

# The true price of trusting custodians

By Dominic Auld, Labaton Sucharow  
25 October 2011

## **Lack of transparency leaves institutional investors in danger of falling victim to unethical and illegal conduct by their custodian bank**

Despite regulatory reform across the global financial services industry, large institutional investors face regular exposure to potentially unnecessary, and in some cases fraudulent, expenses in connection with their assets held by custodian banks. The stakes are high. Global assets in custody exceed \$100trn (€76trn) and recently it has become apparent that the banks' ability to overcharge clients can be both far-reaching and long-running.

Custodian banking is a large and growing business. A relatively small group of banks, many of which are US-based, control the market. The largest player, BNY Mellon, is responsible for more than \$25trn of that total. Other significant players include State Street, J.P. Morgan, RBC Dexia, Citigroup, Northern Trust, HSBC and BNP Paribas.

Individual and aggregated custodian bank service fees are typically a fraction of investment management fees and have not often been a significant point of contention between pension funds and their custodians. However, the relationship model is open to abuse, especially when custodians expand the range of fee-based services offered in order to become more attractive and increase their market share. This diversification may enable custodians to bury the crucial details of varied services in vague, sometimes bundled, contracts. Additionally, the global custody industry has encouraged institutional investors to believe that the bundling of fees will result in lower overall costs.

In fact, due to the built-in opacity of these agreements, the opposite is often true. As a result, institutional investors are in danger of falling victim to unethical and illegal conduct with respect to their assets. While the fees at issue in these instances may appear small, their aggregation can result in the loss of serious amounts of money over a large number of transactions and over a long period of time.

Currency trading is lucrative and profits represent a significant portion of custodial banks' revenue. A Sanford Bernstein analyst report from February 2011 suggests that BNY Mellon, State Street and Northern Trust attribute 7 per cent, 8 per cent and 12 per cent of their total revenues respectively to foreign currency exchange (FX) trading. It now appears that a significant portion of these amounts may in some cases have been generated through deceptive practices in common non-negotiated FX transactions, either by charging unauthorised and undisclosed surcharges or using daily exchange rates selectively. In the latter example, banks do not credit clients with the exchange rate that corresponds to the timing of the investors' FX transactions. Instead, the banks track the movement of currency over the course of the day and report the conversion at the exchange rate that provides the greatest profit margin – for the bank.

In October 2009 California's attorney general sued State Street after an investigation of the state's FX fee exposure found that its major pension systems, CalPERS and CalSTRS, had been overcharged by \$56m over eight years. The lawsuit seeks to recover the amount plus penalties – a total greater than \$200m. The overcharge had been effectively invisible as the custodian allegedly consistently chose the highest daily FX rate and deliberately failed to provide time-stamped records – a practice that violated the contract terms governing FX. On a transaction-by-transaction basis, these amounts were relatively small when compared with the size of the pension systems and the amounts of money being converted, but became material in the aggregate. Pension investors need to be vigilant when reviewing custodial charges precisely because these individual overcharges can falsely appear to be insignificant.

Similar actions have followed or are being considered across the US against BNY Mellon and State Street. In February 2011, State Street reached a \$11.7m settlement with the state of Washington over FX claims – representing 100 per cent of the amount the state was seeking in its contractual dispute over these fees. Additionally, several other state attorney generals are reported to be reviewing claims that public pension plans were overcharged. In May 2011 it was also reported that State Street and BNY Mellon were the subject of Securities & Exchange Commission investigations.

It is clear that the time is right for increased scrutiny of the FX trading operations of all custodians. As non-US institutional investors also regularly require significant amounts of FX, it is important that they too focus on this area and ensure they are not paying more than they should for these services.

In January 2011 the SEC fined BNY Mellon \$24m for depriving many of the bank's pension fund clients of "best execution", a clear violation of SEC rules. The traders involved stood to gain personally when they executed institutional clients' orders at inferior prices in cross trades that gave more attractive prices to hedge fund clients. The chief architect of the scam was a member of the best execution committee and this situation raises real concerns about custodian banks' ability to police themselves.

Custodial banks' behaviour within their securities lending programmes is another emerging area of concern. Custodial lending agents typically structure transactions whereby pension funds and other institutional clients lend securities to hedge funds and other asset managers who wish to borrow shares – often to establish or cover short positions. It appears that in some cases the risk levels assumed by the investor do not correspond to the modest income stream provided by this activity. This is especially true when custodians reinvest the collateral received in lending transactions to high-risk areas that may violate agreed parameters. South Carolina is pursuing BNY Mellon to recover some \$200m in damages it alleges stem from the custodian's deviation from investment guidelines by investing in sub-prime mortgage-backed securities. Swedish buffer fund API's lawsuit against BNY Mellon last year was similar in nature. The fund is seeking \$35.5m in damages in connection with the bank's allegedly negligent investment of securities lending collateral in a structured investment vehicle that later went bankrupt.

It is clear that institutional investors can pay too high a price for the trust they place in their custodians. In order to best fulfil their duty to beneficiaries, pension fund leaderships should be

diligent in examining past custodian performance and be prepared to demand greater clarity, transparency and fairer treatment in the future. Custodian banks operate in a very competitive environment and their most important clients are institutional investors. Pension funds should take a close look at contract documents and transactional reports to determine whether their investments have been exposed to any deceptive or fraudulent activity. In the FX context this may involve a careful review of specific trades to determine if any non-negotiated transactions were inappropriately priced when compared with the rates available at the time of the trades. If custodians claim to be unable to deliver time-stamped records enabling an FX rate comparison, investors should ask “why not?”

In addition, investors should re-examine all contracts related to the custodial bank’s retention, including any proposals submitted by the bank in its original tender and any language covering fee-generating services that might have been added later. In instances where language governing potential fees, surcharges or allowable asset allocations may be vague, unclear or potentially non-existent, investors should have frank discussions with their custodian on what exactly has occurred previously and what will be acceptable in the future.

To better protect assets, institutional investors should continue to challenge their custodial banks to do better by establishing transparent contracts, appropriate fees for services, better oversight and controls for trading activities, reasonable commission structures and returns that correspond to risks assumed. In such a tenuous economy, tolerating serial misconduct is not an option. Recent litigation filed against major custodial banks puts them on notice that their clients have had enough. Institutional investors can leverage these factors to foster a more reasonable and far more transparent environment that ultimately positions their assets to better thrive and grow.

*Dominic Auld is an attorney with US securities litigation firm Labaton Sucharow*