

**GUIDANCE ON CUSTODY ARRANGEMENTS FOR COLLECTIVE
INVESTMENT SCHEMES**

A Discussion Paper



IOSCO

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1 INTRODUCTION

Recent collapses of financial institutions have highlighted a number of hitherto largely unconsidered risks in the fund management industry regarding the custody of cash deposits and non-cash assets. In respect of all of the assets of a collective investment scheme (CIS),¹ the failure of a financial institution with responsibility for custody will have consequences for CIS regulators supervising CIS and fund management entities alike. This is particularly relevant in view of the increase in cross-border activity, which has exposed the need to review the rules in this area.

Following the Windsor Declaration of May 1995, IOSCO is committed to reviewing the adequacy of existing arrangements for the protection of customer assets from the financial difficulties of intermediaries. In July 1995 the Working Party was asked by the Technical Committee to consider the issues associated with ensuring that CIS assets are separately identified and held safe, considering, in particular:

- (a) placement of cash deposits (issues, inter alia, of application of risk limits, credit quality of custodian, deposit compensation schemes where applicable);
- (b) non-cash assets (issues, inter alia, of global custody, selection and qualifications of sub-custodians, custodian duties and responsibilities, and general systemic risk issues such as settlement and registration); and
- (c) use of affiliated custodians.

This paper seeks to provide guidance on the Principles for the Regulation of Collective Investment Schemes, which have been adopted by the IOSCO Technical Committee. This is achieved by identifying the principal risks associated with safe custody of cash deposits and non-cash assets, and by identifying the major considerations which are relevant to selection of custodians, contractual arrangements with custodians, and the monitoring of such arrangements. In considering these issues, the Working Party has taken into account the increasingly global nature of custodial services, and the need to address both domestic and foreign custody issues.

It is recognized that custodians² are subject to different regulations in different jurisdictions and that custodians have differing responsibilities. The guidance recognizes that there are a number of different regulatory approaches that are equally effective and does not seek to endorse one particular approach, nor is it intended to impose binding obligations upon any IOSCO member. Some jurisdictions already have detailed requirements that deal with custody, for whom this guidance will have little practical relevance. Notwithstanding this, the Working Party hopes that the guidance will help IOSCO members reach a common understanding of the principal

¹ ACIS≡ is defined in the Principles for the Regulation of Collective Investment Schemes as An open-ended collective investment scheme that issues redeemable units and invests primarily in transferable securities or money market instruments. For the purposes of the Principles, it excludes schemes investing in property / real estate, mortgages or venture capital≡.

² ACustodian≡ includes a depository.

risks associated with CIS custody, and a better understanding of various methods for structuring effective and safe custodial arrangements.

It is also noted that the custodian relationship may already be regulated by statute. This is reflected in the legal liability imposed on custodians in certain countries. This guidance may therefore only be relevant where the relationship with the custodian is contractual or not otherwise covered by statute.

2 FUNDAMENTAL PRINCIPLES OF CUSTODY

In developing this guidance, the Working Party has been mindful of IOSCO Principle 2 of APrinciples for the Regulation of Collective Investment Schemes[≡] and the Explanatory Memorandum which sets out the fundamental principles of custody as follows:

A2 Custodian, Depositary or Trustee

The regulatory regime must seek to protect the physical and legal integrity of the assets of a CIS by separation of the assets from the assets of management, its related entities and other schemes, as well as from the assets of the custodian itself.

2.1 Appointment of Custodian

A custodian must be appointed to hold the assets or be in a position to ensure their safekeeping. The liability of a custodian for any losses suffered by the investors as a result of its unjustifiable failure to perform its obligations or its improper performance of them cannot be affected by the fact that it has entrusted to a third party all or some of the assets in its safekeeping.

2.2 Financial and Other Resources of the Custodian

The regulatory regime must impose qualifying requirements on custodians in relation to their financial and other resources, which either rely on the status of the custodian (for example, as a bank) or its ability to carry out the tasks required as judged by the regulatory authority under an individual approval regime.

