



ASIC

Australian Securities & Investments Commission

REPORT 291

Custodial and depository services in Australia

July 2012

About this report

This report is for responsible entities, providers of custodial and depository services, and their clients.

It discusses the custodial industry, the current regulatory regime and matters that we consider to be 'good practice'.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Contents

Executive summary	4
Australian custodial industry	4
Our review of the Australian custodial industry	5
Issues relevant to responsible entities and AFS licensee clients	6
Issues relevant to custodians	8
General recommendations	10
Further work.....	11
A Australian custodial industry	13
Custodians	13
Functions performed by custodians.....	14
Custodians as gatekeepers	16
Emerging trends	17
B Custodians and the regulatory framework	18
AFS licences.....	18
Custodians as bare trustee.....	19
Regulatory framework of custodians	19
Custody agreements.....	24
Risk management.....	25
Audit and assurance—GS 007 and SAS 70.....	26
C Client asset risks—Issues for responsible entities and AFS licensee clients	28
Issue 1: Assets held in custody	28
Issue 2: Cash held on deposit	29
Issue 3: Operational risk and opportunities for fraud.....	30
Issue 4: Transfer of assets and records	32
Issue 5: Risk management of outsourced services	32
Issue 6: Insolvency of the custodian or sub-custodian.....	33
D Client asset risks—Issues for custodians	36
Issue 7: Omnibus accounts	36
Issue 8: Stability and safety of IT systems	37
Issue 9: Operational risks created by manual and disparate systems ..	38
Issue 10: Whistleblowing culture and framework	38
Issue 11: Third party valuations.....	39
Issue 12: Breach reporting.....	40
Corporate actions	41
Key terms	43
Related information	45

Executive summary

Australian custodial industry

- 1 Custodians currently play a significant role in the safekeeping of client assets for a number of key reasons:
- (a) As at 31 December 2011, approximately \$1.82 trillion¹ of assets of Australian investors were held in custody.² This is expected to more than triple over the next 15 years to \$6.4 trillion (in nominal terms),³ in part due to the increase in superannuation guarantee contributions.⁴
 - (b) In Australia, custody of a substantial majority of these assets is concentrated with a small number of custodians (see Section A).⁵
 - (c) There have been a number of incidents in the industry, such as the collapse of Opes Prime⁶ and Trio/Astarra⁷, that have led to concerns regarding:
 - (i) the safety of investment assets that custodians hold;
 - (ii) the duty of care custodians exercise; and
 - (iii) whether custodians have appropriate internal controls to ensure the safety of assets held for others.
 - (d) Globally, there has been an increased regulatory focus on the safety of client assets and a number of international initiatives are being developed.⁸
- 2 In this report, the term ‘custodian’ refers to an entity providing a custodial or depository service within the meaning of s766E of the *Corporations Act 2001* (Corporations Act), as well as to persons holding property of a registered managed investment scheme.

¹ Australian Custodial Services Association (ACSA), *Australian investor assets under custody*, ACSA website www.custodial.org.au/public_panel/industrystats_investor.php.

² Excluding other types of custodial arrangements, such as ‘incidental custody’ (see Regulatory Guide 166 *Licensing: Financial requirements* (RG 166) and Pro Forma 209 *Australian financial services licence conditions* (PF 209) for an explanation of ‘incidental’ services).

³ Rice Warner Actuaries, *Investment custody in Australia*, report, March 2011.

⁴ The Australian Government has announced changes that, if agreed to by Parliament, will increase the superannuation guarantee rate from 9% to 12% from 2013–14 to 2019–20.

⁵ ACSA *Australian investor assets under custody*, ACSA website, www.custodial.org.au/public_panel/industrystats_investor.php; Rice Warner Actuaries, *Investment custody in Australia*, report, March 2011.

⁶ Opes Prime Group Limited was a major Australian securities lending and stock broking firm which suffered collapse in 2008.

⁷ Trio Capital Limited, formerly known as Astarra Capital Limited, was a boutique funds management and superannuation firm that collapsed in 2009.

⁸ These international initiatives include the EU Alternative Investment Fund Managers Directive (AIFMD), the US *Dodd–Frank Wall Street Reform and Consumer Protection Act 2010* and various IOSCO principles (to the extent that a comparison can be made with the Australian market and regulatory framework).

- 3 We note the report of the Parliamentary Joint Committee on Corporations and Financial Services (PJC) on the collapse of Trio Capital⁹ and the discussion of an ‘expectation gap’ between the custodian’s obligations and the public’s expectation of them.
- 4 We acknowledge the PJC’s recommendations about:
- (a) suspicious matter reporting by custodians; and
 - (b) the need for responsible entities to provide clearer disclosure about the role of custodians and possibly to adopt a different term to ‘custodian’. We propose the use of the word ‘depository’ rather than the word ‘custodian’ and will consult on this issue in our review of Regulatory Guide 133 *Managed investments: Scheme property arrangements* (RG 133).
- 5 We have prepared this report to inform responsible entities, the custodial industry and users of custodial services about the custodial industry, the current regulatory regime and matters that we consider to be ‘good practice’. It reflects our current regulatory position and is not intended to imply any new regulatory requirement or standard.
- 6 Our report is directed at entities with an Australian financial services (AFS) licence authorisation to provide ‘a custodial or depository service’,¹⁰ and their clients (such as broker–dealers) that hold an AFS licence for dealing in the financial products held under those services (referred to in this report as ‘AFS licensee clients’). It is also directed at responsible entities that hold property of a registered managed investment scheme or engage another person to hold the scheme property. It is not directed at registrable superannuation entities (RSEs)—these entities should refer to the guidance of the Australian Prudential Regulation Authority (APRA). Nonetheless, some of our observations and recommendations may be of interest to them.

Our review of the Australian custodial industry

- 7 Identifying the regulatory risks associated with custodians is part of our role to promote confident and informed investors and fair and efficient financial markets.
- 8 In 2009–2011, we conducted the first phase of our review of the Australian custodial industry, carrying out substantial industry liaison and surveillance. The purpose of this phase was to examine the role of providers of custodial services in the Australian financial services industry, particularly those

⁹ PJC, *Inquiry into the collapse of Trio Capital*, report, PJC, May 2012.

¹⁰ Section 766E of the Corporations Act.

custodians with managed fund and superannuation clients. We focused on the major custodians: see paragraph 27 and Table 3.¹¹

- 9 In late 2011, we commenced the second phase of our review when we met with a majority of the larger custodians, with specific focus on the actual and potential threats to client asset safety.
- 10 Regardless of the scope of our review, we recognise that all participants in the custodial industry perform an important service. Our comments in this report should be considered by any AFS licensee with a custodial or depository service authorisation and by any responsible entity of registered managed investment schemes in respect of custody of scheme property.
- 11 Throughout the first and second phases, we liaised with APRA, the Australian Transaction Reports and Analysis Centre (AUSTRAC), the Association of Superannuation Funds of Australia, the Australian Custodial Services Association (ACSA) and the Financial Service Council, as well as the US Securities and Exchange Commission (SEC) and the UK Financial Services Authority (FSA).¹²
- 12 We appreciate the assistance of all custodians and regulatory and industry bodies with whom we met. We will continue to liaise with industry and consider reform where appropriate.
- 13 Following our consultation with custodians, and general industry liaison, we identified a number of key risks to the safety of client assets.
- 14 In Table 1 and Table 2 we summarise our observations on certain issues regarding client asset safety and advise what we consider to be ‘good practice’. This does not imply any new regulatory requirement or standard. These issues are discussed in greater detail in Sections C–D.

Issues relevant to responsible entities and AFS licensee clients

- 15 In Table 1 we summarise our observations on issues that apply to clients of custodians to the extent that these clients are responsible entities or other AFS licensees. These issues are discussed in greater detail in Section C.

¹¹ We did not consider, as part of this review, those entities that provide custody incidentally as part of another service or those entities that provide custody only to a related company.

¹² The FSA will be split by the end of 2012 to form two separate regulators, comprising the Financial Conduct Authority and Prudential Regulation Authority.

