

## **Draft Report for Discussion**

# **SUPERVISORY PROCESSES IN COLOMBIA: CIS AND THEIR CUSTODIANS**

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## NOTE ON TERMINOLOGY

The custody model in developed markets consists of two tiers, central depositaries being the first tier and custodians being the second. However, the term “custodian” has different meanings in different markets. In developed markets there is today such a degree of specialisation in these activities that “custodian” now only refers to an entity which assures the safe-keeping of a fund’s assets, while an entity which performs the more value-added services on behalf of a fund is known as a “depository”. Indeed, a depository may sub-contract the actual safekeeping of the assets to a custodian and focus exclusively on the more value-added tasks. The table below summaries the significance of key custodial terminology in the major European Markets:

TERM	EUROPEAN MEANING
Central Securities Depository	An entity entrusted with the safekeeping and administration of securities, which enables securities transactions to be processed by book-entry and may moreover have clearing and settlement functions. (In Colombia, the institutions that fall within this category are DCE and DECEVAL.)
Depository	An entity entrusted with specific prudential tasks and responsibilities in relation to CIS. It not only safe-keeps fund assets (i.e. acts as a custodian) but also has certain basic supervisory duties to ensure that the management company is operating the fund in compliance with regulation and the founding documents of the fund.
Custodian	An entity entrusted with the safekeeping and administration of securities and other financial assets on behalf of others, and may moreover provide additional services such as clearing and settlement, cash management, foreign exchange and securities lending. A custodian has no supervisory duties.
Sub-custodian	An entity entrusted by a custodian with a fraction of the assets under the nominal control of that custodian.
Global Sub-custodian	A sub-custodian that provides its client with custody services in respect of securities traded and settled on markets of various countries, through its own network. The global sub-custodian is a single interlocutor providing a range of services that may well overlap with those of the CISs depository if that entity provides services beyond the basic prudential mission of a depository.

In this report we are using the term “custodian” to mean an entity that combines the traditional safekeeping role of a custodian with more value added services such as verification of a fund’s valuation and some basic supervisory tasks. Since in Colombia custodial entities will initially focus on safekeeping and only gradually assume supervisory tasks, it was considered more appropriate to refer to them as “securities custodians” (*custodios de valores*), or custodians for short, in order to avoid confusion with the central depositaries. Once the concept becomes well established in Colombia and there is greater market awareness as to its role, it may be possible for these entities to assume more responsibilities and eventually for specialisation to occur as it has done in Europe between “custodians” and “depositaries”. It may then be appropriate to introduce new terminology.

## SUPERVISORY PROCESSES IN COLOMBIA: CIS AND THEIR CUSTODIANS

### I. INTRODUCTION

The CIS sector is becoming an increasingly significant actor in the financial system. As a result, CIS regulation and supervision is important in order to enhance systemic stability through transparent markets and well-supervised institutions with sound governance regimes. The OECD summarised the challenges facing CIS supervisors as follows:

“Chronicled abuses have included simple theft or misappropriation of assets, sales or redemptions at inappropriate valuations, deceptive promotion techniques, unclear title to assets, negligent or self-interested investment selection or management, failure to specify essential details about the undertaking, unreasonable fees, unenforceability of the obligations of the promoters and lack of an accountable party from whom redress can be sought. Some schemes have become insolvent, leading to very large losses from investors. Some schemes may avoid the outright abuses categorised above, but they may still operate primarily to the benefit of the promoters and other insiders rather than the investors.”<sup>1</sup>

The fact that to date in Colombia such scandals have only occurred in *Fondos de Valores*, which account for a mere 5% of the overall CIS market, does not preclude such problems from occurring in the future in other types of fund, since all types of fund in Colombia are subject to this structural weakness of lack of independence of the custodial function. As well as complementing, or even relieving, the current supervisory authority of some of the more mundane aspects of day-to-day checking of valuations and the like, allowing them to focus on more value-added supervisory activities (see paragraph 2.3 below), the introduction of the concept of independent custodian would lead to greater confidence in Colombian CIS products on the part of the investors if Colombian practices were in line with the best international standards in this respect (see paragraphs 3.1 to 3.3).

In the US, there is no legal obligation to retain the services of an independent custodian, but the vast majority of funds do so for reasons of market image and convenience. The quality and soundness of a fund’s custodian is an element of great weight in the commercialisation of funds there. Undoubtedly, astute marketing personnel at U.S. financial services firms will study the Colombian market and identify current custodial arrangements as a weakness, and then use this as a selling point for American CIS products versus Colombian CIS products, once the Free Trade Treaty between Colombia and the United States comes into effect. In this report, therefore, we will assess the current supervision of the CIS sector in Colombia, emphasising the potential role of CIS custodians in this vital task.

### II. REVIEW OF CURRENT SITUATION

#### 2.1 Off-Site Examinations of CIS

The following table summarises international best practices in off-site supervision and indicates the existence of such processes at both the *Superintendencia Bancaria* (SB) and the *Superintendencia de Valores* (SV).

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<sup>1</sup> *Governance of Collective Investment Schemes (CIS)*, OECD, Draft for Discussion, July 2004, Page 4.

OFF-SITE INSPECTION "BEST PRACTICES"	ALREADY IMPLEMENTED?	
	SB	SV
Regular and frequent revision of key concepts	√	√
Maximum automation of off-site supervisory processes <ul style="list-style-type: none"> <li>- Information received in electronic format</li> <li>- Existence of databases which can be manipulated to perform a variety of analysis</li> <li>- Automatic generation of exception reports</li> </ul>	partial	partial
Coverage of core content: <ol style="list-style-type: none"> <li>1. <u>Legal concepts</u>: use to detect breaches of norms <ul style="list-style-type: none"> <li>- Basic data: capital, assets under management, number of participants, etc.</li> <li>- Observance of limits: investment, liquidity, diversification</li> <li>- Investment in appropriate securities</li> <li>- Operations with derivatives (if appropriate)</li> </ul> </li> <li>2. <u>Economic and Financial concepts</u>: use to detect actions prejudicial to investors and monitor the economic viability of the entity <ul style="list-style-type: none"> <li>- Solvency, risk assumed and profit obtained</li> <li>- Errors in the calculation of the NAV of the fund and per unit (as reported by the custodian)</li> <li>- Check transactions are effected at market prices</li> <li>- Identify potential conflicts of interest</li> </ul> </li> </ol>	√	√

As can be seen from the table above, the supervisory processes of both the SB and the SV are in line with international best practices. The only area of partial fulfilment is that of the maximum automation of the off-site supervisory processes, and this is in hand since both supervisors are in the process of implementing systems that will address this issue (albeit different ones).

## 2.2 On-Site Examinations of CIS

The following table summarises international best practices in on-site supervision and indicates the existence of such processes at both the SB and the SV.

ON-SITE INSPECTION "BEST PRACTICES"	ALREADY IMPLEMENTED?	
	SB	SV
Types of visit <ul style="list-style-type: none"> <li>- Programmed as per annual visit plan (based on date of last visit, with priority given to those institutions that present the greatest risk according to off-site inspection indicators, as well as some randomly selected CIS to prevent them from working out when they are likely to be visited)</li> <li>- Previously announced and agreed visits</li> <li>- Surprise visits</li> <li>- Follow-up visits to verify implementation of recommendations made on previous visit</li> </ul>	√	√

ON-SITE INSPECTION “BEST PRACTICES”	ALREADY IMPLEMENTED?	
	SB	SV
<ul style="list-style-type: none"> <li>- Global inspections</li> <li>- Thematic inspections</li> <li>- Incident-based visits (when problems arise or off-site inspections indicators suggest there are serious issues)</li> </ul>		
<p>Coverage of core content:</p> <p>1. <u>Management of the Entity</u></p> <ul style="list-style-type: none"> <li>- Adequate organisation and sufficient means</li> <li>- Management structure</li> <li>- Autonomy and independence of management decisions</li> <li>- Delegation of functions</li> <li>- Audit Committee</li> <li>- Risk Management Committee</li> <li>- Investment Committee</li> </ul> <p>2. <u>Legal and Regulatory Compliance</u></p> <ul style="list-style-type: none"> <li>- Compliance with all pertinent legal and regulatory norms</li> <li>- Reconciliation of the entity’s internal information with that submitted to the supervisor</li> </ul> <p>3. <u>Internal Controls</u></p> <ul style="list-style-type: none"> <li>- Accounting processes comply with legal norms</li> <li>- Compliance with Business Conduct Rules</li> <li>- Management of conflicts of interest (e.g. between entities of the fund manager’s corporate group and the investor; between the manager and the custodian; between the manager and the investor and between investors of different CIS managed by the same fund manager) and the effectiveness of measures to mitigates them (such as business conduct norms; limiting information flows by Chinese walls; the independence and separation of the custodian and the regulation of connected operations)</li> <li>- Management of operational, financial and legal risks</li> </ul> <p>4. <u>Administration of Client Resources</u></p> <ul style="list-style-type: none"> <li>- Separation of client and company assets</li> <li>- Equal treatment of all classes of investors</li> <li>- Review of the NAV applied at entry to and exit from the CIS</li> <li>- Confirmation of balances and cash flows relating to client operations</li> <li>- Checking to see if settlement of transactions occurs within legally defined timeframes</li> <li>- Reviewing commissions applied and information sent to investors</li> <li>- Relationship with the custodian of the CIS</li> </ul>	<p>√</p> <p>√</p> <p><b>partial</b></p> <p>√</p> <p><b>partial</b></p>	<p>√</p> <p>√</p> <p><b>partial</b></p> <p>√</p> <p><b>partial</b></p>

