Institutional Investor Services

How custodians support Australia's wholesale superannuation and investment sectors

This document explains the role of the wholesale custodian as a critical service provider to institutional investors, in particular Australian's large superannuation funds, life offices and investment managers.

Prepared by the Australian Custodial Services Association, the document provides an overview of the services provided by wholesale custodians, the structure of the industry, and the important contributions made to capability, efficiency and robustness of institutional investor services and market infrastructure.

This paper is intended to provide greater insight into roles and responsibilities of players within the wholesale investment sector, and promote informed dialogue between custodians, their clients, governments and regulators with the common goal of improving efficiency and maintaining the safety of Australian investors.

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Institutional Investor Services *– how custodians support Australia's wholesale superannuation and investment sectors*

Scope

This document describes in broad terms the role played by members of ACSA in supporting institutional investors – in particular, wholesale Australian superannuation funds, life companies and investment managers.

The generic service of acting as a "custodian" can be provided to any asset owner – including individuals, businesses or institutions. Custodial and related services provided to individuals and small business are outside the scope of this paper. Such services entail explicit obligations to customers governed within the regulatory framework of Australian retail financial services.

Context

Wholesale custodians exist to provide services to institutional investors, reduce uncertainty faced by asset owners, and support critical elements of investment infrastructure. These services reduce the frictional costs of investing, lower risk and improve efficiency through scale, expertise and technology investment.

Institutional investors - in the form of superannuation funds, unit trust managers and life insurance companies - are the guardians of a significant portion of the wealth of ordinary Australians. Through the services provided to these institutions, the custodian's role indirectly benefits individual investors and adds efficiency and safety to the wealth management industry.

Notwithstanding these benefits, the role of the wholesale custodian can be easily misunderstood without an appropriate appreciation of institutional investment markets and infrastructure.

Driven by the needs of sophisticated institutional investors and global markets, modern custodial services are complex and supported by highly specialised organisations.

Importantly, wholesale custodians do not underwrite the investment risks of clients (neither institutions, nor underlying individual investors). Clarity on roles and responsibilities within the superannuation and investment sector is fundamental to effective risk management – at both fund and system level - and this theme is explored in detail below.

Client value

Custodians support their institutional clients in the implementation and monitoring of diversified investment practices.

As described in more detail on page 9, demand for custodial services continues to grow based on institution investor demands for support in implementing sophisticated investment strategies, timely and complete information, lower costs and risk mitigation.

Ongoing innovation of institutional investment strategies - including investment into new markets and demand for sophisticated hedging and protection techniques – has been a long-term driver. Custodians deliver efficiency, combining specialist market know-how with high levels of automation and access to market infrastructure.

An additional driver has been the ever-increasing demand for information – whether for valuation, regulatory and tax reporting, risk management or investment performance attribution.

Wholesale custodians act as the definitive record keeper and the “source of truth” for transactions and holdings across funds. Custodians have made significant investment in data warehouse technology, reference data enrichment and sophisticated reporting platforms to further support their clients’ information needs.

The third key driver has been the demonstrable risk-reduction benefits that flow from the effective separation of duties. The safekeeping role of the wholesale custodian allows institutional investors to appoint a range of third-party investment managers and keep their assets separate from the balance sheets of these firms.

Reporting on holdings and trades is performed independently by the custodian across different fund manager portfolios using consistent source data.

The risk reduction benefits are acknowledged at policy level, with the Superannuation Industry (Supervision) Act (and similar legislation in many other jurisdictions) containing the requirement that superannuation funds appoint a custodian.

A need for reflection

The role of the custodian, the importance of safety in superannuation and investment, together with the aftershocks of the global financial crisis (GFC) have all been factors in causing regulators, clients and custodians themselves to reflect on industry structure and risk.

Underlying assumptions around cash and asset security, counterparty and pooling risks, together with critical review of the level of resilience in market infrastructures have all been subject to questioning.

Regulatory and market driven change has included a broad-ranging review of counter-party risk and credit quality, most evident in the continued evolution of prime broker arrangements, increased capital for clearing house participants, tightening of credit review (including currency hedging) and far greater scrutiny of counterparty aggregate exposures.

The custody community has worked with clients to improve understanding of these issues, together with specific risks related to over-the-counter and non traded market investments – especially in terms of counterparty exposure, classification and valuation issues.

This process of reflection and review continues.

While no system is one hundred percent assured, Australia's experience through the past two decades of exponential growth in superannuation, and the more recent testing by the GFC, reveals many strengths.

The custody industry has and continues to play an integral role in the positive positioning of Australia's institutional superannuation and investment sector.

The consumer context

As outlined above, this paper explains the role of the wholesale custodian and their support of institutional investors.

