

# Show me the money



## Funds handling – and the benefits of wire transfers

The recent increase in the number of frauds – many involving counterfeit financial instruments – have been a wake-up call to the bar on two fronts:

- First – fraudsters are targeting all lawyers, not only real estate practitioners. For more on this, see the article ***Fraud: A growing problem affecting all lawyers*** in this issue.
- Second – that there is some confusion about how financial instruments move through the Canadian payments system and how lawyers can verify that funds deposited to their trust accounts are “good” – that is, final and irrevocable.

The following article is based on interview responses provided to LawPRO Magazine by three experts in the field of funds transfer: Martin Scisizzi of Borden Ladner Gervais LLP, Mike Seto of Teranet, and Pierre Roach, Vice President of Payment Services with the Canadian Payments Association.

The principal conclusions to be drawn from the interviews are as follows:

### **1. FUNDS CLEARED THROUGH THE CONVENTIONAL SYSTEM – THE AUTOMATED CLEARING SETTLEMENT SYSTEM (ACSS) – ARE NOT “GOOD” THE MINUTE THEY HIT YOUR TRUST ACCOUNT.**

**IN FACT, IN CERTAIN CIRCUMSTANCES, THESE FUNDS COULD BE SUBJECT TO RETURN FOR WEEKS OR EVEN MONTHS.**

**Pierre:** There is a distinction between a payment item “having cleared” and the payment being final or good funds. Clearing refers to the exchange of paper and electronic payment items between financial institutions (FI) and the reconciliation of balances among participating FIs.

Cheques and other paper payment items are generally cleared overnight following the day of deposit (as explained above, this

does not necessarily equate to “good funds” or funds being final and irrevocable). Settlement occurs on the morning of the next business day through the major financial institutions’ settlement accounts at the Bank of Canada.

Bank drafts and certified cheques cannot normally be returned through the clearing system and are final in most instances; however, there are certain exceptions. If either of these items has been materially altered after it was issued (e.g change of payee or amount), it can be returned through the clearing system for up to 90 days after the date of receipt by the drawee FI.

An item bearing a forged endorsement can be returned for up to six years (prior to June 2008, the return period was unlimited). In the rare event of the drawee financial institution’s default, they could also be subject to return until they are settled the following morning.

**Martin:** Upon deposit of a certified cheque or bank draft for collection, the payee is normally given immediate provisional credit by his bank for the full amount of the instrument. Generally speaking, the collecting bank has the right of “chargeback” by reversing or eliminating the provisional credit where the cheque or bank draft received by it for collection has been dishonoured...

If the drawee bank wishes to dishonour a cheque or other payment instrument (other than a certified cheque or bank draft), it is required to return the item “no later than the business day following receipt by the first organizational unit of the drawee (the bank on which the cheque is drawn) that is able to make or act upon a decision to dishonour the item.” This is usually a branch. A certified cheque or bank draft, strictly speaking, cannot be returned except for “material alterations” or a forged endorsement.

As the clearing process reaches every branch of every deposit-taking financial institution in the country, the time required to present an item physically to a branch of account varies from a day or two for branches in major centres to as long as eight to 10 days for those in more remote locales. It also depends on whether there are intervening statutory holidays.

As a result, generally speaking, it would not be safe to withdraw funds which have been provisionally credited for at least 8 to 10 days. Cheques drawn on U.S. banks can take as long as 30 days to clear.

## 2. THE OTHER FUNDS HANDLING SYSTEM OPERATED BY THE CPA – THE LARGE VALUE TRANSFER SYSTEM (LVTS) – ADDRESSES LAWYERS’ NEED TO KNOW FUNDS IN THEIR TRUST ACCOUNTS ARE “FINAL AND IRREVOCABLE.”

**Mike:** LVTS was introduced in 1999 and is currently the settlement process behind all wire payments between Canadian financial institutions transacting in Canadian funds. (Care should be exercised in relation to inter-branch wires; while a financial institution may use similar message formats (SWIFT), these transactions do not typically go through LVTS and do not automatically attract the same benefits.)

A bit of a misnomer, LVTS is not limited to large value transactions. Payments of just several dollars can be made through this system. However, in 2005, the CPA reported that 89 percent of the total value of transactions cleared and settled through its systems were made through LVTS (compared to about 1 per cent of the number of transactions).

The unique aspects of LVTS are:

- 1) Funds from a completed transaction are backed by pledged collateral and ultimately guaranteed by the Bank of Canada. To participate in LVTS transactions, financial institutions must pledge security to the Bank of Canada to cover the net balances of transactions made during the day. As a consequence, the Bank of Canada guarantees all completed transactions, backed by collateral pledged by financial institutions.
- 2) Once completed, transactions are irrevocable. Each LVTS transaction passes through controls operated by the CPA, that ensure there is sufficient collateral to back it. If controls are successfully passed, including sufficient security remaining, the transaction is completed **irrevocably** (and evidenced by a Payment Confirmation Reference Number – or “PCRN”). The payment is final.<sup>1</sup>

- 3) Timeliness. Typically, it takes under one minute for the CPA to complete a LVTS transaction from the initiation by a financial institution; therefore the claim of “near real-time processing.”

