THE ROLE OF CUSTODY IN EUROPEAN ASSET MANAGEMENT

A Report by Oxford Economic Research Associates

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EUROPEAN ASSET MANAGEMENT ASSOCIATION

THE ROLE OF CUSTODY IN EUROPEAN ASSET MANAGEMENT

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This report is an independent research project commissioned by the European Asset Management Association (EAMA). The report has been written by Oxford Economic Research Associates (OXERA). The Foreword has been written by EAMA.

FOREWORD BY EAMA

Background

The European Asset Management Association ("EAMA") is pleased to publish the appended report by OXERA ("the 2002 EAMA Report"), which it commissioned as a follow-up to the previous study "Risk and Regulation in European Asset Management: Is there a role for Capital Requirements"[1] ("the 2001 EAMA Report").

The 2001 EAMA Report examined the nature and extent of operational risk in the European asset management industry, and whether prescribed minimum capital was the most appropriate regulatory response to such risk. This report also identified the principal operational risks in the asset management process as being "breach of client guidelines" and "misdealing"[2].

Amongst its other conclusions, the report stated[3]:

- *"A move towards raising capital requirements would be counterproductive. It would discourage the necessary development of markets in information and insurance, as well as having a direct impact on competition and entry. High capital requirements may place the European asset management industry at a competitive disadvantage in relation to other countries, most notably the USA. Unless capital requirements are set at unrealistically high levels, they could provide a false sense of security."*

- *"The market failures that occur in asset management are different from those that occur in banks. They arise from information asymmetries and fraud, not in general from systemic risks. They should be corrected directly by a combination of disclosure, auditing, enforcement, insurance, **custody and trustees (emphasis added)**, rather than indirectly through capital requirements."*

EAMA has noted with interest a similar study recently published in the USA by the Investment Company Institute[4], which concluded that:

- under the proposed Basel capital standards, *"independent investment management companies would likely have to hold higher levels of capital than currently, whereas universal banks on average would not, further disadvantaging independent investment management companies"*; and

- *"minimum capital requirements are not the appropriate method for regulating operational risk in investment management companies or, for that matter, banks"*, advocating private insurance and process regulation as preferable alternatives.

[1] Published by the European Asset Management Association in January 2001, and available on the EAMA website www.eama.org.
[2] Reproduced in Table 3.1 of the 2002 EAMA Report.
[3] At page 16.
[4] "The Regulation of Operational Risk in Investment Management Companies" by Charles W Calomiris and Richard J Herring, in Perspective, September 2002, available at www.ici.org/pdf/per08-02.pdf.

The 2002 EAMA Report builds on the findings of the 2001 EAMA Report by examining in more detail one of the alternative forms of investor protection, namely custodianship. In particular, it considers the extent to which custody arrangements in different European countries protect investors against the operational risks that arise in the asset management process.

EAMA's views

EAMA believes that the existence of a professional custodian adds to the overall level of protection afforded to investors. The extent of this protection may depend upon a variety of factors, including the specific duties of the custodian, any additional services provided, and the extent to which it is independent of the investment manager.

The role of the custodian is complex, and is not well understood outside the circle of practitioners who are professionally involved with custody and settlement activities. This study provides a useful service in making information about these activities, across a number of European countries, available to a wider audience, including regulators and investors.

The study also highlights the principal differences between the responsibilities of the trustee/depositary of UCITS, and those of the custodian of segregated account mandates. In respect of UCITS, the trustee/depositary is required by law to undertake additional responsibilities over and above the pure custodial function. In respect of mandates, the responsibilities of the custodian are determined principally by contract and can vary widely.

EAMA believes that this study will lead to greater awareness of the protections that may or may not be present when an investment manager or an investor enters into a contract for custody services. Some of these protections may be available only at an additional cost.

EAMA is not ready to draw firm conclusions from this study, but suggests that there may be scope to give greater clarity over risk-bearing in contracts for custody services, and to enable segregated mandate investors to make an informed choice of whether to contract for additional services and protections according to their priorities and needs.

EAMA is therefore keen to initiate open debate on a number of issues. In the remainder of this foreword EAMA highlights some of the findings and conclusions of the 2002 Report and invites readers to consider their implications. These implications do not only concern investment managers: some of them are matters for consideration by legislators, regulators, custodians and segregated mandate investors.

The role of custodians in investor protection

By comparing the role of the custodian of segregated account mandates with that of the trustee/depositary of UCITS, the research highlights the additional levels of investor protection that arise from the oversight responsibilities imposed by regulations upon the trustee/depositary.

The extent to which custody directly enhances the protection afforded to investors depends on the risk concerned. For example, the study concludes that "C*ustody provides no effective protection against misdealing, fraud or other operational failures, such as failures … to obtain* *best execution”*[5]. This may be because trade execution occurs before the custodian becomes involved in the processing of a transaction. But it also concludes that “*the main protection provided by custody relates to the risk of theft of securities”*, and that custody *“tends to protect against settlement errors and failures to collect all client entitlement*[6]*”*. It goes on to state that “*there is therefore scope for increasing the role of custody in protecting against operational risks. However, many custodians and asset managers do not see a need to revise custody arrangements to improve client protection, especially since this would increase custody fees, which clients might not be willing to pay”*[7].

There are three areas where the survey shows a clear disparity in the level of investor protection for mandates compared to retail funds [8]

- breach of client guidelines;
- mispricing; and
- incorrect management fee calculation.

These disparities may be attributed to the specific monitoring responsibilities for these matters imposed by regulation on trustees/depositaries.

The trustee/depositary plays an important role in preventing or detecting breaches of client guidelines (investment restrictions) for UCITS, where it has regulatory oversight responsibilities, though the custodian does not usually have comparable contractual obligations in respect of segregated account mandates.

At least two custodian respondents to the study’s survey pointed out that they already offer a service to monitor adherence to investment guidelines, though it is the client’s choice whether they utilise this product[9]. In this context the identity of the custodian’s client is relevant, that is, whether the custodian is appointed by the investor or by the investment manager, and whether they are prepared to pay an additional fee for the service. Independent post-trade monitoring may identify breaches of guidelines earlier or more frequently, but only pre-trade monitoring can prevent them occurring in the first place, and when they do arise the investment manager will normally be liable.

The implications of mispricing are very different for an open-ended investment fund, where there are multiple investors buying and selling at net asset value, and a mandate for a single client, where incorrect prices invalidate performance measurement, but do not have a direct financial impact on the investor.

The need for a trustee /depositary to validate the calculation of the investment management fee is greater when this it is borne by many investors in a fund, who are unable to check this for themselves, than with a mandate for a single investor who has both the necessary information and the means to do so.

[5] Section 2.3
[6] Section 2.3
[7] Section 2.3
[8] See Figures 5.1 and 5.2
[9] Section 5.6.1

Greater certainty

One of the key conclusions of the report, from a policy perspective, is the statement that *"It seems desirable that contracts should be made more transparent so that the bearer of risks is clearly identified. In addition, it is important that contracts offered enable risks to be shifted from asset manager to custodian where appropriate"*.[10]

The "*variation in survey responses suggests that there may well be some ambiguity and uncertainty regarding the responsibilities of custodians and their liability in the event of operational failures*"[11] A number of respondents saw a need to revise custody arrangements, including standardisation of custody contracts and a clearer definition and assignment of custodian responsibilities."[12] The report notes that *"contracts between client, asset manager and custodian seem to be incomplete, and it can be unclear where liability lies in the event of a loss. Where loss does arise, it is often resolved through negotiation between the parties.*"[13]

The variety of different situations whereby, for example, (a) the custodian can be appointed by the investment manager or by the investor, (b) the investment manager can in some countries also act as custodian, (c) ancillary functions, such as stocklending, can be undertaken either by the investment manager or by the custodian, can only increase this uncertainty.

A significant consequence of any lack of clarity over which party bears responsibility for particular operational risks is that both parties may then need to be prepared to bear that responsibility, whether by holding regulatory capital, having appropriate insurance, or otherwise. From an economic standpoint, this is clearly results in inefficient duplication of resources, so clarity should be welcomed.

On the other hand, it can be argued that greater clarity does not necessarily mean greater protection for investors. In the event of a failure for which strict liability is uncertain, there may be a greater willingness of all parties involved to participate in a negotiated resolution to ensure redress for the investor, than if some of the parties were able to disclaim all responsibility.

Legislators, regulators, the media and consumers increasingly look for redress whenever there has been loss to consumers, regardless of the moral hazard introduced by abandoning the precept of caveat emptor. Whilst some categories of risk may properly fall on the investor, it is clear that, absent risk transfer through insurance or compensation schemes, the impact of any operational risk events in the asset management process will fall on one or other of the participants, principally the asset manager or the custodian. No system of regulation can completely eliminate risks, and in some instances investors may be willing to bear certain risks themselves, rather than pay the costs associated when others do so. Investors should understand clearly the residual risks which they bear themselves, and what steps are available to them to mitigate or transfer these risks.

[10] Section 2.5
[11] Section 5.7
[12] Section 5.7
[13] Section 2.5

Improved clarity of responsibility of risk-bearing need not imply standardisation, whether forcibly imposed by regulatory intervention, or voluntarily adopted by development of market practice. The report implies the latter route, noting that the legal and regulatory requirements for mandates *"tend to be restricted to the proper safekeeping of assets"* and that *"additional responsibilities would have to be negotiated in the custody agreement between the parties rather than provided for as regulated minimum standards"*[14].

Single market

Global custody is a highly concentrated industry.[15] For UCITS, "*there are no significant cross-country differences in terms of the resulting level of investor protection since all countries have adopted the … UCITS Directive"*.[16] However, it is clear that the regulatory framework for custody differs across the E.U., particularly so far as mandates are concerned. This may hinder the ability of global custodians to provide services that meet the needs of pan-European asset management firms and their clients in the context of a single European market in financial services.

Systemic risk

Regulation is concerned with the management of systemic risk as well as with the protection of investors. Asset management firms do not pose systemic risks in the same way as banks and other financial services firms. This, as EAMA pointed out to the Basel Committee in May 2001, is because "*the asset management firm itself is not a counterparty to transactions*", and because "*clients of asset management firms employ a custodian to keep their assets legally and completely separate … and safe in the event of the asset management company becoming insolvent*".

Systemic risks do however arise from the highly concentrated nature of the global custody business[17]. The concentration of operational risks among a limited number of major global custodians, rather than spread across the larger numbers of local custodians, investment managers or investors could therefore lead to increased likelihood of systemic failure. This suggests that there may be potential conflicts between the regulatory objectives of containing systemic risk and of investor protection.

[14] Section 4.2.3
[15] Section 3.3
[16] Section 2.2
[17] See Table 3.3

Questions

EAMA believes that the study raises a number of interesting questions worthy of further debate, including the following:

1. **Should investors be offered a clearer choice of available services, so they can decide for themselves whether they wish to pay for additional types of protection?**

2. **Should the regulatory obligations on custodians of mandates be harmonised across the E.U. to a greater extent than at present?**

3. **Should there be greater clarity in custody contracts of the parties' respective responsibilities for operational and other risks, and if so in what particular areas?**

4. **How should the respective liabilities of investment managers and custodians be reflected in any regulatory capital requirements for operational risk, so as to avoid unnecessary duplication of capital?**

Next steps

EAMA intends to hold a series of meetings in major European cities early in 2003 for members, custodians, and other interested parties to discuss issues raised by this report. Further details will be published nearer the time. Anyone interested in participating in these meetings, or wishing to submit written responses to issues raised by this study, is invited to reply to the Secretary General, EAMA, 65 Kingsway, London WC2B 6TD, United Kingdom, or by email to info@eama.org .

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1. Introduction

In January 2001, the European Asset Management Association (EAMA) published the report, 'Risks and Regulation in European Asset Management: Is There a Role for Capital Requirements?'[1] This report examined the main operational risks that arise in the asset management process and various mechanisms available to mitigate the risks and protect investors. The particular focus of the report was the adequacy of regulatory capital requirements as an investor-protection mechanism, given the active debate at the European level and internationally in the context of the Basel proposals.

The report concluded that capital does not reduce the incidence of the main operational failures in asset management, and is an expensive regulatory response to the risk of potentially 'low-frequency, high-severity losses' that may arise, for example, from asset management errors, fraud or misappropriation of investor assets. It also argued that alternative forms of investor protection might be more appropriate. These alternatives include disclosure, auditing, compensation schemes, insurance, custodianship, conduct of business regulation, enforcement or combinations of these.

This report builds upon these findings and examines one of the alternative forms of investor protection, namely custodianship. The main aim of the analysis is to evaluate the extent to which custody arrangements in different European countries protect investors against operational risks that arise in the asset management process.

Custody arrangements may be governed either by contract or regulation, so the analysis encompasses both contractual and regulatory arrangements in the countries. The countries included in the analysis are France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Spain and the UK. The analysis considers both custody of assets that are managed on a segregated basis through direct mandates and depositary/trustee arrangements in the case of collective investment schemes (CIS).

The main research undertaken to conduct the analysis and write this report included the following.

- *Analysis of regulation of custody and asset management* – laws and regulations in each of the eight countries were analysed in order to determine the legal and regulatory framework for both mandates and CIS.

- *Survey of custodians and asset managers* – a survey was sent to custodians and asset managers in the eight countries to gather data about industry arrangements and the contractual functions and responsibilities of custodians.

[1] Franks, J., Mayer, C. and OXERA (2001), 'Risks and Regulation in European Asset Management: Is There a Role for Capital Requirements?', a report prepared for EAMA , January 2001. An electronic version of the report is available at http://www.eama.org.

- *Case-study analysis* – the analysis of regulatory and contractual custody arrangements was supplemented by four case studies in order to assess the level of investor protection provided by custodians.

The main research also involved a review of the literature, including industry reports, and conducting interviews with custodians, asset managers and representatives of asset management associations in various countries. In addition, the analysis benefited from regular feedback and comment obtained from members of the EAMA Advisory Panel for this project.

The report is structured as follows:

- chapter 2 presents a summary of the research findings and draws a number of policy conclusions;
- chapter 3 identifies the main operational risks in asset management and outlines the *potential* role of custody in mitigating the risks;
- chapter 4 examines the regulatory framework governing custody in the eight European countries considered in this report;
- chapter 5 presents the results of the survey conducted among custodians and asset managers; and
- chapter 6 describes the four case studies of failures in the asset management process and the role played by custodians.
- Appendix 1 contains a more detailed analysis of the regulatory framework in each of the eight countries, the findings of which are summarised in chapter 4;
- Appendices 2 and 3 reproduce the questionnaires that were sent to custodians and asset managers in order to conduct the survey analysis in chapter 5.

2. Summary of Findings and Policy Implications

This reports provides an analysis of both regulatory and contractual custody arrangements in European asset management, focusing on eight countries. It evaluates the role of custody in protecting investors against operational risks that arise in the asset management process. This chapter summarises the main research findings and discusses the main implications for policy:

- section 2.1 summarises the operational risks in the asset management process and the potential role custody can play in mitigating the risks;
- section 2.2 summarises the regulatory framework governing custody in the countries and any cross-country differences in regulations, as detailed in chapter 4 and Appendix 1;
- section 2.3 summarises the results of the survey conducted among custodians and asset managers;
- section 2.4 summarises the conclusions that emerge from the case study analysis;
- section 2.5 sets out the policy implications.

2.1 Asset management and the role of custody

- There are a number of operational risks that arise in the asset management process, the main ones being breaches of client guidelines, misdealings (eg, errors in execution), and errors in the valuation or pricing of funds under management. Although fraud does not occur frequently, it can create large losses if client funds are misappropriated by the asset manager and/or used to cover irregularities.

- Other operational risks include settlement errors, failure to obtain best execution, stock-lending failures, failures to respond to corporate actions or exercise voting rights, and incorrect management fee calculation.

- Risks may in principle be larger in CIS because investors experience a greater loss of control than when an asset manager offers services tailored to the needs of a particular investor. Also, retail investors who hold units in an investment fund may be less informed, and less able to monitor and exercise control over the manager than an institutional client whose portfolio is managed on a segregated basis.

- Custodianship of client assets is not a homogenous activity. In addition to safe-keeping, custodians may act as settlement agents and provide administrative services such as record-keeping, reporting, collecting dividends and other client entitlements, reclaiming tax or acting as intermediary in corporate actions, including the communication and exercise of voting rights. They may also be responsible for valuation and compliance monitoring and undertake other value-added services, such as stock-lending, performance measurement, cash management or brokerage.

- In performing their functions, custodians have a potential role in mitigating losses to investors from operational failures that arise in the asset management process, either *ex ante* (by reducing the incidence of failures) or *ex post* (by bearing losses and compensating the asset manager's clients in cases where failures occur).

- In light of the main operational risks in the asset management process, the monitoring function performed by custodians is particularly important. Where the custody agreement is extended to give the custodian an oversight role, clients may be protected against an asset manager's misuse of client assets and fraud. This role may be extended to include checking that the holding and disposing of assets is not inconsistent with client guidelines, monitoring the regularity of all dealings, checking the valuation of investment portfolios, and reporting to clients about the manager's performance.

- The role of custody in mitigating operational risks depends on the nature of the custodian's duties and responsibilities. These are determined by minimum standards imposed by law and regulation, as well as by commercial or contractual arrangements between custodians, asset managers and/or clients.

2.2 Regulatory framework

- In all countries, laws and regulations draw a clear distinction between custodianship in the case of mandated asset management and depositary/trustee arrangements in CIS.

- CIS can take various forms in the countries, but fund assets must generally be entrusted to a depositary (in the case of contractual or corporate funds) or trustee (in the case of Irish or UK unit trusts). The role of the depositary/trustee appears to be largely harmonised in Europe, at least if the fund is a retail one and qualifies as an undertaking for collective investments in transferable securities (UCITS).

- In addition to retail funds, countries such as Germany, France and Luxembourg have special institutional funds set up by one or more institutional investors. These funds have a depositary which, by statute, has similar obligations as the depositary of a retail fund. Although the description below focuses on retail funds, it also applies to such special institutional funds.

- In Ireland and the UK, depositaries/trustees must be from outside the group of the management company. In the other countries, common ownership structures are not ruled out, and fund assets are often placed with the group bank acting as depositary.

- In Germany, Italy and Luxembourg, depositaries must be credit institutions licensed to conduct deposit-taking business. In the other countries, non-bank institutions can be authorised to act as depositary or trustee, although banks dominate the market in practice.

- Depositaries/trustees are subject to prudential regulation in all countries, although there are cross-country differences in regulatory capital requirements. They are generally not required to take out special insurance for their custody services, but may be members of a deposit protection or guarantee scheme.

- In addition to safekeeping of fund assets, depositaries/trustees have wide-ranging responsibilities. There are no significant cross-country differences in terms of the resulting level of investor protection, since all countries have adopted the minimum standards imposed by the Council Directive No85/611/EEC of 1985 (UCITS Directive).

- Importantly, depositaries/trustees have a statutory monitoring and control function which refers to checking asset allocation, settlement of transactions, stock-lending, borrowing of the management company and other aspects specified in law and fund rules. They are also in charge of collecting fund income and handling corporate actions. Another important role arises in relation to net asset value (NAV) calculations which must be checked by depositaries/trustees or performed by them.

- The depositary/trustee can be held liable to the management company and unitholders for breaches of duty. However, liability is not absolute. According to the UCITS Directive, it arises where there has been an 'unjustifiable failure to perform obligations' or the 'improper performance of them'. As such, investment fund regulations provide important but not complete protection against investor losses arising from operational failures in the management process.

- In mandated asset management, there is a requirement in all countries that client assets must be held separately from firm assets. However, the UK and Ireland allow self-custody by the asset manager – ie, custody is provided in-house. Although possible and observed in the market, the majority of assets under management are held with third-party custodians. In the other countries, asset management firms must place client assets with an external custodian. Third-party custodianship does not rule out that client assets are held within the group. Group custody is possible in all countries, but more common in Continental Europe.

- Custodianship is a banking activity in Germany and Luxembourg, but not in other countries, where non-bank financial services firms can provide custody; although, in practice, the major custodians are banks or belong to banking groups.

- The only country considered in this report which imposes a specific capital requirement for the provision of custody services is France. Other countries do not have specific, or additional, capital requirements. Custodians are subject to the requirements that generally apply to the institution. These tend to vary between countries and by type of institution providing custody.

- There is generally no requirement for custodians to take out specific insurance for custody assets. In some countries, custodian banks must be members of a deposit protection or guarantee system.

- In contrast to CIS, there is a general lack of minimum regulatory standards for custody in mandated asset management, at least with respect to custodian responsibilities that extend beyond safekeeping. No country has regulations in place which impose monitoring responsibilities on the custodian.

- Thus, custody regulations differ significantly between mandated asset management and CIS in terms of the level of protection afforded to investors. The depositary/trustee of a CIS has a regular monitoring function and, by statute, owes a duty of care to investors (at least in the case of UCITS). In mandated asset management, minimum duties of care are significantly lower or non-existent; custodian responsibilities and duties are governed more by contract than by regulation.

2.3 Survey of custodians and asset managers

- The survey was conducted among a select sample of custodians and asset managers operating in the eight European countries in order to understand the nature of contractual custody agreements and the role played by custody in practice.

- The main custody function is safekeeping. Custody contracts often also contain a number of administrative functions, in particular record-keeping and accounting, settlement of transactions and collection of income receivable.

- Monitoring is a function and responsibility of the depositary/trustee of a retail investment fund. This contrasts with the custody arrangements in the case of mandates, which are mainly contractual and do not include an oversight role. The same distinction applies to valuation. While the depositary/trustee is responsible for checking the NAV in the case of retail funds, the custodian has no valuation function in the case of mandates.

- Custody provides good protection against some but not all operational risks in asset management. Importantly, protection is generally better under depositary/trustee arrangements that apply to retail funds than in the case of mandates.

- One of the most significant differences between retail funds and mandates relates to protection against breaches of client guidelines. This risk is mitigated by depositaries/trustees but not by custodians in the case of mandates. Under current contractual arrangements in mandated asset management, custodians cannot generally be held liable for failures to monitor the asset manager.

- The other main difference occurs with respect to mispricing of fund or client assets. While depositaries/trustees mitigate the risk of losses resulting from pricing errors (eg, by detecting incorrect NAV calculations), custody arrangements in the case of mandates generally afford little protection against this risk.

- Custody provides no effective protection against misdealing, fraud or other operational failures, such as failures by the asset manager to obtain best execution. This applies to both retail funds and mandates, although protection against these risks is somewhat better in the case of retail funds.

- The main protection provided by custody relates to the risk of theft of securities – ie, the custodian assumes a ‘bailment function’ and provides secure premises for client assets. Custody also tends to protect against settlement errors and failures to collect all client entitlements.

- Although custody has a role in client protection, the variation in survey responses suggests that there is some ambiguity and uncertainty regarding the responsibilities of custodians and their liability in the event of operational failures. Even in the case of retail funds, protection is not absolute.

- There is therefore scope for increasing the role of custody in protecting against operational risks. However, many custodians and asset managers do not see a need to revise custody arrangements to improve client protection, especially since this would increase custody fees, which clients might not be willing to pay.

- Proposals of firms which supported the need to revise custody arrangements include standardisation of custody contracts and a clearer definition and assignment of custodian responsibilities.

- Many firms perceive there to be regulatory barriers to entry into the custody market, and some would like to see harmonisation in custody regulations. Other barriers to entry are related to market structure and costs.

2.4 Case studies

- The four case studies consider operational risks in the asset management process and highlight some generic issues about the role played by custodians, depositaries and trustees in protecting investors against losses.

- The first case study illustrates how investors could be at risk if asset managers retain control over client assets. If client assets are strictly segregated and entrusted with an external custodian for safekeeping, there is less risk of misappropriation by the manager.

- The second case study considers the level of protection afforded by current depositary/trustee arrangements in the more regulated market for collective investment schemes. It suggests that, even where there is an independent depositary/trustee responsible for monitoring the management company, losses can arise due to failure to monitor effectively. It also raises concerns that the duty of care implied by regulations and the contract is unclear and ambiguous.

- The third case study also suggests that the role of the depositary/trustee in investor protection is more limited than might be expected, given existing investment fund regulations. In particular, although there is a statutory obligation to monitor the investment decisions of the management company, the monitoring duty of the depositary/trustee is not absolute and investors remain exposed to some operational risks in the management process.

- The fourth case study suggests that fraudulent activities by the asset manager can occur if there is a lack of monitoring by the custodian, or, indeed, if the custodian uses its facilities to assist the asset manager in defrauding investors. However, it also shows that custodians can be held liable for their actions or inactions. In this case, compensation for investors depends critically on the custodian being sufficiently well capitalised.

2.5 Policy implications

The findings of the research have a number of implications for policy and regulation of the European asset management industry.

- Custody provides protection against some operational risks in asset management, such as theft of client securities. However, it is not clear how much protection there is against other risks, especially those that may arise from fraud, breaches of client guidelines, pricing errors or misdealing. Thus, contracts between client, asset manager and custodian seem to be incomplete, and it can be unclear where liability lies in the event of loss. When loss does arise, it is often resolved through negotiation between the parties.

- It seems desirable that contracts should be made more transparent so that the bearer of the risks is clearly identified. In addition, it is important that the contracts offered enable risks to be shifted from asset manager to custodian where appropriate. Thus, asset managers or their clients would be clearly seen to have made a choice from a menu of contracts as to what risks are borne by whom.

- If risks are clearly defined and allocated, capital should not be required of the asset management firm when the risks are being borne by the custodian.

- For small to medium-sized asset management firms, it is desirable for many risks to be borne by custodians, which are often banks and have ‘deep pockets’.

- It is important that custodians are sufficiently well capitalised to cover the risks of failure. Regulatory capital requirements appear to be different depending upon who is custodian. For example, where the asset manager provides self-custody or where custody is outsourced to a non-bank institution, capital requirements appear significantly different from where a custodian bank is used. The case studies in chapter 6 show that, occasionally, there can be large losses in asset management. This suggests that capital requirements for custodians need to be reviewed, especially where the custodian is not a bank.

- Where custodian responsibilities and duties appear to be more comprehensive and well defined, as in UCITS, it is not clear from the case studies exactly what they imply and who bears the losses when failures occur. Current arrangements have worked because of negotiation and the deep pockets of one of the parties involved. However, it may not be wise to rely upon such arrangements in the future.

- Although the issue was not examined in any detail, there may be barriers to entry into the custody market in Europe due to economies of scale, but also national regulations. To the extent that a competitive market for custody has positive implications for the quality of services provided and resulting levels of investor protection, there may be benefits in reducing regulatory obstacles to market entry.

3. Asset Management and the Role of Custody

This chapter discusses the *potential* role of custody in the asset management process, focusing on the main operational risks that arise and how custody *can* mitigate these risks and protect investors against losses. The aim of the chapter is to outline the scope of the research project and highlight the main questions and issues that will be addressed in subsequent chapters.

The chapter is organised into the following sections:

- section 3.1 provides a short description of the nature of the asset management business;
- section 3.2 describes the main operational risks that may arise in the asset management process;
- section 3.3 defines the custody business and the services provided by custodians;
- section 3.4 outlines the potential role of custody as a risk-mitigation mechanism;
- section 3.5 relates custody to regulatory capital as an alternative protection mechanism;
- section 3.6 summarises the scope of the project and the main issues that will be addressed in the analysis of subsequent chapters.

3.1 The asset management business

Asset management is a major industry. In 2000, global assets under management are likely to have exceeded €33 trillion, more than double the 1995 total.[2] Asset managers offer a variety of services and act in a number of capacities for their clients. Clients include individuals, pension funds, corporates, insurance companies, banks, public agencies and charities.

At the one extreme, asset managers can provide advice to clients on portfolio allocations. Advice-only services do not give the manager discretion over the clients' funds. At the other extreme, asset managers may have full power of attorney to manage clients' portfolios at their discretion. Where discretion is granted, asset managers initiate investment transactions and oversee their subsequent execution. Thus, managers place orders with brokers or dealers for the sale and purchase of securities and then monitor the subsequent transactions through to settlement.

Unless the portfolios of investors are very large, asset managers offer their services by pooling small investors' monies to create large portfolios, and managing these large portfolios as collective investment schemes (CIS) (investment funds, unit trusts, etc). For their money, small investors receive units or other types of participation in these schemes. Pooling brings benefits to both investors and their managers. For the managers, it reduces management costs by standardising advice, eliminating personal requirements of particular investors, and increasing management fees by increasing the assets under management. For investors, investing in CIS reduces management expenses through economies of scale, and provides highly qualified and specialised services at a considerably lower price. In addition, investors obtain diversification of risks, which they might not be able to achieve on their own investments.

This research project considers both the management of CIS and segregated asset management under direct mandates.

[2] International Financial Services, London (2001), 'Fund Management Brief', September.

3.2 Operational risks in asset management

There are several classes of risk borne by an investor who employs an asset manager to manage, or advise on the management of, a portfolio. First, there is a risk that the manager's asset selection or recommendation results in an underperformance of the investor's portfolio. Second, the investor may be exposed to loss if the investment firm fails. However, this research project only considers a third class of risk, namely the operational risks that may arise in the asset management process. The main operational risks are summarised in Table 3.1.

