

The Check (*Cheque*) is not *Always* in the Mail: Ontario By-Laws on Electronic Transactions and Record Keeping and Related Concerns about Cheque Imaging

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I. INTRODUCTION

Technology in the land of commerce is evolving as rapidly as in any other field of human endeavour. To remain effective, regulators must be alert and responsive to change, even when it happens outside their immediate sphere of influence. This is certainly true for those of us who regulate lawyers and who attempt to ensure that the public remains protected from dishonest members of the legal profession.

Unfortunately, the sheer pace of technological change, notably including change in the financial services industry, makes it relatively easy to overlook the significance of some developments. The cost of less-than-total vigilance might be diminished regulatory effectiveness. This in turn could result in lawyer dishonesty left undetected, or un-prosecutable, and hence unpunished. From the standpoint of client protection and client compensation funds, we also risk unexpected drains on inevitably finite and precious financial resources.

(a) The Law Society of Upper Canada

The Law Society of Upper Canada was founded by statute in 1797. Its role is to govern the approximately 34,000 lawyers practising in what is now the Province of Ontario, Canada. The Society's central mandate is to regulate the legal profession in the public interest. This includes ensuring the competence, capacity and ethical conduct of all of the Society's members.

The Law Society determines who can become a lawyer and who can remain a lawyer. It sets the standards for admission and it makes the rules of professional conduct. It investigates complaints and prosecutes those who warrant formal discipline. It also makes rules that determine how lawyers in private practice must deal with client funds, and how they are required to account to their governing body for the operation of their trust accounts. If a lawyer steals money from a client, it is the Law Society's Fund for Client Compensation to which the client

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may well turn for redress. If a lawyer is found to be negligent, a Law Society-owned mandatory insurance company, the Lawyers' Professional Indemnity Corporation, aka LawPRO, may pay the judgement or settlement.

In short, whereas the regulation of lawyers and protection of clients in American jurisdictions may be spread among a number of Bar, state and judicial entities, in Ontario (and other Canadian provinces and territories), it is the Law Society – the governing body of a self-regulating legal profession – which holds most, if not all, of the regulatory cards. The Society's responsibilities are broad, indeed.

(b) The Law Society's response to technology

As part of its regulatory responsibilities, the Law Society attempts to keep abreast of technological change in areas where lawyers operate. A few years ago, in 2002, the Law Society turned its attention to the growing impact of electronic transactions on everyday commerce. It asked the questions, "What will all of this mean for lawyers? What will mean for us as a regulator?" The initial answer is the subject of this paper. But, as the paper also points out, there are many more important questions still to be addressed, in some cases rather forcefully. This is especially true as the era of paper cheque transactions rapidly gives way to an increased reliance on electronic imaging, a development driven to a great extent by powerful financial institutions.

II. THE BYLAW ON HANDLING MONEY AND OTHER PROPERTY: BYLAW 19

(a) Section 2

Under its statute¹, the Law Society enacts both Rules of Professional Conduct and Bylaws to govern various aspects of lawyer conduct. Bylaw 19 deals with the handling of "money and other property". At least with respect to the former, its key provision is section 2. This section of the by-law obliges every member (that is, every lawyer in Ontario) who receives money in trust for a client to pay that money into a designated trust account. The account must be held in the name of the member or his or her firm, at a bank or other specified type of financial institution.

(b) Section 3

In addition, section 3 specifies which money may be withdrawn from a trust account:

- money required for payment to a client or a person on behalf of a client;
- money to reimburse the member for disbursements;
- money for fees for which a billing has been delivered;
- money to be transferred into another client trust account;
- money put into the trust account by mistake; and
- money withdrawn with the permission of the Law Society.

While it may be intuitive to most people, the bylaw also prohibits lawyers

1. *Law Society Act*, R.S.O. 1990, c.L-5, as am. The Law Society by-laws discussed in this paper, together with the legislation under which they were made, can be readily accessed on the Society's website: www.lsuc.on.ca.

from taking out more in respect of a client than is actually held in trust on that client's behalf.