Table 1: Issues relevant to responsible entities and certain AFS licensee clients

Issue	Description
1 Assets may be held outside of custodial arrangements	<p>It appears that several responsible entities hold some assets outside of the custodial arrangements, in the name of the responsible entity or a broker who does not have the required net tangible assets (NTA), rather than in the name of the custodian or its nominee.</p> <p>As set out in Regulatory Guide 166 <i>Licensing: Financial requirements</i> (RG 166), under its AFS licence conditions, a responsible entity that relies on a custodian to meet reduced NTA requirements must ensure that all scheme property (apart from certain assets and scheme property that are excluded under the terms of the licence) is held by the custodian.</p> <p>For further discussion of this issue, see paragraphs 81–84.</p>
2 Scheme property, specifically cash, may not be held on trust	<p>Cash is in some cases held on deposit at the custodian rather than on trust.¹³</p> <p>AFS licence conditions generally require a responsible entity that does not have \$5 million NTA to ensure that cash should be held on trust by a custodian that does meet the NTA requirements or is an eligible custodian.</p> <p>For further discussion of this issue, see paragraphs 85–88.</p>
3 High levels of operational risk and opportunities for fraud are present	<p>Custodians appear to have established risk management arrangements and a strong compliance culture. However, a high level of operational risk and opportunities for fraud remain, such as in the continuing practice of accepting written, faxed ‘authorised instructions’.</p> <p>We recommend a number of methods to mitigate risk, including the introduction of streamlined straight-through processing procedures.</p> <p>For further discussion of this issue, see paragraphs 89–94.</p>
4 Assets and records may not be accurately transferred from one custodian to another on a change of custodian	<p>There has been increasing consolidation within the superannuation, managed funds and custodial industry and this is expected to continue. As assets are transferred between different funds and different custodians, we consider that there is an opportunity for fraud and ‘leakage’ of assets and records.</p> <p>We suggest that clients conduct a review of assets and records transferred after the transition to a new custodian as a matter of course.</p> <p>For further discussion of this issue, see paragraphs 95–97.</p>
5 Clients may not adequately consider the outsourced services (particularly offshore) of the custodian in their risk management arrangements, introducing additional threats to the safety of client assets	<p>We have observed an increasing practice of outsourcing key functions to offshore, lower-cost jurisdictions.</p> <p>Where services have been outsourced, responsible entities and clients licensed to deal in financial products¹⁴ may need to consider the risks arising from these outsourced services when developing their risk management arrangements—for example, in structuring a business continuity plan and internal and external audit functions.¹⁵</p> <p>For further discussion of this issue, see paragraphs 98–99.</p>

¹³ For permitted exceptions, please see Class Order [CO 03/1112] *Relief from obligation to hold client money on trust*.

¹⁴ ASIC has responsibility for ensuring compliance with s912A(1)(d), which requires an AFS licensee to have adequate risk management arrangements unless it is a body regulated by APRA.

Issue	Description
<p>6 Clients may not have adequate risk management arrangements to deal with the insolvency of the custodian or sub-custodian</p>	<p>The risk of insolvency or termination of business by custodians in Australia should not normally be a threat to the safety of client assets. However, a number of risks remain, such as assets held in offshore jurisdictions that are subject to different local practices and insolvency laws.</p> <p>We suggest that clients may wish to consider the additional risks that arise as a result of exposure to jurisdictions, sub-custodians and service providers that do not provide appropriate protections and regulation for the relevant product types.</p> <p>For further discussion of this issue, see paragraphs 100–108.</p>

Issues relevant to custodians

- 16 In Table 2 we set out our observations that apply to custodians and should also be considered by responsible entities. Taking into account the role of custodians as gatekeepers and key service providers within the financial services industry, we have identified the following areas of good practice that a custodian may need to consider. These issues are discussed in greater detail in Section D.

Table 2: Issues relevant to custodians

Issue	Description
<p>7 Omnibus accounts may expose client assets to risk</p>	<p>Client assets are typically held through an omnibus account in the name of the custodian or its nominee, rather than in individual accounts for each underlying client.</p> <p>Custodians generally do not consider that there is ‘client money risk’ when omnibus accounts are used. However, our review has found that such risk does exist—for example, when a client’s money is used to settle another client’s obligations.</p> <p>For further discussion of this issue, see paragraphs 109–115.</p>
<p>8 Information technology (IT) systems may not be stable or secure from unauthorised access or use, thereby threatening the safety of custodian systems and client assets</p>	<p>We understand from consultations with custodians that IT security is critical to the integrity and stability of the custodial business. As custodians continue to outsource (particularly offshore) significant functions such as unit pricing, we consider that this may increase the challenge to data integrity and security, which should not be compromised.</p> <p>For further discussion of this issue, see paragraph 116.</p>

¹⁵ For example, see Guidance Statement GS 007 *Audit implications of the use of service organisations for investment management services*, which applies to domestic operations.

Issue	Description
<p>9 Operational risks may be introduced by not upgrading manual and disparate systems</p>	<p>Custodians continue to invest in systems that automate their day-to-day functions; however, our review found there is still a reliance on manual and disparate systems which may be out-of-date, slow and cumbersome. Not upgrading these systems can introduce new operational risks.</p> <p>Custodians should consider whether their systems are able to meet the needs of the business and assess the benefit of investing in new or improved systems.</p> <p>For further discussion of this issue, see paragraphs 117–119.</p>
<p>10 Custodians are at risk of ignoring or not identifying misconduct and suspected misconduct if they do not understand the extent of the AML/CTF Act or foster a ‘whistleblowing’ culture and framework</p>	<p>Custodians have reporting obligations under the <i>Anti-Money Laundering and Counter-Terrorism Financing Act 2006</i> (AML/CTF Act) and, specifically, the obligation to lodge suspicious matter reports (SMRs) with AUSTRAC.</p> <p>Suspicious matter reporting extends to information that may be relevant to the investigation or prosecution of an offence of a law of the Commonwealth or state or territory. Therefore, SMRs should not be limited to matters relating to potential money laundering or terrorism financing.</p> <p>In addition to these legislative requirements, we consider that it is good practice for custodians, and other participants in the financial services industry, to foster a whistleblowing culture and framework, where misconduct, or suspected misconduct, of clients or the custodian and its staff is reportable to ASIC under their risk management arrangements.</p> <p>For further discussion of this issue, see paragraphs 120–121.</p>
<p>11 Custodians may not investigate valuations provided to them that are inaccurate and potentially fraudulent, or raise suspicious matters with AUSTRAC/ASIC</p>	<p>It is our understanding that custodians, as instructed parties, do not generally question ‘reasonable’ looking valuations obtained in accordance with client instructions. We are concerned where such valuations may not be ‘reasonable’ looking.</p> <p>If a custodian observes anything suspicious or anomalous in the valuations and the obligation to lodge an SMR:</p> <ul style="list-style-type: none"> • applies, AUSTRAC expects that the custodian will raise this concern in an SMR; or • does not apply, we encourage the custodian to raise their concerns with their client and, if their concerns are not allayed, raise them with ASIC. <p>For further discussion of this issue, see paragraphs 122–125.</p>

Issue	Description
<p>12 Custodians may not report significant breaches in their investment administration areas to ASIC because they consider these activities to be outside the scope of their AFS licence and breach reporting requirements.</p>	<p>From our discussions with industry, it appears that many custodians do not consider that all investment administrations services (which they provide in addition to their core custodial or depository service) constitute ‘financial services’, and therefore significant breaches in relation to such services are not reportable to ASIC under their obligations as an AFS licensee.</p> <p>We consider it good practice for custodians to ensure that their risk management arrangements cover all activities, including the specific licensed activities of the custodian and its business more generally, and that they develop a culture of transparency for incident recording and breach reporting to ASIC across all of their business.</p> <p>For further discussion of this issue, see paragraph 126.</p>

General recommendations

- 17 There have been discussions about an ‘expectation gap’ between the custodian’s obligations and the public’s expectation of them.
- 18 While there is no express requirement for responsible entities and RSE licensees to identify the fund’s custodian and describe its role in the Product Disclosure Statement (PDS) regime, it will be necessary or appropriate in many cases. This might sometimes be achieved through ‘incorporation by reference’ via the fund’s website.
- 19 We note the PJC’s recommendation that:
- ASIC should consider changing the name ‘custodian’ to a term that better reflects the current role of a custodian. This new term—reflecting the limited role of custodians—must be used in [PDSs].¹⁶
- 20 We consider that it may be appropriate for responsible entities and other financial product issuers to provide clearer disclosure about the role of custodians in retail marketing material, including PDSs. We propose to consult on this issue.
- 21 Custodians and their compliance personnel must continue to recognise their gatekeeping role and the opportunities for misconduct associated with this role. The obligation of custodians that are not bodies regulated by APRA to have adequate arrangements to manage risk would take into account risks that arise from these opportunities. Appropriate steps that custodians should consider include:
- (a) maintaining a proper instruction procedure and only allowing payments from or to previously designated accounts and payees, implementing

¹⁶ PJC, *Inquiry into the collapse of Trio Capital*, report, PJC, May 2011.

- daily reconciliations, and operating dual checks on activities carried out;
- (b) for those clients that have transferred assets from one custodian to another (including through a merger or change in appointment), supporting clients to obtain a review of assets and records that have been transferred;
 - (c) considering IT risk management and ensuring that dependence on IT systems is recognised through risk management arrangements, which may include business continuity plans. A low level of systems integration may lead to a proliferation of disparate systems, with manual overlays, resulting in operational risks;
 - (d) addressing the problems associated with corporate actions,¹⁷ which can create high operational risk partly due to the fact that the actions may be unique and cannot be easily automated. We understand that industry continues to provide significant focus on this issue, including through industry working groups, in an attempt to provide viable and long term solutions;
 - (e) reviewing their processes for reporting under the AML/CTF Act, including:
 - (i) conducting appropriate initial and ongoing customer identification and verification to identify and risk rate clients;
 - (ii) adopting and complying with an AML/CTF program;
 - (iii) keeping certain AML/CTF-related records for the required retention periods; and
 - (iv) lodging required transaction reports with AUSTRAC, such as threshold transaction reports, international funds transfer instructions and SMRs, including those that may be relevant to the investigation or prosecution for an offence under a Commonwealth, state or territory law.

