



# Outreach Session for the New Custody Rules and the CRM2 Sweep

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# Agenda

1. Overview of the new custody rules and FAQ
2. Results of the recent CRM2 compliance sweep
3. Q&A



# Part 1 - Overview of the new custody rules and FAQ

# Overview

- In force on **June 4, 2018**
- Purpose and goals
- Key elements
- Highlights of inquiries received to date

# Overview – Purpose and Goals

- Enhance custody requirements applicable to registered advisers, dealers and investment fund managers
  - Mitigate intermediary risks when registered firms are involved in custody and enhance protection of client assets
  - Codify existing custodial best practices; we did not expect significant impact to the industry
  - Increase consistency in business practices
  - Create a strong regulatory tool against inappropriate practices
  - Give regulators specific custody requirements against which to assess compliance
  - Become more aligned with international standards
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# Overview – Key Elements

1. Require disclosure to clients as to where and how assets are held or accessed, AND any associated risks and benefits
2. Generally require the use of a “Canadian custodian”
3. Permit a “foreign custodian” to be used only if it is “more beneficial” to the client
4. Restrict registered firms from acting as the custodian / sub-custodian for clients, with limited exceptions:
  - Firm meets subset of “Canadian custodian” definition; and
  - Has a system of controls and supervision to manage the custody-related risks to the client or fund

# Overview – Key Elements (cont'd)

5. Restrict the use of a custodian that is not functionally independent\* of the registered firm, with limited exceptions

*\*Functionally independent*

- *Separate mind and management so that the custodian is seen to operate independently*
- *Custodial activities are performed by personnel separate from, and who can act independently from, personnel of the registered firm*
- *Systems and controls to ensure independence of personnel performing the custodial function*

Note: Most bank-owned registered firms are expected to be functionally independent from their affiliated custodians



# Overview – Key Elements (cont'd)

6. Generally, except for bulk trading and cash-only accounts (grandfathered), require client securities and cash to be held in an account of the client or the fund
  - i.e., custodian's records must show who the beneficial owner [i.e., the client or fund] is for the relevant securities and cash

# Overview – Key Elements (cont'd)

7. For assets that are NOT securities or cash AND ALSO assets that are not subject to the custody requirements in s. 14.5.2 of NI 31-103 (i.e., see the exceptions below), the “old” segregation and holding requirements apply:
- Separate and apart from registered firm’s own property;
  - In trust for the client or investment fund, and
  - For cash, in a designated trust account with:
    - A Canadian custodian, or
    - Canadian financial institution, or
    - Foreign custodian if more beneficial for the client or investment fund

# Overview – Exceptions

1. IIROC and MFDA members (if they comply with their SRO custody rules)
2. Registered firms permitted to self-custody or act as sub-custodian – very limited
3. Investment funds subject to NI 81-102 and NI 41-101 funds
4. Customer collateral subject to custodial requirements under NI 94-102 *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions*

# Overview – Exceptions (cont'd)

5. Client name securities or certain units of funds
  - If the security is recorded **only** in the name of the client or fund on the books of the issuer or the issuer's transfer agent
  
6. Permitted clients that are **not** individuals and **not** funds

# Overview – Exceptions (cont'd)

## 7. Mortgages, if:

- The mortgage is registered in the name of the client or investment fund as mortgagee, or
- For syndicated mortgages:
  - Registered in the name of someone registered or licensed under Canadian mortgage brokerage, mortgage administrators or mortgage dealer legislation if the mortgage is held in trust for the client or investment fund, or
  - Registered in the name of each investor that is a mortgagee in respect of the mortgage

# Overview – Exceptions (cont'd)

8. Cash or securities deposited with a dealer as margin for transactions outside of Canada involving certain cleared options or futures
  - Dealer's records to show the beneficial ownership of the assets
9. Cash or securities deposited as security in connection with a short sale of securities with a dealer outside of Canada

Note: For both of these exemptions,

- Dealer is a member of a specified exchange, subject to a regulatory audit, and has net worth over \$50 million
  - Use of foreign dealer is more beneficial to client or fund
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# Overview – Exceptions (cont'd)