In a recent survey conducted on behalf of EAMA,[3] European asset managers were asked to rank the risks, both in terms of frequency of occurrence and amount of possible losses. The ranking is reported in Table 3.1. It suggests that breaches of client guidelines and misdealings (eg, execution errors) present the largest possible risks, both in terms of frequency and impact. In terms of impact, these are followed by errors in pricing funds and fraudulent behaviour by employees of the asset manager, although fraud is not considered as likely to occur. Settlement errors rank highly in terms of frequency, but not impact. Other risks include counterparty failures, failures to collect income on clients' investments, and stock-lending failures.[4] Although not evaluated in the EAMA survey, risks also include the asset manager's failure to respond to corporate actions or exercise voting rights, and the charging of an inappropriate management fee.

[3] Franks, Mayer and OXERA (2001), op. cit.

[4] The survey also considered risks that arise when taking over new business, IT system failures, failures to reconcile assets, and financial insolvency of the asset manager. Apart from the ranking, the survey looked at actual cases of failure and losses incurred. These confirmed the pattern shown in Table 3.1.

Table 3.1: Operational risks in the asset management process

Type of failure	Description	Average ranking of risk: Impact (size of possible loss)	Average ranking of risk: Frequency of occurrence
Breach of client guidelines	Violation of the guidelines, as set out by the client in its contract with the asset manager	1	1
Misdealing	Generally unintentional errors – for example, in issuing orders to brokers	2	2
Mispricing	Incorrect pricing of the NAV of the fund	3	4
Fraud	Dishonest behaviour by employees or managers	4	8
Failure to best execute	Failure to obtain the best price for a client	5	6
Counterparty failure	This arises when a third party, such as a broker, becomes insolvent	6	7
Settlement errors	Mismatch between delivery of shares and receipt of funds, or vice versa	7	3
Failure to collect income receivable	Failure to claim dividends, tax refunds or other client entitlements	8	5
Stock-lending failure	This arises when a party that borrowed securities is unable to repay the amount, and collateral is insufficient to cover the total value of the securities lent	9	9
Failure to respond to corporate actions or exercise voting rights	For example, a client may hold stock in company A which is taken over by company B – failure to complete the relevant documentation may result in failure to transfer stock in company A into stock in company B	n/a	n/a
Incorrect management fee calculation	A client is charged an inappropriate investment management fee	n/a	n/a

Note: The average ranking is based on Franks, Mayer and OXERA (2001), op. cit., p. 80, where 1 is the highest risk and 9 is the lowest; n/a means that the report did not rank the risk.

Most of the risks in Table 3.1 do not apply to asset managers that provide advice-only services. Rather, they apply to firms that manage funds on a discretionary basis and execute transactions on behalf of clients.

Risks depend on a number of other factors. For example, they are likely to be larger in CIS because investors experience a greater loss of control than where an asset manager offers custom-made services that suit the needs of a particular investor. Also, a retail client who holds units in an investment fund may be less informed than an institutional client whose portfolio is managed on a segregated basis. An unsophisticated investor may also be less able to collect adequate information and monitor the manager effectively.

In terms of actual losses reported by the firms in the survey, most were below €1m, although there were occasional losses of, for example, €3m for breaches of client guidelines and €7m for misdealing. Interviews with firms indicated that losses from operational failures could be as much as €20m, although these are infrequent.

The two main questions addressed in this research project are:

- do current custody arrangements in European asset management protect investors from operational risks?
- could (and should) they be improved upon to enhance investor protection?

3.3 The custody business

Custodianship is not a homogeneous activity. Although the origins of the modern custody of investments may be traced to the traditional safe-custody service offered by banks in relation to the physical custody of assets, custodianship today often encompasses more than safekeeping. It includes a number of ancillary services that are related to the holding and protection of investments on behalf of investors.

In addition to safekeeping, custodians may act as settlement agents and provide administrative services, such as record-keeping, reporting, collecting and accounting for client entitlements such as dividends, or acting as intermediary in corporate actions, including the exercise of voting rights. Custodians may also be responsible for valuation, compliance monitoring, performance measurement, stock-lending, cash management, etc.

Broadly speaking, custody business may therefore be defined as the safekeeping of investment assets by parties other than the investor, and the provision of administrative services in relation to those assets. Table 3.2 contains a summary list of the main services offered by custodians. For the purpose of this report, administrative services have been grouped into four categories: administration; valuation; compliance monitoring; and other value-added services.

Table 3.2: Description of custodian functions

Function	Description
Safekeeping	
Safekeeping	Physical custody of clients' investments; maintenance of accounts with central securities depositories or other operators of book-entry systems, including members of such depositories; safekeeping through sub-custodians
Administration	
Recording and accounting	Recording individual rights in investments; handling documentation on purchases and sales of investments; accounting for payments and receipts against investment delivery
Settlement of transactions	Settling purchases and sales of investments
Client reporting	Provision of custody-related information to clients
Communicating and responding to corporate actions	Communicating rights issues, takeovers or other actions to asset managers/clients; responding to actions
Exercising voting rights	Notifying managers/clients of their voting rights and passing on their decisions; providing proxy voting services; exercising voting rights on behalf of fund managers/clients
Collection of income receivable	Collecting and distributing dividends or other client entitlements
Reclaiming tax refunds	Application of client entitlements to reduced rates of withholding tax at source and reclaiming withheld taxes
Valuation	
Pricing	Calculating the value of funds; checking accurate pricing by the manager
Compliance monitoring	
Checking breaches of client guidelines	Checking that transactions are in accordance with client guidelines (eg, that the manager uses their borrowing/investment powers in accordance with the law and contractual guidelines)
Checking reasonableness of execution	For example, checking that the best price is obtained for clients
Ensuring DVP	For example, checking that a transaction is paid for only upon receipt of the securities
Checking securities are only lent to secure parties	See 'securities lending' below
Other value-added services	
Securities lending	Lending securities under custody; checking that securities are only lent to secure counterparties; counterparty risk management; controlling and managing collateral
Risk management	Offering risk-management services to clients
Performance measurement	Measuring the performance of a portfolio, fund or manager against a range of standard benchmarks
Cash management	Managing client monies, in particular cash awaiting investment (eg, placing cash in short-term investment funds); converting currencies; settling trades in different currencies
Sub-custodian network management	Selecting and managing a network of custodians to allow transactions around the world
Brokerage	Executing transactions in securities and derivatives

Custodians have traditionally been banks. However, non-bank entities play a role. For example, central securities depositories (CSDs) hold securities and have been upgrading their services to include many administrative custody functions. CSDs are particularly important given the immobilisation and/or dematerialisation of securities. Where immobilised or dematerialised securities are kept in a CSD, the CSD will itself present one tier of custody. Since owners of securities will not usually be members of the CSD, they will interact with the CSD indirectly through an intermediary custodian, possibly a bank, that is a member of the CSD, thus creating a minimum of two tiers of custody. There may be many more custody tiers, with each intermediary custodian determining its own custody agreements.

In some countries, non-bank investment firms are permitted to undertake custody business for their clients. This applies to the UK and Ireland, for example, where securities brokers and investment managers can act as custodians. Similarly, in France and Italy, securities brokers may provide custody services. In other countries, such as Germany, banking law specifies that custody is a banking activity, and only deposit-taking credit institutions are authorised to hold and administer client assets. Cross-country differences with respect to eligible custodians are discussed in chapter 4.

Where investment managers have permission to act as custodian, they may provide custody 'in-house' for their clients rather than place assets with a third-party custodian. They still have to segregate client assets from firm assets,[5] but do retain control over the assets. Client assets are segregated, but not 'strictly' segregated, as they are not being held by an external custodian. Although some are in principle permitted to provide custody 'in-house', many investment managers or clients employ external custodians, mainly banks, to hold and administer assets. This outsourcing of custody activities has largely been driven by investment managers looking to control their cost base and focusing on their core activities, as well as by clients demanding customised solutions provided by specialist custodians.

In all countries, special provisions apply to the custody of assets held for CIS. Investment fund assets must be placed for safekeeping with an external custodian, which is appointed by the management company that operates and manages the fund. In the case of contractual or corporate investment funds, the custodian of fund assets is referred to as the 'depositary'. Unit trusts have an appointed 'trustee' responsible for the safekeeping of trust assets. The depositary's or trustee's responsibilities encompass more than safekeeping. As further discussed in chapter 4, the depositary or trustee is, by statute, responsible for several administrative functions, including valuation and compliance monitoring.

While custodians of CIS assets are appointed by the investment management company of a fund, this may or may not be the case with segregated portfolios that are managed through direct mandates. Asset managers may appoint a custodian on behalf of their clients, or the custodian may be directly appointed by the client. The custody agreement between asset manager and custodian, or between client and custodian, stipulates the nature of the custodian's duties and responsibilities. These may range from safekeeping only to any of the ancillary functions listed in Table 3.2.

[5] All regulators require separation of client assets, although an exception is made for investment management firms that are licensed as banks. Where mandates to manage assets are given to a bank, management and custodian function will be undertaken by the same banking entity. Asset management by banks is not considered in this report.

The responsibilities of custodians have been given a higher profile in recent years with the development of global custodians, which include large investment banks, securities houses and trust companies. It is estimated that as much as 70% of world-wide assets under custody will be consolidated among the top five players within the next three to five years.[6] These already account for over $26 trillion of funds, as shown in Table 3.3.

Table 3.3: Top ten global custody banks in 2001

	Worldwide assets ($ billion)		Worldwide assets ($ billion)
Bank of New York	6,409	ABN AMRO Mellon	2,771
JP Morgan	6,200	BNP Paribas	1,800
State Street	6,100	Northern Trust	1,700
Citibank N.A.	4,300	HSBC (Global Investor Services)	1,087
Deutsche Bank	3,661	Brown Brothers Harriman	904

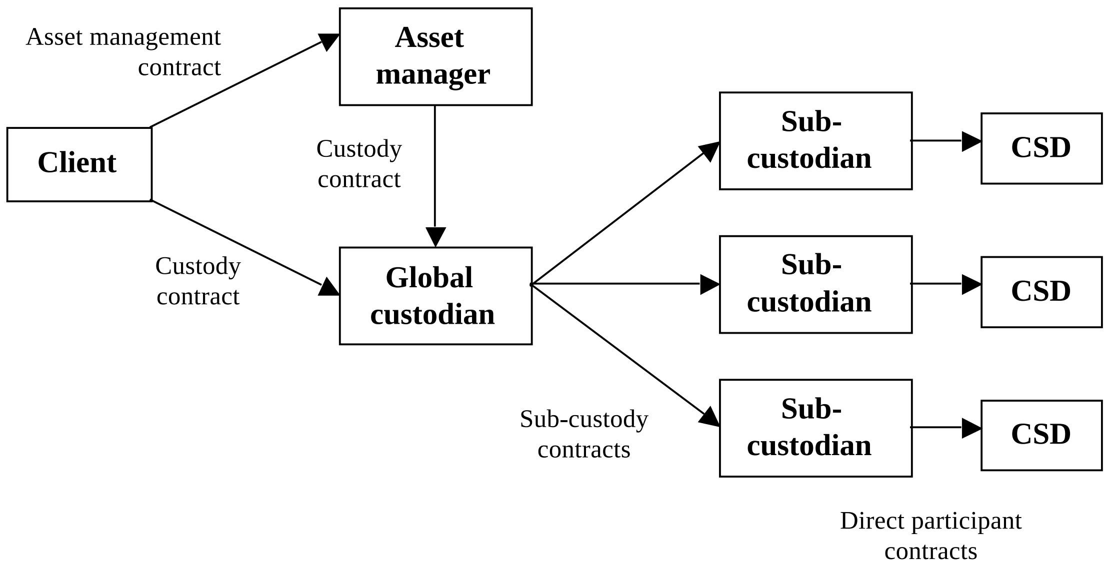
Source: globalcustody.net

Global custody is a service whereby a single custodian assumes responsibility for the custody of a client's portfolio of international securities and cash – ie, the custody service extends beyond the custodian's and client's home base. In respect of overseas assets, the global custodian may perform its obligations either directly through overseas branches, or through a network of sub-custodians who themselves provide custody in their own country and have access to the national CSDs. This is depicted in Figure 3.1 below.

The major clients of global custody have always been private pension funds. Indeed, global custody was first developed in the USA in response to the regulatory needs of pension funds, including the obligation to have independent custodians. Outside the pension market, clients include other entities with large international securities portfolios, such as insurance companies, banks and corporate treasury operations. These may employ a single global custodian for safekeeping and administration purposes at the same time as they work with one or more asset manager to select their investment portfolios. Instead of being directly appointed by investors, global custodians may also be appointed by asset managers on behalf of the investors, or they may operate under a tripartite agreement.

[6] International Financial Services, London (2001), op. cit.

Figure 3.1: Global custody



Source: Based on Thomas Murray Investor Services Ltd.

3.4 Custody as a risk-mitigation mechanism

Custody can mitigate the risks of losses to investors from operational failures in the asset management process in two ways:

- *ex ante*, by reducing the incidence of failures;
- *ex post*, by bearing losses in cases where failures occur.

The role of custody in mitigating risks depends on the nature of the custodian's duties and responsibilities in the asset management process. Although Table 3.2 lists a number of possible custody functions, actual custody arrangements may vary from contract to contract. They are also influenced by minimum standards imposed by law and regulation. Chapter 4 examines the regulatory framework governing custody in the different European countries. Chapter 5 provides survey evidence to assess current industry practice. However, at this stage, it is useful to consider the *potential* role of custody in mitigating risk and use this as a benchmark against which to measure the *actual* effectiveness of regulatory and contractual arrangements.

3.4.1 Segregation of client assets and third-party custody

Custody here is defined as third-party custody and will be distinguished from in-house custody, which is provided by the asset manager itself. Countries which allow the manager to provide custody services for its clients generally require the firm to segregate the assets belonging to clients from those belonging to the firm.[7] The purpose of asset segregation is that client funds are not used to meet the expenses of the firm. Also, if client assets were not segregated, a loss might arise if the firm defaulted. In such a case, the investor might simply become a creditor of the firm in receivership or liquidation. Segregation ensures that client assets do not contribute to settling other creditors' claims. As a result, the potential loss to the investor arising from financial failure is restricted to disruption and inconvenience – disruption arises from the freezing of assets during insolvency proceedings, leading to a loss of liquidity and associated opportunity costs in terms of returns forgone; once assets are unfrozen, investors incur costs in the form of inconvenience from transferring business to a new asset manager.

However, segregation does not necessarily mean that the asset manager ceases to have control over client accounts. Client assets held in a discretionary portfolio may still be moved at the manager's instigation. In the face of financial difficulties, the line between client and firm assets is easily blurred, and the prospect of firm failure provides incentives to use accessible client funds to support the firm's operation. There is a risk of misappropriation. This risk can be reduced if client assets are held by a third-party custodian – ie, if they are *strictly* segregated from the firm.

Third-party custody also protects client assets that are in the process of transmission. Dividend payments and other client entitlements are frequently credited to firm accounts before being allocated to client accounts. In the process, there is at least a temporary period of exposure, and losses may be incurred in the event of a firm default. If there is strict segregation, these funds will be credited directly to the custodian account.

Even in the absence of firm default, custody has a potentially important role, as it may reduce the operational risks that arise in the asset management process (see Table 3.1). The following discussion explains how the various functions and responsibilities of custodians listed (see Table 3.2) can be seen as risk-mitigation mechanisms.

3.4.2 Safekeeping, settlement and administration

At a minimum, the custodian provides secure premises for client assets, thereby reducing the risk of theft and accidental destruction of investments. Additional risk mitigation depends on whether the custodian's functions and responsibilities extend beyond basic safekeeping.

For example, custodians may be employed as settlement systems to facilitate the transfer of interests in investments. Where investment in an asset ordinarily involves the movement of the asset, if both transferor and transferee use the same custodian, the asset does not need to move. Transfer of ownership is simply recorded on the books of the custodian. By effecting transfer of ownership in this way, the CSD or other type of custodian offers a securities settlement service. This type of transfer in immobilised securities avoids the risk of loss or destruction of the investment in the process of moving it.

[7] The exception may be asset managers licensed as banks.

Moreover, the risk of loss upon a failed transfer is lowered because the reduction in time between payment and transfer should reduce the chance that one side suffers by performing its side of a transaction prior to receiving performance from the counterparty.

The custodian may also offer principal programmes and effectively take on settlement risk for clients. Some custodians offer 'contractual settlement', thereby ensuring delivery of an investment at a specified date, although they may retain the right to take back an entry to an investor's account after a certain period of time if the trade has not settled in the market.

On a smaller scale, custodians acting as settlement agents on behalf of asset managers and their clients may reduce settlement errors due to their expertise in dealing with CSDs, cash-payment systems, central counterparties and other third-party communication networks. They are also likely to have invested in systems and procedures which enable them to identify problem trades before settlement, either through their own edit-checking routines or as a result of pre-matching. For example, custodians may have implemented software warnings regarding free payment instructions which prevent automatic processing of transactions without additional release.

Custody arrangements may be such that the collection of client entitlements and the response to corporate actions become responsibilities of the custodian, reducing the potential for failures at the asset management level. Some global custodians have launched international tax information and reclaim systems. Others provide 'contractual income' arrangements and guarantee payable-date crediting of dividend income, although custodians may retain the right to cancel the entry to an account in the case of payment delays and failures by the issuer. Custodians also advertise automated corporate action tools which prompt timely reminders if a response to an impending action is necessary. As regards the exercise of voting rights, most global custodians offer proxy voting as a core service. In addition, they provide information about forthcoming annual general meetings, and may distribute and store detailed information about resolutions, voting guidelines and records.

Custodians may have control systems in place which identify large or risky trades and verify trade information. This may, for example, reveal any errors by asset managers when selecting securities or issuing orders to brokers. Errors may also be revealed through timely and accurate information provided by custodians about where assets are held, when trades have settled and when consideration is received. The asset manager's records of clients' individual rights to assets may thus be checked against custodian reports and verified. Moreover, a regular and independent reconciliation of client property may bring to light both unintentional errors and fraudulent activities of the asset manager.

3.4.3 Compliance monitoring and valuation

Although a custodian's systems and processes may reveal and thereby prevent failures at the asset management level, there may not be an explicit obligation to monitor the assets held in custody and the asset manager's actions in relation to those assets.

Table 3.1 suggested that the main operational risks in the asset management process are:

- *breach of client guidelines* – eg, the asset manager purchases securities not permitted under the contract between client and manager, or under law and regulations;
- *misdealing* – eg, unintentional errors by the asset manager in issuing orders to brokers;
- *mispricing* – incorrect valuation of fund or client assets;
- *fraud* – misappropriation of client assets by the asset management firms or its employees;
- *failure to best execute* – failure of the asset manager to obtain the best price in transactions for clients.

These risks are mitigated if custodians monitor the asset management process. That is, where the custody agreement is extended to give the custodian an oversight role, investors may be protected against an asset manager's misuse of client assets and fraud. This role includes checking that the holding and disposing of assets is not inconsistent with client guidelines and monitoring the regularity of all dealings. It may also extend to regular valuations of investment portfolios and reporting to clients about the manager's performance.

In light of the main operational risks in the asset management process, subsequent chapters pay particular attention to examining the monitoring and oversight functions performed by custodians, under both regulatory and contractual arrangements.

3.4.4 *Ex post* protection

The above discussion has provided a number of examples of how external custody can mitigate operational risks *ex ante*. However, the degree of investor protection afforded by custody arrangements does not only depend on the custodian's ability to reduce the incidence of operational failures, but also on its liability to compensate investors if problems arise.

The custodian will be liable where investor losses are attributable to its breach of duty. This duty is defined in the contractual agreement concluded between the custodian and the client or asset manager, although minimum standards of care may be specified in law and regulations.

For example, suppose the asset manager uses client funds to purchase securities that violate the investment guidelines, as set out by clients in their contract with the asset manager. If the custodian has no obligation to check the actions of the asset manager, it may release client funds to settle the purchase and record the investment in the client's account. The custodian's controls and systems and any reports prepared for the client may reveal the breach of guidelines, but it is not likely that the custodian could be held liable for any losses (eg, the price of the unauthorised securities might have fallen since the purchase).

Similarly, if the asset manager instructs the custodian to deliver client assets, say without collateral to some third party, the custodian may do so as long as this action is consistent with the custodian contract. If problems arise and the counterparty fails, it is unlikely that the custodian could be held liable for any investor losses. The matter would be different if the custodian were responsible for checking that stock is only lent to secure counterparties and that sufficient collateral exists.

As a final example, consider the case where an asset manager tries to manipulate portfolios to present a more successful picture of a particular fund's performance, say by selling unwanted stocks to other clients or transferring securities between client portfolios. The custodian's control systems may well identify such irregularities and thereby prevent investor losses from occurring. However, the custodian might not be held liable for any failure to do so, unless it owed an explicit duty of care to the asset manager's clients. In the absence of any contractual liability, the protection afforded to investors would then depend on the willingness of the custodian to preserve its reputation.

3.5 Custody risk

As with any process, the use of custodians entails its own risks. There are the inevitable risks that the investment could be destroyed, lost or misapplied by the custodian. The custodian may also be negligent in the care exercised in guarding the record-keeping of the investments. There may be a legal risk in the use of custodians where the relationship between client and custodian is not recognised by law, the consequence being that the investment is characterised as an asset of the custodian that would be available to its creditors in the event of its insolvency. The client would become a creditor of the custodian rather than an owner of the custody assets.

While external custody may limit investor exposure to failures in the asset management process, it can increase risks that result from failures at the custodian level. Effectively, the transfer of control over client property in the hands of custodians may shift the risk of potential investor losses from a large number of asset managers to a small number of custodians.

Also, custody is often constituted in tiers of holding. Securities are typically dematerialised and immobilised in a CSD, which constitutes one tier of holding. Where overseas securities are involved, the investor's custodian may operate through a network of sub-custodians or local agents which have access to the overseas CSD, thus introducing another tier of custody (see Figure 3.1). Each tier potentially introduces a number of risk exposures to investors. Thomas Murray Investor Services Ltd (2001) usefully classifies the risks as shown in Table 3.4.[8]

[8] See Thomas Murray Investor Services Ltd (2001), Depository Review and Risk Evaluation Service, for an explanation and country-specific examination of risks.

Table 3.4: Custody and CSD risks

Risk	Description
At the (sub-)custodian level	
Asset-safety risk	The risk that, in the event of default by either the custodian or the sub-custodian, client assets are treated as being part of the assets of the defaulting entity, rather than belonging to clients
Asset-servicing risk	The risk of poor client-asset servicing – for example, in relation to carrying out client instructions or providing information
Financial risk	The financial viability and stability of the custodian or sub-custodian, and its ability to support long-term investment in its business and withstand operational losses
Operational risk	The risk of deficiencies in information systems or internal controls, human failures or management errors
At the CSD level	
Asset-commitment risk	The risk concerning the period of time from when control of securities or cash is given up until receipt of countervalue
Liquidity risk	The risk that insufficient securities or funds are available to meet commitments
Counterparty risk	The risk that a counterparty will not settle its obligations for full value at any time
Financial risk	The ability of the CSD to operate as a financially viable company
Operational risk	The risk that deficiencies in information or internal controls, human errors or management failures will result in losses
CSD-on-CSD risk	The risk that a CSD is taking when linking to another CSD

Source: Thomas Murray Investor Services Ltd (2001).

However, this study does not address custody, sub-custody or CSD risks as such. Neither does it focus on whether and how custody activities should be regulated to enhance the protection of client assets. Instead, the aim is to evaluate the extent to which custody mitigates the risk of operational failures at the asset management level.

3.6 Custody and the interaction with regulatory capital

The assessment of the role of custody in protecting investors against losses due to failures in the asset management process has direct implications for the discussion surrounding the need for regulatory capital requirements.

As discussed in the EAMA report,[9] the economic rationale for imposing capital requirements on financial institutions is to ensure stability of the financial system and provide a capital buffer in order to prevent systemic failure. Unlike in the banking sector, risks in asset management are not systemic in nature, provided that client assets are segregated from own-positions of the legal entity that manages investor funds. If there is segregation of client

[9] Franks, Mayer and OXERA (2001), op. cit.

balances and own-positions, the asset management firm becomes a pure investment service provider.

The operational risks listed in Table 3.1 are unrelated to systemic risks, which raises a question as to the rationale for capital requirements. Capital does not reduce the incidence of operational failures, and is an expensive regulatory response to the risk of potentially 'low-frequency, high-severity' losses due to fraud, physical loss of securities or asset management errors. As discussed above, particular forms of external custody can potentially play an important role in reducing the incidence of operational failures and mitigate risks in the asset management process.

The research project therefore indirectly considers the extent to which custody does, and should, reduce the need of a capital charge for operational risks on European asset managers.

3.7 Summary of issues

This chapter has summarised the main operational risks that arise in the asset management process and the *potential* role of custody in mitigating these risks and protecting investors against losses. The main objective of the research project is to evaluate whether *actual* custody arrangements in European asset management afford adequate protection, and, if failing to do so, whether they should be improved, through changes in practice, legislation and regulation. In pursuing the research objective, a number of issues will have to be addressed.

- The research must examine the minimum standards imposed by the legal and regulatory frameworks governing custody in Europe and identify any cross-country differences.

- Since the custodian's duties and responsibilities depend critically on the nature of the custody contract, the research must also consider the commercial arrangements in different countries and look into the main functions performed by custodians and their contractual liability.

- Where the custodian is appointed by the asset manager, it is not clear whether investors can sue on the basis of a custody agreement to which they are not a party. The research must therefore examine the relationship between custodian, asset manager and client, and the extent to which this protects the client against operational risks.

- In light of the main operational risks in the asset management process, particular attention must be paid to the oversight and supervision responsibilities of custodians. The question is whether, under current regulatory and contractual arrangements, custodians are required to perform a monitoring function.

- A distinction has already been made between in-house and third-party custody, or between segregation and 'strict' segregation of client assets. The latter is likely to provide a higher level of protection. A related issue is the appointment of a custodian that is a separate legal entity, but belongs to the same group as the asset manager. The use of group custodians may raise concerns about the independence of the custodian, as well as about the possibility that any losses may not be disclosed.

- The adequacy of custody arrangements will depend on the identity of the investor. In contrast to professional investors, small private investors do not have the incentives, or are not able, to collect adequate information to make informed decisions, or may not appreciate the risks involved. Neither may they be able to bargain for appropriate protection. Sophisticated investors, on the other hand, are more likely to be aware of any risks and may be in a better position to bargain for a custody contract that suits them.

- In this respect, the research must consider the level of protection afforded under custody arrangements in both segregated asset management and CIS (in particular, retail investment funds), and must distinguish between them.
- The degree of competition in the custody market is likely to have implications not only for custodian fees but also for the services provided, and hence for the level of protection afforded to investors. In particular, the negotiated custody contract may depend on the relative bargaining power of the custodian in relation to its clients. Competition may be adversely affected, for example, by barriers to entry due to economies of scale in the provision of custody, or by regulatory obstacles.

4. Regulatory Framework

This chapter summarises the main features of the regulatory framework governing custody in eight European countries: France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Spain and the UK. The summary of laws and regulations is drawn from the country-specific descriptions contained in Appendix 1.

A detailed legal analysis of the laws and regulations in each of the countries is beyond the scope of this report. Instead, this chapter provides summary information and a cross-country comparison by addressing the following main questions.

- Are client assets segregated from the assets of the manager? Are they ‘strictly’ segregated – ie, held by a third-party custodian? Can the custodian be in the same group as the manager?
- Which types of entity can act as custodian of assets? Is custody business restricted to credit institutions?
- What are the capital requirements for custodians?
- Are custodians required to insure their custody assets?
- What are the main regulatory functions and responsibilities of custodians?
- In particular, to what extent are custodians required to perform a monitoring function?

In all countries, a clear distinction must be drawn between custodianship in the case of mandated asset management and that in the case of CIS. Section 4.1 begins with a summary of arrangements in collective schemes, focusing on retail funds (UCITS), which are subject to considerable regulation both at national and European level. It also briefly considers other investment funds in the countries, such as special institutional funds. Section 4.2 considers mandated asset management where laws and regulations on the role and responsibilities of custodians are significantly weaker. Section 4.3 provides a summary and conclusion.

4.1 Custody in collective investment schemes

There are three basic legal structures of investment funds in Europe.

- The *contractual* form – the fund is a contract under which the investment manager invests funds on behalf of investors.
- The *corporate* form – the fund is a separate corporate entity and the investors are shareholders.
- The *trust* form – the fund is organised as a ‘trust’, a concept of Anglo-Saxon law.

Of the countries surveyed, France, Italy, Luxembourg, the Netherlands and Spain have both corporate and contractual forms of investment funds, while Germany only has the contractual form. Ireland and the UK have traditionally used the trust form, but now have authorised funds in corporate form.[10]

[10] The investment fund structure in these and other countries is surveyed in OECD (2001), ‘Governance Systems for Collective Investment Schemes in OECD Countries’, Financial Affairs Division, Occasional Paper No.1.

No matter under which legal structure the funds operate, in all countries fund assets must be segregated and held in custody by a third party. In addition to safekeeping, the third party is given an important oversight role. In corporate or contractual funds, there is an independent depositary (who may have some ownership linkages to the fund operator) that exercises significant control and monitoring. In the case of unit trusts, the checking functions are undertaken by an independent trustee (although the trustee may, in some cases, be a separate legal entity from the custodian that provides safekeeping for the assets).