In the consumer context, responsibility to the individual members/investors sits squarely with superannuation fund trustees and managed investment responsible entities.

Superannuation funds and managed investment schemes are regulated products provided to consumers by licensed entities. Regardless of the use of service providers or agents by funds, these entities retain sole responsibility for the consumer.

ACSA believes that this obligation is well understood and accepted within the institutional superannuation and investment industry. The obligations are also clearly reflected in the law, financial services licensing regime and regulation governing superannuation and collective investment.

Many custody organisations are ultimately owned by recognised brand names (major domestic or global financial institutions). There may be superficial confusion over the actual role played by the custodian from the retail perspective – especially if things go wrong for consumers.

ACSA and its members recognise the role played by custodians in the context of the financial system as a whole and indeed the broader community. Custodians stand behind their contracted services, but cannot and should not take responsibility for the investment decisions of trustees.

The custodian does not influence, nor is accountable for, the individual consumer's choice of fund, the fund's choice of investment manager, the investment manager's investment approach, nor the fund's decision to hold a particular asset or participate in a particular market.

For these reasons, ACSA strongly recommends that third parties (including media representatives) clarify the specific role of individual entities, and contact the companies involved directly in the first instance.

Providers

Custodians are licensed, regulated and typically bank-owned entities. All major providers of wholesale custodial services operating in Australia are members of the Australian Custodial Services Association. Annexure A provides a list of current full members.

All custodians offering services to superannuation and managed funds in Australia must have an Australian Financial Services License, hold minimum capital levels, and comply with the regulatory regimes of the markets in which they operate.

Annexure B contains a description of domestic, sub, global and master custody. The size of custody sector in Australia is also outlined.

A distinction needs to be made between the function of custody, and entities that are wholesale custodians, and this point is expanded in the following section.

Services

By definition, custody involves being the legal owner of securities (generally held through nominee structures) and acting on behalf of the beneficial owner – in the context of this paper, institutions and large funds.

In the simplest terms, custody is the safekeeping of assets (such as cash, shares, bonds and other investments). The safekeeping function reduces risk for clients (asset owners), and provides the definitive book of record for institutional holdings and transactions.

Core sub and domestic custody services relate to safekeeping of assets, transaction support through the settlement cycle, income collection, corporate event processing, and the provision of a sophisticated range of reporting solutions. Custodians don't decide which assets are bought or sold; they simply hold them securely on behalf of their clients.

These core functions require custodians to be major participants with clearing houses and depositories in supported traded markets (equities, bonds and derivatives), along with domestic and international payment systems. Clients may also request that direct, syndicated, managed fund, over-the-counter and other non-traded forms of assets be held in custody. Non market-traded investments pose specific issues to both asset owners and custodian, and are discussed in more detail below.

In most cases the custodian, either directly or through a related party, may provide ***investment administration*** or ***master/global custody*** services including portfolio valuation, tax and statutory reporting, unit pricing and unit registry (see below).

Administration services are not custodial services per se, and are generally covered by separate arrangements with clients. Some administration services may also be provided for assets not held in custody.

Functionally, the delivery of custodial and related services relies on expert domain knowledge and appropriate technology. Together these capabilities are designed to deliver process efficiency and risk controls, meet the requirements of market settlement and clearing infrastructures, and enable effective reporting to clients and their agents.

More information on services that may be offered is included in Annexure B.

Either directly, or through related or third parties, the custodian may also provide ***additional services*** potentially including foreign exchange, cash and collateral management, securities lending, trade crossing and portfolio optimisation - or even compliance-enablement services (such as acting as trustee or Responsible Entity). Again, these are not custodial services, and are covered by separate arrangement with clients and a specific Australian regulatory regime.

Roles and responsibilities

Responsibility for setting and implementing investment strategy sits squarely with superannuation fund trustees, and managed investment responsible entities.

This is understood and accepted by the professionals within these organisations, and reflected in the law, licensing regime and regulation governing superannuation and collective investment.

For large superannuation funds, execution of investment strategy is typically achieved via the appointment by the fund trustee of specialist investment managers under written agreement which will include the manager's specific investment mandate. Under this scenario, the investment manager makes day-to-day investment decisions, and the custodian settles these transactions in the relevant markets.

At law, a custodian is generally considered to be a "bare trustee" in that the custodian will only act on the proper instructions of their client (or a party duly appointed by the client). The terms on which the custodian will act are established under a custody agreement (written contract) between it and the client. Also see Annexure D.

For almost three decades in Australia, and much longer in other countries, large superannuation (pension) funds and other institutions have recognised the benefits of using a custodian to hold their assets. In many jurisdictions, the use of a custodian is also a requirement under the law.

