

# **Principles regarding the Custody of Collective Investment Schemes' Assets**

## **Consultation Report**



**OICU-IOSCO**

**The Board  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

<b>CR07/2014</b>	<b>OCTOBER 2014</b>
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This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Board or any of its members.

The International Organization of Securities Commissions [www.iosco.org](http://www.iosco.org)

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## Foreword

The Board of the International Organization of Securities Commissions (IOSCO) has published this Consultation Report with the aim of outlining principles against which both the industry and regulators can assess the quality of regulation and industry practices concerning the custody of CISSs' assets. Generally, the proposed principles reflect a level of common approach and a practical guide currently acknowledged by regulators and industry practitioners.

### How to submit comments?

Comments may be submitted by one of the two following methods **on or before 10 December 2014**. To help us process and review your comments more efficiently, please use only one method.

**Important:** All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

#### 1. Email

Send comments to Mr. Mohamed BEN SALEM, Senior Policy Advisor, IOSCO General Secretariat, C/ Oquendo 12, 28006 Madrid, +34 91 417 55 49, at:  
[consultation-2014-07@iosco.org](mailto:consultation-2014-07@iosco.org)

- The subject line of your message MUST indicate “*Principles regarding the Custody of Collective Investment Schemes' Assets*”
- If you attach a document, indicate the software used (e.g., Microsoft WORD,) to create the attachment.
- DO NOT submit attachments as PDF, HTML GIFG, TIFF, PIF, ZIP or EXE files.

#### 2. Paper

Send 3 copies of your paper comment letter to:

Mr. Mohamed BEN SALEM,  
Senior Policy Advisor  
International Organization of Securities Commissions (IOSCO)  
Calle Oquendo 12  
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Your comment letter should indicate prominently that it is a “*Public Comment on Principles regarding the Custody of Collective Investment Schemes' Assets*”

## **Contents**

<b>Chapter</b>	<b>Page</b>
<b>Chapter 1 - Introduction</b>	<b>1</b>
<b>Chapter 2 - Role and responsibilities of custodians</b>	<b>3</b>
<b>Chapter 3 – Key risks around the custody of client assets</b>	<b>6</b>
<b>Chapter 4 – Principles relating to the custody of CIS assets</b>	<b>9</b>
<b>Chapter 5 – Principles relating to the appointment and ongoing engagement of custodians</b>	<b>14</b>

# Chapter 1 - Introduction

## Background

1. IOSCO Committee 5, the committee responsible for Investment Management (**C5**), last examined the "**safekeeping**" of collective investment scheme (**CIS**) assets by "**custodians**" in 1996 when it issued a discussion paper, "*Guidance on Custody Arrangements for Collective Investment Schemes*".<sup>1</sup> There have been notable developments in the CIS custody space since 1996, especially following the events of the 2008 global financial crisis.<sup>2</sup>
2. This consultation paper seeks to clarify, modernise and further develop principles regarding the custody of "**CIS assets**" and obtain stakeholders' views on issues related to the custody<sup>3</sup> of CIS assets consistent with the core IOSCO's "*Objectives and Principles of Securities Regulation June 2010*" (**IOSCO Principles**)<sup>4</sup>.
3. The paper looks at the role and function of entities which provide safekeeping and in some cases also provide ancillary services (e.g. fund administration, mandate monitoring and record keeping) to a CIS, and the responsibilities of the entity or entities responsible for the overall operation of the CIS (**responsible entity**) in relation to appointing and monitoring these entities.
4. C5 recognises that the regulatory regimes for the safekeeping of CIS assets are diverse and the responsibilities and regulatory status of the entities that provide such safekeeping services are also varied (from custodians providing pure asset safekeeping with no ancillary services to authorised depositaries providing safekeeping services and an additional oversight role)<sup>5</sup>.
5. In formulating this consultation document, C5 has drawn on existing IOSCO Principles<sup>6</sup>, previous IOSCO papers on the subject<sup>7</sup> and responses from a recent survey

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<sup>1</sup> See *Guidance on Custody Arrangements for Collective Investment Schemes* IOSCO Discussion Paper, Report of the Technical Committee of IOSCO, September 1996. Available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD60.pdf>.

<sup>2</sup> Please see Appendix A for a summary of the recent regulatory development in relation to CIS custody.

<sup>3</sup> Custody in this paper is taken to mean the safekeeping of CIS assets, see also definition of safekeeping in the Glossary (Appendix B).

<sup>4</sup> See *Objectives and Principles of Securities Regulation*, IOSCO, June 2010. Available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf>.

<sup>5</sup> In some European jurisdictions a single entity (usually referred to as the "**Depositary**") is tasked with both the safekeeping of CIS assets and the oversight of the responsible entity. In other jurisdictions, e.g. Australia, the 'custodian' is responsible for the safekeeping of CIS assets and a 'responsible entity' is separately tasked with oversight of the CIS. In jurisdictions where CIS are formed as trusts, the safekeeping function may be undertaken by a "**Trustee**".

<sup>6</sup> Principle 25 and 31 of the IOSCO Principles. *Objectives and Principles of Securities Regulation*, IOSCO, June 2010, supra fn 4.

<sup>7</sup> See "*Guidance on Custody Arrangements for Collective Investment Schemes*" 1996, supra fn 1 and FR01 "*Recommendations Regarding the Protection of Client Assets*," Final Report, IOSCO Board, 29 January 2014 available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD436.pdf>.

which twenty-eight C5 members from twenty-seven jurisdictions participated.<sup>8</sup> The survey sought information about the legal, regulatory and operational landscape for CIS asset safekeeping in each of those jurisdictions.

## Market update

6. A number of market developments have occurred since the 1996 Paper, which has led IOSCO to consider it necessary to revisit its guidance with regard to the custody of CIS assets.
7. Events like the Lehman Brothers and MF Global insolvencies or the Madoff fraud have focused the attention on CIS asset protection regimes. In particular the Madoff fraud brought the issues of the depositary's liability and potential conflict of interests to the fore, and showed the risks associated with the use of local sub-custodians when those default or fail to perform their duties appropriately. These events have been a significant political driver in financial services regulation, especially in Europe.
8. CIS managers tend to invest in more complex instruments than was the case in the 1990s. In certain jurisdictions, this can be the result of changes in the regulatory framework applying to CIS having extended the scope of eligible assets to classes of assets like derivatives, index-based funds, etc. The enlargement of eligible investment instruments therefore raises the question of the extent of the custodian's safekeeping role and duties.
9. Over the past two decades, there has been a trend toward recording ownership in financial instruments by means of an electronic book entry, instead of through physical stock certificates. The widespread use of electronic book entry to register and keep track of ownership changes in securities has led to a major change in market practices and processes creating new challenges and risks.
10. Lastly, there has been a significant increase in the diversification and internationalisation of CIS portfolios since 1996. With CIS increasingly choosing to seize investment opportunities in a growing number of foreign jurisdictions, the need to appoint sub-custodians in these jurisdictions has developed. It is therefore important to consider the implications notably in terms of the delegation of safe-keeping functions, as custody chains now tend to be longer and more complex, involving many foreign jurisdictions.