10. Cash or securities deposited with a client or fund's counterparty where a security interest has been granted in connection with a "specified derivatives" transaction
  - Counterparty's records to show the beneficial ownership of the assets

# Overview – Worth Noting

- The new rules apply to client securities and cash, not client assets that are not securities or cash
  - Keep original standard on segregation and holding in trust for client as the minimum for assets other than cash and securities
- Differ from NI 81-102 custodial requirements in some respects, including:
  - Certain IIROC member firms meet our “Canadian custodian” definition
  - No requirement to use a single “Canadian custodian”
  - Do not govern who can be the sub-custodian (though there is guidance in this regard)



# Overview – Guidance

## 1. Relationship Disclosure Information

- Examples of risks e.g., use of sub-custodians, non-independent custodians, foreign custodians

## 2. Restriction on self-custody and qualified custodian requirement

- Cash and securities includes portfolio assets of a fund AND cash held by an IFM for investment in, or on the redemption of, securities of a fund (“cash-in-transit”)
- Hold/held includes definition in 14.14(7) of NI 31-103
- Access includes list in s. 12.4 of 31-103CP
- Foreign custodians – permitted use & risks

# Overview – Guidance (cont'd)

3. Exemptions from self-custody and QC requirement
    - IFMs have deemed access to fund assets, and therefore are not typically exempt from the custody rules
  4. Prohibition on self-custody and the use of custodian that is not functionally independent. We set out:
    - Factors we would consider for a system of controls and supervision to manage the risks to a client (e.g., segregation of duties b/w custodial and other functions, asset verification examination by a third party)
    - How a firm may have access to client assets if the custodian is not functionally independent is set out in s. 12.4 of 31-103CP
    - That the relationship between a registered firm and a custodian that is not functionally independent is a conflict that must be managed or avoided, see s. 13.4 of NI 31-103
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# Overview – Guidance (cont'd)

## 5. General prudent custodial practices

- Assets other than cash and securities e.g., gold bullion – use due skill, care and diligence to select custodian (and other factors)
- Registered firms are to encourage their clients or funds to confirm that they are receiving account statements from their custodians, and as applicable, to compare those statements to the statements they receive from the registered firm
- Firms expected to reconcile, on a regular basis, their internal records against custodian's

# Overview – Guidance (cont'd)

## 6. Custodial arrangements

- For investment fund managers
    - Use due skill, care and diligence to select custodian, periodically review custodian
    - Know custodian's practices re selecting and monitoring sub-custodians
    - Have a written custodial agreement including certain terms (location of assets, appointment of sub-custodians, method of holding assets, standard of care of custodian, responsibility for loss)
  - For registered firms other than IFMs
    - Expected to understand the material terms of the custodial agreements of their clients and explain to clients the main purpose of agreement
    - Alert clients to use of sub-custodians
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# Overview – Guidance (cont'd)

7. Client and investment fund assets held by a registered firm in trust
- The minimum standard requirement
  - Investment fund “cash-in-transit” often subject to this segregation and holding requirement
  - IFMs can outsource fund administration functions to service providers (incl. trust accounting) – IFM to ensure that cash-in-transit is, at a minimum, held in a designated trust account at a QC or Canadian financial institution
  - IFM’s are accountable for all outsourced functions and must ensure the service provider has adequate controls

# FAQ – Common Inquiries Received

1. Relationship disclosure information (RDI)
2. Restriction on self custody
3. Meaning of “direct or arrange” and “access”
4. Clarification of NI 81-102/NI 41-101 exemptions
5. Clarification of the exemption that uses the term “recorded only in the name of the client or investment fund”
6. Application of the custody rules to non-resident registered firms and their foreign clients/funds
7. Guidance regarding client statements and the interplay with PM/Dealer service arrangements

# FAQ – 1. RDI – Brief Summary

- Registered firms that “hold or have access” to client assets or “direct or arrange” custodial arrangements for clients must confirm where and how the client’s assets are held, and any related risks and benefits
- We added guidance to 31-103CP to outline our expectations in respect of this RDI disclosure