Bylaw 18 imposes further obligations with respect to how records of such deposit and withdrawal transactions must be kept; we will talk more about that later. But for the moment, let us keep our focus on Bylaw 19.

(c) Controls on withdrawals from trust accounts

It is axiomatic that trust account money does not belong to the lawyer. It must be protected from the risk of both theft and inadvertent loss. Hence a prudent regulator, such as the Law Society of Upper Canada, does not just stipulate when the money must be put into trust and when it may be removed from trust. It also dictates the *manner* in which these things should occur.

Traditionally, money could be removed from a trust account in one of two ways: by a cheque drawn in the member's favour (and not made payable to either "cash" or "bearer"), or by a bank transfer to the member's (general) bank account.

Mindful of the introduction of ATMs, on-line banking and other innovations, the 2002 amendments added a third mechanism: by electronic transfer, in accordance with section 7 of the by-law. This section does not offer lawyers *carte blanche* to transfer electronically that which would otherwise be removed by paper cheque or transfer by bank teller. Rather, it insists on a human element, proper documentation and appropriate oversight. All of this helps ensure that both errors and outright theft are actively discouraged.

(d) Section 7

Section 7 is quite comprehensive and relatively straightforward. It states that the electronic transfer system **MUST** be one that requires one person to enter the data describing the details of the transfer, and another person to actually give effect to the transfer. Each of the two must use a password or access code. The electronic transfer system must also generate, by the end of the next banking day, confirmation of receipt of the data describing the transfer and authorizing the financial institution to process it. This confirmation must specify the originating trust account number, the name of the person or entity to whom the destination account belongs and the number of that account. It must also confirm the time and date of both the request for transfer and the confirmation sent to the lawyer.

The section also imposes a variety of obligations on the lawyer who is utilizing the electronic transfer system. In most cases, the lawyer must personally sign an electronic trust transfer requisition before the transfer can take place. Moreover, the section specifies that by the end of the next banking day following the transfer, the member (typically; departures from this are available only in what the by-law describes as "exceptional circumstances") is obliged to:

- generate a printed copy of the confirmation
- compare it to the original requisition and ensure that the two are consistent
- add identifying information about the client, the subject matter and the file number; and
- sign and date the confirmation.

Some may consider this an extraordinary level of oversight. Yet it is clearly intended to minimize the prospect that an electronic transfer system will be used to pillage a client trust account. Moreover, it restricts a lawyer's ability to assert, when such a loss becomes apparent to an investigator, that it was the "system" that permitted it to happen.

(e) Closing funds

It is worth noting that the by-law also deals separately with electronic transfers of closing funds. Closing funds are defined, in section 7.1, as money necessary to complete or close a real estate transaction. Closing fund transfers by electronic means are subject to restrictions and oversight provisions. These include the need for passwords or access codes, the obligation to generate both a requisition and confirmation and verify that the two are the same, etc. In short, the provisions for electronic closing fund transfers essentially mirror those for other types of electronic transfers.

(f) Automatic withdrawals

Finally, in sections 8.1 thru 8.4, By-Law 19 addresses the automatic withdrawals that are permitted to occur in the context of an electronic real estate transaction using Ontario's so-called Teranet system. Such withdrawals are for document registration fees and the land transfer tax. Apart from imposing a modified regime, similar to that found in sections 7 and 7.1 for authorization and confirmation of such withdrawals, the Teranet provisions also mandate the establishment of special trust accounts. These accounts are to be used exclusively to facilitate electronic registration fee and land transfer tax withdrawals. Special trust accounts are tightly controlled, even more so than regular trust accounts. For instance, the by-law stipulates that money shall be held in a special trust account for no more than five days, after which, failing a Teranet withdrawal, the money must be transferred back to an ordinary client trust account.