**Consultation question 1:** Do you have views on the recent trends identified above and are there any other relevant market developments that should be taken into account in developing the principles regarding the custody of CIS assets?

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<sup>8</sup> The C5 participants who responded to this survey: Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Ireland, Italy, Japan, Jersey, Luxembourg, Mexico, Netherlands, Nigeria, Panama, Portugal, Romania, Singapore, South Africa, Spain, Switzerland, Turkey, United Kingdom, United States - Commodity Futures Trading Commission, United States – Securities & Exchange Commission.

## Chapter 2 - Role and responsibilities of custodians

11. Custodians are appointed by the responsible entity to safekeep CIS assets.
12. All C5 members' regulation seeks to protect the physical and legal integrity of the assets of the CIS. The results of the survey showed that the primary role of the custodian appears to be largely consistent across different jurisdictions to the extent custodians are responsible for safekeeping of the CIS's assets. In addition, the survey showed that the rules on safekeeping and asset segregation are often provided in the relevant local laws and regulations.
13. In addition to the primary function of safekeeping of CIS assets, the survey shows that custodians in some jurisdictions may also be responsible for certain monitoring and oversight functions and other administrative services in addition to their safekeeping duties. These functions are identified below.

### A. Safekeeping of CIS assets

14. The principal activity for which a custodian is engaged in by a CIS or responsible entity is the custody, or safekeeping, of CIS assets. There is no global or uniform definition of the term "custody". It may refer to different obligations in various jurisdictions, including ensuring that the CIS assets are maintained and segregated in a secure arrangement and are not misappropriated by persons with access to the assets<sup>9</sup>, ensuring CIS assets are subject to due skill care and protection<sup>10</sup>, or the appropriate management and keeping of assets by proxy to prevent loss or damage<sup>11</sup>. In almost all the jurisdictions, however, custody or safekeeping involves the holding, keeping, possession or control of the relevant CIS assets by the custodians. Every jurisdiction responded that the segregation of CIS assets is required under their regulatory regime.

**Consultation question 2:** What is your understanding of the role of custodians with respect to CIS assets?

**Consultation question 3:** What is your understanding of term "segregation" in relation to the safekeeping / custody of CIS assets?

15. The custody function applies to all assets which can be held in custody, whether by physical delivery to the custodian or by way of registration in book-entry form in the accounts of the CIS opened with the custodian. CIS assets entrusted to a custodian are generally financial instruments such as equity securities or fixed income securities, but they may also include physical assets in certain jurisdictions (e.g. gold, property, and precious metals).

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<sup>9</sup> Section 17(f) of the U.S. Investment Company Act of 1940 governs the custody of a CIS's assets, including its portfolio securities.

<sup>10</sup> In EU jurisdictions, the AIFMD and the UCITS regime.

<sup>11</sup> Japan.

16. Assets that are physically delivered to and held ('custodied') by the custodian itself, are in the minority of situations. More frequently, assets are not directly held by the custodian but they are recorded in book entry systems or held by other parties such as Central Securities Depositories (CSDs), International Central Securities Depositories (ICSDs), sub custodians, registrars or collateral agents. In addition, all other assets which by their nature cannot be held in custody (e.g. derivative instruments) are subject to the custodian's record-keeping obligation, i.e. the custodian must maintain and keep up-to-date a record of all the CIS' open positions.

**Consultation question 4:** Are there any special considerations or operational issues when holding non-standard assets such as physical commodities (e.g. gold bullion), financial derivative instruments, private placements, wine, arts etc.?

**Consultation question 5:** Should there be specific regulatory requirements for holding non-standard assets?

17. It should be noted that custodians may not be contractually involved when third parties are engaged to maintain CIS positions, e.g. when placing cash deposits with third party deposit taking institutions, concluding derivative contracts with (prime) brokers and receiving collateral into accounts of the CIS with third party lending agents when lending out the CIS's securities. It is hence important to distinguish between the different asset types and contractual situations when clarifying the risks and responsibilities applicable to CIS custodians attached to each asset type.
18. For the purposes of this paper, safekeeping does not include services such as securities lending. It should be noted, however, that a CIS custodian may be called, for example, to hold assets (as CIS assets that are owned by the CIS) that have been delivered to the CIS (i.e. to its custodian) as collateral under a securities lending arrangement. For the purposes of this paper, collateral (depending on the arrangement, i.e. whether the CIS owns the collateral) may be considered as CIS assets subject to safekeeping included as client assets.

**Consultation question 6:** Should additional consideration be given to the treatment of derivative instruments, collateral arrangements, etc., and, more in particular, to the role of custodians in this regard? If yes, what special issues should be addressed?

### **Monitoring and oversight functions**

19. It is noted that in some jurisdictions, it is a legal or regulatory requirement that the custodian shall exercise monitoring and oversight functions over client assets. For example, the EU rules require the depositary to oversee the responsible entity's compliance with the relevant AIFM and UCITS regulations (as transposed into national rules by EU member jurisdictions). Such oversight is conducted ex post and cannot be delegated.
20. In some jurisdictions, such monitoring and oversight functions include ensuring that investments made by the CIS managers comply with the objectives and provisions outlined in the constitutive documents of the CIS, monitoring the investment and operational activities of the CIS, ensuring compliance with laws and regulations

applicable to the CIS, monitoring the sale and redemption of CIS shares and / or valuation of units etc., in variable degrees.<sup>12</sup>

21. In some jurisdictions (e.g. the EU jurisdictions), the custodian may also be required to ensure that the cash flow of the CIS is properly monitored.<sup>13</sup>

#### **Administration / ancillary services**

22. In addition to the safekeeping of client assets, custodians may also provide other services to a CIS ("administrative" or "ancillary" services). Typically these services are provided by the custodian under a contractual arrangement with the responsible entity (usually in the custody agreement) rather than as a result of legal or regulatory requirements. Some of the common ancillary services provided by CIS custodians include fund administration (e.g. corporate actions), investment administration (e.g. fund accounting) and other services such as compliance monitoring.
23. The extent to which a CIS or the responsible entity engages a custodian to provide administrative or ancillary services will depend on various factors, including the responsible entity's specific needs, sophistication of its own systems and the cost-benefit analysis of the proposed delegation arrangement.

**Consultation question 7:** To what extent or under what circumstances should administration / ancillary services form part of the role of a custodian? What are the benefits of having a custodian perform these services? Are there other ancillary services provided by custodians that are critical to the operation / function of a CIS?