# FAQ – 1. RDI – Why must registered firms provide RDI on the custodian?

- The security of a client’s portfolio is essential, a reputable custodian is of utmost importance
- Often registrant will require clients to use a particular custodian, or give clients a list of custodians
- Sometimes, the registrant will have access to the client’s account
  - e.g., to pay bills or may have a power of attorney
  - e.g., for a PM, access is more than the ability to deduct their management fees alone



# FAQ – 1. RDI – Why must registered firms provide RDI on the custodian? (cont'd)

- We expect registrants to have conducted due diligence on custodians and be able to articulate the risks and benefits of using this custodian for the client

# FAQ – 1. RDI – Why must registered firms provide RDI on the custodian? (cont'd)

- We want clients to know who their custodian is and how their assets are being held
  - How safe is this method of holding?
  - How competent or reputable is the custodian? (Is it a “qualified custodian”?)
  - Where are the assets located – in Canada, outside?

# FAQ – 1. RDI – Depth/Level of Detail

- This is relationship disclosure information
- Registrants must disclose the risks and benefits of the custodial arrangement as it relates to the relationship between the firm and the client. For example:
  - **Risk:** the custodian engaged by the client is not a “qualified custodian”
  - **Risk:** a Canadian custodian is chosen for a US tax advantaged account which creates currency exchange implications

# FAQ – 1. RDI – Depth/Level of Detail (cont'd)

- Registrants are not expected to replicate the custodian's disclosure
  - Registrants can direct clients to the custodian for further details (e.g., custodial related risk factors)
- No prescribed form of disclosure, firms to decide on form
  - Can integrate this disclosure in a way that they think is most valuable to clients and efficient for the firm

# FAQ – 1. RDI - Depth/Level of Detail (cont'd)

- Will depend on the custodian being used AND the amount of influence the registrant has regarding choice of custodian, or the firm's access to client assets
  - The more limited the firm's ability to access client assets or direct the client to the custodian, the lighter the disclosure
  - If a "Canadian custodian" is used and firm does not hold or access client securities and cash, disclosure likely to be lighter

# FAQ – 1. RDI - Depth/Level of Detail (cont'd)

- If a “foreign custodian” is used, likely more disclosure on risks and benefits including, for example, it may be more difficult to retrieve client assets on the bankruptcy of foreign custodian, but tax benefits to holding the assets with the foreign custodian, etc.

# FAQ – 1. RDI - Depth/Level of Detail (cont'd)

- A firm would typically be expected to discuss the risks and benefits related to their choice of custodian for their clients (could include the results of their due diligence on the custodian)

# FAQ – 1. RDI - Depth/Level of Detail (cont'd)

- Examples of benefits:
  - Your custodian is a Canadian custodian with assets located in Canada
  - Your custodian has expertise for your mix of investments e.g., foreign, domestic, vanilla, complex, etc.
  - The custodian is qualified to conduct this business
  - A foreign custodian is used for your US tax advantaged securities due to US legal requirements



# FAQ – 1. RDI - Depth/Level of Detail (cont'd)

- Examples of risks:
  - You use a Canadian custodian and you are acquiring foreign securities. This means that you are holding your securities further from the marketplace and there is also exchange rate risk
  - Your custodian uses sub-custodians to hold a portion of your assets. There may be risks and benefits associated with this practice and we encourage you to speak directly with your custodian in this regard

# FAQ – 1. RDI - Depth/Level of Detail (cont'd)

- Examples of risks (cont'd):
  - As you are using a foreign custodian for your US assets you may have difficulty enforcing your legal rights or accessing your assets if the custodian becomes insolvent
  - Your custodian is not independent of the firm (explain whether this could allow the firm access to client funds, incl. how & implications)

**Note:** you may explain why this custodian was chosen over another, etc.

# FAQ – 1. RDI - Depth/Level of Detail (cont'd)

- Consider what else your client might need to know about why you direct your clients to this custodian

# FAQ – 2. Restriction on Self Custody

- Registered firms are generally prohibited from acting as custodians or sub-custodians
  - Codified a current best practice, limited impact
  - Exceptions: certain fund units, client name certificates and mortgages

