

19 August 2011

Committee Secretary  
Parliamentary Joint Committee on Corporations and Financial Services  
PO Box 6100  
Parliament House  
Canberra ACT 2600  
Australia

Dear Sir/Madam,

#### **INQUIRY INTO THE COLLAPSE OF TRIO CAPITAL AND OTHER RELATED MATTERS**

The Australian Custodial Services Association Limited ("ACSA") welcomes the opportunity to assist the Parliamentary Joint Committee with their inquiry into the collapse of Trio Capital and other matters related to that collapse.

ACSA is the peak body representing members of Australia's custodial and investment administration sector. Its mission is to contribute to innovation within its sector, support the development of custody professionals and to keep safe the assets that it holds on behalf of clients. ACSA members hold securities and other assets in excess of \$1.85 trillion and its clients include superannuation funds and managed investment schemes. ACSA members employ more than 3,000 people.

The purpose of this submission is to clarify the role of custodians within the Australian financial services industry. This submission focuses on the legal and regulatory framework applicable to ACSA members and how that framework keeps safe the assets of their underlying clients.

#### ***Role of custodians in the Australian financial services industry***

In Australia, a trustee of a public offer, industry or corporate superannuation fund ("trustee") or managed investment scheme responsible entity ("RE") is solely responsible for the overall management of the fund or scheme, which duties include among others, the obligation to administer and invest the fund or scheme assets in the best interests of members. These trustee

and RE obligations arise from both common law and legislation, such as the *Corporations Act 2001* ("the Act") and the *Superannuation (Industry Supervision) Act 1993* ("SIS"). Essentially, the trustee and RE have full and ultimate responsibility to the investors in the fund or scheme in respect of their investments in the fund or scheme.

### ***Reasons for appointing a custodian***

The law in Australia allows trustees and REs to outsource and delegate their functions (but not abrogate their responsibilities) to service providers, such as among others, custodians in respect of all or some of the assets of the fund or scheme. Trustees and REs appoint custodians for a number of reasons, including:

- commercial and operational reasons. The custodian's core functions include the safekeeping of assets and the settlement of securities transactions. ACSA members are generally settlement participants of ASX Settlement and as such, they are able to facilitate settlement of paperless transactions through CHESS. Whilst safekeeping and settlement is the primary role of a custodian, a custodian will typically provide additional services, such as administration, in relation the fund or scheme, which can be costly and time-consuming to do in-house, particularly because of the substantial investment in technology which is required to provide these services accurately and efficiently; and
- not satisfying the relevant regulator's (Australian Prudential Regulation Authority (APRA) in respect of superannuation trustees or the Australian Securities and Investment Commission (ASIC) in respect of registered managed investment schemes) capital adequacy requirements. Where this is the case, the appointment of a custodian becomes a condition of the license granted to the trustee or RE.

Appointed custodians have duties to the RE or trustee which are set out in the custody agreement between the trustee and the custodian or the RE and the custodian.

A custodian is generally considered to be a "*bare trustee*" because its role is commonly limited to only holding the assets and only transacting on those assets strictly in accordance with the instructions of the trustee or RE. Importantly custodians do not make investment decisions in respect of the assets held or manage those assets and they are not responsible for how the fund or scheme is administered. These are usually trustee or RE obligations.

As a bare trustee, the custodian may only act on the authorised instructions of the trustee or RE or their authorised agents (e.g. an investment manager or administrator). Except in limited circumstances, the custodian must act on all authorised instructions. It is the custodian's responsibility to ensure that it acts only on authorised instructions. The custodian does not have any discretion in relation to the investment of its client's assets. Any losses caused by the failure of the custodian to act on an authorised instruction without reasonable justification may result in a claim for breach of contract or negligence by the client against the custodian.

Additionally, the custodian is only responsible for those assets that are transferred to it (either by the trustee, the RE, another custodian on appointment or by way of settlement following a purchase of assets by the trustee or RE (or an investment manager authorised to do so on their behalf)). These assets are known as “*custodially-held*” assets. This means, that generally a custodian will take a transfer of the assets into its name as registered owner and record the asset into its custody records as being held on behalf of the client. The custodian will then undertake regular valuations of the client’s assets and provide reports to the client on all custodially-held assets as required under the custody agreement.

If however, the assets of a fund or scheme are not purchased in the name of, or transferred to, the custodian, then these assets are deemed to be “*non-custodially held*” assets. A trustee or RE might choose to purchase assets for a fund or scheme but elect not to have these assets held by their appointed custodian for operational reasons. In this case, responsibility for these assets rests solely with the trustee or RE.

### ***How custodians minimise the opportunity for fraud***

The financial services industry is particularly vulnerable to the risk of international fraud. As such, ACSA members are committed to ensuring that opportunities for fraud and corruption are reduced to the lowest possible level of risk.