ON-SITE INSPECTION "BEST PRACTICES"	ALREADY IMPLEMENTED?	
	SB	SV
5. <u>Investment and Custodial practices</u> <ul style="list-style-type: none"> <li>- Investment policy observed</li> <li>- Priority given to client interests</li> <li>- Respect of "best execution" rule</li> <li>- Respect of "best allocation" rule</li> <li>- Fulfilment of legal ratios and limits</li> <li>- Proper valuation of the assets</li> <li>- If there is a separate custodian, then certification by the custodian as to the existence of the assets; if there is no separate custodian, a physical verification and/or count of the assets</li> </ul>	<b>partial</b>	<b>partial</b>
6. <u>Marketing and Sales Practices</u> <ul style="list-style-type: none"> <li>- Veracity of marketing documents and the sales pitch</li> <li>- Acceptability of marketing &amp; sales practices (e.g. no unduly aggressive tactics)</li> <li>- Respect of "cooling off periods" or other customer withdrawal mechanisms</li> <li>- Terms and conditions, including commissions</li> </ul>	<b>partial</b>	<b>partial</b>
7. <u>Archiving of documentation supporting transactions</u> <ul style="list-style-type: none"> <li>- Completeness, both in terms of form and content</li> <li>- Respect of legal norms regarding the period of time for which documents must be held</li> </ul>		
8. <u>Evaluation of the IT systems</u> <ul style="list-style-type: none"> <li>- IT policy and implementation procedures</li> <li>- The IT platform</li> <li>- Communication networks</li> <li>- Security systems</li> <li>- Back-up procedures</li> <li>- Contingency plans</li> </ul>		
Observance of the "four eyes" principle	√	√
Use of own computers to safeguard confidentiality	√	√
Power to order an external audit to be performed in order to complement inspection visits	<b>NO</b>	<b>NO</b>
Power to interview clients of the inspected entity to question them about the quality of services received	√	√

As with off-site supervision processes, the on-site supervisory processes of both supervisors largely conform to international standards. The supervisory processes per se are adequate (although it should be noted that follow-up visits tend to be merged with the next programmed visit due to lack of resources, so our assessment of "types of visit" may err on the side of generosity). Where there are weaknesses, these are primarily related to the content of the inspection and the need for additional powers, rather than to the competence of the staff or the way they are going about their work. From conversations with supervisors at both entities, we learned that help is needed in defining possible conflicts of interest and evaluating methods of managing them, as well as in defining minimum standards for sales and marketing practices and IT systems for CIS. Once such standards were in place, they would be included in the scope of the inspection and investigated using the same methods

and processes as for the other items. In addition to the development of these standards, both supervisors would benefit from additional powers to order an external audit to complement their supervisory activity.

One weakness that cannot be qualified as “minor” is the issue of current institutional arrangements for the custody of CIS assets. This, in the view of the consultants, is a major weakness for the reasons set out in the introduction to this document, namely the vulnerability of CIS to conflicts of interest and fraudulent operations under the type of self-custody arrangements that exist in Colombia today, as has been highlighted by recent problems in the Colombian CIS sector resulting from inadequate separation of management company and fund assets. Although these matters were dealt with in a timely and efficient manner by the relevant supervisory authority, it is likely that these problems would not have arisen had there been a requirement for management companies to deposit CIS assets with an independent custodian of sufficient professional standing.

### **2.3 Impact Of Introducing Custodians On Supervisory Processes**

Our conclusion with regard to both off-site and on-site supervision is that both supervisors are largely performing their tasks in accordance with best international practices. Indeed, in certain situations they do more than supervisors in other countries, largely due to the weakness in third-party supervision in Colombia. Since the current supervisory processes are acceptable and not in need of improvement, we will instead focus our attention on the impact that the introduction of custodians will have on current supervisory processes, as well as the supervisory processes that will have to be put in place to supervise the custodians themselves (see Appendix 1).

The introduction of custodians will not only provide an extra safeguard for the security of the assets of a CIS, thereby boosting investor confidence in the CIS sector, but will also provide much-needed third-party supervision in Colombia. This will free-up resources at the supervising entities and enable them to focus on more value-added tasks.

The type of activities that could be delegated to custodians include:

- Verification of the valuation of the fund
- Verification of the calculation of NAV of each unit in the fund
- Checking compliance with investment, liquidity and diversification limits and ratios
- Checking compliance with the fund’s investment strategy
- Detection of prohibited transactions and investment in ineligible securities
- Payment of the correct amount of dividends and withholding of the correct amount of taxes

Any problem detected would first be notified to the fund manager, who would have a grace period (to be set by the supervisor according to the gravity of the problem) to put it right before the custodian would be obliged to inform the supervisor. This would have the advantage of relieving the supervisor from the burden of daily calculation and reconciliation work, as well as only being required to mobilise resources to rectify breaches when the management company fails to respond to the notification issued by the custodian. Resources freed up in this way could be diverted to conducting more complicated analysis, including:

- Detection of unacceptable sales and marketing practices such as deceptive or unduly aggressive sales tactics and offering special terms to friends and relatives

- Detection of abusive trading practices such as front-running, churning and soft commission arrangements
- Detection of window-dressing transactions (e.g. repos) to manipulate fund performance and make it look better than it really is at a reporting point
- Detection of triangulation and other prohibited transactions between members of the same corporate group
- Detection of mis-management of conflict of interest situations

However, it should be emphasised that delegation of day-to-day supervisory tasks to custodians does not entail any loss or delegation of authority and ultimate accountability of the supervisor. Furthermore, custodians will themselves be supervised entities.

## 2.4 The Impact of Introducing Compulsory Independent Custodians on Fund Costs

The resources available for this project are insufficient to support an extension of the Terms of Reference to conduct a thorough cost to benefits analysis of the introduction of an obligatory independent custodian for CIS funds. However, a rough idea can be gained by comparison with other markets. Looking at international markets, the cost of custody ranges from approximately 0.2% to 0.5% of assets under management per annum, and is normally a fairly modest portion of overall costs. By way of illustration, the table below lists the costs of four major US funds that may be direct competitors with Colombian funds, once the Free Trade Treaty is finalised:

FUND	COST OF CUSTODIAN (% of Total Assets)	OVERALL COSTS (% of Total Assets)
Emerging Markets Growth Fund	0.241	1.11
Morgan Stanley Markets Fund	0.366	2.02
Templeton Emerging Markets Fund	0.284	1.91
Latin American Investment Fund	0.281	2.31

SOURCE: SUGEVAL, "Los Servicios de Custodia", 1999

We do not have specific details on what custodians in Colombia would charge for this service, but neither of the two entities that we spoke to (Citibank and Banco Santander) gave us the impression that these charges would be excessively high. The whole selling proposition of this service from their point of view is that independent custodians benefit from economies of scale, enabling them to provide custody services more cheaply than is the case if each individual fund operator undertakes this activity.

To understand the benefit side of the equation, it would be necessary to have detailed information on the cost structure of Colombian funds to calculate the difference between what custody is costing each fund at the moment and what it would cost were it to be contracted out to an independent custodian. Appointing an independent custodian should lead to savings in the back office costs of the funds, notably in terms of personnel, office space and equipment and professional indemnity insurance.

## III. THE SUPERVISION OF CUSTODIANS

### 3.1 Recommendations of International Organisations

As the CIS sector increasingly becomes a significant actor in the financial system, the

efficiency of which has a major impact on macroeconomic performance as reflected in indicators such as growth, inflation and income, the importance of adequate regulation and supervision of said sector escalates. Regulators have sought to enhance systemic stability through transparent markets and well-supervised institutions with sound governance regimes. Given the cross-border nature of CIS activity, regulators have been spurred to develop some common international standards of supervision. These common international standards are important because they are essentially “best practices” for all regulatory and supervisory authorities with oversight of the CIS sector.