The use of a custodian achieves a separation of duties between the role of the investment manager, brokers and other market players from the legal ownership of client assets and settlement functions.

Settlement - being the moment in time when legal entitlement to a security is exchanged for cash - is performed by the custodian under proper instruction as defined in the custody agreement.

It is important not to ***over*** or ***under*** interpret the benefits provided by the custodian:

- The custody function protects the fund's assets firstly by providing clear separation from each investment manager, and also by ensuring that payments of money and delivery of securities only take place as the result of a proper instruction (and in accordance with the rules and conventions of the relevant market's clearing and settlement functions).

Additionally, the custodian provides a consolidated view of holdings and transactions. This role, as the single trusted record-keeper (across all of the client's assets and portfolios), provides the cornerstone for efficient and consistent reporting and monitoring.

- The custodian does not (and cannot) second guess investment decisions or over-ride proper instructions.

  The role of the custodian is analogous in many respects to that of a bank or credit union processing payments for its customers. Banks or credit unions do not stop payments of customers because they think that spending money on a particular transaction is "wrong" or "unwise". In fact, confidence in the banking system relies on this lack of discretion and client confidentiality.

> The custodial function significantly reduces the risks faced by institutional investors in the specific areas outlined, but does not provide protection against poor investment decisions on the part of the client or their investment manager.

Annexure D provides a more detailed description of the entities involved, regulatory environment and typical contractual interaction.

Client base and value proposition

Custodians support their clients in implementing diversified investment practices – particularly in handling the complexity of settlement and servicing of assets in both domestic and overseas markets, and across many listed and unlisted asset types.

> Demand for custodial services continues to grow and evolve. The major drivers that have driven this demand include growing institutional investor sophistication, demand for information, lower implementation costs, and risk mitigation.

Growth in the need for custodial services:

- First and perhaps foremost has been the ***ongoing innovation of institutional investment strategies*** - including the use of new security types, investment into new markets (traded, derivative, direct and cross-border – developed and emerging) together with demand for sophisticated hedging and protection techniques.

  As the investment universe has expanded, institutions have needed to make use of custody providers to access investment infrastructure (including depositaries and clearing houses), wholesale payment systems, and in-market knowledge to support their chosen instruments.

Moreover, this access must be provided efficiently, combining specialist market know-how with high levels of automation, often across time zones and global markets.

In other words, the asset owner's investment decision to enter a particular market or adopt an innovative investment approach must be backed by the ability to safely transact and account for the subsequent implementation – this represents a core source of value provided by the custodian.

- Another key driver has been the ever-increasing ***demand for information*** – whether for valuation, regulatory and tax reporting, risk management or investment performance attribution – delivered at granular level, and in near real time.

As the definitive record keeper, and independent of the investment management function, custodial records form the "source of truth" for transactions and holdings across individual portfolios within a fund, and therefore feed the raw data on which all down-stream portfolio accounting, monitoring, performance analytics and reporting is based. As the book of record, clients require that custodial systems operate to high standards of integrity, availability and resilience.

Custodians have made significant investment in data warehouse technology, reference data enrichment and sophisticated reporting platforms to further support their client's fiduciary role and demand for information.

- The third driver has been the demonstrable risk-reduction benefits that flow from the ***effective separation of duties***.

Safekeeping by the custodian allows institutional investors to appoint a range of investment managers and keep their assets separate from the balance sheets of these firms, and from other clients of the manager. All value transactions are settled by the custodian, not the fund manager. Reporting on positions and trades is performed independently by the custodian across different fund manager portfolios using consistent source data.

In Australia the Superannuation Industry (Supervision) Act 1993 (Cth) requires a trustee of a regulated superannuation entity to appoint a custodian, and a responsible entity of a registered managed investment scheme may also be required by ASIC to appoint a third party custodian to hold scheme assets where it does not have sufficient net tangible assets or meet certain operational requirements. Similar regulations apply in many other countries. The ARISA legislation in the USA provides for similar separation of duties in pension funds.

Annexure A - ACSA Members

The major custodians servicing Australian institutional investors are full members of the Australian Custodial Services Association (ACSA).

Current full members of ACSA are:

asteron

ausmaq streamlined mfund processing

BNP PARIBAS SECURITIES SERVICES

Bond Street

citigroup

HSBC

IAG Insurance Australia Group

Invia Custodian

J.P.Morgan

Merrill Lynch

nab

netwealth Investment & Superannuation

Northern Trust

Perpetual CORPORATE TRUST

RBC DEXIA INVESTOR SERVICES

STATE STREET.