2.3 Independence

A custodian should be functionally independent of the operator of a CIS and must always act in the best interests of investors.[≡]

The Explanatory Memorandum to the Principles recognizes that:

Aan alternative to the appointment of a formal custodian, but which meets the objective of separation of assets, is the concept of self-custody. Under these arrangements, a CIS may maintain custody or otherwise have access to CIS assets if certain additional protective conditions are met.[≡]

The Explanatory Memorandum to the Principles also recognizes that:

Ain some jurisdictions, custodians are fiduciaries under the law and, as such, have direct responsibilities to investors. In other cases the custodian's responsibilities are under a contract with the operator.[≡]

3 RISKS ASSOCIATED WITH CUSTODY

There are numerous risks associated with the custody of CIS assets, depending upon the nature and extent of duties of the custodian. Effective containment and management of these risks is essential to ensuring safe custody of CIS assets. Different or increased risks may arise if some or all of the assets are held by a custodian in a different jurisdiction from that of the operator of the CIS.

Potential risks should be borne in mind when a custodian is selected as well as during the ongoing relationship. This section of the guidance seeks to identify the principal risks associated with custody and with provision of important services often performed by custodians.

As already noted in the introduction, some of the risks set out here, such as commingling of assets, are eliminated by statutory provisions.

1 Default of the Custodian

The assets of a CIS may be at risk if a custodian defaults. The principal risk is to the cash placed with the custodian, although, depending on the operation of local law, default may render the custodian incapable of carrying out its duties as a whole. Deposit risk is lessened in some countries by the existence of deposit compensation schemes but these are by no means universal nor do they necessarily cover the full amount of the loss.

If the assets of a CIS are not registered or otherwise held in a manner which identifies them from the custodian's own assets, it is also possible that a default may place the assets at risk.

2 Risk of Fraud or Theft by the Custodian

If a custodian or its employees act in a fraudulent manner, the assets of a CIS may be placed at risk.

3 Inadequate Record Keeping

Where a custodian fails to keep or retain records of the identity and status of investments held, or of their beneficial ownership, there is a risk to a CIS that title to its assets may be lost. This may arise as a result of systemic problems or because of a sudden increase in business or changes in personnel.

4 Poor Administration

A CIS may suffer loss where a custodian fails to act on a corporate event, account for dividends or interest income, collect tax refunds or report to the CIS or its investors accurately. Again this may be caused by operational or systems problems or by sudden changes to a custodian's operation.

5 *Mis-Use of Assets*

If a custodian improperly uses a CIS's assets for its own or another customer's purposes, for example, to settle another customer's transaction, there is a risk the CIS will lose title to the investments and may suffer loss.

6 *Counterparty Risk*

If a custodian delivers the assets of a CIS before receiving payment, or fails to obtain payment, there is a risk that the investor will lose title to the assets.

7 *Co-Mingling of Assets*

The assets belonging to a CIS may become co-mingled with the assets of other clients of the custodian if the custodian uses the services of a sub-custodian for the physical deposit of the CIS's and other clients' assets. In such circumstances assets will typically be held in an omnibus account. In order to ensure that the ownership of the CIS's and other clients' assets remains distinct, the custodian must ensure that its books and records legally segregate assets belonging to each of them.

8 *Lack of Care*

Where a custodian fails to exercise due care in selecting and monitoring a sub-custodian to hold CIS assets, the sub-custodian may fail to protect adequately the assets belonging to a CIS. The assets would therefore be exposed to all of the risks identified above.

9 *Country Risks*

In addition to risks associated with the performance of a custodian, there are market factors which may also put at risk the safe keeping of the assets of a CIS. A number of examples are considered below.

Social, economic and political uncertainty in a country may impact upon the safe keeping of assets. Sudden or unanticipated changes in government and economic policy may make it difficult to repatriate assets.

Some jurisdictions do not have centralized or properly controlled registration systems. If the registration of assets is canted out without proper control, there is a risk that title to the assets of a CIS may be lost.

An increasing number of countries have securities depositories, the use of which is legally required for the custody of certain securities issued and traded in those jurisdictions (Acompulsory depository \cong). A depository's use may be effectively compulsory because virtually all securities are maintained in the depository, the depository's involvement is required to transfer ownership of securities, or significant time and expense are associated with keeping securities outside the depository. The use of a compulsory depository could be considered part of the assessment of a country's prevailing custodial risks.