A small number of international bodies have played a significant role in developing common international standards. In 1971 the OECD issued “*Standard Rules for the Operation of Institutions for Collective Investment in Securities*”. These Standard Rules, which were accepted by the OECD Council, formed the basis for later work in achieving global standards. In subsequent years, the International Organisation of Securities Commissions (IOSCO) took the lead in setting global CIS standards as part of its wider objective of promoting cooperation amongst securities market commissions. In 1994 IOSCO issued “*Principles for the Regulation of Collective Investment Schemes*”, followed by the issue of “*Principles for the Supervision of CIS Operators*”. Both the OECD Standard Rules and the IOSCO Principles address the basic features that all CIS should have in order to be acceptable for public offerings, including an adequate legal and regulatory framework, the segregation of the CIS assets, the role of the depositary/custodian, norms for the valuation of assets and the redemption of positions and the obligation of full disclosure.

International cooperation has also proceeded at a regional level. Most notably, the European Commission (EC) has been actively promoting international standards amongst European Union (EU) Member States. In 1985 the Council of the European Community issued its initial Directive on Undertakings for Collective Investment in Transferable Securities (UCITS), and has continued to issue further Directives in this area, with the most recent UCITS Directive being issued in 2002. They go beyond the work of the OECD and IOSCO in the setting of standards and international norms, having as their aim the harmonisation of domestic rules governing CIS in EU Member States and the facilitation of cross-border dealings in particular types of CIS through the fulfilment of common criteria. In March 2004 the EC set out a step-by-step approach to reducing differences in national rules on the custodians used to safeguard assets on behalf of investors in CIS, such as unit trusts, common funds and SICAVs. Implementing this approach over the next two years, in cooperation with national regulators, will make easier the cross-border operation of UCITS. The four main areas for action are: prevention of conflicts of interests, clarifying depositaries' liability, convergence of national prudential requirements and enhancing transparency and investor information.

Despite broad agreement on international principles for CIS governance, no legal form, governance structure or supervisory regime has been acknowledged as inherently superior to other systems. It is left to each country to designate the supervisory authority of its choice to supervise this activity.

### **3.2 Current Practice in Major European Markets**

Unlike the US, where the use of an independent custodian is optional (although the vast majority of American funds choose to use an independent custodian for reasons of convenience), the use of an independent custodian is obligatory in the 25 Member States of the EU. The following table summarises key features of the supervision of, as well as the supervision performed by, securities custodians in the major European Markets in respect of

contractual and trust funds. Arrangements for corporate funds, which have an entirely different governance structure, are not discussed since this type of fund is not found in the Colombian market. Where there is a common European standard, this is stated. It is worth noting that, in the main, regulators in the major markets have gone beyond the common European requirements.

<b>Requirement for a CIS to have a separate custodian</b>	
EU-wide	Segregation of assets outside the fund management company is required for all CIS that qualify as UCITS (i.e. those offered to the public – the vast majority). Segregation entails the “separation and ethical independence” of the fund manager and the custodian so that both companies act independently and in the interests of the fund investors.
<b>Entity responsible for authorising and supervising custodians</b>	
France	La Commission des Operations de Bourse (COB) – the securities market regulator (custody is considered to be a market activity)
Germany	The consolidated financial services supervisor
Italy	CONSOB - the securities market regulator (custody is considered to be a market activity)
Spain	La Comisión Nacional del Mercado de Valores (CNMV) - the securities market regulator (custody is considered to be a market activity)
UK	The consolidated financial services supervisor (the FSA)
<b>Types of entity that may act as a custodian</b>	
EU	Must be an institution subject to public control
France	Credit institutions, investment firms, insurance undertakings and public institutions (such as the Central Bank)
Germany	Credit institutions
Italy	Credit institutions
Spain	Credit institutions and investment firms
UK	Credit institutions, investment firms, insurance undertakings and other regulated legal persons
<b>The minimum capital requirements to act as a custodian</b>	
EU	There is as yet no common standard across the EU – it varies in function of the legal liability of the custodian and the regulatory requirements regarding internal organisation and IT systems. The EU guideline is that the custodian must furnish sufficient financial resources to be able to positively pursue its business and to meet the commitments inherent in its function.
France	€3.8 million

Germany	In function of the type of entity that undertakes custodial activities
Italy	€100 million
Spain	In function of the type of entity that undertakes custodial activities
UK	£4 million (= approximately €6 million)
<b>Additional requirements to act as a custodian</b>	
EU	<p>The directors of the custodian must be of sufficiently good repute and sufficiently experienced in relation to the type of fund managed</p> <p>Proposals for other requirements include the submission of the custodian's programme of activity setting out, <i>inter alia</i>, its organisation structure and its internal procedures. In addition the custodian will have to prove that it has sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms.</p>
France	The custodian must have all the appropriate documentation and approvals of other institutions (e.g. documents of incorporation)
Germany	<p>The application dossier for authorisation must include:</p> <ul style="list-style-type: none"> <li>○ The names and qualifications of shareholders and managers</li> <li>○ A description of the organisation, its activities and its internal procedures</li> <li>○ A description of the human, technical and financial resources of the entity</li> <li>○ Optionally, the custodian may also be requested to provide a copy of the service level agreements (SLA) between itself and the fund management companies for which it acts as a custodian</li> </ul>
Italy	There are no formal additional requirements, although a bank that wishes to undertake the role of custodian may be required to submit an organisation plan to the Central Bank (to ensure that it has the necessary resources to carry out this activity)
Spain	<ul style="list-style-type: none"> <li>○ The entity must show that it has the appropriate means and the capacity to carry out the mission of a custodian</li> <li>○ The entity must furnish a copy of its internal rules of business conduct</li> <li>○ The entity must furnish evidence that it is a member of the relevant settlement systems</li> <li>○ In addition, although there is no legal obligation to do so, in practice entities applying for authorisation as custodians provide a copy of their manual of rules and procedures</li> </ul>
UK	A custodian must be registered to act as an "authorised person" permitted to exercise a "regulated activity". In addition, a custodian may be required to furnish the FSA with a copy of its conditions of service.
<b>The custodian's duties of oversight of the funds for which it acts as a custodian</b>	

EU	<ul style="list-style-type: none"> <li>○ Ensure that the valuation of the units is calculated in accordance with the law and the fund rules</li> <li>○ Ensure that transactions on the units (sale, issue, re-purchase and redemption) are carried out in accordance with the law and the fund rules</li> <li>○ Ensure that the fund's income is applied in accordance with the law and the fund rules</li> <li>○ Check the legality of each operation</li> </ul> <p>Proposals for other oversight duties include checking the compliance with, and ensuring the management company's observance of:</p> <ul style="list-style-type: none"> <li>○ The prudential investment limits</li> <li>○ The investment policy set out in the information sheet or in the prospectus</li> <li>○ The regulatory framework applying to UCITS</li> <li>○ The rules for calculating the value of the fund</li> </ul>
France	<ul style="list-style-type: none"> <li>○ Monitor investment decisions to ensure observance of the investment rules and ratios of the fund</li> <li>○ Check the valuation of the fund</li> <li>○ Verify the fund complies with minimum size requirements</li> <li>○ Check the legality of the management company's actions</li> <li>○ Supervise the organisation of the accounts of the management company</li> </ul>
Germany	<ul style="list-style-type: none"> <li>○ Verify that the purchase and sales prices of the assets of the fund conform to those prevailing in the market at the time of the transaction</li> <li>○ Approve loans taken out on behalf of the fund</li> </ul>
Italy	<ul style="list-style-type: none"> <li>○ Check that investment decisions conform to market rules</li> </ul>
Spain	<ul style="list-style-type: none"> <li>○ Monitor investment decisions to ensure that they comply with market and CIS rules, as well as the fund's investment criteria, ratios and liquidity and diversification limits</li> <li>○ Validate the accounts presented by the fund management company to the CNMV</li> <li>○ Supervise various (unspecified) procedures of the fund management company</li> <li>○ Inform CNMV of any irregularities discovered</li> </ul>
UK	<ul style="list-style-type: none"> <li>○ Check the valuation of the fund (there is a duty to inform the management company if it is incorrect)</li> <li>○ Check that the management company has procedures in place to deal with incorrect valuations, including the means to remedy such errors</li> <li>○ Monitor investment decisions</li> <li>○ Check the internal control procedures put in place by the fund management company</li> <li>○ Supervise the fund management company's observance of its document of constitution</li> </ul>

### 3.2.1 Case Study: Spain

We will now examine in more detail the situation in Spain. Spain has been selected as the most relevant benchmark for Colombia for four reasons:

- It is a country that introduced CIS relatively recently, with great success, as shown by the statistics mentioned in the tables below;
- With the 1992 single market initiative which created, amongst other things, a single market for financial services within the EU, it faced a challenge similar to that which Colombia is facing today with the free-trade agreement with the United States;
- The legal system is based on the Napoleonic Code, as is that of Colombia, and
- It is used as a benchmark by other Latin American countries. (For example, Costa Rica, which is currently in the process of introducing custodians and requiring its CIS to appoint an independent custodian, is using Spain as its model.)