Annexure B – Terminology and Service Overview

Types of custodian

Sub and domestic

Sub and domestic custodians represent the in-country service providers for their respective domestic markets, and generally are the entities that will be direct clearing, settlement and payment system participants.

The distinction between a sub versus domestic custodian relates to the nature of their clients, and as a consequence also their level of systems integration. The term “sub custodian” generally relates to those appointed by other custodians (global or master), and typically integrated as part of a global custody network. The term domestic custodian generally relates to custodians providing services directly to domestic clients only. Some custodians perform both roles.

An inventory of possible sub/domestic custody services that may be offered in Australia:

- Safekeeping (through nominee registration)
- Settlement of trades for listed equities, fixed income, and unlisted securities
- Trade confirmations and cash reporting
- New issue application
- Corporate event reporting and administration
- Registration of physical securities
- Dividend and income collection
- Proxy voting services
- Regulatory reporting
- Payment of income and sales proceeds
- Month end trade and income reports

Delivery of these services would also typically include client service desk access, market information updates, and possibly optional customisation of reports. The custody agreement and/or agreed operating procedures would also include specified cut-off times for trade instruction, the form of proper instructions, and appropriate links to the custodian’s online information portal.

Some sub/domestic custodians may also provide (either directly or through related parties) foreign exchange and cash management services, securities borrowing and lending, contractual income and possibly contractual settlement on certain security types, payment and banking solutions, and portfolio transition management services.

Note that not all services are offered by all custodians, and the list is not exhaustive.

Master and global

Master and global custodians provide services to institutions that invest across borders, supporting multiple portfolios for their clients (generally run by separate professional investment managers).

In practical terms, there is no distinction between the terms global and master custodian, although the label “global” tends to be used for organisations that support the bulk of underlying in-country custody through their own branches (rather than through a sub-custody network of third party providers).

Full Members of Australian Custodial Services Association (ACSA) are wholesale custodians acting in one or more of the sub, domestic and master custody roles.

An inventory of possible master/global custody services that may be offered to Australian clients:

- All of the sub/domestic custody services as outlined above (also specific to each traded market - that is, core custody services will vary depending on the nature of the security type and maturity of the market)
- Portfolio valuation (daily, monthly)
- Tax reporting
- Tax optimisation
- Foreign withholding tax reclaim (if the client invests off-shore)
- Investment mandate monitoring (post trade)
- Investment performance measurement and benchmark comparison
- Performance analytics, including attribution
- Regulatory reporting
- Unit pricing
- Wholesale unit registry
- Trade execution reporting
- Commission recapture
- Transaction cost management (so called “master manager” services)

Note that these services generally do not extend to superannuation individual member administration - which is a separate specialised sector in Australia. Some custodians may have related parties who provide this type of service, but these are typically distinct business lines.

Note that not all services are offered by all custodians, and the list is not exhaustive. Services also continue to evolve over time, with custodians adapting solutions to better service clients’ changing needs.

Investment administration

Investment administration generally refers to the range of asset services that complement core custody functions.

Clients of investment administration can include a range of institutions – and the definition varies somewhat across countries.

In the Australian superannuation context, investment administration services are sometimes referred to as master custody, and can include the services outlined above.

Investment administration can also refer to the so-called "middle office" of investment managers and life insurance companies. The service elements are similar to those provided to superannuation master custody clients, but typically more aligned to daily managed fund processing, integrated to the needs of a single fund manager (the client), and possibly offered in combination with specialised accounting, retail registry and payment system solutions.

In some instances, services to investment managers may include acting as Responsible Entity for wholesale or retail funds. Note that this "compliance enabling" service is a separate specialised sector in Australia with providers requiring an appropriate AFSL and willingness to take on direct end-investor responsibilities. Some custodians may have related parties who provide this type of service, but these are typically distinct business lines and not part of the custodial service.

Role of a nominee company

Nominee companies are special purpose vehicles, and hold no assets other than the assets of their clients.

In Australia, and most other countries, custodians have regulatory requirements to keep assets of clients separate to their own assets, and the use of nominee companies enables a custodian to evidence meeting these requirements.

These nominee companies may not hold an Australian financial services licence, as many of them will have the benefit of an exemption from the requirement to hold an Australian financial services licence under paragraph 7.6.01(1)(k) of the *Corporations Regulations* or will be exempt under paragraph 911A(2)(b) of the Corporations Act because they are acting as an authorised representative of the licensed custodian.

