



strate

South Africa's Central Securities Depository

GUIDANCE NOTE OF STRATE PROPRIETARY LIMITED

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GUIDANCE NOTE - LOSS SHARING MECHANISM

GUIDANCE NOTE ON THE LOSS SHARING MECHANISM IN THE STRATE ENVIRONMENT

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1. What is the general rule with regard to client securities in South Africa in the case of an 'insolvency proceeding' against the CSD Participant?

1.1 The general rule is always (in/out of insolvency) that the *securities of the client remain the client's securities*, notwithstanding a deposit thereof with a CSD Participant or CSD.

Section 36(2)(a) of the Financial Markets Act, 2012 ('FMA') protects the investor's rights by stating that 'No central securities depository or participant may become the owner, co-owner, holder, pledgee or cessionary for the purpose of securing a debt, of securities merely because of - (i) a deposit of securities; or (ii) the registration in its name of (aa) securities; (bb) limited rights in securities; (cc) other rights in securities; (dd) benefits in respect of securities; or (ee) benefits accruing to securities.'

Section 32(2)(p) of the FMA places a duty on the CSD Participant to make adequate arrangements for the safeguarding of clients' ownership rights, including, but not limited to insolvency proceedings.

1.2 In the event of an 'insolvency proceeding' (defined in section 1(2) of the FMA), the securities of the client that are held and maintained by the 'insolvent' CSD Participant will *not* form part of the insolvent estate.

Section 46 of the FMA clearly states that 'any issuance, deposit, withdrawal, transfer, attachment, pledge, cession *in securitatem debiti* or other instruction in respect of securities or an interest in securities that has become effective against third parties, is effective against the insolvency administrator and creditors in any insolvency proceeding.'

1.3 It is very important to note that the FMA and the CSD Rules 'relating to insolvency proceedings and settlement effectiveness of entries in the central securities accounts and securities account, prevail over any other law, legislation, agreement or founding document of any person, and are binding on any person' (section 3(4)). Thus, the FMA and CSD Rules trump the general Insolvency laws on these aspects.

2. When will the loss sharing CSD Rule 16.5.1 apply?

The loss sharing rule is a special CSD Rule, specifically required by section 35(2)(x) of the FMA. It states that the CSD Rules must provide for (iii) 'the manner in which a shortfall in securities in the securities account or central securities account must be apportioned amongst the persons whose securities are held in such account under insolvency proceedings in respect of that participant'. Strate's loss sharing rule is based on recognised and recommended international principles that will be further explained in the answers to the questions below.

The loss sharing rule will only apply where (a) an 'insolvency proceeding' occurs against a CSD Participant, and (b) that CSD Participant also does not hold sufficient securities as it should have in terms of CSD Rule 5.1.1.

The interests of clients (securities holders/account holders), that are effective in terms of the law, may not be fully protected if the relevant CSD Participant subject to insolvency proceedings does not have sufficient securities available to satisfy their interests. CSD Rule 16.5.1 addresses that situation.

CSD Rule 16.5.1 provides a pro rata sharing mechanism for allocating losses to the affected clients in the relevant CSD Participant's insolvency proceeding in case of such a shortfall.

3. Who are the 'affected clients' in the sharing rule?

The 'affected clients' are clients that are holding securities *collectively* in a securities account together with other securities holders. The sharing rule applies therefore to securities that have been 'pooled' together in an omnibus account.

The sharing rule applies on an issue-by-issue basis to a deficiency (shortfall) of securities. If the CSD Participant has a shortfall of X-shares, the Y-shares in its custody will not be part of the sharing rule. This means that the sharing rule will not apply to *all* securities of all issues maintained by the relevant CSD Participant.

Where securities of an issue are not held collectively in an omnibus account, but allocated to only one client and there is a shortfall in that account, that client bears the entire risk of the shortfall.

Besides the omnibus accounts maintained by the CSD Participant for a specific issue, clients may hold their securities individually segregated in specific securities accounts. In terms of CSD Rule 16.5.1, the sharing rule does not apply to individual segregated securities accounts. The sharing rule will apply to the relevant omnibus account where the shortfall is found.

