iapf
representing pension savers

Custody Paper

IAPF Investment Committee
2016

What is a Custodian?

Custodians have been described in some quarters as the “plumbers of the banking industry”. However many investors are unaware of their role and their significance in the industry. The primary function of a custodian is the safekeeping of an investor’s financial assets, e.g. equities, bonds etc. The purpose of this paper is to explore what that means in a little more detail.

Why did Custodians emerge?

In 1974, the Employee Retirement Income Security Act (ERISA) was introduced in the US and it obliged pension funds to segregate the investment management and custody of their underlying assets.[1] This segregation continues to exist today and is a very important tenet in maintaining investor protection (the Madoff case is testament to this).

Description of the Safekeeping Function

The world of investing has become global and technology plays a significant role but to best understand the primary role of a custodian it is useful to recall an era when share certificates existed and represented ownership of a shareholding.

If, at that time, an investment manager decided to buy 1,000 CRH shares on behalf of an investor they would place that trade with a broker and send the details to the client’s custodian. To settle the trade the shares would be re-registered at the relevant Central Securities Depository (“CSD”) and then delivered to the client’s custodian. The custodian would organise for the transfer of funds to the broker to cover the cost of the shares and thereafter would be responsible for the safe guarding of those certificates on behalf of the client in a secure environment, i.e. a vault or safe. This registration and delivery of share certificates was the main reason that settlement periods were longer traditionally.

Taking the above example and extending it to international shares, if an investment manager wished to buy French or US shares then the custodian would need to appoint an agent or a sub-custodian in that market to effect a similar transaction and safekeeping function in line with local requirements. Such sub-custodians may be branches of the appointed custodian or they may be other local custodian banks which operate in those markets.

While the above concepts all still apply today, the most significant change in the industry has been dematerialisation where ownership of securities is now recorded electronically at the CSD. This has increased efficiencies in the marketplace and considerably shortened settlement cycles. A schematic of this practice is set out in Appendix 1.

One final point in relation to this process is that, most commonly, securities are recorded on the books of the depository in the name of the custodian. This is due to the perceived impracticality of registering traded securities in the name of each individual holder. However the ultimate security holders are still the legal owners of the securities, the custodian is simply part of a registration chain linking the owners to the securities. However, it is very important that a custodian has a separate account for their own assets, i.e. that they are not comingled with those of their clients.

Other Functions of Custodians

Other than safekeeping and trade settlement, custodians also perform the following functions:

- Collect income from assets (dividends in the case of equities and coupons in the case of bonds) and administer tax withholding documents and foreign tax reclamation.
- Administer corporate actions on securities such as stock splits, business combinations (mergers), tender offers etc.
- Provide information on the securities and their issuers such as annual general meetings and related proxies
- Maintain currency/cash bank accounts
- Perform foreign exchange transactions
- Perform additional oversight functions in relation to unit funds (see below)

Who are the main Institutions?

By far, the 4 largest custodian banks in the world are[2]:

1. The Bank of New York Mellon
2. State Street Bank and Trust Company
3. JPMorgan Chase
4. Citigroup

Others include BNP, Northern Trust, Brown Brothers Harriman.

Investor's interactions with Custodians

Direct Relationship

Institutional investors who hold securities directly must appoint their own custodian. Traditionally in Ireland investors allowed their investment manager to select and interact with the custodian. However this is not good practice and is generally not the case anymore. One of the benefits of having a custodian is that they provide consolidated reporting across all portfolios managed by various investment managers. This is becoming increasingly important to meet new regulatory reporting requirements such as Solvency II, SORP etc. Some of the criteria when considering a custodian are as follows:

- Services required and available
- Financial stability of the firm
- Fees
- Ability to interact with the portfolio investment managers
- Technology/infrastructure
- Confirmation that the assets of the portfolio are segregated from the assets of the firm
- Strength of the sub-custodian network
- Understanding of protection in the event of a default by any party to the chain of custody
- Review of an appropriate external auditor report e.g. SSAE 16

Unit Trusts

Investors who are unitholders of a unit trust are part of an arrangement where one of the key service providers is a custodian. In this arrangement custodians are usually referred to as trustees or, following more recent regulation, depositaries and are appointed by the unit trust manager or the management company of the unit trust. The role of the trustees or depositaries within unit trusts is broader and includes a fiduciary responsibility to unitholders to oversee the conduct of the Manager manager or the management company of the fund. The annual financial statement of a fund will outline in the trustee report their obligations including whether the fund has been managed in line with the prospectus, the trust deed and relevant regulations.

Following the most recent financial crisis and in particular the implications of Madoff and the collapse of Lehman, regulation has been introduced to increase the liability of trustees/depositaries. Specifically, where unit funds are subject to Alternative Investment Fund (“AIF”) Regulations, trustees are liable to the fund and unitholders for loss by the trustee or its delegate of financial instruments held in its custody. The trustee is also subject to increased verification of ownership requirements of financial instruments to ensure better protection for unitholders. Equivalent requirements are expected in UCITS V which is the next proposed iteration of the UCITS Directive which governs the management of UCITS funds.

References

1. Guide to Custody www.iapf.ie
2. “Assets under Custody, worldwide”. www.globalcustody.net.

Appendix 1:
Typical Schematic for intermediated securities holdings