The wide-spread use of nominee companies in institutional investor servicing can be demonstrated by reviewing the major shareholder lists of major listed companies. For example, the majority of the top twenty shareholders in Telstra are all nominee companies:

Twenty largest shareholders as at 28 August 2009

The following table sets out the Top 20 holders of our shares (when multiple holdings are grouped together):

	Shareholders	Number of Shares	% of Issued Shares
1	HSBC Custody Nominees (Australia) Limited	1,491,898,188	11.99%
2	National Nominees Limited	1,362,322,985	10.95%
3	Future Fund Board Of Guardians	1,351,368,957	10.86%
4	J P Morgan Nominees Australia Ltd	1,228,081,057	9.87%
5	Citicorp Nominees Pty Limited	525,937,886	4.23%
6	RBC Global Services Australia Nominees Pty Ltd	314,531,588	2.53%
7	Cogent Nominees Pty Limited	223,322,012	1.79%
8	ANZ Nominees Limited	162,607,109	1.31%
9	AMP Life Limited	125,113,893	1.01%
10	UBS Nominees Pty Ltd	94,114,333	0.76%
11	Queensland Investment Corporation	92,759,816	0.75%
12	UBS Wealth Management Australia Nominees Pty Ltd	64,432,870	0.52%
13	Australian Reward Investment	53,992,100	0.43%
14	Merrill Lynch (Australia) Nominees Pty Limited	49,153,666	0.40%
15	Australian Foundation Investment Company Limited	48,820,000	0.39%
16	Neweconomy Com Au Nominees Pty Limited	46,418,851	0.37%
17	ANZ Nominees Limited - SL Cash Income Account	44,381,499	0.36%
18	Brispot Nominees Pty Ltd	43,168,865	0.35%
19	Telstra ESOP Trustee Pty Ltd	38,916,450	0.31%
20	Telstra Growthshare Pty Ltd	35,024,355	0.28%
Total		7,396,366,480	59.46%

Source: Telstra Corporation Limited 2009 Annual Report

Omnibus accounts

Traded market securities held by custodians and their nominees are typically registered or held in what are known as 'omnibus accounts'.

An omnibus account is a single account in which the assets of a number of clients may be pooled. For example, shares listed on the Australian Securities Exchange may be held in a single CHESS account, with a single holder identification number (HIN), with the custodian's systems tracking individual client (portfolio) ownership.

The use of omnibus accounts brings considerable efficiency to institutional investor servicing, as a number of functions can be undertaken once by security, rather than many times by individual clients. Examples include dividend processing, corporate event notification and reconciliation functions.

Securities held in an omnibus account are fungible. The client's interest in a number of securities is recorded in the books of the custodian. The client is entitled to recover equivalent securities to those which may have been acquired originally on the client's instructions; in other words, to an identical number of the same securities.

Note that not all assets are fungible, and not all markets fully support the concept of omnibus holdings. In these cases, assets will be registered individually rather than in omnibus accounts. Additionally, some custodians may offer the choice to major clients on whether or not to omnibus securities for that client's holdings. If offered, custody fees may differ for non-omnibus holdings due to the additional work associated with individual processing.

Not-in-custody assets

An important practical consideration in the provision of custody service is to differentiate between reporting on assets versus actual custody of assets. To gain the full benefit of some investments, or for legal reasons, it may not be appropriate (or even possible) to register some assets through nominee arrangements.

In such cases, the client may hold these assets directly. In other cases, specialist custodial nominee arrangements may be offered by some providers. An example is direct real estate where (in most jurisdictions) evidence of asset ownership requires physical deeds of title, along with the physical notation and stamping of encumbrances, lease agreements and the like. In some markets, specialist custody providers may offer services for this type of physical asset. The institutional investor may contract directly with such a specialist provider (not as part of a master custody agreement).

Regardless of whether the client owns the asset directly, or through a specialist nominee, they may request that their master custodian incorporate trades, income and holding information into consolidated reporting for the fund as a whole.

In this scenario, the master custodian is not responsible for custodial functions (they are, by definition, not holding the assets) and are reliant on a third party for data integrity (so called "hear say" reporting).

Note that the use of a third party custodian by the client directly is distinct from a master custodian's appointment of a sub-custodian.

Annexure C – Custody market overview

Client Segments

Custodians provide services to large asset owners and managers; typically superannuation funds, investment managers, insurance companies and banks; endowments, charities and sovereign funds.

Total assets held in custody exceed the size of superannuation system in Australia.

Members of ACSA hold securities in excess of $1.6 trillion in custody and administration, and employ more than 3000 staff. ACSA members include the majority of the wholesale custodial service providers in Australian.

The clients of ACSA members generally comprise:

- Regulated superannuation funds;
- Managed investment schemes;
- Operators of investor-directed portfolio services;
- Life and general insurance companies.

