



Law Debenture *Essentials*
Custodians

Welcome to this, the second in our series of *Law Debenture Essentials*, which aims to share our experience gathered as trustees of more than 250 pension schemes.

This guide to good practice has been produced to help trustees to identify what to expect of their custodians, and to know how to structure their contractual and working relationship with their custodians. The guide has been compiled after discussion with a group of leading pension funds, including the BP, Electricity Supply, GSK, Royal London, Sainsbury and SAUL schemes.

Custodians play a vital supporting role on the pension scheme stage. They hold investments for trustees, collect income, reclaim tax and settle transactions. They also manage cash deposits, cast shareholder votes and exercise other shareholder rights, arrange foreign currency transactions and provide various reports and information, as well as offering a range of other optional services.

Competence and competitiveness in each of these areas is important, and in some cases crucial. Potential risks range from loss of assets at one extreme to a general drain on resources and the frustrations of inefficiency. Custody can be a significant cost area, both in terms of direct costs, and also, potentially, in terms of the indirect costs of uncompetitive rates for cash deposits and foreign exchange, and inefficient operation.

It is only in recent years that custody has begun to receive the attention and focus which it deserves. The historical lack of attention allowed some uncompetitive practices to develop, and standards and practice can vary considerably between custodians and in some cases between clients of the same custodian. Partly because of increased scrutiny, custodians are improving and developing their services, and there has been, and will continue to be, structural change. There has been consolidation of providers, and increased out-sourcing of custody by investment managers.

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Much of this guide refers to the process for selecting and appointing a custodian. This reflects the fact that this is the crucial time at which the terms of the relationship are agreed. Almost everything follows from this stage, although it is vital to establish and maintain an open and trusting relationship with appropriate information, monitoring and contact thereafter. Like all relationships, neglect invites deterioration and disappointment.

This guide is intended to be of interest mainly to larger schemes which need to appoint a “global custodian”. In other cases custodian services are provided indirectly to trustees, without the need for trustees to appoint a custodian – for example where the investment is in a policy with an insurance company which owns the underlying assets and the trustees hold “units” in the policy. This is, for example, typically the case for index-tracking funds. In most such cases it will not be necessary or appropriate for the trustees to give detailed consideration to the service provided by the custodian.

We welcome feedback and suggestions for the development of this guide, as well as comments on the general subject of working with custodians.



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Custodians: Good Practice Guide for Trustees

A Selecting a custodian

		Reader's notes
<p>A1 The first step is to assess the scheme's requirements.</p>	<p>Consideration should be given to:</p> <ul style="list-style-type: none"> ■ What information and reporting is required – in particular investment accounting, investment performance measurement, and compliance reporting. ■ Whether cash-sweeping (consolidating cash from multiple accounts into a single account) is required. ■ Whether the trustees wish to enter into stock-lending arrangements. ■ Whether the trustees wish to operate a commission recapture programme (where brokers rebate some of their commission). ■ Whether the trustees are likely to enter directly into derivative contracts (e.g. in relation to risk protection for the fund). ■ Any special requirements (such as the need to “unitise” funds, or to maintain separate funds or sections within a scheme). 	
<p>A2 Consideration should be given to employing an adviser to help with selection.</p>	<p>Advice on selecting (and monitoring and managing) custodians is provided both by some investment consultants and by specialists. It is very useful for an adviser to have had direct experience of custody operation.</p> <p>Particular care should be taken if the scheme is likely to require non-standard services such as unitisation, or if it may need to enter into some of the more sophisticated types of transactions, such as stock lending, use of derivatives and associated provision of collateral. Trustees should take advice to ensure that the custodian has the requisite capability (in operational and reporting terms).</p>	
<p>A3 A structured selection process should be used.</p>	<p>A standard “invitation to tender” (also known as a “request for proposal” or “RFP”) should be prepared (perhaps by the pensions manager or an appropriate consultant), identifying and requesting:</p> <ul style="list-style-type: none"> ■ The particular services required (perhaps distinguishing between ‘essential’ and ‘nice to have’). ■ Separately identified costs for each component of the service. ■ Details of other “optional” services offered (such as investment performance measurement). ■ Service standards offered (see section D1). ■ Details of the information and reporting which will be provided. ■ Confirmation that the custodian will accept specified key legal documentation terms (see section C2). ■ Interest terms for any cash deposits (for base currency and any local currencies where there are likely to be material balances). 	