Further work

Review of NTA requirements

- 22 In addition to the work completed in our review, we are reviewing the financial resource requirements that apply to AFS licensees providing a custodial or depository service, and under RG 166 for custody provided as part of a registered managed investment scheme. Specifically, we will

¹⁷ 'Corporate action' means any event that brings material change to a company entity and affects its owners. Examples include rights issues, restructuring, dividend payments, mergers, acquisitions, change in responsible entity.

consider whether the \$5 million NTA requirement for a provider of custodial or depository services is adequate,¹⁸ given the significant operational risk to which custodians are subject. We will consult separately on this issue.

Update to guidance on custody

- 23 RG 133 provides regulatory guidance on the holding of scheme property. Under Regulatory Guide 148 *Investor directed portfolio services* (RG 148) and Regulatory Guide 167 *Licensing: Discretionary powers* (RG 167), this guidance also applies to other custodians.¹⁹ We intend to update the guidance in RG 133 and the conditions in Pro Forma 209 *Australian financial services licence conditions* (PF 209) that are applicable to responsible entities and custodians.
- 24 The review of RG 133 will also address amendments that may be required to other guidance, such as RG 148, RG 167 and Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* (RG 168). We will consult with industry when updating these regulatory guides, including in relation to the areas identified in this report.

¹⁸ We note that the APRA NTA requirement for RSE licensees is currently \$5 million.

¹⁹ Apart from the specific reference to compliance committees.

A Australian custodial industry

Key points

The custodial industry in Australia is highly concentrated, with a small number of major custodians holding a significant portion of assets in custody.

There is a significant range of investment administration services provided to clients, in addition to the traditional safekeeping of assets.

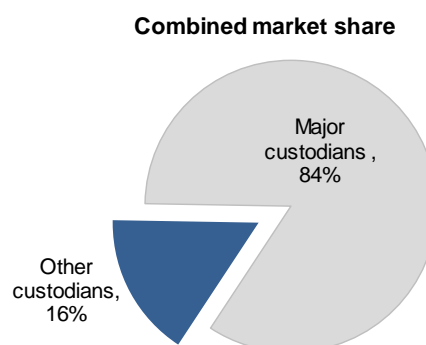
Custodians

- 25 Custodians are key service providers in the financial service industry. The growth of the custodial industry in Australia over the past two decades is closely correlated to the introduction of compulsory superannuation in the early 1990s. The industry has evolved significantly over this period, including:
- (a) through consolidation and the entry of new participants;
 - (b) in response to the innovation of new products and regulatory requirements; and
 - (c) to provide ancillary services in addition to the pure safekeeping of assets held in custody.
- 26 In Australia, the main users of custodial services are:
- (a) superannuation fund trustees (excluding trustees of self-managed superannuation funds);
 - (b) responsible entities of managed funds (including registered managed investment schemes);
 - (c) insurance companies;
 - (d) endowment funds and charities;
 - (e) broker-dealers; and
 - (f) federal and state governments.
- 27 Currently, the industry in Australia is dominated by a small number of major custodians: see Table 3.

Table 3: Assets held in custody in Australia as at 31 December 2011

Major custodians	Assets in custody	Approx. market share
National Australia Bank Asset Servicing	\$539.8bn	30%
JP Morgan Treasury and Securities Services	\$366.5bn	20%
BNP Paribas Securities Services	\$269.1bn	15%
State Street Global Services	\$133.3bn	7%
Citi Global Transaction Services	\$119.2bn	7%
HSBC Securities Services	\$103.3bn	5%

Other significant custodians	Assets in custody
Northern Trust Company*	\$91.5bn
BNY Mellon	\$80.1bn
Perpetual	\$55bn**
RBC Dexia Investor Services	\$46.1bn
Bond St Custodians Limited (part of Macquarie Bank)	\$44.9bn
Asteron	\$16.6bn



* A recent entrant into the Australian market.

** No current data is available for Perpetual. This figure is based on Rice Warner data as at 30 June 2010.

Note: Percentage figures in the chart are approximate.

Source: ACSA as at 31 December 2011. (Please note there have been some significant mandate changes since this date.)

Functions performed by custodians

- 28 The safekeeping of assets is a core custodial service. Other services that may be considered core services include:
- trade and transaction settlement—facilitating the trade and settlement of transactions, with third parties on behalf of the client, for assets held in custody;
 - corporate actions—aggregating clients’ instructions for participating in any rights or obligations arising from assets held in custody;
 - proxy voting—helping clients exercise their voting rights on the securities held in custody; and
 - reconciliations—reconciling the records held by the custodian with another provider’s records, such as the fund administrator or investment

manager. This service provides some assurance regarding the accuracy of their records and can be a means to identify discrepancies, potential fraud or other problems.

Other core services include record keeping and reporting, tax reclamations, cash management, and income and distribution processing.

29 Custody is also associated with a large number of additional products and services. Other services offered by custodians are provided independently of the core services and fall under the broad heading of ‘investment administration’.

30 Investment administration may include:

- (a) mandate monitoring—monitoring, on behalf of the client, the investment managers’ compliance with the investment mandate set by the client; and.
- (b) fund accounting—preparing the financial accounts for the client managed funds or unit trusts, for which the custodian holds assets on behalf of the client. This also involves calculating net asset values and unit pricing.

Other investment administration services include calculating crediting rates, performance monitoring and reporting, tax reporting, and unit registry.

31 There may be other services provided in addition to core services and investment administration, such as foreign exchange, risk measurement and monitoring and securities lending.

32 The operation of a registered scheme, including holding scheme property and associated activities (such as dealing in financial products that are scheme property), is a financial service under the responsible entity’s AFS licence. Holding assets of a registered scheme is not a custodial or depository service,²⁰ although dealing in those assets that are financial products may be a financial service covered under the custodian’s AFS licence. Outside the context of registered schemes, we recognise that not all ancillary and investment administration services provided by custodians are performed under their AFS licence. However, we understand that it is normal practice for these services to be provided under a formal outsourcing arrangement with the clients, typically the custody agreement.

33 We expect that the nature and type of services that may be offered by custodians will continue to evolve and expand over time. For example, as consolidation in the superannuation industry continues, it is possible that certain investment administrative services and compliance monitoring are brought back in-house.

²⁰ See s766E(3)(b) of the Corporations Act.

- 34 Obviously, there is considerable variation in the extent to which a custodian is engaged to provide additional services in addition to core services. This will depend on various factors, including the client's specific needs, sophistication of the client's own systems and the cost–benefit analysis of the proposed outsourcing.

Custodians as gatekeepers

- 35 The use of custodians may be driven by a number of factors, such as:
- (a) for responsible entities, ASIC's financial requirements and the standards in RG 133; and
 - (b) for RSE licensees, the requirements of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) and APRA's requirements for the custody of superannuation entities of which an RSE licensee is to be trustee.
- 36 In addition, custodians are recognised as providing benefits to clients through independent safekeeping of assets and the use of sophisticated and professional systems.
- 37 We consider custodians to be gatekeepers within the financial services industry, with responsibility in the product chain for the safe keeping of client assets. Currently, these gatekeeping responsibilities are established through:
- (a) the existing regulatory framework discussed in Section B;
 - (b) the contractual parameters agreed with clients in the custody agreement;
 - (c) auditing standards—for example, see Standard on Assurance Engagements ASAE 3403 *Assurance reports on controls at a service organisation* and the practice of providing to users of custodial services audit reports prepared in accordance with Guidance Statement GS 007 *Audit implications of the use of service organisations for investment management services* (published by the Auditing and Assurance Standards Board (AUASB)); and
 - (d) industry practice.
- 38 We consider that the function of custodians as gatekeepers in the financial services industry is not inconsistent with single responsible entity principle established by the *Managed Investment Act 1988*. We recognise that responsibility for the operation of the scheme rests solely with the responsible entity under s601FB(2) of the Corporations Act. Nonetheless, the custodian has an important fiduciary role to their responsible entity client to discharge, and we have identified some areas on which we will consult and that may require regulatory change.

Emerging trends

- 39 New entrants in the industry and the consolidation of managed fund and superannuation clients have increased the level of competition among custodians for a reducing number of potential clients. This, as well as other market factors, has tended to impose downward pressure on revenue in the market place. Some custodians are adapting to the increased competition by enhancing their service offering. Conversely, other custodians may have difficulty updating systems to meet client demands because of lower profit margins. Nonetheless, custodians must continue to adhere to appropriate standards, and their legal and regulatory obligations.

B Custodians and the regulatory framework

Key points

Custodians derive their obligations from their AFS licence, the Corporations Act, and other legislation such as the AML/CTF Act, and are expected to take into account ASIC regulatory guidance.