The role of the custodian/depositary/trustee of an investment fund is very similar across different European countries, at least if the fund qualifies as a UCITS. The Council Directive No. 85/611/EEC of 1985 (UCITS Directive) sets out minimum standards for the custody of funds that seek to qualify as UCITS.

This section summarises custody arrangements in the case of CIS and the obligations that arise under the UCITS Directive. It also briefly considers custody arrangements in other investment funds that are not marketed to the public and do not qualify as UCITS, such as special institutional funds. A more detailed description of the relevant laws and regulations in each country is provided in Appendix 1.

4.1.1 Investment funds in contractual and corporate form

The contractual form of investment funds is known under various names, such as the ‘fonds commun de placement’ (FCP) in France and Luxembourg, the ‘fondi communi’ in Italy, and the ‘Publikumsfonds’ or ‘Specialfonds’ in Germany. Investors hold joint-ownership interests in the assets of the fund and engage in a contract under which the investment management company agrees to execute a particular investment strategy as spelled out in the prospectus and other offering documents. Although contractual funds are not free-standing corporations, they are legally distinct from the investment management company.

Examples of corporate funds include the ‘sociétés d’investissement à capital variable’ (SICAVs) in France, Italy or Luxembourg or the ‘open-ended investment companies (OEICs)’ in the UK or Ireland. These investment companies are special purpose companies whose exclusive object it is to invest its funds in securities in order to spread investment risks and to ensure for its shareholders the benefit of the management of their assets.

Both types of funds have an independent depositary that is appointed by the investment management company and must be approved by the authorities.

Although laws and regulations in the countries require that the depositary must be a separate legal entity and act independently, it may be related to the investment management company through ownership linkages. For example, it is common in France, Germany, Italy and Spain that the chosen depositary belongs to the same group as the management company. In many cases, it is the parent bank. Of the countries surveyed, only the UK and Ireland require the depositary to be outside the group.

In all countries, the role of the depositary extends beyond the safekeeping of fund assets, effecting payments and performing back office work. It includes wide-ranging monitoring responsibilities. These responsibilities typically involve verifying portfolio holdings and determining that transactions are effected at appropriate prices and that investment limits and prohibitions are observed. The depositary is also in charge of checking that the NAV of the fund is calculated according to the law and fund rules. In certain cases, it is the depositary's duty to assert claims of investors against the investment manager where the duty of the investment manager to investors has been breached. However, it is generally not the responsibility of the depositary to evaluate the performance of the manager or changes in investment objectives and related policies of the fund.

An exception is granted under Luxembourg and Dutch fund law, where an investment company can waive the requirement to have a depositary within the meaning of the fund law if it markets its units through a stock exchange and satisfies a number of requirements. In particular, the regulatory authorities must be satisfied that investors are awarded protection similar to that of a fund with an independent depositary. The fund and its value must also be regularly assessed by an external auditor. However, most if not all investment companies in Luxembourg do not make use of this exception and have a depositary.

Table 4.1 provides a summary of fund structure and custody regulation in the different countries.

4.1.2 Investment funds with trust structure

Collective investment schemes in trust form are usually referred to as unit trusts. The trust is a special form found in Anglo-Saxon law under which assets are owned by the trust and invested on behalf of the beneficiary. A unit trust scheme is formed on the basis of a legal trust with both a trustee and a fund manager responsible for its operation. The manager is generally given the responsibility of managing the portfolio of the fund while the trustee exercises surveillance to ensure that all regulations are observed. The trust form is observed in Ireland and the UK.

In addition to the relevant fund law and regulations, the trustee has obligations arising from trust law. In particular, it owes a *fiduciary duty* to the unitholders and acts to safeguard their interest.

However, from a practical point of view, the trustee's functions are very similar to those of the depositary of a contractual or corporate fund. The trustee verifies that investment and borrowing limits are observed and that all income is received by the fund. The trustee also notes all breaches of compliance and requires corrective action. When such action is not taken, the trustee contacts the board of the investment manager or the regulatory authorities. In addition to their core surveillance work, some trustees do the NAV calculation, maintain registers, and perform periodic tests of valuations.

Although it is possible that trustee and custodian of assets are separate entities, it is often the case that the trustee also undertakes the safekeeping of fund assets. In any case, the trustee remains responsible for safekeeping. Fund assets are held in the name of the trustee, with the unitholders being the beneficiary owners.

The trustee must be approved and registered as a trust company by the regulatory authorities, which must certify that it has the required expertise and is financially sound. In contrast to the depositaries of the contractual and corporate funds in Continental Europe, the trustee of a UK and Irish unit trust must be entirely independent of the unit trust manager. That is, it must not be related through a common shareholding structure to the manager. Most trustees are themselves banks or wholly owned subsidiaries of banks, but the same bank cannot have subsidiaries that act as trustee and engage in asset management for the same fund.

While unit trusts have been the traditional form of CIS in the UK and Ireland, in both countries the corporate structure (OEIC) is gaining increasing importance. This is mainly due to integration with the European fund market. In Ireland, which has become an important offshore centre for investment funds, most UCITS that are offered to European investors are in corporate form. In the UK, OEICs were introduced in the 1990s, partly because they would be easier to understand for international investors than unit trusts. Many existing unit trusts are being converted to OEICs and marketed both domestically and internationally.

Table 4.1: Collective investment schemes in Europe

Country	Type of CIS	Regulator of CIS	In charge of safekeeping	Oversight responsibilities	Satisfying UCITS Directive?	Depositary/trustee must be bank?	Depositary/trustee outside the group of IM firm?
France	Investment company, contractual fund	Commission des Opérations de Bourse (COB)	Depositary	Depositary	Yes	Not required	Not required
Germany	Contractual fund	Federal Agency for Financial Market Supervision (BAFin)	Depositary	Depositary (Depotbank)	Yes	Yes	Not required
Ireland	Investment company, trust	Central Bank of Ireland	Depositary, custodian/trustee [2]	Depositary, trustee	Yes	Not required	Yes
Italy	Investment company, contractual fund	Bank of Italy, Consob	Depositary	Depositary	Yes	Yes	Not required
Luxembourg	Investment company, contractual fund	Commission de Surveillance du Secteur Financier (CSSF)	Depositary [1]	Depositary [1]	Yes	Yes	Not required
Netherlands	Investment company, contractual fund	Dutch Central Bank	Depositary [1]	Depositary [1]	Yes	Not required	Not required
Spain	Investment company, contractual fund	Comisión Nacional del Mercado de Valores (CNMV)	Depositary	Depositary	Yes	Not required	Not required
UK	Investment company, trust	Financial Services Authority (FSA)	Depositary, custodian/trustee [2]	Depositary, trustee	Yes	Not required	Yes

Notes: [1] Under Luxembourg and Dutch CIS law, investment companies may not need to have a depositary if at least 80% of all units are marketed through one or more stock exchanges and certain other conditions are met. In particular, an independent auditor must, at least twice a month, check the calculation of the NAV and make sure that assets are invested in accordance with law and rules. However, most, if not all, investment companies in Luxembourg nevertheless do have a depositary. [2] It is often, but not always, the case that the custodian and trustee functions are performed by the same entity.

4.1.3 The UCITS Directive

In 1985, the EC Council adopted the UCITS Directive, aimed to raise standards and also to promote cross-border business in CIS among Member States by harmonisation of products. UCITS authorised in their home state do not have to be authorised again in the member states in which they are marketed, but only have to ensure prior notification to the authorities in the targeted Member State. The Directive has also brought a substantial amount of convergence in relation to custodianship of fund assets across Europe.

The UCITS Directive has not been the only international effort undertaken to develop custody standards in CIS business. In 1971, the OECD Committee on Financial Markets issued 'Standard Rules for the Operations of Institutions for Collective Investment in Securities', which allowed the regulatory authorities to approve several arrangements for custodians. In 1994, IOSCO issued its 'Principles for the Regulation of CIS' and specifically stated that supervision of the fund operator should seek to ensure that assets of a CIS are properly held in safekeeping and segregated from assets of management and other entities.[11]

However, the custody rules in the UCITS Directive go beyond requiring a custodian. They require the fund to have a depositary (or trustee) with specific responsibilities for ensuring that the investment fund is run in accordance with the relevant rules. The regulations, which have been adopted by the Member States, can be usefully classified as:

- appointment of independent depositary (Articles 7, 10, 14 and 17);
- eligibility standards (Articles 8 and 15);
- standards of conduct and responsibilities (Article 7 and 14);
- liability for any losses suffered by investors (Articles 7, 9, 14 and 16).

Appointment of independent depositary

The unit trust's or investment company's assets must be entrusted to a depositary (or trustee) for safekeeping. The depositary must be a legal entity that is separate from the management company of the unit trust or the investment company. It must act independently and solely in the interest of the unitholders.

The directive does, however, allow an exception to the requirement of an independent depositary within the meaning of the directive. In the case of investment companies, it allows Member States to decide that investment companies, which market their units through one or more stock exchanges on which their units are admitted to official listing, may not be required to have a depositary. A Member State can avail itself of the option only if it considers that unitholders have protection equivalent to that of unitholders in UCITS which have depositaries.[12]

[11] The OECD and IOSCO principles are summarised in OECD (2001), op. cit.

[12] In particular, such companies must:

- in the absence of provision in law, state in their instruments of incorporation the methods of calculating the NAVs of their units;

The cross-country analysis suggests that only Luxembourg and the Netherlands have incorporated this exemption into their law. However, in practice, investment companies in Luxembourg do not generally make use of it. In all other countries, CIS must have an independent depositary with significant safekeeping and oversight responsibilities.

As noted above, countries have interpreted the term ‘independence’ differently. While independence always implies a legal entity that is separate from the firm managing the funds, it does not necessarily rule out ownership linkages. In the UK and Ireland, unit trust trustees must be from outside the group of the unit trust manager; the same is true for depositaries in the case of OEICs. In the other countries, common ownership structures are not ruled out. For example, in Germany, France, Italy and Spain, it is common that fund assets are placed with a group bank acting as depositary.

Irrespective of whether or not ownership links are permitted, all countries require that the depositary (and the manager) must act independently and solely in the interest of the unitholders.

Eligibility standards

The depositary (or trustee) must either have its registered office in the same Member State as the management company or be established there. It must be an institution that is subject to public control. It must also furnish sufficient financial and professional guarantees to be able to pursue effectively its business as depositary and meet the commitments inherent in that function. Member States are free to determine which categories of institutions are eligible to be depositaries.

The specific eligibility criteria tend to differ between countries. For example, in Germany investment fund law requires the depositary to be a credit institution licensed to conduct deposit-taking business (the Depotbank). The same is the case in Luxembourg and Italy. In France, Spain and the UK, non-bank institutions may in principle be authorised to act as depositaries or trustees. For example, the French Ministry of Finance has designated a list of eligible custodians of funds, which include deposit-taking credit institutions, brokerage firms and other investment firms, insurance companies and the Sociétés des Bourses Françaises (the clearing house and management company of the stock exchange). However, in practice, most depositaries/trustees in France and the UK are banks or subsidiaries of banks.

Depositaries or trustees are subject to minimum capital requirements. These differ between countries. For example, in Germany, depositary banks must show minimum capital of €5m. In the UK, the own-funds requirement is £4m or about €6.5m, and, in Luxembourg, it is LFr350m or about €8.6m. The French requirement for all custodians is a minimum of €3.8m. In Italy, depositaries are subject to the highest capital requirement of all surveyed countries – €100m.

- intervene in the market to prevent the stock exchange values of their units from deviating by more than 5% from their NAVs; and
- establish the NAVs of their units, communicate them to the competent authorities at least twice a week and publish them twice a month.
- At least twice a month, an independent auditor must ensure that the calculation of the value of units is effected in accordance with the law and the company’s instruments of incorporation.

Moreover, Member States must inform the Commission of the identities of the companies benefiting from the exemption.

Depositaries are in general not required to take out insurance for their custody services. However, in the countries where custody of CIS assets is restricted to banks (Germany, Italy and Luxembourg), depositaries are members of a deposit protection or guarantee scheme that is mandatory for banks.

Standard of conduct and responsibilities

The main responsibilities of depositaries/trustees can be summarised as follows:

- ensuring that the sale, issue, repurchase, redemption and cancellation of units effected on behalf of the fund or by the management company are carried out in accordance with the law and the fund rules;
- checking that the value of units is calculated in accordance with the law and the fund rules on a periodic basic;
- carrying out the instructions of the management company, unless they conflict with the law and the fund rules;
- ensuring that, in transactions involving the fund's assets, payment is made by or to the fund within the usual time limits;
- ensuring that the fund's income is applied in accordance with the law and the fund rules;
- scrutinising the conduct of the management company in each accounting period and reporting thereon to the unitholders;
- ensuring that the terms and conditions of any delegation agreement entered into by a fund for the purposes of efficient portfolio management are observed.

These responsibilities have been adopted as minimum standards in the national laws and regulations of all countries. The countries also require that the depositary's or trustee's responsibilities are clearly defined in the contractual fund rules (or the trust deed), which in most cases are subject to regulatory scrutiny.

Thus, in all countries, depositaries of CIS have a regular monitoring and control function which refers to asset allocation, stock-lending, borrowing of the investment company, the settlement of transactions on a DVP basis, and any other aspects specified in the law and fund rules. They are also in charge of handling corporate actions. An important role arises in relation to NAV calculations. Depositaries in all countries are responsible for checking the accuracy of the management company's NAV calculations and, in some cases (eg, in Germany), have to calculate the NAV themselves and reconcile their calculations with those of the management company.

In some countries, such as in France or Spain, the depositary, together with the management company, can be entrusted with the additional responsibilities for creating the fund and drafting the fund rules. It may also be in charge of controlling the legitimacy of the fund's liquidation or carrying out the liquidation itself, as is the case in France, for example.

Liability for losses

A depositary must, in accordance with the national law of the state in which the management company's registered office is situated, be liable to the management company and the unitholders for any loss suffered by them as a result of its *unjustifiable failure to perform its obligations* or its *improper performance* of them. Liability to unitholders may be invoked either directly or indirectly through the management company, depending on the legal nature of the relationship between the depositary, the management company and the unitholders.

The depositary's liability is not affected by the fact that it has entrusted to a third party (sub-custodian) all or some of the assets in its safekeeping.

In all countries, the depositary (or trustee) will be liable for breaches of duty. While it would be difficult for a depositary to defend itself against persistent breaches, its obligation is not absolute. It is possible to envisage circumstances where serious losses may occur to investors in circumstances where the depositary cannot reasonably have been expected to prevent them. Liability arises in the case of 'unjustifiable failure to perform its obligations' or its 'improper performance of them'. This is potentially ambiguous and leaves room for interpretation. Chapter 6 considers two past cases of failures, one in the UK and one in the German fund market, where the depositary's duties to monitor the fund manager have been tested by the regulator or the courts.

Some countries have recognised the possibility that there can be ambiguities in the responsibilities of depositaries and their liability to unitholders. For example, the Luxembourg regulator has issued a circular, which specifically considers responsibilities in the case of handling errors that relate to inaccuracies in the computation of the NAV or instances of non-compliance with investment restrictions applicable to funds. Although the depositary can be held responsible for its breaches of duty on these matters, the circular specifies that the ultimate responsibility remains with the fund promoters. Unitholders will, under all circumstances, be compensated for losses they suffer as a result of any failures.

Another example which shows that the depositary's liability is not a strict one relates to sub-custodians. Once a depositary has demonstrably exercised the level of care and diligence in the appointment and subsequent supervision and monitoring of its agents, it may not be found liable for losses arising due to actions or inaction of such agents. This is explicitly noted, for example, in Irish fund regulations.

Nevertheless, although the protection afforded by the depositary of a CIS is not absolute, the UCITS Directive and the national laws and regulations that adopted the directive impose a significant duty of care on the depositary. Failure to perform this duty will, in many cases, make the depositary responsible for losses.

Interestingly, there are national differences in the way liability to unitholders can be invoked. In Germany, for example, unitholders have no individual rights against the depositary bank, and claims must be made on a collective basis. Luxembourg law specifies that, in the first instance, liability is invoked indirectly through the management company. However, if the management company fails to react within three months of a written notice by an individual unitholder, the unitholder can directly invoke liability from the depositary.

4.1.4 Institutional investment funds

The discussion so far has concentrated on CIS that qualify as UCITS and are marketed to retail investors. However, there are other investment funds – for example, the special funds allowed under German investment fund law. These may be held by between one and ten investors. Only institutional investors are allowed to be unitholders in special funds, with the main investors being insurance companies and pension funds, but also large industrial companies and banks. As the need for investor protection is not perceived to be as large as it is in a publicly marketed fund, the requirements concerning organisational structure and publishing are simplified. For example, while the contractual fund rules of a retail fund need to be sent to, and approved by, the German regulator, this is not required for special funds. These simplifications generally result in lower administration expenses, and, therefore, lower management fees to be paid by the fund. However, as with retail funds, special funds have a depositary which, by law, is entrusted with the safekeeping of fund assets and monitoring. The same is the case in Luxembourg, where the second part of the investment fund law deals with non-UCITS.

In Spain a special law, dated 1987, deals with pension funds and their custody. The main depositary functions of a pension fund depositary are similar to those of a Spanish UCITS. They include basic custody services, as well as a monitoring of the management company.

Institutional funds also exist in other countries, such as France, where institutional investors may set up a fund only for their own investment. The depositary arrangements in this case may be very similar to that in the case of UCITS.

4.2 Custody in mandated asset management

In the case of CIS, the depositary or trustee has a regular monitoring function, and, by statute, owes a duty of care to investors. In particular, it has the responsibility to take reasonable care that the scheme is managed in accordance with the regulations.

The matter is somewhat different in the case of mandated asset management. Minimum regulatory standards for custody arrangements are significantly lower than for CIS. As a result, custodian responsibilities and duties are governed less by regulation than by the contractual agreement concluded between asset manager and custodian, or, where the client appoints the custodian, between client and custodian.

4.2.1 Separation of client assets

As a general rule, all countries' laws and/or regulations require that client assets are separated from those of the firm which manages the client's portfolio, so as to ensure the physical and legal integrity of the assets.

However, this does not necessarily mean that custody assets are held with a third-party custodian. An alternative to the appointment of a third-party custodian for safekeeping is the concept of 'self-custody', which is allowed in some countries. This clearly contrasts CIS arrangements in the countries because CIS assets must always be placed with a third-party custodian.

Under self-custody arrangements, an asset manager provides custody services 'in-house' for its clients. While self-custody generally meets the objective of separation of client assets, assets are not 'strictly' separated. The custody function is integrated with the asset management function in one entity rather than being undertaken by an external custodian. In the UK and Ireland, non-bank investment firms may be given authorisation for self-custody.[13]

However, external custody dominates in terms of assets under management. Both countries also have detailed conduct of business rules for the custody of client assets which must be adhered to by all investment firms.

[13] Where mandates to manage assets are given to a bank, the management and custodian function will be undertaken by the same banking entity. Asset management by banks is not considered in this report.

A separate issue is the safekeeping of client assets by a custodian that is a different legal entity but belongs to the same group as the asset manager. There are no explicit regulations which rule out the use of a group custodian. Indeed, group custodianship is particularly common in countries such as France, Germany and Italy.

In France, the trade association, AFG-ASFFI, has issued 'Professional Ethics'[14] for its members to ensure the autonomy of the investment manager from the custodian and other functional entities within the group. In the UK, where group custody is not as common as on the Continent, The Conduct of Business Sourcebook issued by the Financial Services Authority (FSA), specifies that investors must be informed in writing if an asset manager intends to appoint a group custodian.

4.2.2 Eligible custodians

Apart from the self-custody provisions that apply to some countries and not others, there are certain other differences in laws and regulations regarding the eligibility criteria for custodians. The German Banking Act classifies custody services as a banking activity. Correspondingly, custodians in Germany are banks. Firms that manage assets on a discretionary basis have to keep client assets in a safe-custody account with a credit institution authorised to conduct deposit-taking business in Germany, or, subject to certain additional conditions, a suitable credit institution domiciled abroad. Where the asset management mandate is given to a credit institution, management and custody function may be performed by the same banking entity. The same is the case in Luxembourg. In both countries, custodians must belong to the deposit protection or guarantee system that applies to all banks.

The restriction of custodianship to deposit-taking credit institutions does not apply to other countries. Although the major custodians in the UK are banks, the FSA Conduct of Business Sourcebook extends the list of eligible third-party custodians to include members of recognised investment exchanges, regulated clearing firms, investment firms whose permitted activities include safeguarding and administering investments, and any person outside the UK whose business includes the provision of custodian services and who is able to provide services in a way that is appropriate to the client. As mentioned above, permission to conduct custody business may be given to non-bank investment firms (eg, investment managers themselves). Non-bank custodianship is also allowed in Ireland, France, Spain and in Italy. For example, the Italian regulator can give custody permission to domestic securities investment firms, passported EU investment firms, and non-EU investment firms. In France, although the main custodians are banks, permission to provide custody can be given to brokerage firms, other investment firms and insurance companies.

There are also significant cross-country differences in capital requirements. In France, there is a specific capital requirement for custodians. Any firm providing custody services is subject to the minimum requirement of €3.8m. In other countries, there is no specific, or no additional, requirement for custody services. Instead, custodians are subject to the capital requirements that generally apply to the institution undertaking the services.

[14] AFG-ASFFI (1999), 'Mandated Individualised Portfolio Management Professional Ethics'.

For example, in Germany and Luxembourg, custodians are banks and hence subject to the capital requirement that applies to banks – equal to €5m and LFr350m (or €8.6m), respectively. This is significantly higher than in the UK, for example, where investment firms with a minimum own-funds requirement of €125,000 can safeguard and administer assets, although the total capital requirement increases according to expenditure and risk. The capital requirement in the UK will also be higher for banks (€5m) which dominate the custody market in terms of value of assets.

An interesting addition to the eligibility conditions is provided in the UK rules, which require the investment manager to undertake an appropriate risk assessment of any third-party custodian, both at the time of appointment and on an ongoing basis. The rules also list a number of factors that should be taken into account when selecting a custodian, including:

- expertise and market reputation;
- arrangements for holding and safeguarding investments;
- appropriate legal opinion as to the protection of custody assets in the event of the insolvency of the custodian;
- current industry standard reports;
- whether the custodian is regulated and by whom;
- the credit rating;
- any other activities undertaken by the custodian, and, where relevant, any affiliated companies.

4.2.3 Minimum regulatory standards

Under investment fund laws and regulations, the depositary (or trustee) of a CIS has various responsibilities that go beyond safekeeping. In particular, the depositary has a regular monitoring function. This is not the case outside the investment fund industry. There, the legal and regulatory requirements tend to be restricted to the proper safekeeping of client assets so as to ensure their physical and legal integrity. Additional custodian responsibilities would have to be negotiated in the custody agreement between the parties rather than provided for as regulated minimum standards.

In Germany for example, basic custody rules are laid down in the Safe Custody Act, a special item of legislation for the banking sector. The act specifies the legal responsibility of the custodian to ensure safekeeping and provides for punishment in the case of breaches. For example, the custodian would be responsible for any shortfalls in the custody assets (unless these were due to circumstances beyond its control). The custodian also retains full responsibility if it entrusts a sub-custodian with the safekeeping (unless the client specifically asked for the sub-custodian). The act does not impose any monitoring duties or other responsibilities that go beyond safekeeping.

In France, providers of custody services have to follow rules on the holding and delivery of client assets, the settlement of transactions and the provision of information about matters such as the execution of transactions or impending corporate actions. Custodians also need to satisfy performance requirements relating to information systems, accounting procedures, human resources and internal control. However, there is no explicit monitoring requirement.

Similarly, in the UK, regulations deal with the proper safekeeping of client assets (eg, how assets should be separated and recorded, who is eligible to act as external custodian, or how often records should be reconciled). The rules also specify how custody arrangements should be disclosed in the agreement between asset manager and client. Disclosure is required on matters such as the registration of client assets, the claiming and receiving of client entitlements, the dealing with corporate actions, custody fees, or the provision of regular information regarding the custody investments. However, the rules do not impose minimum standards for these arrangements. With regard to the agreement with the custodian, this should specify the separation of client assets from firm and custodian assets, procedures and authorities for the passing of instructions, and the claiming and receiving of client entitlements. It must also detail the extent of the custodian's liability in the event of a loss of custody assets caused by fraud, default or negligence of the custodian or its agents. Again, no minimum standards are imposed with respect to functions that go beyond the safekeeping of client assets.

In short, the custody laws and regulations that apply to segregated portfolios are generally restricted to safekeeping of client assets. Safekeeping is of course important and protects investors from, for example, theft or accidental destruction of securities. However, any additional custody functions would depend on the custody contract. As such, custody arrangements in mandated asset management tend to be governed more by contract than by specific laws and regulations.

4.2.4 Custody contracts

Custody arrangements in mandated asset management largely depend on the contractual agreement between the parties. The agreement with the custodian may either be concluded by the asset management company on behalf of the investor or by the investor. It is increasingly common for investors, especially institutions, to appoint directly a (global) custodian while having a separate contract with the firm managing their portfolios. In the case of discretionary portfolios, the arrangement is nevertheless often such that the custodian receives instructions from the investment manager rather than the appointing client.

Custody contracts typically contain a long list of services that will be provided by the custodian. These may range from basic safekeeping to various administrative functions, and may include monitoring and valuation. The contracts contain as much operational detail as possible – eg, procedures and authorities for instructions, the types of acceptable instructions, the manner in which transactions are settled, the use of sub-custodian services, the frequency of reconciliations, and the nature of reports.

These duty-defining clauses determine the extent of the contractual duties of the custodian and hence the custodian's liability where client losses are attributable to any breach of duty. Equally important, custody contracts typically contain limitation clauses that limit the liability of the custodian in case of its failure to perform its contractual duties. These may be *force majeure* clauses (eg, to discharge the custodian's duties in the event of a computer failure) or general liability exclusions for consequential damages. The contract may also contain specific limitation clauses that are directly related to failures in the asset management process.

Irrespective of its contractual liability, the custodian may of course choose to make good any losses that arise in the asset management process in order to preserve the client relationship.

However, losses may be so great that liability would have severe consequences for the custodian. The custodian is then likely to weigh the benefits of maintaining its reputation against the financial costs. If the latter outweighs the former, no investor compensation may occur. Thus, the minimum level of protection afforded by custodians must be assessed with respect to their contractual liability.

In the context of this research, it is particularly important to address the custodian's liability with respect to operational failures in the asset management process. Do custodians have a contractual responsibility of oversight and supervision – eg, do they have a 'whistle-blowing' obligation if they receive erroneous or fraudulent instructions by an asset manager? There are reasons to believe that custody agreements are formulated such that they do not contain a general duty of oversight and that custodians assume no responsibility for vetting manager's instructions, although it would be prudent for custodians to assume that they may not escape liability for acting on instructions that are evidently wrong or fraudulent.

Overall, there is a general absence of any detailed laws and regulations which set out minimum standards (other than safekeeping) for custody in the case of direct mandates. This clearly contrasts with the regulatory framework that applies to CIS. Custody arrangements in mandated asset management are largely governed by contract. In order to form a view about the nature of contractual arrangements, a survey was undertaken among custodians and asset managers operating in different countries. The survey informs about the main functions and responsibilities of custodians in relation to the asset manager and client, and their contractual liability in the event of an operational failure in the asset management process. The survey results are presented in the next chapter.

4.3 Summary

The main patterns that emerge from the analysis and cross-country comparison of regulations can be summarised as follows.

- Custody regulations differ significantly between mandated asset management and CIS in terms of the level of protection afforded to clients. The depositary or trustee of a CIS has a regular monitoring function and, by statute, owes a duty of care to investors (at least in the case of UCITS). In mandated asset management, custodian responsibilities and duties are governed more by contract than by regulation; minimum regulatory standards are significantly lower or non-existent.

- The responsibilities of depositaries/trustees of CIS are very similar across the European countries, at least if the fund qualifies as a UCITS. All countries have adopted the UCITS Directive that sets out minimum regulatory standards for the custody of fund assets.

- In some countries, such as Germany, France and Luxembourg, the regulatory standards extend to non-UCITS, which are not marketed to the general public and set up for one or more institutional investors. These special institutional funds have, by statute, depositaries with responsibilities similar to those of UCITS.

- Although regulations are similar with respect to responsibilities of depositaries/trustees, there are a number of regulatory differences, including:

  – *the identity of depositary/trustee* – in some countries (Germany, Italy and Luxembourg), only credit institutions can act as depositary. In other countries, the role can be performed by non-bank institutions, although banks tend to dominate the business in practice;

  – *group custody* – in the UK and Ireland, the depositary/trustee must be independent and cannot be in the same group as the management company. This differs from Continental Europe where there are no such restrictions and group custody is common;

  – *capital requirements* – countries impose different minimum levels of capital on depositaries/trustees;

  – *insurance* – there is a general lack of regulations which require depositaries/ trustees to take out specific insurance cover for custodian activities. In some countries, depositaries and trustees are covered by a deposit protection scheme that is mandatory for all banks.