Technically (and contractually), the "client" will be the company that acts as trustee of the regulated superannuation fund, or the Responsible Entity of the managed fund. For the purposes of describing market segments, this technical distinction is not made with client and fund/scheme treated as synonymous.

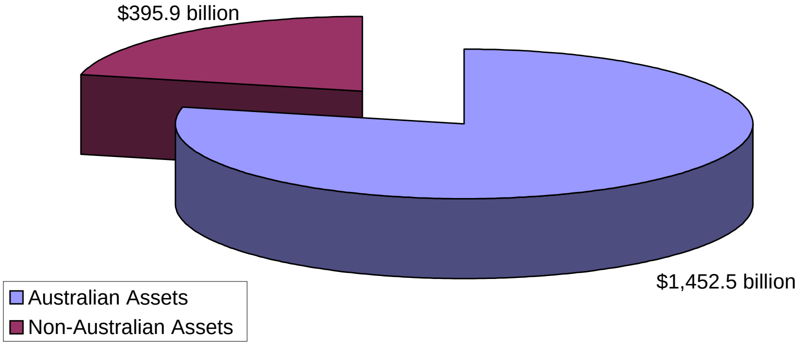
Other clients, though generally much smaller in number (but not necessarily asset size) include:

- Sovereign funds (both Australian and overseas)
- Listed trusts and other closed ended investments
- Some of the larger Australian charitable foundations
- Overseas pension funds
- Other overseas institutions (investment banks, broker/dealers, endowment funds, charitable foundations)

Market structure

ACSA maintains statistics on the custody industry in Australia, including information on members' in-custody and under administration assets, transaction volumes and number of employees.

The statistics distinguish between client location – in-bound investment into Australian markets by overseas based institutions, versus domestic institutions – and the type of services offered, namely domestic, sub and master custody along with administration.



More information on market statistics is available on the ACSA web site
www.custodial.org.au

Appendix D - The legal basis of custody

Superannuation funds and responsible entities of managed investment schemes have a number of duties and obligations under common law and legislation, such as the *Corporations Act* 2001 and the *Superannuation (Industry Supervision) Act* (1993).

Essentially, the trustee and responsible entity have full and ultimate responsibility to the investors in the fund or scheme in respect of management of the fund or scheme and its assets.

In Australia, it is common for trustees and responsible entities to appoint another company to act as a custodian of all or some of the assets of the fund or scheme. In some cases, it is a condition of the licence granted to the trustee or responsible entity by the relevant regulator (ASIC or APRA) that all assets are held by another company in the capacity as a custodian.

ASIC Regulatory Guide 133 sets out the arrangements that a custodian must comply with in order to ensure the safety of assets under its custody. These arrangements require the custodian to have:

- An organisational structure that supports the segregation of client assets from its own assets, segregation of staff in a way that minimises any potential for conflict of interest to arise and structured so that custodial staff are able to report directly to the compliance committee of its client.
- Staffing capabilities whereby staff must have the experience, qualifications, knowledge and skills necessary to perform the functions of a custodian properly and access to specialist areas so that custody staff can adequately carry out their duties.
- Administrative resources associated with the holding of clients' assets which is likely to include computer systems, procedures for recording of client assets, movements of those assets, recording corporate events, pricing those assets and regularly reporting those assets to clients.

The custodian is required to hold client assets in a way which ensures that those assets are clearly identified as belonging to each client and held separate from the assets of other clients. Trustees and responsible entities also have a responsibility to ensure that custodial arrangements are suitable for the particular assets being held.

A custodian must also meet certain minimum financial requirements.

While a custodian is generally considered to hold assets as a trustee, it is considered to act as a ***bare trustee only*** in that a custodian will only act on the proper instructions of the custodian's client.

The terms on which the custodian will act (and hence the manner in which proper instructions may be provided by the client and accepted by the custodian) are established under a custody agreement between it and the client.

The terms of individual custody agreements are commercially sensitive. The identity of clients, their assets or any details on the terms of their contract is confidential.

In general, however, custody agreements do have a number of consistent elements. This is partly driven by compliance with the specific laws and regulations in Australia that deal with the appointment of a custodian by a superannuation fund and by some managed investment schemes.

Some potentially common elements within custody agreements include:

- specifying which asset types and markets for which the custodian offers services;
- a list of specific services, fees and service levels relevant to the specific client profile (for example, trade instruction cut-offs for domestic and overseas markets, income collection expectations, corporate event reporting methods, proxy voting protocols, etc);
- the role of sub-custodians (if any);
- the form of proper instruction, and the approach to be taken regarding unclear or incomplete instructions;
- the standard of care that will apply to custodial services;
- a requirement for indemnity from the client (or fund) in circumstances where the custodian has acted within their contract;
- undertakings regarding business continuity and disaster recovery (planning and testing), professional indemnity insurance, independent audit (typically under the GS007 standard) and AFSL compliance;
- limitation of liability for force majeure events;
- reference to other services (if any) provided to the client (including investment administration, value added services and electronic information delivery systems) – although these will generally be covered under separate agreement.