AFS licences

- 40 In this report, custodian refers to a person providing custodial or depository services for which an AFS licence is required,²¹ or a person who is holding scheme property of a registered managed investment scheme. ASIC is responsible for:
- (a) granting the AFS licence covering the provider of the custodial or depository service or operating a registered scheme; and
 - (b) monitoring AFS licensees' compliance with their licence conditions, the Corporations Act and related regulatory guidance.
- 41 The term 'custodial or depository service' is given a specific statutory definition in s766E of the Corporations Act, and refers to the holding, in certain circumstances, of financial products or a beneficial interest in financial products (other than as a trustee of a registrable superannuation entity or as holder of the assets of a registered managed investment scheme). In connection with their business of holding financial products, a custodian may provide additional services, such as trade settlement, reconciliations, fund accounting, unit pricing and reporting: see paragraphs 28–34. Custodians will generally require an AFS licence authorising dealing (unless they do not deal in financial products).
- 42 To the extent that the services provided by a custodian are not 'financial services', any breaches in relation to such services may not be treated as reportable to ASIC by the custodian. However, there may be a breach reportable by the relevant client, if it represents a significant breach or other reportable matter under the client's obligations. For example, a custodian may incorrectly calculate unit prices of a managed fund or superannuation fund. Ordinarily:
- (a) this would not be reportable as a significant breach by the custodian because the calculation of unit prices does not constitute a 'financial

²¹ See s766A and 911A(1) of the Corporations Act.

service' of the custodian and in any event, may not be 'significant' in terms of the custodian's business; and

- (b) this would be reportable by the operator of the managed fund or RSE licensee client to ASIC under s912D.

43 APRA does not have direct regulatory responsibility for custodians, but does have oversight of RSE licensees: Superannuation Guidance Note SGN 130.1 *Outsourcing*.

Custodians as bare trustee

44 A custodian is responsible for the holding of property for another person who is the beneficial owner.²² The property itself may, for example, be a beneficial interest that is a financial product or a beneficial interest in a financial product. The holder is often referred to as a custodian in circumstances where it holds property but another person retains the management powers and responsibilities in respect of the property.

45 While the custodial industry commonly refers to the role of custodian as a 'bare trustee', ultimately the nature of the relationship between the parties is determined by the substance of the obligations into which they have entered into, rather than the name.

46 Except in limited circumstances, such as a potential breach of law, the custodian is usually required to act on all authorised instructions of the client (e.g. an RSE licensee or responsible entity) or its authorised agents (e.g. an investment manager or administrator).

47 It is the responsibility of the custodian to ensure that it acts only under authorised instructions. Generally, a person referred to as a custodian does not have any discretion as to how a client's assets are to be invested or administered—it can only deal with the assets on the instructions from the client and in accordance with those instructions.

Regulatory framework of custodians

48 Generally a custodian must obtain an AFS licence issued by ASIC to carry on a business of providing custodial or depository services. A responsible entity must also ensure these requirements are met in relation to holding scheme property. The current regulatory framework that applies to these custodians is set out in paragraphs 49–80.

²² A custodian holds the legal title and the client has an equitable interest.

AFS licence: General requirements

- 49 Before we issue an AFS licence, a custodian must establish:
- (a) an organisational structure that supports the segregation of staff to minimise the potential for conflicts of interest to arise, and that is structured so that custodial staff are able to report directly to the compliance committee of its client (where the custody is of scheme property) or the board of directors of the client;
 - (b) staffing capabilities, where staff have the experience, qualifications, knowledge and skills necessary to perform the functions of a custodian properly and access to specialist areas so that custodial staff can adequately carry out their duties;
 - (c) the resources for core administrative activities, which are likely to include computer systems, procedures for recording client assets, movements of those assets, recording corporate events, and regularly reporting those assets to clients;
 - (d) arrangements for how various assets will be held, including that the clients assets be segregated from the custodian's own assets and those of its other clients, except:
 - (i) in the case of a registered scheme:
 - (A) when using an omnibus account that we have permitted under Class Order [CO 98/51] *Relief from duty to separate assets of a managed investment scheme*; or
 - (B) when using prime brokerage services under the circumstances set out in Class Order [CO 03/1111] *Prime brokerage services: relief from obligation to hold scheme property separately*; or
 - (ii) in other cases where other asset holding arrangements are lawful; and
 - (e) custody-related financial resources (see paragraphs 51–54).
- 50 Under s912A, custodians as AFS licensees, must:
- (a) do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly;
 - (b) have in place adequate arrangements for the management of conflicts of interest (see Regulatory Guide 181 *Licensing: Managing conflicts of interest* (RG 181)); and
 - (c) have adequate risk management arrangements²³ (see Regulatory Guide 104 *Licensing: Meeting the general obligations* (RG 104)).

²³ Custodians do not have to demonstrate to ASIC compliance with this requirement if they are regulated by APRA.

AFS licence: Financial requirements

- 51 In Section C of RG 166, we have set out the minimum financial requirements that a custodian should satisfy.²⁴ An entity providing a custodial or depository service, other than incidental to the provision of another financial service provided by it or a related body corporate that is not an investor directed portfolio service (IDPS), should at all times have NTA of \$5 million.²⁵
- 52 This is intended to ensure that the custodian has sufficient financial resources to operate compliantly and to meet operational liabilities. The minimum NTA requirement is also imposed to ensure that there is an opportunity for an orderly wind up of a custodian's business in order to prevent client loss: see RG 166.84. Additional financial requirements may also apply, depending on the other financial services business of the custodian.
- 53 However, these AFS licence financial requirements do not apply if the custodian is regulated by APRA.
- 54 We are currently reviewing the financial resource requirements of custodians, and will consult separately on this issue.

AFS licence: Custody conditions

- 55 Specific AFS licence conditions are imposed on licensed custodians in relation to their licensed business and on responsible entities in relation to scheme property: see conditions 34 and 35 of PF 209.
- 56 RG 133 sets out our guidance on operational standards in relation to the holding of scheme property. Compliance with RG 133 is a condition of a custodian's AFS licence and a responsible entity's AFS licence²⁶ (in the case of scheme property of a registered scheme): see conditions 34 and 35 of PF 209. Similar provisions apply to custodians of superannuation funds under APRA's Cross Industry Circular No. 1 *Custodian requirements for APRA supervised entities* and SGN 130.1.

AFS licence: Audit reporting

- 57 Licensed custodians and responsible entities, as AFS licensees, are required to prepare a profit and loss statement and a balance sheet, in accordance with the law, each financial year: s989B. Licensed custodians must lodge these

²⁴ In addition, the requirements of Sections A and B in RG 166 must be satisfied.

²⁵ With certain exceptions, unless a responsible entity has \$5 million NTA, it must appoint a custodian to hold the scheme property, ensuring that the custodian holds \$5 million NTA, is an ADI or is appointed by an ADI.

²⁶ If a responsible entity uses a custodian, RG 133 requires that the compliance plan for the registered scheme must set out the measures to ensure that members of the scheme are protected from the possible risks arising from the custodial arrangement.

with ASIC, using Form FS70 *Australian financial services licensee profit and loss statement and balance sheet*, as well as lodge an auditor's report using Form FS71 *Australian financial services licensee audit report*.

Client money and property provisions

- 58 Divisions 2 and 3 of Pt 7.8 of the Corporations Act (client money and property provisions) impose certain obligations on custodians in relation to client money and other property:
- (a) Div 2 requires that, subject to certain exceptions, money paid to an AFS licensee, such as a custodian, must be held in an Australian authorised deposit-taking institution (ADI) or other type of account prescribed by the Corporations Regulations 2001 (Corporations Regulations): s981A(1) and 981B(1). The money is taken to be held in trust by the custodian (s981H).
 - (b) Div 3 requires that an AFS licensee, such as a custodian, must ensure that property it receives (other than money) is only dealt with in accordance with:
 - (i) the terms and conditions on which the property was given to the AFS licensee (s984B(1)(b)(i));²⁷ and
 - (ii) any subsequent instructions given by the client to the AFS licensee (s984B(1)(b)(ii)).
- 59 In the case of scheme property of a registered scheme, the property must be held separately, unless relying on:
- (a) [CO 98/51], which permits the use of omnibus accounts under certain conditions: see RG 133; or
 - (b) [CO 03/1111], which permits money to be held by an ADI as custodian under a prime brokerage arrangements.
- 60 Similarly, Class Order [CO 03/1112] *Relief from obligation to hold client money on trust* permits money of a wholesale client not to be held on trust where the custodian is an ADI and the parties expressly agree to this arrangement in writing.

AML/CTF Act: Know your customer due diligence

- 61 Custodians must comply with the initial and ongoing know your customer due diligence requirements under the AML/CTF Act.
- 62 In addition, we consider that there are aspects beyond the know your customer requirements of the AML/CTF Act that may warrant pre-contract

²⁷ Typically, this refers to the terms of the custody agreement.

assessment by the custodian of its client—for example, to assess the client’s service requirements. This assessment may help the custodian comply with its AFS licence obligations (see s912A and RG 104) and reduce the risk of unexpected differences in capabilities or service requirements, which could lead to potentially avoidable operational risks and other issues.

