CFA Institute

131 Finsbury Pavement
7th Floor
London EC2A 1NT
United Kingdom

+44 (0) 20 7330 9500 tel
+44 (0) 20 7330 9501 fax
info@cfainstitute.org
www.cfainstitute.org

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Mr. Mohamed Ben Salem
Senior Policy Advisor
IOSCO General Secretariat
Calle Oquendo 12
28006 Madrid
Spain

Re: Public Comment on Principles regarding the Custody of Collective Investment Schemes' Assets

Dear Mr Ben Salem,

CFA Institute appreciates the opportunity to respond to this consultation -paper on principles regarding the custody of Collective Investment Schemes' assets.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 125,000 members in 150 countries and territories, including more than 118,000 Chartered Financial Analyst® charterholders, and 144 member societies.

Summary

CFA Institute advocates for fair, transparent and ethical market practices. Our positions on issues surrounding the custody of collective investment scheme (CIS) assets are developed with the purpose of protecting the best interests of investors and the fair treatment of clients. In our responses below, we have supported efforts to strengthen the governance of CISs with particular reference to the segregation of CIS assets from those of the depositary or other sub-delegates. We also support efforts to strengthen the independence of the depositary and custodial functions.

Specific Comments

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

CFA Institute members have brought to our attention an issue arising from the implementation of due-diligence and monitoring requirements of sub-custodians under the Altenative Investment Fund Managers Directive (AIFMD) in Europe. CFA Institute believes this issue may be of interest to IOSCO in framing its own principles regarding the custody of CIS assets.

The issue is that AIFMD allows different local implementations of the safe-keeping of assets requirements. However, the pool of sub-custodians to be assessed and monitored is limited since the industry is dominated by only a few entities that operate in several EU jurisdictions. This means it is

likely that the same custodians could be subject to different requirements depending on the different local interpretations of AIFMD. For this reason, a set of international principles should help to harmonise and standardise the requirements and expectations over custodians.

Another issue that has been raised is the proposed treatment of custodians of private securities, and whether custodians of these private securities will be subject to the same kinds of responsibilities as for listed securities. Further regulatory clarification in this area would be welcome.

An additional consideration is the extent to which it should be possible for custodians to engage in administrative or ancillary activities. It is imperative for the protection of investors that the core function of safekeeping is not compromised by, or in conflict with, the provision of any ancillary service provision.

2. What is your understanding of the role of custodians with respect to CIS assets?

CFA Institute agrees with the definition provided that the custody or safekeeping of CIS assets involves the holding, keeping, possession or control of the relevant CIS assets by the custodian.

3. What is your understanding of term "segregation" in relation to the safekeeping / custody of CIS assets?

CFA Institute believes that the term "segregation" in relation to the safekeeping/custody of CIS assets refers to legally ring-fenced accounts that are kept separate (i.e. not commingled) from the assets of the custodian.

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

No further comment.

5. Should there be specific regulatory requirements for holding non-standard assets?

No further comment.

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

No further comment.

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

Ideally, CFA Institute believes that safekeeping would be best executed by an independent and segregated custodial function with no administrative or ancillary responsibilities. A tripartite arrangement of separate custodial, management and administrative functions would seem to provide investors with the most checks and balances to prevent fraud from occurring.

However, we understand that this would likely be difficult to achieve without a potentially large increase in custodial costs or the exclusion of smaller and less lucrative funds from custodial relationships.

Further, outsourcing fund administration to a third party may enable operational efficiencies to be realised where the cost of such outsourcing arrangements is lower than, or more flexibile than, the (fixed) cost of building in-house administrative functions to maintain books and records.

Ancillary functions such as securities lending allow custodians to earn additional revenue by acting as an intermediary for the securities being lent. Fees in lieu of securities lending should be primarily passed to the client (the fund) lending the securities, thereby generating income for fund investors. The collateral deposited with custodians in the process of securities lending can be reused or recycled for other lending purposes. Custodian banks play an important role in the securities financing business generally and thus facilitate the smooth and efficient functioning of financial markets. However, this practice is not risk-less and hence it is important that investors are aware of the risks involved.

For example, cash collateral received by the lending agent (such as a custodian bank) may be reinvested in money market instruments to generate additional return and either held in segregated or commingled accounts, thereby extending and amplifying the process of liquidity transformation initiated by the initial loan of securites against cash collateral. Moreover, securities collateral may be reused by the lending agent to support other lending, including via repo, thereby increasing interconnectedness between investment firms and within financial markets.

Securities financing transactions and collateral re-use are, in essence, a form of shadow banking (i.e. nonbank credit intermediation) and represent a propagation channel for counterparty risk via the indirect exposures that can build up through collateral chains. The higher the potential counterparty risk, the greater the risk to financial stability given the knock-on effects on other interconnected firms. Collateral reuse in a chain of securities financing transactions also increases system leverage.[1]

To ensure that investors are aware of the benefits and risks of securities lending, investment fund clients should be provided with timely disclosures of the nature and extent of securities financing activities and the role of third parties, such as custodians, in this business. Investors should also be

[1] According to the Financial Stability Board's Global Shadow Banking Monitoring Report in 2013, "Even with relatively conservative assumptions, some configurations of repo transactions boost aggregate leverage alongside the stock of money-like liabilities and interconnectedness in ways that might materially increase systemic risk. For example, even with a relatively high collateral haircut of 10%, a three-investor chain can achieve a leverage multiplier of roughly 2-4, which is in the same ball park as the financial leverage of the hedge fund sector globally." (p.35)

provided with clear disclosures of the fees generated via securities lending and the split of fee income between the fund and custodian in respect of such activities.

