
TRANSPARENCY AND TEAMWORK: THE BENEFITS OF USING A THIRD-PARTY CUSTODIAN

by PFM Asset Management LLC

Two recurring themes in public-sector and institutional investing are transparency and avoiding conflicts of interest; they often influence how investors approach many aspects of their investment programs, from selecting an advisor to how trades are executed. However, what some investors may not consider is how their assets are held in custody. Specifically, are the assets held in the investor's name? Does the custodian have the ability to lend out assets? Many financial services companies offer custody services as part of a bundled service platform under one agreement. For example, a broker's or a bank's wealth management arm commonly assumes both investment management and custodial responsibilities. However, this arrangement is not typically considered to be a best practice and may present some risks that necessitate disclosures on financial statements. This article provides an overview of common custodial arrangements, the benefits of using a third-party custodian, and what investors should look for when selecting a safekeeping arrangement.

COMMON CUSTODIAL ARRANGEMENTS

Overall, there are two common types of custodial arrangements:

1. Securities are held by a broker (or a bank acting as a broker) – In this scenario, the broker holds securities in an account it controls. Securities are not held in the investor's name and there is not a separate custodial arrangement.

2. Securities are held by an independent custodian – In this scenario, securities are held in the investor's name by a financial institution in an account that is not under the control of the investment advisor or broker. The agreement between the custodian and investor is separate from the investment advisory agreement.

THE RISKS OF NOT HAVING A SEPARATE CUSTODIAL ARRANGEMENT

Without a separate custodial arrangement to hold securities in the investor's name, investors may be exposed to the following risks:

Lack of Control

Securities that are not held in the investor's name may be loaned out or used by the financial institution as it sees fit. The broker has no fiduciary responsibility to protect the securities. There are some cases in which assets may be held in the investor's name, but the contract may include a provision that allows the financial institution to lend assets. Securities lending by a

custodian adds complexity and may add risk to managing the assets. In this case, it is important for investors to fully understand the terms of their agreement.

While bundled arrangements are convenient for the investor, they can

be problematic when multiple services are provided under one agreement. Investors are unable to hire and fire individual providers as they see fit without affecting other services. A type of bundled arrangement that includes services provided by individual parties

FEATURES INVESTORS SHOULD LOOK FOR IN A CUSTODIAN

Investors should carefully understand the manner in which their assets are held in safekeeping as well as the costs involved in custodial services. Regardless of the custodial arrangement, third party or otherwise, investors should fully understand the terms of the contract. Public-sector investors in particular should be familiar with their state statutes that may require the use of a third-party custodian. In selecting a custodial arrangement, consider looking for the following features:

- A separate agreement, distinct from the brokerage or investment advisory contract.
- Assets held in the investor's name.
- Separate invoices detailing the services and associated costs.
 - In understanding these services, make sure that they are reasonable and are compared on an "apples-to-apples" basis with other providers.
- Accounting guidelines that follow GAAP and meet GASB requirements as applicable.
- Internal controls, such as audit procedures and SSAE 16 reports.

Meeting all of these criteria helps ensure that the custodial arrangement is in the investor's best interest, maintains transparency and supports accurate reporting.



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under separate agreements allows investors to maintain greater control of their investment program.

Lack of Transparency

Providers that bundle services typically communicate one fee that is inclusive of all services, making it challenging for clients to determine how much is earned by the broker and how much is earned by other providers. These arrangements may advertise “free” custody services. Without a clear delineation of the costs of investment management and custodial services, investors cannot accurately compare services and costs among providers when fulfilling their fiduciary duties.

Conflicts of Interest

When one provider handles both portfolio management and custody/safekeeping (especially under one agreement), there is no independent third party clearing and settling trades. We believe that without this independent function, trade execution, the movement of cash, and valuation of assets cannot be objectively verified.

THE BENEFITS OF HAVING AN INDEPENDENT CUSTODIAN

Perhaps the most important aspect of using an independent custodian is that securities are held in the investor’s name and for the investor’s sole benefit.

Additionally, the segregation of duties between the investment manager or broker and custodian provides added controls to the process of accurate record-keeping. We have summarized the various benefits here:

Benefit #1: Fee Transparency

By having separate parties with separate contracts providing brokerage, investment advisory, and custodial services, investors can see clearly how much they are paying for each service.

Benefit #2: Certain Risk Disclosures Are Not Required

Generally accepted accounting principles (GAAP) that are consistent with the standards of the Governmental Accounting Standards Board (GASB), require investors to make certain risk disclosures in the notes to their annual financial reports when securities are not held in the investor’s name. These disclosures are related to custodial credit risk (i.e., the risk that depositors may not be able to recover their assets due to the default of their custodian) and are required for all investments that are not registered in the name of the investor and are held by either the counterparty or the counterparty’s agent or trust department (not in the investor’s name). When assets are held in the investor’s name, these disclosures are not required.

Benefit #3: Independent Valuation Of Holdings

The custodian is the official record-keeper responsible for detailing investments held on behalf of the investor. Additionally, we believe dedicated custodians are best positioned to report and value holdings because of their infrastructure and internal controls. For example, many custodian banks operate under a continuous audit cycle, with internal and external auditors reviewing one or more aspects of the operations on an ongoing basis. Additionally, custodians are required to provide clients with SSAE 16 reports that exist to help ensure that investors’ financial statements are accurate when they rely on a third-party service organization.

Benefit #4: Increased Checks and Balances

We believe it is a best practice to have two independent sources of information with regard to verifying investor account data. Although the investment advisor or broker may not be the official record-keeper, regularly reconciling internal records with those of the custodian can help identify, research and resolve any differences in a timely manner. □

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