- 63 We suggest that custodians may wish to consider making the following inquiries about their clients, as appropriate, in addition to those that may be required under the AML/CTF Act:
- (a) credit assessments;
 - (b) identification and valuation of assets (and reconciliation on transition from a retiring custodian);
 - (c) review of disclosure documents;
 - (d) verifying the status of the client, where the custodian is only able to deal with ‘wholesale’ clients (s761G);
 - (e) review of the scope of business and breadth of the operation for which custody is provided; and
 - (f) review of the client’s corporate records, licence and other regulatory documents that may be relevant.
- 64 We will consult on this issue as part of our review of RG 133.

AML/CTF Act: Suspicious matter reporting

- 65 Entities that provide ‘custodial or depository services’²⁸ are ‘reporting entities’ under the AML/CTF Act and are required to lodge SMRs with AUSTRAC.²⁹ Reporting entities must have an appropriate AML/CTF program that addresses the AML/CTF risk management requirements prescribed in the Anti-Money Laundering and Counter-Terrorism Financing Rules (No.1), including a system for detection, monitoring and reporting suspicious matters.
- 66 AUSTRAC has confirmed that the suspicious matter reporting obligations apply if the reporting entity suspects, on reasonable grounds, that the information may be relevant to the investigation or prosecution of an offence against a Commonwealth, state or territory law. Therefore, SMRs should not be limited to matters relating to potential money laundering or terrorism financing.³⁰

²⁸ See s6 and item 46 of Table 1 of the AML/CTF Act.

²⁹ See s41 of the AML/CTF Act.

³⁰ See www.austrac.gov.au/suspicious_matters.html.

67 AUSTRAC has also confirmed that such SMRs can be lodged with ASIC as well as AUSTRAC.³¹

Protection for whistleblowers

68 In circumstances where the AML/CTF Act may not be applicable, individuals or entities are able to report suspicious matters to ASIC. Protection for such whistleblowers is provided under Pt 9.4AAA of the Corporations Act, including where protection under the AML/CTF Act may not apply.

69 We will consult with industry on this matter in our review of RG 133.

Custody agreements

70 Under conditions 34(g) and (h) of PF 209 the custodian must enter into a written agreement with each of its clients and comply with the content requirements of that condition, including in relation to the following:

- (a) nature of the arrangement and the obligations of each party;
- (b) review, monitoring and assessment;
- (c) how instructions will be provided to the custodian;
- (d) compensation;
- (e) encumbrance prohibition;
- (f) appointment of sub-custodians;
- (g) record and reporting requirements;
- (h) auditor access; and
- (i) RG 133 compliance—how the custodian (or sub-custodian) will certify that it complies with, and will continue to comply with, the requirements of RG 133 when read in conjunction with RG 148 and RG 167.

For the appointment of custodians by RSE licensees, see reg 4.16 of the Superannuation Industry (Supervision) Regulations 1994 and SGN 130.1.

71 In practice, the custody agreement will also describe the following:

- (a) the list of specific services and service levels for the particular client—for example, trade instruction cut-offs for domestic and overseas markets, corporate event reporting, proxy voting, income collection;

³¹ See s243E of the *Australian Securities and Investments Act 2001* (ASIC Act).

- (b) the form of proper instruction, including a list of names and signatures of authorised persons, as well as detailed description of the process for providing and effecting those instructions;
- (c) undertakings regarding business continuity and disaster recovery, independent audit (typically GS 007 standard) and professional indemnity insurance;
- (d) the appointment, monitoring and responsibility for sub-custodians or other agents; and
- (e) liability of both parties and indemnities from the client where the custodian is acting in accordance with its contractual obligations.

Risk management

72 In order to comply with the regulatory arrangements in s912A(1)(h), which apply to custodians (other than bodies regulated by APRA), custodians need to identify and manage the particular risks to which they are or may be subject. Custodians must also monitor and review their risk management arrangements to ensure that the arrangements continue to be appropriate and adequate for their business. Failure to appropriately manage such risks can expose custodians, and ultimately their clients, to significant financial losses, opportunity costs and reputational damage.

Table 4: Key risks of custodians

Legal and compliance risk	<p>Custodians may breach regulations, laws, industry standards, contractual terms and regulatory expectations to which they are subject.</p> <p>Appropriate risk controls may include:</p> <ul style="list-style-type: none"> • correctly identifying such provisions, and establishing and implementing appropriate processes to achieve compliance; and • monitoring and regularly reviewing processes to ensure compliance.
Operational risk	<p>Processes and transactions may not be completed accurately and in a timely manner, including through fraud.</p> <p>Appropriate risk controls may include:</p> <ul style="list-style-type: none"> • separation of duties and dual control; • accounting controls, including reconciliations and reporting; • automation of process through technology; and • appropriate policies and procedures.

Credit risk

Counterparties may default on a transaction, which may result in the custodian having to extend or commit its own funds to complete an obligation of the client (or in the case of an omnibus account, another client or counterparty). As the types of services provided by custodians expand from the passive safekeeping of assets, credit risk is becoming increasingly relevant for custodians to manage. Credit risk can arise, for example, through securities lending where the custodian is lending securities either as principal or agent for the client and managing collateral.

Appropriate risk controls may include:

- due diligence and monitoring of sub-custodians and counterparties;
- appropriate credit rating and credit policy; and
- diversification of counterparties, where possible.

Audit and assurance—GS 007 and SAS 70

- 73 There are some regulatory requirements for custodians to obtain independent auditor's reports in relation to custody. This includes the lodgement of Form FS71 by AFS licensees, compliance plan audits for registered schemes and auditor's reports that must be obtained by operators of platforms that are IDPS.
- 74 Custodians often also obtain audit and assurance reports as a result of their contractual arrangements with users. In relation to investment management services, users are typically provided reports on the custodian's controls as a service organisation, as covered in GS 007.
- 75 GS 007 includes guidance on how to apply the AUASB's relevant auditing and assurance standards when preparing audit and assurance reports on the description, design and operating effectiveness of the service organisation's controls over the investment management services.
- 76 GS 007 is designed to provide detailed and transparent reporting on relevant control frameworks of custodians. Several types of reports are covered in GS007 but they can include descriptions of systems and controls, control objectives, and the nature timing and results of the tests of controls performed by the auditor.
- 77 Some of the custodians currently use US-style audit reports for their Australian-based custodial service operations, based on standards issued by the Auditing Standards Board of the American Institute of Certified Public Accountants. This includes reports prepared in accordance with Statement of Auditing Standards No. 70 *Service organizations* (SAS 70) or its successor Statement on Standards for Attestation Engagements No. 16 *Reporting on*

*controls at a service organization (SSAE 16).*³² SSAE 16 was based on International Standard for Assurance Engagements ISAE 3402 *Assurance reports on controls at a service organization*, issued by the International Auditing and Assurance Board. GS 007 includes guidance on how to apply Australian Standard for Assurance Engagements ASAE 3402 *Assurance reports on controls at service organisations*, which is also based on ISAE 3402.

- 78 GS 007 reports represent standard reporting in the Australian financial services industry to users of investment management services. However, there are no requirements for the GS 007 reports to be provided to ASIC or APRA.
- 79 We may, from time to time, conduct surveillance of responsible entities and custodians and require provision of copies of such internal and external reports.
- 80 In addition, we will consult with industry on receiving material exception reports from the auditors of custodial services.

³² SSAE 16 replaced SAS 70 as the professional standard for service organisations to obtain an independent assessment about the effectiveness of internal controls that are relevant to their customer's financial statements. SSAE 16 is effective for reporting periods ending on or after 15 June 2011.

C Client asset risks—Issues for responsible entities and AFS licensee clients

Key points

We have identified six issues that responsible entities and other AFS licensee clients may wish to consider. These are:

- the implication of holding certain assets outside the custodial relationship (paragraphs 81–84);
- issues arising in relation to cash held on deposit (paragraphs 85–88);
- operational risk and opportunities for fraud (paragraphs 89–94);
- transfer of assets and records following a change in custodian (paragraphs 95–97);
- outsourcing by a custodian, particularly to offshore jurisdictions (paragraphs 98–99); and
- insolvency of a custodian or sub-custodian (paragraphs 100–108).

Issue 1: Assets held in custody

81 From our review, it is apparent that many responsible entities appear to hold some scheme assets outside the custodial relationship. These include:

- (a) derivative contracts, including over-the-counter derivatives;
- (b) private equity interests;
- (c) ‘11 am broker accounts’;
- (d) cash accounts;
- (e) term deposits;
- (f) margin accounts supporting derivative positions;
- (g) unlisted property; and
- (h) direct property loans and mortgages.

82 We understand that this is common industry practice and there may be practical benefits in doing so. Custodians cited a number of examples why clients held assets outside the custodial arrangements, such as the custodian’s capacity and willingness to accept risk or legal responsibility attached to the asset concerned or following the appointment of a third party agent. Custodians consider that assets held outside of the custodial arrangement are the direct responsibility of the client.

- 83 Nonetheless, this has compliance implications for those responsible entities that use custodians to meet their NTA or other financial requirements.
- 84 In addition, any legal and counterparty risk in relation to such assets should be addressed in the custody agreement and any counterparty agreements. The custody agreement would typically provide that liability rests with the client rather than the custodian.

