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Dear Chief Executive

### **Our custody and fund services supervision strategy**

The custody and fund services sector plays a crucial role in the UK financial system in the safeguarding, servicing, and oversight of assets. Our supervisory strategy focuses on ensuring firms in your sector fulfil this core purpose. Effective delivery of these services, in the best interests of your clients and ultimately the end investors, is critical to maintaining confidence and participation in financial markets.

This letter outlines our view of the key risks that custody and fund services firms<sup>1</sup> need to manage in order to protect investors and the integrity of the markets in which they operate. We expect you to take the necessary action required to ensure that these risks are appropriately mitigated.

We ask you to consider and discuss these key risks with your fellow Directors and/or Board and agree what further action you should take to ensure that your firm meets our requirements. In our future supervisory engagement with you, you can expect us to ask you about the actions you and your Board have taken in response to this letter to ensure that customers and markets are adequately protected.

### **Our view of the key causes of harm in your sector**

We see four principal areas of potential harm to your clients and end-consumers, or to market integrity.

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<sup>1</sup> Your firm has been allocated to the 'custody and fund services' portfolio. The custody and fund services portfolio covers firms acting as (i) third-party custodians, (ii) depositaries for both authorised and non-authorised funds; and (iii) third-party administrators who provide services such as fund accounting and transfer agency.

- Disruption to consumers and market participants, or the loss, compromise, or lack of availability of data, due to insufficient operational resilience or weak cyber controls.
- Sub-standard oversight and control of client money and assets leading to financial losses for investors and/or an inability to recover assets efficiently.
- Inadequate depositary oversight of fund managers, and failure to take reasonable care to ensure an authorised Collective Investment Scheme (CIS) is managed in accordance with applicable rules and solely in the interests of the CIS and its unitholders.
- Inadequate oversight of business linked to high risk, illiquid or speculative investment products sold to retail investors, and failures to consider related consumer outcomes.

You are responsible for ensuring that the appropriate people at your firm understand the rules and ensure that your firm complies with them. If in any material respect you are not meeting the rules and standards, you must notify the FCA immediately setting out what you are doing to remedy any breaches.

## **Our supervisory priorities**

### Operational resilience and cyber

We note the significant dependence on technology, people and processes to deliver critical services across your sector. Operational resilience and cyber defences are key sector risks. These are also areas where we have observed significant weakness at some firms. We may seek assurances and evidence that investment programmes are sufficient to ensure that critical services are not too heavily reliant on legacy technology, resulting in resilience, or security risks. The levels of interconnectedness between systems, lack of internal knowledge on how the systems operate, and ineffective oversight of third party or intra-group service providers can all threaten resilience. These are areas where you can expect questioning on how risks have been mitigated.

We expect your firm to prevent, respond to, recover and learn from operational disruptions and to act where weaknesses have been identified. Policy Statement PS21/3 sets out our final rules and guidance on building operational resilience, and these come into force on 31 March 2022. By 31 March 2022, in scope firms must have identified their important business services, set impact tolerances for maximum tolerable disruption and carried out mapping and testing to a level of sophistication necessary to do so. These firms must also have identified any

vulnerabilities in their operational resilience. As soon as practicable after March 2022, and no later than 31 March 2025, in scope firms must have performed mapping and testing so that they are able to remain within impact tolerances for each important business service, and must have made the necessary investments to enable them to operate consistently within impact tolerances.

Given the sensitivity of the confidential investor data you hold, you need to ensure that the services you provide to the market are underpinned by robust security measures. This includes ensuring sufficient protection and security of data from loss, theft, misuse, alteration or destruction. Firms we have identified as posing a greater risk of harm are now subject to proactive technology reviews. We may choose additional firms for an ad-hoc review, including through utilising our cyber and operational resilience assessment tools and our threat-led penetration testing scheme (CBEST).

If your firm suffers material technological failures or cyber-attacks, we expect you to contact us promptly as part of your responsibilities under [Principle 11](#). SUP 15.3 sets out additional rules and guidance on when the FCA would expect notice of matters relating to a firm. This means that we expect a firm to report material operational incidents. An incident may be material if it: results in a significant loss of data, results in the unavailability or loss of control of your IT systems, affects a significant number of customers, or results in unauthorised access to your information systems. This list is not exhaustive. The current level of incident reporting from the sector is inconsistent. You should review your policies and procedures to ensure you are meeting your reporting obligations. You can report incidents by contacting your named FCA supervisor or using the channels on our [contact page](#) if you don't have a named supervisor.