This list is not complete, nor necessarily representative of the elements that may be included in any specific custody agreement. It is anticipated that clients would seek appropriate professional advice on specifying the requirements for services, the provider selection process, and terms of the agreement.

Reference may also be made to third-party services, including member administration, proxy voting, reference data, securities lending, directed brokerage and other potential touch points specific to the organisation and client profile.

What custodians do <u>not</u> do

Custodians do not apply discretion to investment decisions. The institutional investor must have confidence that their investment decisions (typically outsourced to a professional investment manager) are being carried out as instructed - not second-guessed by the custodian.

Appendix E – Contributing to improved Regulatory Efficiency

A changing environment

Aside from the global reappraisal of risk brought on by the GFC, Australia has also embarked on a number of significant regulatory and policy reviews affecting taxation, superannuation and banking.

As these initiatives move to implementation, clients will expect their custodians to interpret and support resultant change.

Market and policy driven change will involve costs. And these costs will ultimately be met by underlying individual investors in superannuation and managed funds.

For market driven change, institutions are informed buyers, and can make decisions on the level of services appropriate to their funds on a cost/benefit basis.

This discretion does not apply to regulator change, which is by definition a compliance issue. Accordingly, it is essential that public policy be implemented through efficient and practical regulation, thus minimising end-to-end costs.

Custodians also play a central role in facilitating off-shore institutions trading in Australian markets (enhancing flows and liquidity). Accordingly, ACSA believes that regulation should anticipate potential negative consequences for Australian capital markets.

The further development of Australia as a financial services hub requires that investment infrastructure be scalable. The more idiosyncratic Australian markets become, the less this will be the case.

Regulation and taxation of the financial system must be framed to allow practical and efficient implementation.

This not only provides lower costs for Australian investors, but also improves the local industry's competitive position on a regional and global basis.

An extract from ACSA's submission to Phase II of the Cooper Review follows, and highlights specific areas of impractical and inefficient regulation.

Extract from Cooper Review Phase Two Submission

The following is an extract from ACSA's submission to the Super System Review (Phase Two – Operation and Efficiency) made in **December 2009**.

The submission recommended:

> *Substantive reduction in the hidden agency costs of administering complex and impractical prudential, tax and accounting regulation.*
>
> *The Review should note that comments on prudential, tax and accounting regulation do not relate to the merits of the underlying policy itself, but rather the potential inefficiency created when policy is implemented via overly complex and impractical law and regulation.*
>
> *These costs are hidden in the sense that neither the buyer of services (the superannuation fund) or the consumer (the member) has an explicit signal as to how much of their overall custody and administration cost is driven by this source of complexity.*
>
> *Complexity in tax and accounting rules can lead to significant levels of exception processing, which directly stands in the way of effective automation, the realisation of scale benefits and streamlined member servicing. Handling "artificial" complexity also competes with a focus on substantive efficiency improvement.*

Hidden Government agency and compliance costs

Significant costs are created by the need for superannuation funds to meet the requirements of Government agencies, tax laws and accounting regulation.

Note that these comments do not necessarily relate to the merits of the policy itself, but rather the inefficiency created by implementing policy through overly complex and impractical statutes and regulations.

The cost of responding to Government oversight may well be a reasonable price to pay for a well regulated system. It could also be argued that the overall cost of tax collection is minimised by having it performed by the private sector (rather than public agencies).

This assumes, however, that actual legislation and regulation allows for efficient implementation.
In practice, there are significant costs associated with regulation and tax administration. These costs are not transparent, and create an ongoing barrier to automation and efficiency. They are also costs that do not respond well to either scale or competitive forces.

Tax administration in particular adds layers of interpretation and procedural complexity that is challenging to specify and automate.

For example, custodians and administrators are called on by their superannuation fund clients to interpret, administer, collect, record, report, audit and remit Federal and State taxes.

Ongoing maintenance also adds cost – whether this includes adapting systems and training staff to handle frequent changes in legislation, or the day-to-day review of securities and transactions to determine appropriate tax and accounting treatment.

Importantly, these comments on complexity and impractical regulation apply equally to both crediting rate and unit priced forms of member administration. The process of fairly allocating member benefits must, as a starting point, deal with equitable treatment of valuing underlying assets and liabilities (including tax).