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<sup>12</sup> France, Germany, Hong Kong, Switzerland, United Kingdom (and other EU jurisdictions pursuant to the AIFMD and UCITS regimes).

<sup>13</sup> Article 21(7) of the AIFMD and article 21(4) of the consolidated UCITS V Directive.

## Chapter 3 – Key risks around the custody of client assets

24. C5 has sought to identify the key risks associated with the custody of client assets. The risks identified below are not meant to be an exhaustive list, and it is recognised that each custodian may have its own unique risk management system, which reflects the nature, scale and complexity of its business.
25. The responsible entity should be mindful of the following risks when selecting a custodian as well as during its relationship with the custodian. Chapter 4 and 5 of this paper set out some principles in relation to the safekeeping of CIS assets and the appointment and ongoing monitoring of custodians.

### A. Risk of co-mingling / misuse of CIS assets / segregation

26. There is a risk that CIS assets in the custodian's care can become co-mingled with (i) assets of the responsible entity; (ii) assets of the custodian; or (iii) the assets of other clients of the custodian (unless CIS assets are held in a permissible "**omnibus account**"). There is also a risk that CIS assets may be misused by the custodian (e.g. to settle the liabilities of another client).
27. The consequences of these risks could result in the ownership of the assets being called into question in the event of misuse or insolvency of the custodian, which may create difficulties differentiating ownership of the assets.

### B. Operational risk

28. Operational risk is the risk of loss of CIS assets resulting from inadequate or failed processes, people and systems or from external events. While this risk cannot be completely eliminated due to its nature, it can be mitigated with appropriate risk controls. Some of the more common operational risks potentially faced by CIS custodians are identified below:

#### (i) Risk of fraud or theft

29. Risk of loss of CIS assets if an employee of the custodian acts in a fraudulent manner (e.g., falsifying records) or steals from client accounts. CIS assets could also be placed at risk if a third party acts in a fraudulent manner e.g. submitting fake withdrawal instructions to the custodian purporting to be the responsible entity.

#### (ii) Information technology risk

30. Given that most CIS assets are held by way of registration in book-entry form in the accounts of the CIS opened with the custodian, an important aspect of a custodial business involves the security and reliability of its information technology (**IT**). Key IT risks include (i) vulnerabilities in IT security which can open the gate for fraud and loss of data integrity; (ii) existence of legacy systems which can give rise to other risks such as human error due to a higher reliance on manual input; and (iii) IT system failures which could result in the custodian failing to act on corporate events or incorrectly calculating asset values, interests, dividends and taxes.

### **(iii) Inadequate record keeping**

31. Appropriate segregation of CIS assets depends on the custodian maintaining proper books and records. Title of CIS assets may be lost or incorrect if the custodian fails to keep or retain proper and adequate records of the identity and status of investments held or their beneficial ownership. This risk is often heightened where there is a change to the custodian's way of operation e.g. changes to internal processes and / or updates to the IT systems used to record assets and client information.

### **(iv) Holding non-standard assets**

32. Some assets, often non-financial securities (e.g. physical commodities such as gold bullion, art work or wine etc.), may call for specialist custodians. For example, the safekeeping of gold bullion would require a custodian with appropriate vault facilities. The holding of such assets may introduce additional operational risks e.g. physical security of assets or other proper storage.

### **(v) Conflicts of interest**

33. The safety and integrity of CIS assets may be at risk if the responsible entity or the custodian fails to identify, address and monitor any conflicts of interests e.g. failure to segregate custodial staff from persons performing other functions (such as investment or trading functions) in a way that minimises conflicts of interest which may exist.

### **(vi) Legal and compliance risk**

34. Legal and compliance risk for the purposes of this paper is where the custodian fails to comply with the applicable laws, the terms of any authorisation it holds, any regulatory or industry requirements, or any contractual obligations.
35. CIS assets may be at risk if a custodian breaches its legal and / or regulatory obligations, which in some cases may result in the custodian being unable to provide safekeeping services for the CIS e.g. from losing its regulatory status to provide safekeeping service or due to insolvency.
36. Compliance failures can originate from a lack of knowledge of the policies and procedures (this could be from poor training, high staff turnover or a poor compliance culture), human error (simply missing steps in a procedure) or an intentional decision to not comply.
37. Breaches of legal and regulatory obligations and compliance failures could jeopardise the safety of CIS assets and cause serious disruptions to the custodial arrangements.

### **Country risk**

38. Where assets are held in foreign jurisdictions, there may be specific country risks that should be taken into account e.g. the effectiveness of the local regulatory regime, whether a judgement can be enforced effectively and other factors that may make it difficult to repatriate CIS assets i.e., language barriers, time zones, lack of direct oversight and political uncertainty that may impact the safekeeping of CIS assets.

### **Concentration risk**

39. A potential concentration risk was identified by some respondents to the survey as a key risk in the custodian business in their jurisdiction.<sup>14</sup> Concentration risk may arise if all CIS assets are held by a single custodian or at a single physical location. The provision of asset safekeeping services is already highly concentrated and the industry continues to consolidate. With the global economy becoming more interconnected, a few large custodians are holding a significant portion of CIS assets globally.

### **Counterparty risk**

40. Typically where cash is placed on deposit with a custodian also in the capacity of a deposit taking institution, the CIS is exposed to the credit risk of that custodian insofar as the cash deposit is concerned, and there is a risk that the custodian may default if it becomes insolvent.

### **Reputational risk**

41. The crystallisation of any of the above-mentioned risks can have an adverse impact on the reputation of those involved in the custody arrangement particularly the custodian and the responsible entity. Reputational damage could trigger a loss of investor confidence and increased redemption at the CIS or litigation against the CIS, responsible entity or custodian.

**Consultation question 8:** Do you agree with the risks presented above? Are there any other key risks associated with the custody of CIS assets?

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<sup>14</sup> Australia, Jersey, Luxembourg.

## Chapter 4 – Principles relating to the custody of CIS assets

***Principle 1 – The regulatory regime should make appropriate provisions for the custodial arrangements of the CIS.***

42. The regulatory regime seeks to protect the physical and legal integrity of CIS assets.
43. To achieve this, the regulatory regimes should consider (where applicable, as a complement to separate regulation e.g. prudential and banking regulation that governs the custodian) having appropriate provisions for the custodial arrangements of the CIS.
44. Principle 1 is designed to ensure there is an appropriate regulatory framework in order to address the key risks relating to the custody of CIS assets.

**Consultation question 9:** Would there be merit in requiring the appointment of a single custodian in order to have certainty over who is ultimately responsible for safekeeping all CIS assets within a given CIS?