4. What is regarded as an 'individually segregated' securities account or central securities account in Strate?

Where a client holds securities in his/her/its own name on the subregister (legal record of ownership held and maintained by the CSD Participant) or a segregated depository account, such as the *Segregated Depository Accounts* ('SDAs') the securities are individually identified and segregated.

However, where a client holds securities not in his own name but under the name of a nominee on the subregister, the securities of that client are not individually identified and segregated on that subregister held and maintained by the CSD Participant.

5. What does pro rata sharing of a loss mean?

The loss in the securities account is shared among clients in proportion to the respective number or amount of such securities credited to each client in the omnibus account.

6. When do you hold 'sufficient securities' as the Rule requires?

Example 1:

A CSD Participant has three account holders, Client-1, Client-2 and Client-3. Each of them has 100 X- shares. According to CSD Rule 5.1.1, the CSD Participant has the obligation to hold 300 X -shares.

If a CSD Participant has credited 100 X-shares to the securities account of its account holder, Client-1, it must hold an equivalent amount of X- shares of the same class. It can't hold, for example, bonds issued by the same issuer, or Y- shares, even though the economic value of the securities held is the same. Securities will be of the 'same description' as other securities if they are issued by the same issuer and they are of the same class of shares or other securities. The question of whether the shares are of the same class is not determined in the CSD Rules, but is determined by South African law.

The CSD Participant will not satisfy the test of holding sufficient securities if it relies on an arrangement where it must first borrow securities in the future, or if there is merely a pledge in favour of the CSD Participant at a higher level in the holding chain.

In South Africa, the FMA and CSD Rules make provision for reconciliation among the securities accounts of the CSD Participants and the CSD with the issuers or their agents (registrars). A successful reconciliation may prove that sufficient securities are held.

7. What is the effect if the CSDP does not hold 'sufficient securities'?

The CSD Participant will have to take steps to make good the shortfall by doing a buy-in from the market, for example, or using its own proprietary (house) securities, etc.

However, if an 'insolvency proceeding' is also brought against the relevant CSD Participant when the shortfall exists, the CSD Participant may not be in a position to make good. In this case, the CSD Rules set out a loss sharing arrangement in CSD Rules 16.5.1 and 16.5.2.

The loss sharing arrangement deals with the sequence in which the shortfall in securities will be borne. (See Question 18 below.)

8. How are rights in the securities 'allocated' as the Rule requires?

Example 2:

A CSD Participant has only two account holders, Client-1 and Client-2. Client-1 has a securities account with 50 X- shares and Client-2 with 100 X- shares. If the CSD Participant only holds 150 X- shares, they are allocated respectively to Client-1 and Client-2. If, however, the CSD Participant holds in total 200 X- shares, 150 are still allocated to Client-1 and Client-2, and the remaining 50 to itself as proprietary holdings. The rights in the securities are allocated in law in the same proportion.

This basic principle (contained in CSD Rule 5.1.3) applies in all cases, but it is particularly relevant in the case of the insolvency of the relevant CSD Participant.

9. How are securities 'allocated' in the case of insolvency?

The allocation of securities in a loss sharing arrangement applies notwithstanding the occurrence of an 'insolvency proceeding' against the CSD Participant or the client. Note that if there is an 'insolvency proceeding' against the CSD Participant, and if the CSD Participant does not hold 'sufficient securities' to satisfy the rights of Client-1 and Client-2 (for instance it only holds 100 X- shares as opposed to the required 150 X- shares), then CSD Rule 16.5 will determine how the insufficient number of shares will be distributed between Client-1 and Client-2.

Note also that if the CSD Participant does not hold any X- shares, but only Y- shares, these shares are not allocated to Client-1 and Client-2, since they are not of the same description as the ones credited to them.

If the relevant CSD Participant is subject to an ‘insolvency proceeding’, the securities of Client-1 and Client-2 do not form part of the property of the CSD Participant and are not available for distribution amongst its creditors. These securities cannot be sold to pay their claims.