# FAQ – 2. Restriction on Self Custody (cont'd)

*Who may self-custody client or fund assets?*

- Limited exceptions for registered firms that are banks or trust companies (with \$10m equity) and IIROC firms (if allowed to custody under IIROC rules)
  - These registered firms must have have a system of controls and supervision to the manage risks to their clients or investment funds [see CP guidance]
  - An ID/IFM could potentially self custody

# FAQ – 3. “direct or arrange” meaning

## *Includes:*

- Telling clients/funds who to use as custodian
- Recommending one or more custodians
- Providing a list of custodians

## *Excludes:*

- Clients who choose their own custodian
  - Registered firms should have documentation to confirm and show that clients chose their own custodian

# FAQ – 3. “direct or arrange” meaning (cont’d)

Not retroactive:

- Clients do not need to change their custodians if they do not meet the new definitions, but RDI should disclose this matter so clients are, at a minimum, aware

## FAQ – 3. “access” meaning

- Access is an ongoing state of affairs; must comply with the custody rules
- Includes the examples in s. 12.4 of 31-103CP
- Excludes discretionary authority over clients’ or funds’ cash or securities by itself
- Excludes the authority to debit client accounts to pay only investment management fees



# FAQ – 4. Clarifying the NI 81-102/NI 41-101 Exceptions

- The new custody rules do not apply to investment funds that are subject to NI 81-102 and NI 41-101 because an alternate custodial regime applies
  - For example: An IFM does not need to ensure its public fund complies with the NI 31-103 custody rules, instead it must ensure that the fund complies with the NI 81-102 or NI 41-101 custody rules
  - s. 14.5.2(7)(a) & (b) of NI 31-103 are not exemptions from the self-custody prohibition in s. 14.5.2(1) of NI 31-103

# FAQ – 4. Clarifying the NI 81-102/NI 41-101 Exceptions (cont'd)

*For a PM, is this exemption available when the client is an NI 81-102 fund, or when the client is holding an NI 81-102 fund, or both?*

- When the client is an NI 81-102 fund, the PM is to ensure the fund complies with the custodial requirements in NI 81-102

# FAQ – 4. Clarifying the NI 81-102/NI 41-101 Exceptions (cont'd)

- When a managed account client is holding an NI 81-102 fund, those units must either be:
  - Held by a qualified custodian who can tell from its records that the managed account client is the beneficial owner of the units (14.5.3(a) of s. NI 31-103), OR
  - Held by any party of the client's choosing, if the units are recorded on the books of the issuer, or the issuer's transfer agent, only in the name of the client. (s. 14.5.2(7)(c) of NI 31-103)
    - i.e., can't be recorded in the name of the PM

# FAQ – 5. Clarifying “only in the name of the client/fund” exemption

*Can a unit of an investment fund that is registered in the name of a portfolio manager acting on behalf of a fully managed account be considered to be held “only” in the name of the client for the purpose of s. 14.5.2(7)(c) of NI 31-103?*

- No. The units of the investment fund must be held in the name of the client (which could be an individual or a fund or another entity)

# FAQ – 5. Clarifying “only in the name of the client/fund” exemption (cont’d)

- PMs can purchase securities for a managed account by relying on subsection (q) of the “accredited investor” definition in s. 1.1 of NI 45-106, BUT:
  - The PM cannot be the entity named on the issuer’s books (s. 14.5.2(7)(c) of NI 31-103 is clear)
  - The name of the client who is not an AI must be recorded on the books of the issuer (the unitholder register) if the s. 14.5.2(7)(c) of NI 31-103 exemption is to apply

# FAQ – 5. Clarifying “only in the name of the client/fund” exemption (cont’d)

- Although a non-AI’s name will appear on the books of the issuer, the PM will be deemed to purchase as principal
- PM (and EMD) to keep appropriate records to demonstrate that the PM purchased the securities as principal in reliance on subsection (q) of the AI definition