Set out below are examples of sources of complex and in some cases very impractical regulation. The approach has been to list issues without describing all of the technical details. The Association would be happy to assist the Review with more information at a more complete level where required.

Tax Administration

- The Australian taxation system is unique and complex. The consequence of this complexity is that many processes remain manual and create process exceptions. Manual processes generally do not benefit from scale.

  Additionally, manual processing inevitably increases the risk of errors, which then require remediation. This re-work drives cost and inconvenience, and can ultimately damage consumer confidence in superannuation.

- The administration workload for tax administration and collection is high and unavoidable. Suppliers to superannuation funds must simply comply, and allocate significant investment simply to keep up with legislative change. This is a pure cost that adds no value and competes with investment in true sources of efficiency and service improvement for members.

  These costs are hidden in the sense that neither the buyer of services (the superannuation fund) nor the consumer (the member) has an explicit signal as to how much of their overall custody and administration cost is driven by this source of complexity.
- A current example is the implementation of TOFA requirements that are pushing significant costs of implementation to custodians, funds and ultimately members.

- Some nine years after the introduction of the GST, a number of State Governments still apply stamp duty to some securities transfers. Collection of duty (stamping), assessing rates, and recording transactions is still a largely manual process.

- The enactment of the Tax Agent Services Act 2009 (Cth) and the unnecessary compliance burden and additional costs that will result if custodians are caught under the new tax agent requirements. Significant work (and third party expense) has been incurred by ACSA simply to understand the new legislation, even before the cost of implementation if regulation does not provide relief.

- The withholding tax rules applicable to Managed Investment Trust distributions to offshore investors are flawed both from an administrative as well as policy perspective. The inability of Australian custodians to withhold tax at source based on the identity of the ultimate beneficial owners has created and will continue to create confusion, delays and costs.

- There are numerous standing working groups on regulation and tax across the industry – constant interpretive work is done (without explicit compensation) in addition to implementation and maintenance costs.

  For example, the definition of 16E securities (so-called "qualifying securities") is contained in a very lengthy section of the ITAA. In practice, the only way of identifying 16E securities is to source the terms and conditions of each security acquired by a superannuation fund, and analyse them for eligibility.
- Every change to taxation implies analysis, interpretation, advice fees, systems changes, new procedures, staff training and amended audit scope. This is a constant and significant overhead.

- A significant proportion of fund accounting and tax reporting function is devoted purely to constant change, maintenance and re-interpretation of rules.

- Complexity applies at a very micro level. For example, the same transaction can be taxed differently, and must be accounted for differently, depending on the entity (trust, superannuation fund, life office asset), and type of transaction. Tax is applied on accrual and entitlement concepts that differ from cash and accounting treatments. This drives significant complexity and potential processing time lags. One specific example is included in the Appendix.

Accounting Standards

- Globalisation - there has been a drive for adoption of global standards over the last 10 years with various transitional and structural adjustments required.

- Inconsistency between accounting standards and market standards has led to unique processes to cater for statutory reporting processes and investor disclosure requirements.

  For example, unit pricing is typically done at 'last market price' while statutory accounts are prepared using 'last bid price'. Apart from the need to administer two price fields and provide reporting using both sources it presents challenges in stale stocks, trading halt stocks, companies considered not to be marketable securities or stocks with fair value concerns. The market standards are only guides and generally presented at a high level. They often can't be more specific due to different types of assets and complexity of assets.

- ED 179 will require superannuation funds to revamp accounting systems. These rules differ from trust, company and other entities, so development cannot be leveraged across systems.

Prudential and related Government regulation

- The obligations of trustees and directors have increased significantly to protect the interests of investors. This has changed and will continue to change procedures and increase the information/disclosure requirements for custodians/administrators.
- Anti-money laundering legislation has been introduced. This has changed the employee recruitment process, emphasis of 'know your client' verification and funds transfer procedures controlled by custodians and administrators.
- Separate regulators for superannuation funds (APRA), managed funds (ASIC) and listed stocks (disclosure role of ASX) have created unique processes and additional burdens on custodians and administrators.

The costs of regulation and tax administration are not mentioned in the Phase Two Issues Paper.

The Review is asked to consider what steps could be taken to ensure that regulation is framed in a way that facilitates practical and low cost implementation.

For example, Government agencies could be required to assess and report on the costs to the superannuation sector of compliance and administration in terms of both one-off expenses and ongoing maintenance.

Radical simplification and harmonisation of tax and accounting across all collective investments (including superannuation) would remove significant unnecessary administrative costs and create greater leverage for systems and process investment.

Good regulation should be easy to understand, implement and maintain.

Investment by the industry in handling idiosyncratic Australian complexity detracts from investment in systems and processes aligned to global and regional service provision.