

The FSA Conduct of Business (COB) regulations promulgated on the 30th November, 2001 require, among other things, that before a regulated firm (potentially for example, an asset manager or pension fund) holds a safe custody investment with a custodian or arranges registration of a safe custody investment through a custodian, it must undertake an appropriate risk assessment of that custodian.

The regulations also expect firms to establish and maintain a system for assessing the appropriateness of its selection of the custodian, to assess the continued appointment of that custodian and to retain a record of the grounds on which a custodian selection and on-going appointment is made.

When these rules are read quickly, they appear to be completely reasonable and relatively easily achieved from a compliance perspective. After all, any prudent man (regulated firm) could be expected to undertake a review of a custodian before entrusting his own or client assets to that custodian.

In the notes to the rules, the FSA gives guidance as to the sorts of things that a regulated firm might examine prior to placing their assets with a custodian. In these guidance notes, the FSA is less than prescriptive, preferring to use suggestion rather than absolute. Words like 'might' and 'appropriate' appear frequently and therefore, it could be construed that what the regulated firm defines or decides today as appropriate, may at some time in the future be proved to be deficient and potentially less than appropriate. The enormity of this increased burden upon regulated firms should not be taken lightly.

Chapter 9 of the rules suggests that in undertaking an assessment of custodians, the following issues might be taken into account:

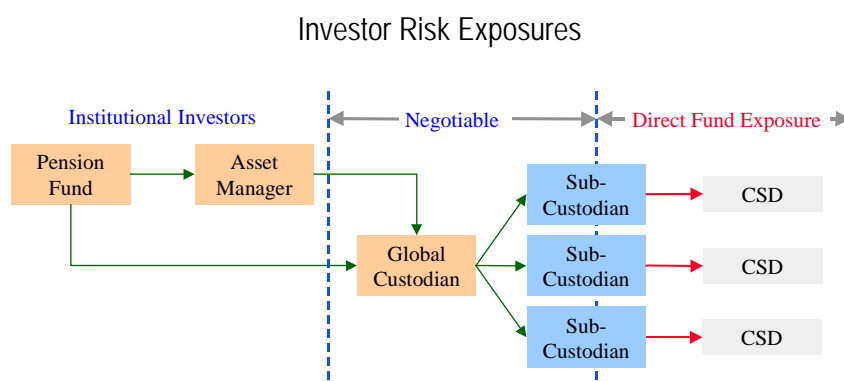
- The expertise and market reputation of the custodian, and, once a safe custody investment has been lodged by the firm with the custodian, the custodian's performance of its services to the firm
- The arrangements for holding and safeguarding an investment
- Appropriate legal opinion as to the protection of custody assets in the event of the insolvency of the custodian
- Current industry standard reports
- Whether the custodian is regulated and by whom
- The capital or financial resources of the custodian
- The credit rating of the custodian
- Any other activities undertaken by the custodian and, if relevant, any affiliated company

Regulated entities should therefore consider very carefully the implications of a casual review of their custodial arrangements. Careful examination of the rules shows that the responsibility for assessing custodial arrangements does not end at the global custodian level. The regulation goes on to state that: in undertaking the risk assessment of the custodian, firms should have regard to all relevant circumstances including legal requirements and custodial practices, in the relevant jurisdiction. For example, if the legal requirements of a jurisdiction in which the firm proposes to hold a safe custody investment with a custodian, makes it mandatory to use a particular custodian for that purpose, then the FSA will regard this fact alone as justifying the use of that custodian. If the use of that custodian is a matter of custodial practice in that jurisdiction, the custodian is likely to be appropriate for that purpose subject to the firm checking whether following the practice is appropriate for its clients' purposes. In

both circumstances, the firm will still be under a duty to ensure the continued appropriateness of the custodian, taking account of the current legal requirements and custodial practice of that jurisdiction.

This paragraph clearly speaks to the use of Central Securities Depositories in global markets about which very few regulated firms (with the exception of prudent and well organised global custodians) have any clear understanding or basis of assessment. Research concluded by Thomas Murray shows that many of the largest institutional investors are blissfully unaware of the risk exposures that they face in custody, even though reading between the lines of custodian contracts usually points them out. A simple examination of the custody schematic below, highlights where responsibility (i.e. risk) rests.

Issues Facing Custody Service Buyers – Regulated Firms



Investors must understand the risks they are exposed to through the use, directly or indirectly, of global custodians, sub-custodians and CSDs

Firms currently face a daunting task defining and quantifying their risk exposures, have difficulty in monitoring the performance of custodians against best market practice and have an even more difficult task in the evaluation and selection of custodians. To extend the range of assessment and ongoing monitoring to CSDs is a significant escalation of responsibility and administrative activity for which many regulated entities should seek specialist support.

It is not clear generally at this time how most regulated firms will respond to these new rules. Some groups have felt that in the absence of regulatory prescription, they are able to point to meeting notes, custody surveys and annual reports for compliance comfort. Others (at least one major custodian and one specialist custodian consultancy) have responded more formally by producing substantial information packs, private custodian ratings and operational benchmarking reports to meet their own and/or client needs.

These new regulations clearly place an increased burden on regulated firms to demonstrate best practice, but at this time it appears that many groups are either unaware of that, or are comfortable that their existing arrangements 'ain't broke'.

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