***Principle 2 – CIS assets should be segregated from:***

- (i) *the assets of the responsible entity, its related<sup>15</sup> entities and other schemes;*
  - (ii) *the assets of the custodian / sub-custodian throughout the custody chain; and*
  - (iii) *the assets of other clients of the custodian throughout the custody chain (unless CIS assets are held in a permissible omnibus account).*
45. Proper segregation of assets is essential in ensuring the safekeeping of CIS assets. This fundamental principle of CIS safekeeping is embedded in principle 25 of the IOSCO Principles which states that, "*the regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.*"
  46. In order to ensure that the ownership of the CIS's and other clients' assets remain distinct, the custodian must ensure that appropriate segregation arrangements are in place to allow for the identification of assets belonging to each party. Such segregation should be observed throughout the custody chain i.e. where sub-custodians are appointed (regardless of how many levels of sub-delegation are involved), the sub-custodians' own assets should not be co-mingled with assets of the sub-custodian's clients. A key objective of the segregation requirements all along the custody chain is to prevent the loss of assets as a result of the insolvency of a sub-custodian or custodian.
  47. Every jurisdiction responded to the survey that the segregation of CIS assets is required under its regulatory regime with the most common segregations occurring between:
    - CIS assets from the assets of the responsible entity and its related entities;
    - CIS assets of a given CIS from the assets of other CIS clients;
    - CIS assets from the assets of the custodian; and
    - CIS assets from the assets of other clients of the custodian.

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<sup>15</sup> Also referred to as "affiliated" entities in the United States.

48. Some jurisdictions allow CIS assets to be co-mingled with the assets of other clients in an omnibus account. An omnibus account typically refers to the holding of CIS assets in an account in the name of the custodian or its nominee (and marked as CIS assets, i.e. not as assets of the custodian or its nominee itself), rather than in individual accounts for each underlying client. The segregation of assets among different clients generally occurs operationally, through IT systems and books and records, rather than through the use of separate individual client accounts.
49. The survey results indicated that the term ‘omnibus accounts’ is generally used for co-mingled accounts at sub-custodian level although accounts co-mingling assets of various clients may also be used at the custodian level subject to certain safeguards such as daily reconciliation against the custodian’s records, i.e. where co-mingled accounts are used, the custodian’s records should differentiate assets belonging to each client and ensure that records be accurately maintained with frequent reconciliations being performed at the co-mingled account level. In any case, the custodians' or sub-custodians’ own assets should not be co-mingled with CIS assets.
50. Principle 2 is designed to address the risk of the misuse and / or co-mingling of CIS assets and operational risk.

**Consultation question 10:** Should the custodian segregate assets only between its own and CIS assets, or should it segregate assets through individual, separate accounts for each client?

**Consultation question 11:** Should the rule of segregation apply throughout the custody chain, i.e. through the different levels of delegation to sub-custodians?

**Consultation question 12:** Should the requirement of proper segregation be combined with an additional requirement of the recognition of the segregation at custodian or sub-custodian level in the event of the insolvency of the custodian or sub-custodian?

***Principle 3 – CIS assets should be entrusted to a third party custodian. In limited circumstances where the regulatory regime permits self-custody of CIS assets, additional safeguards should be put in place to ensure proper segregation and protection of CIS assets.***

51. To avoid conflicts of interest and ensure a high level of protection, CIS assets are generally entrusted to a third party custodian, responsible for the safekeeping of the assets.
52. In limited cases, as an alternative to the appointment of a formal third-party custodian, the regulatory regime may allow "self-custody", under which the CIS or the responsible entity may be permitted to hold the CIS assets.<sup>16</sup> Some regimes permit self-custody for

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<sup>16</sup> Most regulatory regimes do not allow self-custody of CIS assets e.g. Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, Nigeria, Panama, Portugal, Romania, Singapore, South Africa, Spain, Switzerland, Turkey. In the context of this paper, self-custody does not include arrangements where custody is provided by a party related to the CIS or the responsible entity (i.e., related bank).

certain types of assets only and require that these assets be handled separately by another unit within the responsible entity.

53. For jurisdictions<sup>17</sup> which allow some form of self-custody, additional requirements are often imposed on self-custodians, such as:
- additional disclosure requirements;
  - additional capital requirements;
  - holding the CIS assets in the safekeeping of a bank or other company that is supervised by regulatory authorities;
  - physically segregating CIS assets from the assets of others;
  - designating specific persons who are permitted access the CIS assets; and
  - requiring an independent public accountant to verify the assets held by the self-custodian and to conduct a certain number of examinations without giving prior notice to the responsible entity.
54. Where self-custody is permitted by the regulatory regime, the following additional minimum conditions should be considered :
- (a) the division of the responsible entity engaged in custody / administration must be functionally independent of the fund management division of the responsible entity;
  - (b) conflicts of interest at the group level must be appropriately identified, managed and monitored; and
  - (c) proper disclosure to investors including what measures and safeguards have been put in place to ensure proper segregation and protection of CIS assets must be required.
55. Principle 3 is designed to address the risks of self-custody.

**Consultation question 13:** Are there any other conditions that should be considered when a CIS uses self-custody?

***Principle 4 – The custodian should be functionally independent from the responsible entity.***

56. Many jurisdictions require that CIS assets be held by an eligible third party custodian appointed by the responsible entity, often with an additional requirement that such custodian be independent of the responsible entity.
57. It is recognised that the concept of “independence” varies among jurisdictions, with some regulatory regimes insisting upon there being no shareholding relationship of the custodian with the responsible entity, while others allow cross shareholdings between the responsible entity and the custodian. Instead of restricting shareholding relationships, some regulatory systems achieve the required degree of independence by the establishment of a separate corporate structure for the custodian, an independent board and separate lines of reporting to the management of the custodian.

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<sup>17</sup> Australia, Jersey, United Kingdom, United States.

58. In terms of performance of custodial functions, all regulatory regimes should seek to ensure that the custodian is independent in the way it performs its obligations, i.e. a custodian should be functionally independent of the responsible entity.
59. This functional independence may be achieved in a variety of ways provided each is appropriate to the broader regulatory framework of the relevant jurisdiction. Functional independence as a minimum requirement is to be distinguished from a structural or “legal independence”. According to principle 25 of the IOSCO Principles, it is not mandatory for the custodian and the responsible entity to be legally separate entities or for the custodian and the responsible entity to not have common shareholders or directors, although it is open to the regulatory regime to prohibit or restrict this. A functional separation, however, necessarily implies a hierarchical separation, which will involve assessing where key decisions are taken.
60. As a general principle, the CIS or the responsible entity must therefore seek to ensure the custodian it appoints is functionally independent of the responsible entity. Whether or not the responsible entity and the custodian are related parties, the safekeeping activities must be performed by officers who are separate from, and able to act independently from, officers involved in investment or trading decisions. Consequently, to be considered functionally independent, there should be systems and controls in place to ensure that the persons fulfilling the custodial function (e.g., the safekeeping of CIS assets) are functionally independent from the persons fulfilling the CIS’s management or administration functions. As such, a custodian should not carry out activities with regard to the CIS or the responsible entity that may create conflicts of interest between the CIS, the investors in the CIS, or the responsible entity and itself, unless the custodian has functionally and hierarchically separated the performance of its custodian tasks from its other potentially conflicting tasks, and the potential conflicts of interest are properly identified, managed, monitored and, possibly, disclosed to the investors of the CIS. Each regulatory regime is free to prescribe (or not) more detailed requirements in this regard.<sup>18</sup>
61. Principle 4 is designed to address operational risk (in particular, the risk of fraud and theft and legal and compliance risk), conflicts of interest and the risk of the misuse and / or co-mingling of CIS assets.