10. Can segregation of securities accounts be used to allocate rights in securities?

Yes, CSD Rule 5.1.3 places a duty on CSD Participants to ensure that the securities are segregated and identifiable as belonging to a specific person. This is in accordance with section 32(2)(m) of the FMA, which also places a duty on a CSD Participant to use separate securities accounts for securities held by it for its own account and for those held for or on behalf of its clients.

11. Do clients have the option to hold a segregated securities account apart from that of the CSD Participant?

Yes, CSD Rules 5.1.5 and 5.1.4 make provision for this option.

12. Does a client have the option to hold an individual segregated securities account apart from that of other clients?

Yes, CSD Rules 5.1.5 and 5.1.4 make provision for this kind of segregation. Note that this is different from the holding in an *omnibus account*, where all the securities of the same kind are pooled together in one account held and maintained by the CSD Participant.

13. Are there individual segregated securities accounts in the Strate environment today?

Yes.

There are many *Own Name Securities Accounts* where the name of the client will be directly indicated as the owner of the securities. If using this structure, Client-10 will hold as an Own Name Client. There are also *Segregated Depository Accounts* (‘SDAs’) where the name of the client will be directly indicated as the owner of the securities. If using this structure, Client-11 will hold as an SDA client.

In the case of the *Own Name Client-10*, the name will be indicated on the record held and maintained by the CSD Participant (on the subregister). In the case of the *SDA Client-11*, the name will be indicated on the record held and maintained by the CSD itself, namely Strate (on the central securities account).

14. Why are the segregation options offered by CSD Participants important for the loss sharing arrangements?

If there is an ‘insolvency proceeding’ in respect of your CSD Participant;
and your CSD Participant does not hold ‘sufficient securities’;
Then the shortfall will be borne in a different manner by segregated accounts and omnibus accounts. CSD Rule 16.5.1 determines the position.

CSD Rule 5.1.7 stipulates that the required segregation must be:

- For the benefit of its clients generally;
- In a way that a specific client is identifiable so as to ensure that such securities do not form part of the property of the CSD Participant and is not available for distribution among, or realisation for, the benefit of creditors of such CSD Participant; and

- So that such securities are correctly allocated to the rights of the clients of that CSD Participant.

15. What is the duty of the CSD Participant in offering the segregation option?

In terms of CSD Rule 5.1.5, a CSD Participant must offer each client the option of opening a segregated account to enable the client to distinguish its securities from those of the CSD Participant's other clients. Such a segregated account can be held in a central securities account at the CSD itself or in a securities account at the CSD Participant.

The notification by the CSD Participant to offer to hold securities in a segregated account as set out in CSD Rule 5.1.5, must be in writing (CSD Rule 5.1.6).

The client must be notified of

- Both options as set out in CSD Rule 5.1.5;
- The fees and charges required by it for its services for each option; and
- The applicable loss sharing arrangements, in terms of CSD Rule 16.5, upon the occurrence of an 'insolvency proceeding'.

16. What must the client do on receipt of the notification from the CSD Participant?

The client must confirm its choice of segregation in writing in terms of CSD Rule 5.1.8. If the client does not respond to this offer made by the CSD Participant within 90 days, the CSD Participant may retain the existing central securities account(s) or securities account(s).

17. Is the loss sharing CSD Rule enabled in terms of the applicable South African legislation?

Yes, see section 35(2)(x)(iii) of the FMA.

18. How will the shortfall that is now part of the 'loss sharing arrangement' be borne?

The *first rule* is that the CSD Participant's own securities of the same kind, if there are any, must be used to make up for the shortfall in securities. See CSD Rule 16.5.2.1.

The *second rule* is that if a shortfall remains in the securities accounts even after applying CSD Rule 16.5.2.1, then all of the CSD Participant's clients who hold securities of the same kind (X- shares) collectively (in an omnibus account), must bear the shortfall in proportion to their holdings. This pro rata sharing of the loss will be calculated at the time immediately preceding the occurrence of the 'insolvency proceeding' against the CSD Participant.

