

GLOBAL CUSTODIAN, ASSET SERVICER, MASTER CUSTODIAN

What's in a Name?



For purposes of this article, "global custodian" is defined as a trust bank custodian.

While investment opportunities have flourished in recent years for family offices, there are clear advantages to employing a global custodian. Whether a family office wishes for a global custodian to be the sole asset servicer or be the 'gatekeeper' of data from aggregators and brokers, the role of a global custodian goes far beyond mere safekeeping.

Today's family office is more sophisticated and their investment opportunities more varied and complex than ever before. The fast pace of the marketplace requires that they have ready access to comprehensive and proactive information about their investments. As the rate of change increases in the investment arena and the regulatory environment continues to tighten, the value proposition of the global custodian – Risk Management; Operational Efficiency; Accuracy and Access to Data; and Technology – is, in fact, more relevant today than ever.

A premier global custodian offers a concentrated and streamlined solution to managing all investments in one place, not only providing safety of assets, but also peace of mind to investors with investments spanning the globe. By reviewing the options, family offices can determine which solution is best for their particular situation.

RISK MANAGEMENT

A global custodian's primary and most fundamental responsibility is to safeguard financial assets, facilitate clear title and immediate client access, and assure that ownership records are held in a secure environment.

But beyond the safekeeping of assets, family offices also need to protect their wealth against several additional layers of risk – including everything from misinformation to human error to outright fraud. Engaging a premier

global custodian provides one of the strongest shields against many such risks.

Safekeeping and Protection Against Institutional Risk

As a first protection against fraud or institutional insolvency, client assets held at a global custodian are not considered to be assets of that financial institution and do not appear on the bank's financial records. Unlike a broker dealer, a global custodian is required to hold client assets separate and apart from corporate assets at all times. In the case of corporate insolvency, this allows for timely delivery of client assets, which is possible as client assets are easily identified, immune from any proceeding against the custodial organization and cannot be encumbered by bankruptcy proceedings and lawsuits initiated by the bank's creditors.

Investment Risk

Although global custodians did not emerge until the mid-eighties, the first global custodians originated in the mid-seventies when ERISA

FACT

If a global custody bank fails, your trust investments are not subject to the claims of the bank creditors because your assets held in trust, fiduciary and custodial accounts are not assets of the bank. The failure of a global custody bank will have no adverse effect on the title to trust, fiduciary or custodial assets; they remain the property of the asset owners.



required U.S. Pension Plan sponsors to segregate the custody of assets from investment management activities in an effort to provide an additional layer of protection to plan assets. Simply assigning the responsibility for trade settlement and reconciliation to the global custodian eliminates the largest opportunity for manager-perpetrated fraud – false reporting of assets and activity within the client’s account. In addition, the role of the global custodian also naturally extends to serving as the watchdog against unintended investment risk. Top-tier global custodians have developed sophisticated compliance monitoring systems designed to help assure that underlying investment portfolios are managed within the stated investment guidelines and to alert the client to any activity that may indicate the portfolio is out of compliance with the client’s guidelines and, therefore, potentially subject to greater market risks than anticipated. Global custodians have a natural advantage in closely assessing and monitoring this type of investment risk as they are privy to pending activity within the portfolio, and are therefore able to identify potential risks earlier than systems solely dependent on the receipt of information regarding activity that has already settled.

Administrative Risk

The risks inherent in the daily administration of complex investment portfolios and their underlying assets are diverse, including everything from consistency and rigor in processing, to human error, data security and disaster recovery. In opting to use a global custodian, family offices find a partner in monitoring and minimizing these risks, which are often overlooked and difficult to monitor when assets are spread across multiple institutions.

To begin, global custodians are regulated by numerous federal and state agencies and undergo audits to guarantee the organization has sound operating procedures that are strictly adhered to in daily operations. Global custody banks are all required to file an annual SSAE16 – the Statement on Accounting Standards that governs the control environment in which client assets are administered. Those standards apply to everything from rules around the movement of cash and other assets, to the processing of corporate actions and reporting to the IRS.

Further, as federally regulated banks, global custodians are held to the highest possible standards regarding both privacy and data security and are required to maintain strict and well-defined data management policies which are formally audited annually. Policies and procedures are supplemented with advanced technology (and regular training and education for all employees) to assure confidentiality both within the organization and for information made available online.

The use of a global custodian also provides significant protection in terms of disaster recovery and more importantly business continuity. Records related to client assets held at a global custodian benefit from the substantial disaster recovery infrastructure and planning of that financial institution. Financial institutions that are serious about their disaster recovery planning will have redundant data centers, sited geographically so that it is unlikely a single disaster would impact all processing. They will protect client data by taking a copy of electronic data and moving it off site immediately. Further, in the event of disaster, the elaborate business continuity planning of a large financial institution will be comprehensive and minimally provide

responses to five common threats to client servicing: loss of building, loss of staff, loss of technology, loss of non-electronic paper records and loss of external service providers.