The following tables chart the development and expansion of the CIS sector in Spain. Although it had been in existence since 1952, it was not until the mid-1980s that the CIS sector really began to play a major role in the financial system, with total CIS assets growing from 2% of GNP in 1989 to 30% in 2002 (which is above the EU average of 27% of GNP). In terms of family savings, CIS represented 29% of total family savings in 2002 compared to only 0,9% in 1987 (with 60% in bank deposits in both years).

	Until 1984	1985-1989	1990-1998	1999-2003
<b>Basic Regulation</b> (Principal Stages in Development)	<ul style="list-style-type: none"> <li>▪ <u>1952</u>: Investment Company Law (Ley SIM)</li> <li>▪ <u>1958</u>: New "SIM" Law</li> <li>▪ <u>1964</u>: Decree-Law 7/64 allows investment co.s (SIM), investment funds (FIM) &amp; variable capital investment co.s (SIMCAV) and a Ministerial Order on SIMs</li> <li>▪ <u>1970</u>: Ministerial Order on FIMs</li> <li>▪ <u>1984</u>: CIS Law</li> </ul>	<ul style="list-style-type: none"> <li>▪ <u>1985</u>: CIS Regulations and Ministerial Order on investment ratios</li> <li>▪ <u>1988</u>: Securities Market Law (LMV)</li> </ul>	<ul style="list-style-type: none"> <li>▪ <u>1990</u>: Royal Decree on CIS</li> <li>▪ <u>1991</u>: Ministerial Order on CIS management co.s</li> <li>▪ <u>1992</u>: Ministerial Order on custody</li> <li>▪ <u>1993</u>: Ministerial Order on derivatives &amp; risk management</li> <li>▪ <u>1997</u>: Royal Decree on CIS investments in unlisted shares</li> <li>▪ <u>1998</u>: Ministerial Order on prospectus and other information to be disclosed + new LMV and new law on real estate CIS</li> </ul>	<ul style="list-style-type: none"> <li>▪ <u>1999</u>: preparation for the Euro and new CIS tax regime</li> <li>▪ <u>2001</u>: 1990 Royal Decree on CIS amended – introduction of new investment vehicles such as indexed funds and funds of funds</li> <li>▪ <u>2003</u>: New CIS tax regime (elimination of tax on transfers between funds)</li> </ul>
<b>Factors encouraging growth</b>	Financial innovation	More types of CIS, new LMV & the 1985 EU UCITS Directive	Tax, fund design and publicity	Competition
<b>Supervisor</b>	MEH	MEH & CNMV	CNMV	CNMV
<b>Type of CIS</b>	SIM	FIM	FIM, FIAMM & SIMCAV	Specialised CIS & Funds of funds
<b>N° of CIS</b>	276	470	2 472	5 303
<b>Assets</b>	€1 794 million	€7 061 million	€211 903 million	€193 635 million

Source: CNMV of Spain

Note: MEH stands for *Ministerio de Economía y Hacienda* or the Finance Ministry and CNMV stands for *Comisión Nacional del Mercado de Valores* or the Securities Market Commission.

The nature of the investments has changed over the time-period shown in the table above. In the 1960s there was a stock exchange boom and most CIS invested heavily in shares. By the mid-1980s CIS had begun to invest in government bonds as well as shares, and by 1990 funds were investing almost exclusively in fixed income securities, both government and corporate. In the past decade total CIS investment in equities has been low. Total CIS investment in shares peaked at 6% of total market capitalisation in 1998, but had descended to only 3% in 2002 – below the EU average of 5% and well below the US average of 22%.

<b>CIS IN SPAIN</b>	<b>1991</b>	<b>1995</b>	<b>2000</b>	<b>2002</b>
Investment Funds	373	756	2 477	2 538
Investment Co.s	289	268	1 670	2 775
<b>INSTITUTIONS</b>	<b>662</b>	<b>1 024</b>	<b>4 147</b>	<b>5 313</b>
Funds (millions)	1.15	2.95	7.69	7.09
Co.s (thousands)	96.8	92.6	186.7	338.1
<b>PARTICIPANTS</b> (millions)	<b>1.24</b>	<b>3.04</b>	<b>7.88</b>	<b>7.43</b>
Funds (€ millions)	23 260	73 282	186 068	174 735
Co.s (€ thousands)	2 101	2 509	15 439	18 900
<b>ASSETS</b> (€ millions)	<b>25 361</b>	<b>75 791</b>	<b>201 507</b>	<b>193 635</b>
per participant (€)	<b>20 420</b>	<b>24 947</b>	<b>25 572</b>	<b>26 067</b>

SOURCE: CNMV of Spain

	<b>Number</b>	<b>Participants</b>	<b>Assets</b>
<b>Foreign CIS</b>	218	200.8 thousand	€6 538 million
<b>Real Estate CIS</b>	7	70.6 thousand	€1 142 million
<b>Venture Capital</b>	82	11.0 thousand	€1 424 million
<b>Pension Funds</b>	802	5.5 million	€44 542 million

SOURCE: CNMV of Spain

Investor protection is achieved through:

- Norms on the independence and separation of the fund manager and custodian
- Rules of business conduct
- Norms on transactions with connected parties
- The dissemination of information to fund participants
- The supervision assured by the CNMV, particularly in respect of operations where a conflict of interest may arise

Of particular relevance to this report are arrangements for the custody of CIS assets in Spain. The appointment of an independent custodian is considered crucial not only to promote investor confidence in the product, but also to ensure proper governance and supervision of the funds. In common with the other European countries, a CIS may have only one custodian and no entity may simultaneously be the manager and custodian of any given CIS. However, Spain goes further than most other European countries by prohibiting any entity from being

the custodian of a CIS managed by a management company belonging to the same corporate group, unless the following conditions are satisfied:

- There are specific procedures in place that prevent conflicts of interest and information flows, such as Chinese walls. Such procedures must be verified by an independent body, which will make a report to the CNMV. Unless the report is unqualified, the custodian must be substituted.
- There are no directors who also sit on the board of other group companies, and in particular that the management company is run by directors who are completely independent of those of the custodian.
- The fund management company and the custodian are domiciled in completely separate locations.

In addition, the custodian must report investments by the fund in its own securities to the CNMV. Under no circumstances should the amount of this investment exceed the 1% of the total portfolio of the fund.

In Spain both the fund management business and custodial services are in the hands of the banks. Investment funds are perceived by the Spanish investor to be substitute products for traditional bank deposits, and the migration out of deposits into funds has been so massive than the banks were keen to develop both fund management and custodial activities. The separation of fund management from custody is therefore not drastic.

Investment funds are considered to be institutional investors and as such are not eligible for relief from either the Investment Guarantee Fund or the Deposit Guarantee Fund in the case that the custodian becomes insolvent. However, there are strict requirements as to the recording of the assets of funds and their separation from those of the custodian, and the CNMV can order the transfer of assets held on behalf of funds from one custodian to another, without the investors incurring any extra costs, should a fund's custodian become insolvent. Unusually for a developed market, there is a requirement for custodians to be rated in Spain, and this rating feeds into the overall rating of the fund.

### 3.3 Current Practice in Major Latin American Markets

The following table summarises key features of the supervision of, as well as the supervision performed by, securities custodians in the major Latin American Markets.

<b>Requirement for a CIS to have a separate custodian</b>	
Argentina	Mutual Funds, Insurance Companies and Pension funds, must deposit their investments in a custodian bank. However, only in the case of Pension Funds is there a prohibition on the custodian being a member of the same corporate group.
Brazil	None - there is no requirement that the custodian be independent from the fund management company, but custodians do exist
Chile	For local mutual and pension funds, only first-tier custody exists: funds must have their own account in the central depository (DCV). In contrast, foreign mutual funds must also have a second-tier custodian in Chile in order to represent them and keep custody of their assets.