***Principle 5 – The responsible entity should seek to ensure that the custody arrangements in place are disclosed appropriately to investors in the CIS offering documents or otherwise made transparent to investors.***

62. The safekeeping of CIS assets is a significant component of the CIS arrangement between the custodian and the CIS / responsible entity. The responsible entity should seek to ensure that the custodial arrangements and any risks associated with the arrangements are properly disclosed to investors and any significant changes updated to investors. Where CIS assets are held in a foreign jurisdiction, the responsible entity should consider disclosing this arrangement and the associated risks. Where self

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<sup>18</sup> In the EU, under the new UCITS V directive, the European Commission is to specify the conditions for fulfilling this “independence requirement” within a period of four years from the entry into force of the directive (which is 17 September 2014).

custody is being used, the responsible entity should also consider specifically disclosing the existence of this arrangement and what additional safeguards have been put in place to mitigate any potential conflicts of interest.

63. As a matter of best practice, the responsible entity should also consider disclosing the identity of the custodian and sub-custodian and their respective roles.
64. Principle 5 is designed to address legal and compliance risk, reputational risk and country risk.

<p><b>Consultation question 14:</b> Do principles 1 to 5 adequately address the key risks associated with the safekeeping of CIS assets?</p>
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## Chapter 5 – Principles relating to the appointment and ongoing engagement of custodians

### *Principle 6 – The responsible entity should use appropriate care, skill and diligence when appointing a custodian to safekeep CIS assets.*

65. The responsible entity should use appropriate care, skill and diligence in the selection, instruction and monitoring of its custodian.<sup>19</sup> The responsible entity may also consider cost and service delivery, the regulatory status of the custodian (i.e. authorisation to undertake custody business), its place of establishment, its organisational competence (e.g. whether its systems are equipped to deal with specialised or non-custodial assets), reputation, financial soundness and, where custodial property may be held off-shore, its network of or relationship with sub-custodians, and the compliance framework in relation to this. The responsible entity may also consider the custodian's management of potential conflict of interest to ensure it is satisfied they are properly identified and mitigated. Where relevant, it may consider examining other activities conducted by the entity providing custodial services.
66. In addition, given the importance of the custodian's role, the responsible entity should take into consideration the custodian's business continuity plans, and its own contingency arrangements for the recovery of assets held with the custodian, in the event of disruption or cessation of the custodian's operations (e.g. due to financial difficulty or natural disasters), as part of its selection process for custodians. If appropriate, the responsible entity may procure the services of a suitable third party to assist it with the selection process.
67. In turn, the responsible entity should consider whether the custodian it appoints uses all care and skill in the selection and monitoring of its sub-custodians (e.g. handling of illiquid assets, volume of assets, some kind of diversification, proportionality, reasonable approach) and consider the matters referred to above particularly in relation to segregation processes.
68. Principle 6 is designed to provide coverage of the risks identified in Chapter 3 as the responsible entity should consider the key risks during its assessment of a custodian.

**Consultation question 15:** Are there any other selection criteria that may be relevant for the proper selection and appointment of a custodian?

**Consultation question 16:** Should additional consideration be given to the selection of specialist custodians? If so, what factors should a responsible entity take into account when selecting a specialist custodian?

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<sup>19</sup> What is appropriate would depend on a number of factors including size, capital and whether the custodian itself is subject to or under a regulatory regime.

***Principle 7 – The responsible entity should at a minimum, consider a custodian's legal / regulatory status, financial resources and organisational capabilities during the due diligence process.***

69. The responsible entity should be able to demonstrate why the appointed custodian is appropriate for the CIS.<sup>20</sup> For example, based on the due diligence conducted on the custodian, the responsible entity should consider the appropriateness of each appointment after considering the CIS' strategy and the types of assets which the CIS needs the custodian to hold.

70. While the results of the survey showed that most regulatory regimes do not impose a particular selection process with respect to selecting a custodian or sub-custodian, it is open to each regime to do so. The responsible entity may wish to consider the following factors prior to formal appointment:

**A. Legal and regulatory status**

71. The survey results showed that the type of entity which can act as a CIS custodian is varied, ranging from credit institutions which are often subject to prudential regulation, broker / dealers and trust companies. Most regulatory regimes require CIS custodians to be licensed, authorised or approved and to be subject to some form of ongoing regulatory oversight. A responsible entity should consider whether the custodian meets the necessary legal and regulatory requirements to act as a custodian in the jurisdiction in which it is operating. This could be satisfied by obtaining an undertaking from the custodian as to its regulatory status.

**B. Capital / financial resource requirements**

72. Most regulatory regimes have a minimum capital or financial resource requirement for CIS custodians. While the amount varies between jurisdictions, as part of its due diligence, the responsible entity may wish to make enquiries into the custodians' financial capacity to safekeep CIS assets. The responsible entity may also want to consider the credit worthiness of the custodian especially if cash assets are being placed on deposit with the custodian.

**C. Organisational capabilities**

73. Whether a custodian has ability to safekeep CIS assets is largely dependent on the custodian's infrastructure and operational capabilities. The responsible entity may wish to give some consideration to the following factors during its due diligence process:

- Human resources – is the custodian able to cover the time zones required and does the custodian have the human capital to properly record and preserve the physical and legal integrity of CIS assets? If services are outsourced to offshore third parties, has the responsible entity considered whether the arrangement is appropriate and has it considered additional risks it poses?

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<sup>20</sup> The responsible entity may consider several factors when considering the appropriateness of a custodian. For example, the fact that a custodian is a large credit institution does not automatically mean that it is able to handle the recording keeping and custody of an unlisted property fund or a hedge fund.

- Management – does the custodian have a competent management team in place? Is there an appropriate governance structure in place to ensure that any conflicts of interests are properly managed, and does it facilitate breach reporting or whistleblowing?
- IT systems and processes – are the custodian's IT systems up to date, secure and sufficiently sophisticated? Is there a heavy reliance on manual procedures? Does the custodian engage in regular system testing and system and data backups?
- Infrastructure – does the custodian have suitable infrastructure in place e.g. for non-standard CIS assets such as physical commodities, is the custodian equipped to hold the assets and ensure its safety?
- Global network – if the CIS requires global custodian coverage, does the custodian have the capabilities to meet this demand and what is the sub-custodian network that it uses?
- Risk management – does the custodian have a robust risk management framework in place to ensure that where possible, CIS custody risk is mitigated? Does the custodian regularly reconcile records to mitigate the risk of CIS assets being misused / co-mingled?