Finally, the diversity of a global custodian's client base requires a significant investment in keeping its processes and technology up-to-date. A global custodian's technology is constantly being updated to not only report on changing and new financial instruments and markets, but to also accurately process and account for them. These enhancements go beyond mere updates to reporting technology and involve changes to data models and calculation engines, as well as insuring compatibility with existing outputs.

OPERATIONAL EFFICIENCY

In so many instances, diversification is touted as the best means of protection. And yet, to each rule there is an exception. In the case of investment diversification, someone still needs to maintain control over all of the various relationships, documents and reports. When those elements all fall under one provider, the result is improved operational efficiency.

In its role as asset servicer, the global custodian is responsible for administering investment related activities – such as trade settlement, collection of income and other entitlements, proxy processing and managing class action filings – as well as all client-initiated transactions and cash movement activities. Spurred by client demand, the global custodian's role has followed a natural progression from pure custody and safekeeping to more specialized asset servicing. This core responsibility spans both domestic and global assets across a broad array of asset classes, including long-only equity and fixed income investments, private equity, hedge funds and activity managed cash portfolios.

The global custodian can add the greatest value, in terms of improved operational efficiency, when all (or most) of these activities occur under one roof. Processing of basic transactions is most efficient when fewer parties are involved, allowing for consistency in procedures, authorizations, accounting and reporting. For instance, cash management across multiple accounts/portfolios/legal entities can be done in a more timely, accurate manner if everything is held within one organization and a single online tool is used to initiate and approve all cash transactions. Use of one global custodian helps assure all assets are administered and reported on using a single, well-defined methodology, resulting in increased accuracy and efficiency downstream.

FACT

In the event of an IRS audit, a global custodian is considered the official book of record – making a global custodian's consolidated K-1 the most accurate source of tax data and also providing enhanced audit control for the family office.

For family offices with international investments, the choice to work with a global custodian is even more critical, as only the premier global custodians have dedicated professionals on the ground conducting transactions in their local markets. Instead of a broker in New York conducting a transaction via phone or wire in Singapore, the true global custodian has offices in Singapore where the transaction can be conducted with ease and expertise in local procedures.

ACCURACY OF DATA

Accuracy in the maintenance of accounting records and in the preparation of online and hard copy reports – a key priority for high-net-worth individuals and the family offices that serve them – is without question a core competency of a global custodian. This requirement touches every aspect of a global custodian's duties – ranging from the maintenance of accurate client profiles and cash balances, to recording market transactions, collecting income entitlements, processing complex corporate actions and capturing the detailed tax characteristics of every transaction within an account. Accuracy is promoted by well-developed operating procedures with numerous internal controls, fault-sensitive technology and post-execution audits and reconciliations. More importantly, the global custodian has the unique ability to capture all of the relevant data points at the moment the transaction occurs – ensuring the data is not only comprehensive but is a true “recording” of actual account activity.

A global custodian is uniquely focused on the importance of these activities, as they are responsible for delivering comprehensive 1099 and other tax reporting to the IRS.

ACCESS TO DATA

The role of the global custodian has further evolved to include the delivery of data through sophisticated technology and reporting platforms designed to provide the private investor with the tools necessary to simplify a very complex financial picture.

A global custodian having direct access to all of a client's assets can also provide a service that is both highly efficient and reliable. With all assets under one roof, activities such as aggregating multiple portfolios and effecting cross-portfolio transactions are easily accomplished by the

global custodian without the delays common when assets are dispersed in multiple locations. More importantly, since the global custodian is responsible for all records, such processes are inherently more reliable.

In most cases, the client is free to select from a menu of services or plug in their own sources and systems if they prefer. In either case, the information flow and operation is designed to be transparent and seamless.

CUTTING-EDGE TECHNOLOGY

The top-tier global custodians provide an array of services ranging from comprehensive daily, monthly and quarterly analytic reports, to sophisticated online systems that compete with the best technology and reporting platforms available. Information systems developed with the family office client in mind provide basic portfolio information (positions, transactions and performance), user-defined consolidations, sophisticated analytic reports, partnership reporting, a document repository and often a client-accessible report writer. Clients can also use such systems to initiate communications with the custodian, such as directions to move funds between several different internal and external accounts simultaneously.

Global custodians, with their commitment and deep knowledge of the family office client, provide systems that are most suited to their needs. While in many cases the technology and reporting solutions offered by a top-tier global custodian eliminate the need for a family office to purchase or build (and maintain and integrate) their own technology solutions, a global custody solution can also easily be applied within an existing framework that includes the use of in-house systems (including GLs and Portfolio Management systems) and/or external aggregation-based software applications.

GLOBAL CUSTODIAN: PLAYS WELL WITH OTHERS

There are a variety of legitimate reasons that a family office might not be inclined to allow a global custodian to hold all assets. Even for those family offices, the global custodian still has a vital role to play. Keeping as much information concentrated in one central location will ease the burden during tax time, as well as any other time data is needed in the blink of an eye.