Our view

As set out in RG 166, under its AFS licence conditions, a responsible entity that relies on a custodian to meet reduced NTA requirements must ensure that all (rather than part only) scheme property (apart from certain assets and scheme property that are excluded under the terms of the licence) is held by a custodian.

We will consider whether some broader allowance should be made for holdings of cash, derivatives and other assets that carry liabilities for the holder and consult about this issue.

Issue 2: Cash held on deposit

- 85 AFS licence conditions generally require responsible entities that do not have \$5 million NTA to ensure that, like other scheme property, cash should be held by a custodian that does have \$5 million NTA or is an eligible custodian.³³ However, it was observed during our review that cash is generally held on deposit at the custodian or in the name of the responsible entity, rather than on trust, if the custodian is an ADI.
- 86 We consider that holding money on deposit, rather than on trust, does not comply with any requirement that the account should be held on trust by the custodian. In addition, where the bank account is held in the name of the responsible entity, the responsible entity may not be complying with the financial requirements of its AFS licence.
- 87 As funds held in custody increase in the industry, there will be a related increase in the level of cash holdings held on deposit. Holding large amounts of cash on deposit with a concentrated number of ADIs may introduce a credit risk for the client that they may not have specifically considered.
- 88 One major way to control credit risk is to diversify counterparties. Clients engaging a custodian would generally be obliged to take into consideration the custodian's (or its preferred ADI's) creditworthiness and financial standing.

³³ See RG 166.84, which defines 'eligible custodian' as:

- an Australian ADI;
- a market participant or clearing participant; or
- a sub-custodian appointed by one of the above.

Our view

We consider that cash balances of responsible entities held as part of registered managed investment schemes, as with other scheme property, must be held in accordance with RG 133 and RG 166 in order for the responsible entity to comply with its AFS licence requirements. The responsible entity must exercise the same level of controls, including reporting lines under RG 133, for any cash that is held by the responsible entity on deposit with the custodian.

In addition, as part of maintaining adequate risk management arrangements for their business, we consider it prudent for clients that are AFS licensees to consider whether there are better ways of managing the credit risk to cash balances, including continuously assessing the level of credit risk they are exposed to through their custodian (or its ADI) and potential diversification of counterparties.

Issue 3: Operational risk and opportunities for fraud

- 89 Based on our consultation with industry, custodians appear to have an established risk management arrangements and compliance culture. They have established procedures and processes to discharge their multifarious and sometimes cross-jurisdictional obligations.
- 90 From our review, it is apparent that a range of methods are employed to manage opportunities for error and fraud, including:
- (a) daily reconciliations of cash and securities, as well as intraday reconciliations;
 - (b) processes around proper instructions, such as verifying signatures against list of authorised signatories with copies of sample signatures held on file;
 - (c) segregation of accounts, control units and staff roles, such as requiring staff absences at regular intervals, authorised access levels, clear lines for which staff can instruct others and in relation to what subject matter;
 - (d) independent audit of transactions;
 - (e) IT systems controls;
 - (f) AML/CTF Act transaction monitoring of cash accounts;
 - (g) investigation and management of exceptions; and
 - (h) regular system testing with exception reporting.
- 91 Other processes that may assist in the management of fraud include:
- (a) the requirement to reconcile ‘front’ and ‘back’ office activities; and
 - (b) reporting to clients on a regular basis. Reporting to clients will normally be formally agreed and included in the custody agreement.

- 92 However, a high level of operational risk and opportunities for fraud remain. We recognise that some of the most effective risk and fraud controls continue to be:
- (a) regular (ideally daily) reconciliations;
 - (b) the use of dual controls—essentially a ‘checker’ for each process that carries fraud risk or risk of material error, with particular scrutiny applied where there might be collusion between parties;
 - (c) the appropriate segregation of duties; and
 - (d) rotation of staff across different functions, which should also assist in reducing ‘key person risk’ (where only a few key individuals understand the relevant systems and processes). This is particularly critical for manual or legacy systems that may not be given priority by the business. Rotation of staff across different functions will also help identify and potentially prevent any collusion for fraud or other illegal activities.
- 93 One recurring area of risk is the processes for accepting and acting upon ‘authorised instructions’. We have observed that many custodial clients still use written, faxed instructions with related call back and signature verification procedures rather than streamlined straight-through processing procedures, which require access key verification by the authorising party. We acknowledge that there may be costs and other impediments to using straight-through processing procedures and that some custodians are implementing other procedures to mitigate risk in relation to faxed instructions, such as automated workflow delivery. Nonetheless, straight-through processing procedures are generally considered to be less vulnerable to fraud.
- 94 There is also a risk that unauthorised staff of the client may be involved in the trading of assets. There may also be confusion about the timeframe for acting on instructions provided in another jurisdiction.

Our view

We suggest that the custody agreement should clearly set out the process by which authorised instructions are provided to the custodian and by whom those are provided: see RG 133.20(d) and condition 34 of PF 209.

A robust process by which instructions are given and received that is established and documented in the agreement and monitored by an established compliance function can help address these risks. Instructions may be given by individual email, fax or the SWIFT network (SWIFT), rather than by a generic inbox for instructions or even mail.

Where straight-through processing procedures are not commercially viable, specific consideration may need to be given by the client to the method of sending instructions and appropriate safeguards to mitigate risk.

Issue 4: Transfer of assets and records

- 95 There has been increasing consolidation within the superannuation, managed funds and custodial industry, and this is expected to continue. In addition, funds under management in the funds management industry are expected to more than triple in the next 15 years.³⁴ As assets are transferred between different funds and different custodians, we consider that there is an opportunity for fraud and ‘leakage’ of assets and records, particularly where there may be insufficient local capacity to handle the transfer of assets.
- 96 In an environment where increased merger activity is the norm, there may be a risk of insufficient human, financial and technological resources to deliver the system migration accurately and on time.³⁵ This may affect, at least temporarily, the continuity of the merged funds in their everyday operations (this is also the case for fund administrator transfers that may be tied to a custodian as a bundled service on behalf of a responsible entity).
- 97 Any large-scale migration of fund membership is likely to involve complex data transfers between systems that may not always be compatible with one another, and/or require additional layers of work for IT support teams. Ordinary system migrations consist of a two-way process: an outward migration by one custodian, which is then followed by an inward migration by the acquiring custodian.

Our view

The process of transition needs to be managed appropriately to minimise any adverse impact on existing business operations and clients. We suggest that responsible entities and other AFS licensee clients should organise a review of the transition following a change of custodian as a matter of course. We understand that this is currently conducted only about half of the time.

Issue 5: Risk management of outsourced services

- 98 We also observed the increasing practice of outsourcing key functions to offshore, lower-cost jurisdictions. We understand that that several types of functions have been outsourced offshore (not necessarily in all cases) including:
- (a) providing specialised tax reporting, including dual cost accounting;
 - (b) unit registry services;

³⁴ Rice Warner Actuaries, *Investment custody in Australia*, report, March 2011.

³⁵ See requirements of s912A(1)(a), (d), (e) and (h), RG 104 and Regulatory Guide 105 *Licensing: Organisation competence* (RG 105).

- (c) property and infrastructure sub-custody;
- (d) domestic banking services;
- (e) proxy voting;
- (f) fund accounting;
- (g) unit pricing;
- (h) shareholder services;
- (i) operations controls;
- (j) entitlements;
- (k) trade management;
- (l) central payment management; and
- (m) capital gains tax, stock and investment manager reconciliations.

99 This type of outsourcing introduces a change in the risk profile for the activity as monitoring and oversight can be more difficult, particularly where there is fragmentation of some processes.

Our view

Where services involved in the provision of a custodial or depository service, or the custody of scheme property, have been outsourced offshore, AFS licensee clients³⁶ may need to consider the risks arising from the inclusion of such outsourced services in their risk management arrangements, such as their business continuity plans and internal and external audit functions.³⁷

Specifically, responsible entities, as well as providers of custodial and depository services, need to consider the principles set out in RG 133. Responsible entities may also need to give this issue particular attention in their compliance plans for each relevant registered scheme where the outsourced functions establish material risks to compliance.

Issue 6: Insolvency of the custodian or sub-custodian

- 100 Legally, the risk of insolvency or termination of business by custodians in Australia should not usually be a threat to the safety of client assets.
- 101 Custodians tend to be well capitalised, and must adhere to the mandatory NTA requirements set out in RG 166, unless they are regulated by APRA. Custodians must also ensure that client assets are segregated and identifiable from the custodian's own assets, as well as the assets of other clients (except

³⁶ See requirements of s912A(1)(a), (d), (e) and (h), RG 104 and RG 105. Our good practice recommendations relate to s912A(1)(h), which excludes bodies regulated by APRA.

³⁷ For example, see GS 007 which applies to domestic operations. Similar provisions are contained in APRA's SGN 130.1.

in some circumstances, including where the use of omnibus accounts is permitted). This segregation is one of the key elements of the custodial relationship, as it ensures that beneficial title to the assets does not transfer to the custodian.