- Custody laws and regulations of UCITS assets appear to provide a significant, and largely standardised, level of investor protection against operational risks in asset management. However, the depositary's/trustee's responsibilities are not fully, or unambiguously, defined by law and regulation. Chapters 5 and 6 present evidence supporting the view that the depositary's/trustee's liability is not absolute. Chapter 5 examines the issue by means of a survey analysis. Chapter 6 considers two past cases of failures in the fund management process where depositary/trustee responsibilities have been put to the test by the regulator or the courts.

- There is a general lack of minimum regulatory standards for custody in mandated asset management, at least with respect to custodian responsibilities that extend beyond safekeeping. No country has regulations in place which impose monitoring responsibilities on the custodian.

- In mandated asset management, the main regulatory differences between countries relate to the following.

  – *Segregation of client assets* – client assets must be held separately from firm assets in all countries. However, the UK and Ireland allow self-custody by the asset manager. In other countries, asset management firms must place client assets with a third-party custodian. Third-party custodianship does not rule out the possibility that client assets are held within the group. Group custody is possible in all countries, but more common in Continental Europe.

  – *Identity of custodian* – custodianship is a banking activity in Germany and Luxembourg, but not in other countries, where non-bank financial services firms can provide custody.

– *Capital requirements* – the only country with a specific capital requirement for the provision of custody services is France. Other countries do not have specific, or additional, capital requirements. Custodians are subject to the requirements that generally apply to the institution. These tend to vary between countries and depend on the type of institution providing custody.

– *Insurance* – there is generally no requirement for custodians to take out specific insurance for custody assets. In some countries, custodian banks must be members of a deposit-protection system.

- Custody arrangements in mandated asset management are governed more by contract than by regulation. Chapter 5 examines current market practice and contractual custody arrangements by means of a survey conducted among custodians and asset managers. The analysis shows that custody contracts often contain a long list of custodian functions and responsibilities which extend well beyond the mere safekeeping of assets. However, the findings suggest that current custody arrangements may not always be adequate to protect clients against the main operational risks in the asset management process.

5. Survey of Custodians and Asset Managers

This chapter summarises the results of a survey that was devised to obtain information on the nature of custody arrangements in eight European countries, focusing on the role of custody in protecting investors against operational risks in the asset management process.

The purpose of the survey was not to undertake a rigorous empirical evaluation of the extent to which current industry arrangements mitigate risks and protect investors in the various countries. Rather, it was conducted among a select number of firms to identify and highlight a number of issues relevant to this research project. As such, the survey results should not be interpreted as conclusive evidence about the actual role of custody in the asset management process.

The chapter is organised into the following sections:

- section 5.1 sets out the methodology and describes the sample of survey respondents;
- section 5.2 summarises the nature of custody arrangements, focusing on three aspects: self-custody, group custody and the appointment of custodians;
- section 5.3 examines the main functions and responsibilities of custodians;
- section 5.4 explores the extent to which custody arrangements protect clients against the main operational risks in asset management;
- section 5.5 summarises past cases of operational failures in asset management that led to losses which were borne by custodians;
- section 5.6 considers firms' proposals for changes in current custody arrangements, including the need to harmonise custody arrangements in Europe;
- section 5.7 provides a summary of the main results of the survey.

The summary of the regulatory framework provided in chapter 4 suggested that there are important differences between depositary/trustee arrangements in CIS and custody arrangements in mandated asset management. The survey chapter therefore separately examines CIS and mandates.

Among the CIS, a further distinction needs to be drawn between retail funds (UCITS) and the special institutional funds that can be found in some countries (see section 4.1). However, the survey responses were similar for both types of investment fund. This chapter therefore ignores special institutional funds. Instead, it focuses on the role of the depositary/trustee in retail fund management and contrasts this with the role of the custodian in mandated asset management.

A copy of the survey that was sent to custodians (asset managers) is provided in Appendix 2 (Appendix 3).

5.1 Methodology and sample description

The sample of firms was selected on the basis of the countries under consideration in this report (France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Spain and the UK). The survey was sent to both custodians and asset managers in these countries. The main objective of this dual approach was to allow cross-checking and contrasting of the survey responses provided by custodians and asset managers.

The survey was sent to 33 asset management firms, most of which participated in a previous survey, conducted in the year 2000 as part of the EAMA study on ‘Risks and Regulation in European Asset Management’.[15] The respondents to the previous survey did not include Spanish or Luxembourg asset management firms. In order to cover the Spanish market, the fund management association (Inverco) distributed the questionnaire to some of its members. Similarly, the Luxembourg association (ALFI) assisted in suggesting two of its members. However, no responses were received from the firms.

The custodians were selected to ensure a broad coverage of countries, using the help of several asset management firms who provided contacts with their own custodians and/or the fund management associations in the countries. In total, the survey was sent to 22 custodians.

A total of 21 firms participated in the survey, corresponding to a response rate of 38%. The final sample comprised nine custodians and 12 asset managers, many of which are main players in their national markets and globally. Although most respondent firms were based in the UK, France and Germany, there is at least one representative firm from each of the other countries analysed in this report:

- *France* – three custodians and two asset managers;
- *Germany* – two custodians and two asset managers;
- *Ireland* – one asset manager;
- *Italy* – two asset managers;
- *Luxembourg* – one custodian;
- *the Netherlands* – one custodian;
- *Spain* – one custodian;
- *the UK* – one custodian and five asset managers.

Given the relatively small sample size, any survey findings must be interpreted with some caution. Nevertheless, the evidence provides insight into the nature of custody arrangements and the level of protection afforded by custodians against the main operational risks in asset management.

The custodians are mainly global custodians that operate in many countries. Although asked to give information about the value of assets held for domestic clients only, in many cases the firms provided information on total (worldwide) assets held in custody. As shown in Table 5.1, custody assets totalled €9.3 trillion, with one custodian holding more than half of the assets.[16]

[15] Franks, Mayer and OXERA (2001), op. cit.

[16] Custodians were also asked to break down their assets according to client base, but the breakdown was not always consistent. It is therefore not possible to present aggregate statistics on the client base.

Table 5.1: Total custody assets in the sample of custodians

	Custody assets (€ billion)
Minimum	2
Mean	1,166
Median	421
Maximum	5,600
Total	**9,320**

Notes: The summary statistics are problematic because most, but not all, firms provided the amounts for total (worldwide) assets held in custody instead of the assets held for domestic clients only.

All but two custodians (ie, 78%) act as depositary and/or trustee of UCITS.

As discussed in chapter 4, trustees in the UK or Ireland may be different legal entities than the custodians of the assets of the unit trust. However, all three respondents that operate as custodians in these countries stated that they would always, or in most cases, act as both custodian and trustee for the same unit trust.

The 12 asset managers in the sample manage total assets of €1 trillion, the smallest having €3.9 billion under management and the largest €529 billion (see Table 5.2).

Table 5.2: Total assets under management in the sample of asset managers

	Total assets under management (€ billion)
Minimum	3.9
Mean	88.7
Median	53.0
Maximum	528.8
Total	**1,060.0**

The asset management firms were asked to provide a percentage breakdown of assets under management by type of client or vehicle. Table 5.3 reports the average percentage breakdown by country.

Table 5.3: Average percentage breakdown of total assets

	France	Germany	Ireland	Italy	UK
CIS (retail, UCITS)	47	3	17.2	90.9	18.4
Other investment funds	16	59.5	18.2	2.6	8.8
Mandates – institutional	37.5	37.5	64.6	4.6	70.95
Mandates – private	0	0	0	1.9	1.9

The asset managers in the sample that operate in France, Italy and Germany manage over half of their assets for CIS. For the French and Italian firms, these are mainly retail funds; for the German firms, the CIS are special funds set up for institutional investors. The proportion of mandated asset management is highest in the UK, where pension and insurance company funds make up a significant amount of total assets under management.

Although the sample of asset managers is small, this breakdown of assets broadly reflects the pattern of assets under management described in the previous EAMA report on the 'Risks and Regulation in European Asset Management'[17] – the collective investment scheme business is comparatively more significant in Continental Europe than in the UK.

5.2 Nature of custody arrangements

This section describes custody arrangements in the sample, focusing on three main aspects – self-custody provided by asset management firms; group versus non-group custodianship; and appointment of the custodian.

5.2.1 Self-custody versus external custodianship

As discussed in chapter 4, asset managers in the UK and Ireland are allowed to provide self-custody rather than place client assets with an external custodian. This is possible in the case of mandates, but not investment funds where fund assets need to be entrusted with an independent depositary/trustee for safekeeping.

Although some asset managers provide custody as an integral part of their service, the proportion of funds under external custodianship has risen considerably. This has been noted in the previous EAMA report[18] and a recent British Invisibles study.[19] In 1989, the use of separate custodians by asset managers in the UK was rare. By 1997, it was 50% and this increased further to 71% in 1999. Among the larger funds, external custodianship is more common.

Nevertheless, two of the UK asset managers in the sample provide self-custody, for 20% and 40% of their total assets under management, respectively. All other asset managers hold all client assets with an external custodian.

5.2.2 Group versus non-group custodianship

A separate issue is group custody, where assets are held with a custodian that is a separate legal entity but from within the same group as the asset manager. Regulations in the countries generally allow group custody, at least in the case of mandates.

In the case of retail funds, UK and Irish unit trust regulations require the trustee to be entirely independent from the unit trust manager. This is the same for the depositary of an open-ended investment company (OEIC). On the Continent, common ownership links between management company and depositary are permitted.

In order to evaluate whether group custody is common in the sample, custodians were asked to indicate how often the investment management company, in the case of UCITS, or the asset manager of a client's segregated portfolio belongs to the same group as their firm acting as custodian/depositary/trustee – 'always', 'frequently', 'infrequently' or 'never'.

[17] Franks, J., Mayer, C. and OXERA (2001), op. cit.
[18] Franks, J., Mayer, C. and OXERA (2001), op. cit.
[19] British Invisibles (2000), 'Fund Management', City Business Series 2000, Statistical Update.

In general, the custodians' responses suggest that group custodianship tends to be 'infrequent':

- In the case of retail funds, all but one custodian said that the investment management company 'infrequently' belongs to the same group as the trustee/depositary. The one (French) custodian replied 'frequently'.

- In the case of mandates, all but one custodian said that the asset manager 'infrequently' belongs to the same group as the custodian. The one (French) custodian replied 'frequently'.

Separately, the asset managers were asked whether they belong to a group and, if so, what fraction of their assets is held with a group custodian.[20] Eight of the asset managers belong to a group, of which four belong to a group in which another entity is authorised to provide custody services. The percentage of assets held in group custody is high in Italy (98%) and Germany (80%).

The sample of asset managers that belong to a group is too small to draw any conclusions, and not all firms provided information on the fraction of assets held within the group. However, it is widely known that market structures are such that group custodianship is more common in countries such as France, Italy and Germany compared with the UK. In the former, asset management firms often belong to a group with a parent bank which acts as custodian or depositary. In the UK, a higher proportion of client assets is outsourced to non-group custodians.[21]

5.2.3 Appointment of custodian

While depositaries/trustees are generally appointed by the investment company, the custodian in the case of mandates may be appointed by either the asset manager or the client directly. The custodians and asset managers in the sample were asked to indicate how often, in the case of mandates, appointment occurs by the client directly.

The custodians stated that, on average, for about 75% of assets held in custody, appointment occurs by the client directly. Some custodians noted that, even where they are appointed by the asset manager, the custody contract is typically concluded with the client. An alternative arrangement is a tripartite agreement concluded between custodian, asset manager and client.

All asset managers in France, Germany, Ireland and Italy said that they 'infrequently' appoint the custodian on behalf of their clients in the case of mandates. In the UK, three asset managers said that they 'never' appoint the custodian, but two said they do so 'frequently'.

In the context of this study, the issue of who appoints the custodian is important if it has implications for the nature of custody arrangements, and the level of client protection afforded by custody. There may be differences in the functions and responsibilities specified in the custody contract, depending on whether the custodian is appointed by the client directly or by the asset manager.

[20] The asset managers that provide self-custody are not counted as firms that use a group custodian.
[21] See Franks, J., Mayer, C. and OXERA (2001), op. cit.

One custodian stated that it offers a standard custody contract, but if the client wants specific services, the contract might be adjusted accordingly. Similarly, one asset manager noted that individual clients may add, delete or amend clauses, depending on their needs and preferences. However, most firms stated that there are no significant differences in the contract, no matter who appoints the custodian. Indeed, one asset manager noted that there are no differences because custodians set and fix the terms of contract.

5.3 Custodian functions and responsibilities

As discussed in chapter 3, custodians can perform a number of functions and take on several responsibilities (see Table 3.2). In the case of UCITS, many functions and responsibilities are defined as minimum standards in laws and regulations. In the case of mandates, they depend more on the commercial or contractual arrangements between the parties.

In order to form a view about current custody arrangements, including depositary/trustee schemes, the survey asked firms to indicate how often contracts contain a specific function or responsibility ('always', 'frequently', 'infrequently' or 'never'). The survey results are discussed below.

The results suggest that there are no significant cross-country differences in the functions and responsibilities performed by custodians/depositaries/trustees.[22] This could be due to several reasons:

- there are indeed few cross-country differences in custody arrangements;
- the firms operate in different countries and therefore provided information that, on average, applies to all their operations;
- firms are asked to indicate how often the custodian performs a specific function, using the scale 'always', 'frequently', 'infrequently' or 'never'. This scaling of possible answers may not have been detailed enough to reveal any differences;
- the samples are too small to make cross-country inferences.

Despite the many possible reasons, in-depth interviews conducted with custodians and asset managers suggested that there may indeed be no significant differences in the functions and responsibilities performed by custodians in different countries. The survey results in Table 5.4 are therefore presented as aggregate statistics covering responses from all countries.

Furthermore, given the generally small differences between the responses of custodians and asset managers, Table 5.4 aggregates all firms' responses and presents the average (median) response given by the firms.[23] It also reports the percentage of firms whose response was that a specific function or responsibility is 'always' or 'frequently' included in the custody contract.

[22] Similarly, no notable cross-country differences were observed with respect to the level of investor protection provided by custody. The results are reported in section 5.4.

[23] The only differences were:

- client reporting and exercise of voting rights—the average response of asset managers was 'infrequently', that of custodians 'always' (in the case of both retail funds and mandates);
- valuation (done by custodian)—asset managers said 'never', custodians said 'always' (in the case of retail funds only). But both agreed that the trustee/depositary 'always' checked the NAV calculations.

Table 5.4: Functions and responsibilities of custodians

	Retail funds		Mandates	
Functions/responsibilities	**Average response**	**% of firms responding 'always' or 'frequently'**	**Average response**	**% of firms responding 'always' or 'frequently'**
Safekeeping				
Safekeeping	Always	100	Always	100
Administration				
Recording client rights in investments, handling documentation, accounting, etc	Always	100	Always	93
Settlement of transactions	Always	94	Always	100
Client reporting	Frequently	65	Frequently	69
Communicating/responding to corporate actions	Always	94	Always	81
Exercise of voting rights	Frequently	59	Frequently	56
Collection of income receivable	Always	100	Always	88
Reclaiming tax	Frequently	82	Always/ Frequently	94
Compliance monitoring				
Monitoring AM firm's compliance with law or regulations	Always	94	Never	19
Monitoring AM firm's compliance with contractual (client) guidelines	Frequently	65	Never	19
Valuation				
Valuation (done by custodian)	Frequently	56	Infrequently	33
Checking NAV calculations of AM firm	Always	76	Never	6
Other value-added services				
Securities lending (done by custodian)	Infrequently	27	Infrequently	21
Checking that AM firm lends stock only to secure party and that there is sufficient collateral	Infrequently	31	Infrequently/ Never	36
Performance measurement	Never	13	Infrequently	20
Cash management	Frequently/ Infrequently	50	Frequently	53
Brokerage	Never	6	Never	6

Notes: The custodian functions and responsibilities are defined as in Table 3.2. 'AM firm' refers to the firm that manages the fund or client portfolio. 'Average response' indicates the median response given by firms.

As explained in chapter 3, the various functions and responsibilities of custodians can be classified into five categories. For each category, the survey results suggest the following.

- *Safekeeping* – all respondents agreed that this is the main custody function, which is 'always' performed by custodians, both in the case of mandates and UCITS.

- *Administration* – this includes record-keeping and accounting, settlement, client reporting, communicating corporate actions, exercise of voting rights, collecting income and reclaiming tax refunds. The functions are performed, depending on the specific custody contract. For example, client reporting and the exercise of voting rights are less frequently included in contracts than some of the other administrative functions. Importantly, there is little difference between mandates and UCITS.

- *Compliance monitoring* – as discussed in the previous chapters, the monitoring function is critical to assessing the role of custody in protecting clients against the main operational risks in asset management. The survey results confirm that there is a marked difference between mandates and retail funds. In general, monitoring is 'never' part of the custody contract in the case of mandates, but is 'always' the responsibility of the depositary/trustee in the case of retail funds.

  For retail funds, the monitoring mainly concerns checking compliance with the laws and regulations. There is less responsibility with respect to checking 'client guidelines' – ie, issues that are not specified in the law but laid down, for example, in the fund prospectus.

- *Valuation* – there is a marked difference between mandates and retail funds. In the case of mandates, valuation is 'never/infrequently' a custodian responsibility. In the case of retail funds, it 'always' is. This confirms the description of regulations in chapter 4 – valuation is, by statute, a key responsibility of the depositary/trustee.

  For retail funds, the depositary/trustee either calculates the NAV or checks the NAV calculations of the management company. The survey results suggest that the checking is more common than the actual calculation. In some cases, depositaries/trustees seem to perform both functions.

- *value-added services* – these include stock-lending, cash management, performance management and brokerage services. For the purpose of this study, the value-added services are less important from a client-protection point of view, with the possible exception of stock-lending. In general, the functions are 'infrequently' or 'never' undertaken by the custodian, neither for mandates nor for retail funds.

Several firms noted that some of the functions listed in Table 5.4 are performed only upon the formal request of the client; this applies to functions such as claiming tax refunds and the exercise of voting rights. Others pointed out that some functions are subject to a separate contract, rather than the main custody contract. This applies particularly to stock-lending, but also to performance evaluation and cash management.

One UK asset manager noted the difference in the functions performed by the custodian and the trustee in the case of unit trusts. The firm stated that the custodian is 'never' responsible for monitoring laws or client guidelines and checking the NAV calculations of the management firm, but that the trustee 'always' is.

Another firm mentioned that custody is separate from fund administration, and that record-keeping and valuation are only performed by the custodian/trustee/depositary where it is in charge of administration (eg, if the asset manager has outsourced administration).

Overall, the survey results suggest the following.

- Safekeeping is the main custody function.

- Custody contracts contain a number of administrative functions, in particular record-keeping and accounting, settlement of transactions and collection of income receivable.

- Monitoring is a function and responsibility of the depositary/trustee of UCITS, as defined in laws and regulations. This contrasts with the custody arrangements in the case of mandates, which are mainly contractual and do not include an oversight role. The same distinction applies to valuation. While the depositary/trustee is responsible for checking the NAV in the case of UCITS, the custodian has no valuation function in the case of mandates.

- Custodians can, subject to a special agreement, provide a number of value-added services. However, these are not immediately relevant for this research.

- There is considerable variation in the survey responses – for example, Table 5.4 reports only few functions and responsibilities that are included in 100% of the contracts. The variation suggests that custody arrangements are not uniform, even in the case of retail funds.

5.4 The role of custody in protecting against operational risks

The functions and responsibilities of custodians, depositaries and trustees are indicative of the nature of current custody arrangements and the level of protection provided by custody. However, the survey sought to obtain a direct assessment of the extent to which custody mitigates the main operational risks that may arise in the asset management process.
Two approaches were adopted:

- Firms were asked to indicate their perception of the level of protection provided, taking into account the fact that protection may be both *ex ante* (ie, preventing the operational failure from occurring) and *ex post* (ie, bearing the risk/loss if problems arise).

- Firms were asked specifically to evaluate *ex post* protection, by considering the liability of custodians, depositaries or trustees in the event of an operational failure.

The survey results obtained for the two approaches are described below.

5.4.1 Protection against various operational risks in asset management

Under the first approach, firms were asked to evaluate the role of custody as a protection mechanism against 12 types of operational risk (described in more detail in Table 3.1). For each operational risk, they were instructed to consider the combination of *ex ante* and *ex post* protection, and evaluate protection overall, using a scale from 1 to 5 (1 indicating very good protection, 5 indicating no protection).

Figures 5.1 and 5.2 show the results, reporting the percentage of firms which evaluate the level of protection to be 'very good' (response 1) or 'good' (response 2). The figures distinguish between depositary/trustee arrangements in retail funds (Figure 5.1) and custodianship in the case of mandates (Figure 5.2). Separate evaluations are shown for the sample of custodians and asset managers.

Figure 5.1: Retail funds – protection provided by custodian/trustee/depositary is 'very good' or 'good'

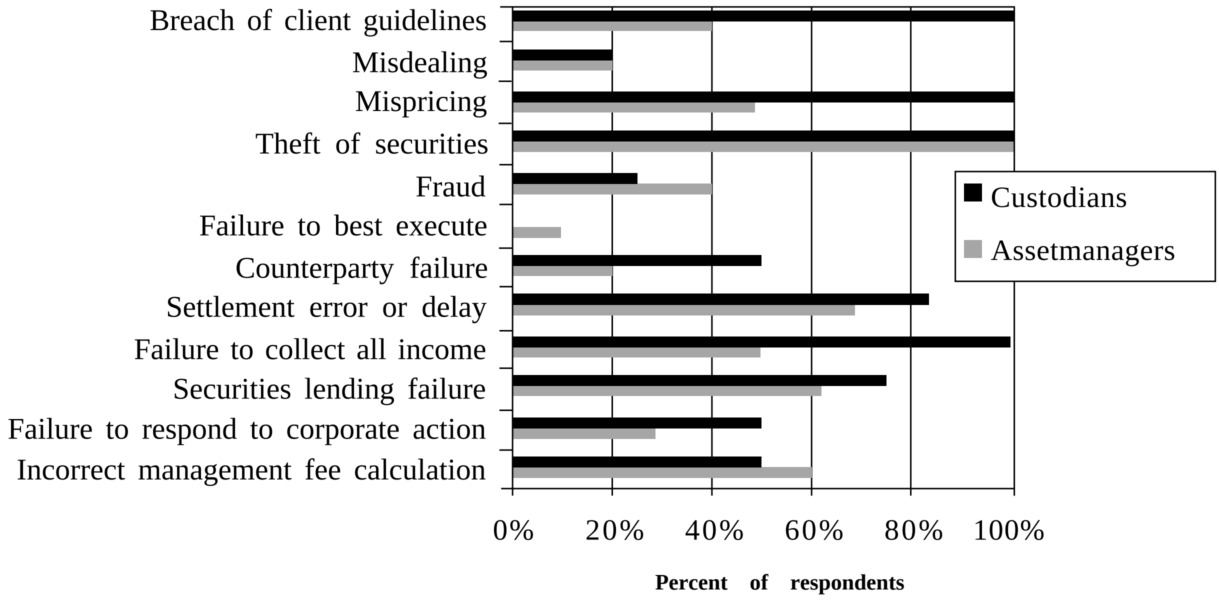
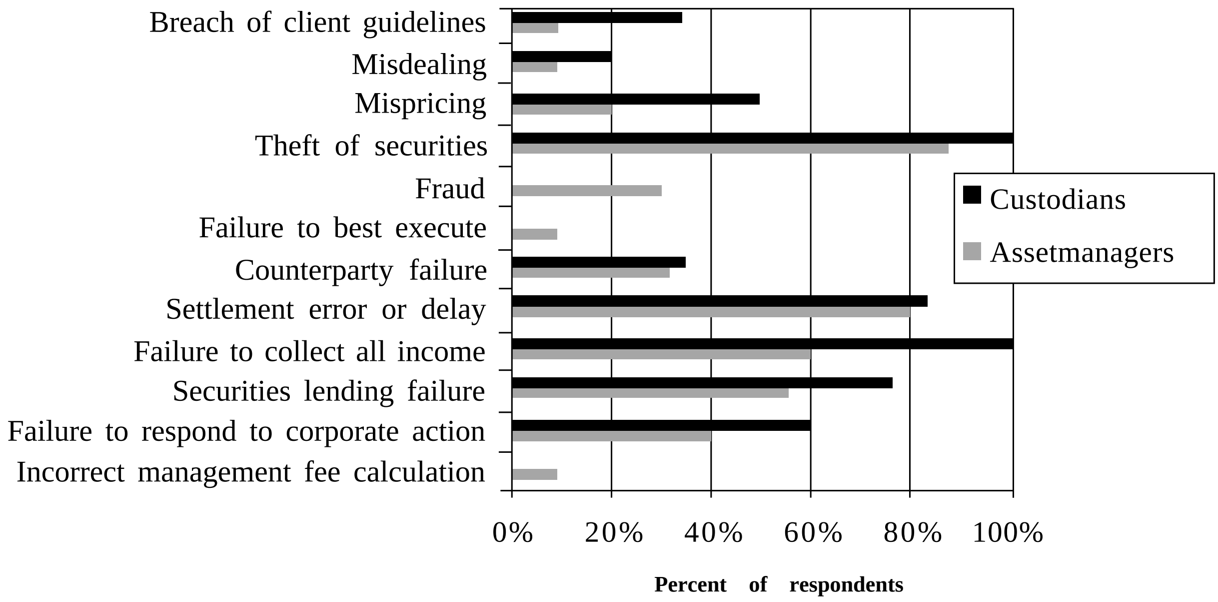


Figure 5.2: Mandates: – protection provided by custodian is 'very good' or 'good'



The survey results can be summarised as follows:

- Theft of securities is the main risk that is effectively mitigated by custodianship. This is consistent with the finding in section 5.3 above that safekeeping is the most important function performed by custodians – ie, custodians have a 'bailment function' and provide secure premises for client assets.

- Custodians also have a role in reducing settlement errors and failures to collect any income that accrues to clients on their investments.

- As regards the main operational risks in asset management – in particular, breach of client guidelines, misdealing, mispricing and fraud (see Table 3.1) – custody arrangements do not provide good protection in the case of mandates. For example, none of the custodians indicated that protection against fraud is 'good' or 'very good', and only the minority of firms believed that custody arrangements protect well against breaches of client guidelines, misdealing or valuation errors by the asset manager.

- In the case of retail funds, all custodians indicated that depositary/trustee arrangements offer 'good' or 'very good' protection against breaches of client guidelines and NAV calculation errors. However, not all asset managers agreed, and suggested that the level of protection may be lower.

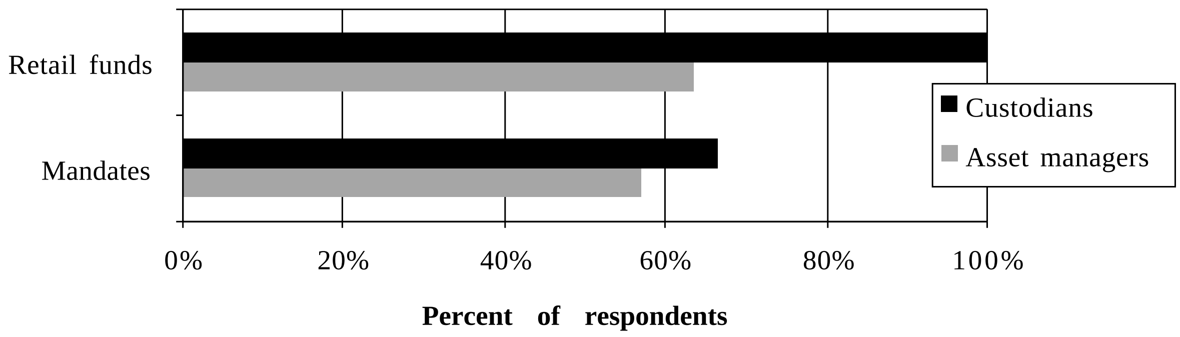
- As with mandates, the depositary/trustee does not protect well against the risks of misdealing (eg, errors by the asset manager in issuing orders to brokers) or fraud. Nevertheless, protection is perceived to be somewhat better than in the case of mandates.

Overall, the results suggest that custodianship provides good protection against some, but not all, operational risks in asset management. Protection is generally better under depositary/trustee arrangements that apply to retail funds than in the case of mandates. The most significant difference occurs with respect to breaches of client guidelines and mispricing. These risks are mitigated by depositaries/trustees but generally not by custodians in the case of mandates. Although somewhat better in the case of retail funds, custody does not provide good protection against misdealing, fraud or some other operational failures, such as failures by the asset manager to achieve best execution.

In addition to evaluating the role of custody in relation to each of the specific operational risks in asset management, firms were asked to give an *overall* evaluation. Figure 5.3 shows the percentage of respondents indicating that the overall level of protection afforded by custodians, depositaries or trustees is 'good' or 'very good'.

Although firms indicated that custody does not provide good protection against some of the main operational risks, the majority of firms – in particular the custodians – perceived the overall level of protection to be 'good' or 'very good'. The overall evaluation is also consistent with the view that protection is better in the case of retail funds, with 100% of custodians indicating that protection provided by depositaries or trustees is good. The percentage of asset managers is lower at 63%. One explanation for the generally lower evaluation of asset managers is that they might, at least in the first instance, mitigate any operational risks themselves and compensate investors in the event of failures.