III. THE BY-LAW ON RECORD KEEPING: BY-LAW 18

Like other regulators, the Law Society of Upper Canada imposes certain minimum standards on record keeping, especially by lawyers in private practice. As with By-Law 19, the dominant objective is to protect client monies held in trust. The Law Society's requirements ensure that lawyers are accountable both to the client and to the regulator for the proper operation and safeguarding of client trust accounts. Review of a lawyer's mandatory financial records will also help the Society to determine whether serious misconduct, such as misappropriation of client trust funds, has actually occurred.

Most of the record-keeping obligations are found in By-Law 18. Again like By-Law 19, By-Law 18 envisions an increasingly electronic environment. It, too, accommodates an increased reliance on electronic recordkeeping.

The by-law does not itself, however, ensure the accuracy or reliability of an electronic record (such as an imaged cheque) in a lawyer's possession. As dis-

cussed in more detail in the next section of this paper, this point has particular significance as Canada and other jurisdictions move closer to a predominantly imaged environment for cheque processing.

(a) Section 2

By-Law 18 canvasses a number of forms of records and transactions. For our purposes, it is most important to focus on section 2. This section requires every member of the Law Society to “record all money and other property received and disbursed in accordance with the member’s practice”. It specifies twelve types of records that lawyers must keep. These include various types of books of original entry, client trust ledgers, fees books, reconciliation statements, bank passbooks, etc. Not surprisingly, the list also includes the signed electronic transfer requisitions and confirmations of transfers of trust funds as well as the signed Teranet withdrawal authorizations and confirmation described above.

Also notable among the list of records in section 2 is the requirement in paragraph 10: “bank statements or pass books, cashed cheques and detailed duplicate deposit slips”. Before the advent of cheque imaging, this would mean that members would receive and store cancelled cheques, among other things, to comply with the by-law. This in turn would enable an investigator or auditor to verify the legitimacy of trust transactions (noting that the issuance of cheques is one of the three methods by which trust monies can be expended pursuant to By-Law 19).

(b) Electronic storage

In the digital era, however, hard copies are no longer guaranteed. This is why section 4 By-Law 18 provides, first, that all financial records described in section 2 may be stored electronically but, also, that “if a financial record is posted by ... electronic means, a member shall ensure that a paper copy of the record may be produced promptly on the Society’s request.” A financial record posted by electronic means would, therefore, include an imaged cheque, and producing it promptly would mean that the lawyer would have to be able to generate a reliable hard copy.

(c) Duration of obligation

These are not short-term obligations. According to section 6 of the by-law, most records must be capable of production by the member for six full fiscal years. Cancelled cheques, however, fall within a category of records that must be kept for a minimum of ten fiscal years.

In short, a member’s keeping of electronic records – again, most typically cancelled cheques that have been imaged – will comply with By-Law 18 if the lawyer keeps or is able to produce *reliable* copies of imaged records for a minimum of ten years.

As is often said, though, in these situations, the devil is in the details...

IV. KEEPING TRACK OF IMAGED CHEQUES: SOME QUESTIONS FOR REGULATORS TO ASK

Like those in other jurisdictions, notably the United States, Canada’s major

financial institutions are moving rapidly to replace the complex process of clearing paper cheques with a more streamlined, and ostensibly more cost effective, electronic system. This raises some interesting questions, especially in the context of the 10 year record keeping obligations imposed by By-Law 18.

(a) *Advantages of imaging*

The trumpeted advantages of electronic imaging, clearing and retention are well known. They include, among others, more convenient access to account information, improved speed and efficiency in processing, easier record keeping, and an enhanced ability to do account reconciliation. But as we said at the outset, this new technology also demands the attention of the regulator, to ensure that the regulatory mandate and function remain unimpeded.

(b) *Imaging in Canada*

In very basic terms², within the next couple of years, it is expected that most hard copy cheques in Canada will be imaged. Images will be captured either upon deposit or shortly afterwards, when the cheque is delivered to the financial institution's regional processing centre. It is the imaged cheque which will be cleared and which will ultimately be "returned" (electronically or by hard-copy printout accompanying a monthly statement) to the customer upon whose account the cheque is drawn. It is the imaged cheque which will stimulate the removal of funds from one account and the deposit of those funds into another account. It is also the imaged cheque which will become the official record of the transaction. The hard copy cheque will be retained at the point of image capture (either the branch or the regional centre), but for only for a limited period – perhaps as short as 10 days. After that, it will be destroyed.