10 Regulatory Regime

If assets are to be held in other jurisdictions, consideration should be given to the effectiveness of the local regulatory regime. If the regulatory regime has few, or no, qualifying criteria for custodians, there may be additional risks to the assets of a CIS.

11 Enforcement of Judgements

In selecting a custodian from a particular jurisdiction, it should be determined whether judgements can be enforced effectively.

4 GUIDANCE ON CUSTODY OF CASH DEPOSITS AND NON-CASH ASSETS

The following paragraphs provide guidance on a number of matters relating to the custody of cash deposits and non-cash assets including the selection of a custodian, contractual arrangements with a custodian, monitoring of custodial arrangements and cash management alternatives.

A Selection of a Custodian

In selecting the most appropriate custodian, the diligence which is conducted should seek to establish that a custodian can perform its responsibilities effectively, so that the risks associated with safe custody are minimized. If a CIS wishes to manage assets in several jurisdictions, the selection process should ensure suitable sub-custodians are available to carry out the work locally. The guidance which is given below applies in respect of both domestic and foreign custody.

1 *Reputation*

The reputation of a custodian should be considered. This can be established in a number of ways. If a CIS has had previous dealings with the custodian these can be taken into account. References can be obtained, perhaps from existing customers. Credit ratings can be obtained which may provide further information. In addition, industry publications and surveys may provide relevant information.

2 *Expertise*

The selection process should ensure a custodian is able to carry out the duties which are assigned to him. Different types of CIS require differing custodial arrangements.

3 *Network*

If a custodian has a network in different jurisdictions, it may be able to provide a more integrated and effective custody service. This may be important to a CIS which manages assets in different jurisdictions, and would thus be a relevant consideration in the selection process.

4 *Prevailing Custodial Practices*

The selection process should take into account prevailing local practices. This includes the manner in which securities are maintained (e.g. whether they are held in physical or uncertificated form) and the physical protections which are available for certificated securities, (e.g. the use of vaults or other facilities). The method of keeping custodial records, (e.g. the use of computers, microfilm or paper records) and custodial communications systems (e.g. the use of electronic media, telex or telephone) and the quality of technology should also be taken into account.

If there are accepted practices in a jurisdiction it is possible that all custodians will operate on a similar basis. Custodians may, however, operate to differing standards within that regime. Where an operator of a CIS is not satisfied with a local practice, it may be necessary to negotiate additional protections for CIS assets, such as contractual protections or enhanced monitoring of custodial activity.

5 *Special Arrangements*

There may be special arrangements in place which should be considered at the time of selection. Such arrangements may include insurance or guarantees covering the loss of assets. Special procedures may also be in operation which depart from local practices and are designed to reduce custodial risks. For example, a CIS and a custodian may enter into contractual arrangements that supplement a country's prevailing custodial practices.

B **Contractual Arrangements with a Custodian**

A custodian should have a contract in writing with the operator of a CIS or a CIS itself, which should be reviewed periodically. The contract will set out the rights and responsibilities of the CIS and the custodian. Some countries, however, may have specific provisions at a statutory level. When negotiating an agreement, a CIS should consider what provisions are necessary to ensure protection for the CIS's assets. A number of examples of such provisions to be considered are listed below.

1 *Authority to Give Instructions*

An agreement should address the issue of which employees of the CIS or the operator are permitted to give instructions to the custodian. The types of acceptable instructions should also be specified. This will safeguard CIS assets and ensure the CIS manages effectively its day-to-day relationship with the custodian.

2 *Service Levels*

The agreement should specify the types of service which the custodian is required to perform. The standards should cover all the activities which the custodian is required to undertake. These may include agreeing on the manner in which transactions should be settled, the frequency of reconciliations and the reporting of problems to the CIS.

3 *Access*

If the operator of a CIS or the CIS's accountants require access to a custodian's internal procedures and records, the frequency and type of access should be specified in the agreement. Access may be required to conduct periodic inspections of the custodian's operation or to resolve particular problems which may have arisen in connection with the CIS.

