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Association for Financial Markets in Europe

The Role of the Custody Industry

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Custodians…

- enable investors to connect to the capital markets;
- hold assets in safekeeping, ensuring that investors are appropriately protected;
- facilitate the settlement process whereby ownership of assets is transferred between buyers and sellers;
- provide a link between issuers and investors, e.g. by processing dividends or votes in corporate events, and maintaining a record of ownership.

Context

AFME is a longstanding supporter of the objectives of the Saving and Investment Union initiative. The renewed agenda of the European Commission identifies the need to deliver sustainable growth of our economy to maintain the international competitiveness of EU markets. Growing retail and institutional investment into European companies is of critical importance to meeting the financing challenges of the future. Custodian banks play a pivotal role as an intermediary in meeting the needs of both issuers and investors in the financial lifecycle. This paper provides a brief overview on how they fulfil that important role to ensure the stability of global financial services.

Issuers

Capital markets are a critical source of financing for European corporate and sovereign issuers. Companies seek to raise capital as efficiently and inexpensively as possible, from a large and diverse investor base. Issuers access capital markets through centralised market infrastructure. Newly issued securities must be registered at a Central Securities Depository (CSD), known as the "issuer CSD", which provides the issuer with notary services – in other words, maintaining the first-level record of who the securities are registered to. In today's world, nearly all such securities are held in a digital, electronic form.

Securities are also typically traded on one or more trading venues, which provide a platform for secondary market participants to buy or sell the securities.

Investors

Investors wishing to buy or sell securities (e.g. shares or debt securities) typically access markets through a financial institution (such as a broker), to whom they instruct their order. Investors can be individuals ("retail investors", typically accessing markets via a broker or a credit institution) or institutions such as asset managers, pension funds, insurance companies, or banks.

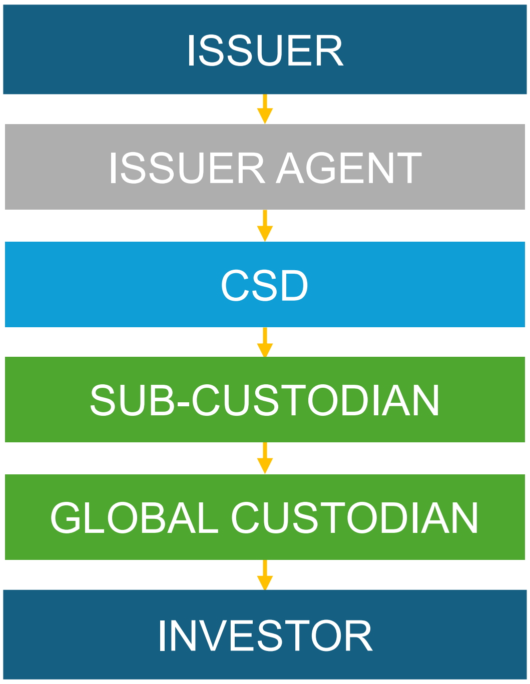
Once the trade has been executed, the settlement process takes place through custodians and settlement intermediaries to effect the necessary update to the CSD's register (facilitating the transfer of ownership from seller to buyer, in exchange for the agreed cash amount). This takes place in the Securities Settlement System operated by the CSD, through the input of "settlement instructions" by the buyer and seller, usually through intermediaries acting on their behalf.

Role of the Custodian

Custodians provide a means for investors to connect to the CSD by acting as an intermediary in the chain of custody. They hold investors' assets in safekeeping, and provide a record of their ownership, maintaining direct accounts with the relevant CSD, for securities, and central bank, for cash. Custodians help facilitate the settlement process, by instructing updates to the CSD's records and facilitating the corresponding cash payment upon instructions from the investor. Practically, this may involve taking deposits from and extending credit to clients in order to facilitate settlement. This deposit-taking and lending is specifically for custody-related purposes and therefore very different to the general banking activities of a retail or investment bank.

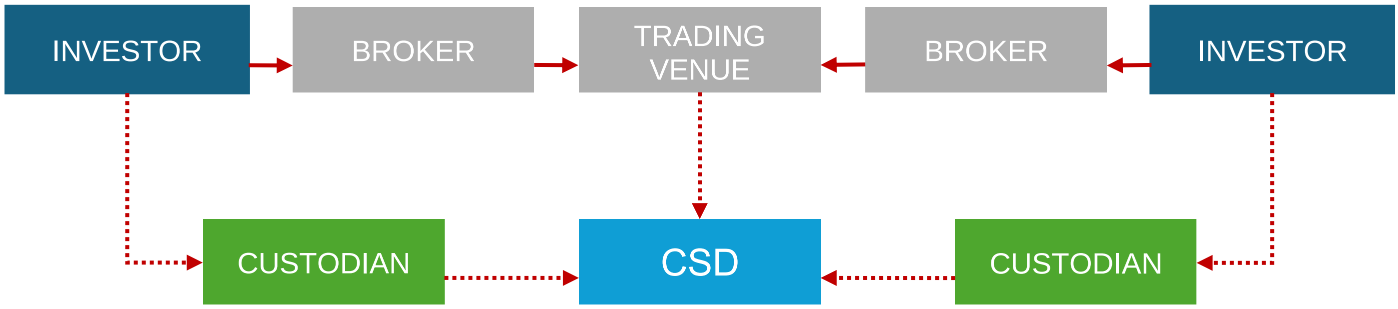
Custodians also carry out various administrative functions in addition to their safekeeping obligations. One example of this function is by managing corporate actions and proxy voting services to investors. Securities are often subject to a range of corporate actions, effected by the issuer. These can range from simple income distributions (such as a dividend) to more complex transformations of the underlying assets (such as mergers or stock splits). Via the CSD, custodians process these corporate actions on behalf of the investors, and also communicate voting instructions back to the issuer in the case of general meetings. Typically, custodians also provide additional services, such as tax reclaim services.