- 102 RG 133.20(f) precludes the custodian, appointed by a responsible entity or IDPS operator, or a sub-custodian, from taking any type of mortgage or charge over a client's assets, except in limited circumstances or with the consent of the client.³⁸
- 103 As set out in RG 133, under PF 209, the custodian must ensure in a number of circumstances that any delegation to a sub-custodian occurs on substantively the same minimum terms in the sub-custody agreement as required in the custody agreement. This includes that the sub-custodian segregates the client assets and generally does not take any kind of security interest over them.³⁹
- 104 Even where the above requirements apply, a number of risks remain from the potential insolvency of the custodian or sub-custodian.
- 105 Breaches may occur where omnibus accounts have not been correctly operated. Operationally, client balances can be netted off but certain client(s) may remain short. Any debit balance must be rectified by the custodian immediately, which may not be possible if the custodian has become or likely to become insolvent: see paragraphs 109–115.
- 106 Through other activities of the custodian, entered into in its own name (e.g. where the custodian has borrowed securities as principal through a lending program), the custodian's insolvency may lead to default.
- 107 Even with the requirements of RG 133 and PF 209, it is possible that:
- (a) assets held in another jurisdiction through a related or unrelated sub-custodian will be held under different local practices, and cannot be traced or recovered or are subject to a lien in favour of the sub-custodian or related entity; and
 - (b) the insolvency laws of particular jurisdictions, including those of the custodian's parent company, may not recognise or honour the client's assets as being separate from the custodian's own assets.
- 108 In any event, there may be substantial delay in the repatriation of assets and possible legal costs, particularly if the documentation is not adequate.

³⁸ See equivalent provisions for RSE licensees under APRA's Cross Industry Circular No.1.

³⁹ See equivalent provisions for RSE licensees under APRA's Cross Industry Circular No.1.

Our view

We recommend that AFS licensee clients of custodians specifically consider in their risk management arrangements the additional risks that may arise because of exposure to jurisdictions, sub-custodians and service providers that do not provide appropriate protections for and regulation of product types.⁴⁰

We would expect custodians and AFS licensee clients to consider liability in relation to such assets specifically.

Ultimately, a more prudent approach may be for licensees setting the investment strategy and making investment decisions to avoid such jurisdictions, sub-custodians and service providers entirely, where possible.

If such investments are made, however, it may be necessary for clients to specifically consider how liability in relation to such assets can be addressed in their custody agreement, and to take into account in their risk management arrangements the risks they are assuming (including credit risk on the counterparty).

In addition, we propose to consider the risks associated with securities lending in our review of RG 133.

⁴⁰ See requirements of s912A(1)(a), (d), (e) and (h), RG 104 and RG 105.

D Client asset risks—Issues for custodians

Key points

Given the role of custodians as gatekeepers and key service providers within the financial services industry, we have identified the following issues that a custodian may wish to consider:

- unauthorised debiting of omnibus accounts (paragraphs 109–115);
- stability and safety of IT systems (paragraph 116);
- operational risks created by manual and disparate systems (paragraphs 117–119);
- whistleblowing culture and framework (paragraphs 120–121);
- reporting in relation to suspicious third party valuations (paragraphs 122–125); and
- breach reporting in relation to custodial and investment administration services (paragraph 126).

We also discuss the risks inherent in corporate actions: paragraphs 127–132.

Issue 7: Omnibus accounts

- 109 Client assets are typically held through an omnibus account in the name of the custodian or its nominee, rather than in individual accounts for each underlying client. This is common industry practice, in Australia and globally.⁴¹
- 110 The legal segregation of assets between different clients tends to occur only operationally, through IT systems, rather than physically through separate client accounts. To support the integrity of the structure, reliable records must be maintained to facilitate the identification of client assets. This is particularly important for securities lending.
- 111 We note that custodians generally do not consider that there is ‘client money risk’⁴² when omnibus accounts are used. However, our inquiries illustrate that such risk cannot be ignored.
- 112 It is practically possible, in breach of the custody agreement, for assets of one client to be used to settle the obligations of another client, albeit

⁴¹ Except for a small number of countries where separate client accounts are maintained, or when specifically requested by the client to do so.

⁴² Used generally when referring to client money as well as non-cash assets.

temporarily since the assets are co-mingled in one collective pool. This may occur where liabilities attach to assets held in custody, or where one side of a client's back-to-back trade does not settle. For example, custodians with broker-dealer clients are being required to manage the client money risk associated with back-to-back trades.⁴³

- 113 We consider such practice to be in breach of the client money and property provisions of the Corporations Act, if one client has not provided the custodian with express permission to use its assets to settle the obligations of another client. These provisions apply with limited exceptions that permit certain transactions involving derivatives.
- 114 Similarly, if the custodian has agreed to satisfy a call on any unpaid liability but this has not been pre-funded by the client, the custodian must manage the client money risk appropriately. We consider that the custodian must use its own funds, rather than the funds of any other client(s) and then seek to recover the funds via the contractual and other remedies set out in the custody agreement.
- 115 We understand that the FSA in the United Kingdom may in the future investigate the use of omnibus accounts and any risks posed by holding custody assets in this way. We will continue to monitor the FSA's position on the use of omnibus accounts.

Our view

Custodians must maintain appropriate controls for the use of omnibus accounts. We consider that any unauthorised use of an omnibus account that leaves the account with an insufficient balance to cover client entitlements, even where this is rectified intraday, is a breach of Div 3 of Pt 7.8 (apart from the exceptions that may apply for transactions involving derivatives).

Further, any unauthorised debiting of the account is a breach that must be assessed for significance to ensure compliance with the breach reporting requirement under s912D.

Issue 8: Stability and safety of IT systems

- 116 A substantial part of a custodial business is the virtual environment in which it operates and the assets, for which the custodian is charged with safekeeping, are held. Given the heavy reliance on IT systems, IT security (particularly for protection against fraud or loss of data integrity), a subset of operational risk, will continue to be a key risk for custodians.

⁴³ In this regard, industry did consider possible system changes to the CHESSE system although the proposal is not being progressed at this time.

Our view

We understand that custodians recognise that IT security is critical and that they seek to mitigate any threats or potential threats to it. As custodians continue to outsource and offshore significant functions this will increase the challenge to elements of data integrity and security.

Issue 9: Operational risks created by manual and disparate systems

- 117 The custodial business is characterised by the high volume, low margin transactions that can involve processes multiple times intraday. Custodians have continued to invest in systems that automate these processes. Nevertheless, we continue to see a reliance on manual and disparate systems which may be out of date, slow and cumbersome.
- 118 Challenges to operational compliance are shown by the nature and volume of formal breach reports that we receive, as well as our specific analysis of internal breach and incident registers that we conducted as part of our review.
- 119 Challenges to operational compliance are compounded in an environment of high staff turnover, reduction in the number of clients through consolidation, cost cutting and outsourcing, particularly offshore.

Our view

Custodians may wish to consider the benefit of investing in systems that allow for the automation of processes, so that they will have adequate technological resources to manage operational risk, to remain efficient and ultimately cost effective.⁴⁴

Issue 10: Whistleblowing culture and framework

- 120 Custodians have obligations as ‘designated service providers’ to establish a suspicious matter reporting framework under the AML/CTF Act, which is not limited to matters relating to potential money laundering or terrorism financing: see paragraphs 65–67.
- 121 The PJC has also recognised the importance of suspicious matter reporting and the requirement to establish an adequate framework for facilitating this obligation.

⁴⁴ See requirements of s912A(1)(a), (d), (e) and (h), RG 104 and RG 105.

Our view

In the circumstances set out in the AML/CTF Act, suspicious matters are reportable to AUSTRAC.

In circumstances where the obligation to lodge an SMR does not arise under the AML/CTF Act, we encourage custodians to raise issues with ASIC and rely on the whistleblower protections in s1317AA of the Corporations Act: see Information Sheet 52 *Protection for whistleblowers* (INFO 52).

In addition to the requirements of the AML/CTF Act, we consider it good practice for custodians and other participants in the industry to foster a transparent whistleblowing culture and framework, where misconduct or suspected misconduct of clients, as well as the custodian and its staff, is reportable under their risk management arrangements.

Custodians may wish to discuss their whistleblowing framework and policy with clients.

We will consult with industry on this matter in our review of RG 133.

Issue 11: Third party valuations

- 122 A potential area for fraud is the provision of spurious valuations—for example, if the client provides the custodian with the valuation of an underlying fund priced by the client or the issuer of a financial product or the issuer’s own separate custodian, and the custodian is then required to use the valuation to calculate the unit price of the feeder vehicle. This may arise when reliance is placed on entities that may be subject to conflicts of interest for the underlying valuations or data, the unit pricing methodology and tax calculation approach.
- 123 We understand that custodians, as instructed parties, do not generally question ‘reasonable looking’ valuations obtained in accordance with client instructions. The validity of the valuation and ultimately accuracy of the fund value is the responsibility of their client.
- 124 In any event, some challenges exist in relation to valuations and unit pricing generally, including:
- (a) difficulties in valuing and sourcing valuations for illiquid, unlisted or otherwise infrequently valued assets;
 - (b) sourcing accurate and timely asset prices, particularly in unlisted investments; and
 - (c) suspended share or unit prices.