At a fundamental level, having an independent custodian reduces the potential for fraud because it essentially involves a segregation of the front office duties typically undertaken by a trustee or RE, and the back-office duties of payment and settlement which are undertaken by the custodian. The risk of fraud is heightened if there is no such segregation of duties, because it is possible for employees of the RE or trustee to more readily undertake fraudulent activities which are not readily detectable. The existence of a third party custodian will generally result in enhanced fraud detection because of the need for reconciliation of front and back-office activities and investigation of reconciliation breaks typically undertaken by the custodian.

Furthermore, within custody organisations, additional policies are implemented which manage the risk of fraud within the custodial organisation. ACSA members have established policies relating to fraud detection that are intended to reduce the likelihood of fraud and increase fraud detection including:

- Segregation of duties between functions so that more than one person is required to complete key tasks. A custodian would operate under this principle in acting on client instructions, including instructions relating to cash payments to be made from fund assets.
- Custody transactions are only carried out when a properly authorised instruction is received directly from the trustee or RE (or an investment manager contractually appointed and properly authorised to provide the custodian instructions under the custody agreement). Clear allocation of duties should also be in place for trustees and REs to ensure that fraud

risk is considered with appropriate disclosure to investors contained in the Product Disclosure Document (PDS).

- Custody staff are subject to screening or background checks and are required to complete training, which outlines industry standards and ethical conduct including “whistleblower” policies. This is in addition to staff training and guidance provided by the trustee and RE to their staff, which should include training and guidance to ensure that suspicious transactions are escalated and dealt with either internally or externally to the appropriate regulator.
- Custodians may undertake reconciliations on behalf of clients which are based on a custody client’s instructions that can be available to a custody client’s internal or external auditors or external compliance committee.
- Custodians provide regular reporting to their custody clients, auditors or external compliance committees to enable them to identify unusual results.
- A custodian is required to observe the requirements of the AML/CTF Act, that includes among other things, ongoing monitoring of suspicious transactions.

### ***Regulatory overlay***

Each ACSA member is the holder of an Australian financial services licence, and as such is subject to the obligations imposed on it under the Corporations Act 2001 (the Act) (including the general duties of a licensee outlined in section 912A of the Act). Each ACSA member is authorised to carry on a financial services business of providing a custodial or depository service. A licensee with such an authorisation must satisfy certain minimum financial requirements which are a condition of its Australian financial services licence, including an obligation to maintain \$5 million in net tangible assets.

The operators of registered managed investment schemes and the trustees of superannuation funds, are also subject to substantial regulatory oversight, and under guidance and prudential standards applicable to REs and trustees REs and trustees are required to procure certain standards from custodians which they appoint.

In addition to the controls outlined above ACSA members prepare detailed reports pertaining to the internal control environment relating to the services they undertake on behalf of clients. These reports are subject to independent audit with external auditors preparing assurance reports in accordance with the *Standard on Assurance Engagements 3402, Assurance reports on Controls at a Service Organisation*, issued by the Auditing and Assurance Standards Board. Equivalent reports may also be prepared under the American Institute of Certified Public Accountants Statement on Auditing Standards No.70 (SAS 70) - *Reports on Processing of Transactions by Service Organisations*.

*Regulatory Guides 104 and 133* set out the standards for custodians that an RE must impose in order to ensure the safety of assets held by the custodian. These arrangements require that the RE ensure that the custodian has:

- *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.
- *adequate risk management systems, that include a robust business continuity and disaster recovery plans.* In designing risk management systems, custodians are required to have documented processes to identify, analyse, evaluate, treat and communicate risks in the business and to monitor and report on risk management issues on an ongoing basis.

A trustee is subject to similar requirements to ensure custodial standards under APRA Cross Circular No.1.

Under both ASIC and APRA guidance, an RE and a trustee respectively must require its custodian 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 REs also have a responsibility to ensure that custodial arrangements are suitable for the particular assets being held.

### **Conclusion**


Custodians perform an important role in securing the investment and superannuation assets of ordinary Australians, invested in managed investment schemes and superannuation funds. The use of a custodian is an important tool in managing fraud in the industry, because custodial functions are undertaken separately from the front office functions of the RE and trustee. Custodians have strong policy frameworks designed to enhance the protection of client assets and as the holders of Australian financial services licences, must meet licensee obligations, including the obligation to meet minimum financial requirements.

It must however be recognised that a custodians' role is limited, and does not extend to the performance of the management and investment functions undertaken by REs, trustees, or their

investment managers, whereas , a custodian acts on proper instructions under the terms of the custody agreement. In assessing the implications of the collapse of Trio Capital, ACSA members urge the Committee to recognise the valuable role played by a custodian in safekeeping assets while understanding that custodians are not responsible for poor investment decisions or even fraudulent conduct that may be undertaken by the REs or trustees who appoint the custodian, or their delegates.

Should you require any clarification regarding the issues we have raised ACSA would be happy to assist you.

Yours faithfully,

A rectangular area that has been redacted, likely containing a signature or name. It is bounded by a thin black line on the top, left, and right sides, with the bottom side open.

Paul Cutts  
Chair, Australian Custodial Services Association