In short, they are a pivotal intermediary in both the "vertical" chain, connecting issuers of securities with investors, and the "horizontal" chain, connecting buyers and sellers.



"vertical" flow

Issuers are connected with investors by custodians and CSDs. The payment of income (e.g. dividends) and execution of other corporate events is done through this chain. The investor also typically exercises its rights (e.g. voting in general meetings) through the custodian.
The number of intermediaries between the end investor and the CSD can vary. For example, there could be multiple CSDs in the holding chain, or the investor could make use of another intermediary such as a prime broker or a trustee.
Issuers may also use an issuer agent.
In the case of funds, such as AIFs or UCITS, the fund is typically connected via a depositary.



“horizontal” flow

Custodians facilitate the transfer of ownership of assets between different investors. Participants seeking to buy or sell assets typically access markets through brokers and/or trading venues such as stock exchanges.
Once a transaction is agreed, the buyer and seller instruct their custodian to facilitate settlement at the CSD, where the ownership record is updated. Multiple settlement intermediaries can be involved in the process.
Many transactions may also be centrally cleared, involving the interposition of a CCP between the trading and settlement layers.

Frequently Asked Questions

How are custodians regulated?

- Custodians are subject to, and impacted by, many European capital market regulations.
- The record keeping part of a custodian’s business is classified as a Category B “ancillary service” under MIFID2.
- As part of the business model, custodians also take cash deposits from their clients to ensure that they have the short-term funding to carry out their operational activities. Custodians therefore need to have a banking licence and are subject to the same prudential requirements as a traditional bank.
- Custodians are also subject to various regulatory requirements to appropriately protect and safeguard clients’ assets.
- In relation to funds, custodians which are appointed as depositaries need to meet the requirements of the UCITS and AIFMD directives.

How are customers’ assets protected?

- Custodians are subject to strict regulatory requirements to ensure that investors’ assets are appropriately protected.
- This is also a question of national law – determining the property rights associated with the assets and ensuring that they are appropriately protected in the event of the insolvency of a custodian or another party in the chain of intermediaries.
- Custodians segregate clients’ assets from their own proprietary assets, and do not take beneficial title over clients’ assets – thereby ensuring that the assets will be returned to the client in the unlikely event of a custodian insolvency.

Why don't investors connect directly to the CSD?

- Investors typically want to invest in multiple markets, and thus need to be connected to the relevant CSD in each market.
- This would constitute a significant financial, operational and legal burden for the investor.
- It is therefore more efficient for the investor to connect indirectly through a custodian who aggregates this flow of assets together to create an economy of scale when connecting to local CSDs.
- Custody arrangements also help to support cross-border investment by providing a straightforward way for non-domestic investors to access local CSDs.

Are custodians subject to ESG regulation?

- Custodians keep books and records of what their clients are investing in.
- So, for example, a client might have a diverse portfolio of investments. The client may be directly subject to a range of disclosure requirements (for example under the Sustainable Finance Disclosure Regulation).
- As intermediaries in the chain of custody, Custodians are generally not required to report on the disclosures made by their clients. The client may, in some cases, be required to seek external assurance of the accuracy of their disclosures. The client would typically ask an audit firm for such assurance.

What is the difference between a custodian and a depositary?

- Retail investors often invest in funds as well as (or instead of) in individual securities. Some types of funds are required by EU regulation to appoint a legal person (called a depositary) to safeguard the assets of the fund. This task is very similar to the work described above in relation to securities, and so, very often, the depositary who is appointed will be a financial institution who is already acting as a custodian of securities.
- Among the functions performed by a depositary, there are four main categories: (i) the custody and asset registration function; (ii) supervision of the asset management companies (iii) the cash control function; and (iv) the monitoring and oversight function.
- The role of the custodian is limited to a series of assets, known as custodial assets, while the depositary extends its supervisory tasks to non-custodial assets, or objects of recordkeeping, such as unlisted shares, derivatives, OTC instruments or deposits and cash accounts opened in third entities.

What is the difference between a sub-custodian and a global custodian?

- Global custodians offer their clients a single point of access for custody services across multiple jurisdictions around the world.
- They do this by managing a network of sub-custodians, or "agent banks", who are directly connected to the CSDs of different markets.
- Securities holding chains can therefore often involve multiple custodial intermediaries. Although it can look complicated, this approach provides the means to connect many investors to many issuers located in different jurisdictions together in a safe and efficient manner.

Annex – List of policy areas relevant to custodians

Given the critical role that custodians play in connecting securities market participants, they are impacted by a broad range of laws and regulations, including but not limited to those listed below. Potential legislative or regulatory changes in any of these areas should carefully consider the potential impact on custody services.

- Settlement – including CSDR settlement discipline rules; T+1; settlement finality laws
- Clearing – including EMIR
- Insolvency laws
- Asset servicing – including Shareholder Rights Directive, FASTER Payment
- Capital Requirements Regulation
- Outsourcing rules
- Supply chain regulations such as DORA and Critical Third Parties
- Fund regulation – including AIFMD and UCITSD
- Digital assets