**Global custody of endowment funds**

**DAVID PALFREYMAN, MA MBA LLB**
**Bursar & Fellow, New College, Oxford, OX1 3BN**
**(01865 279550; e-mail via kate.hunter@new.ox.ac.uk )**

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## Introduction

Those responsible for the governance and management of some independent/private schools (or of the umbrella charities which own some such schools [1]), of many universities, and of all Oxbridge colleges [2] – hereafter 'educational institutions', 'EIs' – will invest their endowment (often permanent) to achieve capital growth and to generate income. Such endowment may include agricultural land and commercial property, but most of it will be held as equities and bonds, as securities within a portfolio that will also include a varying level of cash. Almost always the EI will appoint a fund manager (hereafter 'FM') to manage the portfolio under a contract for investment or asset management services, and this contract typically includes provision for the FM to have the portfolio of securities lodged in the name of the EI with a third-party – a custodian bank (hereafter 'CB') – with which FM has a global custody agreement (see the *Financial Times* (6 September 2005) for a 'Special Report' on the global custody industry: note that, increasingly, the FM will be outsourcing its 'back-office' tasks to the CB, as well as buying traditional custodianship). There may, however, be a trend for the FM no longer to organize the EI:CB arrangement lest thereby it risks incurring liability to the EI should the CB act negligently or become insolvent and the EI suffer losses: the FM will leave the EI free to appoint its own CB. Regardless of how the CB is appointed, the FM will electronically instruct that CB to transfer securities in and out of the EI's account, again a process done electronically rather than there being share certificates and the like, and with all the securities at the CB being 'pooled' or 'fungible' rather than held as an identifiable bundle of certificates in a tin-box with the EI's name on it (as might indeed have been the norm before the 'immobilisation' and the 'dematerialisation' of securities trading over the last twenty years, with the development of systems such as CREST). The CB will hold the EI's cash in a cash account, as is usual for any bank account. It will also collect dividends and settle trades. There will be tiers of custodianship, with sub-custodians and nominees holding assets in other countries: these cross-border holdings will mean that foreign laws impact on the custodial structure. See Note 3 for sample wording in an EI:FM contract concerning the CB arrangements.

The EI:FM legal relationship is a contract for the purchase of investment expertise, the contract containing the usual array of indemnity, exemption, and limitation of liability clauses [4], and with the FM being under a duty to provide the asset management service 'with reasonable care and skill' (s13, Supply of Goods and Services Act 1982). Similarly, the FM:CB agreement over the provision of global custody services to FM and its clients is a contract, with the FM acting as the EI's agent in instructing the CB to set up accounts for the EI as one of FM's clients. If the EI directly appoints the CB, again there will be a contract, the FM being the agent of the EI when routinely instructing the CB and, as with the EI:FM or the alternative FM:CB contract, the CB service to the EI needs to be delivered 'with reasonable skill and care': also these standard contracts drawn up by CBs will (probably) be subject to s2(2) of the Unfair Contract Terms Act 1977 and its requirement for 'reasonableness' where clauses attempt to exclude or restrict CB's liability. (NB: the Unfair Terms in Consumer Contracts Regulations 1999 do not apply since the EI is not a consumer in reaching an agreement with CB; it is a business to business relationship.) The issue for this article is the analysis of the legal relationship between EI and CB, especially since there may be no direct documentation or contract between them and the EI may not necessarily have seen the FM:CB global custody agreement (and its range of indemnity, exemption, and limitation of liability clauses [5]). Is EI the bailor of these assets and CB the bailee, the legal relationship founded on the law of bailment? Is CB the trustee and legal owner of the assets now held in trust with the EI being the equitable/beneficial owner, the legal relationship being rooted in equity or the law of trusts? Depending on this legal analysis – bailment or trust, or some amalgam of both – what then are the risks for the EI in having its securities and portfolio cash held by CB as arranged by FM, or even if under a direct contract between EI and CB?

**Why global custody?**

Theoretically, but in the age of electronic securities not practically, the EI could itself hold the securities and cash, awaiting advice from its FM that it should buy this and sell that; more conveniently, the FM could hold the assets, simply sending the EI income from time to time. Or, as occasionally (and perhaps increasingly) happens, the EI could have a direct agreement with a CB, but with the CB accepting instructions from the FM in terms of dealings in the portfolio. Why then is (or was) the norm for the EI to have the assets held at arms-length by the CB, via the indirect legal relationship created through the EI:FM investment management contract? It is clearly convenient for FM to channel all its clients through one CB (thereby also achieving economy of scale in buying custodian services), and for the EI not to have to be involved in the frequent and routine communications between the two. Crucially, however, the use of the CB (whether directly appointed by the EI, or indirectly via the FM) means that, in the event of the insolvency of the FM, the EI's assets are meant to be safe from the creditors of the FM. Similarly, if the CB becomes insolvent, the EI's securities are again ring-fenced and supposedly safe from the CB's creditors - if they are indeed held by the CB under bailment or under a trust, and subject, crucially, to the CB's records clearly showing the EI's assets as being held in an account in the name of the EI or of the FM-EI, not in the name of either the CB or of the FM alone. In contrast, the EI's cash is potentially at risk, as became clear when Barings Bank went bust in the mid-1990s and the clients of Barings Investment Management feared that their assets under a fund management contract with BIM and held by Barings Bank as a CB might be pursued by the creditors of Barings Bank. In fact, the ring-fence around the securities was secure, and – after some anxious days – it also became clear that even the cash with Barings as a CB was not available to the other customers of Barings as a manager of funds and more generally as a bank. This is because the Insolvency Act 1986 defines property widely (s436) and in s283 (1) (a) declares that a bankrupt's estate does not include 'property [the EI's assets] held by the bankrupt [CB] on trust for any other person [EI]: the EI's money and securities are ring-fenced from CB's creditors (see paras 16.26 & 16.31 of the Chapter on Insolvency in *English*

*Private Law*, 2000). How effectively the securities are protected will be considered below in terms of bailment and trust.