Mexico	None – there is no requirement that the custodian be independent from the fund management company
Peru	YES – in the case of “ <i>fondos mutuos</i> ” (i.e. not corporate funds) there is a requirement that the custodian be operationally independent from the fund management company, although it may form part of the same corporate group
<b>Date of introduction of the institution of custodians</b>	
Argentina	Since the launch of the Private Pension Funds ( <i>Administradoras de Fondos de Jubilaciones y Pensiones, AFJP</i> ) in 1994, the use of custodians for local investors has become formalised. Before that time, the service was basically only provided to foreign investors and retail clients.
Brazil	1974
Chile	Custody services have been offered for some time, but since the introduction of the central depository (DCV) in 1995, a crucial change has occurred in the market and now all the agents (banks, brokers, etc) have introduced the “securities custodian” concept.
Mexico	The offering and recognition of custody services began in the early 1990's after the establishment of the central securities depository (CSD) in 1987.
Peru	1998
<b>Entity responsible for authorising and supervising custodians</b>	
Argentina	Since custody services are provided by financial institutions, the regulator is the Argentinean Central Bank. The Securities Exchange Commission supervises the <i>Caja de Valores</i> (central depository and clearing house)
Brazil	The CVM – the securities market supervisor, because custodial activity is a “securities market activity”
Chile	As an institution, it is supervised by the Superintendence for Banks and Financial Institutions (SBIF). However, in relation to its securities market activity, it is regulated by the SVS – The Securities and Insurance Supervisor – as this is the entity that regulates all securities market activity.
Mexico	The CNBV – supervision of financial entities is consolidated in Mexico
Peru	CONASEV – the securities market supervisor, because custodial activity is a “securities market activity”
<b>Types of entity that may act as a custodian</b>	
Argentina	Commercial and Investment banks. Brokers can only act as custodians for retail clients.
Brazil	Commercial banks, investment banks, stock exchanges, brokers and dealers

Chile	Commercial Banks, brokers and dealers and private companies that comply with requirements in the applicable laws. All of them must contract the first-tier custody services of the central depository (DCV).
Mexico	Commercial banks, investment banks, and broker dealers.
Peru	Banks authorised by the banking supervisor
<b>The minimum capital requirements to act as a custodian</b>	
Argentina	Same as those required to act as a private bank- there is no separate capital requirement to undertake custodial activities.
Brazil	They are the same as for the incorporation of the institution – there is no separate capital requirement to undertake custodial activities
Chile	There is no special capital requirement to be a custodian besides that to act as a bank or broker.
Mexico	As long as an entity is authorised to act as a Bank in Mexico, it may offer custody services. There is no separate capital requirement to act as a custodian.
Peru	They are the same as for obtaining the banking licence – there is no separate capital requirement to undertake custodial activities
<b>Additional requirements to act as a custodian</b>	
Argentina	YES. Custodians for AFJP and Insurance Companies must be registered and authorized by the <i>Superintendencia de Seguros y AFJP</i> .
Brazil	YES – as per the CVM Normative Instruction N°. 89 of Nov/88
Chile	None. It must only be a company legally established in Chile and comply with the regulations established in the law.
Mexico	None.
Peru	YES, such as systems to properly identify the assets of each fund for which it acts as a custodian and operational manuals
<b>The custodian's duties of oversight of the funds for which it acts as a custodian</b>	
Argentina	YES – the custodian has the responsibility to advise the fund management company of any irregularities, and, if the latter does not amend the problem, then the custodian must inform the regulator.
Brazil	None - a Custodian's duty is solely to assure safe custody of assets
Chile	None - the custodian's only duty it to safe keep the securities.
Mexico	None – Mexico has adopted the US model, whereby funds are corporate entities and the board has responsibility for oversight

Peru	The custodian has the responsibility to advise the fund management company of any irregularities, and, if the latter does not rectify the problem, then the custodian must inform CONASEV
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SOURCE: Banco Santander (Colombia), CONASEV (Peru), CNBV (Mexico)

### 3.4 The Powers and Faculties Necessary to Authorise and Supervise Custodians

In many countries, supervisory authorities, and in particular Securities Commissions, must authorise custodians because custodianship is considered to be a “securities market activity” rather than a traditional banking activity covered by the general banking license. The formality of this authorisation process varies from country to country, depending on what the banking license covers. In some countries, for example, the CIS operator need only present the name of their proposed custodian to the supervisor for approval to act in that capacity for a particular fund, so that there is no formal authorisation process to act as a custodian as such. Under this scenario, reasons for vetoing a custodian might be lack of proper operational independence between the fund operator and the custodian, but that may not necessarily preclude the custodian from acting as custodian to other funds.

In Colombia, given that banks appear to be precluded by law from fulfilling custodial activities (see Article 118 of Law 45 1990), the concept of “securities custody” cannot be said to be covered by the general banking license. It would therefore be advisable for Colombia to institute a more formal authorisation procedure. The following table lists the concepts that will be included in a “full” authorisation of custodians, and indicates whether the SB and the SV are currently endowed with the appropriate faculties and competencies in Colombian law in order to perform the necessary supervisory tasks.

ELEMENT OF AUTHORISATION PROCESS FOR REVIEW BY SUPERVISOR	POSSESSION OF NECESSARY COMPETENCE/ FACULTY	
	SB	SV
Description of the strategy for the development of custody services	√	√
Evidence that the Custodian possesses the financial, human and technological resources necessary in order to accomplish its mission	√	√
A description of the organisation structure, detailing personnel, their qualifications, their job descriptions and their tasks and responsibilities	√	√
A description of the internal control systems	√	√
A description of the IT systems and the means of data protection in accordance with all statutory requirements	√	√
A description of measures for preventing unauthorised access to and or destruction of data / documentation	√	√
A description of measures for safeguarding the confidentiality of information and avoiding abusive use of such information	√	√
Evidence of membership of the relevant settlement systems	√	√
A copy of the standard custody contract detailing terms and	√	√

ELEMENT OF AUTHORISATION PROCESS FOR REVIEW BY SUPERVISOR	POSSESSION OF NECESSARY COMPETENCE/ FACULTY	
	SB	SV
conditions		
Notification of contracts to be concluded with sub-custodians	√	√

The following table lists the concepts that will be included in the supervision of custodians, and indicates whether the SB and the SV are currently endowed with the appropriate faculties and competencies in Colombian law in order to perform the necessary supervisory tasks.

CONCEPT TO BE INSPECTED	POSSESSION OF NECESSARY COMPETENCE/ FACULTY	
	SB	SV
Custodian possesses the financial, human and technological resources necessary in order to accomplish its mission	√	√
IT systems and procedures cover the following: <ul style="list-style-type: none"> <li>- measures to preserve and protect information and restore it in case of collapse of the IT systems, disasters, etc.</li> <li>- procedures for the backup and duplication of databases storing information on fund assets</li> <li>- procedures for the correction of incorrect entries</li> </ul>	√	√
The custodian is in compliance with all relevant laws and norms, including (but not limited to) rules governing: <ul style="list-style-type: none"> <li>- disclosure of information to clients</li> <li>- shareholder communication</li> <li>- securities transaction record-keeping</li> <li>- secrecy</li> <li>- escheatment (i.e. the transfer of assets of untraceable ownership to the State) and lost and stolen assets</li> <li>- overdrafts</li> </ul>	√	√
The custodian has an appropriate risk management policy, processes and procedures to identify, measure, monitor and control the following types of risk: <ul style="list-style-type: none"> <li>- transaction / operational risk</li> <li>- compliance risk</li> <li>- credit / counterparty risk</li> <li>- strategic risk</li> <li>- reputation risk</li> </ul>	√	√
The custodian has an appropriate system of internal control, including: <ul style="list-style-type: none"> <li>- separation of duties (both physical and logical)</li> <li>- dual control over movements of assets</li> <li>- accounting controls</li> <li>- custody agreements</li> </ul>	√	√

CONCEPT TO BE INSPECTED	POSSESSION OF NECESSARY COMPETENCE/FACULTY	
	SB	SV
<ul style="list-style-type: none"> <li>- MIS system (overdraft reports, failed trade reports, reconciliation reports, etc.)</li> <li>- contingency planning (e.g. how to maintain operations in the event of IT systems failure)</li> <li>- audits (both internal and external)</li> </ul>		
The client has subscribed to appropriate insurance policies and has sufficient insurance coverage given the scope of its activities	√	√
The custodian's responsibilities to its client funds are clearly delimited in contracts celebrated with the later	√	√
The custodian has an appropriate due-diligence process for the selection of sub-custodians and other service providers	√	√
Where any aspect of the custodian's task is delegated (e.g. to a sub-custodian), the custodian has in place clearly defined agreements and appropriate systems and procedures to monitor the performance of the sub-custodian	√	√
The custodian has appropriate security features (vault, lighting, alarms, etc.), IT systems, facilities, processes and procedures to safe-guard assets	√	√
The custodian has appropriate new business/accounts acceptance procedures	√	√
Assets are registered and accounted for in a way that ensures they are segregated from those of the fund management company, other client funds and those of the custodian itself	√	√
Registration of the assets (securities and cash) of each fund is correct and up to date	√	√
The custodian has efficient processes in place for the timely and accurate settlement of transactions on asset funds subsequent to dealings by the managers of the client funds	√	√
The custodian has efficient systems and processes in place to ensure that transactions on the assets of client funds are performed at the market prices prevailing at the time of execution	√	√
The custodian has efficient processes for the timely and accurate collection and application of income to the client funds, and for follow-up when those who owe the fund dividends or interest do not transfer the payment on time	√	√
The custodian has efficient systems and procedures in place the accurately reflect the impact of corporate actions (such as restructurings and capital augmentations) on the assets in custody	√	√
The custodian has efficient systems and procedures in place to verify that the costs, fees and other expenses being charged to the client funds are appropriate	√	√
Reconciliations between the custodian's records and those of the central depositories are conducted on a regular basis and are in balance	√	√
Reconciliations between the custodian's records and those of the	√	√