Data Aggregators

Newly emerging technologies have paved the way for data aggregators to appear as a less expensive solution to a global custodian. While there may in fact be a good case for using some of these sophisticated platforms, a premier global custodian's role remains critical to the success of the family office. If, for example, information must be gathered from multiple sources, there is less certainty that the imported information will be accurate and timely. Problems that are exacerbated when assets are dispersed range from incomplete and untimely data feeds, to inconsistency in processing tax lots and pricing assets. Additionally, aggregation applications may be challenged in their ability to keep pace with the issuance of new securities, accounting requirements and the evolution of foreign markets. A single global custodian simplifies many such activities and helps assure that transactions are consistently processed quickly and accurately.

Broker Dealers

Oftentimes, a family office will rely on a broker dealer to manage and conduct transactions, assuming that the broker dealer's records will serve as the Book of Record should tax issues arise. This is not the case. Only a premier global custodian can serve as the official Book of Record in an IRS audit, making the data found on the K-1 form the most accurate source of information for the family office. Employing a global custodian does not impede a family office from working with brokers; instead, it can enhance reporting across all brokers and other sources of investment income.

CONCLUSION

A global custodian should serve as the foundation for constructing any network of financial providers, as consolidating a client's assets under the umbrella of a single master custodian can provide significant leverage in managing financial responsibilities. The strongest global custodians have demonstrated a continuous investment in, and re-engineering of, services, operations and technology to meet the changing investment climate and regulatory demands. So while on the surface, data aggregators may seem like an effective means to manage a family office, the need for a global custodian remains essential to the success of a family office's foundational infrastructure.

DID YOU KNOW?

- Northern Trust's SSAE16 – the Statement on Accounting Standards that governs the control environment in which client assets are administered – is 117 pages.
- Northern Trust maintains alternate workspace around the globe dedicated for use in disaster scenarios and also a defined "Business Resiliency – work from home" program to validate Northern Trust's ability to conduct business at home should a disaster occur. These two initiatives are designed to help provide continuity of business activities in times of disaster.
- Northern Trust has implemented a resilient design for its corporate data centers such that both facilities represent mirror images of one another, each acting in a peer capacity to back the other up. Further, the data centers reside in two distinctly separate geographic locations such that it is highly unlikely a significant common threat exists to both. Electronic data is continuously mirrored between the data centers to help provide for no or minimal loss of data and to maximize our recovery capabilities to meet client business needs. In the event of a disaster at one of our corporate data centers, the other data center is equipped to resume critical processing within 12 hours or less.
- Northern Trust's online Money Movement tool allows family offices to initiate and approve all cash movement activities across all accounts using a single application and based option initiation/approval guidelines customized to each client's preferences and operating procedures.
- Northern Trust's annual investment to stay abreast of the latest developments in secure and reliable technology will be \$1.8 billion over the next three years.
- Most family offices use multiple money managers. Having a global custodian can streamline the communications across multiple relationships and minimize risk. Northern Trust's Investment Management Liaison Group currently works with approximately 2,700 money managers worldwide.

NORTHERN TRUST'S GLOBAL FAMILY & PRIVATE INVESTMENT OFFICES

For three decades, Global Family & Private Investment Offices has supported the needs of family offices. Global Family & Private Investment Offices currently serves more than 350 clients, including 20% of the *Forbes* 400 wealthiest Americans. Through family offices, we address clients' investing, reporting and other financial needs.

Since its creation in 1982, Global Family & Private Investment Offices has had the privilege to partner with family offices and has learned the following:

- Today, half of the family offices that Global Family & Private Investment Offices serves use the office as a vehicle for family education. Of those, more than half use outside consultants to manage the education process so future generations can continue to manage assets in line with the family's original mission.
- The vast majority of families served by Global Family & Private Investment Offices use a private foundation to foster a shared vision among family members. More than two-thirds of their family offices support the foundation through such services as grant administration and tax reporting.
- Through a number of safe and secure networking programs, Global Family & Private Investment Offices connects clients with other high-net-worth families to discuss everything from one another's experiences implementing office setup to how they report value back to the family.
- Fifty-eight percent of clients served by Global Family & Private Investment Offices have an operating business – real estate, agriculture and entertainment being the most common.
- Nearly one in three family offices that Global Family & Private Investment Offices serves is run by a family member.

IRS CIRCULAR 230 NOTICE: To the extent that this message or any attachment concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law. For more information about this notice, see <http://www.northerntrust.com/circular230>.

LEGAL, INVESTMENT AND TAX NOTICE: This information is not intended to be and should not be treated as legal advice, investment advice or tax advice. Readers, including professionals, should under no circumstances rely upon this information as a substitute for their own research or for obtaining specific legal or tax advice from their own council.

