FMA
FINANCIAL MARKETS AUTHORITY
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Thematic review of MIS custody arrangements – summary findings

For any managed investment scheme it's important that scheme property – money and investments – is kept safe. The function of looking after scheme property is called custody. Under the Financial Markets Conduct Act 2013 (FMC Act), custody for retail managed investment schemes is the responsibility of the independent licensed supervisor. This separates custody functions from management of the scheme, and provides an additional layer of protection for investors.

Executive summary

In 2017, the International Monetary Fund (IMF) published its Financial Stability Assessment Programme (FSAP) review of New Zealand's financial sector. One of its recommendations was to consider separate licensing and direct supervision of custodians for managed investment schemes (MIS). The FMA has also received reports of inconsistent practices by different custodians and involving different types of assets.

To give us a better understanding of practices and risks in this area, we engaged PricewaterhouseCoopers (PwC) to carry out a thematic review of MIS custody practices, focusing on retail managed funds[1]. This review found that retail scheme assets are, with very few exceptions, being held in custody. It did not suggest that client money is currently at risk, but noted some practices that could be improved to strengthen the safeguarding of client money.

It also found that there are a few different models of custody being used, so it is difficult to get a consistent picture across the industry. The review found one model that involves supervisors delegating much of the administration of custody to the fund manager. This reduces the degree of actual separation between custody and management, and increases custody risk. The review also found there was insufficient oversight of custody in some cases where duties were delegated back to fund managers, which further raises risk.

We will be following up with supervisors as a result of this work, to clarify our expectations regarding custody practices and oversight.

The role of the custodian

The FMC Act prescribes a segregation of duties in relation to retail MIS. Generally, while the manager of the scheme is responsible for the investment strategy, the custodian is responsible for holding and safeguarding the scheme property (segregation of legal ownership) and for keeping records of the scheme property (a segregation of functions).

Under this law, supervisors are responsible for custody. As such, by default, the supervisor of the scheme is also its custodian. Depending on the scheme's governing documents, a supervisor may appoint another appropriate independent person as custodian.

We recognise that the legislation requires the custodian to "ensure" that accurate records are kept, rather than requiring the custodian to keep all records itself. We are concerned that delegating the recording of scheme property back to the

1: The scope of this review includes unrestricted KiwiSaver schemes and non-KiwiSaver retail managed funds. Due to their unique structure and characteristics, it does not include property schemes, forestry schemes, restricted KiwiSaver schemes, superannuation schemes, or workplace saving schemes.

manager undermines the separation of functions and duties that the legislation seeks to achieve. We will be looking into this further with supervisors.

FSAP recommendations

The IMF noted that MIS custodians are not required to be licensed in New Zealand and are not subject to prudential requirements or ongoing supervision by any Government agency. It also noted that other jurisdictions typically require licensing (or other levels of authorisation) and ongoing regulatory oversight for custodians.

Custodians perform key functions regarding safeguarding investors' assets. The IMF noted that, aside from indirect oversight through the monitoring of supervisors, the FMA has no visibility of MIS custody activities. Therefore, one of the IMF's main recommendations was to: "Require that the provision of custody services to be subject to licensing and supervision"[2].

Overview of the MIS custody landscape

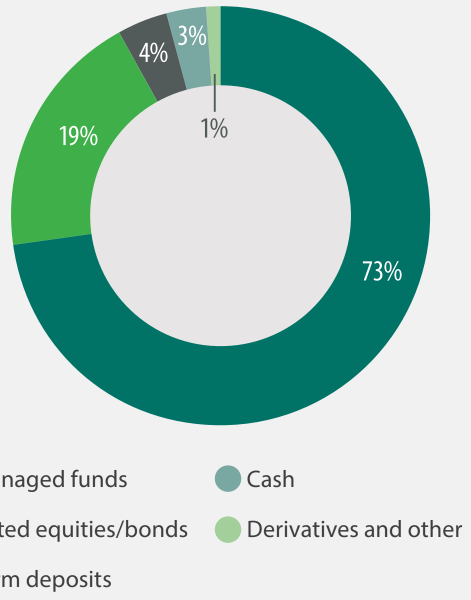
The way scheme property is held in custody varies across schemes and asset classes. In this section we look at different asset classes and their various custody risks.