CONCEPT TO BE INSPECTED	POSSESSION OF NECESSARY COMPETENCE/FACULTY	
	SB	SV
client funds are conducted on a regular basis and are in balance		
The custodian has in place adequate systems and procedures to detect compliance with investment policies and limits by the managers of the client funds	√	√
The custodian has in place adequate systems and procedures to perform the valuation of the fund in accordance with the approved methodology, formula and schedule (timing/regularity), as well as all applicable laws and norms	√	√
The custodian has in place systems to detect errors in valuation by the managers of the client funds and procedures to remedy and notify the relevant fund manager of errors when such occur	√	√
The custodian has procedures to manage conflicts of interest appropriately	√	√
The custodian has appropriate procedures to safeguard the confidentiality of information and a policy on access to and the flow of such information within the organisation	√	√
The custodian has appropriate procedures for archiving documentation in support of operations, so as to facilitate the audit trail	√	√
The custodian has in place appropriate processes and procedures to answer client queries and resolve customer complaints	√	√

As with other institutions under its tutelage, the supervisory authority will also need to conduct regular off-site analysis of the financial position of the custodian in order to monitor its financial health. (For a copy of the USA's Comptroller of Currency Administrator of National Banks' examination plan for a custodian, see Appendix 1.)

### 3.5 Selecting the Appropriate Supervisor for Colombian Custodians

The Finance Ministry is currently exploring options for the merger of the existing two supervisory authorities, the SB and the SV, so that eventually the issue of who supervises custodians will become a moot point. The new organisation will be organised completely differently from the existing agencies. For example, it has been suggested that there will be three divisions: market conduct (in charge of day-to-day supervision of the market activities and financial products of all financial entities), prudential supervision (in charge of monitoring the financial health and well-being of market operators) and licensing and enforcement. However, due to the complexities of the legal and political process required to execute this strategy, it is difficult to predict when exactly this new agency will come into being: our best estimate is that the merger process may take anywhere between eighteen months and five years to complete.

In the interim, before the consolidated financial supervision authority comes into being, it will be necessary to appoint one or other of the supervisory authorities to supervise custodians. The following table sets out the principal arguments in favour of both SB and SV

as the supervisory authority for custodians:

POINTS TO CONSIDER	MOST APPROPRIATE AGENCY
<p><i>THE INTERNATIONAL EXPERIENCE FACTOR</i></p> <p>As seen in paragraphs 3.1 to 3.3 above, this argument is not conclusive either way, since there are examples in international experience both of the securities regulator and of the banking supervisor having responsibility for supervising custodians. Furthermore, international organisations such as IOSCO, the OECD and the EU Working Group do not provide guidance on this subject.</p>	SB or SV
<p><i>THE COMPETENCE FACTOR</i></p> <p>As seen in paragraph 3.4 above, both the SB and the SV have the necessary competencies to conduct supervision of custodians.</p>	SB or SV
<p><i>THE "SUPERVISORY MARKET SHARE" FACTOR</i></p> <p><b><u>The supervisor who currently supervises the greater part of the CIS market should supervise the custodians of the CIS:</u></b> SB supervises around 95% of the market while SV supervises the remaining 5%.</p>	SB
<p><i>THE EFFICIENCY FACTOR</i></p> <p><b><u>The impact of the choice of supervisor on the cost of supervision:</u></b> Since the charges for supervision depend on the activities undertaken, it will make no difference to intermediaries whether the supervision is undertaken by the SB or the SV, since the cost will be the same.</p>	SB or SV
<p><i>THE INSTITUTIONAL FACTOR</i></p> <p><b><u>Current lead supervisor of the entity likely to act as custodians:</u></b> Given that the Colombian legal framework appears to expressly forbid banks from undertaking custodial activities, the institution that appears to be best adapted and habilitated to fulfil this role is the fiduciary. Fiduciaries are supervised by the SB.</p> <p><b><u>Current lead supervisor of the first tier of the custodial/depository system:</u></b> Custodians will in essence be the second tier of the custody infrastructure, with central depositories continuing to actually hold the underlying assets and to maintain registers of transfers in ownership subsequent to transactions. In Colombia today, DECEVAL, the central depository, is a private institution supervised by the SV.</p>	SB  SV
<p><i>THE FOCUS FACTOR</i></p> <p><b><u>Prudential requirements versus risk disclosure (for investor protection):</u></b> CIS are market-based investment vehicles that are not normally subject to the same prudential controls and safeguards as banks and insurances companies, since the insolvency of a CIS does not result in nearly the same degree of systemic risk as would be the case should one of the latter institutions fail. The principle that investors must bear all the risks inherent in their investment decisions, which characterises all capital market investments, is also valid for investments in CIS. The objective of the CIS regulatory and supervisory regime should therefore be to</p>	SV

POINTS TO CONSIDER	MOST APPROPRIATE AGENCY
protect the investor against fraud, negligence and conflicts of interest, to ensure that each CIS observes the rules of fair and transparent operation and that investors are adequately informed of the risks involved in their investment. This is the focus of the securities regulator rather than the banking supervisor.	
<p style="text-align: center;"><i>THE FUNCTIONAL FACTOR</i></p> <p><b>The nature of custodial services:</b> The provision of custodial services is a market activity, as defined in France and Spain for example. As such, this activity should be supervised by the securities market regulator. In Colombia, there are already several examples of “market activities” undertaken by entities normally under the tutelage of the SB being supervised by the SV.</p>	SV
<p style="text-align: center;"><i>THE ECONOMIC FACTOR</i></p> <p><b><u>The capital markets need to be strengthened in order to achieve greater prosperity in Colombia and a strong securities regulator would contribute to this:</u></b> The banking sector is well-established in Colombia, but the development of the capital markets is lagging. Various studies have confirmed that economic growth is greatest when the development of both the banking sector and the capital markets is high: in the 1996 World Bank study by Asli Demirgüç-Kunt and Ross Levine<sup>2</sup>, for example, countries with a highly developed banking sector but under-developed capital markets had average GNP growth of 2.2% over a 17-year period, while those with both highly developed banking sectors and capital market sectors had average GDP growth of 3.7%. The existence of a strong securities market regulator is crucial to the development of capital markets. By giving the SV the responsibility of supervising custodians, the Colombian government would enhance the SV in the perception of market participants, and thereby strengthen it. This would also help the SV to be more of an equal partner in the proposed future merger of the two supervisory authorities.</p>	SV

Numerically, there are more factors in favour of the SV being given the responsibility to supervise custodians in the interim before the new consolidated financial supervisory authority comes into being. However, this assumes that all arguments are weighted equally. Ultimately, the decision which supervisor to assign this task will be political and the Government may weight some arguments more than others.

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<sup>2</sup> Demirgüç-Kunt, Asli and Ross Levine, “*Stock Market Development & Financial Intermediaries: Stylised Facts*”, World Bank Economic Review, May 1996

**The Comptroller of Currency Administrator of National Banks'  
Examination Plan for Custodians**

**GENERAL PROCEDURES**

These general procedures are intended to assist examiners in determining the adequacy of an entity's policies, procedures and internal controls regarding custody services risk and risk management. The extent of testing and procedures performed should be based upon the examiner's assessment of risk. This assessment should include consideration of work performed by other regulatory agencies, internal and external auditors and other internal compliance review unit, formalised policies and procedures, and the effectiveness of internal controls and management information systems (MIS).

Objective: To determine the scope of the examination of custody services and identify examination activities necessary to achieve the stated objectives.

