

## Sub-custodian risk is being discussed seriously and sensibly thanks to 17f-7

Richard Greensted - 6 Dec 1999

### SEC plans focus thoughts on a subject that was once avoided

It is a measure of the maturity of the global custody business that the issue of sub-custodian risk is now seriously and sensibly discussed. Until fairly recently the whole subject of risk was something that the custodians liked to avoid, concocting elaborate - and ultimately worthless - agent bank indemnities to divert attention from the fact that they accepted very little liability when it came to the shortcomings of their sub-custodians.

Risk is now on the agenda as a result of plans by the SEC to introduce a new rule as part of the Investment Company Act of 1940. The proposed rule, known as 17f-7, relates to securities depositories and would complement 17f-5, which governs the custody of assets of registered management investment companies with custodians outside the US.

17f-7 would require global custodians to evaluate each securities depository and provide investment advisors with risk information.

Derek Duggan of industry consultant Thomas Murray explains the thinking behind the SEC's approach.



'The SEC sees 17f-7 as a form of partnership between global custodians and investment advisers'

Derek Duggan,  
Thomas Murray

"The SEC sees 17f-7 as a form of partnership between global custodians and investment advisers," he says. "Information on the depositories and risks would be made available to investment advisors by the global custodians, who, for their part, would evaluate the risks as part of their overall assessment of investment risk in local markets."

But the custodians are not convinced that 17f-7 is a good idea. "We have serious concerns about any initiative that seeks to impose further responsibilities on us for depository risk," says Andrew Osborne, senior vice-president and head of worldwide network management for The Northern Trust Company.

"By definition, we believe that the risk involved in using a depository is an investment risk."

One of the main reasons for the custodians' position is that in

many markets the use of a depository is obligatory.

While the global custodians may be better positioned than investment advisers to assess the depositories, there is very little they can do to mitigate the risks involved in using them.

These risks are often related to the wider local market infrastructure, or to the ownership of the depository.

The SEC is trying to come up with a workable compromise and is negotiating with the [Investment Company Institute](#), which represents the US mutual fund industry, and the [Association of Global Custodians](#).

As well as 17f-7, the SEC is proposing further amendments to rule 17f-5. These two rules would allow assets to be held in depositories, subject to certain standards and conditions being met. 17f-5 has been amended since its introduction in 1984, to take account of the increased cross-border activity of regulated firms.

But even those amendments - such as removing minimum capital requirements - have not been universally welcomed.

"Relaxation of 17f-5 complicates our role because it opens up markets where we might have some concerns about the risks," says Patrick Costello, vice president and manager of network management for [Mellon Trust](#).

Thomas Murray's Duggan explains what some of the risks are and why the SEC is getting involved.

"Investors are directly exposed to risk of loss from the moment cash is paid from a global custodian's bank account, with a sub-custodian to facilitate the purchase of a security," he says.

"Different operational and custody risk exposures surround securities held in local markets where they have been bought and held on behalf of investment funds. Responsibility for the risk of loss has traditionally been regarded as an investment risk assumed by an investment adviser on behalf of a fund.

"The difficulty is that the investment adviser is often in a poor position to gather information on depositories.

"Through their local agents global custodians are better able to analyse and monitor depositories, but do not accept responsibility for the selection or ongoing use of these entities, the use of which is effectively mandatory.

"This has led to some disagreement between global custodians and investment advisers over who should be responsible for

risks associated with transaction processing and custody which involves local market depositories."

Thomas Murray's proposed solution to this debate has been to launch a global Depository Review and Risk Evaluation Service in an alliance with Standard & Poor's, the global credit ratings, analysis and research firm.

This service will assess the structure and operational effectiveness of central securities depositories (CSDs), providing information on protection of assets, risk minimisation and service quality to custodian banks, brokers, international central securities depositories, asset managers and investors.

The service has clearly been designed with 17f-7 in mind, although it remains to be seen whether global custodians will be able to delegate their due diligence work to a third party.