Figure 5.3: Overall protection provided by custodian/depositary/trustee is 'very good' or 'good'



Some additional comments that were made by firms in relation to risk mitigation and client protection included the following.

- One custodian said that it did not provide an evaluation because the level of protection against each of the risks could only be determined on a case-by-case basis.

- One asset manager specifically noted that, in the case of mandates, the risks of misdealing, best execution failures, mispricing, breach of client guidelines, counterparty failures and wrong management fee calculations are mitigated only at the asset management level, not at the custodian level.

- One custodian noted that the custody contract in the case of mandates does not cover any monitoring responsibility with respect to the asset manager's behaviour. Rather, the custodian would generally assume that any instructions given by the asset manager are valid.

- One custodian stated that 'the lack of information on the transactions of the asset manager means that any requirement for the custodian to oversee the actions is clearly insufficient and unsuitable.'

In the survey, firms were also asked to indicate whether (in the case of mandates) custodians offered contracts that differ significantly in the level of protection they afford to clients (eg, depending on the clients' needs and preferences); 33% of all respondents replied 'yes', 67% said 'no'.

5.4.2 *Ex post* liability of custodians

To provide further information about the level of protection afforded by custody, the survey specifically examined *ex post* protection – ie, in the event of an operational failure, do custodians provide protection by bearing any losses incurred as a result of the failure and compensating investors?

This depends on the custodian's legal or contractual liability. In the survey, firms were therefore asked to consider a number of simplified examples of operational failure in the asset management process, and to evaluate whether it is 'likely' or 'unlikely' that the custodian, depositary or trustee could be held liable. Table 5.5 shows the percentage of firms that evaluated liability to be 'likely'. As above, the results are reported separately for the sample of custodians and asset managers.

Table 5.5: Percentage of firms indicating that custodian liability is 'likely'

		Sample of custodians (%)		Sample of asset managers (%)	
	Example of failure	**Retail Funds**	**Mandates**	**Retail Funds**	**Mandates**
1	The AM firm uses client funds to purchase securities that *breach client guidelines*. The value of the unauthorised securities falls and the AM firm is unable to cover the loss.	86	0	40	0
2	The AM firm has incorrectly valued client or fund assets. The *mispricing* is revealed.	86	0	33	0
3	Dividend *income is not collected*. Tax refunds are not claimed.	100	71	90	90
4	There is an *untimely response to a corporate action*, resulting in a loss for clients.	71	43	80	60
5	Client securities are delivered before payment is received. The *counterparty fails* and the client incurs a loss.	86	86	89	70
6	Client *securities are lent but not returned*. There is insufficient collateral.	50	67	70	50
7	An overseas *sub-custodian defaults* while settling transactions. Client funds are lost.	100	67	90	70
8	The AM firm *misuses client funds* to cover significant own-account trading losses. Both AM firm accounts and client accounts are held by the custodian. The AM firm defaults.	71	57	40	30
9	The AM firm *manipulates portfolios* to present a better performance picture by shifting securities between client accounts. All client accounts are held by the custodian.	71	43	20	20
10	The AM firm *charges its clients higher commission charges* than those charged to the AM firm by the broker. The irregularity is revealed.	50	0	20	10
11	The AM firm engages in *'churning'* – ie, trades heavily for clients to generate excessive management fees. The irregularity is revealed and it can be proved that the custodian had noticed the irregularity but did nothing about it.	43	14	22	11

Note: 'AM firm' refers to the firm that manages the fund or client portfolio.

The results in the table again show important differences between retail funds and mandates. *Ex post* protection provided by the depositary/trustee of a retail fund is generally better than that provided under custody arrangements in the case of mandates. Consistent with the findings above, the differences are most significant in relation to two operational failures.

- *Breach of client guidelines* (example 1) – in the sample, 86% of custodians stated that they could be held liable if the management company of a retail fund purchased securities which breached client guidelines. Any losses incurred by investors in the fund (eg, resulting from a fall in the price of the unauthorised securities) would be covered by the depositary if the management company were not able to do so. In contrast, none of the custodians would assume liability if the breach of guidelines had occurred in a segregated portfolio managed by direct mandate.

  The asset managers in the sample were generally less optimistic that depositaries/trustees could be held liable for breaches of client guidelines, with 40% of asset managers indicating that liability was likely. However, all agreed that liability was unlikely in the case of mandates.

- *Mispricing* (example 2) – the majority of custodians (86%) agreed that valuation of fund assets was one of the duties of depositaries/trustees and that liability was likely if the duty were breached. In contrast, no custodian would assume liability under current contractual arrangements in the case of mandates.

  Asset managers were again less convinced about the liability of depositaries/trustees (33% said that liability was likely), but all agreed that no liability could be invoked in the case of mandates.

Other operational failures where liability was considered to be more likely than not include failures to collect income (example 3); corporate action failures (example 4); counterparty failures in the settlement process (example 5); uses of client funds by the asset manager to cover own-account trading losses (example 8); and portfolio manipulations (example 9). Liability was in general considered to be more likely in the case of retail funds than mandates.

The survey respondents made a number of additional comments on the liability of custodians, depositaries or trustees which are worth noting.

- One custodian (acting as depositary/trustee) accepted liability in the event of pricing failures (example 2) and excessive commissions (example 11), but only at the second level. In the first instance, the losses would have to be borne by the management company of the fund.

- Another custodian stated that it could be liable in examples 1, 2 and 3 if it were acting as the fund administrator of the investment fund. Also, the custodian would not accept liability if the losses occurred in the case of mandates.

- With regard to ‘churning’ (example 11), a custodian noted that the liability would depend on the scale of the irregularity and whether or not it should have been apparent to the custodian. Similar comments were made with respect to some of the other examples where liability would depend on the circumstances. For example, one custodian would assume liability for the failure of a sub-custodian (example 7) provided that the sub-custodian belonged to the same group. For other sub-custodians, the firm would accept responsibility only with respect to selecting and monitoring the sub-custodians. Another custodian said that example 5 could invoke liability, but only in the case of DVP transactions. Indeed, that custodian noted that it would only accept to settle transactions on a DVP basis or else ask the client for indemnification.

- One custodian noted that liability for certain failures may exist in the case of both mandates and retail funds. However, the difference between custodianship, in the case of mandates, and depositary/trustee arrangements, in the case of funds, is that 'the liability of the depositary/trustee is typically statutory whereas it is purely contractual for the custodian [of a portfolio managed through a mandate]'.

Overall, the survey evidence suggests that custody provides *ex post* protection against a number of operational risks in asset management. The level of protection, or the likelihood of custodian liability, is greater under depositary/trustee arrangements that apply to retail funds than in the case of mandated asset management. In particular, depositaries/trustees are more likely to be liable if the management company violates client guidelines or incorrectly values fund assets. Under contractual arrangements in mandated asset management, custodians do not breach their duty and cannot therefore be held liable for the same failures.

The survey results in Table 5.5 present aggregate statistics and reveal general patterns that emerge across the sample of firms. However, it is important to note the variations in the responses provided. For example, why did most, but not all, depositaries/trustees indicate that they could be held liable in the event of breaches of client guidelines and mispricing? This variation in responses suggests that there may well be some ambiguity and uncertainty regarding the responsibilities of depositaries/trustees.

5.5 Past cases of operational failures and the role of the custodian

In order to further evaluate the effectiveness of custody as an *ex post* protection mechanism against operational risks in asset management, firms were asked to indicate whether there had been any incidents of operational failures in the last three years that had led to losses and were borne by the custodian/trustee/depositary.

Many firms, especially the custodians, considered the information to be confidential and were not willing to disclose it. Of the nine custodians in the sample, two firms did not provide any information, four stated that there had been no losses, and the three firms that said 'yes, there have been losses' were not willing to disclose information about the source of loss or amount.

The response rate was better for the asset management firms in the sample. Only one of the 12 firms failed to provide the information. Of the 11 that responded, two indicated that there had been no losses. The majority of the remaining nine firms said that there had been failures in the asset management process, the losses of which had been borne by custodians. The asset managers provided the following information on the failure that led to the largest loss:

- a corporate action failure in the form of a rights issue which was taken up at the incorrect price (€380,000);
- a corporate action failure (more than £250,000);
- a corporate action failure (€100,000);
- the custodian had sold shares of funds instead of redeeming them ($100,000);

- a corporate action failure ($75,000);
- settlement failures resulting in claims from brokers (less than €20,000);
- settlement failures which led to interest claims against the custodian (no significant amounts);
- a settlement delay (loss unknown).

This evidence suggests that there have been losses in the asset management process which were compensated by custodians. Most losses related to corporate action failures or settlement failures. No case was mentioned by the firms relating to the failure of the custodian to monitor the asset management process, and losses were generally small.
Chapter 6 discusses more high-profile cases of operational failures in the asset management industry and the role played by custodians/depositaries/trustees in protecting investors.

5.6 Proposals for changes in current custody arrangements

In the final part of the survey, firms were asked to give their opinions on the need to change current custody arrangements in order to enhance investor protection against operational risks in the asset management process. They were also asked to comment on the need to harmonise or standardise custody arrangements across Europe and their perception of barriers to entry into the custody market.

5.6.1 Evaluation of the need to change current custody arrangements

Only a minority of firms believed that there was a need to change current custody arrangements: 28% of firms indicated that arrangements should be changed to enhance protection compared to 72% who said that no change was necessary. This vote did not differ between custodians and asset managers.

Moreover, 78% of firms stated that any such changes in custody arrangements would lead to higher custody fees. The majority of firms (62%) believed that clients would not generally be willing to pay higher fees.

Firms' perception of the need to change custody arrangements broadly reflects their evaluation of the degree of protection provided by the current arrangements (section 5.5). For example, 57% of the firms that voted for maintaining the status quo had evaluated the degree of protection in the case of mandates to be 'very good'. In contrast, none of the firms that voted for a change in the current arrangements stated that protection was 'very good'.

Comments of those firms that voted against a change in protection included the following.

- 'It is not clear that custodians should assume greater responsibility. After all, there are many things which are beyond their control. One area where custodians could be more active is to monitor that the asset manager follows investment guidelines. We already offer such a service to our clients.' (A custodian)

- 'We are able to provide a comprehensive investment manager compliance monitoring service – however, it is the client's choice whether they utilise this product.' (A custodian)

- ‘The custodian should not oversee, verify and question the actions regarding the investment strategy of the asset manager. This should remain the responsibility of the asset management firm itself. Otherwise this would mean a mixture of responsibilities of the asset manager.’ (A custodian)

- ‘Investors are already protected by the deposit protection scheme and the insurances we offer as custodian.’ (A custodian)

5.6.2 Proposals for changes in current custody arrangements

Some of the firms that voted for a change in current custody arrangements made specific comments on possible changes to enhance investor protection. In turn, these included:

- ‘ratings for asset managers and depositaries’ (a custodian);
- ‘a clearer assignment of responsibilities between the depositary and the asset manager’ (a custodian);
- ‘standardise contracts’ (an asset manager);
- ‘more external controls’ (an asset manager);
- ‘clearer definition of obligations and organisational requirements for custodians, and sanctions in case of failure’ (an asset manager);
- ‘present regulations regarding custodianship of UCITS should be extended to mandates’ (an asset manager).

5.6.3 Harmonisation of custody arrangements

In addition, a number of firms stated that they agreed with two statements that were put to them for comment in the questionnaire:

> Harmonisation of custody regulation at the European level is necessary.
>
> Greater clarity and/or uniformity in the contractual arrangements would enhance investor protection.

Seven firms provided comments that broadly support the statements. One firm raised some objections, and the remaining firms did not discuss the statements. Supporting comments included:

- ‘We agree with both statements.’ (A custodian)

- ‘Custodians would welcome harmonisation. Harmonisation would strengthen the market.’ (A custodian)

- ‘We fully agree that the harmonisation of custody regulation in Europe would be very preferable and helpful. Thus, consistent Custody Agreements would help both investors and custodians to keep track of the miscellaneous articles of the contract. Investors could be even more protected with clear and concise formulation not only of legal requirements but also of services.’ (A custodian)

- ‘Provided that the harmonisation of custody regulations at the European level leads to a real advantage for our customers, ie, greater protection … we would anticipate a lot of benefits for all parties involved.’ (An asset manager)

- ‘We are satisfied with the clarity and uniformity of contractual arrangements. Harmonisation of custody regulation at the European level would benefit the European asset management industry.’ (An asset manager)

- ‘Regarding the first statement: If not a real necessity, [harmonisation] could be a help for the asset manager when negotiating with a new custodian imposed by the client.’ (An asset manager)

- ‘Harmonisation is necessary in order to give the same level of investor protection in all European countries and to improve competition in the custody market. The legal framework could be enhanced by better contractual arrangements, but organisational and technological issues should also be considered.’ (An asset manager)

The firm that raised the objections argued that:

- ‘The level of protection and contractual arrangements are available for negotiation between the respective parties at present. Harmonisation of regulation would not necessarily improve the level of investor protection that can currently be negotiated.’

5.6.4 Barriers to entry into the custody market

The issue of harmonisation is related to the survey responses to the question of whether firms perceived there to be any barriers to entry of custodians in other EU or overseas markets. Sixteen firms in the sample responded to the question, and 59% believed that there are indeed barriers to entry. The split was almost identical in the two sub-samples of custodians and asset managers.

The only barriers to entry mentioned by custodians are national regulations and the lack of harmonisation.

- ‘The custodian has to comply with the regulations and laws of the target country and has to respond to the requirements of the relevant supervisory authority.’
- ‘European legislation – the key thing is there is little or no cohesion across financial services legislation – ie, there is no single piece of legislation which goes across all countries. Each country has its own legislation, historical and new and so each has its own barriers to entry – some are more restrictive than others and some have heavier obligations from the regulators for particular types of client. There has been a call for “harmonisation of taxes” which would make the “cross-border pooling” issue easier to deal with.’
- ‘European regulations are not harmonised. The European passport should be amended in order to cover custody/trustee activities.’
- ‘It is easy in some markets, but hard in others – eg, Germany – the KAG structure funds make it expensive and time-consuming to comply with proper regulating and reporting.’

The barriers to entry listed by the asset managers tended to be different.

- ‘High cost/investment in systems requires high volume of assets under custody to make a return; credit rating’.
- ‘Barriers to entry are linked with the market share owned by custodians, the level of concentration of this activity and the size of other actors. The number of assets has to be high to absorb the administrative and IT costs which are high.’
- ‘The legal framework requiring a local presence, capital requirements, etc. This combined with the fact that custody can only be performed on a very large scale due to low margins … Therefore I believe that only the largest will survive in the market.’
- ‘Different regulations and obligations for custodians; capital requirements; investments in human resources and technology in order to establish relationships with asset management companies and distributors.’
- ‘The main barriers to entry are:
  - the ability to set up and maintain a custody/record-keeping system;
  - to build a sub-custodian network from scratch;
  - to hire and maintain skilled operations staff;
  - to stay ahead of the market changes such as SWIFT ISO 15022 and T+1.’

One asset manager commented that ‘the trend in custody has been towards consolidation amongst the established providers, with the necessary commitment to resources and technology, rather than the arrival of new entrants.’

5.7 Summary

This chapter presented evidence on the role of custody in protecting investors against operational risks in asset management, based on a survey conducted among custodians and asset managers operating in eight European countries.

The aim of the survey was not to undertake a rigorous empirical evaluation of current custody arrangements in the various countries. Rather, the responses of a select sample of firms were used to examine the main issues that are relevant to this research project. The evidence obtained from the survey suggests the following.

- The main function performed by custodians is safekeeping. Custodians also undertake a number of administrative functions, in particular record-keeping, settlement, and the collection of income receivable. Subject to a special agreement, custodians provide a number of other value-added services.

- Compliance monitoring and valuation are functions and responsibilities of the depositary/trustee of UCITS, as defined in laws and regulations. This contrasts with the custody arrangements in the case of mandates, which are mainly contractual and do not generally include an oversight role.

- Custody does provide good protection against some but not all operational risks in asset management. Importantly, protection is generally better under depositary/trustee arrangements that apply to retail funds than in the case of mandates.

- One of the most significant differences between retail funds and mandates occurs with respect to breaches of client guidelines. This risk is mitigated by depositaries/trustees but not by custodians in the case of mandates. Under current contractual arrangements in mandated asset management, custodians cannot generally be held liable for failures to monitor the asset manager.

- The other main difference occurs with respect to mispricing of fund or client assets. While depositaries/trustees mitigate the risk of losses resulting from pricing errors (eg, incorrect NAV calculations), custody arrangements in the case of mandates afford little protection against this risk.

- Custody provides no good protection against misdealing, fraud or other operational failures, such as failures by the asset manager to achieve best execution. This applies to both retail funds and mandates, although protection against these risks is somewhat better in the case of retail funds.

- The main protection provided by custody relates to the risk of theft of securities – ie, the custodian assumes a ‘bailment function’ and provides secure premises for client assets. Custody also tends to protect against settlement errors and failures to collect all client entitlements.

- Although custody has a role in client protection, the variation in survey responses suggests that there may well be some ambiguity and uncertainty regarding the responsibilities of custodians and their liability in the event of operational failures, even in the case of retail funds.

- There is scope for increasing the role of custody in protection against operational risks. However, many custodians and asset managers did not see a need to revise custody arrangements to improve client protection, especially since this would increase custody fees, which clients might not be willing to pay.

- Proposals of firms which supported the need to revise custody arrangements included standardisation of custody contracts and a clearer definition and assignment of custodian responsibilities.

- Many firms perceived there to be regulatory barriers to entry into the custody market, and some would like to see harmonisation in custody regulations. Other barriers to entry are related to market structure and costs.

6. Case Studies

This chapter examines four cases in which investors were exposed to operational risks in the asset management process. They raise generic issues for the role of custody in investor protection, and illustrate:

- the way in which failures in the asset management process can create losses for investors;
- the potential protection afforded by third-party custodians;
- that current custody arrangements may not be sufficient to eliminate risks;
- a potential lack of clarity in the duty of care provided by custodians, even in the more regulated market for collective investment schemes;
- that particular forms of custody can nevertheless mitigate the risks of loss for investors;
- that any compensation for investors depends on the custodian being sufficiently well capitalised.

The description of the cases is entirely based on official information. It is not intended to indicate inappropriate behaviour by any individual or company.

6.1 Failure of a UK financial adviser[24]

Key facts

- Albion Management Services Ltd, formerly known as Albion Investment Management Ltd, was a UK authorised independent financial adviser, regulated by the Financial Services Authority (FSA).[25] On January 16th 2002, the High Court granted an order for the compulsory winding-up of the firm, following a petition by the FSA. The Official Receiver London was appointed liquidator.

- The FSA asked the court to wind up Albion on the grounds of insolvency because it did not have the means to make up the shortfall of about £1m in client assets. Albion had been holding client assets, such as shares – some of which appeared to be missing. In addition, the FSA alleged that Albion had misrepresented the true position to clients over a period of many years.

- The order followed earlier regulatory action on November 15th 2001, which included suspending Albion's authorisation to conduct investment business. Albion was also prohibited from dealing with client assets, and the FSA took possession of certain valuable securities for safekeeping.

- Creditors of Albion were asked to make their claims to the Official Receiver London. Once the extent of the losses was known, investors would be able to apply for compensation to the Financial Services Compensation Scheme.

[24] All information is taken from an FSA press release—FSA/PN/005/2002, January 17th 2002.
[25] Until November 2001, when the FSA assumed its full regulatory powers, the firm was regulated by the Personal Investment Authority (PIA).

Some lessons

Although information on this particular case is limited (mainly due to the continuing investigation at the time of writing this report), it suggests that investors may be at risk if investment managers retain control over client assets. This may be the case even when assets are formally separated from those of the manager. The loss might have been avoided if client assets had been kept by a third-party custodian.

6.2 Failure in a UK authorised collective investment scheme[26]

Key facts

- In September 1996, dealings in three Morgan Grenfell funds were suspended after the discovery of irregularities in the management of the funds. Trading resumed after Deutsche Bank, the parent company, injected £180m into the funds.

- For a period of time, the irregularities that took place remained undetected by the internal control system of Morgan Grenfell Asset Management Ltd (MGAM) and the external supervision by the trustees. The Investment Management Regulatory Organisation (IMRO), which was the regulatory body for investment managers in the UK before the FSA assumed its full regulatory powers in 2001, brought forward charges against Morgan Grenfell's fund management subsidiaries, senior employees and compliance staff, and the funds' trustees.

- Investors in the three funds were compensated directly by MGAM for the difference between the investment return from their Morgan Grenfell fund and the investment return provided by a specially compiled index of comparable funds. The total compensation costs borne by the firm for losses amounted to more than £210m.

Background

MGAM was the UK asset management arm of Deutsche Morgan Grenfell and part of the Deutsche Bank Group. Its subsidiary, MG Unit Trust Managers (MGUTM), was the appointed fund manager of the MG European Growth Trust and the MG Europa Fund. MGUTM delegated the day-to-day management of the two unit trusts to another subsidiary, MG International Fund Management (MGIFM). MGIFM was also delegated responsibility to manage the MG European Capital Growth Fund, a Dublin-registered investment fund.

Origins of the failure

After taking over the management of the funds in 1994, the individual fund manager started changing the nature of the funds' investments. From being well diversified, the portfolios in due course became increasingly concentrated in high-risk holdings of unlisted securities. While pursuing this investment strategy, the fund manager faced two primary barriers arising from unit trust regulations:

- the regulatory rule that restricted, to 10% of a fund, unit trust holdings in unapproved securities (ie, securities which were not listed in an eligible securities market and which were not issued on terms that a listing would be applied for within 12 months);

[26] This case has been described in a previous report prepared for EAMA by Franks, J., Mayer, C. and OXERA (2001), op. cit.

- the rule that prevented unit trusts acquiring more than 10% in securities issued by one issuer.

To assist in circumventing these regulations, the fund manager set up holding companies, mainly in Luxembourg. These companies were used as special purpose vehicles to hold or acquire problem securities in the funds. They created an indirect exposure to unapproved securities in excess of that permitted by strict adherence to the spirit, as well as the letter, of the rules. In addition, the funds held bonds that had been structured to exploit loopholes in the regulations.[27] By April 1996, the fund manager had increased the proportion of unlisted, risky companies in the European Growth portfolio to 33% and thus far above regulatory limits.[28]

Overall, it may be claimed that the funds were managed in a way that abided by the letter rather than the spirit of the regulations, leading to a risk and investment profile that was inappropriate for retail funds and could have created liquidity problems.

IMRO's investigation

The problems in the management of the Morgan Grenfell funds were discovered by IMRO towards the end of August 1996, and dealings in the funds were suspended on September 2nd 1996. Trading in the funds resumed on September 5th after Deutsche Bank, MGAM's parent institution, injected approximately £180m into the portfolios by buying the particular securities out of the funds.

The fund manager was suspended and, on September 16th, finally dismissed. In mid-October, the chief executive of MGAM and four other senior employees left the company.

On December 20th 1996, IMRO and MGAM finalised the investor compensation package. All investors in the three funds at any time between August 1995 and September 1996 were compensated directly by MGAM for the difference between the investment return from their Morgan Grenfell fund and the investment return provided by a specially compiled index of comparable funds. In addition, MGAM paid interest on the compensation payments from April 1997. The total compensation costs borne by the firm for losses in this case amounted to more than £210m.

Failure of internal control systems

For its part, IMRO spent the next eight months investigating and imposing penalties for what it perceived as ineffective controls at Morgan Grenfell, and the lack of effective oversight on the part of the funds' trustees. The fund manager himself became the subject of an investigation by the Serious Fraud Office.

According to IMRO, the fact that the fund manager's actions continued for a lengthy period of time, and that MGAM's management and its compliance staff failed to ensure that the funds were managed according to the regulations and their prospectuses, was largely owing to a lack of adequate internal control and monitoring procedures.[29] In particular, investigations revealed

[27] See IMRO Press Release, Ref 05/97.
[28] See IMRO Press Release, Ref 01/99.
[29] See IMRO Press Releases, Ref 05/97, 01/99.

problems related to inadequate documentation requirements and record-keeping. The lack of control allowed the fund manager to build up excessively risky portfolios and push the investments beyond existing regulatory limits on unit trust holdings in unquoted equities or securities of a single issuer. Due diligence was not sufficiently exercised to prevent the assets of the funds being used or invested contrary to unit trust regulations – for instance, it was not recognised that some of the holding companies were not genuine investments, but special purpose vehicles used to circumvent regulatory rules.[30]

As a result of IMRO's investigations, the chief executive and several members of senior management and compliance were reprimanded. They were charged IMRO's investigation costs and a contribution to its disciplinary costs.

On April 16th 1997, IMRO also fined Morgan Grenfell's subsidiaries, MGIFM and MGUTM, £2m for mismanagement of the European funds.[31] In addition to the £2m fine, the investment firms had to pay £1m to defray IMRO's investigation costs. In deciding on an appropriate fine, IMRO took into account the number of investors affected, the potential losses, and, in mitigation, Morgan Grenfell's quick action to compensate investors in the funds.

Trustees' failures

IMRO's investigation and proceedings extended to the funds' trustees. Under UK regulation, trustees have two main functions:

- to take the assets of a unit trust into custody and hold them in trust for unitholders;
- supervision to ensure that unit trust managers comply with regulatory rules and investment objectives. This function extends to reporting to unitholders on manager compliance.

General Accident was trustee of a number of unit trusts managed by MGUTM, including the European Growth Trust and the Europa Fund. When General Accident resigned in early 1996, The Royal Bank of Scotland took over the trusteeship of the funds. Both General Accident and The Royal Bank of Scotland agreed to a settlement of the disciplinary proceedings and to fines of £120,000 and £290,000, respectively. The trustees were also charged the IMRO investigation costs of more than £247,416 for General Accident and £143,020 for The Royal Bank of Scotland. The fines were brought on the basis that the trustees did not exercise an appropriate level of supervision of MGUTM's operation of the unit trusts, and did not identify and report that the trusts' investments in unapproved securities were in excess of the limits permitted by the regulations. In addition, General Accident was charged for not taking into its custody or providing safe custody for bearer share certificates[32] in two companies acquired by the European Growth Trust on August 2nd 1995 for £16m.[33]

[30] See IMRO Press Releases, Ref 07/98, 05/97.
[31] See IMRO Press Release, Ref 05/97.
[32] A bearer share certificate is not registered in the name of the holder, who can sell it or claim dividends upon presentation of the certificate to a bank or a broker.
[33] See IMRO Press Releases, Ref 03/98, 04/98.

Some lessons

As discussed in chapter 4, unit trust regulations give trustees an important role in protecting investors. However, the events at MGAM illustrate that, even where there are independent trustees responsible for monitoring the asset management firm – in this case, a unit trust manager – losses can arise due to failure to monitor effectively. They also raise the concern that, if MGAM had not had a parent with a deep pocket and a valuable reputation, investors might not all have received adequate compensation. While the investor compensation fund would have provided some recompense to investors, it is not obvious that it would have provided full compensation to all investors. It is also unclear to what extent the trustee would have been obliged by regulations and the nature of the contract to contribute. In other words, the concern is that the implied duty of care is not clear and unambiguous, and therefore may not provide sufficient investor protection in the event of failure by the investment manager.

6.3 Problems in a German collective investment scheme[34]

Key facts

- On September 18th 2001, the German Federal Court of Justice concluded a lawsuit for damages of an investor against a depositary bank of a German investment fund.

- After the investor's purchase, the units lost considerable value. The investor claimed that the exclusive investment of the fund in Japanese options violated the principle of geographical risk diversification. Consequently, he sued the depositary bank for failing to perform its duty of supervising the fund and the management company.

- The charge was denied on the basis that a depositary bank is not responsible for checking the suitability of investment decisions of the management company, only their legality with respect to the law and the fund rules. The investor's losses were therefore not compensated for by the depositary bank.

Origins of the losses

On August 23rd and September 21st 1989, the investor invested DM25,000 and DM8,436.80 in the investment fund, buying 250 and 80 units each valued at DM100 and DM105.16, respectively. The fund was a fund in options ('Optionsscheinfond'). It was issued and managed by a German investment management company and, as required by German investment fund law (KAGG), had a depositary bank ('Depotbank') entrusted with safekeeping the fund assets and in charge of monitoring. The depositary bank was also one of the main fund distributors. Due to adverse market movements, the value of the fund units fell considerably, and, in October 1997, had reached a low of DM3.15. In 1993 and 1994, the fund had invested exclusively in Japanese options. The investor sued the depositary bank for breaching its duty to supervise the investment management company in adhering to the principle of geographical risk diversification. The investor's claim for compensation amounted to a total of DM33,436.80 plus interest.

[34] The information is based on the published ruling of the German Federal Court of Justice; BGH, Urteil vom 18 September 2001 (XI ZR 337/00, Frankfurt a. M.).

The court's decision

The Federal Court of Justice discharged the depositary bank of any liability for compensation because it had not breached its duties according to the KAGG. The court explained that the legal duties of a depositary bank are those of safekeeping of fund assets and bringing unitholders' claims against the management company. They also include the monitoring and control of the management company so as to prevent legal or contractual breaches against fund law and rules. Moreover, according to the KAGG, the depositary bank has the obligation to act solely in the interest of unitholders and to take preventive steps, should their interest be violated.

