Global Investor

Keeping control of your assets

As investment in emerging markets grows custodians are being forced into far-away places. How should the risks be managed? By Joanna Wrighton.

It was a hot day. The man whose job it was to carry share certificates between brokers decided to go home for lunch. He left the certificates in their usual sports bag in the back seat of his car. Someone smashed the car window and stole the bag, taking with them share certificates worth thousands of pounds.

Incidents like this illustrate the problems custodians face in emerging markets. The safekeeping of assets and the difficulties associated with setting up operations there make the custodians' role far more complex. But their clients often judge the service by developed country standards and want them to assume the same amount of risk. "Certain custodians will put in a disclaimer saying 'invest at your own risk'," says Ruth Chalfin, a vice president of investment management firm Clay Finlay in New York. "I would like them to take full responsibility as they already do in developed markets."

This attitude is becoming more common among emerging market investors as competition for global custody business increases. Nobody is suggesting custodians take responsibility for a bad investment but many think they should indemnify against operational risk. Custodians have a responsibility to make sure certificates under their charge are not being carried around in sports bags, for example. "If custodians facilitate investment in emerging markets they are giving it a clean bill of health. By providing a service in those markets they are saying the operational risks are reasonable. Equally, I think they should be paid for accepting those risks," says Ross Whitehill, a director of consultants Thomas Murray.

The main custody-related risks in emerging markets lie in trade settlement and share registration, payment mechanisms, a lack of disclosure concerning corporate action and an undeveloped legal and regulatory infrastructure.

One of the most important is settlement and registration in markets where shares are traded physically. Too many trades do not settle on settlement date and the leading banks are working on reducing this fail risk.

Standard Chartered Equitor insists on timely instructions from its clients so that it can pre-match the trade. "The sooner the client gets instructions to us the better," says Darwin Doo, director of institutional services, Asia Pacific region, at Standard Chartered. "We then verbally confirm with the counterparty that settlement can take place on the day it is supposed to."

Brokers can be the weak link in the settlement chain. While custodians have no control over a client's choice of intermediaries they can monitor their performance. "If a broker has a less efficient back office and is always late we track these statistics and present them to the clients," says Doo. "We look at each failure and analyze the reason. The customer is then in a good position to put pressure on the broker."

Investors can also help limit the number of failed trades. Says Emily Bredhal, settlement operations manager at Chicago-based Wanger Asset Management: "You have to have a good matrix of automatic instructions set up. You also have to give your counterparties the names of people they can deal with directly in the same time zone."

Ross Whitehill: pay custodians to assume risks

"Unless you are aggressive and savvy about the markets you are in it's a case of buyer beware," says one fund manager. In *Global Investor's* annual custody survey clients stressed the need for local market information and regular updates from their custodians. This information is an important area of risk management.

"As a custodian we take on a significant amount of risk in terms of getting information to our clients," says Tomas Manon, vice president in charge of custody in Europe at Morgan Stanley. For example, in eastern Europe corporate action is an area of concern as information is hard to obtain. "If a company has been restructured the information is often leaked after the event and by dubious sources," says Manon. "Even if we get the information months late we are sometimes the first to know." The bank will then try to recreate the previous investment position. "This is probably one of the biggest risks we take," says Manon. Morgan Stanley assumes liability for the information it provides to its clients.

Clients can use information about market practices to better protect themselves. For example, when trading through the exchange in Singapore and selling to a broker/dealer you make sure you have good instructions in place on trade date. So check that your custodian has ensured all your trades are set up and acknowledged by the sub-custodian. If your broker has a buyer and the trade is not set up you will be bought in on the value date.

In India, settlement is made easier if your sub-agent bank is located in the area where you are trading. If your bank is in Bombay it is difficult to settle in Calcutta because you cannot come in for pay-in and pay-out day.