8. Do you agree with the risks presented above? Are there any other keys risks associated with the custody of CIS assets?

CFA Institute agrees that the risks presented accurately represent the key risks associated with the custody of CIS assets. These are: the risk of co-mingling / misuse of CIS assets / inadequate asset segregation; operational risk; the risk of fraud or theft; and information technology risks. Further, there are risks associated with inadequate record keeping, holding non-standard assets, conflicts of interest, legal and compliance risks, country risk, concentration risk, counterparty risk, and reputational risk. We have no further examples to add to this list.

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

CFA Institute believes that having a single custodian may be problematic in the context of international CISs, which may require multiple custodians in different jurisdictions. We believe a solution to this issue could be derived from the example of the UCITS directive in the European Union, under which sub-custodial arrangements are permitted but a single depositary or trustee is charged with the governance of the CIS and held ultimately accountable for the safekeeping of assets.

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

CFA Institute believes that, ideally, assets should be segregated within the custodian in separate accounts for each client. However, we recognise this may be challenging to implement. To encourage investor protection, we believe that investors, and not only the CIS and regulators, should have access to more information about custodians in order to be able to perform due diligence.

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

CFA Institute believes that the rule of segregation should apply throughout the custody chain. Any differences in the extent of segregation between different levels of delegation will likely incentivise undesirable regulatory arbitrage.

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

CFA Institute believes that segregation requirements are of limited benefit unless they are recognised by local bankruptcy law. For segregation to be meaningful, segregated funds should have recognition at all custodian levels in the event of an insolvency.

13. Are there any other conditions that should be considered when a CIS uses self-custody?

CFA Institute agrees that the listed conditions should be considered a minimum requirement when a CIS uses self-custody. Specifically, the management and custody/administration functions must be independent of each other; conflicts of interest must be appropriately identified, managed and monitored; and disclosure should be made to investors including the measures and safeguards that have been put in place to ensure proper segregation and protection of CIS assets.

However, in general, CFA Institute's position is to strongly stress our preference for independent third-party custody. Without third-party custody there will always be a higher possibility and propensity for fraud.

14. Do principles 1 to 5 adequately address the key risks associated with the safekeeping of CIS assets?

CFA Institute broadly agrees that principles 1 to 5 adequately address the key risks associated with the safekeeping of CIS assets. These principles are listed in an appendix to this comment letter. However, we note that principle 4, relating to custodians being functionally independent from the responsible entity, has also been addressed by the European Securities and Markets Authority (ESMA) in its recent consultation paper on depositaries under the UCITS V directive. In order to achieve functional independence without resorting to shareholding restrictions, ESMA proposed to prohibit any member of the management body of one of the relevant entities (i.e. the management/investment company or depositary) from also being a member of the management body of the other. CFA Institute supports this proposal.

CFA Institute also wishes to stress that we believe custody arrangements should be disclosed to investors in the prospectus / offering documents specifically; that is, prior to any investment taking place.

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

CFA Institute agrees with the selection criteria listed as being relevant for the selection and appointment of custodians. The relevant characteristics are: cost and service delivery, the regulatory status of the custodian, organizational competence, location, reputation, financial soundness and relationships with sub-custodians. We do not have any selection criteria to add to this list.

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

No further comment.

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

CFA Institute considers that, as a general principle, in cases of sub-delegation, the original depositary should bear full responsibility for the sub-delegates. We do not think there should be an exhaustive list for what is necessary to fulfil this fiduciary duty. The depositary should also have the responsibility of ensuring the conditions under which CIS assets are segregated are met at all times. In cases where safe-keeping is delegated to a third party, we believe that the third party should be required to immediately notify the depositary of any changes in conditions or applicable insolvency laws.

We agree with the proposals in this consultation that the responsible entity and the custodian should document provisions for designated individuals authorised to provide instructions, termination of the agreement as well as provisions for defaults, liability and indemnity. Such provisions should also exist and be documented in cases where a custodian delegates to a sub-custodian.

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

CFA Institute agrees with the proposed steps for effective monitoring by the responsible entity of its custodian. These steps include regular liaison with staff, frequent reporting, physical access on request, and independent audit of the custodian. These steps should help the responsible entity satisfy on an ongoing basis whether the custodian is suitable in respect of its regulatory status, competence, reputation, financial soundness and relationships with sub-custodians. Finally, contingency arrangements should be pre-agreed for the recovery of assets from the custodian in the event of the disruption or cessation of the custodian's operations.

We have no further comments in regards to the monitoring of sub-custodians.

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

No further comment.

Concluding Remarks

CFA Institute welcomes the opportunity to comment on the proposed principles for the custody of CIS assets. Please do not hesitate to contact us should you wish further elaboration of the points raised.

Yours faithfully,

Sviatoslav Rosov, PhD
Analyst, Capital Markets Policy, EMEA
CFA Institute

+44 20 7330 9558
sviatoslav.rosov@cfainstitute.org

Rhodri Preece, CFA
Head, Capital Markets Policy, EMEA
CFA Institute

+44 20 7330 9522
rhodri.preece@cfainstitute.org

Appendix – Principles Regarding the Custody of Collective Investment Scheme Assets

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

Principle 2: CIS assets should be segregated from:

- The assets of the responsible entity, its related entities and other schemes;
- The assets of the custodian / sub-custodian throughout the custody chain; and
- The assets of other clients of the custodian throughout the custody chain (unless CIS assets are held in a permissible omnibus account).

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

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

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

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

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

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

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