1. Review the following documents to identify any previously noted problems that require follow-up:
  - previous examination reports
  - examination conclusion comments
  - supervisory strategy
  - follow-up activities
  - work papers from the previous examination
  - internal and external audit reports, and if necessary, audit work papers
2. Examine the entity's file for:
  - Any useful MIS or other information obtained from the entity as part of the ongoing supervision process
  - Any useful information obtained from the review of applicable board and committee minutes
  - A list of board and executive or senior management committees that supervise custody services, including a list of members and meeting schedules. Also obtain the name and phone number of the person who maintains copies of minutes.
  - Reports related to custody services that have been furnished to any applicable committee or to the board of directors
3. Verify the completeness of requested information with the request list
4. Determine, during early discussions with management, whether there have been:
  - Any significant changes in policy, procedures, computer systems, or personnel relating to custody activities or processes
  - Material changes in products, volumes, or market focus
  - Significant levels and trends for exceptions, fails, or losses for each custody services area
5. Review the entity's business and strategic plans and determine whether management's plans for the custody activities are clear and reflect the current direction of the business
6. Using what you learn from these procedures and discussions with management,

determine the scope of the examination and its objectives

## **CUSTODY SERVICES: QUANTITY OF RISK**

Objective: To develop an overall conclusion on the quantity of risk, the examiner should first evaluate the quantity of transaction, compliance, credit, reputation and strategic risks. Only after quantifying these risks should the examiner come to an overall conclusion on the quantity of risk.

### **Transaction Risk**

Transaction risk is encountered in custody activities because of the high volume of transaction processing inherent in the business. An entity controls transaction risk by implementing a strong control environment.

Objective: To determine the quantity of transaction risk present in the entity's delivery and administration of custody services.

1. Evaluate the custody products and services the entity offers. Consider:
  - New products
  - New markets
  - Changes in technology
2. Evaluate the total volume (in both currency and numbers) of transactions processed and the volume and age of exceptions. Consider:
  - Volume of transactions settled daily
  - Percentage of transactions requiring manual intervention
  - Percentage of transactions that fail (rejects, trade fails, etc.)
  - Volume and age of reconciling items
  - Cash
  - Securities by depositary
  - House accounts (suspense, receivables, taxes, etc.)
3. Review the total market value of all assets held in custody services accounts. Consider both the size and number of accounts.
4. Evaluate the significance of system and technology risks identified in IT audits and internal control reviews of the custody services area

### **Compliance Risk**

Objective: To determine the quantity of compliance risk related to the entity's custody services activities

1. Review the nature and extent of custody activities, including new products, services and markets that may have an impact on compliance risk
2. Evaluate the volume and significance of litigation and customer complaints
3. Evaluate the volume and significance of non-compliance and non-conformance with policies and procedures, laws, regulations and prescribed practices

4. Determine whether you must sample accounts to verify compliance with relevant laws and regulations. Consider identified weaknesses in internal control, audit, compliance, or risk management systems when making your decision.

### **Credit Risk**

Credit risk is encountered in custody services activities when a counterparty does not fulfil its contractual part of a transaction and the entity has to extend or commit its funds to complete the transaction.

Objective: To determine the quantity of credit risk present in the entity's delivery and administration of custody services

1. Review the types and volumes of custody services products that require the entity to use a counterparty. Consider whether:
  - Counterparty credit limits including daylight overdraft, pre-settlement and settlement lines are appropriate
  - Credit risk is increasing or elevated because of services such as contractual settlement and contractual income payment
  - The entity is using settlement systems with irrevocable payments, with delivery commitment features, or where settlement is not DVP
  - The entity has conducted due diligence reviews of its third-party sub-custodians when it provides global custody services
  - The entity offers indemnification against borrower default or other credit risks when the entity offers securities lending
2. Review the overdraft list to determine the size, age and general trend of these items

### **Strategic Risk**

To evaluate strategic risk, an examiner should consider the levels of risk associated with an entity's custody services activities in relation to the entity's strategic objectives.

Objective: To determine the quantity of strategic risk present in the entity's delivery and administration of custody services

1. Review the strategic plan for custody services and discuss with management the strategic objectives the entity has established for its custody activities. Consider the entity's:
  - Goals for revenue and net income growth
  - Current technology capacity assessments
  - Future technology needs
  - Staffing
  - New markets
2. Determine whether any weaknesses were identified in other areas that may hamper the entity's ability to achieve its strategic goals

### **Reputation Risk**

A sound reputation is essential for a custodian. The examiner's estimation of the quantity of

reputation risk depends upon the level of transaction and compliance risk and the quality of the entity's control systems.

Objective: To determine the quantity of reputation risk present in the entity's delivery and administration of custody services.

1. Review the transaction risk, compliance risk and strategic risk factors to determine whether:
  - The entity's strategic plan is in place and being followed
  - The control structure is appropriate for the volume and nature of the transactions processed
  - The compliance and audit programmes have adequate policies and procedures for the entity's custody business
  - The entity's reputation has suffered from lawsuits, complaints or losses caused by custody services

## **CUSTODY SERVICES: QUALITY OF RISK MANAGEMENT**

### **Policy**

Objective: To determine whether the board and senior management have provided management with guidance on strategic direction and the organisational structure of the entity's custody services.

1. Review minutes, resolutions, bylaws or other documents to determine whether the board of directors or its designated committee has approved and periodically reviewed:
  - The strategic plan, strategic direction of the custody business and budgeting process
  - The organisational structure of the custody business, including delegation of the administration of the custody business in designated persons or committees
2. Evaluate the entity's strategies for custody services products through discussion with management and a review of technology plans. Consider:
  - Whether custody services are consistent with the entity's overall mission, strategic goals and operating plans
  - The level of management's knowledge of the industry operating systems
  - Whether management evaluates internal controls, security risks and vulnerabilities
  - The entity's internal expertise and technical training
  - Management's attention to system security monitoring and testing
  - Management's knowledge of and compliance with applicable laws, regulations and interpretations as they pertain to custody services

Objective: To determine the adequacy of policies on custody services.

1. Determine whether the entity's policies incorporate internal controls, accounts acceptance, monitoring, new product approvals and audit
2. Determine whether the entity has adopted policies and procedures specifically required by applicable law or regulation

### **Processes**

Review the entity's custody services to determine whether the board and senior management have provided an adequate system of controls, procedures and practices for administering the processes needed to perform its custody services.

Objective: To determine the effectiveness of the control processes for custody services.

Note: the adequacy and scope of the audit coverage may affect the level of examiner testing and sampling of custodial control activities. Whenever possible, evaluate the audit early in the examination process.

1. Evaluate audit's process review of custody services. Consider:
  - Whether the audit scope covers significant activities and controls
  - The quality of audit reports
  - The independence of the audit function, including authority and reporting lines
2. Discuss with senior management its control process to gain an understanding of:
  - The control culture and structure
  - The results of any control self-assessment including administrative reviews of custody accounts
  - The control placed on high-risk custody processes (cash movements, asset movements and corporate actions)
  - The availability of any independent tests of the control structure
  - Compliance reviews of processes and internal controls used
  - MIS processes used to control high-risk activities
3. Determine whether logical access controls on computer systems adequately segregate duties. Does the process for monitoring logical access to all systems include:
  - A review of job profiles for segregation of duties related to logical access needs (system to system)?
  - A timely review of all changes in logical access by independent personnel?
  - The prompt removal of logical access for terminated and transferred employees?
  - Notification of security personnel or senior management when emergency access (firecall) is used?
4. Determine the adequacy of the control processes and segregation of duties for assets held off premises and on premises. Consider:
  - Logical access controls (for offsite depositories and custodians) such as:
    - Dual control procedures
    - Independent free receipt and free delivery monitoring
    - Independent daily position change verification
    - Independent monthly position verification
  - Physical access controls such as:
    - Dual control procedures
    - Vault entry records
    - Asset tickets
    - Physical security measures
    - Periodic vault counts
5. Evaluate the entity's control process for monitoring the accuracy of the accounting controls for its custody services activities. Consider:

- The promptness with which assets are posted to the system
  - The process for managing routine and non routine manual instructions
  - The process for confirming that posted debit and credit totals agree with posting totals (including rejects):
  - The separation of duties between:
    - Data input and asset balancing functions
    - Authorisation and release of assets or funds
  - Periodic trial balances
  - The timeliness of independent reconciliation functions and exception reporting standards (including aged items) regarding:
    - Reconciliation and review of positions
    - Reconciliation of assets held at each central depository and other custodians
    - Reconciliation and review of suspense (house) accounts
    - Internal control standards for follow-up, resolution and reporting standards for exceptions
  - The effectiveness of the charge-off policy
6. Evaluate the bank's control processes for house accounts, failed trades, and corporate actions. Consider whether:
- House accounts are established only after senior management approves their stated purpose
  - House accounts are reconciled and reviewed by independent personnel, and aged items have trigger dates for escalation to senior management
  - All failed trades are appropriately processed and monitored
  - The bank's control process for corporate actions includes testing for sufficiency by account and by units
  - The control process for corporate actions included trigger dates and monitoring by personnel independent of the processing function

Objective: To determine the adequacy of the account acceptance process. (Review any audit or compliance reports for coverage of account acceptance.)