# FAQ – 5. Clarifying “only in the name of the client/fund” exemption (cont’d)

*Who can hold physical share certificates?*

- Physical share certificates can be held by a law firm, a registrant or another party if the securities are recorded on the books of the issuer, or issuer's transfer agent, **ONLY** in the name of the client or investment fund
- Physical share certificates recorded otherwise, are expected to be held with a qualified custodian

# FAQ – 6. Non-Resident Registrants and their Foreign Clients

- Historically been subject to s. 14.7 of NI 31-103: ensure all client assets held either:
  - In client name,
  - With a custodian or sub-custodian that meets the definitions in Part 6 of NI 81-102, OR
  - With an investment dealer that is a member of IIROC
- The new custody rules are not more restrictive; may be more flexible



# FAQ – 6. Non-Resident Registrants and their Foreign Clients

- We may take a practical approach on a case by case basis
  - We would consider whether there is a similar robust regime in the foreign client's jurisdiction
  - Otherwise, the firm should be able to explain why a foreign client is less protected than a Canadian client, if that is the case

# FAQ – 7. Client Statement Guidance

## ***Background***

s. 14.5.2 of the NI 31-103CP sets out that registered firms are to encourage their clients or funds to confirm that they are receiving account statements from their custodians, and as applicable, to compare those statements to the statements they receive from the registered firm

## ***Question***

*How does this companion policy guidance interact with CSA Staff Notice 31-347 for PM / Dealer service arrangements?*

# FAQ – 7. Client Statement Guidance

- The CP guidance uses the words "as applicable" to account for the unique circumstances in CSA Staff Notice 31-347, for example
- The CP guidance is designed for situations where two statements are being given and contemplates IIROC and financial institution custodians
- If registrants meet the terms of the CSA Staff Notice 31-347 guidance, they can still operate under that guidance (such that clients receive a single statement from the investment dealer)



# Part 2 - Results of the recent CRM2 compliance sweep

# The CRM2 Sweep

- Sample selected
- Areas of focus
- Common deficiencies identified
  - Inadequate policies and procedures
  - Inadequate client statements and reports

# Inadequate Policies and Procedures

- Inadequate or no policies and procedures for client reporting
- Ineffective internal controls over client reporting
- Registrants need to have written P&Ps for preparation of:
  - Account statements and additional statements
  - Trade confirmations
  - Report on charges and other compensation/ investment performance reports

# Inadequate Policies and Procedures (cont'd)

- P&Ps relating to client reports:
  - Describe the steps a PM takes to ensure it is appropriate to rely on the delivery of client statements by the IIROC Dealer Member that acts as custodian for the PM's client accounts
  - Needs to address both initial and ongoing assessment to demonstrate that the PM is meeting its statement delivery obligations

# Inadequate Policies and Procedures (cont'd)

- P&Ps relating to market value of securities:
  - That describe the method for determining market value of different types of securities
  - Provide guidelines to follow if you cannot determine market value of a security
  - If closing price is used to determine market value, guidelines for a periodic comparison of closing price to the last bid price for long positions and last ask price for short positions



# Inadequate Policies and Procedures (cont'd)

- P&Ps relating to position cost of securities:
  - Identify whether the Registrant reports original cost or book cost
  - Describe how the Registrant delivers cost position information to its clients (e.g., combined with the client statements or delivered separately and at least once every 3 months)

# Inadequate Policies and Procedures (cont'd)

- P&Ps that describe how the Registrant will treat position cost for securities that:
  - Are transferred in from another firm
  - Are built up with successive purchases
  - Were purchased or transferred-in before July 15, 2015

# Inadequate Policies and Procedures (cont'd)

- P&Ps that describe how an IFM satisfies its obligations to deliver security holder statements
- If there is no dealer or adviser of record for a security holder on the records of an IFM (orphaned accounts) the IFM must deliver the following annually:
  - Transactional information
  - Information on account positions
  - Position cost information

# Inadequate Policies and Procedures (cont'd)

- P&Ps to describe how an IFM satisfies the duty to provide information to dealers and advisers
- P&Ps that describe how a Scholarship Plan Dealer satisfies its obligations to deliver statements
- If not registered in another dealer or adviser category, must deliver annually
  - Transactional information
  - Information on account positions