In the early days of LVTS, financial institutions were batching their transactions, thereby frustrating the benefits of near real time processing to wire customers. More recently, all of the major banks have introduced online commercial banking suites that include an online wire service (i.e. LVTS) and have been processing transactions individually. However, it is important to note that all of the banks have various and differing internal regulatory processes that may result in manual processing. This may delay a financial institution in processing a LVTS transaction but regardless, LVTS processing is far faster end to end than ACSS.

### COST ISSUES

The practical disadvantage of LVTS is its cost. A transaction usually costs \$10-\$15 for the entity making the payment and another \$10 to the party receiving payments. This varies slightly between financial institutions. (Not overly onerous when compared to the cost of obtaining certified cheques – around \$12 – and potential courier costs for delivery, but many firms have successfully negotiated with their banks to waive certification fees.) Additionally, if online services are used, some institutions require set up costs (some implement security devices with users) and others have monthly service charges.

An LVTS payment will not completely assure you that the underlying transaction is good (i.e. although the payment transaction is final and irrevocable, if there is a problem with the making of the payment itself – e.g. money laundering – there could be a claim that results in a reversal outside of the actual payment process). But it should provide a situation where your trust account will not be short due to a fraudulent instrument.

**Pierre:** A clear benefit for beneficiaries is that LVTS payments are final and irrevocable, once received by the beneficiary’s FI. In addition, the receipt of “good funds” can generally be confirmed the same day (with the potential exception of payments sent towards the end of the day).

As a sender of LVTS payments, one caution is to ensure you are dealing with a legitimate party as a beneficiary. Since payments are final once sent, they could not be stopped or reversed through the clearing system in the event of a scam. However, this issue is not unique to LVTS.

<sup>1</sup> As provided under the Payment Clearing and Settlement Act, S.C.1996, c.6 and the LVTS BY Law, sections 42 and 43 (available: [http://www.cdnpay.ca/systems/lvts\\_overview.asp](http://www.cdnpay.ca/systems/lvts_overview.asp))

## RISK MANAGEMENT RECOMMENDATIONS

**Pierre:** As a payment recipient, the best option from an irrevocability perspective is to request payment by wire transfer through the Large Value Transfer System (LVTS). LVTS payments are final and irrevocable as soon as they are received by the beneficiary's FI.

At a minimum, you should be very cautious about accepting items that have been endorsed over to another party, as there could be a risk of forged endorsement. Only accepting certified cheques directly from the account holder, or confirming the key details such as payee and amount with the account holder can avoid the risk of material alteration.

**Martin:** The reality is that certified cheques will continue to be the predominant method of payment. Given this, lawyers should ask their bank to "call" certified cheques – that is, have your bank call the bank that certified the cheque to confirm the details on cheque and the certification. This is not bullet-proof, but is a measure of insurance.

**Mike:** It's all about risk. The firm must make its decision cognizant of its willingness to assume risk, its knowledge about the client/entity making the payment and the amount. Mindful that most payments do not go astray, there will be circumstances in which lawyers can continue to use certified cheques that will not be subject to return.

However, in situations involving identifiable risk factors (a new and unfamiliar client, client pushing to complete deal quickly, funds moving offshore or other circumstances that are unusual or suspicious), the minimum that should be done is to check with your financial institution as to whether it is safe to withdraw from the deposit (note the absence of reference to "clearing" or "settling"). Expect, however, a response indicating upwards of several days.

If timeliness is an issue, consider a wire. Return the certified cheque or other instrument and kindly ask the payor to wire funds to your account. By using LVTS, risks associated with paper instruments (e.g. forged endorsements and fraudulent instruments) are avoided. While this may not prevent a claim down the road that the payment itself should never have been made, this should prevent you from having to deal with a shortage in your trust account.

**LawPRO:** If you have decided that wiring funds as LVTS payments is the way to go, be sure to also consider the following:

- You may not be able to get confirmation of the receipt of "good funds" where the transaction is occurring late in the business day. The earlier in the day you can move funds and close your transaction, the better.
- Although the CPA can do its part of an LVTS transaction very quickly, your instructions have to be sent to your individual financial institution to initiate the transfer, and then by the FI through the LVTS. Contact your financial institution to review its on-line or other systems for initiating and receiving wire transfers, and the costs per transaction and/or per month. You need to be confident that delays or mistakes are unlikely in the handling by the financial institutions at either end of the process.
- Is it enough for you to confirm receipt of a wire transfer by reference to your on-line banking system? Ask your financial institution for advice, including whether wire transactions as line items on a statement are referenced in a specifically identifiable way on which you can rely.
- Ask your financial institution if it uses true LVTS wires for inter-branch wires or if it will offer the same protections against reversibility as LVTS regardless of the clearing system that it uses.
- Don't forget that the Law Society of Upper Canada's By-law 9 contains requirements related to electronic transfers of trust funds. You must keep those requirements in mind when evaluating any electronic system for wiring funds.