#### Protection of Custody Assets and Money (CASS)

Whenever you hold or control client money or safe custody assets as part of your business you must follow rules set out in the Client Assets Sourcebook. This is essential to ensure that clients' safe custody assets and money are protected and capable of being transferred promptly if a firm fails. Compliance enhances market integrity by giving participants confidence that their money and assets are protected in case of a firm failure. Reflecting its importance, CASS will be subject to significant ongoing supervisory engagement. While there has been investment in CASS compliance by firms in this sector, we have observed weaknesses in change management (operational, regulatory and business), high dependence on legacy/end of life IT infrastructure and high levels of manual processing and controls in some cases.

We think that challenges with CASS compliance often have their root causes in poor governance and oversight, under-investment in systems, and failure fully to consider CASS impacts when managing change. We have seen cases where the root causes also include a lack of adequate CASS knowledge. We expect you to take steps to deal with these challenges if present in your firm. When considering CASS compliance, we will act where we see firms falling below expectations, and will be prepared to use the full range of regulatory tools, including enforcement action where we identify serious misconduct.

Aside from compliance with existing standards, the sector faces significant technological change. We expect firms to have considered and to be appropriately prepared for technological developments, such as potentially increasing use of distributed ledger technology (DLT). Adequate preparation now is likely to help ensure that you can better manage the risk of disruption that can be caused by change, both for your clients and your business model.

#### Depositary oversight

Depositaries have an important role in overseeing the activities of managers of authorised funds. When doing so, depositaries of these funds must act honestly, fairly, professionally, independently and solely in the interest of fund investors. We continue to observe weaknesses in depositaries' oversight and often an absence of effective challenge of the fund manager. This can lead to potential harm to unitholders and investors. We also have concerns about the robustness of controls used to oversee fund liquidity, and investment and borrowing limits. We have seen examples of a lack of holistic judgements in these areas, including for example a narrow interpretation of the applicable COLL rule requiring a 'prudent spread of risk' and the lack of policies or procedures related to it.

Where you undertake this role, we expect you to assure yourself that you undertake your oversight function effectively. We may seek evidence that firms have an appropriate level of access to an AFM's operations, adequate resourcing and ask firms to demonstrate that they have been able to challenge AFMs effectively in investors' and unitholders' interests.

#### Speculative and illiquid investments

Speculative and illiquid investments, such as mini-bonds, are often very high risk and are unlikely to be suitable for most retail investors. These securities are not normally covered by protections under the Financial Services Compensation Scheme, may be unregulated, can have a high instance of scams and may offer unrealistic returns. We have not observed custody and fund service firms manufacturing or promoting these products. However, firms in this sector

may contract with and provide services to the issuers or promoters of these products, such as trustee, safekeeping and administrative services. In some cases, FCA regulated custody and fund services firms may inadvertently provide increased legitimacy to the marketing of unregulated products. Promoters of these products may exploit the FCA badge of a regulated entity from which it is procuring services, to create false confidence surrounding a product, marketing claims or consumer protections.

In our supervision of your sector, we have observed a small number of instances where firms have displayed a disregard for consumer outcomes in their activities and inadequate due diligence on parties with which they have contracted. Where your firm is engaged in unregulated activity related to speculative and illiquid investments, firms are still subject to certain relevant regulatory requirements, including specific Principles for Business. They need always to demonstrate that they are satisfying the minimum requirements for authorisation as set out in Schedule 6 FSMA.

We expect to examine firms which provide services for speculative and illiquid investments. Where we determine that there is evidence of serious misconduct, we may take disciplinary action against a firm or an individual.

### Market and regulatory changes

We expect firms to keep abreast of, and adequately prepare for market developments and regulatory change. One recent change in regulatory requirements is the Investment Firms Prudential Regime (IFPR). IFPR came into force on 1 January 2022. It refocuses prudential requirements and expectations away from a sole focus on the risks firms face, to also consider and look to ensure adequate capital to manage the potential harm firms can pose to consumers and markets. We expect you to understand how the new standards apply to your firm.

Firms in this sector typically have business models that rely heavily on technology and often have complex system infrastructures. We want firms in the sector to understand how future technology developments could impact the services that they offer, as well as understanding if there are risks to your business model that could be caused by disruption from new technology, and to plan appropriately.

### **Next steps**

If you have any queries about this letter, please contact our dedicated Supervision Hub on 0300 500 0597. This is the primary contact for your firm's day-to-day interactions with the FCA.

Further details of how we can be reached are available on our website at <https://www.fca.org.uk/contact>.

We recognise there may be occasions when your firm faces urgent issues of strategic importance and in such circumstances, please contact the Head of the Asset Management Department, Nike Trost at [Nike.Trost@fca.org.uk](mailto:Nike.Trost@fca.org.uk).

Yours faithfully

Edwin Schooling Latter  
Director Markets and Wholesale Policy and Wholesale Supervision  
Financial Conduct Authority