Example 3 a:

A CSD Participant has two account holders Client-1 and Client-2 in an omnibus account. Client-1 has 60 X- shares in the omnibus account with the CSD Participant and Client-2 has 120 X- shares in the same omnibus account with the CSD Participant. Thus the CSD Participant holds in total 180 X-shares with the CSD and they are properly allocated to Client-1 and Client-2. There is no shortfall.

Example 3 b:

If, however, the same CSD Participant holds a total of 210 X-shares with the CSD, 180 are still allocated to Client-1 and Client-2, and 30 to itself (in its proprietary account).

If the CSD Participant has a shortfall of 30 X-shares, the 30 X-shares in the proprietary account of the CSD Participant must first be used to make up the shortfall. Therefore, Client-1 and client-2 will not share in the loss.

Example 3 c:

If, however, the CSD Participant has a shortfall of 100 X- shares, the 30 X- shares in the proprietary account of the CSD Participant must first be used to make up the shortfall. This means that the remaining shortfall is now 70 X-shares.

What is left in the pool? 180 shares (originally) minus shortfall of 70 shares (remember the CSD Participant may not be able to buy-in or recover these 70 shares because of its insolvency) equals 110 shares.

Example 3 d:

A CSD Participant has two account holders Client-1 and Client-2 in an omnibus account.

Client-1 has 60 X -shares in the omnibus account with the CSD Participant and Client-2 has 120 X- shares in the same omnibus account with the CSD Participant. Thus the CSD Participant holds in total 180 X-shares with the CSD and they are properly allocated to Client-1 and Client-2. (See Example 3 a above.) If the CSD Participant becomes insolvent and it is discovered that there is a shortfall of 30 X- shares, the loss sharing rule may be applied.

If the CSD Participant has no X- shares of its own to make up the shortfall, then the shortfall must be divided fairly among the clients in the omnibus account according to the sharing rule.

The shortfall of 30 X- shares will therefore be divided in terms of CSD Rule 16.5.2.2 between Client-1 and Client-2 in proportion to their respective holdings in the omnibus account.

This is so because they both hold X-shares collectively with the same CSD Participant, their custodian.

Collectively, there were 180 shares for Client-1 and Client-2, as allocated originally. Client-1's pro rata interest in the total pool has been (originally) 60 out of 180 = 0.33. Client 2's pro rata interest in the total pool has been (originally) 120 out of 180 = 0.66. What is left? 180 shares (originally) minus the shortfall of 30 shares (the CSD Participant could not recover these 30 X- shares because of its insolvency) equals 150 shares.

Client- 1's pro rata interest in the total pool is (currently) $0.33 \times 150 \text{ shares} = 50 \text{ shares}$
This means Client-1 shares a loss of 10 shares (60 shares minus 50 shares = 10 share loss).
Client- 2's pro rata interest in the total pool is (currently) $0.66 \times 150 \text{ shares} = 100 \text{ shares}$
This means Client-2 shares a loss of 20 shares (120 shares minus 100 shares= 20 share loss).

In summary, instead of the original 180 shares, there are only 150 shares left in the omnibus account, due to the loss.

The loss of 30 shares is shared rateably, so Client-1's loss is 10 shares and Client-2's loss is 20 shares.

The Guidance Note deals with various issues that are highly complex. In light of the importance of these matters, Strate's Legal and Regulatory Division has decided to issue this new Guidance Note. Please note that this Guidance Notes is issued for your information and aims to assist you in interpreting the legal and regulatory requirements, but that it does not form part of the CSD Rules and Directives. It must therefore be noted that, notwithstanding the Guidance Note, readers should still exercise their own judgments regarding the information and interpretation.

Guidance Note on the Loss Sharing Mechanism In the Strate Environment

If there is any doubt about the application of these guidelines, please consult the Strate Legal and Regulatory Division of Strate (Pty) Ltd.