However, the court made clear that the supervisory function is restricted to checking the legality of actions and not their suitability. The depositary bank therefore has no obligation to control and evaluate whether investment decisions make economic sense. Rather, the KAGG provides that the depositary bank must follow the instructions of the management company as long as these do not violate law or fund rules.

The depositary's failure to intervene in the exclusive investment of fund assets in Japanese options did not constitute a breach of duty under law. The KAGG provides that risk diversification is a basic principle to which a fund must adhere, but the law does not require a geographical spreading of investments. Within the legal investment limits that apply to a single issuer, a securities fund is allowed to invest exclusively in securities of a single country.

In addition, the portfolio allocation did not violate the contractual fund rules. These specified that the fund would invest mainly in domestic and foreign options. Options would be selected on the basis of economic and market developments in the various countries and companies, with a view to achieving growth. The court argued that these general rules did not imply an obligation to diversify the portfolio across different countries.

The prospectus to market the fund included a statement that 'great importance is attached to a broad diversification of risks.' However, the court concluded that the supervisory function of the depositary is limited to a fund's adherence to the law and fund rules. It does not extend to monitoring whether a particular portfolio strategy conforms with the prospectus. The court ruling therefore did not address the question of whether a 'broad diversification of risk' necessitated geographical diversification.

In its decision, the court also made the general point that a unitholder has no individual rights against a depositary bank. Rather, any claims for damages against a depositary bank must be done by the unitholders through an *action pro socio* – ie, brought forward by the community of all unitholders.

Some lessons

The case suggests that the court had a restrictive evaluation of the monitoring duty of the depositary. While depositaries have a role in mitigating risks, the case casts some doubt that, in the current system, investors are fully protected from failures in the investment management process. However, it does not rule out the possibility that, had clear responsibilities been assigned to the depositary, the outcome would have been different. Moreover, if the management company had violated law and fund rules, it is likely that, under the current regulatory framework, the depositary would have borne any losses incurred by investors.

6.4 Failure of a US investment manager[35]

The fourth case refers to the failure of a US investment manager. Although this report does not consider custody arrangements in the USA or draw any comparisons with European arrangements, the case nevertheless raises some generic issues and presents a useful illustration of the potential role played by custodians in protecting investors against operational risks.

Key facts

- On December 17th 2001, the US Securities Exchange Commission (SEC) and the Commodities and Futures Trading Commission (CFTC) issued orders against Republic New York Securities Corporation for assisting in a fraud perpetrated by Martin Armstrong and his companies.
- The fraudulent activities by Armstrong included commingling investor funds to conceal trading losses; improperly charging 'performance fees' based upon false performance claims; and making withdrawals from client accounts for improper disbursements. The losses incurred by investors exceeded $700m.
- Republic Securities, which acted as custodian of the client accounts, agreed to pay restitution totalling about $606m. Its parent company agreed to pay certain defrauded investors the difference between the restitution amount and Republic Securities' available capital.

Background facts

Martin Armstrong owned and controlled a series of limited-liability companies formed in the Turks and Caicos Islands, British West Indies, that were headquartered in Princeton, New Jersey. These entities included Princeton Economics International, Ltd (PEI), an investment adviser, Princeton Global Management Ltd (PGM), and a series of special-purpose companies that issued notes to investors (Princeton Notes). These were marketed in Japan by Cresvale International Limited Tokyo Branch (Cresvale Tokyo), a wholly owned indirect subsidiary of PEI.

The investor proceeds from the Princeton Notes were deposited with a custodian: Republic Securities, a broker-dealer and futures commission merchant registered with the SEC and CFTC.

Origins of the failure

Starting from at least June 1992 to August 1999, Armstrong sold billions of dollars worth of Princeton Notes to Japanese investors on the premise that he was a successful commodities trader whose knowledge of world currency moves would ensure safe, profitable investments.
The Princeton Notes were issued by a series of special-purpose companies formed in the Turks and Caicos Islands (Princeton Issuers). Armstrong informed investors that he would open individual accounts for each of the PGM Issuers. From early 1995 to 1999, these accounts were maintained at Republic Securities.

[35] The case study is based on SEC Release No. 45157, December 17th 2001; CFTC Press Release No. 4590-01 December 17th 2001, and CFTC Docket No. 02-03.

Armstrong, directly and through PEI, PGM, and Cresvale Tokyo, told investors that the proceeds of the notes would be invested mainly in US government agency debt instruments. Marketing materials claimed that ‘the overriding principle behind Princeton’s approach to managing funds for clients is the preservation of the client’s capital,’ and that the basic approach to fund management and investment was extremely conservative.

Armstrong bolstered his representations about the safety of the Princeton Notes by deliberately confusing Republic Securities with its affiliate Republic Bank, pointing to the bank’s capitalisation, large gold reserves, and bond rating. In addition, Armstrong persuaded Republic Securities to execute fiduciary agreements for each Princeton Issuer account so as to bolster representations to investors that Republic was fully aware of the fiduciary responsibility.

Armstrong also told investors that Republic Securities would hold the proceeds of each note in a segregated account. He told investors that the segregated accounts would protect them in the event that Republic Securities filed for bankruptcy, and that ‘PEI is not permitted to wire funds from the account to anyone other than the original source.’

Armstrong’s representations concerning the safe and conservative nature of his investment strategy were false. Rather than investing solely in US government agency debt instruments, Armstrong traded currencies, metals, bonds, options and futures. His trading losses from this risky and speculative trading were staggering: from 1995 to 1999, Armstrong incurred in excess of $550m in net trading losses and costs.

In addition, beginning in at least 1995, Armstrong commingled the investor funds and moved cash and securities among the various Princeton-related accounts without regard to the promises made to investors about the segregation of accounts. The Temporary Receiver appointed by the court for PEI found that Armstrong transferred approximately $282m from the Princeton Issuer accounts to PEI’s account, ostensibly as management and performance fees. Pursuant to the standard terms of the Princeton Notes, PEI would not have been entitled to the vast majority of these fees in light of the results of Armstrong’s trading. According to the Temporary Receiver, Armstrong also diverted approximately $169m directly from the Princeton Issuers accounts to his own personal benefit.

Failure of the custodian

According to the SEC and CFTC orders, Republic was an active participant in, and beneficiary of, Armstrong’s fraudulent scheme. Examples include:

- From November 1995 to July 1999, Republic Securities prepared and delivered more than 200 letters concerning the NAV of the accounts. The majority of these letters materially overstated the account balance (eg, they did not account for trading losses). The letters were prepared and signed by the President of the Futures Division and his assistant, who knew that Armstrong planned to show the letters to investors.

- Members of the Futures Division enabled Armstrong to commingle funds among the various accounts to fund his trading losses and divert funds to his own benefit, even though Republic Securities knew from the fiduciary agreements that Armstrong was stating that the funds would be held in segregated accounts.

- In March 1999, the Futures President prepared two letters for Armstrong to present to investors to bolster Armstrong's representations that the investor funds were held in segregated accounts. These letters were false.

- In July 1999, Republic Securities provided Armstrong with a letter signed by its president that falsely stated that the Futures President had authority to sign NAV letters. In addition, in August 1999, the Futures Operations Manager prepared a letter which stated that the balance in certain PGM accounts as of March 31st 1999 was approximately $369m, but omitted to state that those accounts were collateralising the trading accounts at that time, and that the true net value in all of the Princeton accounts was only approximately $16m. In an effort to conceal his fraudulent activities, Armstrong provided both of these letters to the Japanese Financial Supervisory Agency, which had launched an inquiry.

- Republic Securities did not follow its internal guidelines and compliance procedures. Its 'know your customer' policy required the following activities to be reviewed: any increase in the level of customer activity; any move to a more speculative investment strategy; accounts reflecting significant trading losses; and accounts reflecting monetary transactions that are not consistent with trading activity. All four activities were prevalent, but were not monitored by Republic Securities.

From 1995 to 1999, the Futures Division was the most profitable business sector at Republic Securities and the fees relating to Armstrong's business accounted for virtually all of the Futures Division's revenues. From 1995 to 1999, commissions and fees from Armstrong's business totalled approximately $35m.

The charges against the custodian

In late August 1999, a senior official at Republic Securities' parent company learned about the inquiry by the Japanese Financial Supervisory Agency. Following an internal investigation, Republic Securities and its parent company notified law enforcement about the inquiry and the discovery of a large number of false NAV letters.

On September 13th 1999, Armstrong was arrested on criminal fraud charges and, on September 29th 1999, he was indicted by the federal grand jury in the Southern District of New York on 14 counts of conspiracy, securities fraud, and wire fraud.

At least 55 defrauded investors filed lawsuits against Armstrong, the Princeton entities, Republic Securities, officers of Republic Securities and Republic Securities' parent company, seeking to recover the losses caused by their investments in the Princeton Notes.

On December 17th 2001, Republic Securities entered a plea of guilty to federal charges of securities fraud and conspiracy to commit securities and commodities fraud. It agreed to the entry of an order directing it to pay restitution totalling approximately $606m. Its parent company agreed to pay certain defrauded investors the difference between the restitution amount and Republic Securities' available capital in exchange for releases by those investors.

Also on December 17th 2001, the SEC revoked Republic Securities' registration as a broker or dealer. The CFTC revoked the firm's registration and required it to pay a civil monetary penalty of $5m.

The CFTC Chairman commented:

> The CFTC is committed to protecting futures investors around the world. We have already charged Martin Armstrong with running a fraudulent futures trading scheme. Now we are taking action against Republic for using its facilities to assist Armstrong in defrauding investors.[36]

The CFTC Acting Director of Enforcement said:

> When a registrant handling customer business fails to act to stop conduct that has every appearance of being part of a fraudulent scheme, that registrant can be liable for the fraud as an aider and abettor. The Commission sanctioned Republic because the firm's actions and inactions in this affair assisted a fraudulent scheme.[37]

Some lessons

In the Republic case, the fraudulent activities by the investment manager were made possible not only through the lack of monitoring by the custodian but also because employees of the custodian abetted the fraud. Thus, both inaction and actions of custodians can increase the risk of losses for investors arising in the investment management process. However, the fraud was revealed and the custodian was held liable for its failure and participation in the scheme. The loss to investors could have been significant, but the deep pockets of the custodian (and its parent) allowed full compensation. This shows that compensation for investors depends critically on the custodian being sufficiently well capitalised.

[36] CFTC Press Release No. 4590-01 December 17th 2001.
[37] CFTC Press Release No. 4590-01 December 17th 2001.

Appendix 1: Regulatory Framework in Eight European Countries

Appendix 1 summarises the regulatory framework governing the role of custody in asset management in eight European countries:

- France (section A.1.1);
- Germany (section A.1.2);
- Ireland (section A.1.3);
- Italy (section A.1.4);
- Luxembourg (section A.1.5);
- the Netherlands (section A.1.6);
- Spain (section A.1.7);
- the UK (section A.1.8).

Each country-specific section is split into two parts: the first describes custody arrangements in mandated asset management; the second focuses on the role of the depositary/trustee of investment funds.

The summaries are intended to give an overview of the regulatory frameworks in the countries. A detailed legal analysis of the laws and regulations in each country is beyond the scope of this report.

A1.1 France

A1.1.1 Regulators and regulations

Asset managers in France are governed by the regulations and fall under the jurisdiction of the Commission des Opérations de Bourse (COB). The COB is an independent administrative body responsible for authorisation and supervision of the activity of individual and collective portfolio management. It is also the regulatory authority responsible for investor protection in France and for law enforcement, partly through the imposition of administrative sanctions in respect of breaches of its regulations.

The Financial Activities Modernisation Act, enacted on July 2nd 1996, allows management companies the freedom of choice of their purpose. They can either manage exclusively UCITS (sociétés de gestion d'OPCVM), or expand their purpose to cover all types of asset management, including UCITS, in which case they are called portfolio management companies (sociétés de gestion de portefeuille).

Custody activities in the French market are regulated and supervised by the Conseil des Marchés Financiers (CMF). To the extent that the major custodians are banks, they are also subject to regulations of, or are supervised by, a number of other authorities, such as the Ministry of Economy and Finance, the French Central Bank, the Commission Bancaire, the Comité des Etablissements de Crédit et des Entreprise d'Investissement, and the Comité de la Réglementation Bancaire et Financière.

A1.1.2 Mandated asset management

Mandated individualised portfolio management is performed using highly diversified legal and organisational structures. It is generally presented in two forms:

- as a management company or entity within a group exclusively responsible for portfolio management;

- as a structure offering a range of services and products in the field of asset and liability management on behalf of clients. This is especially true in the case of institutions or multi-capacity groups that also act as custodians of assets.

In the latter case, the 'Professional Ethics' defined by the trade association, AFG-ASFFI, specify that the autonomy of the management activity must be ensured and must include the principle of the separation of fields of activities and operation.[38]

Segregation of client assets and custody

In France, client assets must be held separately from those of the asset management company and in a client's own account with a custodian. The COB must be informed about the identity of the custodian when applying for authorisation to conduct business and about any subsequent changes in the custody arrangements. French custodians are mainly regulated by the CMF and must comply with the Code Monétaire et Financier. General custody rules are contained in the CMF regulations (Règlement générale du CMF). Additional regulations and 'performance requirements' are contained in the 'Cahier des charges du teneur de compte-conservateur'.

Eligible custodians

Authorisation to conduct custody business may be given to credit institutions and investment firms, subject to a special capital requirement for custodians of at least €3.8m. In addition, the custodian must satisfy requirements that relate to matters such as human resources, information systems, accounting, client protection and internal control. Credit institutions and investment firms operating in other EEA countries may provide custody services in France, provided that they are authorised in their home country to safeguard and administer custody assets.

Functions and responsibilities of custodians

Under general CMF regulations, the custodian has the following obligations in relation to its clients' assets (the client may be the asset management firm or the investor):

- to safeguard assets held in custody;
- not to use custody assets without the client's express consent and to return them if instructed to do so;
- to ensure that all assets and transactions in assets are booked in strict accordance with applicable rules and procedures;
- to take the steps necessary to segregate, in the books of any central securities depository, its own assets, the assets of any UCITS for which it is depositary, and the assets of its other clients;
- to inform its clients of:
  - corporate actions requiring a response from the client;
  - items needed for the purpose of drawing up the client's tax return;
  - any events affecting the client's rights in respect of the custody assets;
  - the execution of any trades and of cash held for the client;

[38] AFG-ASFFI (1999), 'Mandated Individualised Portfolio Management Professional Ethics'.

- to issue periodically, and at least once a year, an attestation specifying the nature and number of securities held in the custody account.

The general rules also specify that the liability of the custodian must not be affected by the appointment of a sub-custodian. Separate custody rules apply to central depositories and to payment and settlement systems.

In addition to the general regulations, custodians must adhere to a number of 'performance requirements'. These contain details about matters relating to transactions in client assets. For example, they require that the custodian should detect and take appropriate actions if transactions are not completed within the time limits set by market rules or rules of payment and settlement systems. The custodian must also contact the counterparty if an expected delivery of securities is not received by a scheduled date. The requirements further relate to the custodian's required information processing systems, accounting procedures and internal controls.

A1.1.3 Investment funds

Types of investment fund

The French collective investment market is the second-largest domestic market after the United States. CIS in France are called OPCVMs (Organismes de placement collectif des valeurs mobilière) and are defined in the UCITS Directive. They are divided into two main categories which differ with respect to their legal form: SICAVs (sociétés d'investissement à capital variable), which are open-ended investment companies, and FCPs (fonds communs de placement), which have a contractual form and represent 'co-ownerships' of transferable securities. FCPs are gaining market share and now represent more than half of the market.

Custody of fund assets and eligible depositaries

The assets of OPCVMs or UCITS must be held by independent depositaries which act as custodian and perform a monitoring role. This requirement was set out in the French fund legislation of 1988.

The following categories of entities have been designated by the Ministry of Economy and Finance, which also has responsibility for assuring that CIS actions comply with applicable laws and regulations, as eligible depositaries of funds:

- banks;
- Banque de France;
- Caisse des Depôts et Consignations;
- brokerage firms and other investment firms licensed to act as depositary;
- insurance companies;
- Sociétés des Bourses Françaises (the clearing house and the managing company of the Paris Stock Exchange).

According to French investment fund law, the depositary must have its registered office in France and must be a legal entity other than the investment management company. Depositaries are subject to the capital requirements for custodians of €3.8m. The regulator for depositaries is the COB, although depositaries, being custodians, will also be subject to the Code Monétaire et Financier of the CMF.

As with direct mandates, the management of UCITS is carried out within a very varied legal and organisational framework. It appears, more often than not, as just one of the activities of institutions or multi-capacity groups which also undertake custodian functions. In these cases, fund regulation specifies that the custodian must act independently from the management company. Moreover, the Professional Ethics of the AFG-ASFFI require the autonomy of the UCITS management activity and the avoidance of possible conflicts of interest.

Functions and responsibilities of depositaries

In November 1993, the COB imposed a regulation stating that the functions of a depositary of a UCITS that go beyond safekeeping are:

- to ensure that the asset management company respects the investment rules specified in the prospectus;
- to ensure lawfulness of investment operations and NAV calculations;
- to examine the portfolio holdings at specified intervals and ensure that they are compatible with the fund's stated objectives;
- to execute the investment management company's orders unless they are contrary to the law;
- to ensure that the scheme respects the minimal asset and accounting procedures.

The depositary participates in all basic points in the life cycle of the UCITS, including its creation, change of investment manager, mergers and acquisition, or liquidation. It carries out its functions according to a written agreement between the fund and the depositary, which must be available for inspection by the COB.

Where rules are not observed by the management company, the depositary must follow prescribed procedures and bring problems to the attention of the portfolio manager or fund operator, the auditor of the fund, and the COB or the judicial authorities. The depositary remains legally responsible to the investors.

Institutional investment funds

The depositary arrangements described above apply to UCITS. The French investment fund market also has institutional investment funds, where institutional investors set up a fund only for their own investment. Depositary arrangements in this case may be very similar to those in the case of UCITS.

A1.2 Germany

A1.2.1 Regulators and regulations

The German Banking Act (KWG) classifies custodian services as a banking activity that correspondingly requires a licence from the Federal Agency for Financial Market Supervision (BAFin).

Basic safe-custody rules are laid down in the Safe Custody Act (Depotgesetz), a special item of legislation for the banking sector. For investment funds, additional strict safe-custody rules arise according to the Investment Companies Act (KAGG).

A1.2.2 Mandated asset management

Segregation of client assets and eligible custodians

According to the KWG, financial services institutions that manage assets on a discretionary basis have to keep securities in a safe-custody account of the client at a credit institution, which is subject to a minimum capital requirement of €5m. Otherwise, asset managers would require a licence to conduct safe-custody business and hence would be credit institutions themselves.

The same requirement is laid down in the Code of Conduct rules of the Securities Trading Act (WePHG). Investment services firms which are not deposit-taking credit institutions must immediately pass on funds and securities that they accept in the course of investment business to a credit institution authorised to conduct deposit-taking business in Germany, or to a suitable credit institution based abroad, which is authorised to conduct deposit-taking business and with which the client is granted a legal status equivalent to that under the German Safe Custody Act.

The firm must immediately inform the client of the account in which the funds and securities are placed, and whether the credit institution with which the funds and securities are held belongs to an institution designed to protect the claims of depositors and investors (such as the deposit protection scheme in Germany). In addition, it must inform the client about the extent to which the securities are protected by such institutions.

Functions and responsibilities of custodians

The Safe Custody Act deals with custody in the form of collective safe custody, or, at the special request of the owner or where only individual securities are issued, in the form of individual safe custody. Owing to rationalisation and cost factors and the general benefits of the book-entry system, only collective custody of immobilised or dematerialised securities is of significance today.

In line with the possibilities laid down by the Safe Custody Act, the securities acquired by an investor are, as a rule, kept and administered, via a bank, at Clearstream Banking AG Frankfurt, the Central Securities Depository. Almost all banks engaged in custody operations maintain accounts with Clearstream. Institutions without a direct link to Clearstream can make use of the services offered by Clearstream indirectly via its customers.

The act specifies the legal responsibility of the custodian to ensure safekeeping and provides for punishment in case of breaches. For example, custodians are responsible for any shortfalls in the custody assets unless these were due to circumstances beyond their control. Custodians also retain full responsibility if they entrust a third-party custodian (sub-custodian) with the safekeeping, unless the client specifically asked for the third party. The act requires special audit examinations for custodians, in addition to those of the Banking Act.

The responsibility of the custodian under the act is restricted to proper safekeeping. There are no legal requirements that the custodian should perform any function other than safekeeping. In particular, there is no requirement for the custodian to perform a monitoring function. Additional custodian responsibilities will be subject to contractual arrangements between client and custodian, or between asset manager and custodian.

A1.2.3 Investment funds

Types of investment fund

There are two types of investment fund in Germany:

- *Retail funds* (Publikumsfonds) – these are investment funds that issue their shares to the general public (ie, to an unlimited number of investors). Securities funds come under the scope of the UCITS Directive.

- *Special funds* (Spezialfonds) – these are investment funds that issue their shares only to a limited number of institutional investors (up to ten), such as insurance companies, pension schemes and other companies. Special funds are subject to the same investment and tax rules as retail funds.

Both are contractual funds that are managed by an investment management company (Kapitalanlagegesellschaft, KAG). The investor acquiring a unit enters into a contract with a manager whereby the investor acquirers a share of a certain asset pool.

German banking law defines investment fund management as a specialised form of banking. Thus, institutions carrying out CIS business are subject to supervision by BAFin.

For retail and special funds, strict safe-custody rules arise according to the KAGG, BAFin circulars defining the application of the law, and the fund rules (Allgemeine und Besondere Vertragsbedingungen).

A specimen of the fund rules, which contain the contractual obligations, is published by the trade association, Bundesverband Deutscher Investment-Gesellschaften (BVI). Firms are free to add obligations as long as these do not violate the law. For retail funds, the fund rules need to be sent to, and approved by, the regulator.

Custody of fund assets and eligible depositaries

The KAGG and fund rules require the separation of fund assets from the business capital of the investment company managing the fund. The investment fund assets must be kept in the custody and under the supervision of a depositary bank (Depotbank). A qualifying depositary must be a credit institution as defined in the Banking Act and therefore needs a written licence by BAFin. It must have its registered office in Germany and satisfy a minimum capital requirement of €5m.

Depositary banks are not required to take out insurance for their custody services, but they must be members of a deposit protection scheme which ensures that deposited funds will be fully maintained in case of the depositary's insolvency. As soon as the amount of funds deposited with a single depositary exceeds that which is protected by the scheme, the depositary has to transfer this amount to another institution to ensure full protection.

The investment management company is responsible for appointing the depositary bank, and will always be the party concluding the custody agreement. A substantial number of German investment companies are affiliated to their respective parent bank, which is acting as depositary bank for the funds managed by the investment company. However, despite the possible affiliation, the investment company and the depositary have to be two legally separate companies (eg, the bank must not share the same directors as the investment company), with distinct capital requirements.

The choice and any changes of depositary bank have to be approved by BAFin. BAFin may also request a change of depositary bank.

Functions and responsibilities of depositaries

All assets of an investment fund are kept safe by the depositary bank either in a blocked account for securities or in a blocked account for bank balances.

The legal relationship between the investment company, the depositary bank and the investor is defined by the KAGG. In particular, the depositary bank is obliged to act independently of the investment company and solely in the interest of the investors in the fund. However, it has to pursue instructions of the investment company, as long as these do not contravene the legal or contractual requirements.

The authorities and responsibilities of the depositary bank include:

- the safekeeping of all assets;
- the supervision of the investment company's compliance with the relevant laws and regulations, and with the fund rules;
- the issue of unit certificates against payment of the purchase price, and acceptance of unit certificates for redemption against payment of the redemption price;
- recalculating the NAV of the fund and reconciling it with the NAV calculations of the investment company;
- ensuring that transactions are effected within the usual time limits;
- entering fund income into its books and distributing investor entitlements where these arise;
- informing the investment company about corporate actions and the operational handling of corporate actions;
- conducting price checks to ensure that execution prices are in line with market prices;
- where necessary, taking actions against the investment management company in the bank's own name and on behalf of clients;
- distributing the assets held in custody on default of the investment management company.

The supervisory and control function of the depositary bank refers to asset allocation, stock-lending, borrowing of the investment company, the settlement of transactions on a DVP/RVP basis, and any other aspects specified in the KAGG and fund rules.

The depositary does not report directly to the unitholders; rather, the investment company has to publish annual and semi-annual reports, and the depositary bank has to confirm the statement of the fund's assets that is included in the report.

For its services the depositary bank receives a fee, which is typically made up of a custodian charge and a separate fee for supervisory and control activities.

The depositary bank may entrust another bank with the safekeeping of fund assets – eg, it may place securities that are traded on foreign exchanges with a foreign bank. However, these banks must offer deposit protection.

The KAGG specifies that the depositary bank must be audited by a qualified auditor on an annual basis. The auditor checks whether the depositary bank fulfils its legal and contractual duties. The audit report is submitted to the BAFin and the Deutsche Bundesbank. Depositary banks are subject to supervision by BAFin. BAFin may require a replacement of depositary in case of non-compliance with statutory provisions.

A1.3 Ireland

A1.3.1 Regulators and regulations

While the Department of Finance is responsible for the development of legislation regarding the regulation of financial services, the principal regulatory body with responsibility for implementing legislation is the Central Bank of Ireland. The Investment Intermediaries Act 1995 provides legislation necessary for the authorisation and supervision by investment firms by the Central Bank. The act contains special rules for the safekeeping of client assets of investment firms, including investment managers. Separate custody provisions apply to CIS, as laid down in the Irish UCITS regulations or corresponding regulations for non-UCITS.

The main types of custodian are Irish banks, which are subject to prudential supervision by the Central Bank. Non-bank investment firms, including stockbrokers and certain investment managers, may be authorised to provide custody-type services themselves. However, in terms of volume of assets, this type of business is small. There are also a number of foreign institutions that are based in Ireland to take advantage of low tax rates. These may be granted permission subject to certain conditions and negotiation with the Department of Finance. Eligibility criteria for third-party custodians contained in the Investment Intermediaries Act 1995 and the UCITS regulations are described below.

A1.3.2 Mandated asset management

Segregation of client assets and eligible custodians

Section 52 of the Investment Intermediaries Act 1995 specifies that client assets must be segregated and held separately from the firm's own assets; they need not be held with a third-party custodian. Rather, both registered and bearer investments can be held in the physical possession of the firm *or* with an eligible custodian.

Eligible third-party custodians include:

- an EU credit institution authorised to undertake deposit-taking business;
- a bank located in the OECD, which is subject to regulations similar to those of an EU credit institution;
- an institution whose authorisation under the Investment Services Directive includes the provision of safe-custody services;
- any other institution upon agreement with the Central Bank.

Custodians which are credit institutions are required to have minimum paid-up capital of IR£5m. Non-credit institutions which provide custody services must at all times maintain a minimum capital requirement of €125,000 or one-quarter of their preceding year's fixed overheads, whichever is higher.

Responsibilities of investment firms and/or third-party custodians

The act empowers the Central Bank to impose requirements in relation to the safekeeping of client money and investment instruments. These requirements apply to all authorised investment firms, including investment managers. With regard to the safekeeping of investment instruments, the investment firm must:

- keep safe, or arrange for the safekeeping of, any documents of title relating to them;
- ensure that any registrable investments which it buys or holds for a client are properly registered in the client's name or with the consent of the client in the name of an eligible nominee;
- ensure that, where title to investments is recorded electronically, client entitlements are separately identifiable from those of the authorised firm in the records of the firm maintaining the records of entitlement;
- not use a client's investment instruments for its own account unless it has obtained the client's prior written consent to do so.

Before the firm provides safe-custody facilities to a client, it must notify the client in writing of the obligations that the firm will have to the client in relation to:

- registering safe-custody investments, if these are not registered in the client's name;
- claiming and receiving dividends, interest payments and other rights accruing to the client;
- exercising conversion and subscription rights;
- dealing with takeovers, other offers or capital reorganisations;
- exercising voting rights;
- the extent of the authorised firm's liability in the event of a default by an eligible custodian.

If the assets are held with a third-party custodian, the custodian must agree in writing that the client account will be separated from any investments belonging to the firm, and that the safe-custody investments will not be withdrawn from the account except by the firm or on the firm's instruction. The custodian also has to deliver, on request, a written statement to the authorised firm specifying the amounts held for clients. There is no requirement for the third-party custodian to perform any other function such as monitoring.

The investment firm is required to reconcile its books and records at least every six months and promptly correct any discrepancies revealed. Reconciliation includes the counting and inspection of all custody investments held by the firm, and obtaining written confirmation from third parties in respect of all investments held by them. At least once a year, the firm must document all safe-custody investments to the client. Specific requirements also exist for any collateral a firm holds on behalf of clients.

Besides the Investment Intermediaries Act, the Central Bank of Ireland has issued a Code of Conduct for Investment Management Firms operating in Ireland. Investment managers must ensure that each client is given a copy of the firm's investment management agreement at the outset of the client relationship. In addition to setting out the basis on which the firm's services are provided, the agreement must include details of the firm's arrangement for custody of investments held for clients.

A.1.3.3 Investment funds

Types of investment fund

Ireland has established itself as an important offshore investment fund centre in Europe. Under Irish law, funds can be formed as unit trusts, investment companies or investment limited partnerships. A unit trust operates as an investment fund under a trust deed made between the management company and trustee. It may qualify as an open-ended UCITS, but most UCITS offered to the European market are in corporate form. All funds are supervised by the Central Bank of Ireland.

