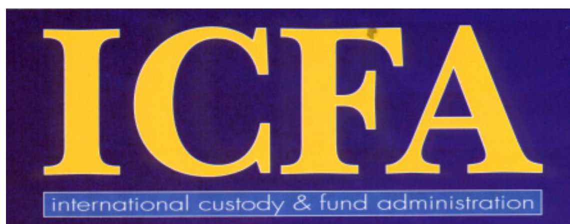

Last word

One step ahead

Ross Whitehill looks at strategies for fund managers who wish to mitigate the effect of custodian consolidation

Efficiency is a survival imperative in business, more so now than ever before. Market share and competitiveness help to ensure business growth and improve profit opportunities. Shareholder value can also be increased through efficiency and anticipation of potential changes to the operating environment. These basic principles of business are in part the drivers behind the increasing numbers of mergers, acquisitions and general consolidation in the banking industry.

The impact on staff and shareholders in consolidating entities is clearly significant and not always as we are becoming aware, entirely positive. The much sought after efficiencies that are often expected can remain elusive.

Clearly the impact on clients is taken into consideration when the consolidation transaction is being put in place but often the clients who are not in the top quartiles of revenue producers of the consolidating entities are of lesser consequence to the transaction. That's fine unless your group happens to be one of the smaller clients of the consolidation. This has occurred time and time again for clients of global custodians who have either exited the custody business, merged or formed strategic alliances.

So how can smaller clients of global custodians ensure that they are adequately protected in the event that a take-over/consolidating transaction occurs? One thing is clear, protecting yourself from a 'demarketing' exercise is not easy and the consequences of being demarketed can leave you with comparatively poor service commitments and custody contracts to protect your assets.

Companies protect themselves from take-over through a variety of ways via "poison pills" and it occurs to us that those funds that are potentially at risk should similarly construct methods to protect themselves. We recognise that smaller funds have less muscle than their larger counterparts but there are times when they have useful leverage, for example at the time of initial negotiation of a custody contract when the custodian is at his keenest to win the business, or when things have gone wrong at the custodian's end and the custodian is trying to restore the relationship.

The simplest form of protection (which surprisingly, is often neglected) is the termination clause in the custody agreement. Most custody agreements provide for a mutual 90 days notice of termination period by either party, but some we have reviewed are as little as 60 days. Even at 90 days notice from a custodian, how many funds have the resources available to properly evaluate a group of alternative custodians, select a replacement, negotiate a meaningful contract, and arrange a smooth transition?

How else can a small fund realistically minimise its 'demarketing' risk? Without doubt the custody contract is the place to legislate for change. Clauses that enforce a workable minimum notice period on the custodian but do not unduly restrict the funds flexibility work well. A 180 day notice by the custodian and 60 by the fund has often been acceptable. A penalty cost clause is helpful to the fund also. Such a clause would require the outgoing custodian to absorb the funds costs of evaluating and selecting a new provider, meeting the costs of reregistration, broker crossing fees and stamp duty as applicable, should the custodian exit the business or materially alter the basis and contractual arrangements on which the service was provided in, say, the following three years. Clearly custodians do not like as a matter of course to write such clauses into their contracts with smaller funds, but if the custodian has no intention of exiting the business, then there should be less concern that the clause will be invoked and, at the value custody businesses have changed hands in recent times, for the incoming custodian to absorb the costs described above on behalf of the better prepared clients, should remain an inconsequential cost of getting the deal done.

> **"Companies protect themselves from takeover via "poison pills" ... funds at risk should similarly protect themselves"**

In these volatile times of a rapidly consolidating industry, funds must prepare themselves for what is an increasing likely scenario. The custodian they appoint today, may not be the custodian they use tomorrow. Those that prepare for evolution in the industry will be financially fitter. ICFA

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