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New Rules for Custody of Client Assets in Force Soon

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Last summer, the Canadian Securities Administrators (CSA) published the final version of the amendments to registrants' obligations with respect to the custody of client assets, among other changes, under National Instrument 31-103, *Registration Requirements, Exemptions and Ongoing Registrant Obligations*. The rules related to the custody of client assets, including assets of investment funds, will come into force on June 4, 2018.

In addition to summarizing the amendments relating to these new custody requirements, we have identified steps that all registered firms should take to ensure these requirements are fulfilled. We recommend that registered firms review their custodial arrangements, their disclosure to clients, their prime brokerage and custodial agreements, and their policies and procedures regarding custody of client assets.

Summary of Custody Amendments

The following is a summary of the amendments relating to the new custody requirements:

1. A registered firm should not act as the custodian of a client or investment fund's cash or securities unless the registrant

    a. is a Canadian bank, a trust company with equity of at least $10 million or an IIROC-regulated investment dealer that is permitted to hold client assets;

    b. has established policies and procedures to manage the risks to the client associated with such custody; and

    c. has disclosed where and how such assets are held and the risks and benefits thereof.

2. A registered firm that selects the custodian or has access to the assets of a client is generally required to use a "Canadian custodian"[1] to hold such assets and may use a Canadian financial institute to hold cash.

    a. This does not apply to a registered firm in respect of the following:

        i. assets of a client deposited with a dealer as margin for transactions outside Canada or options on futures, provided that the registered firm takes steps to ensure that the records of the holder of the assets show that the client is the beneficial owner of the assets;

        ii. assets of a client over which the client has granted a security interest in connection with a derivatives transaction, provided that the registered firm takes steps to ensure that the records of the holder of the assets show that the client is the beneficial owner of the assets; and

        iii. assets of a client deposited as security in connection with a short sale with a dealer outside Canada, provided that certain conditions are met.

    b. A "foreign custodian"[2] may be the custodian of the cash and securities of a client of a registrant if a reasonable person would conclude that using the foreign custodian is better for the client than using a Canadian custodian.

c. The "qualified custodian"[3] and account bank must be independent of the registrant unless conditions, like the conditions for self-custodians in 1 above, are met.

3. A registered firm that is subject to 1 and 2 above must take reasonable steps to ensure that cash and securities of a client or investment fund are held using an account number or other designation in the records of the qualified custodian or the Canadian financial institution sufficient to show that the client or investment fund is the beneficial owner of such cash or securities, unless

a. in the case of cash held in an account in the name of the registered firm, such cash is held separately from the registered firm's own property in a designated trust account in trust for clients or investment funds; or

b. in the case of cash or securities held for the purpose of bulk trading, such cash and securities are held in the name of the registered firm in trust for its clients or investment funds and the cash or securities are transferred to the client's or investment fund's account with its custodian or account bank as soon as possible following a trade.

4. Items 1 and 2 above do not apply to certain clients or in respect of certain assets. Specifically, the custodian requirements referred to above do not apply to the following:

a. an 81-102-governed mutual fund or any investment fund offered by way of a prospectus;

b. a security recorded in the name of the client on the books and records of the issuer or transfer agent of the issuer;

c. cash and securities of a permitted client that is not an individual or an investment fund if the permitted client has acknowledged that the prescribed custodial requirements would otherwise apply;

d. certain collateral pledged in respect of derivatives transactions under National Instrument 94-102, *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions*; and

e. certain securities evidencing indebtedness secured by a mortgage.

5. A registered firm that is permitted to hold a client's assets under 1 above must hold the assets

a. separate and apart from its own property;

b. in trust for the client; and

c. in the case of cash, in a designated trust account with a Canadian custodian or Canadian financial institution unless a reasonable person would conclude that a foreign custodian would be more beneficial to the client.

6. A registered firm must disclose the following to its clients:

a. the location where, and a general description of how, the assets are held;

b. the risks and benefits to the client associated with the location and manner in which the assets are held; and

c. if the registered firm has access to a client's assets, how the client's assets are accessible by the registered firm and the risks and benefits to the client associated with the manner in which the registered firm has access to the client's assets.

How to Prepare?

We recommend that registered firms do the following to ensure adherence to the new requirements:

- Managers of private investment funds and managed accounts who have not done so already should assess their current arrangements for the custody of client assets. It is likely that most assets are already held by a "qualified custodian" given the term's broad definition in NI 31-103. However, registrants will need to update their disclosure regarding the custody of client assets and

provide it to their clients. The new disclosure requirements, referred to in 6 above, will require consideration by the firm's investment, operations and legal professionals, particularly if the firm uses foreign custodians.

- There is a risk that some of the entities that hold cash and securities for a registrant's clients are not qualified custodians under the new rules. Of particular concern, in our view, are foreign custodians that are not affiliates of a Canadian bank or trust company or of a foreign bank or trust company and do not have equity at least equal to C$100 million. If a foreign custodian does not meet the equity test, the test may be satisfied if the bank or trust company affiliate that meets the equity test guarantees the custodian's obligations. When a registrant is not comfortable that an entity that holds client assets is a qualified custodian, the registrant will be required to enter into new relationships that meet the requirements of the new rules.
- The new custodial rules also necessitate a review of the contractual arrangements with the prime brokers, custodians and account banks that hold client cash and securities. Registrants should ensure that all accounts are opened and maintained in the name of the fund or other beneficiary. The Companion Policy to NI 31-103 provides further that the Canadian regulators expect that investment fund managers will consider whether the custodian it appoints uses all reasonable diligence, care and skill in the selection and monitoring of its subcustodians, whether the subcustodians would meet the definition of a "qualified custodian," whether the appropriate segregation arrangements are observed throughout the custody chain of the portfolio assets of the investment fund, whether their custodial agreements provide for key matters such as the location of portfolio assets, any appointment of a subcustodian, the method of holding portfolio assets, the standard of care of the custodian and the responsibility for loss. Although we expect that most prime brokerage, custodian and other securities account agreements provide for the foregoing, it is unlikely that registrants will have much influence on how their counterparties conduct their business and allocate risk to comply with NI 31-103. Practically, the best a registrant can do is to provide further disclosure to its clients about the issues raised by the Canadian regulators and the related risks.
- All registrants should update their policies and procedures related to the custody of client assets, the process and requirements for entering into new client asset-custody arrangements and for review of these arrangements.

[1]Canadian custodian means a Canadian bank, a trust company formed and regulated in Canada, an affiliate of a Canadian bank or trust company or an investment dealer that is a member of IIROC.

[2]Foreign custodian means an entity that is incorporated in a foreign country, regulated as a banking institution or trust company in a foreign country and has equity at least equivalent to $100 million, an affiliate of the foregoing or a foreign affiliate of a Canadian bank, trust company or dealer registered with IIROC.

[3]Qualified custodian means a Canadian custodian or a foreign custodian.

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