4 *Indemnification*

The operator of a CIS and the custodian should agree the terms, if any, on which a CIS is to be indemnified in the event of loss. There may be loss to a CIS as a result of the custodian failing in its obligations under the agreement.

5 *Sub-Custodians*

A custodian may use the services of a sub-custodian in other jurisdictions. A written agreement should be in place between the custodian and the sub-custodian. The retention of a sub-custodian and the services to be provided should be specified in the contract. The contract should specify the custodian's liability for the actions of a delegate.

6 *Additional Protective Measures*

There are a number of additional measures which can be taken to ensure that the terms of the contract are clear and enforceable. These might include obtaining approval for the agreement from the operator of a CIS. The contract could be filed with, or available to, the relevant regulatory authority. The nature of the custodial arrangements and the identity of the custodian could be disclosed in the CIS's prospectus or other offering document.

7 *Disclosure of Risks*

In particular circumstances, the prospectus of a CIS may disclose risks associated with custody. Typically such disclosure would relate to market practices, as described above. A CIS may wish to ensure that such risks are explained in full to ensure that investors understand the true extent of any exposure.

C **Monitoring Custody Arrangements**

Custody arrangements, once established, should be monitored to an appropriate level to ensure the custodian is complying with the terms of the custody agreement and to identify any unanticipated problems that may arise. This may require the operator of a CIS to establish procedures to ensure compliance, having regard to the legal and regulatory environment to the circumstances and to the CIS's affairs. For example, some countries have specific responsibilities for custodians at a statutory level.

1 *Regulatory Regime*

The regulatory regime in place may monitor the activities of a custodian. While the presence of such oversight should provide comfort to the CIS, it should not be considered to relieve the CIS of its own responsibilities.

Alternatively, the regulatory regime may require a CIS to monitor the activities of a custodian. This may be particularly appropriate if some or all of the CIS's assets are held in a foreign country.

2 *Custody Agreement*

A CIS may describe the monitoring it proposes to undertake in its agreement with the custodian. For example, the agreement may require the custodian to report to the CIS any breaches of the agreement or breaches of regulatory rules. A CIS may also wish to receive notification of any material changes to the operation of the custodian.

The custody agreement may also prescribe the scope and frequency of periodic inspections of the custodian by the CIS in connection with the CIS's affairs. In addition, the agreement could require the custodian to provide the CIS with any reports produced by auditors and, where appropriate, regulatory authorities. Again this may assist the CIS in its own monitoring.

3 *Asset Reconciliations*

A CIS should receive asset reconciliations from the custodian which confirm the assets held by the custodian on behalf of the CIS. The frequency of reconciliations may be determined by the regulatory regime or, alternatively, by agreement between the CIS and the custodian.

4 *Periodic Inspections*

Depending upon the prudential environment in which the custodian operates, a CIS may wish to undertake periodic inspections of the custodian. The inspections might cover each of the activities undertaken by the custodian on behalf of the CIS. Areas to be examined might include accounting, administration and management of sub-custodial arrangements. Matters arising could be discussed with the custodian which would be required to follow up and resolve issues raised.

5 *Financial Review*

The CIS may wish to receive information periodically concerning the financial position of the custodian. This will enable the CIS to monitor the custodian's financial resources. Depending on the jurisdiction, such information could include reports and accounts, audit letters and financial statements prepared for regulatory authorities.

6 *Operational Concerns*

A CIS operator may wish to meet with personnel of the custodian on a periodic basis to discuss concerns arising out of the day-to-day operations of the CIS's custodial arrangements. Such meetings can provide a forum for resolving operational issues and may help the CIS operator identify larger concerns.

D Cash Management Alternatives

The following alternatives are set out in connection with the liquidity portion of the assets of a CIS. They can be utilized depending on each jurisdiction's own specific framework, as individual jurisdictions consider appropriate. The interrelationship between regulatory policy on CIS cash deposits and each country's own system of banking regulation means that common solutions are unlikely, although common principles can be identified. If a CIS places its liquidities on terms that are effectively guaranteed, any further regulation may be unnecessary.

