufficient guidance about what types of entities should qualify as a lending client.

The OBA submission was referred to the Professional Regulation Committee, which concluded that the professions should be consulted on a new proposed definition of "lending client" as described above. In its deliberations, the Committee considered the following:

a) The rules appear to have been drafted to provide an exception to the conflict rules where the lender is an institutional lender.
b) The term "finance company" is ambiguous because there is no general understanding as to what entities would or would not qualify as lending clients.
c) The application of the term "finance company", without further clarification, could allow the exemption to apply to entities that are not insitutional lenders.

d) The proposed amendment, as described above, would eliminate ambiguity and provide additional clarity and guidance as to the meaning of the term finance company.
e) The proposed amendment would restrict the term "lending client" to those entities that could be considered institutional lenders.
f) Consultation is required to ensure that the amended definition of "lending client" encompasses those entities that could be considered institutional lenders, while excluding those entities that could not be considered institutional lenders.

Background

A. Context

In 2018, the Law Society received a submission from the OBA, which advised of a possible gap in the rules and provided suggestions for a solution.

The issue relates to the meaning of "lending client" as used in Rules 3.4-14 – 3.4-16. Those rules provides an exception to a lawyer's general duty to avoid conflicts of interest; they allow a lawyer to represent both a lender and borrower in a mortgage or loan transaction when the lender is a "lending client". Lending client is defined in Rule 3.4-13 as a "client that is a bank, trust company, insurance company, credit union or finance company that lends money in the ordinary course of its business."

According to the OBA, the inclusion of the term "finance company", without a definition of the term, does not provide sufficient guidance about what types of entities should be considered to fall within the rule. The experience of Law Society staff in Spot Audit and the Practice Management Helpline also indicate that there is some confusion about the meaning of the term, particularly when the lender is a corporation established to lend money for private mortgages.

B. Rules Governing Exemptions for Borrowers and Lenders

The rules addressing conflicts of interest provide exemptions for lawyers acting for borrowers and lenders in certain situations.

Rule 3.4-12 provides that:

> Subject to rule 3.4-14, a lawyer or two or more lawyers acting in partnership or association must not act for or otherwise represent both lender and borrower in a mortgage or loan transaction.

Rule 3.4-14 provides that a lawyer may represent both a borrower and a lender in a mortgage or loan transaction in certain enumerated situations, including where the lender is a lending client. As discussed above, rule 3.4-13 provides a definition of "lending client", which includes a "finance company".

Although the rules about acting for borrower and lender are not explicit in this regard, it appears that the provisions were originally drafted to allow a lawyer to act for both parties where the lender is an institutional lender. Paragraph [1] of the Commentary to Rule 3.4-16 provides:

> Rules 3.4-13 to 3.4-16 are intended to simplify the advice and consent process between a lawyer and institutional lender clients. Such clients are generally sophisticated. Their acknowledgement of the terms of and consent to the joint retainer is usually confirmed in the documentation of the transaction (e.g. mortgage loan instructions) and the consent is generally acknowledged by such clients when the lawyer is requested to act.

In order for a lawyer to represent both a borrower and a lending client, according to a leading legal ethics text, "the lending client must be a regulated financial institution (bank, trust company, insurance company, credit union or finance company) which lends money in the ordinary course of its business."[1] The definition of lending client in rule 3.4-13 does not specifically indicate that the lending client must be a regulated institution, although banks, trust companies, insurance companies, and credit unions are statutorily regulated entities.

Analysis

There does not appear to be any confusion with respect to the reference to banks, trust companies, insurance companies, and credit unions in rule 3.4-13. All are known entities defined by governing legislation. For instance, banks are listed in Schedules I or II to the *Bank Act*, S.C. 1991, c.46, while trust companies, insurance companies, and credit unions are all defined and regulated under various provincial and federal statutes. The types of entities that may be considered finance companies, however, are not so generally identifiable or as clearly defined in statute.

The following paragraphs set out a possible definition of finance company, based on reference to existing statutes and regulations that employ the term "finance company" in situations comparable to the situations encompassed by rules 3.4-13 to 3.4-16.

Finance company is a defined term in two regulations to the *Mortgage Brokers, Lenders and Administrators Act*, 2006 ("MBLAA"). The relevant provisions in these regulations deal with exemptions from requirements to be licensed under that Act. Section 17(2) of O.Reg. 407/07 to the MBLAA, defines a finance company as a corporation or a partnership, other than a financial institution, that satisfies both of the following two criteria:

[1] Simon Chester and Charlotte Conlin, "Conflicts of Interest", *Canadian Legal Practice* ed. Adam M. Dodek and Jeffrey Hoskins, Toronto: Lexis Nexis, 2018), Looseleaf ed., paragraph 4.403.3.

I) a material business activity of the corporation or partnership involves making or refinancing loans, or entering into other similar arrangements for advancing funds or credit; and

II) the shares or ownership interests of the corporation or partnership, or another person or entity with which it is affiliated, are listed on a stock exchange in Canada or outside Canada that is a **prescribed stock exchange** for the purposes of the Income Tax Act (Canada) (emphasis added).[2]

The proposed definition of "finance company" includes the above criteria, but updates it by referring to Designated Stock exchange, which is the current term used for the purposes of the Income Tax Act.[3]

The proposed amendment extends the definition of "finance company" beyond that referred to in MBLAA regulations, to include other institutional lenders, specifically those listed as approved lenders under the *National Housing Act* ("NHA"), as published by the Canadian Mortgage and Housing Corporation ("CMHC").[4]

NHA-approved lenders must satisfy the requirements in a regulation under that Act (SOR 2012-232 under the Act). Section 2 of the regulation provides that, in order to be designated as an approved lender for the purposes of Part 1 under the NHA, a person must meet the criteria set out in paragraphs 3(1)(a) or (b):

a) a corporation whose articles do not restrict its powers to lend in the jurisdictions in which it operates and

(i) a financially sound institution with at least $3,000,000 of unencumbered paid-up capital that is incorporated by or under an Act of Parliament or of the legislature of a province;

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[2] See O. Reg. 407-07 under the Mortgage Brokers, Lenders and Administrators Act, section 7(2), online at https://www.ontario.ca/laws/regulation/070407, and O. Reg. 409-07 (s. 17(2) under the Mortgage Brokers, Lenders and Administrators Act, online at https://www.ontario.ca/laws/regulation/070409.

