

CUSTODIAN ISSUES

1. This paper does not attempt to provide more than an outline of the issues and may not cover them all. The information upon which it is based has been drawn from a number of sources, including a recent one-day event hosted by the London School of Economics law department and research conducted among members of the UK Shareholders' Association (UKSA). The principal issue is security: how safe are investments held by custodians? A secondary issue is compensation: what happens when security fails?
2. Wikipedia defines custodian as "*a specialised financial institution responsible for safeguarding a firm's or individual's financial assets....*" I have seen the risks defined as insolvency of the custodian, errors, poor administration, mismanagement, fraud and negligence in its operation. An article in PMI News in July 2011 began by stating, "*..... custody is not a risk-less activity....*" and reported that, "*One major UK corporate pension fund (had told) a conference in London.... that the insolvency of its custodian was the third highest risk on its list of risk exposures....*".
3. Custodians are not without blemish. Earlier this year, a major custodian was fined £23m by the FCA "*as an example of a firm that has acted with complete disregard for the interests of its customers,*" judging it to have "*significant failings in culture and controls*". It was its transitions management business that incurred the penalty, not its custodian activities, but its clients "*include large investment management firms and pension funds holding the funds and savings of retail investors.*"
4. It is fair to say that recognition of the risks faced by investors is growing, by commentators and by investors themselves. An investor's principal relationship is with his or her stockbroker, but the investments are held by a third party, the custodian, with which the investor has no contractual relationship. The custodian may be a wholly owned subsidiary of the broker, or an unrelated third party. It may employ a sub-custodian, which further dilutes the original contract with the stockbroker. Custodians and sub-custodians may be abroad, in a non-UK jurisdiction, subject to another country's laws.
5. An UKSA member asked his broker – believed to be the second largest, with some 440,000 customers – for clarification of his position. He had found a statement that, "*Where your assets are held by a nominee or sub-custodian we cannot ensure that you would not lose any assets if the entity fails.*" He was told that this was because the assets would be outside their control, but he could not understand why his brokers could put him at risk and wash their hands of responsibility. He had also noted that, under the terms he had originally signed up to, the broker had stated, "*In providing our Custody Service, we are responsible for the safe keeping of your Assets.*" This had given him some comfort, but the clause is no longer to be found in its current terms and conditions and, when he asked why, the answer was simply, "*Oh our terms have been updated.*"
6. An investor using a pooled nominee account has no way of knowing whether the number of shares held by his or her custodian is equal to the number that should have been purchased by the broker on behalf of all its clients. The experience of some investors with whom I have been in contact strongly suggests that the numbers do not always agree. In one instance there was an admission that an investment had been temporarily 'lost'; this was for an institutional investor not an individual, but only an institutional investor is likely to be in a position to check its holdings. In another recent instance, which was a private investor, a bond issue being redeemed by the issuer, held for the investor by two separate custodians, resulted in immediate redemption by one but a 17 day delay by the other, with no credible explanation offered by the latter.
7. Institutional investors are in a position to be much closer to their custodians and even to choose them. I hear from such a source that it is not unusual to find custodians operating with quite low grade staff. Whereas institutional investors are warned of the risks they face and may well have professional advice to assist them, private investors have to take a great deal in blind trust of their nominee account providers, their stockbrokers.
8. Among the reasons for suspecting that not all is well with custodian arrangements are the delays and obstacles being experienced by private investors as they seek to transfer their holdings from one broker to another; this is happening increasingly because of changes to charges brought about by the RDR. As the whole point of holding shares in pooled nominee accounts is supposed to be administrative simplicity, it should be a simple matter for transfers to take place swiftly, especially as a charge of £25 per holding is not untypical; Investors Chronicle, however, has reported that transfers can take up to five months (which I have indeed experienced myself), while the weekend Telegraph Money supplement says it can be nine. More seriously, perhaps,

one broker, believed to have 250,000 customers, is issuing a list of demands, including requiring statements of net worth and income sources, before it will agree to any transfer at all; as there can be no legal justification for such demands, it is not surprising that some of its customers are, as reported to me, becoming nervous about the security of their investments.

9. Transfer delays can freeze investments. Being unable to sell when a share price is falling may seriously damage an investor's wealth. When a whole portfolio is trapped, an investor's position could be worse. This is very likely to be the situation if the broker or its custodian, or a sub-custodian, goes bust. Before any investor can sell anything, or even be sure of what he or she will eventually be left with, the custodian's records will need to be reconciled with all related investments; this will inevitably take time, even if the total is found to be correct and no adjustments are needed. Users of pooled nominee accounts are commonly warned in their brokers' terms and conditions that shortfalls may be found and their only recourse then will be to whatever compensation arrangements are in place – which may take a long time to pay up.
10. Compensation in the UK is limited to £50,000. This is well below the value of many ISAs and SIPPs, let alone portfolios held outside these wrappers. Its application is open to doubt too, as the value of investments lost will be open to interpretation and may not meet an investor's expectations. A current advertisement appearing in numerous outlets states boldly, "*For extra peace of mind, the FSCS covers your investment up to £50,000,*" which suggests that there is 100% cover for a failed investment, but that seems unlikely to be true.
11. These are not negligible risks. Two online articles by *The International Investor* explain the position quite nicely, to be found here <http://the-international-investor.com/investment-faq/stock-broker-account-safety> and here <http://the-international-investor.com/investment-faq/international-investor-protection-rules-compensation-scheme-limits>. The following paragraphs are taken from the first of these, after describing how account segregation is meant to protect investors' interests.

"Segregation is effectively an honour system, where the broker is expected to do the right thing and keep client and firm assets separate. In some cases, regulators and exchanges will be checking up on their holdings regularly, but obviously they can't keep an eye on what's in which account all the time. So the system is open to fraud and abuse. If your stock broker decides to sell or move shares from nominee accounts, they will be able to do so.

"And of course, fraud like this is most likely to happen when the firm is on the edge of collapse, needs cash or assets to meet its own liabilities and the temptation to 'borrow' client assets for a while to tide them over becomes too great – or simply when the management decides it's time to loot client assets and retire somewhere with no extradition treaty. So the point at which segregation is likely to offer no protection is just when you need it most.

"It's also worth being aware that even if there hasn't been deliberate fraud, when a stock broker collapses its records often turn out to be shaky. So establishing which clients own what in the nominee account may take a lot of work and assets may sometimes turn out to have been misplaced in the turmoil. So while the industry often presents segregation as the thing that guarantees the safety of your investments, it's nothing of the kind. The safety it offers is limited and the system is close to being the absolute minimum that could be accepted, rather than added protection for investors."
12. For all investors using ISAs and SIPPs, but also for many others who are unable to find a broker offering an alternative, there is no escaping the use of one or more custodians for holding their investments. With paper certificates, or the use of sponsored Crest accounts, the only risk is the company in which their money is invested and it is to a large extent a visible risk, but when forced to use pooled nominee accounts to hold those investments the risks are multiplied and largely invisible. One major broker regularly encourages investors to surrender their certificates and place their investments into its pooled nominee account, but fails to mention these additional risks – even after having had the matter drawn to its attention.
13. The use of pooled nominee accounts is increasing and this seems likely to continue for the foreseeable future. The FT reported last November that, "*Britain is increasingly becoming a nation of DIY investors, with assets managed by execution-only brokers jumping by a fifth in the past nine months alone.*" An increasing number of private investors will therefore face the risks imposed by the need to place their investments in the hands of custodians. The risks are increasing and the situation cannot be seen as other than very worrying.

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