

GFOA Resource: Understanding Safekeeping and Third-Party Custodial Services for Investing

This resource is a companion piece to GFOA's Best Practice - Using Safekeeping and Third-Party Custodial Services.

Background

To accompany GFOA's Best Practice – *Using Safekeeping and Third-Party Custodial Services*¹, this resource serves to help governments better understand the concepts discussed in the BP and how to best determine their and implement the appropriate product and services that are deemed appropriate.

The current BP states that - **GFOA recommends that governments use an Independent third-party custodial service for safekeeping of investments. Governments need to weigh the risk versus the costs of the services and understand exactly how the failure of a safekeeping provider would impact the government's ability to access its investment assets.**

The BP highlights two types of safekeeping services (arrangements) that governments will generally encounter:

- Basic Safekeeping Provider, a brokerage firm or banking institution.
- Custodial Safekeeping Provider, usually a banking institution.

Overview of Custodial vs. Safekeeping Agreements

The safety of public funds should be the primary investment objective of all governments, and the separation of the safekeeping function from the investment function is critical to this goal. An independent third-party in a safekeeping arrangement may be a financial institution completely separate from where the depository cash assets are being held (Custodial Safekeeping Provider), or it may be a separate division of that same named institution (Basic Safekeeping Provider). Governments should ensure that if they are using the same institution for both trading their assets and engaging in safekeeping services, that there are proper firewalls and protections in place to safeguard their entity's money. **Governments should also be aware of and incorporate state and local laws related to custody and safekeeping.**

The differences between custodial and safekeeping agreements can be confusing, as often these two terms are incorrectly used or are used interchangeably. It is critical that governments, and custodial and safekeeping entities alike, be specific in contract language to ensure all parties clearly understand the ramifications of that contract and the responsibilities held by each party.

Vendors may use these two terms interchangeably; however, they are not the same product. For instance, some vendors will have entities sign a "custody agreement" when they are actually receiving a basic safekeeping arrangement. Some vendors will only offer one type of agreement. It is important that governments are cognizant of what they are being sold and whether it truly offers the benefits they are expecting.

Understanding Safekeeping and Custodial Services

The below definitions are drawn from GFOA's Best Practice, Using Safekeeping and Third-Party Custodian Services.

In a typical safekeeping agreement, the government arranges for a firm other than the party that is selling the investment to provide for the transfer and safekeeping of securities. This allows for investment transactions to be settled on a delivery-versus-payment (DVP) basis, wherein a secure delivery and payment occur simultaneously. A safekeeping account does not protect the government from making a bad investment choice or acquiring a defaulted or improper security.

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- Basic Safekeeping Provider, a brokerage firm or banking institution
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Basic Safekeeping Provider

Under this arrangement, many times the fees are nominal or the service is provided at no direct cost as part of a broader relationship. Governments need to understand what services are being provided and how the investment assets are being held. General elements of a basic safekeeping arrangement are as follows:

- The investment assets are held in the safekeeping firm's name for the benefit of the government.
- The assets are considered general assets of the firm and may not be protected from being used to help pay the safekeeping firm's creditors.
- Broker/Dealer accounts may be covered by SIPC Insurance, which is limited to \$500,000 and does not cover any changes in the market value of securities.
- May allow the ability to use any broker-dealer, depending on the contract arrangement.
- May have limited capability related to the sweep of funds to other accounts, such as only allowing accounts held at the same financial institution.
- Most operate on an actual receipt of funds basis, subject to delayed credit.
- Reporting is provided for account on a basic level, generally with limited detail and no roll-up capabilities.
- Basic safekeeping arrangements may affect the government's ability to access its assets timely.

Custodial Safekeeping Provider

A Custodial Safekeeping Provider has a fiduciary responsibility to its clients and usually charges a set fee based on asset volume. Custodial arrangements with these providers are often referred to as a special type of safekeeping service that is held within a Trust Department of the custodial bank, thus creating an independence from the regular commercial or retail bank. The elements of a Custodial Safekeeping Provider arrangement are as follows:

- Investment assets are protected from the claims of creditors, as the assets are considered legally separate from the bank or financial institution.
- Investment assets are held in the government's name and account.

- Usually includes an automated overnight cash sweep system to the investment vehicle of the government's choice.
- Ability to use any broker/dealer for trades that settle into account.
- Comprehensive reporting, including roll-ups and customizable reporting options.
- Income is generally posted to account on the payable date.

Per the above, it is critical that governments understand the need for independent custodial and safekeeping services. This is important to consider, especially as it relates to governments accessing and controlling its assets in a timely manner. Remember – there are costs associated with each product. Governments should understand that products marketed as “free” rarely are free, and there is a cost to each type of arrangement.

Determining the Best Agreement for Your Organization

Different governments will inevitably have different needs for service. The following checklist provides questions designed to help your government evaluate its safekeeping agreement:

- Foundational Questions
 - Do you understand the difference between basic safekeeping services and custodial safekeeping services?
 - If you already use safekeeping services, do you know which type of service is used by your entity?
 - Do not assume based on the title of the documents you signed.
 - If you do not know, reach out to your banking partner and legal counsel to verify the type of agreement your entity currently has.
 - Do/did you have a procurement process for this service? (See Procurement for Financial Services Best Practice for additional information)
 - If you have a basic safekeeping arrangement, do you understand the risk you are taking by not using a custodial safekeeping arrangement?
- Agreement Details
 - Is there an automated overnight cash sweep system to the investment vehicle of the government's choice? Does your government need this?
 - Can any broker/dealer be used for trades that settle into your account? Does your government need this?
 - What reporting requirements does your entity need and are they correctly provided by the institution that holds your safekeeping account? Does your entity manage portfolios for other entities as well that may require separate reporting capabilities?
 - Do you understand the cost of this service (fee structure), and how it was or will be incorporated into your overall banking services?
 - Is income posted to account on the payable date? Does your government need this?
 - Have you reviewed whether the service you currently have or are considering meets the needs of your entity?
 - What charges accompany the service and how long are they in place?

- Logistical Considerations
 - Do you know the applicable state and local law related to custody and safekeeping?
 - Are your assets held directly in your government's account (custodial arrangement) or in the safekeeping firm's name for the benefit of your government (basic arrangement)? Does the arrangement and cost align with your government's risk tolerance?

Much of the above relate to your organization's tolerance for risk. This will look different for every organization, so be sure to have discussions with your potential safekeeping entity related to this point.

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ⁱ <https://www.gfoa.org/materials/using-safekeeping-and-third-party-custodian-services>