74. In the absence of separate regulation, to support the above requirements, each regulatory regime may want to consider some kind of monitoring of compliance with these requirements.

75. Principle 7 is an extension of Principle 6 and designed to provide coverage of the key risks identified in Chapter 3 especially operational risks.

***Principle 8 – The responsible entity should formally document its relationship with the custodian and the agreement should seek to include provisions about the scope of the custodian's responsibility and liability.***

76. The responsible entity or the CIS and the custodian should document their relationship and formulate custody arrangements with care and clarify the duties and responsibilities of the various parties to the custodial arrangements. These provisions could include, for example:

- (a) designated individuals at the CIS or responsible entity authorised to provide instructions;
- (b) provisions for termination of the agreement (e.g. from breach of contract); and
- (c) (where it is not already provided for under law or as a regulatory requirement) defaults and liability and indemnity provisions as appropriate.

77. As a matter of best practice, any agreement should seek to contain clear provisions concerning the custodian's liability for losses suffered by investors.

78. Where a custodian delegates to a sub-custodian, a written agreement should be in place to document this relationship which should seek to include appropriate liability and indemnity provisions. As a general matter, the custodian's liability will not be affected by the fact that it has entrusted to a third party all or some of the assets in its safekeeping.

79. **Consultation question 17:** What should be the scope of a custodian's liability to the responsible entity as its client? What should be the scope of a sub-custodian's liability to the master custodian or responsible entity (if any)? And what are the appropriate limitations of this liability, if any?

80. While it is not mandatory for regulatory regimes to impose content requirements for such agreements or to impose specific terms in relation to the appointment of the custodian or sub-custodian, it is open to each regime to do so.
81. For example, the regulatory regime may provide, either directly or through mandatory terms in the custody agreement, that the custodian is liable only to the responsible entity or CIS itself for breach of the terms of the agreement or other negligence connected with the performance of its functions. Alternatively, as in certain EU countries, the law and the agreement may both provide that the custodian is directly liable to CIS investors and extends beyond breach and negligence to loss of assets, subject to conditions.
82. Principle 8 is designed primarily to address operational risk and in particular, legal and compliance risk.

***Principle 9 – Custody arrangements should be monitored on an ongoing basis for compliance with the terms of the custody agreement.***

83. Custody arrangements, once established, should be monitored to ensure the custodian's (and in some cases, the sub-custodian's) compliance with the terms of the contract. This may involve regular liaison with key staff, frequent reporting (e.g. asset reconciliation), physical access on request, independent audit of custodian and the provision by the custodian of assistance and information.
84. In turn, where applicable, the custodian must have the ability to monitor the sub-custodian's compliance with the terms of the relationship.
85. The responsible entity should also consider taking reasonable steps to satisfy itself on an ongoing basis as to the continued suitability of any appointed custodian, in respect of its regulatory status, its organisational competence, reputation, financial soundness and, where custodial property may be held off-shore, its network of or relationship with sub-custodians, and the compliance framework in relation to this.
86. The responsible entity should also seek to ensure that up-to-date contingency arrangements are in place, pre-agreed with the custodian, for the recovery of assets from the custodian, in the event of disruption or cessation of the custodian's operations. The responsible entity should also remain cognisant of actual or potential risks facing the custodian, and have in place contingency plans for moving CIS assets to another custodian should the necessity arise. Where the responsible entity lacks the resources to adequately monitor its custodian, it may consider appointing a third party (e.g. an auditor) with the capacity to do so.
87. Regulatory regimes may, as appropriate, impose requirements in relation to the monitoring and audit of, and access to, custodians and sub-custodians (e.g. an

obligation on the custodian to report any inappropriate asset use). However, it is open to each regime to do so.

88. **Consultation question 18:** Are there any other steps that the responsible entity can take to ensure proper monitoring of its custodian? Are there any other steps the custodian can take to ensure proper monitoring of sub-custodians?

89. Principle 9 is designed to address operational risk and in particular, legal and compliance risk.

90. **Consultation question 19:** Do principles 6 to 9 adequately address the key risks associated with the appointment and monitoring of CIS custodians and sub-custodians?

## APPENDIX A

### Recent regulatory developments in CIS custody

1. The implications from events related to the 2008 financial crisis and several corporate collapses (such as the Madoff affair) have led to increased concerns generally about the safekeeping of CIS assets, including in relation to CIS. As such, these events became a significant political driver in financial services regulation, especially in Europe.

#### **Europe**

2. The most notable result of this was the initiative to regulate alternative investment fund managers and, consequently, the introduction of the Alternative Investment Fund Managers Directive (2011/61/EU) of 8 June 2011 (**AIFMD**). A key component of the AIFMD is the clarification and harmonisation of the rules relating to the appointment, functions and liability of depositaries of alternative investment funds (**AIFs**) (see below). This was then followed by a revision of the UCITS directive (**UCITS V**) (i.e. Directive 2014/91/EU of 23 July 2014), with the stated aim to further enhance retail investor protection and effectively bring the UCITS regime into line with the new AIFMD standards through the introduction of a range of corresponding measures (such as the harmonisation of the duties and liabilities of UCITS depositaries across the EU) in areas that, in a UCITS retail investors' context, had previously been regulated in less prescriptive terms and that had led to different approaches across the European Union<sup>21</sup>.
3. The new depositary regime under the AIFMD and UCITS V<sup>22</sup> includes a clarification of the eligibility, duties, responsibilities and liabilities of depositaries of AIFs and UCITS and a set of rules under which they can delegate tasks and responsibilities. The main features of this regime are summarised below:

#### ***Depositary safekeeping duties and corresponding liability***

4. Under the AIFMD and UCITS V, the depositary's duty to safekeep consists of either custody or record-keeping depending on the type of asset owned by the AIF/UCITS. As such, the AIFMD and UCITS V distinguish between:
  - (i) financial instruments that are capable of being held in custody (whether by physical delivery to the depositary or by way of registration in book-entry form in the accounts of the AIF/UCITS opened with the depositary or with another entity further down the custody chain), where the depositary will be liable for the loss of such assets on a strict liability basis (i.e. irrespective of fault or negligence) unless the depositary can prove that the loss of assets is due to an "*external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary*"; and

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<sup>21</sup> The UCITS IV regime provided, for example, that a UCITS' assets must be « entrusted to a depositary for safekeeping », without giving any indication as to the ambit of this duty of safekeeping and making reference to national laws in respect of the precise contours of the duties of the depositaries.