The relevant regulations are the UCITS Regulations 1989, or, for non-UCITS and depending on the legal form of the fund, the Unit Trusts Act 1991, the Companies Act 1990 or the Investment Limited Partnerships Act 1995.

Custody of fund assets and eligible trustees/custodians

According to these regulations, the trust deed (in the case of a unit trust scheme), the articles of association (in the case of an investment company) and the partnership agreement (in the case of an investment limited partnership) must provide that the funds' assets are entrusted to a trustee for safekeeping. In the case of investment companies, however, the trustee is normally called a custodian. There are very few practical operational differences between the duties of the trustee and the custodian.

Irish investment fund regulations also lay down that assets of a unit trust or investment company must be entrusted for safekeeping to a trustee/custodian, who must be separate and independent from the management company or investment company. A trustee/custodian must either have its registered office in Ireland or have established a place of business there if its registered office is in an EU Member State.

An eligible trustee/custodian must be a credit institution authorised in Ireland or an Irish branch of a credit institution (within the meaning of the first EU Banking Directive), with a minimum paid-up share capital of IR£5m. Alternatively, it may be a wholly owned subsidiary of a credit institution or of certain other financial institutions (not necessarily within the EU), provided that these institutions have paid-up share capital of IR£5m and provide guarantees for the trustee's/custodian's liabilities.

The Central Bank may permit non-credit institutions to act as trustee/custodian to Irish investment funds, provided they are located in Ireland and have sought approval of the bank. The minimum capital requirement for non-credit institutions is €125,000 or an expenditure requirement of one-quarter of the preceding year's fixed overheads, whichever is higher. In order to obtain approval, the trustee/custodian must satisfy the bank that it has appropriate expertise and experience; that it has sufficient management resources; that its directors and managers are persons of integrity and have appropriate knowledge and experience; that internal affairs are organised and controlled in a reasonable manner; and that well-defined compliance procedures are in place. However, there is no requirement for the trustee/custodian to be insured in respect of the custody services provided.

Functions and responsibilities of trustees/custodians

A trustee/custodian may not be replaced without approval by the Central Bank. Its duties and responsibilities include the following:

- to ensure that transactions effected by, or on behalf of, a unit trust or investment company are carried out in accordance with the regulations and the trust deed or articles of association;
- to ensure that the value of units is calculated in accordance with regulations and the trust deed or articles of association;
- to carry out instructions of the management company or investment company unless they conflict with regulations, the trust deed or articles of association;
- to ensure that any consideration in relation to transactions is remitted to it within time limits which are acceptable market practice;
- to ensure that fund income is applied in accordance with regulations and the trust deed or articles of association;
- to inquire into the conduct of the management company or the investment company in each annual accounting period and report thereon to the unitholders. The report must state whether the fund has been managed in accordance with the limitations imposed on the investment and borrowing powers, and with any other provision of the regulations and the trust deed or articles of association;
- to act independently and solely in the interest of the unitholders;
- in case of a unit trust, to create and cancel units in accordance with the trust deed and on receipt of a written instruction from the management company, but only if it believes that the creation or cancellation is in the interest of participants.

The trustee/custodian is liable to the management company or investment company and the unitholders for any loss suffered by them as a result of its unjustifiable failure to perform its obligations or its improper performance. 'Unjustifiable failure to perform its obligations' and 'improper performance' are the terms used in the UCITS Directive. For non-UCITS, the Central Bank adopted the concepts of 'exercise due care and diligence' and 'negligence, fraud, bad faith, wilful default or recklessness'.

A trustee/custodian may employ a sub-custodian, but all sub-custodian agreements must be approved by the Bank and the trustee/custodian remains liable even if fund assets are entrusted to a third party. In particular, the trustee/custodian is expected to exercise care and diligence in choosing a third party as a safekeeping agent and maintain an appropriate level of supervision.

It must also ensure that the third party holds custody assets separately and on a fiduciary basis. In jurisdictions where fiduciary duties are not recognised, the trustee/custodian must ensure that the legal entitlement of the scheme to the assets is assured.

While responsible for sub-custodians, the trustee's/custodian's liability is not a strict one; once a trustee/custodian has demonstrably exercised an appropriate level of care and diligence in the appointment and subsequent supervision/monitoring of its agents, it is unlikely to be found liable by the courts for losses arising in respect of the actions or inaction of such agents.

The Central Bank permits trust deeds/custodian agreements to provide that the trustee/custodian is not responsible for any loss directly or indirectly caused by the failure of a central securities depository (CSD), securities settlement or clearing system in the performance of its obligations. This recognises that, in some markets, certain assets must be held by a CSD, and that the trustee/custodian has no choice and no control over the operation of the CSD or settlement/clearing systems it must use.

A1.4 Italy

A1.4.1 Regulators and regulations

In Italy, the supervision of financial services institutions is divided between the Bank of Italy and Consob. Generally speaking, the Bank of Italy is responsible for prudential supervision, information monitoring, and conducting on-site controls with the aim of limiting risks and ensuring the stability of intermediaries. Consob has a role in ensuring transparency and proper conduct.

With regard to the supervision of asset management companies, the respective roles of the two bodies depend on the type of asset management. The management of collective investment funds largely falls under the supervision of the Bank of Italy, whereas the management of segregated accounts is supervised by Consob. In practice, it is difficult to distinguish precisely between the role of Consob and the Bank of Italy in the regulation of asset management companies. Moreover, asset management companies are allowed to engage jointly in the activities of management on a collective basis as well as on a client-by-client basis.

General provisions for the segregation and custody of client assets and the special custody rules that apply in the case of investment funds are contained in the Consolidated Law on Financial Intermediation, which came into force in 1998. In addition, regulations or decrees have been issued by the Bank of Italy concerning eligibility requirements of custodians and the role of the depositary of investment funds.

A1.4.2 Mandated asset management

Segregation of client assets and eligible custodians

The Consolidated Law deals with the holding of clients' assets and ensures that there is separation between the assets of individual customers, and between client assets and those of the asset management company. Under the Consolidated Law, client assets have to be held separately from those of other clients and from those of the company. In effect, this means that client assets must be held outside the company with a third-party custodian. However, they may be held within the group to which the company belongs. The Law also stipulates that each client's assets have to be reported separately. The asset management company is prohibited from the use of client assets unless authorised in writing by the client. It must promptly deposit with a bank any sums of money received from clients.

The following institutions are allowed to undertake custody services:

- Italian banks;
- Italian securities investment firms (SIMs);
- EU banks, financial companies and investment firms, subject to completion of the relevant passporting procedure;
- non-EU banks and investment firms, subject to authorisation from the regulator.

Thus, in the case of mandated individualised portfolio management, non-banks can provide custody for client assets. Where the assets are placed with an Italian bank, the requirements for the bank are the standard requirements that apply to any bank. According to the legislative decree of September 1st 1999 and the Bank of Italy Supervisory Instructions of April 21st 1999, the bank must be a joint-stock company or a cooperative company with limited liability with registered offices in Italy. It must have fully paid-in capital of €6.3m, or, if a cooperative, €2m. Non-bank custodians are subject to the capital requirements that apply to investment firms.

Responsibilities of custodians

The Consolidated Law does not impose any obligations on the custodian that extend beyond the basic safekeeping of client assets.

A1.4.3 Investment funds

Types of investment fund

Collective investment undertakings in Italy are organised as:

- open-end mutual investment funds (fondi comuni mobiliari aperti);
- variable-capital investment companies (SICAV);
- closed-end mutual investment funds (fondi comuni mobiliari chiusi);
- closed-end funds for collective investment in immovable property (fondi comuni immobiliari chiusi).

Custody of fund assets and eligible depositaries

Investment funds must have a depositary, which is appointed by the investment management company. Investment management companies are usually affiliated with other financial organisations. In particular, they are often subsidiaries inside a banking group. Therefore, the parent bank often acts as the depositary bank. Italian fund law does not require the depositary to be outside the group, but it must act independently from the management company and in the sole interest of unitholders.

The Bank of Italy, after consulting Consob, established conditions for accepting appointment as the depositary bank and the procedures for sub-depositing fund assets.

Depositaries are regulated at the general level by the Consolidated Law and more specifically by the Bank of Italy Regulation of September 20th 1999. According to the regulation, the appointment of the depositary bank is subject to the following legal conditions:

- the bank must be an Italian bank or an Italian branch of a bank with a legal seat in another EU country;
- the supervisory capital must be at least €100m;
- the bank must have experience commensurate to the appointment;
- the bank's organisational structure must be such as to ensure the efficient and correct performance of the entrusted tasks.

There is no requirement for the depositary to have insurance on the sums kept in custody. However, as any other bank, the depositary must take part in the 'fondo interbanciarior di tutela dei depositi', an inter-bank consortium for the protection of clients' deposits.

The depositary bank is entrusted with the custody of financial instruments and cash of the funds. In addition, the depositary performs legal controls on each fund-related transaction and is responsible to the management company and the investors.

The rules governing each mutual fund must indicate the identity of the depositary, specify the division of tasks between manager and depositary, and regulate the relationship between the two. The fund rules must be approved by the Bank of Italy.

Functions and responsibilities of depositaries

In performing its functions, the depositary must:

- verify the legitimacy of the operations of issuing and redeeming units, the calculation of their value and the application of fund income;
- verify that, in transactions involving fund assets, any consideration is remitted to it within the usual time limits;
- check that trades ordered by the collective investment undertakings are settled according to the rules of the markets in which they are effected;
- carry out the instructions of the investment management company unless they conflict with the law, the fund rules or the prescriptions of the supervisory authority. Such verification must cover all transactions ordered by the company and concern the legitimacy of each one.

The depositary has no direct contact with the unitholders. Any reports to them are made by the management company.

The depositary is liable to the investment management company and unitholders for any loss suffered by them as a result of its failure to perform its obligations. However, there is an ongoing debate as to whether an individual unitholder can directly sue the depositary for any losses, or whether this must be done by the management company, as the contractual counterparty.

A1.5 Luxembourg

A1.5.1 Regulators and regulations

In Luxembourg, all firms providing professional activities in the financial sector, including asset managers, require authorisation from, and are supervised by, the Commission de Surveillance du Secteur Financier (CSSF). Authorisation procedures and conduct rules for firms are laid down in the (amended) 1993 law on the financial sector. The law also defines the custodianship of client assets in mandated asset management. Separate custody arrangements apply to investment funds under Luxembourg investment fund law. Investment funds are also supervised by the CSSF.

A1.5.2 Mandated asset management

Segregation of client assets and eligible custodians

Client assets must be placed with an authorised custodian that is subject to official supervision. Authorised custodians of client assets must be banks or credit institutions. Under Luxembourg law, these are subject to a minimum capital requirement of LFr350m (or about €8.6m), of which LFr250m must be paid up. They also require written authorisation issued by the minister who is in charge of the CSSF. Banks are obliged to be members of a deposit guarantee system and an investor indemnification system.

Credit institutions of the EU, which are authorised and supervised by the competent authorities of another Member State, may also act as custodian and are not subject to authorisation by the Luxembourg authorities. Credit institutions of non-EU origin that intend to establish a branch in Luxembourg are subject to the same regulations for authorisation as credit institutions established under Luxembourg law.

There are also non-bank professional custodians whose business consists of receiving deposits of securities and other financial instruments, solely from asset managers and other financial institutions, for the purposes of safe custody and administration, and for facilitating their transmission. These are subject to proof of capital of at least LFr100m (€2.5m).

The requirement to segregate client assets ensures that these are not included in the asset manager's global assets in the event of bankruptcy, and cannot be seized by the manager's creditors. They must also be accounted for separately from the manager's own property and cannot be disposed of for the manager's own account.

The segregation rules apply to non-bank asset management companies. Where mandates to manage assets are given to a credit institution, which is common in Luxembourg, the management and custodian functions will be undertaken by the same entity.

A1.5.3 Investment funds

Luxembourg is a leading European base for offshore funds. The assets of investment funds domiciled in Luxembourg in mid-2000 were estimated to be the highest in Europe, and second only to those of the USA. Most of these funds are formed by promoters based in other countries, but which have their registered office and central administration in Luxembourg. The portfolio management function is often outsourced abroad.

The investment fund and management company are both subject to authorisation and regulation by the CSSF. The investment fund law of Luxembourg has been framed with the objective of incorporating all features of the UCITS Directive.

Types of investment funds

Three categories of fund comply with the definition of UCITS, as set out in the EU Directive, which was introduced into Luxembourg legislation by a law dated March 30th 1988:

- the 'fond commun de placement (FCP) en valeurs mobilières', which invests in transferable securities – this type of collective fund is managed by an investment management company under the law of contract. The fund itself has no legal personality.
- the SICAV, which invests in transferable securities and is a limited-liability company with variable share capital;
- 'other UCITS', which groups all UCITS not falling under the first two categories. These generally take the form of 'societés d'investissement a capital fixe' (SICAFs), where the nominal value of the issued capital does not change. Such companies may, however, repurchase their own shares.

There are other types of fund subject to Luxembourg investment fund law which do not comply with the UCITS Directive, such as closed-ended funds or funds not investing in transferable securities. In addition, non-UCITS include funds that are not open to the general public but dedicated to certain (institutional) investors. The main difference between the regulation of UCITS and other funds lies in the fact that investment regulations are less restrictive for the other funds. However, custody-related regulations are very similar.

Custody of fund assets and eligible depositaries

In general, the assets of a Luxembourg collective investment fund or investment company must be kept safe by a depositary. The depositary must be a bank incorporated under Luxembourg law or Luxembourg branches of banks established in an EU Member State. Only non-UCITS may have depositaries which are branches of banks established outside the EU. As noted above, under Luxembourg law, credit institutions are subject to a minimum capital requirement of LFr350m (or about €8.6m), of which LFr250m must be paid up.

The investment management company is solely responsible for the selection of the depositary. The two entities may be part of the same group, but must not have any directors in common.

Exceptions to the depositary requirement

There are two exceptions to the requirement of having a depositary for investment companies. First, investment companies which market their units exclusively through one or more stock exchange on which their units are admitted to official listing are not required to have a depositary within the meaning of the fund law. Second, investment companies which market at least 80% of their units through a stock exchange are not required to have a depositary, provided that their units are admitted to official listing on the stock exchanges of those Member States where the units are marketed, and that any transactions are effected at stock-exchange prices. However, the unitholders must be protected to the same degree as those in investment companies with depositaries. In particular, the investment companies must:

- state in their instruments the methods of calculation of the NAVs of their units;
- intervene in the market to prevent stock exchange values from deviating by more than 5% from NAVs;
- establish the NAVs, communicate them twice weekly to the regulator, and publish them twice a month.

Although Luxembourg fund law allows for these exceptions, they are not relevant in practice – most, if not all, investment companies have a depositary.

Functions and responsibilities of depositaries

Pursuant to a commentary of the articles of the 1988 law, the concept of custody used to describe the role of the depositary should be understood not in the sense of 'safekeeping', but in the sense of 'supervision'. The depositary must have knowledge at any time of how the assets of the fund have been invested, and where and how these are available.

In addition, the depositary's supervision and monitoring responsibilities extend to ensuring that:

- the sale, issue, repurchase and cancellation of units are carried out in accordance with the law and the fund rules;
- the value of units is calculated conforming with the law and the fund rules;
- instructions of the management company are carried out, unless in conflict with the law or the fund rules;
- any consideration in transactions involving the fund's assets is remitted to the fund within the usual time limits;
- a fund's income is applied in accordance with the law and the fund rules.

These responsibilities also apply if a management company entrusts the management of the fund's assets to portfolio managers established abroad.

In addition, the depositary is responsible for the collection of dividends, interest and proceeds of matured securities, the exercise of options, and, in general, for any other operation concerning the day-to-day administration of the securities and liquid assets making up the fund.

None of the depositary's responsibilities is discharged if it entrusts the safekeeping of fund assets to a third party. Any provision of the fund rules or any agreement aiming to exclude or limit the depositary's liability in this respect are void. More generally, the depositary cannot, in any case, release itself from its duties.

Similar to depositaries in other European countries, in Luxembourg the depositary must act independently and solely in the interest of the investors in the fund. The depositary is liable to the management company and the unitholders for any loss suffered by them as a result of unjustifiable failure to perform its obligations or its improper performance of them. Anyone suffering damages must prove the depositary's negligence in respect of its supervision duty and the link between cause and effect.

Under the 1988 law, liability to unitholders is invoked indirectly through the management company. If the management company fails to react within three months of a written notice by a unitholder, the unitholder may directly invoke liability from the depositary.

A CSSF circular specifically deals with responsibilities in the case of dealing with errors that relate to inaccuracies in the computation of the NAV or instances of non-compliance with investment restrictions applicable to funds. Although the depositary can be held responsible for its breaches of duty on these matters, the circular specifies that the ultimate responsibility remains with the fund promoters. Investors will, under all circumstances, be compensated for losses they suffer as a result of any failures.

A1.6 The Netherlands

A1.6.1 Regulators and regulations

Investment firms, including asset managers, are regulated by the Stichting Toezicht Effectenverkeer (STE), which is an independent organisation charged with the supervision of securities trade in the Netherlands. CIS are regulated by the Dutch Central Bank (De Nederlandsche Bank). The main legislation for the former is the Act on the Supervision of Securities Trade 1995 and the subsequent decree which elaborates the principles laid down by the act; for the latter, it is the Act on the Supervision of Collective Investment Schemes and related regulations.

In addition, the Securities Giro Transfer Act of 1977 provides for the establishment of an institute (Necigef) effecting the safekeeping, administration and general control of the book-entry securities transfer system. At Necigef, collective deposits are set up in respect of which the owners are entitled to their proportionate share. Necigef determines which securities may enter its book-entry transfer system. Almost all securities listed on the Amsterdam Stock Exchange have been declared book-entry securities and are kept in safe custody by Necigef.

A1.6.2 Mandated asset management

Segregation of client assets

The segregation of securities and client monies from an investment firm's own assets is a fundamental requirement in the Netherlands. The Act on the Supervision of Securities Trade 1995 and the subsequent decree stipulate that an investment firm must make arrangements in respect of the securities and monies of clients such that, according to the judgement of the STE, the rights of clients are sufficiently protected and securities and monies are prevented from being used by the investment firm for its own account.

Eligible custodians

Only credit institutions may physically hold client securities and monies. Investment firms may access funds by mandates over individual clients' accounts arranged by way of a tripartite agreement between client, bank and firm. They are not allowed to hold client assets themselves. If an investment firm finds that a client has transferred monies or securities to an account in the name of the institution, the investment firm must immediately re-transfer the assets to the account of the client. The credit institution that administers the client money or securities' account may only release monies against receipt of securities or vice versa. If agreed, a client can limit the mandate and make it the bank's responsibility to ensure this.

An alternative approach to individual client mandates is available for some investment firms. Segregation of client assets is achieved by using an independent legal entity (effectengiro) whose sole activity is the provision of custody services – ie, the opening, managing, administering and disposing of accounts with credit institutions to hold client monies. The effectengiro must be managed independently of the investment firm. It must administer transactions separately for each client and only undertake them on instructions of the investment firm. It must also ensure that total receivables of clients always correspond to the balance in its accounts with credit institutions, but it is not required to keep a separate bank account per client. The effectengiro only acts in the interests of the clients of the investment firm and is liable to clients for losses sustained by them in so far as such losses are the result of culpable failure to comply with its obligations. In particular, the effectengiro must ensure that there is a proper administrative organisation in relation to the securities and monies held in custody.

Both approaches require the strict separation of client assets and the physical holding of client assets by credit institutions only.

A1.6.3 Investment funds

Types of investment fund

Collective investment funds in the Netherlands are mainly governed by the Act on the Supervision of Collective Investment Schemes. They can be organised in two forms:

- *corporate* – investment companies (beleggingsmaatschappij);
- *contractual* – investment funds (beleggingsfonds).

Unlike most other countries, Dutch investment funds, in both corporate and contractual form, are listed and traded on the stock exchange. If admitted to the Amsterdam Stock Exchange, they are subject to the rules and regulations of the Amsterdam Exchanges NV. Many Dutch investment funds do not meet the UCITS specifications. Most funds held by Dutch investors are UCITS incorporated in other jurisdictions.

Custody of fund assets

The assets of a contractual fund must be deposited for safekeeping with a depositary (bewaarder), which is independent of the management company.

Unlike contractual funds, Dutch investment companies do not usually have an independent depositary, but are able to hold their assets for safekeeping. The argument is that investment companies are subject to company law which provides for a sufficient segregation of assets. Because of this and the fact that company law provides for the consultation of shareholders, there is no need to stipulate that investment companies, unlike contractual funds, be subject to further monitoring of their activities by a depositary. There are two cases in which the requirement of a depositary may be waived.

Exception to the depositary requirement

According to the Dutch law, the first case where there is no need for an investment company to have a depositary is if the units have been, or will be, admitted to listing on a stock exchange within one year of the date of issue, and are, or will be, marketed exclusively through the exchange(s).

The second case where no depositary is required is where the investment company markets, or will market, at least 80% of its units through one or more stock exchanges, and where, among other things:

- the supervisory authority is of the opinion that the interests of the unitholders are protected;
- transactions in the units are effected solely at the stock exchange price;
- the instruments of incorporation specify the method for calculating the NAV of the units and the frequency of publishing the values.

Investment companies without a depositary must:

- intervene in the market in order to prevent the stock exchange value differing by more than 5% from the NAV;
- determine the NAV daily and communicate it to the supervisory authority (the public) at least twice a week (twice a month);
- instruct an auditor to ascertain at least twice a month that the value of the units is calculated in accordance with the instruments of incorporation and the law. The auditor must also ascertain that the assets have been invested in accordance with the instruments and the law.

If an investment company opts to charge a depositary with safekeeping of its assets, this depositary must comply with all the requirements imposed by the law.

Eligible depositaries

Only a legal entity whose business is to provide safe custody and administration services to third parties in respect of investment objectives may act as depositary. More specifically, the Dutch Central Bank will only grant authorisation to a CIS if the depositary meets certain requirements relating to expertise and trustworthiness, financial resources, management, and the supply of information to potential investors. With regard to financial resources, the Decree on the Supervision of CIS provides that the depositary must have own funds of at least €113,445.05. Furthermore, the depositary must provide sufficient security from liability or losses ensuing from fire, transportation of monies and documents of value, fraud and robbery (eg, through an insurance policy).

In general (but not necessarily), the depositary is a bank and subject to banking regulation.

The management company is not allowed to have any financial or personal links with the depositary. However, the two entities may have a shareholder in common, provided that mutual independence has been safeguarded.

Functions and responsibilities of depositaries

Dutch law lays down that the agreement concluded between CIS and the depositary with regard to administration and safekeeping must meet certain requirements:

- the depositary must act solely in the interest of the unitholders;
- the control over documents of value in safekeeping is exercised solely by the CIS and the depositary acting together;
- the depositary only surrenders documents of value against receipt of a declaration of the CIS stating that surrender is required for the regular performance of the management function;
- the depositary is accountable to the CIS and the unitholders, and liable for losses suffered by them resulting from culpable non-performance or defective performance of its obligations. This also holds if the depositary entrusts the assets to a third party;
- the proposal of the management company to change the terms and conditions of the CIS is made together with the depositary;
- if the depositary resigns, a meeting of unitholders is held within a period of four weeks to provide for the appointment of a new depositary.

The agreement must also stipulate that it is the depositary's responsibility to:

- ascertain that the sale, issue, repurchase, redemption and revocation of units is effected in accordance with the law or the terms and conditions of the CIS;
- ascertain that the consideration in the case of transactions is received within the usual periods;
- ascertain that the income is allocated in accordance with the law and the terms and conditions of the CIS;
- ascertain that the value of the units is calculated in accordance with the law and the terms and conditions of the CIS;
- follow the instructions of the CIS unless they are contrary to the law or the terms and conditions of the CIS.

A1.7 Spain

A1.7.1 Regulators and regulations

The supervisory body of the Spanish financial market is the Comisión Nacional del Mercado de Valores (CNMV). It is in charge of monitoring the activity of all financial institutions that operate in the Spanish market. One of its main tasks is to ensure compliance with the applicable laws and regulations.

The main law applying to asset management and custodianship is the Securities Market Act, or the Ley del Mercado de Valores (24/1988), as modified by a law of 1998 (37/1988), which implemented the Investment Services Directive in Spain, and a law dated 2000 (14/2000). The main law is complemented by a number of royal decrees and orders. Separate laws and regulations exist for Spanish investment funds, with the main regulation being the Spanish Investment Fund Law, or the Reguladora De Las Instituciones De Inversion Colectiva (46/1984). In addition, there is a pension fund law (Law 8/1987) which regulates custody arrangements for pension funds. Custodianship of pension funds is also briefly referred to below.

A1.7.2 Mandated asset management

The Securities Market Act of 1988, as modified by subsequent legislation, regulates all aspects of the Spanish securities market, including asset management and custodianship, and provides a coherent regulatory framework that was previously absent. The act also created the CNMV as the main supervisor of the securities market.

The act establishes that there are three types of regulated investment services firm: securities companies (sociedades de valores), securities agencies (agencias de valores) and portfolio management firms (sociedades gestoras de carteras). The latter are defined as firms that advise on investments and/or provide the discretionary and individualised management of portfolios in relation to mandates conferred by investors.

Eligible custodians

Custodianship of assets is reserved exclusively for securities companies or agencies and authorised credit institutions. Custodians are subject to the respective capital requirements that apply to securities companies or agencies and credit institutions, but Spanish regulations do not require specific, or additional, capital to carry out the custody function. All custodians must adhere to the Fondo Garantía de Inversiones, a deposit protection insurance scheme, providing insurance that is proportional to the value and volume of deposited financial instruments.

Functions and responsibilities of custodians

Under Spanish law, custodians have a number of obligations and must perform functions, which include the following:

- safekeeping custody assets and keeping a register of securities through annotations in the accounts;
- informing about any changes that may affect the value of the securities under custody;
- collecting and paying dividends;
- communicating the possibility of exercising other rights;
- returning the securities under custody when solicited to do so by the person with whom the custody contract is concluded.

The custody contract between custodian and depositor (investor or asset manager) must be presented by the custodian to the CNMV and can be consulted by the public.

The Securities Market Act is complemented by a number of royal decrees and orders, such as the decrees of 1993 and 1999 implementing rules of conduct in securities markets, and in particular, mandated asset management. However, these do not provide for any wide-ranging responsibilities of a custodian. This contrasts with the specific regulations that exist in the case of investment funds.

A1.7.3 Investment funds

Types of investment fund

Two types of CIS are found in Spain:

- the investment fund, which is a contractual fund in which net assets are divided into units;
- the open-ended investment company (OEIC).

The main laws and regulations in relation to CIS are laid down in the Spanish Investment Fund Law of 1984 as well as in a number of subsequent royal decrees and orders.

Custody of fund assets and eligible depositaries

According to regulations, the fund assets must be entrusted to a depositary for safekeeping. The depositary must be an entity that is duly licensed in Spain to carry out such activities, and may be a bank, a savings bank, a credit cooperation as well as a non-bank investment firm (securities companies or agencies). Capital requirements vary depending on the type of financial institution acting as depositary. The Spanish Ministry for the Economy, in conjunction with the CNMV, can determine special requirements for overseas depositaries so as to guarantee that the investment fund maintains ownership and full use of the assets.

No single company can act as both management company and depositary. The management company and depositary must have different and independent directors, operate from different locations and separate their activities. The fund is also forbidden to hold more than 1% of its assets in securities issued by the depositary. However, the management company and depositary may belong to the same group, provided that certain norms of separation between the two guarantee their independence. In particular, they must take measures to guarantee that information regarding their respective activities is out of reach from the staff of the other entity. Both institutions must provide documentation that ensures that their functions are performed in an autonomous way and that any conflict of interest between the group entities and the unitholders is avoided. The management company must also provide documentation of the exact nature of its relationship with the depositary. Finally, in its report to unitholders, the management company must disclose any acquisitions and sales of securities in which the depositary is the seller and the buyer, respectively.

Functions and responsibilities of depositaries

The depositary is responsible for the safekeeping of fund assets and remains responsible even if it entrusts a third party with the safekeeping of all or part of the assets. Apart from safekeeping, the depositary performs a regular monitoring role and functions in line with the UCITS Directive. The responsibilities include:

- drafting the fund rules together with the management company;
- supervising the management of the fund and reporting any irregularities to the CNMV;
- issuing units jointly with the management company;
- carrying out subscriptions of the unitholders and charging the receipts to the fund accounts;
- paying out dividends and other entitlements;
- carrying out the purchase and sales of securities on behalf of the fund and receiving all interest and dividends paid on securities;
- receiving and holding the liquid assets of the fund.

The depositary owes a duty of care directly to investors as it is required to act solely in the interest of the investors. Failure to perform its duty can make the depositary liable for losses arising to investors. Liability can be invoked directly or indirectly through the management company.

Overall, the depositary of a Spanish investment fund has, conforming to the UCITS Directive, wide-ranging responsibilities. These include monitoring of the management company.