Main asset classes across managed investment schemes

Across all schemes, we found that the majority of retail scheme property is invested in other managed funds, listed equities and bonds (see Fig. 1).

- In general terms, the custodian of listed equities and bonds is on record as the shareholder or bondholder on behalf of the scheme. Ownership changes are recorded through a central securities depository when trades occur via an exchange.
- Custody of term deposits and cash typically involves the custodian having a bank account on behalf of the scheme.

Fig. 1: Breakdown of scheme property across asset classes



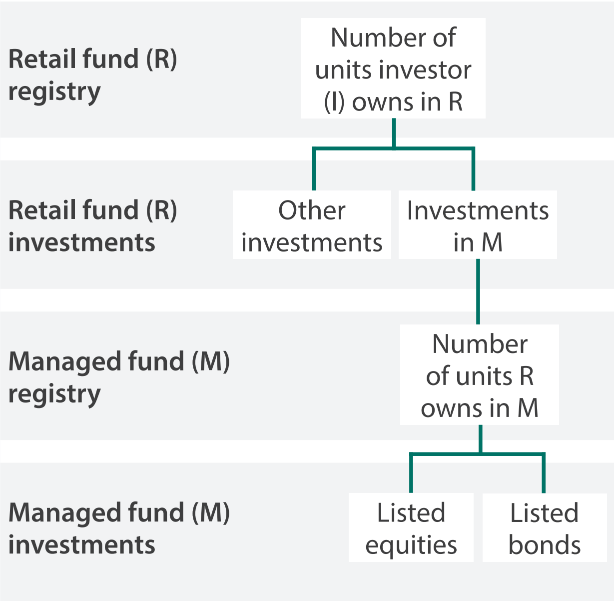
- Custody of other assets (such as derivatives and mortgages) usually involves arrangements and contracts being entered into by the custodian on behalf of the scheme.

When a scheme invests in a managed fund, part of the actual custody risk lies with the underlying fund that holds the direct investments (typically equities and bonds).

The diagram on the following page shows the different layers of administration that are involved in recording the holdings of an investor (I) in a retail fund (R) that invests in a managed fund (M).

In its registry, retail fund R records who owns units in its fund. The units represent fractions of the pooled investments held by R. If R invests in managed fund M, M's registry shows the number of units that R holds. Those units represent fractions of M's pooled investments (in this example listed equities and bonds). This pattern repeats itself as long as underlying funds invest in other funds.

2: NZ FSAP – Fund Management – Regulation, Supervision, and Systemic Risk Monitoring – May 2017 – CR17117, Table1. New Zealand: Main recommendations on Regulation and Supervision of Managed Investment Schemes.



If M is a retail MIS, its custody arrangements are regulated by the FMC Act. If M is a wholesale fund[3], the FMC Act and FMC Regulations[4] do not apply, other than fair dealing provisions.

Local MIS managers typically set up wholesale funds to capture the benefits of scale in the management of their direct investments. Usually multiple retail funds 'feed' investments into a single wholesale scheme with a particular strategy. MIS managers also use other (third-party) wholesale funds to gain international investment exposure.

There are two main custodian types

There are two basic types of MIS custodian in New Zealand: specialist custodian and supervisor custodian.

<u>Specialist custodians</u>

Specialist custodians have dedicated and experienced custodial personnel and offer custodial services as a distinct line of business. They are expected to have the appropriate systems needed to operate at scale. In some instances, specialist custodians are appointed to hold assets such as equities, bonds and managed funds, while other assets such as cash and term deposits are held by a supervisor custodian.

Under MIS trust deeds, specialist custodians are typically appointed by the scheme supervisor after due diligence and selection, which is driven by the MIS manager.