1 Diversification

Where cash deposits are not fully protected, diversification of cash deposits and other monetary instruments should be considered. Diversification could be considered on the following basis:

- X that financial institution exposure should follow the level of diversification for securities of a single issuer (e.g. no more than of CIS assets should be exposed to a single financial institution); or
- X the minimum level for wholesale deposits (e.g. 1 000 000\$).

Portfolio diversification should take into account the overall credit exposure of a financial institution. This would include not only liquid assets but also monetary instruments issued by or techniques entered into by the same financial institution, including short-term notes, swaps and repurchase agreements.

Commentary:

Diversification of risk is an essential feature of CIS and the basis for probably the most common core requirement for investment of their assets, that CIS must have an adequate spread of investments. Despite this, few regulatory regimes mandate diversification of cash deposits. This gives rise to the anomalous situation where a CIS's exposure to the shares or debentures of a single issuer may not exceed, say, 10% of net asset value but as much as 50% (or more in some cases) of net asset value may be placed as the unsecured obligation of a single financial institution. This is notwithstanding the possibility that cash holdings may form part of the investment strategy of the CIS.

There are, however, some practical reasons for this lack of a diversification requirement. Cash in a securities portfolio is usually held for short-term, administrative or strategic purposes and a requirement to spread deposits across several banks could be both administratively inconvenient and costly. An inflexible diversification requirement can impose operational constraints, for example on the settlement process, out of proportion to the risk involved.

Nonetheless it would be prudent policy to consider diversification of cash held above a certain level, to the extent that it is not fully protected. As cash does not usually amount to more than a small percentage of a normally invested securities portfolio it may be that

most CIS would remain unaffected. Diversification is generally only an issue when a CIS has a high level of liquidity. In order that a CIS should not be unreasonably disadvantaged by any need to diversify, the diversification requirement should take into account administrative convenience and considerations of the best return, and an appropriate balance should be struck between the risk of default and operational efficiency.

To the extent cash deposits are at risk, the risk is present whether the bank is connected to the CIS manager or not. In the care of insolvency the issue is the credit quality of the financial institution with which the CIS has cash deposits, regardless of any affiliation with the manager. The public perception however appears to be that the use of a connected bank carries greater risks, perhaps because of the added potential for conflicts of interest.

2 Disclosure

The offering document of the CIS should consider explicitly disclosing how its uninvested cash would be placed. The CIS's periodic financial reports should also consider disclosing details of deposits held or cash management techniques applied.

Commentary:

The anomalous treatment of cash and securities holdings in a CIS commonly extends to disclosure, both in a CIS's offering document and financial reports. Aside from the name of the custodian, offering documents and financial reports generally disclose little or no information about liquidity arrangements. Typically, details of deposits are not disclosed.

Commentary:

The concerns of investors about the risks faced by the CIS in which they invest could be addressed by improved disclosure in this area. Investors can form their own assessment of the creditworthiness of the banks with which the CIS proposes to place deposits, or other policies applied, and address any concerns they may have about these of an affiliated entity. The need to disclose such information should also prompt CIS managers to consider the adequacy of their cash deposits standards and encourage the introduction of appropriate safeguards.

3 Cash Alternatives

Subject to the existence of appropriate markets and systems, CIS operators should consider the use of cash alternatives such as short-term government securities, commercial paper or repurchase agreements instead of holding unprotected cash in a portfolio.

Commentary:

In some jurisdictions, CIS typically invest their cash balances in short-term government securities, commercial paper and overnight / over-the-weekend repurchase agreements on government securities (repos). This puts the CIS in the position of holding securities, rather than being a depositor of the bank, and the usual rules on diversification of securities then apply. There may however need to be sufficient economies of scale for the CIS operator to justify the operational costs involved.

A repo is an agreement by the CIS to purchase certain securities, generally government securities, at one price and to sell these securities back to the counterparty at a different price on the repurchase date. The difference in the price reflects the rate of return on the repo and is typically based on the short-term interest rate.

Appropriate markets and regulations must however be in place before repos can be actively utilised. These should include the requirement that the counterparty itself present minimal credit risks. The custodian should receive for the CIS's account the, underlying securities of the repo, at a value equal to at least 100% of the ultimate repurchase price.