1. Evaluate the adequacy of the processes for account acceptance and product development for custody services. Select a sample of new accounts received and determine whether:
- The entity assessed the client's custody requirements
  - Due diligence reviews include customer identification and expected transaction information
  - The entity could lawfully service the account
  - The entity assess the account's potential to be profitable
  - A committee of senior management received notice of the new account (including house accounts) and approved its acceptance
  - Any accepted account failed to meet one or more of the requirements of the entity's established policy

Objective: To determine the adequacy of the management information systems (MIS) process. (Review any audit or compliance reports for coverage of MIS.)

1. Determine the types and frequency of reports to management. Consider:
- Transaction exception reports (failed trades, missed corporate actions, etc.)
  - Operational exception reports (out-of-balance errors)

- Volume and efficiency reports
2. Evaluate the entity's process for determining the adequacy of its custody information systems. Determine whether:
    - Critical applications or data are identified
    - Security controls are defined
    - Vulnerabilities associated with custody services are identified
  3. Determine the effectiveness of the entity's back-up process and contingency planning process. Consider:
    - Frequency of data backups
    - Location where backups are kept
    - Disaster recovery plan
    - Testing of the disaster recovery plan
    - Review of the MIS plans of third-party service bureau or outsourced vendor (if applicable)

Objective: To determine the effectiveness of the processes designed to evaluate and manage outsourced functions or third-party (vendor) services used by custody services.

1. Evaluate the entity's risk assessment process for outsourced or vendor services. Consider whether:
  - Strategic and business plans are consistent with outsourcing activity
  - Senior management and the board of directors are involved in outsourcing decisions and vendor selection
2. Evaluate the entity's due diligence process in gathering and analysing vendor information prior to entering into a contract. Determine whether management consider:
  - Vendor reputation
  - Financial condition
  - Costs for development, maintenance and support
  - Internal controls and recovery processes
  - Establishing standards of service
  - The vendor's insurance coverage
3. Determine whether the entity has reviewed vendor contracts to ensure that the responsibilities of each party are appropriately identified.
4. Determine whether the entity has a process for evaluating existing vendor services. Consider whether:
  - Management designates personnel responsible for vendor management
  - Designated personnel are held accountable for monitoring ongoing activities and services
  - The entity has an adequate process to ensure that software maintained by a vendor is under a software escrow agreement and that the file is regularly confirmed as current

Objective: To determine the effectiveness of the processes designed to ensure compliance with applicable laws. Consider the following:

1. Determine whether the entity maintains the following minimum records, as per

- securities transaction recordkeeping rules:
- chronological records
  - account records
  - memorandum or order tickets
  - records of broker/dealer
2. Determine whether records are accurate and provide an adequate basis for audit.
  3. Determine whether the entity notifies the customer of transactions as required by relevant norms.
  4. Determine the process used by the entity to code accounts so as to pass information received from issuers, such as proxies and annual reports, to beneficial owners as appropriate.
  5. Review the entity's responses to requests for information from issuers to determine whether the responses were appropriate and timely.
  6. Evaluate the entity's processes governing free-riding (if this practice is illegal in your jurisdiction).
  7. Determine whether the entity's process for escheatment of unclaimed items is appropriate. Consider:
    - Whether the entity ages outstanding cheques, suspense account entries or house account entries.
    - Whether the entity has filed escheatment report with the proper jurisdiction (if appropriate)
  8. Determine whether overdrafts are monitored and reported to the entity's financial controller for accurate reporting and reserve requirements
  9. Determine whether the entity has written procedures to report lost and stolen securities to the appropriate authorities.
  10. Determine through inquiry with senior management whether the entity has a process to determine the laws applicable to their custody services activities, and whether they have established processes to maintain compliance with them. Consider:
    - National laws
    - Country laws governing sub-custodians in the network
    - Central depositories requirements
    - Foreign tax regulations and reclaim practices

### **Safekeeping**

Objective: To determine the effectiveness of the processes designed to ensure proper safekeeping of custody assets.

1. Determine whether any further review of the safekeeping process is needed after reviewing the audit and control processes related to on-premises and off-premises safekeeping. Consider:
  - The scope of the audit coverage

- The size and nature (age) of exceptions reported
  - Charge-offs due to lost or stolen securities
2. For global custody activities, determine whether the entity performs effective due diligence before entering a market. Consider:
    - Country risk
    - The settlement environment
    - Restrictions on foreign investment
    - Investability of the market
    - Availability and integrity of financial information
    - Ability to perform services profitably
    - Payment systems risk
  3. Determine whether the entity's due diligence process for selecting a global sub-custodian is appropriate. Consider whether:
    - The entity performed a review of the institution's financial strength and its insurance coverage
    - The entity reviewed the sub-custodian's position in and knowledge of the local market
    - The entity determined that the sub-custodian has an adequate internal control system
    - The entity determined that the sub-custodian has an appropriate level of automation, and that its plans for future systems development are adequate
    - The entity evaluated the quality and experience of the personnel of the sub-custodian

## **Settlement**

Objective: To determine the effectiveness of the processes designed to ensure proper settlement.

1. Evaluate the effectiveness of the process for settlement of trades. Consider whether:
  - Proper trade instructions are received
  - Trade instructions are properly documented
  - Trade tickets/memoranda are properly controlled & contain all required information
  - Independent reconciliation of broker confirmations to trade tickets is done
  - Failed trades are monitored
  - Confirmations are sent as required and contain all necessary data
  - Customer accounts are monitored to determine that the securities or cash needed for settlement are available
  - Information and instructions from the central depositories agree with custodians security movements and control system
  - Settlements are Delivery Versus Payment
  - Central depository position changes are matched to the changes on the entity's own accounting records
2. For cross-border trades, determine whether, in addition to the processes in (1) above, the process for conducting foreign exchange (FX) is adequate. Consider:
  - FX and forward contract instructions for each trade or per standing instructions
  - Indemnity for FX risk when the customer does not want to use FX or forward contracts.

## **Corporate Actions**

Objective: to determine the effectiveness of the processes designed to ensure effective and efficient servicing of assets in custody and on loan

1. Evaluate the income collection process based upon a review of the following:
  - The methods and services subscribed to that provide information (or forecasts) on income from custody assets (scrutinise regular payments, e.g. asset-backed securities)
  - The internal control process, including maps, suspense accounts and the suspense account monitoring and control process for processing income payments
  - The process for aging items in the income suspense accounts (review for possible unclaimed property or escheatment issues)
  - Whether income payments are contractual or actual
  - The process for monitoring, verifying and posting reinvested income
  - The process for managing fixed income premiums and discounts
  
2. Evaluate the entity's corporate actions process. Consider whether:
  - The entity subscribes to a service that provides information about tender offers, mergers, called debt issues and class actions
  - Bonds are redeemed promptly
  - The monitoring and call-back procedures on voluntary corporate actions are appropriate
  - The entity uses a recorded line
  - The procedures for domestic corporate actions and mini-tenders are adequate
  - The monitoring process for each new corporate action is adequate
  - The customers are properly notified about voluntary actions
  - The response monitoring process included balancing responses by customer count and by total par or shares (sufficiency)
  - The process to document customer responses on voluntary actions is adequate
  - The review process for completed corporate actions is monitored
  - The procedures for cross-border corporate actions are adequate
  - Although the process is the same as for domestic corporate actions, in relation to corporate actions on foreign stocks, also consider:
    - the process for translation of documents received in foreign languages
    - the experience of the staff and access to legal counsel
    - the entity's process to limit liability for missed or misinterpreted actions
  
3. Determine whether the process for addressing tax reclaims on foreign securities is appropriate. Consider whether the entity:
  - Obtains updated information from foreign tax authorities
  - Effectively manages the language difference
  - Monitors the statutes of limitations for filing tax reclaims
  - Effectively manages the length of time required to obtain refunds (some countries process reclaims only once per year)
  - Requires that claims be filed for individual/beneficial owners rather than commingled/omnibus accounts

### **Overdrafts**

Objective: To determine the effectiveness of the processes and to evaluate and monitor overdrafts in custody services.

1. Evaluate the overdraft process. Consider whether:
  - Overdrafts are aged and have appropriate escalation processes
  - The size of the overdraft is part of the escalation process
  - The reason for the overdraft is appropriate
  - The overdraft process considers free-riding
2. Determine whether the bank has a process for identifying credit limits for overdrafts.

SOURCE: Comptroller of the National Currency Administrator of National Banks, Comptroller's Handbook: Custody Services (Asset Management Series), January 2002