<sup>22</sup> Upon the entry into force of the UCITS V directive (i.e. 17 September 2014), EU Member States will have 18 months (i.e. until 18 March 2016) to transpose it into national law; however, the existing EU UCITS depositaries will have a longer transition period (42 months, i.e. until 18 March 2018) to comply with the new requirements.

- (ii) all other assets (such as over the counter (**OTC**) derivatives), which are subject to the depositary's record-keeping obligations (i.e. the depositary must maintain and keep up-to-date a record of all the AIF's/UCITS' open positions) and its duty to verify the AIF's/UCITS ownership of these assets. The depositary will only be liable for the loss of these assets, if such loss is suffered as a result of its negligence or intentional failure to properly fulfil its obligations under the AIFMD/UCITS V.
5. In the case of (i) above, a AIF/UCITS depositary is obliged to return a financial instrument of the identical type or corresponding amount to the AIF/UCITS, without undue delay, if it is deemed liable for the loss. In addition, the depositary's liability will not be affected by the fact that it has entrusted to a third party all or some of its custody tasks. Therefore, the depositary will be liable for the loss of assets even where the loss occurred at the level of the sub-custodian. Unlike depositaries of AIFs, which are permitted under AIFMD to transfer liability for the loss of financial instruments held in custody to the relevant sub-custodian under certain conditions, depositaries of UCITS will not be permitted to exclude or limit their liability under contract.<sup>23</sup>

### *Delegation*

6. The AIFMD and UCITS V introduce new requirements in relation to the delegation of safekeeping duties by a depositary to sub-custodians. The new requirements generally relate to the operation of sub-custodians and require that sub-custodians:
- (i) have structures and expertise that are adequate for the safekeeping of the assets that are entrusted to them;
  - (ii) are subject to effective prudential regulation and regulatory supervision;
  - (iii) are subject to an external periodic audit; and
  - (iv) take all necessary steps to ensure that in the event of the sub-custodians' insolvency that the assets of the AIF/UCITS are not available for distribution to creditors.
7. Furthermore, the depositary should not delegate its safekeeping duties unless it can demonstrate that: (i) there is an objective reason for the delegation; (ii) it has exercised due skill and care in the selection and ongoing monitoring of the sub-custodian; and (iii) the delegation is not made with the intention of avoiding the requirements of the AIFMD/UCITS V.

### *Additional duties of the depositary*

8. In addition to the new safekeeping requirements which, as described above, distinguish between (i) financial instruments that can be held in custody by the depositary and (ii) record-keeping and ownership verification requirements relating to other assets, the AIFMD and UCITS V include an additional uniform list of oversight duties (which typically involves conducting ex-post controls and verifications of processes and procedures that are under the responsibility of the AIF/UCITS operator or the AIF/UCITS itself<sup>24</sup>) as well as new cash flow monitoring requirements. As to the latter,

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<sup>23</sup> In its original proposal, the European Commission noted that it would be inappropriate and unfeasible to require retail investors to understand the consequences of such contracts.

<sup>24</sup> These oversight duties include (i) verifying that units are sold, issued, repurchased, redeemed and cancelled in compliance with applicable rules; (ii) ensuring that the value of units is calculated in

AIFMD and UCITS depositaries are/will be required to ensure that the cash flows of AIFs/UCITS are properly monitored and to ensure that all payments made by or on behalf of an investor upon the subscription of units have been received and that all cash has been booked in cash accounts that meet certain conditions.

9. These developments, which have resulted, *inter alia*, in a new European standard concerning the safekeeping of CIS assets (as described above), trigger the question whether the existing IOSCO principle in relation to the protection of investors' assets where these are invested in CIS<sup>25</sup> requires further clarification or guidance for the purpose of enhancing investors' protection and at the same time allowing the International Monetary Fund to better assess the implementation of the IOSCO principles by the IOSCO jurisdictions.

### **Australia**

10. The safety of CIS assets, the duty of care custodians' exercise and whether custodians have appropriate internal controls to ensure the safety of assets held for others were examined in Australia after the global financial crisis.
11. In 2012, the Australian Securities and Investments Commission ("ASIC") released a report on custodial and depositary services.<sup>26</sup> The review identified a number of key risks to the safety of CIS assets for example:
  - unauthorised debiting of omnibus accounts;
  - stability and safety of it systems;
  - operational risks created by manual and disparate systems;
  - whistleblowing culture and framework;
  - reporting in relation to suspicious third party valuations;
  - breach reports relating to custodial and investment administration services; and
  - the risks inherent in corporate actions such as share buy-backs and rights.
12. Recommendations of good practices were made for each risk (in line with existing regulatory guidance) for custodians and the responsible entity to consider. ASIC also foreshadowed its intention to consult with industry about updating existing regulatory requirements for holding CIS assets and possibly proposing (i) changes to the financial resource requirements of custodians; and (ii) requiring the responsible entity to provide clearer disclosure about the role of custodians in retail marketing material.

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accordance with applicable rules; (iii) carrying out instructions of the AIFM/UCITS unless they conflict with applicable rules; (iv) verifying that considerations are remitted within the usual time limits; and (v) verifying that an AIF's/UCITS' income is applied in accordance with applicable rules.

<sup>25</sup> Principle 25 in "*Objectives and Principles of Securities Regulation*" IOSCO, June 2010, p.10, *supra*, fn 4, which provides that "the regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets", cf. <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf>.

<sup>26</sup> <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep291-published-5-July-2012.pdf>.

## APPENDIX B

### Glossary

<b>CIS</b>	a registered / authorised open-ended <sup>27</sup> collective investment scheme that issues redeemable units and invests primarily in transferable securities or money market instruments. For the purposes of this paper, this excludes private funds such as hedge funds which use prime brokers <sup>28</sup> and schemes which invest in private equity and venture capital. <sup>29</sup>
<b>CIS assets</b>	assets owned by the CIS (including cash), held on behalf of clients, which are either (i) assets which can be held in custody ("custodial assets"), whether by physical delivery to the custodian or by way of registration in book-entry form in the accounts of the CIS opened with the custodian, or (ii) other assets which by their nature cannot be held in custody ('non-custodial assets', e.g. derivative instruments) which are subject to the custodian's record-keeping obligation, i.e. the custodian must maintain and keep up-to-date a record of all the CIS' open positions. For the purposes of this paper, collateral (depending on the arrangement) may be included as CIS assets.
<b>Custodian</b>	includes a "trustee" or "depository", but not a sub-custodian. It is the entity which the responsible entity has entrusted with the safekeeping of the assets of the CIS. In some jurisdictions additional functions and duties are carried out by the custodian.
<b>Depository</b>	an entity which is responsible for the custody / safekeeping of the assets of a CIS, which could also be imposed with other additional oversight responsibilities of the investment manager of the CIS.
<b>Omnibus account</b>	holding of CIS assets in an account in the name of the custodian or its nominee, rather than in individual accounts for each underlying client.
<b>Responsible entity</b>	the entity or entities that has / have overall responsibility for the management and performance of the functions of the CIS, in particular, its compliance with the legal and regulatory framework in its respective jurisdiction. <sup>30</sup>

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<sup>27</sup> This paper may also be relevant for closed-ended collective investment schemes.