		Reader's notes
<p>A4 Quotations should be requested from at least 3 'short-listed' custodians.</p>	<ul style="list-style-type: none"> ■ The basis of pricing of foreign exchange transactions (and the extent of netting offsetting transactions). ■ Confirmation that the custodian will provide benchmarking and monitoring data to advisers offering reporting services (see section D3). ■ Charges made to enable third parties to provide services (e.g. stock lending and foreign exchange via other counterparties). ■ Details of the contracting party for the custodian, and its credit rating (and whether a guarantee from the parent bank is provided if the contracting party is a subsidiary). ■ Details of the organisation of the custodian (chart; structure; operations methodology and geographical locations). ■ A copy of the custodian's most recent FRAG 21 (or successor) report. This is a report commissioned by the custodian from an accountancy firm relating to the custodian's controls and procedures. ■ Services offered by the custodian, and any charges, for transferring to it from an existing custodian. <p>Relevant background information about the scheme should, of course, be included with the invitation to tender.</p>	
<p>A5 References from schemes of comparable size should be taken up.</p>	<p>At least three references are suggested.</p> <p>Existing investment managers could also be consulted for their experience in working with the short-listed custodians.</p>	
<p>A6 A site visit should be considered.</p>	<p>A site visit can provide valuable information about the custodian. Site visits can radically alter perceptions of a custodian's service.</p> <p>A visit is likely to be more appropriate for an in-house pensions manager and/or pensions accountant rather than the trustees. If an adviser is involved with the selection, then it is highly desirable that he or she attends the site visits.</p> <p>Meeting with the team which will actually carry out routine work for a client is important.</p>	

B Fees

<p>B1 Fees should be quoted and invoiced on a disaggregated basis, showing the breakdown for each service provided (and showing the basis of calculation), to foster transparency and auditability.</p>	<p>Quotations and invoices should identify:</p> <ul style="list-style-type: none"> ■ The transaction charge by country (with details of transaction volumes). ■ The holding charge (by country and type of security so far as is relevant). ■ Charges for voting and other activity. ■ Any overdraft charges (although these should not arise in the ordinary course). ■ Charges for additional services. 	
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	<p>When reviewing costs (and quotations), consideration should be given to the cost implications of the likely investment portfolios (in terms of their geographic split and the likely volume of transactions).</p> <p>Performance-related fees are unlikely to be appropriate for custodians.</p>	Reader's notes
<p>B2 Fees should be benchmarked against the market on a regular basis.</p>	<p>There has been a general downward movement in fees over recent years. It therefore pays to review fee levels for competitiveness regularly. Custodians might be asked if they are prepared to confirm (in writing) that their fee levels are in line with the lowest fees being quoted by them for schemes of a similar size, and that fee levels will be reduced in future in line with the lowest fees offered by them to schemes with comparable assets.</p> <p>Advice can also be taken on the competitiveness of fees (either from investment consultants who are familiar with the custody market, or from specialist advisers on custody).</p>	

C Documentation

<p>C1 Legal advice should be taken before signing a custody agreement.</p>	<p>Advice should be sought from a lawyer who is familiar with custody documentation, who is aware of the “key” provisions and who knows what changes can realistically be requested. This is a specialist area. Custodians must be appointed in the manner required by section 47 of the Pensions Act 1995.</p>	
<p>C2 Identify and focus on the key provisions in custody agreements.</p>	<p>Legal advice will be appropriate, and the following points are some suggested (but not exhaustive) areas for consideration relating to core services provided by custodians:</p> <ul style="list-style-type: none"> ■ The custodian’s general duty (of professionalism and care) should be defined. ■ The liability accepted by custodians (including the liability accepted for any sub-custodians) should be carefully considered and defined. ■ The extent of any exclusion or restriction of liability should be reviewed carefully. ■ The agreement should address the custodian’s duty in the selection, use and monitoring of sub-custodians and any agents. ■ Details of the reconciliations to be undertaken should be specified. ■ Careful consideration should be given to any provision which deems the trustee to have accepted statements unless objections are raised within a stated period. ■ The extent of any indemnity required from the trustees should be carefully reviewed, and consideration given to restricting this to the assets available from time to time in the pension scheme to meet such a liability. ■ Foreign exchange terms should be specified (including the extent of any netting, and how the applicable rate is to be determined). ■ Service standards should be specified and reported upon (see section D1). 	

- Can the agreement only be amended by written agreement between the parties?
- Is there any penalty or material notice period for the trustees to terminate the appointment?
- Does English law govern the agreement, and is it subject to the exclusive jurisdiction of the English courts?

D Service standards and reporting

D1

Service standards should be agreed and reported upon.

Service standards should be specified in the invitation to tender and agreed in advance of appointment as part of the contractual documentation (perhaps in the form of a separate Service Level Agreement set out in a schedule to the agreement):

Service standards and benchmarks should be clearly defined. Likely areas include:

- Settlement of transactions: volumes; value of late settlements and failed trades, identifying each investment manager or portfolio separately, if more than one.
- Reconciliation: extent of reconciliation with investment manager records and with sub-custodians, with quantification and explanation of any failure to reconcile.
- Collection of income on investments: including details and the proportion of income paid after the due or contractual date.
- Corporate governance activity: e.g. the method of voting and the number of votes which were cast by investment managers as a proportion of the total number of possible votes.
- Interest rates on deposits for each currency in which material deposit balances are held.
- Foreign exchange transaction rates: comparing actual rates determined by the custodian with agreed competitive benchmark rates.
- Timeliness and completeness of withholding tax recovery, showing the total amount of outstanding tax claims.
- Custodians should be asked to identify which additional service areas they can report upon (this is a rapidly developing area). Care should be taken to avoid being overloaded with marginally relevant data.
- Regular reports should be provided for trustees (perhaps quarterly or half yearly) in a concise and understandable format.