(c) *Concerns related to By-Law 18*

As we have seen, By-Law 18 requires lawyers to produce cancelled cheques on demand for a minimum of ten fiscal years. The rationale for this is to establish a paper trail from the lawyer's client trust account to the payee, and back to the lawyer who has kept the cheque *in specie*. The Law Society has also recognized that cancelled cheques, for the purpose of By-Law 18, *can* include imaged cheques that can be printed and produced in hard copy.

But acknowledging that imaged cheques are acceptable in principle is not the same as offering a blanket endorsement of all imaging protocols and practices. It is not beyond the pale to worry about what an unscrupulous actor might try to do to an imaged cheque, perhaps with the aid of some fairly basic, and now ubiquitous, digital image manipulation tools. One example of possible manipulation of

² Source: Canadian Payments Association, "The Transition to Cheque Imaging: Record Retention for Cheques and Other Payment Items", Consultation Document, November, 2001. Various organizations, including the Federation of Law Societies of Canada, have responded to this Consultation Document. The Canadian Payments Association is currently reviewing the submissions it received.

the system could be where a dishonest lawyer alters the digitalized cheque drawn on a trust account for a legitimate purpose, to show a higher amount than was actually the case, and thereby shield a payment made for an illegitimate purpose.

In the course of audit or investigation, regulators need to be able to rely on an imaged cheque as authentic. Hence the regulator needs to ask a lot of questions when a new imaging and retention protocol is introduced. These questions will explore issues of security, accountability and cost, among others.

(d) Security considerations

It is likely that many of the questions we are asking in Canada will also resonate elsewhere. Here, then, are some questions that Canadian regulators, might ask when probing the security and reliability of a cheque imaging protocol:

When the financial institution returns copies of imaged cheques, or when the lawyer prints them off the on-line Internet banking site, in his or her office, how can one verify that the front and back (the latter containing the endorsement) belong to the same cheques? Is this the responsibility of the drawee institution? How does the drawee institution verify that good images have been captured?

For what period must the financial institution retain the imaged cheques? Is this left to the individual institution to determine, or are there national standards? At least in Ontario, our obligation to regulate the legal profession and to investigate alleged misconduct is not subject to statutory or other time limits. Is it worth suggesting, then, that imaged cheques drawn on client trust accounts should be stored by a reliable entity in perpetuity?

What is the appropriate schedule for retaining the original signed copy of an imaged cheque before it is destroyed? Say a lawyer is required to resolve trust account discrepancies within 30 days. The imaged cheque may not come back to the lawyer until almost that period has elapsed. In these circumstances, even 30 days for retention of a paper cheque, for comparison and verification purposes, may not be long enough, and 10 days is certainly insufficient. Would, say, 45 days be long enough?

What specific indicators of authenticity will replace fingerprints, watermarks and, of course, actual signatures, as probative tools, once the original cheque is destroyed?

What standards and procedures exist to confirm that the signatures on imaged cheques are reliable, especially once the source cheques are destroyed? To what extent can a handwriting expert assess such signatures, if they are challenged?

Whose responsibility is it to ensure that the bank copy, stored electronically, is the same as the payor's copy of the imaged cheque?

(e) Standards and accountability

Regulators might also seek assurances that there will be a clear source of accountability, and universally recognized standards and controls for cheque

imaging. Ideally, there would be an ongoing, permanent and independent review (quality control) process, capable of certifying (and where appropriate, testifying) that an imaged cheque is akin to a “true copy”.

