CCMA ACMC Canadian Capital Markets Association / Association canadienne des marchés des capitaux

What Investment Fund Managers Should Consider as They Prepare for T+2

*[**Note**: Visit the CCMA website for background on T+2; read the CCMA's 'T+2 Readiness Self-Assessment Checklist' for steps to get your T+2 project up and running… or running faster (see www.ccma.acmc.ca, Resources, Publications]*

The institutional trade flow process consists of the following four major information transfers:

1. ***Order initiation:*** Buy-side (e.g., portfolio manager) communicates trade instructions to a broker/dealer
2. ***Notice of execution (NOE):*** Broker/dealer communicates the details of the trade executed
3. ***Trade allocations:*** Buy-side (e.g., portfolio manager) communicates trade allocation details at the client and block levels to the broker/dealer
4. ***Trade allocations and settlement instructions:*** Buy-side communicates trade details to the custodian to allow order confirmation at the client and block level.

Three of these transfers rely on the buy-side – investment fund or portfolio managers. While custodians, broker/dealers, service providers, vendors and infrastructure – such as the Canadian Depository for Securities and exchanges – will help, the primary responsibility for readiness is the investment manager's. The final step before settlement – the exchange of payment for securities bought or sold, is an agreement on (confirmation of) trade details between the broker/dealer(s) and the custodian(s) or affirmation of trades in an automated matching facility such as Omgeo.

Briefly, there are three areas that portfolio managers and other buy side/investment managers will want to pay particular attention to because of the effects of moving from a T+3 to a T+2 maximum standard settlement cycle.

1. Portfolio management

- Misaligned settlement cycles may create a funding shortfall
- Potential cost of credit to cover mismatches, especially during transition
- ➔ **Consider how moving to T+2 will affect your cash management practices and processes**

2. Operations

- Less time to notify and receive corrections from sub-advisors in different time zones
- Less time to instruct foreign exchange movements
- Less time to settle a security transaction
- Less time to make corrections
- Less time to recall securities under securities lending programs
- Less time for designated brokers to acquire and dispose of securities for ETF unit creation and redemption
- ➔ **Map all current processes to see where steps can be reduced or accelerated**

3. Client relationship/policy

- Segregated cash flow timing
- Pooled fund subscription and redemption cash flow timing
- ➔ **Understand the implications of mismatched cash flows:** Pooled fund managers must take into account the best interests of all unit holders (allowing a client to subscribe or redeem on a cycle that would negatively impact the fund could see a manager run afoul of his/her fiduciary obligations, e.g., permitting one client to subscribe on a T+3 cycle when the fund purchases

securities on a T+2 cycle would leave the fund overdrawn for a day, the cost of which would inappropriately be borne by all unitholders). For a segregated account, the ramifications are the same, but any negative impact is borne only by that one client, meaning the client can decide if the mismatch is in their best interest/acceptable based on their own circumstances.

High priority

- Obtain any data from your custodian(s) and broker(s)/dealer(s) regarding the timeliness and accuracy of the data you provide
- Look at CCMA and UST2 support material – identify where your firm may have to change its practices
- Review the asset classes your investment policy permits you to hold and check out the CCMA T+2 Asset List on the CCMA website to see if the categories' settlement timeline will be changing; in particular, focus on the fund category: while most funds will move from T+3 to T+2, some may not
- Communicate any changes and expectations to upstream and downstream parties (e.g., new timelines to sub-advisors)
- Speak to your custodian(s), broker(s)/dealer(s) or matching utilities regarding any revised deadlines for issuing trade notifications, allocations, and settlement instructions
- Find out the T+2 development and testing plans of your:
    - Custodian(s)
    - Broker/dealer(s)
    - Service provider(s)
    - Vendor(s)
- Know and prepare for the schedule for industry T+2 development and testing for the change to a maximum standard T+2 settlement (systems changes by December 31, 2016; testing from Q1 through Q3, 2017; implementation September 5, 2017)
- Communicate with downstream parties (e.g., sub-advisors) to confirm their state of readiness
- If you are in the process of buying a new portfolio management system or upgrading other systems, make sure to check about their ability to smoothly manage a change in settlement date

