METHODS & RULES FOR THE SEGREGATION OF SECURITIES

UNIDROIT COMMITTEE ON EMERGING MARKETS ISSUES, FOLLOW-UP AND IMPLEMENTATION

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AGENDA

1. OBJECTIVE OF SEGREGATION RULE
2. SEGREGATION
3. CHALLENGES
4. LEGAL CONSEQUENCES
5. OTHER ASPECTS
6. OBLIGATION OF INTERMEDIARY
7. UNIDROIT CONVENTION
8. ASSET SAFETY
9. ACCOUNTS & HOLDING MODELS
10. SOUTH AFRICA’S DESIGNATED SEGREGATED ACCOUNTS (“SDA”)
OBJECTIVE of segregation rule

- Enhance investor protection
- Allow for an efficient functioning of holding through securities accounts in structures using multiple tiers, including omnibus accounts

Securities (segregated) vs Cash (fungible)
SEGREGATION

Financial reporting purposes or legal consequences?

- A method of protecting Account Holder (client) assets and positions by holding or accounting for them *separately* from those of Intermediary (account provider = participant, broker, etc.)

- Other ways to safeguard clients against misappropriation and theft = internal controls, insurance, compensation schemes, etc.

- Different levels or throughout chain up to CSD?

- Requirement by law/contract?

- MiFID, FSA - CASS Rule 6.3.5R, CPSS-IOSCO March 2011(Recommendation 12); UNIDROIT art 25(4)

- Rebuttable presumption in some countries that an account always contains client assets where Intermediary has account with upper-tier

- Reconcile records regularly to keep them current and accurate!
CHALLENGES?

No!

- "Fungibility in omnibus simplifies admin"
- "Omnibus is more cost effective"
- "Omnibus can settle in bulk"
- "System constraints for segregation in an upper-tier"
- "Only large clients can demand segregation"
- "Power in relationships lies with institutions not clients"
- "Standard terms in mandates"
- "Internal accounts already have segregation"
- "Segregation arrangements are risky, because liquidator ignore them anyway"
- "Who pay for the administration of segregated accounts following insolvency?"
LEGAL CONSEQUENCES

Substantive laws must support segregation

- A segregation requirement without any legal consequences drawn from it, **does not help!**
- But, segregation **plus** sufficient securities to satisfy all client claims **help!**
- But, segregation **plus** prohibit *attachment* of segregated client accounts by creditors of the Intermediary **help!**
- But, segregation **plus** safeguard client securities in *insolvency* of Intermediary (prevent use of client securities for Intermediary’s own account) **help!**
OTHER ASPECTS
Custody risk
Property law
Corporate law
Insolvency law
Tax collection
Money Laundering
Regulation
Supervision
Etc!

- Allocation of rights to identified client securities
- Ownership v Co-ownership
- Legal certainty in transfer, pledge, attachments, loss sharing, etc
- Transparency and disclosure
- Reconciliation
- Debit balances/imbalances
- Prioritising claims in Insolvency
- No Liens in favour of custodian (where client securities are pledged to secure an obligation of custodian)
- Supervisory authorities must enforce effective segregation of client assets by custodians
OBLIGATION OF INTERMEDIARY

- Duty of care of custodian; art 28 UNIDROIT

- In cross-border holdings, investors must understand extent of a custodian’s responsibility for securities in chain

- In CSD-to-CSD Links, home country CSD must ensure that other CSD protects client securities adequately

- Custodian’s liability for “losses” of assets/value?

- Remedial duty to replace, regardless of source or nature of loss?
  