It is also worth considering whether compensation might be available from financial institutions if security or quality control systems fail and loss due to lawyer dishonesty is incurred as a result. Can, for example, Client Protection funds seek restitution for loss that is wholly or partly facilitated by cheque imaging vulnerabilities? (Perhaps, though, the *better* question is whether a client or other party who has been wronged by a lawyer who was able to forge or alter an imaged cheque drawn on a trust account can seek redress from the bank directly!)

(f) Evidentiary considerations

At the prosecution stage, it is trite law in Canada that any evidence presented in a courtroom or before an administrative tribunal (such as a Law Society discipline hearing panel) must be the “best evidence” available. It is legitimate to inquire if statutory amendments are required to guarantee that “cheque”, for evidentiary purposes, will in all circumstances include a digital image of a cheque. Will existing rules suffice in your jurisdiction? Or will you face difficulties establishing that an imaged cheque purportedly drawn (improperly or otherwise) on a lawyer’s trust account is *bona fide*?

(g) Technical and cost issues

If, as is the case in Ontario, a jurisdiction expects its lawyers to be able to produce imaged cheques on demand for a specified period, this gives rise to a whole set of technical and cost questions. For example:

Will special software and/or hardware have to be purchased to ensure that lawyers and notaries can securely store and print imaged cheques, both during the period when they are stored in the database of the financial institution and afterwards?

Will the regulator even have access to imaged documents in the possession of the financial institution for storage purposes, when the lawyer who is under audit or investigation has generated or otherwise handled those documents? What retrieval costs will be involved?

What, if any, costs will be charged for viewing imaged cheques on-line? What would a customer have to do to retrieve and compare a paper cheque during the retention period, before the paper cheque is destroyed?

Will there be a single format for the return of digital images in hard copy (that is, when the images are not printed locally by the customer)? Will such a standard format include the front and back of each cheque? Will there be legibility requirements – for instance, no more than eight, high-resolution images per page?

(h) Anticipated response from financial institutions

Some of these concerns are more likely to be satisfied than others. Banks and other financial institutions may be willing to improve security to some extent, to pro-

mote overall consumer confidence in the new technology. They may, however, be less willing to respond to the more specific concerns of those who regulate lawyers.

Retention schedules are one likely point of contention. Obviously, banks will be reluctant to store bulky original cheques for anything longer than a token period. They take up valuable, and expensive, storage space. Financial institutions may also balk at the notion of extended storage of cheque images that, given transaction volumes, will over a relatively short period of time consume many, many terabytes of computer memory.

Regulators can also expect financial institutions to assert that electronic imaging, when properly implemented, is less amenable to fraud than conventional paper clearing methods. Arguably, an imaged cheque is hard to alter or forge than a paper one. This may or may not be 100% valid, but regulators are certainly entitled to ask financial institutions to back up such assertions with hard data and proof that adequate safeguards are in place.

Ultimately, it is the regulator's obligation to ensure that the right questions are asked, and asked again, especially when the initial answers are not entirely satisfactory.

V. CONCLUSION

The Law Society of Upper Canada, like other regulators, has demonstrated its awareness of the need to keep pace with technology. Changes to its by-laws on money handling and record keeping reflect that appreciation. The changes, particularly the provisions dealing with electronic funds transfers in By-Law 19, balance traditional concerns about accountability and oversight with a willingness to accommodate new technologies *so long as appropriate safeguards are maintained*.

Much, however, occurs outside the scope of the regulator's influence. This is especially true where large financial institutions are concerned. The movement towards an image-based cheque-processing environment is one obvious illustration of a situation where the regulator must assert itself. The role of the regulator is to ensure that changes made for the sake of technological efficiency and cost effectiveness nonetheless preserve its ability to protect the public from dishonest lawyers.

Of course, it is fair to say that, in most jurisdictions, governments are the final arbiters of competing public policies. They are perhaps best situated to ensure that even the most worthwhile, customer-friendly (and e-commerce friendly) evolution of technology in the financial services industry does not undermine the functions assigned to professional regulators. These include the prevention, investigation, prosecution and compensation of lawyer misconduct.