Practical systems-related and procedural actions

- Identify technology and processing problems in the T+3 world – these will only be more challenging in a T+2 environment
    - Are delays due to where your firm is located? West coast and non-western-hemisphere firms – for different reasons – will be under greater time pressure and may need to look at amending processes, changing work hours, or increasing staffing
    - Are delays due to technology – or lack of technology – issues? Is your firm still using faxes or secure emails with attachments? Expect pressure to find technological or outsourced solutions
- Are there problems you don't know you have? In the best interests of smooth operations, some staff may have been using long-standing excel macro or other work-arounds – make sure to canvas everyone's input
- Analyse and prepare to update tools (systems or processes) you use to project cash flow (e.g., timing of dividends, verify corporate actions, check accrued interest)
- Work with your custodian(s), broker(s)/dealer(s), service providers and vendors to:
    - Eliminate, if at all possible, all data entry that will require rekeying information by finding out if your custodian(s) has/have an automated input system or identifying vendor(s) or a virtual matching utility that can help
    - Check and fix, or create, standing settlement instructions so as many transactions can be processed in automated fashion; check your data and check what data your custodian(s) and broker/dealer(s) have/need
    - Examine purchases of non-Canadian securities, both cross-U.S.-border and, more importantly, non-western-hemisphere

    - ☐ Identify securities that have features that may mean the securities take longer to clear and settle (restricted or legended shares – e.g., cannot be sold to non-residents, physical securities, etc.)
    - ☐ Discuss any securities lending recall challenges with your custodian
    - ☐ Discuss any foreign currency exchange/settlement concerns
    - ☐ Find out if there will be any processing timing/cut-off changes
    - ☐ Check if there will be any contract changes required, in particular, in service level agreements
- ☐ Validate claims by service providers and vendors who say they will be T+2 ready

Exceptions

- ☐ Investigate holiday processing issues (processing delays or partial delays when markets are closed in one country (or province) and open in the other(s)): the issues of domestic trades settling in Canada following, for example, Canada's May Victoria Day weekend may differ from cross-border trades settling in the U.S. after America's Memorial Day. Today, trades executed on trade date often can be reported on the morning of T+1 due to overnight batch processing, with corrections made and trades matched by the various parties to the trade by the end of T+2, for settlement on T+3, even when there is a holiday in either country during the period. However, in a T+2 world, if there is a holiday in the middle of the process (T+1 or T+2) when a trade requires correction, there will not be enough time to make the correction, have the trade matched, and settle on time if processes still rely on overnight batch processing – work with your custodian(s) and broker(s) to prepare for this or face the consequences associated with the cost of fails
- ☐ Revisit your error prevention and correction processes to see how they can be improved

Paperwork

- ☐ Review and comment on, as appropriate, the August 18, 2016 CSA release for comment of a discussion paper and proposed amendments to National Instrument 24-101 – Institutional Trade Processing
- ☐ Revisit standard issuing documents, like prospectuses or trust agreements, which may reference a settlement period
- ☐ Prepare any needed – and, as necessary, file – any required compliance and documentary changes (e.g., trade-matching agreement or statement, subscription/redemption notification for institutional investors, etc.)

Communications

- ☐ Develop internal communications and build awareness so staff can help clients
- ☐ Plan your client communications strategy – understand what your clients (including institutional ones) need to know and how to convey it effectively
- ☐ To stay informed,
    - ☐ Sign up for the CCMA newsletter by emailing info@ccma-acmc.ca; share the newsletter with others in your firm and those you interact with in the securities clearing and settlement chain
    - ☐ Check the CCMA website regularly
    - ☐ Consider joining a CCMA committee

Final Note: The devil is in the details…