D2

Matters of significant concern should be reported immediately to the trustees (or someone appointed by them to receive notice).

Matters of concern include:

- Any change of ownership of the custodian.
- Any departure of relevant senior staff.
- Any significant changes in the commitment towards custody as a business activity.
- Any loss of securities.
- Any breach of regulatory obligations.
- Any change in the custodian's credit rating.
- Any material concerns in relation to sub-custodians.

D3
Subscription to a benchmarking service should be considered.

Specialist advisers offer to compare the service provided to an individual scheme with the service delivered by the scheme's custodian to other clients, and with the service delivered by custodians generally. For this purpose, information is provided to the adviser by custodians on a client by client basis (normally for no extra charge). Such services are likely to be economic (in terms of being likely to pay for themselves) for schemes with segregated assets in excess of about £250 million.

D4
Any areas for ongoing compliance monitoring and reporting on investment restrictions should be identified.

Where a scheme has to comply with investment restrictions (for example in a scheme's trust deed, SIP, or in the investment management agreement) which apply to investment generally then it may be possible for these to be identified and reported upon by the custodian. Where the restrictions can be monitored by a (single) investment manager, or where they apply to each manager separately, then it is likely to be more appropriate for the investment manager to monitor and report.

E Operational issues

E1
Consideration should be given to who can best provide certain services.

Various services and activities can be carried out by other parties. Consideration should be given as to the alternative costs and risks. Examples include:

- Investment managers can effect foreign exchange transactions directly (rather than leaving this to the custodian). It might, for example, be appropriate for investment managers to carry out capital purchases and sales and for the custodian to convert income and other lower value transactions.
- Consideration should also be given as to the need to convert all foreign exchange transactions immediately to £ Sterling; it may be appropriate for investment managers to maintain foreign currency balances where there will be a need in the near future to buy securities in that currency.
- Stock lending can be effected by investment managers or by third parties (charges made by the custodian should be identified), although there may be a loss of control.

E2
The custodian's policy and practice relating to tax recovery should be understood.

The number of markets where there is a need to reclaim tax is falling, but the issue is still significant. It is important that a custodian promptly initiates and then diligently pursues tax recovery, reporting on the amounts outstanding. Time delays vary considerably between countries – from a few months to a number of years. Custodians typically have *de minimis* limits below which they do not seek to recover, as costs outweigh the amount involved. Such a limit should be disclosed and agreed.

E3
Standard reports on a custodian's operational controls should be obtained, reviewed and provided to the scheme's auditors.

These reports, for example currently FRAG 21/94 and SAS 70 (in the United States), are commissioned and obtained by custodians on their operational and control systems. (It should be noted that the terms of reference are not independently set.) The scheme's auditors should be asked to draw attention to any issues of concern raised in the reports and any material shortcoming in the scope of the report.

E4
Audit work relating to the custodian should be discussed with the scheme's auditors as part of the audit planning process.

Trustees should ensure that the auditor is experienced in dealing with custodian reviews.

F Maintaining and reviewing the relationship

		Reader's notes
F1 Regular relationship meetings should be held (perhaps twice a year).	Perhaps with the pensions manager or pensions accountant, or with an appropriate committee of the trustees.	
F2 Where possible, attempts should be made to resolve problems and to maintain good relationships rather than changing custodian.	Regular dialogue and timely discussion of difficulties is important – these are often addressed too late.	
F3 An annual attendance by the custodian at a trustee meeting should be considered.	Such a meeting can build mutual understanding, and can encourage the maintenance of high levels of service. Questions and areas for any presentation should be specified in advance and could be prepared following a discussion with the investment manager(s).	
F4 A periodic formal review of the relationship should be carried out.	A review once every three years may be appropriate. The aim of the review is to consider the range of services and costs available in the (rapidly developing) market, and to attempt to ensure that the scheme is receiving optimal service at optimal cost.	

G Transferring to a new custodian

G1 The appointment of and transition to a new custodian should be planned as a major project.	<p>A transition team should be considered and a project plan, with timescales and responsibilities agreed. Custodians should demonstrate their ability to manage the transfer with a dedicated team, in a timely and efficient manner.</p> <p>It might be possible to agree a sophisticated and 'free' transition service with an in-coming custodian (for example, the in-coming custodian might waive transaction charges on securities received).</p> <p>Consultation with the scheme's auditor in planning a transition can be very helpful.</p> <p>A post-transfer audit should be considered, to confirm a successful transition and reconciliation.</p> <p>Residual issues should be identified and considered: for example income received by an out-going custodian after a transition and 'in the pipeline' tax reclaims and dividends, together with any securities where ownership cannot be immediately transferred from the out-going to the in-coming custodian.</p>	
	<p>Important Note: Please note that this document is not intended to be, or to replace the need to take appropriate professional advice in the relevant subject areas.</p>	



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