Safekeeping Questions

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The £126 million fine levied by the UK Financial Conduct Authority (FCA) on BNY Mellon in April for breaches of the rules on the safekeeping of client assets was the latest in a series of similar sanctions. The fine was the eighteenth penalty levied in four years on UK financial institutions for breaches of the UK's custody rules (or "CASS") regime, apparently highlighting a widespread industry problem.

The FCA's repeated fines signal a tough new approach to safekeeping, a topic that runs like a thread through a series of European post-crisis directives and regulations. The Alternative Investment Fund Managers Directive (AIFMD), the fifth version of the UCITS directive (UCITS V), the European Market Infrastructure Regulation (EMIR) and the Central Securities Depositories Regulation (CSDR) all seek to impose higher standards for the custody of client assets.

In this article, we provide a summary of the key recent initiatives in this area. We also highlight questions investors might ask of their asset managers to ensure they are staying in compliance with the changing regulations on asset safety.

Safekeeping in AIFMD, UCITS V and MiFID II

AIFMD, which came into force in 2013, introduced a new legal liability regime for fund depositaries. Henceforth, depositaries were obliged to return identical instruments (or the corresponding value in cash) to a fund in the event of a loss of assets held in custody.

In practical terms, this meant that depositaries had to assume liability for all losses incurred in their network of sub-custodians (including collateral agents, prime brokers and transfer agents), as well as for oversight, record-keeping and cash monitoring duties. Depositaries also had to ensure that all client assets under custody are segregated at the sub-custodian level.

The introduction of AIFMD exposed a gap in investor protection levels across Europe's fund business: confusingly, AIFMD imposed higher standards of responsibility on depositaries of riskier alternative investment funds than those required from the depositaries for Europe's UCITS funds, which are marketed to retail investors and are therefore notionally safer by design.

The fifth iteration of Europe's UCITS directive (UCITS V), which comes into force EU-wide in March 2016, addressed this gap by imposing legal liability for losses on UCITS' depositaries.

In two areas, the UCITS V legal liability regime is tighter than that of AIFMD: under UCITS, a depositary may not transfer its legal liability under certain circumstances to a third party; and UCITS V makes the depositary liable for assets lost at a central securities depository (CSD), a provision absent in AIFMD. This latter rule may have an impact on the markets in which a UCITS manager seeks to invest.

The publication of the final ("*level II")* text of UCITS V is expected in August 2015.

Meanwhile, asset safety is also a key theme in the second Markets in Financial Instruments Directive (MiFID II), which takes effect from March 2017.

In common with the first MiFID directive, published in 2004, MiFID II focuses on high-level organisational and conduct of business arrangements at investment firms. However, the revised directive also aims to address some of the challenges highlighted by high-profile investment firm failures (such as those of Lehman and MF Global), where insolvency practitioners faced considerable difficulty in identifying, recovering and distributing client assets, in spite of the client asset protection rules in force at the time.

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Specifically, MiFID II aims to restrict the indiscriminate use of title transfer collateral arrangements (under which a client transfers ownership of its assets to an investment firm), limit the ability of investment firms to grant third parties a security interest over client assets, limit the extent to which client funds can be placed on deposit with affiliates of an investment firm, and ensure that insolvency practitioners and regulators are provided with improved information about client assets.

The incoming MiFID II client assets regime appears to follow closely the requirements imposed by the UK Financial Conduct Authority via its Client Asset Sourcebook (CASS). As a result, UK investment firms may not be heavily impacted by MiFID II from a safekeeping perspective; investment firms in other EU jurisdictions may have to do more to meet the new standards.

Where is the Segregation?

While the issue of segregation of client assets has been a common theme throughout post-crisis financial regulation, there is still considerable debate about how segregation should be applied in practice.

There are three principal ways of holding client securities at the level of an individual market: in omnibus accounts (where the assets of one client are commingled with those of other clients in the books of the sub-custodian, and in the sub-custodian's account at the local CSD); with segregation at the level of the sub-custodian; and with designated segregation (where the beneficial owner's name is recorded by a share registrar in the local market or at the local CSD).

These options offer progressively higher levels of safety of client assets but, because they involve a multiplication of client accounts and heavier record-keeping requirements at the level of the custodian, they may also incur increasing costs, although in these days of increased automation, not necessarily so.