  (fraud/insolvency/negligence/misuse/poor administration/inadequate record keeping/failure to protect customer’s interests in securities (including voting rights and distributions))
UNIDROIT art 24
Integrity of Issue
(chapter iv)

• Intermediary must keep or have available sufficient securities of each description so that total amount/number is equal to total amount/number of all securities credited to securities accounts of all its Account Holders

• Thus, what you have = credit on record
The securities are *allocated* to *rights* of Account Holders of that Intermediary, notwithstanding holding model.
UNIDROIT art 25(2)

Legal Consequence

- Securities that are allocated do not form part of property of Intermediary, but are allocated to the rights of Account Holders

- Cannot be distributed or realised for benefit of creditors of Intermediary (cf art 20 priority rule for secured creditors for shortfall and Intermediary is insolvent)
UNIDROIT art 25(3)

Non-Convention Law

- Allocation must be effected by Non-Convention Law
- What “arrangements” do Intermediaries make for allocation in terms of *your* laws?
UNIDROIT art 25(4)
Possible Arrangements

• Hold in segregated form at upper tier either for the benefit of its AHs generally or particular AHs/groups of AHs

• Account Holders separated from Intermediary’s own account?

• Account Holders separated and identified inter se? A v B v C v D
Contracting States may declare that where securities held by Intermediary are in segregated form for AHs *inter se*, the *allocation* in art 25(1) does *not* apply to the securities held by the Intermediary for *its own account.*
UNIDROIT art 25(6)
Investors protected in Insolvency!

- The allocation and segregation rule applies notwithstanding commencement or continuation of *insolvency* proceedings in relation to Intermediary
ASSET SAFETY
Lehman and financial crisis of 2008

• Consequential systemic risk if no proper segregation and allocation
• What are associated risks/benefits of choosing a particular account holding structure?

Are accounts in CSDs segregated or held on omnibus level?
Account Holding Models (1)
Omnibus Accounts

The CSD maintains an omnibus account for each of the sub-custodians.

The Sub-Custodian keeps an omnibus account for Global Custodian A and an omnibus account for Global Custodian B.

The Global Custodian keeps a segregated account for each client.
Account Holding Models (2)

Segregated Accounts

The CSD maintains a separate omnibus account for each of the sub-custodians.

Sub-Custodian 1

The Sub-Custodian keeps a segregated account for each of the Global Custodian’s clients as well as segregated accounts for each of their direct clients.

Global Custodian A

Client 1

Client 2

Global Custodian B

Client 1

Client 2

The Global Custodian keeps a segregated account for each client.
Account Holding Models (3)
Designated Segregated Accounts

The CSD keeps a segregated account for each of the Global Custodian’s clients as well as segregated accounts for each of the Sub-Custodian’s own direct clients.

The Sub-Custodian keeps a segregated account for each of the Global Custodian’s clients as well as segregated accounts for each of their own direct clients.

The Global Custodian keeps a segregated account for each client.
Account Holding Models: A Summary

• At “custodian” level, there are a number of ways that a client’s assets can be recorded, with the assumption being that the clients assets are always segregated.

• Commonly used Account Holding Models include; Omnibus Accounts, Segregated Accounts, and Designated Segregated accounts.

• When a Custodian maintains records in an omnibus account there is only a single account in the books of the CSD that holds the position of all their clients.

• A Global Custodian, Broker or Asset Manager will operate segregated accounts in their own books and may also ask the appointed Sub-Custodian to operate segregated accounts. The Sub-Custodian CSD would however maintain an omnibus account of all of these positions and the CSD would not know the identity of the clients.

• To provide more protection in the case of Sub-Custodian failure, Clients can through their Global Custodian, Broker or Asset Manager open a designated segregated account at the CSD.
SOUTH AFRICA’S SDA IN THE CSD

- Designated segregated accounts in *Strate* are optional, but fully regulated in law and rules
- Full accounting records are maintained throughout the value chain
- International Clients (Institutional clients) request this
- CSD has different risk profile: move away from failing Intermediary with internal segregation to trusted third party
- Unique position of Primary and Secondary Participant in *Strate*
BENEFITS OF SDA

“Segregated Depository Account”

- CSD can act as definite book of record (by law)
- Evidence of legal ownership is not in “frozen pool” after insolvency
- Liquidator’s time delays cut-out or drastically shortened
- Systemic risk addressed and liquidity available
- Intermediary (not CSD) still maintains relationship with Account Holder
- Primary and Secondary Intermediary linked to CSD for quick response
CONCLUSION & QUESTIONS

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