Yet, if the custody arrangement is so protective, why does the FM:CB (or also any EI:CB) global custody agreement typically refer to fierce-sounding legal concepts such as set-off, a lien, a general lien and a pledge (see the sample wording in Note 5) as the means of the CB utilizing its possession of the EI assets to ensure the FM's (and, indirectly, the EI's) indemnity to the CB is honoured before the CB releases the assets back to the EI? It may be one thing for the CB to use these legal concepts to recover from the EI any custodian charges unpaid by the insolvent FM: such charges will be merely a few £1000s. It is entirely another for the CB to be able seemingly to refuse to transfer back the EI assets where the 'losses, costs, liabilities or expenses' sought by the CB may be substantial and also be heavily disputed by the EI (and/or the FM). At the extreme, and expensive in terms of the EI's potential liability (perhaps where CB claims FM negligently sent electronically a disabling virus or worm into its IT system…), the entire EI securities and cash could be at risk [6], thereby somewhat, on the face of it, defeating the safe-custody concept! Moreover, the EI manager might reasonably be puzzled that a custody contract supposedly buying a service aimed at producing peace of mind for the EI in terms of the safety of its endowment can contain such broad and unlimited indemnities, and can invoke threatening legal concepts such as set-off, liens, and pledges; the EI's contracts for the purchase of catering supplies and stationery, or for its hire of photocopiers, or its contracts for audit services and window-cleaning, etc, will not involve such draconian terms. And the non-lawyer EI manager can be forgiven for being confused when a leading text on banking law notes that the topic of custody is 'fraught with difficulties' (R. Cranston, 2002, *Principles of Banking Law*, p 331).

**Bailment or trust?**

In considering whether the legal relationship between the EI and the CB is based on bailment or trust, or some mix of the two, the texts listed in Note 7 will be cited by the author as appropriate in the rest of this article. Benjamin in the 1996 edition of her book commented on the 'lack of consensus in the current legal analysis' (p 3) as to what is the legal basis of the custodianship of securities (traditionally seen as bailment, but, she argued, now to be more appropriately based on trust law); by the 2002 edition (Benjamin & Yates) the trust approach is strongly to the fore, the bailment concept being seen as inadequate and ineffective. This analysis fits with the Austen-Peters text (2000), and seems generally to be accepted (but not necessarily publicly confirmed) amongst the lawyers acting for custodian banks – and by texts such as Cranston cited above, at p 334; also I.G. MacNeil, 2005, *The Law on Financial Investments*, at pp 73-78 exploring the validity of the trust concept in common law countries and its inapplicability in civil code jurisdictions. This crucial common law – civil law difference is also examined in Chapter 4 of J. Dalhuisen, 2004, *Dalhuisen on International Commercial, Financial and Trade Law*, who, like Ooi cited below and R. Goode (2003, *Legal Problems of Credit and Security*, in Section 8 of Chapter VI), discusses in addition the conflict of laws problem arising with the custodianship of cross-border securities and the *lex situs*. The spirited defence of bailment asserted by Beaves (1998) appears to have been overwhelmed by the trust concept, despite the attempt of Palmer in the section on bailment within

*English Private Law* (2000) to sustain the Beaves' line: 'It is argued that principles akin to those of bailment should govern the 'global custody' of electronically stored securities which have no material existence.' (para 13.15, citing in notes 116 and 117 the Chapter by Beaves in Palmer & McKendrick).

First, however, before considering bailment and trust, what of the law of agency? While the FM is the agent of the EI in instructing CB where FM simply adds the EI to its global custody arrangement (or, alternatively, the FM becomes the agent of the EI in routinely instructing CB under a direct EI:CB custody arrangement) and while agency does imply an indemnity from principal to agent for the latter's proper actions (B&R, para 7.056) as well as utilising the concept of a possessory lien (B&R, paras 7.070 and 7.086), the EI legal relationship with CB is not based in the law of agency since the lack of legal title vested in the CB under a trust would make it much more cumbersome for the CB to deal in the EI assets. After all the EI could hardly transfer the endowment securities to the FM, or a CB, without protection from third-parties or their eventual return being guaranteed by the law of bailment or the law of trusts; and, if it did, in the event of the insolvency of the FM or CB, the EI's assets would not be protected under the law of agency from such third-parties as the creditors of FM or CB as agents of EI.