Specialist custodians tend to obtain a 'bulk' controls assurance review twice a year that they provide to all of their clients, in line with overseas standards. Due to their mature business structure, such reviews tend to have few material findings, and generally receive unmodified assurance opinions.

There is no licensing regime for specialist custodians in New Zealand. However, two licensed supervisors do operate separate specialist custody business units.

<u>Supervisor custodians</u>

Supervisor custodians typically have limited dedicated custodial expertise, personnel, or systems. The supervisor itself is the custodian, and relies on others to perform custodial functions. They hold scheme property, and usually appoint third-party fund administrators and the MIS managers to perform custodial functions, such as trade settlement, account maintenance and reconciliation, on their behalf. Supervisor custodians generally do not offer custodial functions as a stand-alone service, and bundle their cost into an overall fee rather than charging a separate fee for custody.

Supervisor custodians have a supervisor licence, and are regulated by the FMA. This means we can set expectations for the activities they perform and delegate, and monitor the extent to which these expectations are met.

3: Wholesale funds are investment funds that do not offer investment services to retail clients.
4: Financial Markets Conduct Regulations 2014

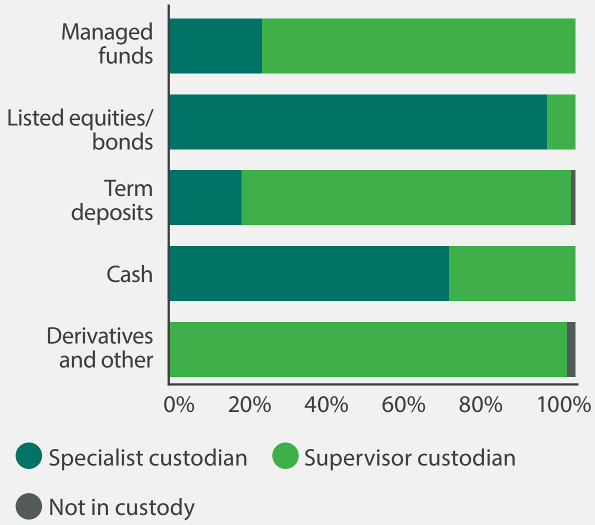
Most scheme property is held by supervisor custodians

As shown in the table below, the majority of scheme property in scope of this review is held by supervisor custodians.

As at 30 June 2018	Specialist custodian[5]	Supervisor custodian
Number	10	3[6]
% of total scheme property held	39%	61%[7]
% of KiwiSaver scheme property held	23%	77%
% of non-KiwiSaver scheme property held	55%	45%

Fig. 2 shows the breakdown per asset class.

Fig. 2: Breakdown of custody type per asset class



Smaller funds tend to utilise supervisor custodians, rather than paying for specialist custody. Larger schemes, including KiwiSaver schemes, may also use supervisor custodians for certain types of scheme property, such as wholesale fund units, cash and term deposits. This is a common structure that evolved from the structures that were in place before the FMC Act came into force. Most of PwC's findings, and the assurance review findings we reviewed, relate to supervisor custodians.

Key findings

Wholesale funds are the primary asset of many schemes

The majority of all retail scheme property (73%) is invested in other managed funds, generally wholesale funds. Supervisor custodians hold 77% of these managed funds, specialist custodians hold 23%. The wholesale funds are often managed by the retail MIS manager (or a related party of the MIS manager). Wholesale funds managed by third-party investment managers are used for most international investments and occasionally for access to New Zealand investments.

Given wholesale funds make up a large proportion of retail MIS scheme property, custody of wholesale fund units is of particular interest. Wholesale funds and their custodial arrangements are not regulated (other than being subject to the fair dealing provisions of the FMC Act) in New Zealand. As such, the FMA has very little sense of the size, structure, practices or risks in this sector.

While we understand anecdotally that wholesale funds are typically established under a unit trust structure and their trust deeds would generally stipulate that underlying investments should be held with a specialist custodian, this is a matter of business practice and not a regulatory requirement.