A1.7.4 Pension funds

A monitoring responsibility is also imposed on the custodian/depositary of a Spanish pension fund. Under the pension fund law of 1987, the management company must appoint a depositary to provide custody of the securities of the pension funds, which can be any deposit-taking financial institution domiciled in Spain. The depositary functions in relation to pension funds include:

- providing custody of transferable securities and other securities of the fund;
- following the instructions of the management company in relation to the sale and purchase of assets, and undertaking any other operation agreed by the management company, adjusted to comply with the legal rules;
- looking after the management company on behalf of the pension fund promoters, participants and beneficiaries.

A1.8 The UK

A1.8.1 Background, regulators and regulations

The custody of assets was first made a regulated activity in the UK in 1997, when the Financial Services Act 1986 (Extension of Scope of Act) Order 1996 came fully into force. The Order inserted a new paragraph into the act, which sets out the types of financial services for which an authorisation is required, as follows:

> Custody of Investments
>
> (1) Safeguarding and administering or arranging for the safeguarding and administration of assets belonging to another where –
>
> (a) those assets consist of or include investments; or
>
> (b) the arrangements for their safeguarding and administration are such that those assets may consist of or include investments and the arrangements have at any time been held out as being arrangements under which investments would be safeguarded and administered.
>
> (2) Offering and agreeing to safeguard and administer, or to arrange for the safeguarding and administration of, assets belonging to another where the circumstances fall within sub-paragraphs (1)(a) and (b) above.

Although the order did not substantially alter the way in which many investment firms conducted their custody business, because much of their work related to investment business that was already authorisable prior to the Order, the fact that the Order was issued reflected a need for specific regulation. Indeed, it followed a number of scandals in the UK, such as the Maxwell affair, and other instances where custody assets were threatened or abused.

With regard to the scope of the regulation, ‘safeguarding’ involves physical possession of tangible assets, physical possession of documents evidencing intangible assets, or protecting the integrity of intangible assets. This interpretation of safeguarding embraces not only traditional formats of investments, it also encompasses dematerialised investments which cannot be possessed but which are held in custody by being vested in the name of the custodian.

‘Administration’ includes functions such as: maintaining accounts with clearing houses, settling transactions in investments, operating through depositories or sub-custodians, operating nominee accounts which identify each customer’s assets in a ledger, cash processing in relation to customers’ assets, collecting and dealing with the dividends and other income associated with safeguarded assets, or carrying out corporate actions for customers in relation to assets being safeguarded.

The scope of the regulation extends beyond those who actually administer and safeguard assets to include those who ‘arrange’ for such services. This is based on the belief that, where assets are being safeguarded and administered, there will always be someone responsible for arranging all of this who should be regulated.

Although custody services are still defined in a similar way, there have been a number of changes in the regulatory framework governing the UK financial services industry since 1997. This summary of UK custody regulations is based on the rules introduced when the Financial Services Authority (FSA) assumed its full powers and responsibilities under the Financial Services and Markets Act 2000. As of December 2001, the FSA is the single statutory regulator responsible for regulating the UK financial services industry, covering investment business, deposit-taking and insurance.

Under the new framework, any UK authorised firm conducting custody activities is subject to the custody rules, as detailed in Chapter 9.1 of the FSA Conduct of Business Sourcebook. Firms that merely arrange for the provision of safe-custody services are only subject to a sub-set of the rules. In particular, they are subject to rules on choosing an appropriate custodian, on risk disclosures and on record-keeping, as further explained below.

The main custody rules also apply to a trustee firm or depositary that acts as a custodian for a CIS, although the relevant investment fund regulations and the provisions of the trust instrument or scheme constitution contain additional obligations. In particular, trustee/depositary arrangements in the case of CIS are subject to the rules laid down in the Collective Investment Schemes Sourcebook.

A1.8.2 Mandated asset management

Segregation of client assets and custodianship

The custody rules defined in the FSA Conduct of Business Sourcebook require any investment firm, including an asset manager, to take appropriate steps to protect safe-custody investments for which it is responsible. The main aims are to restrict the co-mingling of client’s and firm’s assets, and to minimise the risk of the client’s safe-custody investments being used by the firm without the client’s agreement or contrary to the client’s wishes, or being treated as the firm’s assets in the event of its insolvency. Thus, any investment firm must segregate safe-custody investments from its own investments. However, there is no obligation for a non-bank investment firm to use a third-party custodian. Custody assets can be held in the physical possession of the firm or with an eligible third-party custodian.

In practice, this means that two main types of firm provide custody services: non-bank investment firms and banks. Investment managers may, in connection with the provision of a discretionary portfolio management service, retain or have under their control documents of title to investments. Similarly, stockbrokers may, with the explicit consent of the customer, retain custody of the investments that they have arranged to purchase in order to facilitate administration and to cut costs – particularly when it comes to selling them in the future. Many investment firms, however, choose external custodians to hold their safe-custody assets. The main independent eligible custodians are banks. Eligibility criteria for third-party custodians are discussed below.

Where a safe-custody investment is recorded in an account with the investment firm, the title of that account must make it clear that the investments belong to a client, and are segregated from the firm's investments. Where recorded in an account with a custodian, the custodian must make it clear in the title of the account that the investment belongs to one or more clients of the firm.

A firm is not allowed to use a safe-custody investment for its own account (or for the account of another client) unless the client has been notified and, in the case of private customers, has given written consent.

With regard to registration of securities, the firm must effect appropriate registration or recording of legal title in the name of one of the following: the client; a nominee company; a third-party custodian (provided certain conditions are met and the client has been notified); the firm itself; or another third party.

Eligible third-party custodians and selection criteria

Eligible third-party custodians include:

- approved banks;[39]
- approved trustees and depositaries;[40]
- a member of a recognised investment exchange;
- firms whose permitted activities include safeguarding and administering investments;
- regulated clearing firms;
- any person outside the UK whose business includes the provision of custodial services and who is able to provide such services in a way that is appropriate to the client.

UK prudential rules give investment firms the permission to hold client assets subject to an own-funds requirement of €125,000. There also is a liquid capital requirement, which depends on expenditure, position risk, counterparty risk and foreign exchange risk. The expenditure requirement is more than twice as high for investment firms that hold client assets (the fraction of expenditure is 13/52) than for those that do not (the fraction is 6/52). Separate capital requirements apply to the other eligible custodians. For example, banks must have minimum own funds of €5m, and trustees and depositaries are subject to a requirement of £4m (€6.5m).[41]

[39] Approved banks include the Bank of England and other central banks in the OECD area; a bank or building society that offers unrestricted banking services; and any other institution that is subject to regulation by a national banking regulator, required to provide audited accounts, and has minimum net assets of £5m and a surplus of revenue over expenditure for the last two financial years.
[40] In relation to trusts and CIS.
[41] These rules are not contained in the FSA's Code of Business Sourcebook but in the separate Prudential Sourcebook.

Before holding custody assets with a custodian or recommending a custodian to a private customer, the firm is required to undertake an appropriate risk assessment of that custodian. It is also expected to assess periodically the continued appointment of the custodian. Factors taken into account should include:

- expertise and market reputation;
- arrangements for holding and safeguarding an investment;
- appropriate legal opinion as to the protection of custody assets in the event of the insolvency of the custodian;
- current industry standard reports;
- whether the custodian is regulated and by whom;
- the credit rating;
- any other activities undertaken by the custodian and, if relevant, any affiliated companies.

Disclosure in the case of group or overseas custodians

There is no requirement that the custodian must be independent from the firm. However, before custody assets are held with a custodian that belongs to the same group, the firm must inform the client in writing.

With regard to overseas markets, before holding or arranging for another person or firm to hold a customer's safe-custody investment overseas, a firm must notify the customer in writing that there may be different settlement, legal and regulatory requirements in overseas jurisdictions from those applying in the UK.

Client and custody agreement

The custody rules also specify what needs to be disclosed in the agreement between firm and client. Before the firm provides custody services, it must notify the client about matters such as:

- the registration of the safe-custody investment, if these are not to be registered in the client's name;
- the extent of the firm's liability in the event of a default by a custodian;
- claiming and receiving client entitlements;
- dealing with corporate actions;
- the arrangements for the provision of information regarding the custody investment;
- the fees and costs of safe-custody services;
- if applicable, notification that the client's investment may be pooled with that of other clients and the implications of such pooling.

The firm must also provide to each client, on an annual basis or more frequently, a statement listing all custody assets held for the client.

Where a firm holds investments with a custodian, it must agree in writing appropriate terms and conditions with the custodians. The custody agreement should specify:

- that the title of the account indicates that any safe-custody investment credited to it does not belong to the firm;

- that the custodian will hold and record client assets separately from any investments belonging to the firm or the custodian;
- that the custodian will deliver to the firm statements which give a description of, and detail the amounts of, all the safe-custody investments credited to the account;
- that the custodian will not claim any lien, right of retention or sale over any safe-custody investment unless notified by the firm that the client has given written consent;
- that the custodian is not to permit withdrawal of any safe-custody investment from the account except for delivery to the firm or on the firm's instructions;
- the procedures and authorities for the passing of instructions to or by the firm;
- the claiming and receiving of dividends, interest or other entitlements accruing to the client;
- the extent of the custodian's liability in the event of the loss of custody assets caused by the fraud, wilful default or negligence of the custodian, or an agent appointed by the custodian.

Other rules

With regard to stock-lending, the activity is permitted subject to the consent of the customer and if appropriate terms and conditions are followed. If a safe-custody investment of a private customer is used for stock-lending, the firm must ensure that:

- the relevant collateral is provided;
- the current realisable value is monitored daily;
- the firm provides the relevant collateral to make up any difference where the realisable collateral value falls below that of the safe-custody investment, unless otherwise agreed by the customer.

A firm must, as often as necessary, but no less than every 25 business days, perform a reconciliation of its record of safe-custody investments that it does not physically hold with statements obtained from custodians. In the case of dematerialised custody investments not held through a custodian, it must perform the reconciliation with statements obtained from the person who maintains the record of legal entitlements.

A1.8.3 Investment funds

Types of investment fund

CIS in the UK may be either regulated schemes (authorised unit trusts, OEICs and recognised schemes), or unregulated schemes, which may be in the form of unit trusts, open-ended investment companies or any other form of arrangements (eg, limited partnership). Closed-ended funds are organised as investment trusts or companies.

This summary describes the custody provisions in the case of authorised unit trust schemes, which used to comply with the Financial Services Act (Regulated Schemes) Regulations 1991. The 1991 Regulations were made to conform partly to the UCITS Directive. Although most other EU Member States have different legal structures of investment funds, the unit trust structure is compatible with the UCITS Directive.

While unit trusts have been the traditional form of CIS in the UK, in the 1990s laws provided for the formation of OEICs. These effectively combine many features of a corporate fund and those of a trust-based fund. A driving factor in the introduction of such vehicles was that they would be more straightforward for international investors to understand than unit trusts. OEICs comply with the Financial Services (Open Ended Investment Companies) Regulations 1997.

With the reorganisation of the FSA at the end of 2001, both unit trust and OEIC regulations have been combined in the Collective Investment Schemes Sourcebook. This summary is therefore based on the Collective Investment Schemes Sourcebook. Note that OEICs are now referred to as investment companies with variable capital (ICVCs).

The role of the depositary of an ICVC and its responsibilities in relation to the authorised corporate director of the fund and its shareholders are, for the purpose of this study, identical to those of the trustee of an authorised unit trust in relation to the unit trust manager of the trust and its unitholders. The summary therefore focuses on trustee arrangements.

Eligible trustees

The trustee must be a body incorporated in the UK or in another EU Member State and authorised under the Financial Services and Markets Act 2000. Firms which act as trustee of an authorised unit trust scheme must satisfy a minimum own-funds requirement of £4m (€6.5m). All trustees that operate in the UK market are banks or belong to a banking group.
The trustee must be entirely independent of the unit trust manager. Trustees must not, for example, be related through a common shareholding structure with the manager. Most trustees are themselves banks or wholly owned subsidiaries of banks, but the same bank cannot have subsidiaries that act as trustee and engage in asset management work for the same fund.

Although the trustee may be a separate entity from the custodian of the fund assets, it often is the case that the same entity is trustee (with a monitoring function) and custodian (with a safekeeping function).

Functions and responsibilities of trustees

The CIS Sourcebook contains regulations regarding the general powers and duties of managers and trustees of authorised unit trusts. Both manager and trustee have fiduciary duties stemming from the regulations as well as from general law, the trust deed and other documents relating to the individual scheme (scheme particulars). Generally, the manager has the executive responsibility for the scheme, in that the manager is responsible for managing the investments, performing the valuations and determining the prices. The trustee has the duty of oversight and supervision, and safeguards the title to the investments and the interests of the unitholders in them.

The main safekeeping and administrative responsibilities of the trustee under the rules of the CIS Sourcebook can be summarised as follows:

- the trustee is entrusted with the control over the property of the scheme. It must take into its custody or under its control all the capital property of the scheme and hold it in trust for the holders in accordance with the regulations and the trust deed;

- it is responsible for the collection of any income due to be paid to the scheme and for claiming any repayment of tax, and must hold any income received in trust for the unitholders;
- it must take all steps and maintain all documents which are necessary to ensure that transactions entered into by the manager in accordance with its powers under the regulations are completed;
- it must keep records as are necessary to comply with the regulations and to demonstrate that compliance has been achieved;
- it must take all steps and maintain all documents as are necessary to secure that instructions given to it by the manager as to the exercise of rights (including voting rights) are carried out. The trustee must also forward to the manager any notices of meetings, reports, circulars, proxy solicitations and other documents received by it as registered holder of the trust's investments. The trustee may exercise voting rights itself, but only after consultation with the manager.

In relation to monitoring the unit trust manager, the rules consider the following main responsibilities:

- the trustee must take reasonable care to ensure that the unit trust is managed in accordance with the management duties imposed on the manager by the rules;
- it must take all reasonable steps and exercise due diligence to monitor the management of the trust sufficiently to ensure that the manager does not exceed its investment and borrowing powers conferred on the manager by the rules;
- it may require the manager to cancel any transaction or make a corresponding transaction to restore the previous situation (and meet any resulting loss or expense) if it is of the opinion that a particular acquisition or disposal of trust property by the manager exceeds the powers conferred on the manager by the rules;
- it must satisfy itself on reasonable grounds and on a continuing basis that the manager is adopting procedures and methods which are appropriate to ensure the proper valuation of the unit trust and pricing of the units, and that the manager maintains sufficient record to show compliance with the rules concerning valuation and pricing.

If the trustee is not satisfied with the management of the scheme, it must immediately upon becoming aware of the circumstances inform the FSA about the matter.

Appendix 2: Questionnaire Sent to Custodians

Part 1: Characteristics of your firm

1) Name of firm ____________________

2) Your name and contact details ____________________

____

3) Your position in the firm ____________________

4) Main types of activity performed by your firm____________________

____

5) What is your firm's main regulatory body?____________________

6) If your firm belongs to a group, what are the main types of activity performed by the parent company of your group?

____

7) Please provide the following information on your firm's capital requirement (if any) and actual capital, indicating the date to which it refers (if the information is not available, a range may be appropriate):

   Initial/minimum capital requirement ____________________

   Total capital requirement ____________________

   Actual capital ____________________

8) Are you required to hold capital specifically for your custody services? YES/NO

Part 2: Assets held in custody

This part seeks to obtain information on the type of assets held in custody and the clients of your firm. If possible, the information should refer to custody operations with respect to domestic clients only. Please indicate the date to which the information applies. If the exact information is not available, a range is sufficient.

1) Please provide details on the total value of assets held in custody by your firm.

	Value of custody assets
Total value	
of which:	
client money	
client investments (ie, securities)	

2) Please provide an **approximate percentage breakdown** of custody assets by *ownership*, both in terms of the value of assets held and the number of custody contracts.

	In terms of value of custody assets	**In terms of number of custody contracts**
Collective investment scheme		
Pension fund		
Insurance company		
Charity or similar		
Private client		
Other (please specify)		

3) Does your firm act as a depositary of an investment fund or as a trustee of a unit trust, as defined under the EU UCITS Directive of 1985?

YES/NO

If **NO**, please go to Question 2.4.

If **YES**:

Please indicate the *value of assets* held for UCITS (as an approximate percentage of total assets held for collective investment schemes).

____

How often does the investment management company of a fund belong to the same group as your firm?

always/frequently/infrequently/never

If your firm is acting as a unit trust trustee in Ireland or the UK, how often is your firm both trustee and custodian of the unit trust?

always/frequently/infrequently/never

4) In the case of segregated portfolios, who *appoints* your firm to provide custody services (ie, with whom does your firm conclude the custody agreement)?

Please provide **an approximate percentage breakdown** of custody assets according to whether your firm was appointed by an asset management company (AM firm) on behalf of investors or directly by the investors.

	In terms of value custody assets	**In terms of number of contracts**
Appointed by AM firm		
Appointed by investor directly		
Other arrangement (please specify)		

How often does the AM firm of an investor's portfolio belong to the same group as your firm?

always/frequently/infrequently/never

Part 3: Custodian functions and responsibilities

1) This question seeks to identify the main functions and responsibilities of your firm acting as a custodian, depositary and/or trustee. Please indicate how often custody contracts contain the specific function or responsibility using a scale from 1 to 4 (1 = always, 2 = frequently, 3 = infrequently and 4 = never). Please distinguish between assets held in custody for collective investment schemes (retail funds, UCITS), other investment funds (eg, special institutional funds) and mandates. 'AM firm' refers to the firm that manages the fund or client portfolio.

Functions/responsibilities	**Retail funds**	**Other funds**	**Mandates**
Safe-keeping			
Recording client rights in investments, handling documentation, accounting, etc			
Settlement of transactions			
Client reporting			
Communicating/responding to corporate actions			
Exercise of voting rights			
Collection of income receivable			
Reclaiming tax			
Monitoring AM firm's compliance with law or regulations			
Monitoring AM firm's compliance with contractual (client) guidelines			
Valuation (done by custodian)			
Checking NAV calculations of AM firm			
Securities lending (done by custodian)			
Checking that AM firm lends stock only to secure party and that there is sufficient collateral			
Performance measurement			
Cash management			
Brokerage			
Other (please specify)			

In the case of mandates, please indicate – if applicable – whether there are any significant differences in the custody contract depending on whether your firm is appointed by the AM firm on behalf of the investor or by the investor directly.

Part 4: Custody as a risk mitigation mechanism

1) The table below lists operational failures that may arise *in the asset management process*. These could lead to investor losses. For each failure, please evaluate the protection provided by the custodian/depositary/trustee using a scale from 1 to 5 (1 is very good protection, 5 is no protection).

   Protection may be both *ex ante* (ie, preventing the failure from occurring) or *ex post* (ie, bearing the risk/loss if things go wrong). Please distinguish between the role of the depositary/trustee in the case of collective investment schemes (retail funds, UCITS) or other funds (eg, special institutional funds) and custody in the case of mandates.

	Retail funds	**Other funds**	**Mandate**
Theft of securities			
Fraud at level of AM firm			
Misdealing [1]			
Failure to best execute [2]			
Settlement error or delay			
Mispricing [3]			
Breach of client guidelines [4]			
Counterparty failure			
Failure to collect all income			
Failure to respond to corporate action or exercise voting rights			
Incorrect management fee calculation			
Securities lending failure [5]			
Other (please specify)			

Notes: [1]Errors in buying and selling. [2]Failure of the AM firm to obtain the best price for clients. [3]Incorrect valuation of fund or client assets. [4]For example, the AM firm purchases securities not permitted under the contract between client and firm or under law and regulations. [5]For example, securities are lent but not returned and there is insufficient collateral.

2) Please provide an *overall* evaluation of the role of the custodian/depositary/trustee in investor protection using a scale from 1 to 5 (1 is very good protection, 5 is no protection).

   Overall protection in retail investment funds

   Overall protection in other investment funds (eg, institutional funds)

   Overall protection in mandated asset management

3) In the case of mandated asset management, does your firm offer custody contracts which differ significantly in the level of protection they afford to investors (eg, depending on the investors' needs and demands)?

YES/NO

4) This question addresses your firm's legal and contractual liability regarding the AM firm's client in the event of an operational failure in the asset management process. Based on the standard custody agreement (and any relevant laws/regulations), could your firm acting as custodian, depositary or trustee be held liable for any of the following failures? **Please tick the box if liability is likely**, distinguishing between retail funds (UCITS), other funds (eg, special institutional funds) and mandates.

	Retail funds	**Other funds**	**Mandate**
The AM firm uses client funds to purchase securities that breach client guidelines. The value of the unauthorised securities falls and the AM firm is unable to cover the loss.			
The AM firm has incorrectly valued client or fund assets. The mispricing is revealed.			
Dividend income is not collected. Tax refunds are not claimed.			
There is an untimely response to a corporate action, resulting in a loss for clients.			
Client securities are delivered before payment is received. The counterparty fails and the client incurs a loss.			
Client securities are lent but not returned. There is insufficient collateral.			
An overseas sub-custodian defaults while settling transactions. Client funds are lost.			
The AM firm uses client funds to cover significant own-account trading losses. Both AM firm accounts and client accounts are held by your firm. The AM firm defaults.			
The AM firm manipulates portfolios to present a better performance picture by shifting securities between client accounts. All client accounts are held by your firm.			
The AM firm charges its clients higher commission charges than those charged to the AM firm by the broker. The irregularity is revealed.			
The AM firm engages in 'churning' – ie, trades heavily for clients to generate excessive management fees. The irregularity is revealed and it can be proven that your firm had noticed the irregularity but did nothing about it.			

5) Did your firm bear any losses from operational failures in the asset management process in the last three years?

YES/NO

If **YES**, what approximately was the largest loss and what was the failure?

6) In the absence of any legal or contractual liability, please set out the considerations your firm would generally take into account in deciding whether to make good any losses to investors that arise as a result of an operational failure in the asset management process.

7) Does your regulator require insurance for custody services? YES/NO

Are your firm's custody services insured? YES/NO

If **YES**, please list the main functions and responsibilities listed above that are *not* covered by your existing insurance.

8) Are client assets protected by a deposit protection institution? YES/NO

9) Please use this space if you would like to comment further on Questions 1 to 4. We are particularly interested to hear your views on whether the custodian is, or should be, expected to oversee, verify and question the actions of the AM firm.

10) Do you think current custody arrangements should be revised to enhance investor protection against failures in the asset management process?

YES/NO

If **YES**, please use this space if you would like to comment on possible changes in practice, legislation and/or regulation.

11) If custody arrangements were changed to enhance investor protection, would this lead to increases in custody fees?

YES/NO

If YES, do you think the clients of your firm would be willing to pay higher fees for better protection?

YES/NO

12) Do you perceive any barriers to entry of custodians operating in other EU or overseas markets?

YES/NO

If **YES**, please list the main barriers to entry into the custody market.

13) You may wish to comment on the following statements. ‘Harmonisation of custody regulation at the European level is necessary.’ ‘Greater clarity and/or uniformity in the contractual arrangements would enhance investor protection.’

Appendix 3: Questionnaire Sent to Asset Managers

Part 1: Characteristics of your firm

1) Name of firm ____________________

2) Your name and contact details ____________________

____

3) Your position in the firm ____________________

4) Your firm's total assets under management ____________________

5) Please provide an **approximate percentage breakdown** of your firm's total assets under management.

Collective investment schemes (retail, UCITS)	
Other investment funds (eg, special institutional)	
Mandates – institutional clients	
Mandates – private clients	
Other (please specify)	

6) Does your firm belong to a group? YES/NO

If **YES**:
Is a member of your group authorised to undertake custody business? YES/NO

If **YES**, what percentage of your firm's client assets is held by a group custodian? _______%

7) Does your firm ever provide 'self-custody' – ie, the custody of client assets is done by your firm rather than by a separate legal entity?
YES/NO

If **YES**, what percentage of your firm's client assets is held by your firm? ______________%

Part 2: Custodian functions and responsibilities

1) This question seeks to identify the main functions and responsibilities of custodians, depositaries and/or trustees. Please indicate how often custody contracts contain the specific function or responsibility using a scale from 1 to 4 (1 = always, 2 = frequently, 3 = infrequently and 4 = never). Please distinguish between assets held in custody for collective investment schemes (retail funds, UCITS), other investment funds (eg, special institutional funds) and mandates. 'AM firm' refers to the firm that manages the fund or client portfolio.

Functions/responsibilities	**Retail funds**	**Other funds**	**Mandates**
Safe-keeping			
Recording client rights in investments, handling documentation, accounting, etc			
Settlement of transactions			
Client reporting			
Communicating/responding to corporate actions			
Exercise of voting rights			
Collection of income receivable			
Reclaiming tax			
Monitoring AM firm's compliance with law or regulations			
Monitoring AM firm's compliance with contractual (client) guidelines			
Valuation (done by custodian)			
Checking NAV calculations of AM firm			
Securities lending (done by custodian)			
Checking that AM firm lends stock only to secure party and that there is sufficient collateral			
Performance measurement			
Cash management			
Brokerage			
Other (please specify)			

2) In the case of mandates, how often does your firm (rather than the client) appoint the custodian?

always/frequently/infrequently/never

Please indicate whether there are any significant differences in the custody agreement depending on who appoints the custodian.

Part 3: Custody as a risk mitigation mechanism

1) The table below lists operational failures that may arise *in the asset management process*. These could lead to investor losses. For each failure, please evaluate protection provided by the custodian/depositary/trustee using a scale from 1 to 5 (1 is very good protection, 5 is no protection).

   Protection may be both *ex ante* (ie, preventing the failure from occurring) or *ex post* (ie, bearing the risk/loss if things go wrong). Please distinguish between the role of the depositary/trustee in the case of collective investment schemes (retail funds, UCITS) or other funds (eg, special institutional funds) and custody in the case of mandates.

	Retail funds	**Other funds**	**Mandates**
Misdealing[1]			
Failure to best execute[2]			
Settlement error or delay			
Mispricing[3]			
Breach of client guidelines[4]			
Theft of securities			
Fraud at level of AM firm			
Counterparty failure			
Failure to collect all income			
Failure to respond to corporate action or exercise voting rights			
Incorrect management fee calculation			
Securities lending failure[5]			
Other (please specify)			

Notes: [1]Errors in buying and selling. [2]Failure of the AM firm to obtain the best price for clients. [3]Incorrect valuation of client or fund assets. [4]For example, the AM firm purchases securities not permitted under the contract between client and firm or under law and regulations. [5]For example, securities are lent but not returned and there is insufficient collateral.

2) Please provide an *overall* evaluation of the role of the custodian/depositary/trustee in investor protection using a scale from 1 to 5 (1 is very good protection, 5 is no protection).

   Overall protection in retail investment funds
   Overall protection in other investment funds (eg, institutional funds)
   Overall protection in mandated asset management

3) In the case of mandated asset management, do custodians offer custody agreements that differ significantly in the level of investor protection (eg, depending on client needs and demands)?

   YES/NO

4) This question addresses the *legal and contractual liability of the custodian, depositary or trustee* regarding the AM firm's clients in the event of an operational failure in the asset management process. In your opinion, based on the standard custody agreement (and any relevant laws/regulations), could the custodian, depositary or trustee be held liable for any of the following failures? **Please tick the box if liability is likely**, distinguishing between retail funds (UCITS), other funds (eg, special institutional funds) and mandates.

	Retail funds	Other funds	Mandates
The AM firm uses client funds to purchase securities that breach client guidelines. The value of the unauthorised securities falls and the AM firm is unable to cover the loss.			
The AM firm has incorrectly valued client or fund assets for a number of years. The mispricing is revealed.			
Dividend income is not collected. Tax refunds are not claimed.			
There is an untimely response to a corporate action, resulting in a loss for clients.			
Client securities are delivered before payment is received. The counterparty fails and the client incurs a loss.			
Client securities are lent but not returned. There is insufficient collateral.			
An overseas sub-custodian defaults while settling transactions. Client funds are lost.			
The AM firm uses client funds to cover significant own-account trading losses. Both AM firm accounts and client accounts are held by the same custodian. The AM firm defaults.			
The AM firm manipulates portfolios to present a better performance picture by shifting securities between client accounts. All client accounts are held by the same custodian.			
The AM firm charges its clients higher commission charges than those charged to the AM firm by the broker. The irregularity is revealed.			
The AM firm engages in 'churning' – ie, trades heavily for clients to generate excessive management fees. The irregularity is revealed and it can be proven that the custodian had noticed the irregularity but did nothing about it.			

5) Have there been any losses from operational failures in relation to client assets of your firm that were borne by the custodian, depositary or trustee?

YES/NO

If **YES**, what was the largest loss and what was the failure?

____

6) Do you think current custody arrangements should be revised to enhance investor protection against failures in the asset management process?

YES/NO

If **YES**, please use this space if you would like to comment on possible changes in practice, legislation and/or regulation.

____

____

____

7) If custody arrangements were changed to enhance investor protection, would this lead to increases in custody fees?

YES/NO

If **YES**, do you think the clients of your firm would be willing to pay higher fees for better protection?

YES/NO

8) Do you perceive any barriers to entry of custodians operating in other EU or overseas markets?

YES/NO

If **YES**, please list the main barriers to entry into the custody market.

____

____

____

9) You may wish to comment on the following statements. ‘Harmonisation of custody regulation at the European level is necessary.’ ‘Greater clarity and/or uniformity in the contractual arrangements would enhance investor protection.’

____

____

____

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