*Bailment:* Beaves notes that banks traditionally held share certificates in safe-custody for customers (in 'the brown envelope', if not a tin-box), and that the law of bailment applied, the bank being a rewarded bailee and the assets being safe (physically) and also protected from the creditors of the bank were it to become insolvent. But bailment can be used only for tangible personal property/chattels, and not 'dematerialised' securities as very much intangible property where there can be no physical possession (see Palmer, p 99: 'It is almost universally agreed that no one can become a bailee without possession of a tangible thing'; see also Austen-Peters, paras 2.27-2.29). Moreover, usually any tangible document, such as a share certificate, will be 'immobilised' in some remote depository – only its reference number will shift from one CB's IT system to another's as the equity is traded, and hence only the depository (with which the EI has no contractual link) could be said to have bailment of a tangible thing (presumably with the CB, or one of its sub-custodians being the bailor, perhaps as the agent of the EI). There is also the fact that such 'electronic' securities will be pooled/fungible inside the CB, even if it keeps an account in the name of the EI, and bailment shuns commingled assets where the bailors' assets are no longer identifiable – this is not an issue for the trust analysis (see Austen-Peters, paras 3.22-3.49 and the citation of *Hunter v Moss* [1993] 1 WLR 934 and [1994] 1 WLR 452, CA: the general requirement for certainty of the subject matter when creating a trust does not necessarily entail a need for the segregation of trust assets where the subject matter of the particular trust is intangible property). Beaves bravely calls for 'A New Approach to Bailment', arguing that common law bailment could be developed to recognize that there need not be physical possession, that intangibles can be bailed, and that pooling need not be fatal to the concept of bailment (citing *Hunter v Moss* by analogy to bailment): 'surely a reasonable and entirely logical approach' (p 126). Why, he wonders, go to the trouble of declaring a trust when one could stick with the tradition of bailment and simply update the concept for the IT age? Failing that, he claims that, anyway, there need not be precision in defining the global custody legal relationship between FM/EI and CB, whether it is common law bailment or a trust within equity, as long as a remedy is available under one or the other ‘that does substantial justice to the interests of the parties’ (p 136): this may indeed be sound legal common-sense, concentrating on the practical outcome by way of remedy and redress rather than on the theory and legal reasoning likely to lead to that desired outcome. The innocent EI governor and manager, however, might find it odd that the EI endowment assets are to be shifted around within the global custody industry without the EI, the FM and the CB – and, seemingly, the Law – being at all clear about the legal basis on which the EI is supposedly safe-guarding them through the CB arrangement: it is difficult to think of any other activity of the EI where sizeable assets are to be transferred and substantial indemnities given in the context of such legal uncertainty!

*Trust law:* So, what of the analysis of the global custody arrangement as the creation of a trust, the CB having legal title to the securities and the EI retaining equitable/beneficial ownership? Turning to Underhill & Hayton and pp 3-37 comparing agency and bailment with the concept of the trust and discussing the commercial uses of the trust, we note that both bailment and the trust would protect the EI assets in the event of the insolvency of FM or CB, that each also offers the legal remedy of tracing should the CB make an unauthorized sale of EI assets, that both legal concepts involve the imposition of a fiduciary duty upon CB but with the fiduciary duty of a trustee being at the highest level, and that (in terms of protecting the CB) the trustee has a lien over trust assets (as does sometimes the bailee over the assets in bailment) and is provided with a broad indemnity from trust funds subject to the trustee acting properly: see U&H, pp 619-621, on the role of the custodian, and pp 811-821 on the trustee’s lien and indemnity [8]. Overall, the trust much more effectively than agency and bailment meets the needs of *both* the EI and the CB (see Austen-Peters, paras 2.30-2.32). As U&H also comment: ‘The trust is, therefore, a very flexible, useful device; its uses are as unlimited as the imagination of lawyers in taking account of the wishes of bankers and businessmen in the commercial context’. It is not surprising that Maitland (*Selected Essays*, 1936, p 129) regarded the ‘trust idea’ as ‘the greatest and most distinctive achievement performed by Englishmen in the field of jurisprudence’.

That said, as Ooi comments (p xxx), in exploring the private international law aspects of the custodianship of a portfolio that includes a proportion of directly-held overseas equities and bonds, the problem of *situs* is not necessarily dealt with by the English Law trust concept and hence such EI holdings, like the EI cash, may be subject ‘to at least as many foreign law risks as there are nationalities of shares held…’: ‘present rules [within the conflict of laws] are not sufficiently certain and predictable, nor theoretically coherent…’. See also Dalhuisen, Goode and Wood cited above; along with Chapter 10 of Austen-Peters, who notes ‘the myriad possible custodial scenarios’ that arise as cross-border securities trading grows within ‘the increasingly global marketplace’ (para 10.03) and cites *Macmillan Inc v Bishopgate Investment Trust plc (No 3)* [1996] 1 WLR 387, CA, as applied in *Re Harvard Securities Ltd* [1997] 2 BCLC 369. The conflict of laws mess could like something like this, with bits of the EI’s overseas equities holdings tangled up in the legal dispute: the EI, FM and the local CB office are all in common law country A (and the agreements between them are under the law of country A, which does not have legislation on custody); the HQ of the CB is in civil code country B, which happens to have specific legislation regulating custodianship; the CB is in dispute with three of its sub-custodians/nominees, one in another common law country C (which has legislation governing custody arrangements), another in civil code country D (no such legislation), and a third in civil code country E (with legislation on custodianship); and, in so far as the securities physically exist anywhere (as opposed to being 'dematerialised' reference numbers transferred from one CB/sub-CB IT system to another as they are bought and sold) they are 'immobilised' in depositories in countries C and D… Should the EI be worried, and, even if it is, can it realistically do anything useful? Yes, it should be; but, no, there is probably nothing the EI can do. Could the EI, in exercising due diligence before appointing the CB, have reasonably been expected to vet the CB's chain and tiers of sub-custodians? Hardly. Can the EI reasonably rely on the fact that the FSA has approved the CB? Presumably.

**Uncertainty and risk**

Given that the operation of global custody is crucial to the twenty-first century world of fund management and that it (supposedly [9]) safe-guards £'000s of billions of securities belonging to charities, pension funds, unit trusts and investment trusts, it is strange that there is any doubt at all over the legal vehicle being used: even if there is a strengthening consensus that, under English Law and in other common law countries (unless they have appropriate legislation governing custodianship) trust law is the most appropriate legal analysis. A charitable view might be that the professionalism and common-sense of the custodian business means that there has been no need for litigation and hence there is no definitive case-law; perhaps things just do not go wrong and the custodian's lien and indemnity are never invoked, nor the efficacy of the ring-fencing tested in litigation. Moreover, given that the safe-custody of the securities is a matter of trust law, and that of the cash is covered by general banking law, the concepts of lien, of a general (banker's) lien [10], of pledge, of set-off, and of indemnity do all apply: hence the somewhat scatter-gun effect of the sample wording in Note 5 (including its rather desperate appeal – perhaps hinting at Ooi's concerns over the *situs* problem - to 'other rights to which it [CB] may be entitled under any applicable law'!).

A less charitable view could be that the custodian industry should by now be clear over the legal underpinning of its activities, and should communicate rather more effectively with its customers as to the exact nature of the legal relationship the client and custodian are creating. Increased clarity would be useful in helping charity trustees comply with the Trustee Act 2000 which imposes a statutory duty of care (defined in s1 as exercising 'such care and skill as is reasonable in the circumstances') in relation to the appointment of 'agents, nominees and custodians' (ss 11, 16 and 17) and in the review of such arrangements (s22). The Members of Councils in chartered universities and the Members of Boards of Governors in statutory universities are charity trustees (see Chapter 4 of D. Palfreyman & D.A. Warner, 2002, *Higher Education Law*; and D.J. Farrington & D. Palfreyman, 2006 (forthcoming, Oxford University Press), *The Law of Higher Education*), as are the governors of independent schools, as those controlling the EI for the purposes of the Charities Act 1993. For the governors and managers of the EI to appoint a FM and hence indirectly a CB, or to directly appoint a CB, without being certain whether the endowment securities are to be held in trust by the CB and thereby most effectively ring-fenced (assuming, as noted earlier, that they are effectively designated as the EI's assets within the CB's records, and not those of the CB itself or of the FM alone) [11], and without fully understanding the extent of the indemnity given to the CB if a trustee, might suggest the exercise of insufficient ‘care and skill’ and potentially give rise to a breach of trust. This could still be the case even if the EI wins any litigation with CB over the reasonableness of exclusion and limitation of liability clauses (Austen-Peters, paras 7.29 & 7.30), or successfully challenges the scope of the CB’s indemnity clause, or convinces a court that the CB has acted improperly in its trustee role and should not be protected by the indemnity, or shows that the CB has failed in its duty of care (Austen-Peters, paras 7.11-7.16), or can get the FSA to declare that the CB has breached its rules (Note 12; and see also Austen-Peters, Chapter 9, describing the mid-1990s impetus for enhanced regulation that came from the Maxwell raids on the Mirror Group pension funds and from the collapse of Barings Bank arising from the wrongful acts of Mr Leeson).

**What is to be done?**

This legal uncertainty and the very different wording used by CBs in their standard contracts mean that EIs being sensibly cautious about entering into such custodian contracts (either directly or indirectly via their FM contract) could each incur significant lawyer fees in checking out the proposed custody agreement. What might be done to prevent the legal wheel being expensively reinvented whenever an EI needs to appoint a FM/CB? Short of some form of national, EU or even international legislation and regulation [13]… the EIs could collectively take legal advice and then agree what standard terms they will accept from the CBs, thereby leaving them as EIs less vulnerable to being faced with a take it or leave it attitude on the part of the CBs than is the case when one EI alone tries to renegotiate the standard terms of a CB. The FSA in regulating CBs could suggest/approve model terms for a custody agreement (see Austen-Peters, para 7.28). The CBs might collectively standardize their individual standard terms in an attempt to be more customer-friendly, and especially to charities that have better things to spend their money on than legal fees. The Charity Commission, as the ultimate regulator of EIs, could tell EIs that they should not agree over-broad and uncapped indemnity clauses in CBs’ standard agreements, thereby putting charity assets at (albeit very remote) risk, and it too might propose model terms (a starting point could be for less well-funded charities to see just what terms the charity ‘big-boys’ such as the Welcome Trust are prepared to accept in a global custody agreement). The OFT could scrutinize the CB industry, as once it cleaned up the photocopier hire industry and just as it is currently investigating alleged fee-fixing at the independent schools end of the EI range.

**Conclusion**

But that is in theory what might happen, what could be done if there was the willingness to be proactive. What is likely to happen in practice? The EIs are not noted for their collectivist efficiency (possible illegal collaboration over school fees apart!). The FSA will not want the hassle of knocking CB heads together. The CBs are in a near-monopoly position and their client base is conveniently fragmented: no need for them to bother being customer-friendly and to curtail their lawyers from armour-plating the standard agreements ever more in favour of the CBs (and nor, in a competitive low-margin business, is it economic for them to have to negotiate over these standard terms, and especially with one small charity at a time). The Charity Commission will hesitate to interfere with the CB's protective lien and indemnity awarded under the same trust law that underpins charity law and also protects charity trustees. The OFT will say it is up to the FSA. So, nothing will change: each EI will have to spend what it feels necessary on lawyer fees to determine whether the proposed FM:CB custody arrangement is acceptable.

Perhaps, however, the school/college bursar or the university director of finance, having digested this article, can save a few £s of legal fees by now being a little better informed over the key issues of the EI:CB legal relationship [14] and whether it really is worth trying to get the CB to vary its standard terms a little less in favour of the supplier and make them rather less reminiscent of the trading practices of the unregulated Halcyon Days of the used-car dealer. The pragmatic school/college bursar or university director of finance may well decide, furthermore, to concentrate on: 1) ensuring that the CB is on the FSA-approved list; 2) checking that the FM has complied with FSA rules in selecting the CB; and 3) above all confirming both with the FM and directly with the CB that the EI's assets will be held by the CB in the name of the EI or of the 'FM-EI' and not in the name of either the CB or the FM alone – once this is achieved it may well, as Beaves suggests, be academic whether the assets are held in trust or under bailment, as long as they are effectively ring-fenced against the creditors of either the insolvent CB or FM [15]. Beyond such fairly simple due-diligence, the energetic EI officer might also: 4) want to see that the EI's securities can not be used by the CB for stock-lending; and 5) whether, where the asset allocation includes any substantial direct holding of US equities and/or corporate bonds, CB or FM will have a contractual obligation to file a claim on behalf of the EI when a class action securities case is under way [16].

Otherwise, the costs in terms of management time and legal fees in any detailed scrutiny of the CB standard agreement, given the rather small chance of achieving any useful changes in favour of the EI in relation to the extent of the CB's exclusion/limitation of liability clauses drawn firmly in its favour, mean that it is not cost-effective for the EI to go much further than items 1-4 above. Yet, in an age of arguably excessive and simplistic 'tick-the-box' risk assessment/management imposed on charity trustees and in the absence of any helpful guidance from the Charity Commission on just how much due diligence is appropriate, the pragmatist may well feel constrained to put common-sense to one side and reach for the EI's lawyer… Yet, having reached for the lawyer and if the lawyer is not able to provide instant reassurance, how much further can the diligent trustee be expected to go in trying to renegotiate standard terms – and, indeed, to the extent that he/she tries to do so and fails, does that mean the court might later offer less protection under the unfair terms legislation on the basis that the EI had behaved like a sophisticated B2B purchaser, had duly taken legal advice, had haggled over the standard terms, had eventually agreed the contract, and hence should not now be shouting that it was after all jolly unfair?

**Notes**

[1] For example, the Harpur Trust/Bedford Charity, which runs four independent schools in Bedford and has a permanent endowment of over £50m (the author is chair of its Endowment Committee). Some 80% is held in securities.

[2] New College has a permanent endowment of c£125m, of which around £100m is in securities.

[3] For example, the New College 'Discretionary Management Agreement' with one of its FMs has a clause on 'Safeguarding Assets': 'The Manager shall appoint a custodian on behalf of the Client… The Custodian has confirmed to the Manager that it will use reasonable care and diligence in carrying out these services and will at all times act in good faith… Investments forming part of the Portfolio may be pooled… Such investments may not be identifiable by separate certificates or other physical documents of title… The Manager does not accept liability for any loss due to the negligence, willful default or fraud of the Custodian or any of its nominee companies or agents… The Client's money shall be held in pooled client bank accounts with the Custodian…'.

[4] The New College contract with one of its FMs contains such clauses as 'Liability of Manager' (limited only to the Manager's 'negligence, wilful default or fraud') and 'Client's Warranties and Liabilities' ('… the Client agrees to indemnify the Manager and its employees or delegates against all costs, losses, claims and expenses which may reasonably be incurred by the Manager… arising out of any action properly taken by the Manager in accordance with the Agreement…'). With respect to the extent of the EI's indemnity to the FM it might be possible to get this limited to the value of the portfolio, rather than potentially the *entire* endowment and *all* the functional assets of the EI being put at risk (vanishingly remote or not). After all, if this clause is designed to cover the indemnity the FM has in turn given to a CB as a trustee (*if* the CB is indeed a trustee – see discussion in the main text), then the limit to that FM:CB indemnity will be the total value of the assets held in trust, since the trust law lien/indemnity protection of trustees does not extend to the trustees being able to sue the beneficiaries personally should the entire value of the trust fund be exhausted in meeting the claims of the trustees.

[5] a) For instance, the following extracts from a FM:CB 'Global Custody Agreement': the Bank will open 'Securities Accounts' and 'Cash Accounts'; 'The Bank may cause the Client's Securities to be held in an omnibus account with one or more other customers…'; '… the Client agrees to indemnify the Bank and each of its Affiliates on demand against each and every claim, loss, liability or cost that may be suffered or incurred by the Bank…'; '… the Bank will carry out its duties under this Agreement with the skill and care reasonably expected of a professional custodian and banker…'; '… [the Bank will be liable to the Client only for any loss that is] a direct result of the negligence, willful default or fraud of the Bank…'; 'The Bank… may set off or transfer any sums held for the Client… towards the satisfaction of any liability of the Client to the Bank…'; '[If the Bank] incurs any losses, costs, liabilities or expenses for the Client's Account pursuant to this Agreement, [the Bank], in addition to any general lien or other rights to which it may be entitled under any applicable law, [will] have a general lien and right of pledge on all or any of the Assets in the Account until the satisfaction of all sums (including interest, fees and expenses) for which the Client is from time to time liable to the Bank or its Affiliate under or in

connection with this Agreement…'; '... where the Client is acting as agent or on behalf of one or more other persons [FM's clients], all obligations and liabilities under this Agreement will be deemed to be joint and several…'.

b) This CB's willingness to accept at least some liability is welcome compared with the standard term in the draft FM:CB contract of a competitor that went this far in excluding liability (the CB shall be 'absolved from any liability howsoever arising') and in limiting liability (the CB 'shall only be required to exercise that degree of care which it gives to its own property of a similar kind under its own custody in the relevant market, and shall not be subject to any stricter standard of care or more extensive liability whether under the terms of this Agreement or the tort of negligence or pursuant to any fiduciary duty which [CB] may be found to owe to the [FM/EI]…'). In fact, that CB did agree to amend this limitation of liability clause to accept that the CB should 'exercise that degree of reasonable skill and care expected of a professional custodian'.
c) Such exclusion and limitation clauses seem excessive. After all, as R-M. Antoine (*Trusts and Related Tax Issues in Offshore Financial Law*, 2005) notes (para 10.107): 'Very wide exemption clauses make nonsense of the fundamental rule binding trustees to carry out the duties imposed under the trust [*if* global custody is indeed a trust over the assets] honestly and in good faith. They may also violate the principle that there are certain fundamental duties (irreducible core duties) which must be left to a trustee to perform if a trust is to subsist' (citing D. Hayton, 'The Irreducible Core Content of Trusteeship', as Chapter 3 of A.J. Oakley (ed), *Trends in Contemporary Trust Law*, 1996).
d) Hayton regards these core duties of trusteeship as including (presumably even for a CB *if* global custody is the creation of a trust): neither the exclusion of the duty to act in good faith (honestly and consciously) nor exemption from liability for 'reckless indifference' (as opposed to ordinary negligence and probably even gross negligence). If the FM:CB agreement really can reduce the duties and liabilities of trusteeship to a core as minimalist as not including gross negligence let alone ordinary negligence (and might even permit the exclusion of reckless indifference), it is hardly surprising that some commentators see the Law as tending 'firmly to favour custodians' (see Note 13 below).
e) Moreover, as Antoine also notes (para 10.108): 'intriguingly' courts have found that the duty to exercise care and diligence is not part of such a core of trusteeship and 'they have held that all that is required is that the trustee acts honestly, in good faith, and reasonably'; seemingly, clauses 'attempting to exempt liabilities where trustees act negligently, imprudently, or even contrary to the skills which they proclaimed that they had, do not violate public policy and are allowed' (citing *Armitage v Nurse* [1998] Ch 241). The clause at issue in *Armitage* reading: 'No trustee shall be liable for any loss or damage [to the assets of the trust] at any time or from any cause whatsoever unless such loss or damage shall be caused by his own actual fraud…'. Antoine doubts, however, whether such generous treatment should (or would) apply to professionals acting as trustees (as, arguably, in the case of CBs): and here UCTA 1977 perhaps also impacts. Moreover, if the CB really deserves to be let off liability, there is always the court's discretion available to any deserving trustee under s61 Trustee Act 1925 to relieve the trustee 'either

wholly or partly from personal liability' if the court thinks the trustee 'has acted honestly and reasonably, and ought fairly to be excused for the breach of trust'.

[6] One University with direct agreements both with a FM and also with a CB could not negotiate a cap on its general liability to the CB, but did get a £1m limit in relation to any contamination of CB's IT system by negligence on the part of the FM in electronically communicating with the CB, while also ensuring that the FM carried insurance for that £1m. The relevant wording in that EI:CB agreement in relation to the general indemnity was: 'The Customer [EI] shall be liable for and agrees to indemnify and keep indemnified and hold harmless [CB]… against and from any and all Losses howsoever arising from or in connection with this Agreement or the performance of [CB] duties under this Agreement including disputes between the parties or the enforcement of this Agreement, provided that nothing in this Agreement shall require that [CB]… be indemnified for [its] fraud, negligence, wilful default or breach of terms'. In respect of the electronic communications, the wording read: 'The Customer warrants that the Customer shall be fully responsible for any Authorised Third Party's use of Electronic Access [ie. by the FM]… The Customer shall use reasonable endeavours to ensure that no computer viruses, worms, software bombs or similar items are introduced into Electronic Access [by the FM] and will indemnify [CB] for any Losses that it suffers as a result of any such introduction'.

[7] Key texts consulted:

**Agency** *Bowstead & Reynolds on Agency* (2001)

**Bailment** N. E. Palmer (1991) *Bailment*

**Custody** A. O. Austen-Peters (2000) *Custody of Investments: Law and Practice*

J. Benjamin & M. Yates (2002) *The Law of Global Custody: Legal Risk Management in Securities Investment and Collateral*

J. Benjamin (2000) *Interests in Securities: A Proprietary Law Analysis of International Securities Markets*

M. S. Ooi (2003) *Shares and other securities in the conflict of laws*

A. W. Beaves, 'Global Custody – A Tentative Analysis of Property and Contract', in N.E. Palmer & E. McKendrick (1998) *Interests in Goods*

**Trusts** *Underhill and Hayton Law of Trusts and Trustees* (2003)

See also A. Pretto-Sakmann, 2005, *Boundaries of Personal Property: shares and sub-shares*, discussing the very essence of shares as securities within the taxonomy of personal property and 'the sleepy academic debate around it', analyzing the literature (including Benjamin, Austen-Peters, and Ooi), and challenging the Benjamin thesis of dematerialized shares-as-property with the idea of such shares-as-also-obligations.

[8] U&H comment: 'The right to an indemnity is normally crucially important for a trustee', noting s31 of the Trustee Act 2000 ('A trustee (a) is entitled to be reimbursed from the trust funds, or (b) may pay out of the trust funds, expenses properly incurred by him when acting on behalf of the trust.') and that 'expenses' will include damages properly paid out to a third-party (whether in contract or in tort) and all costs arising from necessary litigation; and also commenting that this indemnity will 'cover actual and contingent liabilities and also possible potential liabilities that can be identified', and that it 'takes precedence over all beneficial interests' (pp 812-819).

[9] The safe-guarding, of course, is, and can never be, total: the securities held in the UK may be effectively ring-fenced, but the cash has no special protection under trust law; the securities held by sub-custodians in the USA, elsewhere in Europe, and in the Far East may be even better protected by local legislation defining and regulation applying to global custody, or they may not *and* the local general law might prove less effective at protecting the EI's equitable/beneficial ownership than the English law of trusts: see Ooi, as others, as considered above. There is, of course, also the fact that, on newly appointing an FM, the EI may have transferred a sizeable amount of cash for the FM to begin to invest via the CB, or, similarly, on the EI terminating its EI:FM contract, the CB may legitimately have transferred a significant lump of cash back to the FM for onward transmission to the EI (or the EI's new FM): what if, at this very point that the FM is holding the cash (rather than the CB), the FM becomes insolvent? Or if at this point there is fraud within a small FM which does not have substantial business assets from which to compensate clients for any such fraud?

[10] See Palmer on locatio custodiae (p 773), and the banker's general lien over deposited paper/tangible securities arising as a matter of commercial custom based on the law merchant (pp 773, 774 & 879); as confirmed in *Paget's Law of Banking* (M. Hopgood, 2003, paras 29.2 & 29.4), even if such depositing of securities for safe custody would normally be 'inconsistent with a right of lien' unless (as is indeed the case with CBs) the bank also collects in dividends and interest (para 29.9) – the point is then made that set-off, or the right to combine assets, is a better analysis than the concept of the banker's lien (para 29.13).

[11] There is some doubt as to whether the FM:CB agreement needs expressly to declare that the assets of FM's client(s) – the EI – will be held in trust (and, similarly, where an EI:CB agreement is made directly between the EI and CB), or whether it is sufficient for there merely to be evidence of the intention to create a trust. But in the event of a dispute and litigation how would such an intention be demonstrated subsequently by either or both of the parties? Why would the EI want to assert a trust but the CB deny its existence? Perhaps if the latter had failed to meet the high level of fiduciary duty expected of a trustee, and especially as a professional trustee who must also meet 'the duty of care' set out in s1 of the Trustee Act 2000 as being 'such care and skill as is reasonable in the circumstances' enhanced as appropriate if the trustee has 'any special knowledge or experience that it is reasonable to expect' – here, of a CB business? Or vice-versa, the EI challenging the applicability of the trust concept? Perhaps if the EI was unhappy that the CB was unreasonably invoking the very broad indemnity due to it as a trustee*? As in some other countries (notably the USA: see Austen-Peters, paras 5.06 & 5.07, plus 5.22) it might yet be preferable if the global custody industry operating within the UK was defined and regulated under specific modern legislation (see Note 12 below), rather than relying on a consensus among practitioner lawyers that certain academic lawyers (notably Austen-Peters and Benjamin) have produced a convincing analysis of the legal relationship between the CB and the clients of the FMs with which it has a global custody agreement as being based on the law of trusts. *One reason that the New College FM requires an indemnity from College, as worded in Note 4 above, is because the FM's global custody agreement will in turn require the FM to indemnify the CB, possibly in the 'joint and several' way referred to in Note 5 above.

[12] The FSA (Financial Services Authority) regulates CBs: see its rules re 'Clients Assets' and 'Custody' at the FSA web-site (http://fsahandbook.info/FSA/handbook.jsp?doc=/handbook/CASS/2/1). These rules cover the role of the FM in 'arranging the safeguarding and administration of assets' for its clients with a CB selected by the FM, as well as the CB itself as the custodian, and are designed 'to restrict the commingling of client and [FM or CB] assets… or [the assets] being treated as the firm's assets in the event of its insolvency'. Where the FM selects a CB it 'must undertake an appropriate risk assessment of that custodian', including 'taking into account', inter alia, 'an appropriate legal opinion as to the protection of custody assets in the event of the insolvency of the custodian'. (Might, or indeed should, the EI request sight of the risk assessment and of the legal opinion, or be content with an assurance from FM that it has complied with FSA guidance in selecting and appointing the CB?) Similarly, 'an explanation of pooling' should be provided, and the client warned that, 'in the event of an unreconcilable shortfall after the failure of the custodian, clients may share in that shortfall in proportion to their original share of the assets in the pool'; while the FM should also ensure that 'the custodian will not claim any lien, right of retention or sale over any [EI assets] except where the firm has notified the custodian in writing that the client has provided written consent or in respect of any charges relating to the administration or safekeeping of the [assets]'. The FM needs to advise the EI of 'the extent of the custodian's liability in the event of the loss of a safe custody investment caused by the fraud, wilful default or negligence of the custodian'. The FSA Handbook does not explicitly state that the EI:CB legal relationship is founded in the law of trusts: a point noted by G. Thomas & A. Hudson (2004, *The Law of Trusts*) who, in considering the power of the FSA under the Financial Services and Markets Act 2000 (Sch 2, para 5) to regulate FMs and CBs that hold client assets in custody, comment that there is 'no clear use of the term 'trustee' [in the FSMA]…', although they agree that such custodianship is 'more closely analogous to the role of trustee' (para 47.20). Like Austen-Peters and Benjamin, they further note that, following *Hunter v Moss*, it is possible to have a trust of intangible property, such as financial instruments, even if the property is not segregated and hence can not be identified (para 48.07).

[13] The Financial Markets Law Committee's Report on Property Interests in Investments (www.fmlc.org) was given the remit of drafting 'proposals for an investment securities statute' and duly considered the US experience of the 1994 redraft of Article 8 of the Uniform Commercial Code as 'the most fully developed, market-responsive set of rules governing investment securities' that has 'made the market more efficient and workable': all in all, a model for improving English Law 'to meet the legitimate needs of the modern market' (including the key provision of 'insolvency immunity' as in Article 8-503 (a) of the US legislation). Austen-Peters (para 7.45) argues that: 'Under general law, the balance between the protection of investors' interests and the right of custodians to avoid liability seems firmly to favour custodians'; while 'the cost and complexity' of the investor seeking redress against the custodian also suggests the need for greater regulation (para 8.01). Note that the EU 2007 Directive MiFID, along with the impact of Basel II and UCIT III, will add to the regulation (and complexity) of global custody (and indeed of fund management).

[14] Austen-Peters (pp 207-9) provides a useful check-list of key issues for the EI to consider in reaching an agreement with a CB: (inter alia) from whom does the CB take instructions (the FM?); are the assets on loan or held on trust or in bailment to

protect them in the event of CB's insolvency; will the assets be pooled; what is the liability of the CB for its fraud or negligence; who is liable for fraud or negligence on the part of a sub-custodian; what may the assets be used for; can they be used for stock-lending; what are the CB's reporting obligations; should the CB 'whistle-blow' on the FM; is there a lien in favour of CB; does CB have an indemnity; will the CB exercise share-holder voting rights; what is the governing law? See also Note 12 above as to whether the EI should add to this list requesting the FM to show it has met FSA guidance in selecting and appointing a CB. If the CB is to be appointed directly by the EI should the EI by way if due diligence itself do the same risk assessment and obtain a legal opinion as the FM would be expected to do by the FSA – or can the EI reasonably rely on the fact that the CB is on the FSA-approved list?

[15] The EI will be charged a fee by the FM, and that fee will usually have rolled up within it the fee charged by the CB to the FM for global custody services (perhaps a minimum of £40/45K pa for a small FM and all its clients). If the EI goes for a direct agreement with a CB it is likely to cost in fees at least £20K pa, and the FM is unlikely to reduce its fee to the EI since it will hardly save anything on the FM:CB fee by not adding the EI to that arrangement. If, moreover, the EI is less able to renegotiate the CB's standard terms than even a small FM, the only reason that an EI would want a direct EI:CB contract is to cover the (hopefully vanishingly remote) risk that, in theory, the FM within a FM:CB arrangement could instruct the CB to liquidate all the EI assets and transfer the cash to the FM's account, and the (small) FM predominantly owner-manager team might then abscond with it! Presumably that is a less likely scenario with a large FM, where such collusion is more difficult and where other employees would anyway be left behind and remain in place to run an underlying sound business. It seems unlikely, however, that an extra fee of, say, £25K pa (including VAT) as perhaps an addition of 20% to the cost of fund management for a medium-sized portfolio could be justified as proper use of charity expenditure, or equally unlikely that the EI trustees could be criticized for not closing out this very remote risk of fraud on the part of the small/'boutique' FM: but, again, it would be helpful for charity trustees to have some guidance from the Charity Commission as to just how paranoid they should be in fulfilling their general fiduciary duty and now their statutory duty of care in appointing a FM/CB.

[16] In Cox, J.D. & Thomas, R.S. (2005) 'Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements', 58 *Stanford Law Review* 411, the interesting issue is addressed of the fiduciary duty of care upon the trustees of an institutional fund to ensure they recover for the fund its share of any damages arising from securities fraud class actions (in 2004 such actions produced c$5.5 billion in the USA: eventual probable settlements in respect of Enron, WorldCom, Tyco, etc, could easily dwarf that figure…). In many cases the fund will rely on CB at least to alert them of the opportunity to make a claim if not to fully act on their behalf in filing a claim. Thus, the CB might, in turn, incur liability to the fund if it does not properly discharge this task. As Cox and Thomas argue, such liability might arise either under the contract between investor and CB imposing 'either explicitly or implicitly' upon the latter the professional obligation that, as the agent of the former, it will exercise the degree of care expected of the reasonable and average custodian; or under the general fiduciary duty upon the CB ('The custodian holds legal title to the securities that its customer, the institutional investor, owes

beneficially and must manage this property for the benefit of the institutional investor. This control over the property of another creates fiduciary obligations under both the duty of care and duty of loyalty in performing its duties.'). This analysis of the legal relationship between the investor and the CB seems to fit with the one explored in this article in terms of the EI and its CB. The investor may well wish to check its agreement with CB in relation to this issue of US securities class actions (assuming it has a directly invested asset allocation in US equities and corporate bonds), and also consider what happens if it changes CB (will the former CB continue to notify the investor of, or even to act for the investor in filing for, any such action arising from what might be holdings that have since been sold?). Similarly, if the EI holds equities/bonds via FM's unitised vehicle(s) for the USA and if the investor changes FM, it seems unlikely that X years later a cheque will arrive for the EI's share of the amounts recovered by the unit trust via any securities class action settlements!



SUPPLEMENT (27/4/07)

In M. Blair & G. Walker, 2006, Financial Services Law (OUP) the following points are made:

a) 'Whilst it would be ideal for clients to have legal title to their regulated investments, in practice this rarely happens' (10.154).

b) Re 'depositaries outside the UK which are subject to different legal and regulatory systems' - 'Such arrangements frequently present complex questions of insolvency law and conflict of laws as to the level of protection afforded in the event of the third party's insolvency or the occurrence of other supervening events' (10.157).

c) 'There are conflicting authorities (and therefore the law is far from being settled) on the question of whether or not fungible securities held by a custodian are capable of forming the subject matter of a trust (the issue being lack of certainty as to the subject matter at any given time)' (10.158).

d) 'It is clear, however, that whilst the rules [FSA CASS re custody, collateral, client money] seek to minimise any risk of loss to investment firms' clients they by no means guarantee that clients will not ultimately suffer loss' (10-150).