Retail fund ownership of units of a wholesale fund is evidenced by the wholesale fund's registry. There are no regulations regarding wholesale fund registries, though some wholesale fund registry providers obtain independent 'controls assurance reviews'. These reviews support the MIS custodian in its oversight of the scheme property. This is especially important where the wholesale fund is a related party of the retail MIS manager and segregation of duties is less obvious.

We expect retail MIS managers to perform and document due diligence on the custodial arrangements of the wholesale funds they consider investing in, to ensure that retail scheme property held by the other managers is secured to the level

5: Including specialist custodian business units of supervisors.
6: New Zealand has five licensed MIS supervisors. Not all of them held scheme property in scope of the review.
7: Including 0.05% not held in custody.

required under the FMC Act. We expect supervisors to provide oversight of these practices.

Scheme property not held in custody

The FMC Act requires that all scheme property be held in custody. While we found that 99.95% of scheme property is held in custody, there are certain asset types that are not always (or never) held in custody. This tends to happen in cases where the asset is bespoke, such as OTC derivatives[8], or is held in the form of accounts with trading banks, such as call accounts and term deposits.

Bank accounts are contractual arrangements between the bank and depositor. They are typically opened by the supervisor under a nominee subsidiary entity[9]. We found that 81% of term deposits were held by supervisor custodians and 18% were held by specialist custodians, leaving 1% of term deposits not held with a custodian.

Some specialist custodians accept bank accounts and term deposits into custody, but the majority do not. While we recognise this creates a difficulty for MIS managers, supervisors, and custodians, the requirements are clear.

Derivatives as an asset class make up less than 1% of the direct scheme property in scope of this review. While we recognise that in other jurisdictions derivatives are not always considered to be in custody, New Zealand law does not make any exception for this asset class.

We plan to provide further guidance about our expectations for custodial control of these kinds of bespoke assets.

Supervisor oversight is not consistent and at times insufficient

Supervisors are responsible as custodians of schemes under the FMC Act, with very specific exceptions.

The FMC Act explicitly states that supervisors retain joint and several liability for custody, including any outsourced functions. Also, we expect any licensed entity to provide sufficient oversight of outsourced functions.

In practice, we have found that supervisors often delegate the day-to-day activities of settlement, record-keeping and reconciliations to a specialist custodian or to the MIS manager and administrator of the scheme.

Where a specialist custodian is appointed, the relationship and operational interface are generally controlled by the MIS manager who, along with the administrator, performs most of the ongoing oversight. Although the supervisor formally appoints the specialist custodian, we found that the supervisor generally relies on the MIS manager's selection process and due diligence. The review also found that some market participants perceived a conflict of interest where a supervisor appoints their own specialist custodian business unit. Provided that the MIS manager and the supervisor conduct and document their due diligence properly, this is not a major concern for us.

The supervisor normally receives quarterly certificates from the MIS manager attesting, among other things, that the specialist custodian is adequately performing all of its functions, and that any issues are being actively managed.

The supervisor does not always maintain their own records of scheme property, and where they do receive reporting directly from specialist custodians, their analysis and reconciliation of this information against manager records may not be frequent, comprehensive or consistent.

Where no specialist custodian is involved, the supervisor custodian is generally operationally remote from scheme property, and from the custodial functions they have delegated to the MIS manager and administrator. This means the supervisor custodian needs ongoing assurance that these functions are being performed to the same standard as if they were being performed by the

8: Over-the-counter derivatives – contract between two or more parties trading a security not listed on an exchange. The value is determined by the value of an underlying asset.
9: Holds securities or other assets as a custodian (registered owner) on behalf of an actual owner (beneficial owner) under a custodial agreement.

supervisor custodian itself.

Our review found that the supervisor custodians generally do not have the infrastructure to perform their own independent controls over scheme property required to maintain this kind of detailed, ongoing oversight.