<sup>28</sup> Assets held with prime brokers (as an intermediary holding client assets) are covered in FR01/2014 *Recommendations Regarding the Protection of Client Assets*, IOSCO, January 2014, supra fn 7; <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD436.pdf>.

<sup>29</sup> While the primary focus of this paper is on publicly offered, open-ended CIS, the principles set out in this paper may be applied to a broader range of funds, including for example, non-publicly offered funds and hedge funds.

<sup>30</sup> The identification of the "responsible entity" may vary among jurisdictions and types of CIS. In some jurisdictions, the responsible entity could be the management company or the CIS itself. In others, the management company may play a role in carrying out the principles, but may be overseen by an independent body (e.g. board of directors, depository or custodian).

<b>Sub-custodian</b>	a third party entity appointed by another custodian typically by way of written agreement to safekeep CIS assets on behalf of that custodian.
<b>Safekeeping</b>	consists of either custody or record-keeping depending on the type of asset owned by the CIS (the CIS assets). For the purposes of this paper, safekeeping does not include services such as securities lending.
<b>Trustee</b>	the entity responsible for holding the CIS assets of a CIS on trust for the holder of the CIS, which is structured as a unit trust.

## APPENDIX C

### Principles regarding the Custody of Collective Investment Scheme Assets

- Principle 1: The regulatory regime should make appropriate provisions for the custodial arrangements of the CIS.
- Principle 2: CIS assets should be segregated from:
- the assets of the responsible entity, its related entities and other schemes;
  - the assets of the custodian / sub-custodian throughout the custody chain; and
  - the assets of other clients of the custodian throughout the custody chain (unless CIS assets are held in a permissible omnibus account).
- Principle 3: CIS assets should be entrusted to a third party custodian. In limited circumstances where the regulatory regime permits self-custody of CIS assets, additional safeguards should be put in place to ensure proper segregation and protection of CIS assets.
- Principle 4: The custodian should be functionally independent from the responsible entity.
- Principle 5: The responsible entity should seek to ensure that the custody arrangements in place are disclosed appropriately to investors in the CIS offering documents or otherwise made transparent to investors.
- Principle 6: The responsible entity should use appropriate care, skill and diligence when appointing a custodian to safekeep CIS assets.
- Principle 7: The responsible entity should at a minimum, consider a custodian's legal / regulatory status, financial resources and organisational capabilities during the due diligence process.
- Principle 8: The responsible entity should formally document its relationship with the custodian and the agreement should seek to include provisions about the scope of the custodian's responsibility and liability.
- Principle 9: Custody arrangements should be monitored on an ongoing basis for compliance with the terms of the custody agreement.

**APPENDIX D**  
**List of consultation questions**

1. Do you have views on the recent trends identified above and are there any other relevant market developments that should be taken into account in developing the principles regarding the custody of CIS assets?
2. What is your understanding of the role of custodians with respect to CIS assets?
3. What is your understanding of term “segregation” in relation to the safekeeping / custody of CIS assets?
4. Are there any special considerations or operational issues when holding non-standard assets such as physical commodities (e.g. gold bullion), financial derivative instruments, private placements, wine, arts etc.?
5. Should there be specific regulatory requirements for holding non-standard assets?
6. Should additional consideration be given to the treatment of derivative instruments, collateral arrangements, etc., and, more in particular, to the role of custodians in this regard? If yes, what special issues should be addressed?
7. To what extent or under what circumstances should administration / ancillary services form part of the role of a custodian? What are the benefits of having a custodian perform these services? Are there other ancillary services provided by custodians that are critical to the operation / function of a CIS?
8. Do you agree with the risks presented above? Are there any other keys risks associated with the custody of CIS assets?
9. Would there be merit in requiring the appointment of a single custodian in order to have certainty over who is ultimately responsible for safekeeping all CIS assets within a given CIS?
10. Should the custodian segregate assets, only between its own and CIS assets, or should it segregate assets through individual, separate accounts for each client?
11. Should the rule of segregation apply throughout the custody chain, i.e. through the different levels of delegation to sub-custodians?
12. Should the requirement of proper segregation be combined with an additional requirement of the recognition of the segregation at custodian or sub-custodian level in the event of the insolvency of the custodian or sub-custodian?
13. Are there any other conditions that should be considered when a CIS uses self-custody?
14. Do principles 1 to 5 adequately address the key risks associated with the safekeeping of CIS assets?
15. Are there any other selection criteria that may be relevant for the proper selection and appointment of a custodian?

16. Should additional consideration be given to the selection of specialist custodians? If so, what factors should a responsible entity take into account when selecting a specialist custodian?
17. What should be the scope of custodian's liability to the responsible entity as its client? What should be the scope of a sub-custodian's liability to the master custodian or responsible entity (if any)? And what are the appropriate limitations of this liability, if any?
18. Are there any other steps that the responsible entity can take to ensure proper monitoring of its custodian? Are there any other steps the custodian can take to ensure proper monitoring of sub-custodians?
19. Do principles 6 to 9 adequately address the key risks associated with the appointment and monitoring of CIS custodians and sub-custodians?

## Appendix E

### List of Working Group Members

<b>C5 Member jurisdiction</b>	<b>Organisation</b>
Australia	Australian Securities and Investments Commission (ASIC) - Co-Chair
Luxembourg	Commission de Surveillance du Secteur Financier (CSSF) - Co-Chair
Belgium	Financial Services and Markets Authority (FSMA)
Brazil	Brazilian Financial and Capital Markets Association (ANBIMA)
France	Autorité des Marchés Financiers (AMF) - Chair of C5
Germany	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFIN)
Hong Kong	Securities and Futures Commission (SFC)
Ireland	Central Bank of Ireland (CBI)
Italy	Commissione Nazionale per le Società e la Borsa (CONSOB)
Jersey	Jersey Financial Services Commission (JFSC)
Mexico	Comisión Nacional Bancaria y de Valores (CNBV)
Nigeria	Securities and Exchange Commission (SEC)
Romania	Autoritatea de Supraveghere Financiară (ASF).
Singapore	Monetary Authority of Singapore (MAS)
Spain	Comisión Nacional del Mercado de Valores (CNMV)
South Africa	Financial Services Board (FSB)
Switzerland	Swiss Financial Market Supervisory Authority (FINMA)
Turkey	Capital Markets Board (CMB)
United Kingdom	Financial Conduct Authority (FCA)
United States of America	Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC)