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# **CUSTODIAN SERVICES IN THE ISRAELI CAPITAL MARKET**

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## **FINAL RECOMMENDATIONS OF THE INTERMINISTERIAL COMMITTEE**

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December 2011

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## **1. Background**

In August 2010, the Interministerial Committee for the Examination of Custodian Services in Israel and the need to Improve its Regulation (hereafter: the “Committee”) submitted to the Minister of Finance a detailed interim report, which summarized its findings and recommendations (hereafter: the “Committee’s Interim Report”).<sup>1</sup> Since that time, the members of the Committee have worked in full cooperation to formulate its final conclusions, which will take account the comments of the public and the recent changes in custodian legislation in the US and Europe.

In this report<sup>2</sup>, the term “custody” relates to the service of safekeeping securities for their owners in a manner that documents the investor’s ownership rights and protects them, as well as allowing the investor to benefit from the fruits of that ownership. Properly functioning custodian services in the capital market provide the foundation for sound financial activity, since they guarantee the investor’s most fundamental rights in the capital market.

As stated in the Committee’s Interim Report, the global financial crisis reached its peak during the period of the Committee’s work. Two main phenomena of the crisis were the focus of regulatory attention and they raised the priority of custody to an even higher level on the international agenda. The first is the damage to the resilience and stability of various financial institutions, which emphasized the importance of protecting client assets during a collapse, including the maintenance of appropriate

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<sup>1</sup> See [http://www.isa.gov.il/Download/IsaFile\\_5026.pdf](http://www.isa.gov.il/Download/IsaFile_5026.pdf).

<sup>2</sup> The official report in Hebrew may be found at [http://www.isa.gov.il/Download/IsaFile\\_6427.pdf](http://www.isa.gov.il/Download/IsaFile_6427.pdf)

segregation between assets of the custodian and those of the clients (i.e. segregated accounts).<sup>3</sup> The second involves the cases of fraud that came to light, which emphasized the importance of enforcing the obligations of intermediaries in the capital market in the provision of custodian services, particularly with regard to the appropriate recording of asset ownership rights and ongoing reconciliation of those records. These two phenomena involve the most fundamental obligations of custodians with regard to the provision of custodian services.

The importance of these principles came to light recently during the collapse of the MF Global investment Bank (hereafter: MF Global), which occurred in October of this year. This event reflects the importance of custodian services in the capital market and the fact that the lack of comprehensive, clear and uniform regulation of custodian services in Israel increases the legal, operational and credit risks involved in custody, both in Israel and with respect to the public's holdings abroad.

The Committee has found that there have been major developments in the custodian market worldwide in recent years, both with respect to the market's size and the growing importance of global custodians, which constitute the main players in the market, and as a result the Committee has studied the changes in the regulation of this service worldwide. Thus, the Committee has surveyed what has been done in the developed countries and found that there exists broad and comprehensive regulation of custodian services and that in recent years there has been a clear trend towards the tightening of this regulation. In particular, the requirements applying to entities providing custodian services (whether directly or as intermediaries) have become much more stringent in the US, due to the efforts of the Securities and Exchange Commission (SEC).

The Committee found that custodian services have gained little regulatory attention in Israel, even though they are essential to the activity of the capital market, and therefore the Committee proposes that financial regulators in Israel introduce regulation in this area that are comprehensive and uniform.

This document includes a short description of the Committee's findings and recommendations (for the complete version see the **Interim Report** released to the public for comments in October 2010). In addition, it includes a description of events and trends worldwide, which illustrate the importance of regulation in this area for Israel, i.e. the collapse of MF Global and the exposure of local entities to this type of event; the increased use of custodian services worldwide; and the regulatory developments in the US and Europe, which reflect the trend toward more stringent supervision, as well as the importance attributed to this issue. Finally, the Committee's final recommendations are attached to this document as Appendix A.

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<sup>3</sup> The main question that arises in this context is the extent of clients' exposure to the risk that the creditors of a custodian in financial difficulties (or one that has collapsed) can be paid from the clients' assets, which are held for them by the custodian. If the custodian has violated his obligations and not maintained appropriate segregation between his assets and those of the clients (i.e. segregated accounts), then the clients' assets are liable to be exposed in this sense.

## **2. The work of the Committee and its recommendations**

The Committee examined the provision of custodian services in Israel, as well as in developed markets worldwide. The Committee, with the assistance of a consulting company that specializes in the area of international custody, also surveyed the regulatory systems governing custodian services in various developed countries. The Committee found that this issue is explicitly dealt with by legislators worldwide and that this includes clear and effective tools for legal enforcement.

The Committee found that the regulatory treatment of custody is insufficient. Among other things, the Committee concluded that existing regulation does not give sufficient attention to the laws and standards that govern the activity between financial intermediaries and providers of custodian services. In addition, the attention given by existing regulation to the implementation of internal and external auditing of custody services is insufficient.

The Committee has reached the conclusion that a comprehensive framework is needed in Israel to regulate the provision of custodian services, which will also relate to the foreign investments of Israeli investors. The Committee feels that the lack of comprehensive, clear and uniform regulation of custodian activity in primary and secondary financial legislation increases the legal and operational risks involved in custody and such regulation will reduce these risks, increase the confidence of the public in the capital market in Israel and improve the attractiveness of the market for foreign investors.

The recommendations of the Committee regarding the content of regulation in this area are derived from, among other things, an examination by the Committee of the needs of local and global investors and of active participants in the Israeli capital market and an examination of the accepted standards worldwide in this area.

As described in detail in this document and its appendixes, the custody of financial assets in the US is subject to accepted legal principles, federal and state law and contract law and the UCC, as well as specific laws according to the nature of the parties and of the assets, including investment funds, pension funds and investment advisers.

In the EU, custodian services are regulated as part of the Markets in Financial Instruments Directive (hereafter: MiFID), as one layer within a coherent and efficient framework regulating investment services, which focuses on the obligations of investment firms.<sup>4</sup> For additional details, see Appendix D.

The Committee recommends instituting minimum uniform requirements that will apply to anyone providing custodian services for securities and financial assets in the capital market in Israel, whether directly or indirectly. It should be mentioned that, in many cases, clients do not deal directly with the entity providing custody of their assets but rather with an intermediary, who arranges the custody of the

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<sup>4</sup> See the Directive of the European Committee EC/2004/39 and 2006/73/EC (hereafter: the “MiFID regulations”).

assets on their behalf with a third party (i.e. a third party custodian). Therefore, a significant portion of the Committee's recommendations focus on the standards that obligate intermediaries with respect to proper custody.<sup>5</sup>

Please find below a summary of the issues covered by the Committee's recommendations:

- **Definition of custodian services and providers of custodian services for the purposes of the report:** The Committee's recommendations are focused on the regulation of core services related to custody.<sup>6</sup> The Committee defined the key links in the chain of custodian services provision for the purposes of the report, including the intermediary, the custodian, the third party custodian and the sub-custodian.
- **Definition of the basic obligations of a custodian services provider:** The obligations include ensuring the ownership rights of client assets and client cash and ensuring the rights accompanying the ownership of assets (such as, rights in the distribution of a dividend or interest payments), including the right to realize them.
- **Segregation of assets, records and documentation, reconciliation requirements and reporting requirements:** The Committee recommends imposing a number of obligations whose purpose is to facilitate separate identification of the clients' assets, a continuous ability to monitor the existence of the assets and the recording of their ownership rights and the ability of the client to monitor his assets. The Committee also recommends the establishment of clear internal procedures in this matter.
- **Dealing with client cash:** The Committee recommends the adoption of principles for dealing with client cash that is incidental to custodian activity, with the purpose of ensuring the appropriate custody of the cash.
- **The appointment of a third party custodian and the ongoing supervision over him:** The Committee recommends imposing a number of requirements in the choice of a third party custodian and the ongoing supervision over him, in order to protect the client's basic interests. The model that was adopted by the Committee does not limit the entities in the market in their relations with a third party custodian. However, the Committee recommends that regulatory obligations be imposed on the intermediary in order to ensure the client's rights. Among other

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<sup>5</sup> This applies to local investments and is certainly correct for investments abroad.

<sup>6</sup> The Committee surveyed a variety of services provided by a custodian: **custody** – the holding of securities purchased by the client. This is the basic service provided by a custodian, from which are derived all the other services; **settlement** – the transfer and receipt of securities and cash receipts derived from the sale or purchase of those securities; **asset servicing** – the custodian is responsible for ensuring that his clients benefit from payments and rights derived from ownership of the securities with respect to income events, according to which the client is entitled to various payments (such as dividends or interest) or **voluntary and involuntary corporate actions** as a result of which the client is entitled to certain benefits (such as splits of a security and acquisition offers); **other services** – since the custodian has extensive experience and familiarity with market practice, he is responsible for updating the client with regard to any major changes in market conditions, trading and settlement procedures and taxation issues. It should be stated that according to current practice, global custodians provide an additional layer of services that are aimed primarily at improving the quality of the management of securities deposited with them by their clients and income produced from those securities.

things, the Committee recommends that an obligation be imposed on the intermediary to take into consideration certain criteria in choosing a third party custodian, with the purpose of ensuring that the third party custodian can fulfill his role appropriately, and that rules be established to implement the criteria in the selection process. It is also recommended that the intermediary be obligated to sign a contract with the third party custodian in order to formalize the legal relationship between them, which will include instructions that are meant to ensure that the intermediary can fulfill the requirements proposed in the recommendations. The Committee is also introducing disclosure requirements in the case of a relationship with a third party custodian, including a requirement to present the methodology used in selecting the third party custodian and the manner in which it was used.

- **Responsibility for failure or damage:** The Committee dealt with the question of the custodian's responsibility towards a client due to damage or failure, as well as the responsibility of an intermediary due to failures caused by a third party custodian. Following the public discussion, the Committee decided not to establish a rule determining responsibility as part of its recommendations (and thus left this issue to be solved legally according to general law). Nonetheless, the Committee recommends that the legal relations between an intermediary and a third party custodian be formalized according to an agreement to be signed between them, which will determine, among other things, the arrangements for contractual responsibility in the event of damage to the client's assets. The Committee also recommends that the arrangements for responsibility be taken into consideration in the selection of a third party custodian by an intermediary.
- **Transactions in client assets:** The Committee recommends a number of conditions that need to be fulfilled in order for a custodian or intermediary to carry out transactions (such as lending) in the client's assets.
- **External auditing:** The Committee dealt with the question of external audits of custodian services and, following an in-depth discussions and after studying the corresponding requirements in international regulation, recommends the implementation of an external independent audit of custodian matters, which will be carried out at least once annually. As part of the audit, an examination will be made of the record systems with respect to the assets and cash held in custody, as well as the internal system of procedures and audits.
- **Regulation, supervision and enforcement:** The Committee recommends that the regulator who supervises the activity of a custodian or an intermediary will verify the regulation, supervision and enforcement of the proposed recommendations. It should be emphasized that the Committee did not in general deal with the matter of supervision and the functions of the supervisors and left these matters to be considered by each of the supervisors.

### **3. Main trends in the custodian market worldwide**

In recent years, there has been a clear upward trend in the use of custodian services and in the volume of assets involved, where global custodians control a dominant share of the global

market.<sup>7</sup> This trend, which can be expected to continue, is a result of, among other things, the following factors:

- 3.1 An increase in cross-border trade in assets, the expansion to emerging markets and to transactions in a wider variety of financial instruments.
- 3.2 The preference of banks and investment managers to obtain services from global custodians rather than local ones, due to, among other things, their economies of scale.
- 3.3 Many countries, including Israel, encourage their citizens to save for the long term and even require this by law. The public's savings are channeled to institutional entities that require local and global custodian services.

Custodian services are on the one hand very costly and on the other hand involve significant risk to the service provider if he fails in providing service to his customers. In addition, this market is characterized by fierce competition among the large global banks, as a result of which profit margins on a transaction are kept low. This situation has led to the development of concentration in the global custodian industry, with the result that it is controlled by a small number of global financial institutions who are known as global custodians. They specialize in the holding of securities for investors in most of the world's markets and essentially facilitate it. Therefore, they constitute a critical part of the market infrastructure in all the developed markets and fulfill an important role in the opening up of developing markets.<sup>8</sup> Thus, for example, 75% of the value of assets deposited with custodians worldwide is held by only four banks (directly or indirectly).<sup>9</sup>

In view of the importance of custodian services in the global capital market, there are a number of commercial companies that provide analytical services to custodians and provide ratings of custodians.

#### **4. The global financial crisis as background to the Committee's recommendations**

During the period of the Committee's investigation, there was a major deterioration in the situation of international financial institutions. Starting in 2008, when the financial crisis began, reports of financial institutions that had gone bankrupt or were in an unstable situation became more and more frequent. Thus, for example, the collapse of MF Global, an American investment company was reported in October 2011. There are suspicions that, among other things, the

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<sup>7</sup> [http://www.globalcustody.net/asset\\_under?custody/](http://www.globalcustody.net/asset_under?custody/)

<sup>8</sup> Global custodians can operate in two alternative ways. According to the first model, the global custodian himself enters into a market and in general becomes a member of the stock market and/or its clearinghouse in that market (e.g. the membership of Citibank in the Tel Aviv Stock Exchange Clearinghouse). In the second model, the global custodian becomes the client of a sub-custodian in the specific market. In the first model, the global custodian is the institution that directly holds his clients' securities in that market. In the second model, the global custodian becomes a link in the ownership chain described above, where the sub-custodian serves as the party actually holding the securities in the clearinghouse, while on his books he holds the deposit of a security in the name of the global custodian.

<sup>9</sup> [http://www.mdo-services.com/fileadmin/templates/pdf/publications/MGI%20Presentation\\_2009%20final.pdf](http://www.mdo-services.com/fileadmin/templates/pdf/publications/MGI%20Presentation_2009%20final.pdf)

company did not segregate its funds from those of its clients, that it used client funds when it became financial distressed and that there was inadequate monitoring of the flow of funds and their designation.

The deposit of securities and funds with a custodian that is not careful about properly segregating between its own assets and those of its clients can expose the client to significant risk in a time of crisis and even during normal periods. The events during which the stability of foreign financial entities was threatened illustrate the immediate need for the regulation of custodian services, with emphasis on the segregation of clients' assets and other assets, the prevention of mixing between assets and the use of clients' assets in transactions, the selection of a custodian who meets appropriate standards and the use of continuous internal and external controls to ensure the implementation of the aforementioned principles. In particular, the present circumstances reflect the importance of imposing the proposed arrangement on the rights of Israeli clients that hold securities outside Israel. As such, the standards to be adopted regarding the domestic market shall apply to the foreign custodian through their imposition on relations between the Israeli intermediary on the one hand and the foreign custodian (the method used to select him, the contractual relations with him and the supervision over him) on the other hand. The events have also reinforced the need to define, by means of a clear contract, the extent of responsibility in the event of damage to a client.

## **5. The main recent regulatory developments**

### **5.1 American law**

The main source of regulations in the area of custody in the US is Rule 17f of the Investment Company Act (under Custody of Securities)<sup>10</sup> which proposes a coherent system of regulation to deal specifically with custodian services. This arrangement relates to the holding of assets (including securities of portfolio companies) of investment funds and in particular mutual funds. Custodian services are likely to be subject to contract and other law, depending on the type of fund or held assets. Thus, the custody of ERISA Plan Assets is also subject to ERISA,<sup>11</sup> broker/dealers are subject to the Securities Act of 1934 and the Securities Investor Protection Act (SIPA) and custody of US Treasury Securities, as well as banks that hold custodian assets, are subject to federal law and the applicable regulations. For further details on American law, see Appendix C of this document.

Another source of the regulation of custodian services in the US is Regulation 206(4)-2 of the Investment Advisers Act of 1940 which applies to Registered Investment Advisers (RIA).<sup>12</sup>

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<sup>10</sup> The Investment Company Act of 1940 at <http://www.sec.gov/about/laws/ica40.pdf>.

<sup>11</sup> Employee Retirement Income Security Act of 1974 (ERISA).

<sup>12</sup> A Registered Investment Adviser (RIA) is an investment adviser registered with the SEC. The term "investment adviser" in American law is broader than it is in Israel and also includes individuals who are generally defined as "portfolio managers" in Israel.

### **5.1.1 Tightening of the regulation of investment advisers**

Following the financial crisis and the cases of fraud that came to light, regulations in the US regarding custodian services provided by investment advisers themselves or those who contract with a third party to provide their clients with custodian services were made more stringent.<sup>13</sup> The new instructions were adopted by the SEC as part of Rule 206(4)-2 based on the Investment Advisers Act of 1940 and reflect a tightening of regulation. The instructions, which went into effect in March 2010, involve primarily the following: the imposition of an obligation on investment advisers to deposit the assets of their clients only with a qualified custodian;<sup>14</sup> the imposition of responsibility on an investment adviser that his clients' assets deposited for custody will be held by him in segregated accounts; the investment adviser is required to provide his clients with information regarding the custodian and to verify that the custodian sends a report to the client on the status of his account at least once each quarter; and the obligation that an audit be performed by an external independent accountant. For further details regarding this legislation, and in particular the nature of the audit required by the SEC, see Appendix C of this document.

### **5.1.2 The Financial Reform Bill in the US**

The Dodd Frank Financial Reform Bill,<sup>15</sup> which was passed by Congress in June 2010 and went into effect in July 2011, constitutes a regulatory response to the crisis. It also relates to custodianship and establishes the obligation of performing an audit to be carried out by an external accountant (regarding segregation of assets).

The law adds a new paragraph to the Advisers Act which is entitled "Custody of Clients' Assets" and which requires SEC-registered advisers to segregate assets and prescribes an examination of the assets by an independent account. It also authorizes the SEC to issue a set of rules aimed at protecting clients in this context.<sup>16</sup> This is the primary legislative clause,

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<sup>13</sup> It should be stated, as already mentioned, that the US regulations in this area are likely to indirectly apply to other entities (such as brokers) who provide custodian services and are a party related to the investment adviser.

<sup>14</sup> "Qualified custodians" include the types of financial institutions that clients and advisers customarily turn to for custodian services. These include banks and savings associations (Amended rule 206(4)-2(c)(3)(i)) and registered broker-dealers (Rule 206(4)-2(c)(3)(ii)). In order to allow advisers that also offer futures advice to comply with Commodity Futures Trading Commission rules, "qualified custodians" also include registered futures commission merchants. 206(4)-2(c)(3)(iii). "Qualified custodians" include foreign financial institutions that customarily hold financial assets for their customers, provided that the foreign financial institution keeps advisory clients' assets in customer accounts segregated from its proprietary assets. In addition, a Mutual Fund Transfer Agent may be considered in certain circumstances as qualified custodian (a transfer agent may serve such role to an open ended mutual fund in lieu of a qualified custodian) See SEC Commission, 17 CFR Parts 275 and 279, [Release No. IA-2176; File No. S7-28-02] RIN 3235-AH 26, Custody of Funds or Securities of Clients by Investment Advisers. Available at [http://www.sec.gov/rules/final/ia-2176.htm#P80\\_16014](http://www.sec.gov/rules/final/ia-2176.htm#P80_16014)

<sup>15</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:h4173enr.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf)

<sup>16</sup> Paragraph 411 of the Dodd-Frank Act added Paragraph 223 to the Advisers Act which stated as follows:

in contrast to Rule 206(4)-2 mentioned in the previous section which is a secondary component of the legislation.

## **5.2 The EU – Markets in Financial Instruments Directives (MiFID) II**

The MiFID regulations apply to “investment firms”, a term which is defined in detail and refers to financial intermediaries (any entity authorized to provide investment services). In our context, an investment firm can refer to a custodian or intermediary (for example, a broker or custodian) who arranges custody with a third party on behalf of his client.

In October 2011, the European Commission issued a proposed directive that amended these regulations (hereafter: MiFID II), against the background of the financial crisis, with the goal of creating a safer, more transparent and more responsible financial system, as well as to improve the European capital market.<sup>17</sup> The proposal includes a variety of tools that are meant to deal with the problems that arose during the financial crisis and imposes stringent and more comprehensive regulation, as well as a commitment from the G20 countries to improve the transparency and rationality of the financial markets.

In general, the proposal’s instructions and arrangements expand the scope of existing regulations both with respect to the range of financial products and the supervised financial entities. Among other things, the proposal changes the classification of custody services from ancillary services to investment services. This significantly alters the status of custody services as independent services even if they do not accompany other financial services that are not subject to the MiFID. According to this proposal, a custodian that provides custody services for financial instruments will be considered to be an investment firm, even if those services do not accompany other financial services, and will for the most part be subject to the aforementioned instructions. For additional details, see Appendix D.

## **6. Selection of a third party custodian**

As stated above, a significant portion of the Committee’s discussions focused on intermediaries since a large proportion of custodian services are not provided directly by a custodian, but rather through an arrangement between a financial intermediary and a third party custodian. This is certainly the case for investments of Israeli clients abroad. Therefore, an important issue in this context is the scope of obligations and requirements to be imposed on intermediaries with respect to custodian services.

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"An investment adviser registered under this title shall take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe".

<sup>17</sup> Proposal for a Directive on Markets in Financial Instruments Repealing Directive 2004/39/EC of the European Parliament and of the Council. October 20th, 2011, COM(2011) 656 final, 2011/0298 (COD). See [http://ec.europa.eu/internal\\_market/securities/docs/isd/mifid/COM\\_2011\\_656\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_656_en.pdf)

According to the model recommended by the Committee, the entities in the market should not be restricted in their relations with a third party custodian. However, the Committee recommends that appropriate norms be applied to the selection of and relations with a third party custodian and ongoing supervision over him. The Committee recommends that an obligation be imposed on the intermediary to consider certain criteria in choosing the third party custodian and to establish rules for the implementation of the criteria in the selection process.

The Committee recommends that the criteria will include the following: the ability of the third party custodian to provide an appropriate level of service; the designation of legal responsibility that applies to a third party custodian; the rules of selection used by a third party custodian with respect to sub-custodians he is connected to, including with respect to segregation of accounts at each sub-custodian and with respect to the legal responsibility of each sub-custodian; the third party custodian's arrangements for continuous monitoring and supervision of the sub-custodians he is connected to; the financial resilience of the third party custodian, which includes such things as equity, credit rating, insurance arrangements and guarantees or other means of ensuring his solidity as a provider of custodian services.

In addition, it is proposed that a broad disclosure requirement be imposed with respect to the policy for selecting and contracting with a third party custodian, the implementation of this policy and the monitoring of activity of a third party custodian.

The Committee found that as a result of the importance of custodian services in the global capital market, there exist a number of commercial companies that provide information and analysis related to this market, including ratings of custodians. This rating can serve as an aid when an intermediary is considering contracting with a custodian.<sup>18</sup> Appendix E includes a short review of custodian ratings.

## **7. Conclusion**

The Committee recommends adopting comprehensive, clear and uniform regulations regarding custodian activity that will be implemented by the three financial supervisors in Israel (Israel Securities Authority, the Capital Market Branch in the Ministry of Finance and Banking Supervision) and which will in the future also relate to clear and concrete legal instruments for enforcement.

The Committee's recommendations regarding the content of regulation in this area are derived from the positions of the entities who are members of the Committee, the comments of the public on the Committee's Interim Report and the conclusions drawn from a comparison to the accepted norms in other countries in this context.

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<sup>18</sup> Banks in Israel are also rated in this manner since they provide custodian services to foreign entities.

On this basis, the Committee formulated the principles for regulation, which consist of a proposed list of recommended standards that will apply to custodian activity and which are attached to this report.

**Appendix A – Final version following the comments of the public:**  
**Principles for the regulation of custodian services in the Israeli capital market**  
**Recommendations of the Interministerial Committee**

This appendix to the main report lists the recommendations of the Committee for the Regulation of Custodian Services in the Israeli Capital Market.

**Definitions**

Client assets	A financial instrument owned, held, managed or kept in custody by the client of a custodian or intermediary. <sup>19</sup>
Client cash	Cash owned, managed or supervised by the client of a custodian or intermediary.
Custodian	Someone who provides custodian services for client assets; <sup>20</sup> the custodian can also be a third party custodian or sub-custodian.
Intermediary	Someone who provides custodian services for client assets through another entity. <sup>21</sup>
Third party custodian	Someone who provides custodian services for client assets to an intermediary whether as a custodian or as an intermediary through a sub-custodian. <sup>22</sup>
Sub-custodian	Someone who provides custodian services for client assets of a third party custodian.
Financial instrument	A security as defined in Clause 1 of the Securities Law – 5728-1968 and also any arrangement that the Joint Trust Investments Law – 5754-1994 applies to and any other contract or arrangement, whether they have been listed for trade or not and whether or not they have been physically settled or settled in cash, an activity that requires payment of cash by one side to another and which is meant to create a benefit or financial return to one of the sides or to protect one of the sides against financial risk, including through reference to a base asset, interest rate, exchange rate index or commodity.

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<sup>19</sup> The client may be the direct owner of the client assets or alternatively can be a fund, portfolio manager, intermediary, global custodian or other type of service provider. Management implies management under the discretion of the manager.

<sup>20</sup> The intention is to an entity that directly provides custodian services, without the need to deposit the client assets with a third party custodian. In the Israeli market, members of the Tel Aviv Stock Exchange Clearinghouse are the only entities that may fit this definition.

<sup>21</sup> An intermediary is someone who provides service through the use of another entity's services, i.e. a third party custodian or sub-custodian. It should be emphasized that when a custodian deposits his client's asset with a third party custodian then for the purpose of the rules described in this document, he will be considered to be an intermediary and not a custodian. An example of a situation in which a custodian operates as an intermediary is when a custodian (a bank or bank account) receives an instruction to purchase a foreign security for a client and arranges custody for him in a foreign market. With respect to these activities, he will not be considered to be a custodian but rather an intermediary.

<sup>22</sup> The third party custodian may himself be (i) a custodian who provides the custodian services or (ii) an intermediary who deposits the client assets with another entity. A common example of a situation in which a third party custodian is an intermediary is when a custodian holds client assets with a sub-custodian in a foreign jurisdiction.

Ineligible client                      A client that is not on the list of eligible clients in the Law Regulating the Provision of Advice in Investments, the Marketing of Investments and the Management of Investment Portfolios – 1995.

### **Custody of client assets**

1. A custodian or intermediary that provides or arranges for custody of client assets and/or client cash, will use all reasonable means to ensure the client's ownership rights over the assets and cash and the preservation of rights derived from the ownership of the assets, including the receipt of dividends, interest payments, announcements and various rights of the client as a result of his ownership of the assets.
2. A custodian or intermediary that provides or arranges for custodian services will provide organizational and computerized systems whose purpose is to minimize damage to the client's ability to sell the assets deposited for custody or threats to the rights derived from ownership of those assets.
3. A custodian or intermediary can provide custodian services only to clients with whom he has signed a written contract/document that prescribes the legal relations between them, including the definition of rights, obligations and responsibility of each side, according to the rules and requirements described in this appendix.
4. A custodian or intermediary will be committed to prudence and maintenance of trust with regard to his clients.
5. The instructions included in this document will not apply to a client's transaction in a financial instrument in which the custodian or intermediary is the counterparty in the transaction.

### **Segregation of assets, records, management of accounts and reconciliation**

6. A custodian or intermediary will not mix the following, including in his records and in his books:
  - a. The assets of one client with those of another;
  - b. Client assets with those of the custodian or intermediary.
7. The custodian or intermediary must maintain records and accounts that clearly separate between various client assets and that allow him to immediately identify the assets held for each of his clients.
8. A custodian must carry out reconciliations on an ongoing basis between the records he maintains for client assets and those maintained by the clearinghouse or a parallel entity that maintains the final records for them; an intermediary must carry out reconciliations on an ongoing basis between the records he maintains for client assets and those maintained by the third party custodian that provides him with custody services for them.
9. A custodian or intermediary must establish and implement internal procedures that are meant to ensure the maintenance of appropriate standards of recording and management with respect to client assets and client cash, in order to prevent, as much as possible, the possibility of harm to a customer due to failure or negligence.

10. A custodian or intermediary will not create a right of lien, offset or encumbrance or any other right with respect to client assets whether for his own benefit or that of a third party, unless with the written consent of the client or in accordance with the law; excluded from this is (i) custodian fees charged by the custodian or intermediary for the client assets deposited with him and (ii) amounts charged by the custodian or intermediary that constitute a fee for the transaction in the client assets.

### **Client cash**

11. With regard to the handling of a client's cash by a custodian or intermediary the following instructions will apply:
  - a. Client cash will be deposited by a custodian or intermediary in one of the following ways:
    - i. In an account maintained by a bank as defined in the Banking Law (Licensing) – 5741-1981 (hereafter: an "Israeli bank"), or
    - ii. In an account maintained at a financial institution outside of Israel that accepts deposits and is under the supervision of an entity authorized to do so in that country (hereafter: a "foreign financial institution").
    - iii. In an account maintained at the Bank of Israel.
  - b. When a custodian or intermediary deposits client cash at an Israeli bank or a foreign financial institution he will take all reasonable measures to ensure that:
    - i. Both the Israeli bank or foreign financial institution at which the money is deposited and any third party, including creditors of an intermediary and of the Israeli bank or the foreign financial institution where the cash is deposited, will not view these funds as those of the custodian or intermediary.
    - ii. The client cash is deposited in an account designated as "[name of the custodian or intermediary] for clients".
  - c. The requirements according to sub-paragraph (b) will not apply to a custodian or intermediary that is an Israeli bank or foreign financial institution that deposits the client's cash in an account under the name of the client which is maintained with him.
12. In order to fulfill his obligation to safeguard clients' rights with respect to client cash, a custodian or intermediary will adopt appropriate standards and internal procedures in the selection, appointment and periodic evaluation of any Israeli bank or foreign financial institution at which he deposits client cash. In choosing which Israeli bank or foreign financial institution to use for this purpose, the intermediary will take into account, among other things, their financial solidity.
13. A custodian or intermediary will maintain written records of the following:
  - a. The considerations based on which he chose to contract with an Israeli bank or foreign financial institution for the purpose of depositing and holding his client's cash; and
  - b. The results of the periodic evaluation carried out for each of the Israeli banks and foreign financial institutions with which he is connected for the purpose of depositing and holding client cash.

### **Reports to clients**

14. A custodian or intermediary will provide each client with periodic reports that list the assets and cash for which they are providing or arranging custodian services, including all the information needed by a client to properly monitor the safekeeping services that have been provided or arranged by them during the period since the previous report of this type.
15. In the event that a custodian or intermediary enters into a transaction, or arranges one, using client assets, as stated in Paragraphs 28-30 below, he will provide the client with copies of each of the following items:
  - a. Confirmation with respect to each transaction, which describes the terms of the transaction, will be sent to the client immediately upon the execution of the transaction;
  - b. Periodic reports of these transactions, including details of the transaction and the fee or other payments that the client is eligible for with respect to such a transaction.

### **The intermediary – contracting, monitoring, documentation and supervision regarding a third party custodian or sub-custodian**

16. An intermediary must act with prudence, in good faith and with diligence in selecting and contracting with a third party custodian with whom the intermediary will deposit the client's assets. In implementing the aforementioned, the intermediary will, among other things, establish appropriate rules for the selection and evaluation of the characteristics listed below and will document the implementation of those rules in the selection process of a third party custodian and in the decision to contract with him:
  - a. The ability of the third party custodian to provide an appropriate level of service which will ensure that the intermediary meets the requirements imposed on him, as described in this document. Within this framework, he will consider the third party custodian's rating, as provided by a rating agency or entities with recognized expertise in rating custodian services. If an unrated third party custodian is chosen, this will be stated and justified.
  - b. The arrangement for legal responsibility with respect to the third party custodian.
  - c. The rules for selection that are followed by a third party custodian with respect to sub-custodians to which he is connected, including the matter of segregation between accounts at each sub-custodian and the issue of legal responsibility that obligates the sub-custodian.
  - d. The arrangements of a third party custodian for ongoing monitoring and supervision of sub-custodians to which he is connected.
  - e. The financial solidity of the third party custodian, including equity, credit rating, insurance arrangements and guarantees or other means of ensuring his solidity as a provider of custodian services.

17. An intermediary will sign a contract or similar document to formalize the legal relations with a third party custodian. A contract or similar document will contain the following instructions:
  - a. Instructions that are intended to ensure that the intermediary can meet the requirements imposed on him in this document.
  - b. Determination of the scope of the third party custodian's responsibility in the event of damage or loss caused to the client's assets as a result of the actions of (1) the third party custodian himself and (2) a sub-custodian operating on his behalf.
18. An intermediary will carry out continuous periodic examinations in order to determine whether the third party custodian is fulfilling the rules he has established and his obligations towards him.
19. An intermediary will maintain written documentation as follows:
  - a. The evaluations carried out when selecting and contracting with a third party custodian.
  - b. The results of the periodic evaluations of each third party custodian to which he is connected by a contract or similar document as mentioned above.
20. An intermediary will use all reasonable means to ensure the following:
  - a. That client assets held with a third party custodian are in fact segregated from assets owned by the intermediary and the third party custodian.
  - b. That the client assets held by a third party custodian are deposited in an account under the name of the intermediary, such that the rights of the intermediary's clients with regard to their assets are clearly documented. (For example, an account under the name "[intermediary's name] for clients" or alternatively their designation will be clear through a different method of designation.)
21. An intermediary will use all reasonable means to ensure that dividends, interest payments and the client's various rights as a result of his ownership of the assets held for him by a third party custodian are requested and received and that relevant notifications and reports are conveyed regarding the client's assets that are held for him by a third party custodian.
22. An intermediary will use all reasonable means to ensure that client assets held with a third party custodian can at any time be freely transferred following an instruction given by the intermediary to the third party custodian, subject to the payment of fees or payments to which the third party custodian is eligible with respect to the custody of the assets.
23. An intermediary will use all reasonable means to ensure his legal right to receive copies of records maintained by the third party custodian with respect to client assets deposited with him, on an ongoing basis and also by request.
24. An intermediary will receive from the third party custodian on an ongoing basis and by request periodic reports and reports on account status, which document all the transactions and balances and cash related to the client's assets.
25. An intermediary will not allow a third party custodian or any sub-custodian operating on his behalf to create a right of lien, offset, encumbrance or any other right due to the client assets and/or client cash, apart from the right granted by the intermediary to a third party custodian with respect to: (i) custodian fees charged by a third party custodian with regard

- to the client assets deposited with him by the intermediary; (ii) an amount charged by the third party custodian which constitutes a return on a transaction involving the client's assets.
26. An intermediary will use all reasonable means in order to deposit and hold client assets with a third party custodian that operates in a country with appropriate regulation with respect to the provision of custodian services. In this paragraph: "appropriate regulation" is regulation that is equivalent or similar to that proposed in the rules appearing in this document. If this is not possible, a risk warning will be provided to a client as required below; however this will not diminish the obligations of the intermediary with respect to the process of selection, contracting, monitoring, documentation and supervision with respect to the third party custodian through which he has decided to operate in that country.
  27. If it becomes known to the intermediary that the third party custodian is not fulfilling his obligations to the intermediary and as a result the intermediary is prevented from following the rules included in this document and is not able to provide appropriate protection for the client's assets, he is to demand that the third party custodian take all reasonable measures in order to rectify the failures within a reasonable amount of time. If the failures have not been rectified in a satisfactory manner, he must withdraw the clients' funds from the third party custodian at the earliest possible opportunity.

#### **Transactions using client assets**

28. Client assets will not be used in transactions of any kind, such as lending, (including when the client receives a fee or some other payment for such use of his assets) without prior written consent of the client. With regard to these recommendations, a transaction of an intermediary who manages investment portfolios of client assets is not considered to be a "transaction with client assets".
29. The aforementioned consent will specify at least the following:
  - a. The terms that apply to said transactions;
  - b. Clear, complete and accurate information regarding the third party custodian's obligations and responsibility regarding the use of client assets, including the terms of their return;
  - c. An explanation of the risks involved in the transactions and a declaration of the client that he understands these risks; and also details of fees and any other payments that the customer is to receive for the transactions.
30. With respect to the use of client assets, a custodian or intermediary will verify that the following requirements are fulfilled:
  - a. His operational controls and internal procedures are sufficient to ensure that only assets belonging to clients who have signed an agreement in accordance with Paragraphs 28 and 29 are being used for the execution of transactions and in order to ensure that the use of the assets is in accordance with the terms agreed upon.
  - b. There are appropriate records being kept regarding transactions carried out using client assets

- c. If the aforementioned client assets are held with a third party custodian in an omnibus account, any additional required steps have been taken in order to comply with sub-paragraphs (a) and (b) above.

**Presentations and notifications from an intermediary to his clients**

31. a. An intermediary will present to a client whose assets are held with a third party custodian a report that contains the following:
  1. A description of the policies for selection and contracting with a third party custodian and the methodology for monitoring the activity of a third party custodian.
  2. A description of the implementation of the aforementioned policy in the selection of a third party custodian with whom the intermediary is connected.
- b. An intermediary will present the client with a report, as mentioned in sub-paragraph (a) when contracting with the client. In addition, the intermediary will present the client with periodic updates.
- c. Notwithstanding the aforementioned, an intermediary who is a mutual fund, pension fund, provident fund or insurer will issue the aforementioned information to the public in place of the individual disclosure to a client.
32. The intermediary will notify the client at the first opportunity of becoming aware that the instruction of the client can only be carried out in the following circumstances:
  - a. In jurisdictions in which custodian services are not subject to appropriate regulation; or
  - b. When the custodian is not able, from an operational viewpoint, to segregate the client's assets from the intermediary's assets or those of the third party custodian.The requirement of notification will apply to the first instruction to be given by the client with regard to the aforementioned jurisdiction or with regard to the aforementioned third party custodian.
33. With respect to a client who is not an eligible client, the intermediary will implement the following in addition to the notification mentioned in Paragraph 32 above:
  - a. The intermediary will list for the client the risks involved in depositing assets in the circumstances described above.
  - b. With respect to the holding of client assets in a foreign jurisdiction, the intermediary will warn the client that the law applying in the foreign jurisdiction may differ from local regulations and may not provide the same level of protection of ownership rights.
  - c. He will obtain written confirmation from the customer that he has read the notification, has understood the aforementioned risk warning and is interested in carrying out the transaction(s).
34. An intermediary will notify a client of any encumbrance, offset right or other right on a security that any third party custodian may hold on assets of that client.

**External audit by an accountant**

35. An independent external accountant will carry out an audit of a custodian or an intermediary at least once annually as follows:
- a. The accountant will examine the record system, the segregation of assets and the required reconciliations, as stated in Paragraphs 6-9 above, as well as the implementation of Paragraph 11 above.
  - b. The accountant will examine the controls put in place by the custodian or intermediary in order to fulfill the requirements according to these recommendations and also the effectiveness of these controls.
  - c. The accountant will prepare a detailed report of the examinations he has carried out and will present it to the board of directors of the intermediary or custodian.

**Regulation, supervision and enforcement**

36. A regulator who supervises the activity of a custodian or intermediary, according to the circumstances, will verify the regulation, supervision and enforcement of the rules contained in these recommendations, according to his judgment and in accordance with his existing powers of regulation, supervision and enforcement and those that will be provided to him.
37. A custodian or intermediary will fulfill the requirements of the regulator that supervises his activity according to the law applying to the provision of custodian services.

**Preservation of competition**

38. A custodian or intermediary will fulfill these instructions fairly and without diminishing competition.

**Taxation**

39. The instructions of the tax laws in Israel will continue to apply to a custodian, a third party custodian or an intermediary, according to the circumstances, with respect to foreign residents that make use of a custodian/third party custodian/intermediary for their investments in Israel, both with regard to tax liability (or exemption) and tax deductions at source for income created in Israel, whether the investment was carried out through specific accounts in the name of a foreign resident client or through omnibus accounts. The reporting, identification and responsibility regarding the Tax Authority in Israel with respect to foreign resident investments carried out through omnibus accounts will be in accordance with the directives of the Tax Authority in this matter.
40. The instructions of the tax laws in Israel will continue to apply to a custodian, a third party custodian or an intermediary, according to the circumstances, with respect to residents of Israel that make use of a custodian/third party custodian/intermediary to invest in Israel and/or abroad, both with respect to tax liability (or exemption) and with respect to tax deduction at source from income produced from these investments.

## Appendix B: Description of the collapse of MF Global

On October 31, 2011, following the opening of an investigation by the SEC and Department of Justice, MF Global filed for bankruptcy in a New York court. The investigation was looking into complaints by the company's clients, according to which hundreds of millions of dollars had gone missing. Apparently, the debts of the company had accumulated as a result of its investments in the bond market.<sup>23</sup>

Based on publications in the Israeli<sup>24</sup> and foreign<sup>25</sup> media, there is a strong suspicion that the company did not segregate its funds from those of its clients and that it used client funds to cover shortfalls. What stands out from the affair is a serious lack of monitoring with regard to the flow of funds and their designation. With regard to some of the money, it is unclear, even now, whether they belong to the company or to its clients. In the week prior to the collapse, the company did not keep accurate records. The company issued requests to move funds between various accounts but only a small portion of the funds were in fact moved. Even among regulators in the various enforcement authorities and the trustee, there is no consensus as to the ownership of some of the money. This situation is reflected in the difficulty faced by the regulators and the trustee in estimating the shortfall at \$1.2 billion and in identifying the ownership of funds that were located.

Thus, for example, on the day that it filed for bankruptcy, MF Global moved a sum of \$220 million to a futures account under the name of its clients. The company believed that it owned this amount and wished to use it to reduce the shortfall in the account under the name of its clients.<sup>26</sup> The SEC issued an instruction not to move this amount from the broker-dealer account since it was unclear who the funds belong to. The Commodity Futures Trading Commission (CFTC)<sup>27</sup> on the other hand issued an instruction to leave the amount in a transit account, i.e. the futures account, which had a shortfall even after this deposit.<sup>28</sup> Meanwhile the trustee believes the shortfall (in the amount of \$1.2 billion) does not include this amount. Furthermore, at the beginning of November, stories were published which claimed that some of the missing funds (about \$600 million) had been "located" and deposited in a

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<sup>23</sup> For information on the company's bankruptcy, including court documents and also details of the trustee and stories published in the media, see <http://www.cftc.gov/IndustryOversight/Intermediaries/mfglobal>. It is worth mentioning that already in 2009, the CFTC imposed a fine on the company (as part of a settlement) in the amount of \$10 million for not fulfilling various regulations related to supervision and risk management. See <http://www.cftc.gov/PressRoom/PressReleases/pr5763-09>.

<sup>24</sup> Tamar Kovlantz and Iran Peer, "Discount, Migdal and Excellence are exposed to MF", November 1, 2011, see <http://www.globes.co.il/news/article.aspx?QUID-1057,U1320314730024&did=1000694191>.

<sup>25</sup> Ben Protes, "Regulators Investigating MF Global for Missing Money", New York Times, November 2, 2011. See <http://dealbook.nytimes.com/2011/10/31/regulators-investigating-mf-globa/?scp=2&sq=mf%20global&st=cse>.

<sup>26</sup> "MF Global officials believed the money was excess cash held in reserve for customers, based on calculations made Oct. 28. MF Global's push to move the \$220 million was part of a broader effort to fill a shortfall in customer assets that had been identified and communicated to regulators early in the morning of Oct. 31, people familiar with the firm's thinking said."

<sup>27</sup> The US Commodity Futures Trading Commission. See <http://www.cftc.gov/index.htm>.

<sup>28</sup> Scott Patterson and Aaron Lucchetti, "MF's Money Trail Zigzags", November 30, Wall Street Journal. See <http://online.wsj.com/articl/SB1000424052970203441704577068311530372668.html>.

## Custody Services in the Israeli Capital Market

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custodian account at JPMorgan Chase & Co.<sup>29</sup> However, in later reports, JP Morgan claimed that this was not the “missing money”<sup>30</sup> and that basically the location and ownership of the money is uncertain.<sup>31</sup>

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<sup>29</sup> Cristina Alesci and Matthew Leising, “MF Global Missing Funds Said to Be Found”, November 4, 2011. See <http://www.bloomberg.com/new/2011-11-04/mf-s-mission-client-funds-said-to-be-located-in-jpmorgan-custodian-account.html>.

<sup>30</sup> Paul Joseph Watson, MF Global Money Now “Missing” After Reports it Was Sent to JP Morgan, [www.insofar.com](http://www.insofar.com). November 17, 2011. See <http://www.infowars.com/mf-global-money-now-missingafter-reports-it-was-sent-to-jp-morgan/>

<sup>31</sup> Nick Brown, Christopher Doering, MF Global may return funds, cuts more jobs. November 17, 2011.

<http://www.calgaryherald.com/business/Global%2Breturn%2Bfunds%2Bcuts%2Bmore%2Bjobs/5725823/story.html#ixzz1fXugy8If>

(The attorney of the trustee stated that "Kobak had no further details on the missing \$600 million. "Exactly what happened, I don't think anyone knows," he said. ")

## Appendix C – US laws regulating custodian services

Following are the various arrangements that apply to the provision of custodian services in the US, according to the type of law, the entity to which the law applies or the type of managed assets.

**Investment funds:** Following are the main instructions that apply to custodian services in the context of registered investment companies (RIC) (hereafter: funds) according to Rule 17f of the Investment Company Act:

- A fund is permitted to deposit securities and to hold them in custody only with certain authorized entities that are subject to regulatory supervision and inspection, primarily a bank or member of the national stock exchange.<sup>32</sup>
- The law imposes obligations related to the management of records and the physical segregation of assets, apart from in specific cases (such as securities that are encumbered or held in trust in the context of a loan). (Rule 17f-2)
- Holding of assets subject to verification by an external accountant at least three times during a financial year, at least two of which will be without prior notice. Reports confirming the execution of such an examination and describing the examination carried out are to be submitted to the SEC following such examinations. (Rule 17f-2)
- Appointment of a foreign custodian (as prescribed by Rule 17f-5)<sup>33</sup>
  - The fund's board of directors or trustee is responsible for ensuring that appropriate custodian services handle the custody of the fund's assets. The board of directors is permitted to delegate its authority and to appoint a foreign sub-custodian outside the US.
  - The law specifies due care and reasonable commercial standards that apply to the board of directors or the custodian, according to the circumstances, when coming to appoint a sub-custodian and supervise his activity.<sup>34</sup>
  - A foreign custodian is required to meet certain standards, such as: procedures for internal control, information security, financial solidity, reputation and the applicable regulatory regime will be the RIC regime and that it will be possible to enforce it. In

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<sup>32</sup> The Company Investment Act Rule 17f(1): "Every registered management company shall place and maintain its securities and similar investments in the custody of ( (A) a bank or banks having the qualifications prescribed in paragraph (1) of section 26(a) of this title for the trustees of unit investment trusts; or (B) a company which is a member of a national securities exchange as defined in the Securities Exchange Act of 1934, subject to such rules and regulations as the Commission may from time to time prescribe for the protection of investors; or (C) such registered company, but only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors".

<sup>33</sup> See also SEC Commission Final Rule: Custody of Investment Company Assets with a Securities Depository, 17 CFR Part 270, [Release No. IC-25934; File No. S7-22-01] RIN 3235-AG71.  
[http://www.sec.gov/rules/final/ic-25934.htm#P77\\_18628](http://www.sec.gov/rules/final/ic-25934.htm#P77_18628)

<sup>34</sup> Investment Company Act, Rule 17f-4.

general, the opinion of a local expert is required (in the source country of the foreign custodian) who will confirm the fulfillment of the terms specified by law.

- The law may also apply to a state chartered fund.<sup>35</sup>

**Broker-dealer:** Rule 15c-3 of the Securities Act of 1934 regulates the holding of client securities by a broker-dealer as follows:

- A broker-dealer is required to physically hold and maintain securities that have been fully paid for.<sup>36</sup> He is permitted to borrow and to use his clients' securities only with the client's written consent and the deposit of collateral in order to ensure the client's rights.
- In the event that the broker-dealer defaults, all the cash balances and securities are brought together in one account, which will be accessible to the trustee in order to be allocated to clients and creditors.

### **Banks**

Banks that hold assets in custody are subject to the relevant banking laws, which specify, among other things, that assets held in custody (not including cash balances held off-balance sheet) are subject to the rights specified in the custodian documents and are not accessible to the bank's creditors.

### **Tightening of regulation regarding investment advisers in the US**

Following the Madoff affair, regulations regarding custodian services in the US were made more stringent by means of Rule 206(4)-2 of the Investment Advisers Act of 1940.<sup>37</sup> The rule applies to investment advisers who themselves provide custodian services or contract with a third party (a third party custodian). The following relates primarily to areas in which regulation was tightened by means of this law.

- Qualified custodian

An investment adviser is permitted to deposit the assets of his clients only with a qualified custodian.<sup>38</sup>In general, this term includes the following: banks, qualified brokers-dealers or a

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<sup>35</sup> Investment Company Act, Rules 17f-2, 17f-5.

<sup>36</sup> A broker-dealer must promptly obtain and maintain physical possession or control of all fully-paid securities (Securities Exchange Act of 1934, Rule 15c-3).

<sup>37</sup> It should be mentioned that, as described below, the regulatory system that applies in this area in the US may apply indirectly to other bodies (such as brokers) which provide custodian services and are a related party to investment advisers.

<sup>38</sup> "Qualified custodians" include the types of financial institutions that clients and advisers customarily turn to for custodian services. These include banks and savings associations (Amended rule 206(4)-2(c)(3)(i)) and registered broker-dealers (Rule 206(4)-2(c)(3)(ii)). In order to allow advisers that also offer futures advice to comply with Commodity Futures Trading Commission rules, "qualified custodians" also include registered futures commission merchants. 206(4)-2(c)(3)(iii). "Qualified custodians" include foreign financial institutions that customarily hold financial assets for their customers, provided that the foreign financial institution keeps advisory clients' assets in customer accounts segregated from its proprietary assets. In addition, a Mutual Fund Transfer Agent may be considered in certain circumstances as qualified custodian (a transfer agent may serve such role to an open ended mutual fund in lieu of a qualified custodian) See SEC Commission, 17 CFR Parts 275 and 279, [Release No. IA-2176;

foreign financial institution that regularly provides custodian services to its clients, on the condition that the aforementioned segregate the clients' assets from their own.

- The holding of assets in custody in segregated accounts  
An investment adviser is responsible that his clients' assets are deposited for custody (with a qualified custodian, as mentioned above) and are held by him in segregated accounts under the name of each client or in an account that contains only the assets of the clients registered in trust under the name of the investment adviser for his clients.
- Supervision and reporting to clients  
An investment adviser must inform his clients of the name of the place or the institution where his assets are being kept, the address of the institution and the manner in which the assets and cash are being kept. In the account status report sent to the client, the investment adviser must include a message that suggests and urges the client to compare the report that he has received from the investment adviser to the report received directly from the custodian. The investment adviser must verify that the custodian sends the client an account status report at least once every quarter.
- Audit by an accountant  
In accordance with the changes adopted by the SEC,<sup>39</sup> an independent external accountant must carry out an examination at least once annually without prior notice and on different days during the course of the year. As part of this audit, the accountant will verify the investment adviser's records for the actual holding and custody of assets and will produce a report that describes the nature of his examination and its findings ("external audit report"). If the adviser is himself a custodian or custody has been arranged with an entity that is connected to him, the independent auditing accountant must be subject to the audit of the Public Company Accounting Oversight Board (PCAOB). The accountant must submit the external audit report to the SEC within 120 days from the date of the audit. If major discrepancies are found during the audit, the accountant has only one day to report them to the SEC. In addition, if it is decided to terminate the relations between the accountant and the investment adviser, then he must report this to the SEC within 4 days and this will include the reason for the termination and any significant related matters.

Apart from the external audit report, the SEC has imposed an additional layer of control on custodian services, which apply in the event that the investment adviser is the custodian (for

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File No. S7-28-02] RIN 3235-AH 26, Custody of Funds or Securities of Clients by Investment Advisers. Available at [http://www.sec.gov/rules/final/ia-2176.htm#P80\\_16014](http://www.sec.gov/rules/final/ia-2176.htm#P80_16014)

<sup>39</sup> The SEC issued Rule 206(4)-2 which constitutes an amendment to the Advisers Act and which went into effect in March 2010. The amendment will be implemented through a new section called "Custody of Funds or Securities of Clients by Investment Advisers" which was integrated into the Act and which expands the regulation of the custodian market. See [http://taft.law.uc.edu/CCL/InvAdvRIs/rule206\(4\)-2.html](http://taft.law.uc.edu/CCL/InvAdvRIs/rule206(4)-2.html).

example, in the case of a broker-dealer) or when the investment adviser and custodian are related parties (for example, they belong to the same holding company). In these circumstances, the investment adviser has the obligation to obtain an internal audit report from the custodian, which will be produced at least once during a calendar year and will include an opinion by an external accountant who is subject to the audit of the PCAOB, with regard to, among other things, the internal audit of the custodian and his segregations of assets ("internal audit report"). Therefore, in the event that the investment adviser is also the provider of custodian services, he will be subject to both an external audit and an internal audit. The obligation to produce such a report in this case is meant to deal with the additional risks involved in receiving services from the same entity/related party and to tighten supervision and control in these cases and in order to encourage a situation in which custodian services are obtained from an entity that is not a related party.

In view of the directive issued by the SEC in the context of the aforementioned amendments to the law,<sup>40</sup> the internal audit report can be written according to American audit standard SSAE16 (which replaced standard SAS 70)<sup>41</sup> regarding reports issued after June 2011. This standard regulates the performance of accounting audits in organizations that rely on service bureaus in processes that significantly affect their financial reporting. The standard requires an examination of all relevant audits for financial reporting (it allows reporting of additional audits) and relates to the presentation of criteria and audit methodology when examining processes in the organization. In general, according to the standard, the auditor must carry out an audit process for providing attestation regarding the control systems in the organization. In addition to the auditor's attestation, the report includes, among other things, a description by management of the services provided by the service bureau and the audit system, as well as its signed declaration regarding the appropriate planning and effectiveness of the audits of the service. In addition, the report must include a description of the findings from the accountant's examination of the service bureau. A major change in the new standard is the imposing of responsibility on the management of the service bureau for the information that is contained in the report and for the reporting of problems and controls in the company, as well as the accountant's audit process in forming his opinion of the report.

It is worth mentioning that in order to provide a similar solution for consumers outside the US, the International Auditing and Assurance Standards Board (IAASB) issued a parallel international auditing standard.<sup>42</sup>

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<sup>40</sup> <http://www.sec.gov/rules/final/2009/ia-2968.pdf>

<sup>41</sup> Statement on Standards for Attestation Engagements (SSAE) No. 16  
[http://www.cpa2biz.com/AST/Main/CPA2BIZ\\_Primary/AuditAttest/IndustryspecificGuidance/PRDOVR~PC-0127910/PC-0127910.jsp#TabContent7](http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/AuditAttest/IndustryspecificGuidance/PRDOVR~PC-0127910/PC-0127910.jsp#TabContent7).

<sup>42</sup> International Standard on Assurance Engagement (ISAE) No. 3402  
<http://www.ifac.org/sites/default/files/downloads/b014-2010-iaasb-handbook-isa-3402.pdf>.

## Appendix D: Regulation of custodian services in the EU

### Markets in Financial Instruments Directive (MiFID) II

In October 2011, against the background of the financial crisis, the European Commission issued a proposed directive that amended the aforementioned regulations (hereafter: MiFID II), with the goal of creating a safer, more transparent and more responsible financial system, as well as to improve the European capital market.<sup>43</sup> The proposal includes a variety of tools that are meant to deal with the problems that arose during the financial crisis and imposes stringent and more comprehensive regulation, as well as a commitment from the G20 countries to improve the transparency and rationality of the financial markets.

In general, among the various instructions and arrangements, the proposal expands the scope of existing regulations both with respect to the range of financial products and supervised financial entities, by making additional entities subject to authorization and registration regimes, by reducing the number of entities enjoying an exemption<sup>44</sup> and by including entities from countries that are not EU members. The change will strengthen the regulatory authority based on the Directive and the compliance requirements that apply to financial entities.

In our context, custodian services themselves are excluded from the list of investment services according to the law as it stands today and they are considered to be ancillary services.<sup>45</sup> According to MiFID II, the list of investment services will be expanded to include the following:<sup>46</sup>

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<sup>43</sup> Proposal for a Directive on Markets in Financial Instruments Repealing Directive 2004/39/EC of the European Parliament and of the Council. October 20<sup>th</sup>, 2011, COM(2011) 656 final, 2011/0298 (COD). See [http://ec.europa.eu/internal\\_market/securities/docs/isd/mifid/COM\\_2011\\_656\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_656_en.pdf)

<sup>44</sup> Thus, for example, Paragraph 2 of the Directive will be changed such that, among other things, sub-paragraph (k) is deleted:

*"persons whose main business consists of dealing on own account in commodities and/or commodity derivatives. This exception shall not apply where the persons that deal on own account in commodities and/or commodity derivatives are part of a group the main business of which is the provision of other investment services within the meaning of this Directive or banking services under Directive 2000/12/EC;"*

<sup>45</sup> Paragraph 4 of the Directive includes a glossary of terms, as follows:

"(22) 'Investment services and activities' means any of the services and activities listed in Section A of Annex I relating to any of the instruments listed in Section C of Annex I; The Commission shall (adopt by means of delegated acts in accordance with Article 94 measures specifying: the derivative contracts mentioned in Section C 7 of Annex I that have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognized clearing houses or are subject to regular margin calls; the derivative contracts mentioned in Section C 10 of Annex I that have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognized clearing houses or are subject to regular margin calls;"

(23) 'Ancillary service' means any of the services listed in Section B of Annex I."

<sup>46</sup> Paragraph B of Appendix 1 includes a list of ancillary services. The aforementioned Paragraph A(9) will be deleted from Paragraph B(1). See page 168 in

[http://ec.europa.eu/internal\\_market/securities/docs/isd/mifid/COM\\_2011\\_656\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/mifid/COM_2011_656_en.pdf)

*"(9) Safekeeping and administration of financial instruments for the account of clients, including **custodianship** and related services such as cash/collateral management;  
(10) Operation of Organised Trading Facilities."*

**In short this amendment significantly changes the status of custodian services as an independent service even if it is not ancillary to other financial services that are not subject to MiFID.** In accordance with this proposal, a custodian that provides custodian services in financial instruments will be considered an investment firm even if he is not ancillary to another financial service and will be subject to the vast majority of the aforementioned instructions. It is worth mentioning that in practice this change is not all that significant since most entities that provide custodian services are subject to the MiFID due to other services that they provide. It should also be said that the regulations accompanying the Directive (which were defined in the Committee's Interim Report as "MiFID level 2") have not been changed up till now and it is possible that they will be changed in the future on this issue.

## **Appendix E: Rating of custodians**

Below is a short survey of custodian rating.

### **Thomas Murray<sup>47</sup>**

The Company provides services that are intended to help investors manage the quality, costs and risks of their activity in the various capital markets worldwide and in the receipt of financial services from the international capital industry. Among other things, the Company provides custodian rating services (as well as other financial services) on a scale from C to AAA as an indicator of the stability and quality of these services. In addition, the report “supplements” the aforementioned rating with a trend, based on information possessed by the Company at that time (such as stability, positive trend, negative trend and warning that there may be a change in the rating of the custodian services).

The Company produces these rating for global custodians, sub-custodians and local non-bank custodians. The purpose of the rating is to ensure that the rated custodian is able to provide core custodian services, clearinghouse services (primarily financial settlement and reports), basic banking services (management of cash balances, credit and foreign currency), management of assets (receipt of income, applications for tax refunds and proxy voting) and additional services (such as loaning of securities, measurement of performance and monitoring of transactions costs) and that they meet compulsory standards.

The Company’s rating evaluates, among other things, the capabilities of sub-custodians, the core services they provides, their internal auditing system and their ability to manage risk.<sup>48</sup>

The rating report is produced at the request of a specific client and its publication is subject to his discretion.

### **Globalcustodian.net<sup>49</sup>**

The Company provides information on providers of financial services and in particular custody. Among other things, it assigns ratings to global custodians and in particular custodians that are banks according to the volume of the assets they hold. According to the information possessed by the Company, assets in the amount of \$120 trillion are held by custodians.<sup>50</sup>

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<sup>47</sup> See the Company’s website at [www.thomasmurray.com](http://www.thomasmurray.com). The Company surveys and analyzes 250 global custodians and monitors risk in over 100 capital market infrastructures.

<sup>48</sup> This analysis also looks at: credentials – the experience and commitment to providing custodian services and management of its business; core services – the ability to provide services of the highest standard while maintaining minimum risk; financial settlement; safekeeping; corporate governance; taxes; income; management of cash balances, operational and internal functions; evaluation of IT and communication systems; management of customer relations; risks; evaluation of financial positions, asset management and risk management.

<sup>49</sup> For the Company’s website, see [http://www.globalcustody.net.il/about\\_us](http://www.globalcustody.net.il/about_us).

<sup>50</sup> See [http://globalcustody.net.il/custody\\_assets\\_worldwide](http://globalcustody.net.il/custody_assets_worldwide) for a table comparing various custodians according to the quantity of assets they hold.

### **Global Custodian**

Each year, Global Custodian magazine publishes the rating of banks around the world that provide custody service, according to level of satisfaction with the bank and whether it meets various standards, such as credit rating, service to customers, level of service, technical and operational capabilities, efficient handling of non-conventional cases and backup and understanding of local regulations.<sup>51</sup>

The website of the magazine<sup>52</sup> provides information on a daily basis that includes news, events and other developments in the capital market and in custody services, in particular.

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<sup>51</sup> See a discussion of the ratings for 2011.

<http://home.globalcustodian.com/ressreleaseshow.do?id=90>

<sup>52</sup> <http://home.globalcustodian.com>