Overall, we think that supervisors should be carrying out more active oversight. This is particularly important where any functions associated with custody have been delegated to the MIS manager to perform. This practice potentially weakens the separation of functions sought by the legislation. If it is to be permitted, it must be accompanied by rigorous oversight from the supervisor.

We plan to prepare guidance on our expectations regarding supervisor oversight of custody. While the review found that formal monitoring controls performed by supervisors have improved over the past year, it also found there is a need for more consistency and clarity on how controls must be set to meet the control objectives set out in the FMC Regulations.

Assurance review practices are not consistent

The FMC Regulations require custodians to obtain an annual assurance engagement. We were pleased that our review of assurance reports indicated that the number of reviews with modified opinions (i.e. reviews where problems with procedures and controls were identified) has decreased, and the issues were largely resolved during the following reporting period.

The findings from the results of the assurance reviews were generally positive, but we did note several items that will require further consideration:

- The review found a variety of approaches implemented by schemes, which leads to custodial arrangements that are inconsistent for different schemes using the same custodian. Similarly, we found that reliance by custodians on third parties, such as administrators, creates unique arrangements between custodians and administrators. As a consequence, scheme-level assurance reviews are required – as opposed to custodian or administrator-level reviews. A degree of standardisation of custodial processes and controls across schemes and administrators could consolidate assurance requirements, and reduce duplication and costs.
- The review suggests that individual assurance providers are applying different approaches and interpretations of the technical standards for assessing control design and effectiveness. We encourage assurance providers to work with supervisors to move towards greater consistency (including minimum requirements) when assessing controls.
- New Zealand has no requirement for asset verification reviews, a practice that is common globally. These reviews enable an independent assessment of the existence and value of the scheme assets held by the custodian.

We intend to provide further guidance around our assurance reviews expectations.

Next steps

The provisions for custody set out in the FMC Act provide a framework for protection of customer assets, through:

- the separation of custody from management
- making supervisors responsible for custody (including oversight of all functions); and
- requiring independent assurance of custody controls.

We consider that the way these provisions have been implemented to date means there are some potential weaknesses that warrant additional guidance and focus.

We recognise that some of the issues identified have arisen out of business practicality and are meant to minimise the costs of custodial arrangements where the market generally considers the likelihood of risk crystallisation to be low. These factors need to be balanced against the clear expectation in the legislation about segregation of functions and duties. We will engage with supervisors and MIS managers to understand concerns and clarify our expectations in this area.

Following this, we will consider any remaining policy questions and, in the longer term, whether there is a case to seek a requirement for licensing of custodians.

We have no direct influence on the way wholesale funds implement custodial arrangements. We will consider the extent to which we can indirectly influence practices in that area by clarifying and reinforcing our expectations of MIS managers that invest in these funds, and of their supervisors.

About PwC's review

PwC was asked to analyse and report on:

1. the various custodian arrangements, their risks and associated risk-mitigating factors
2. custodian oversight provided by supervisors, and
3. the cause of qualified and adverse assurance opinions, to determine if there were common themes.

This was in expectation that any findings would then be considered by the FMA to determine where to provide guidance about expected practices and arrangements, and potential improvements. This would enable us to assess whether desired practices would require legal reform and to reach an informed conclusion as to whether we should seek licensing of MIS custodians.

PwC collected survey information from all 54 licensed MIS managers of managed funds within the scope of the review, and interviewed various stakeholders, including 15 MIS managers of managed funds, as well as custodians, supervisors, administrators, and assurance providers.

To ensure a representative sample of the market, the MIS managers interviewed were selected with consideration of size, type of products, supervisor, and custodial arrangements.

The survey was conducted by PwC in late 2018, based on June 2018 data. Interviews were conducted between January and March 2019 and their report was issued in May 2019. PwC's review did not involve developing a plan for the FMA.

This report notes the FMA's findings and analysis of information from the PwC report as well as our independent observations, and does therefore not reflect the views of PwC.

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