# Inadequate Policies and Procedures (cont'd)

- P&Ps relating to trade confirmations:
  - Detail the requirements to deliver trade confirmation to your clients
  - Describe the internal controls surrounding the preparation, reconciliation, review and delivery of a trade confirmation

# Inadequate Policies and Procedures (cont'd)

- P&Ps relating to reports on charges and other compensation
  - Describe the requirement to provide your clients with an annual report on charges and other compensation for each of their accounts
  - Describe the internal controls surrounding the preparation, reconciliation, review, and approval of the reports
  - If applicable, guidelines over providing consolidated reports

# Inadequate Policies and Procedures (cont'd)

- P&Ps relating to Investment Performance Reports
  - Describe the requirement to provide the Registrant's clients with an annual investment performance report for each of their accounts
  - Describe the internal controls surrounding the preparation, reconciliation, review, and approval of the reports
  - Identify the money-weighted rate of return calculation method used by your firm to calculate annualized total percentage return

# Inadequate Policies and Procedures (cont'd)

- P&Ps surrounding Investment Performance Reports
  - If the Registrant uses both money weighted rate of return and time-weighted rate of return, identify how the time-weighted rate of return is calculated
  - For accounts opened before July 15, 2015, describe the policy for determining the deemed account opening date
  - If applicable, guidelines over providing consolidated reports



# Inadequate Client Statements and Reports

- Registrants not delivering the required client statements, compensation reports or performance reports
  - EMDs that held client assets
  - EMDs that received trailing commissions
  - PMs that thought they had met their obligations because their clients' custodians were delivering statements

# Inadequate Client Statements and Reports (cont'd)

- Client statements were provided on a consolidated basis
- Compensation Reports:
  - Did not include adequate disclosures about the operating and/or transaction charges when clients with multiple accounts designated one account to pay for all the fees incurred
  - Were consolidated inappropriately (e.g. for a family group) or without obtaining written client consent

# Inadequate Client Statements and Reports (cont'd)

- Performance Reports:
  - Were missing information
  - Did not include text, tables and charts
  - Had inadequate disclosures when presenting benchmarks
  - Were consolidated inappropriately (e.g. for a family group) or without obtaining written client consent



# Part 3 - Resources

# Resources

## Custody Rules

- National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*:
  - Section 1.1 – definitions of Canadian custodian, foreign custodian, qualified custodian
  - Sections 9.2 and 9.3 – exemptions for IIROC and MFDA member firms
  - Paragraphs 14.2(2) (a.1) and (a.2) – RDI
  - Sections 14.5.1 to 14.6.2 – the custody rules and exemptions therefrom
  - Companion policy guidance related to the above

# Resources (cont'd)

## Custody Rules (cont'd)

- National Instrument 45-106 *Prospectus Exemptions*
  - Section 1.1 – definition of accredited investor (para. q)
- CSA Staff Notice 31-347 *Guidance for Portfolio Managers for Service Arrangements with IIROC Dealer Members*

# Resources (cont'd)

## CRM 2 Sweep

- National Instrument 31-103 and related NI 31-103CP:
  - Section 11.1 – Compliance System
  - Part 14 Handling client accounts – firms
- OSC Staff Notice 33-749 *Annual Summary Report for Dealers, Advisers and Investment Fund Managers*
- Section 3.1 b) ii) of OSC Staff Notice 33-748 *Annual Summary Report for Dealers, Advisers and Investment Fund Managers*

# Resources (cont'd)

## CRM 2 Sweep (cont'd)

- CSA Staff Notice 31-345 *Cost Disclosure, Performance Reporting and Client Statements – Frequently Asked Questions and Additional Guidance*
- CSA Staff Notice 31-347 *Guidance for Portfolio Managers for Service Arrangements with IIROC Dealer Members*
- OSC Outreach Session – CRM2 Reporting to Clients and Portfolio Manager - IIROC Dealer Member Service Arrangements (PMDSAs) – February 21, 2017





# Questions?



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