[3] In 2007, the two lists of prescribed stock exchanges were replaced with three categories of stock exchange: Designated Stock Exchange, Recognized Stock Exchange and Stock Exchange. Designated stock exchanges are designated by the Minister of Finance and are listed on the Department of Finance website. They include all stock exchanges that were prescribed in the Income Tax Regulations immediately before the new regime took effect in 2007. In considering whether a stock exchange should be designated, the Minister of Finance considers a number of factors relating to its structure and governance. For foreign-based exchanges, those criteria include that the host country is a member in good standing of the international financial community through membership in organizations such as the World Trade Organization, and that there is a securities and judicial framework in the host country that provides rights and remedies to Canadian investors. See Department of Finance Canada https://www.fin.gc.ca/act/fim-imf/dse-bvd-eng.asp, which includes information about the designation process as well as a list of designated stock exchanges

[4] The NHA list is available at https://www.cmhc-schl.gc.ca/en/hoficlincl/moloin/aple/index.cfm.

(ii) a federal financial institution or an authorized foreign bank within the meaning of section 2 of the Bank Act;

(iii) a trust, loan or insurance corporation that is incorporated or regulated by or under an Act of the legislature of a province,

(iv) a cooperative credit society that is incorporated and regulated by or under an Act of the legislature of a province;

(v) a federal or provincial department, agency, or Crown corporation; or

(vi) any other entity as long as the housing loans that it insures with the Corporation are guaranteed by Her Majesty in the right of Canada or a province; or

b) a federally or provincially-regulated pension fund, or its subsidiary, that was designated, before the coming into force of these Regulations, as an approved lender under section 5 of the Act.[5]

Mortgage investment companies ("MICs") would not be considered finance companies unless they could satisfy either the NHA requirements, or fall within the definition of finance company under the MBLAA.[6]

A MIC is an unregulated lender. As a result, the residential mortgages provided by these entities are not subject to the lending rules set out by federal or provincial governments. Nor are MIC mortgages insured by the Canada Mortgage and Housing Corporation (CMHC).[7] There are an estimated 200-300 MICs in Canada, with a significant number formed since 2007.[8]

MICs provide mortgages to borrowers who would typically not qualify for a loan with a regulated financial institution because of their credit history and credit risk profile. Such borrowers may include self-employed individuals, real estate investors and recent

[5] Housing Loan (Insurance, Guarantee and Protection) Regulations, SOR 2012-232, online at http://laws-lois.justice.gc.ca/eng/regulations/SOR-2012-232/page-1.html.
[6] Through additional discussions with the OBA we are aware of a particular instance in which a lawyer confronted this issue with respect to a MIC. The lawyer conducted an analysis similar to the approach that is proposed by the OBA and concluded that this MIC was not a finance company for the purposes of Rule 3.4-14.
[7] Canada Mortgage and Housing Corporation, "Business/Government/Housing Organizations", online at https://www.cmhc-schl.gc.ca/en/Housing-Observer-Online/2016-Housing-Observer/A-Look-at-Mortgage-Investment-Corporations.
[8] Ibid.

immigrants. According to the CMHC, MICs typically charge higher mortgage rates compared to regulated and quasi-regulated lenders. [9]

According to the OBA, the proposed amendment would clarify which companies may be considered finance companies without broadening the definition too widely. However, other legal organizations have suggested that the proposed amendment inappropriately narrows the definition of "finance company" because it would exclude sophisticated entities, with active lending businesses and considerable capital. Accordingly, consultation with the professions and the public is recommended to enable the Law Society to have a better understanding of the issue.

Conclusion

To eliminate ambiguity and appropriately determine the scope of the term "lending client", the Law Society seeks input on the following proposed amendments to Rule 3.4-13 of the Rules of Professional Conduct:

> In Rules 3.4-14 to 3.4-16 a 'lending client' is any of the following:
>
> a) a bank, trust company, insurance company, or credit union;
> b) a finance company that is a corporation or partnership:
> iii) whose material business involves making or refinancing loans, or entering into other similar arrangements for advancing funds or credit; and,
> iv) whose shares or ownership interests (or another person or entity with which it is affiliated) are listed on a stock exchange within or outside Canada that is a Designated Stock exchange for the purposes of the *Income Tax Act* (Canada); or
> c) a person designated as an approved lender under the *National Housing Act (Canada).*

Questions

The Committee seeks input on the following questions by June 30, 2019:

1.Is an amendment required to define the term "finance company" as used in rules 3.4-13-3.4-16?

[9] Canada Mortgage and Housing Corporation: *Research Insight: Risk Profile of Mortgage Investment Corporations*, August 2016, online at https://financialfreedomisajourney.com/wp-content/uploads/2017/06/Mortgage-Investment-Corporations-Risk-Profile-CMHC.pdf

2. If so, is the proposed amendment appropriate? Why or why not?

3. What factors should be considered in determining if a finance company is a lending client?

4. Does the proposed amendment address those factors? Why or why not?

5. Are mortgages provided by MICs substantively different from mortgages provided by institutional lenders?

6. What other matters could impact consideration of the definition of “finance company” and “lending client”?