Nonetheless, we are concerned where such valuations may not appear to be reasonable in the circumstances.

- 125 In recognition of the client's ultimate responsibility for valuations and unit pricing, custodians reported that any problems encountered in these matters are reported in the first instance to their clients.

Our view

In the case of a registered managed investment scheme, the ultimate responsibility for the accuracy of unit pricing and the integrity of the assets remains with the responsible entity. However, where the custodian observes anything suspicious or anomalous about such underlying assets and the obligation to lodge an SMR:

- applies, AUSTRAC expects that the custodian will raise this concern in an SMR; or
- does not apply, we encourage the custodian to raise this with the responsible entity, and if the custodian's concerns are not allayed, raise the matter with ASIC.

We will consult with industry on this matter in reviewing our guidance relating to custody, including in RG 133.

Issue 12: Breach reporting

- 126 Some activities frequently provided by custodians, often referred to as 'investment administration services', such as unit pricing, fund accounting and valuations, may fall outside the definition of 'financial services' (s766A) and specifically the narrow statutory definition of 'custodial or depository service' (s766E) and 'dealing in a financial product' (s766C). From our discussions with industry, it appears that many custodians do not consider that all investment administration services constitute 'financial services'. As a result, significant breaches in relation to such services are not reported to ASIC by the custodian as an AFS licensee.

Our view

We consider that it is good practice for custodians to ensure that their risk management arrangements cover all activities, including the specific licensed activities and their business more generally. We suggest that custodians adopt a culture of transparency in relation to incident recording and breach reporting to ASIC.

We will consult with industry on this matter in our review of RG 133.

Corporate actions

- 127 Corporate actions, such as share buy-backs and rights issues, are one of the most significant operational risk areas for custodians, for several reasons:
- (a) *Manual processing*—Due to their nature, corporate actions are processed manually throughout the industry. Clients and custodians continue to rely on faxes and postal and courier services for much of their proxy communication, despite electronic methods of communication being available. Many meeting notifications are manually processed, adding to the operational risk.
 - (b) *Identification*—Custodians may be required to identify
 - (i) when the corporate action is announced;
 - (ii) how to interpret it; and
 - (iii) which clients it affects.
 - (c) *Non-standard corporate action messages*—Many of the corporate actions are non-standard. Although many custodians and clients are using standard corporate action messages for proxy voting, unfortunately, these do not capture all processes required.
 - (d) *Timeline pressures*—As a result of manual processing, it is difficult to ensure notifications or instructions are delivered on time. With several intermediaries in a chain, manual processing compounds the delays in unpredictable ways.
 - (e) *Inconsistent or confusing terms*—Sometimes, different terms are used in different markets for the same transactions.
 - (f) *Language barriers*—Different languages and time zones compound the delays and potential for errors.
 - (g) *Lack of audit and confirmation trail*—A major weakness has been a lack of audit and confirmation of the vote, and the results after the meeting.
 - (h) *Lack of reconciliation*—Similarly, there has been a lack of reconciliation of instructions from investors to sub-custodians to custodians.
 - (i) *SWIFT*—Since 2005, SWIFT and key industry players have been working on new message standards to tackle these challenges. However, SWIFT is not used uniformly throughout the industry.
- 128 Some corporate actions are outsourced to proxy voting specialist firms but the risk still remains.
- 129 We understand that ASX Limited (ASX) is initiating a project to improve the capture and delivery of corporate information from listed entities (presently corporate action announcements are manually keyed by ASX

staff). This change will require the issuer to complete a set of standard templates or upload by standardised format, resulting in a straight-through processing electronic solution from the listed entity to the information user.

- 130 In addition, attempts are being made in the industry to standardise data templates relating to tax file numbers, Australian business numbers (ABNs), banking details, distribution resource planning elections, powers of attorney and share registers.
- 131 Despite the matter receiving significant attention from the industry, the issues remain a work-in-progress.
- 132 We do not have any specific recommendations for corporate actions, but will continue to liaise with industry on this issue.

Key terms

Term	Meaning in this document
ACSA	Australian Custodial Services Association
ADI	An authorised deposit-taking institution—has the meaning given in s5 of the <i>Banking Act 1959</i>
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services Note: This is a definition contained in s761A.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act Note: This is a definition contained in s761A.
AFS licensee clients	AFS licensees that are clients of custodians
AML/CTF Act	<i>Anti-Money Laundering and Counter-Terrorism Financing Act 2006</i>
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASIC Act	<i>Australian Securities and Investments Commission Act 2001</i>
ASX	ASX Limited (ACN 008 624 691) or the exchange market operated by ASX Limited
AUASB	Auditing and Assurance Standards Board
AUSTRAC	Australian Transaction Reports and Analysis Centre
CHESS	Clearing House Electronic Subregister System, operated by ASX
client money	Money that is paid to an AFS licensee in the circumstances described in s981A
client money and property provisions	Divs 2 and 3 respectively of Pt 7.8 of the Corporations Act
corporate action	Any event that brings material change to a company entity and affects its owners, including rights issues, restructuring, dividend payments, mergers, acquisitions and changes in responsible entity
Corporations Act	<i>Corporations Act 2001</i> , including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001

Term	Meaning in this document
custodial or depository service	Has the meaning given in s766E of the Corporations Act
custody	Provision of a custodial or depository service or holding scheme property of a registered managed investment scheme
custody agreement	The contract governing the provision of custody between the custodian and the client or a person acting under an arrangement with the client
FSA	Financial Services Authority—the securities regulator in the United Kingdom
GS 007	Guidance Statement GS 007 <i>Audit implications of the use of service organisations for investment management services</i> , published by the AUASB
IOSCO	International Organization of Securities Commissions
NTA	Net tangible assets
PDS	Product Disclosure Statement
registered managed investment scheme	A managed investment scheme registered under Ch 5C of the Corporations Act
responsible entities	Has the meaning given to it in s9 of the Corporations Act
RG 133 (for example)	An ASIC regulatory guide (in this example numbered 133)
RSE	Registrable superannuation entity
s766E (for example)	A section of the Corporations Act (in this example number 766E), unless otherwise specified
SAS 70	Statement of Auditing Standards No. 70 <i>Service organizations</i>
SEC	Securities and Exchange Commission—the regulator in the United States
SIS Act	<i>Superannuation Industry (Supervision) Act 1993</i>
SGN 130.1	Superannuation Guidance Note 130.1 <i>Outsourcing</i> , published by APRA
SMR	Suspicious matter report
suspicious matter reporting	The requirement to lodge an SMR in the circumstances set out in the AML/CTF Act
SSAE 16	Statement on Standards for Attestation Engagements No. 16 <i>Reporting on controls at a service organization</i>
SWIFT	Society for Worldwide Interbank Financial Telecommunications

Related information

Headnotes

AFS licensee clients, client asset risks, custodial or depository services, custodians, good practice guidance, responsible entities, SMR, suspicious matter report, suspicious matter reporting

Class orders and pro formas

[CO 98/51] *Relief from duty to separate assets of a managed investment scheme*

[CO 03/1111] *Prime brokerage services: relief from obligation to hold scheme property separately*

[CO 03/1112] *Relief from obligation to hold client money on trust*

PF 209 *Australian financial services licence conditions*

Regulatory guides

RG 104 *Licensing: Meeting the general obligations*

RG 105 *Licensing: Organisational competence*

RG 133 *Managed investments: Scheme property arrangements*

RG 148 *Investor directed portfolio services*

RG 166 *Licensing: Financial requirements*

RG 167 *Licensing: Discretionary powers*

RG 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)*

RG 181 *Licensing: Managing conflicts of interest*

Legislation

Alternative Investment Fund Managers Directive (EU)

AML/CTF Act, s6 and 41, item 46 of Table 1

ASIC Act, s243E

Corporations Act, Pt 7.8, Divs 2 and 3, Pt 9.4AAA, s601FB(2), 761G, 766A, 766C, 766E, 911A(1), 912A, 912D, 981A, 981B, 981H, 984B(1)(b)(i), 984B(1)(b)(ii), 1317AA,

Dodd–Frank Wall Street Reform and Consumer Protection Act 2010 (US)

Managed Investment Act 1998

SIS Act; Superannuation Industry (Supervision) Regulations 1994, reg 4.16

Reports

PJC, May 2011, *Inquiry in the collapse of Trio Capital*

Rice Warner Actuaries, March 2011, *Investment custody in Australia*

Forms

Form FS70 *Australian financial services licensee profit and loss statement and balance sheet*

Form FS71 *Australian financial services licensee audit report*

Guidance statements, guidance notes and circulars

Cross Industry Circular No. 1 *Custodian requirements for APRA supervised entities*

GS 007 *Audit implication of the use of service organisation for investment management services*

SGN 130.1 *Outsourcing*

Standards

ASAE 3402 *Assurance reports on controls at service organisations*

ASAE 3403 *Assurance reports on controls at a service organisation*

ISAE 3402 *Assurance reports on controls at a service organization*

SAS 70 *Service organizations*

SSAE 16 *Reporting on controls at a service organization*