Historically, global custodians have favoured the omnibus account structure, not only because it increased the efficiency of securities settlement but because it also facilitated potentially lucrative practices such as securities lending (which was easier from a single pooled account than from multiple individual accounts).

However, omnibus accounts can expose investors to additional risks: a shortfall in an omnibus account will be shared *pro rata* with other investors, irrespective of how the shortfall arose.

Such risks may arise from one client in an omnibus account using riskier strategies than another, or from the custodian's business practices. For example, the UK FCA fined BNY Mellon for using clients' assets, held in omnibus accounts, and without the express prior consent of all those clients, to settle a transaction before corresponding assets had been received under a covering trade of the relevant client. This resulted in some clients' assets being used without consent to settle other clients' trades.

Investors need to review not only which account holding structure is safest and most cost-effective, but also what their options are in individual geographical markets.

"Investors should at least ensure that their assets are segregated from someone else's assets at the level of the global custodian," suggests Tim Reucroft, director of research at Thomas Murray IDS. "Ideally, this segregation should go all the way down to the CSD, which protects you if the custodian gets into trouble. However, many CSDs don't yet offer this level of segregation."

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Europe's CSD Regulation (CSDR), which entered into force in October 2014, required CSDs "to segregate the securities accounts maintained for each participant and offer, upon request, further segregation of the accounts of the participants' clients, which in some cases might be available only at a higher cost to be borne by the participants' clients requesting further segregation."

According to Reucroft, there's one area of regulation that CSDR has omitted to cover—the portability of client positions if a custodian gets into trouble.

"In the derivatives market, the portability of client positions at central counterparty clearing houses (CCPs) is a hot topic," says Reucroft.

"There's an emphasis on being able to move trades if a clearing broker gets into trouble. But there hasn't so far been much discussion of portability in the cash securities markets. You can't automatically move positions from one settlement bank to another within the CSD."

Regulation and market practice in this area are evolving rapidly, meriting particular attention by asset owners.

Addressing Joint Ownership

Despite the fact that several prominent past frauds (for example, Maxwell and Madoff) have involved the joint ownership or control of asset management businesses and the depositaries responsible for the custody and safekeeping of client assets, there is no formal requirement in European regulation that these functions be carried out by legally separate entities.

Thomas Murray IDS calculates that over thirty different providers of UCITS funds use affiliated custodians for the safekeeping function.

According to Tim Reucroft, such arrangements raise a number of questions for investors.

"To avoid the possibility of a repeat of Madoff, it's clear that it would be preferable to use an independent, third-party depositary bank. But that's not the way the industry operates. Many major funds have an in-house depositary," says Reucroft.

"And it's not just a question of asset safety, but of commercial terms too: if my fund uses an in-house depositary, how do I know they've negotiated safekeeping fees down to the bone, or ensured that, if securities lending takes place, are the returns on that activity fair?"

In November 2014, the European Securities and Markets Authority (ESMA) issued technical advice to the European Commission on the parts of UCITS V relating to the depositary function. In particular, ESMA set out what it saw as the measures necessary to ensure that the depositary acts solely in the interest of UCITS investors, even if the depositary and the manager of the UCITS investment company are part of the same financial group.

In its technical advice, ESMA proposed restrictions on the common management and supervision of UCITS investment companies and the UCITS depositary, and a requirement for a minimum number of independent directors at both the investment company and the depositary if both are part of the same financial group.

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ESMA added that "the choice of the depositary shall be justified to investors upon request".

So even if investors in European UCITS entrust the safekeeping of their assets to an entity affiliated with the asset manager, they may now start probing further into the details of these arrangements.

"Asset managers using in-house depositaries will now have to be prepared to answer questions from clients about how they are complying with the ESMA guidelines and meeting the best standards of service," says Thomas Murray IDS's Tim Reucroft.

"And investors should ask their fund managers what they are doing to comply with the ESMA guidelines and whether they can prove that their commercial terms are the best available."

A Hot Topic

Whether the new and more prescriptive rules for the safekeeping of client assets make it more difficult for asset managers and depositaries to remain part of the same financial group remains to be seen.

But there's no doubt that asset safety is an increasingly hot topic amongst European investors. As the region's pension savings shift steadily from defined benefit to defined contribution schemes, investment funds are growing in size and importance, placing extra responsibility on funds' depositaries. Meanwhile, recurring fines on financial institutions for breaches of client asset rules suggest that there's still a lot of work to do to improve standards.

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