

# METHODS & RULES FOR THE SEGREGATION OF SECURITIES

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

2<sup>ND</sup> MEETING, RIO DE JANEIRO, March 2012

DR MARIA VERMAAS STRATE LTD, SOUTH AFRICA

# 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**

Securities (segregated)  
v Cash (fungible)

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



# 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

# UNIDROIT art 25(1) requirement

- The securities are *allocated* to *rights* of Account Holders of that Intermediary, notwithstanding holding model



# UNIDROIT art 25(2)

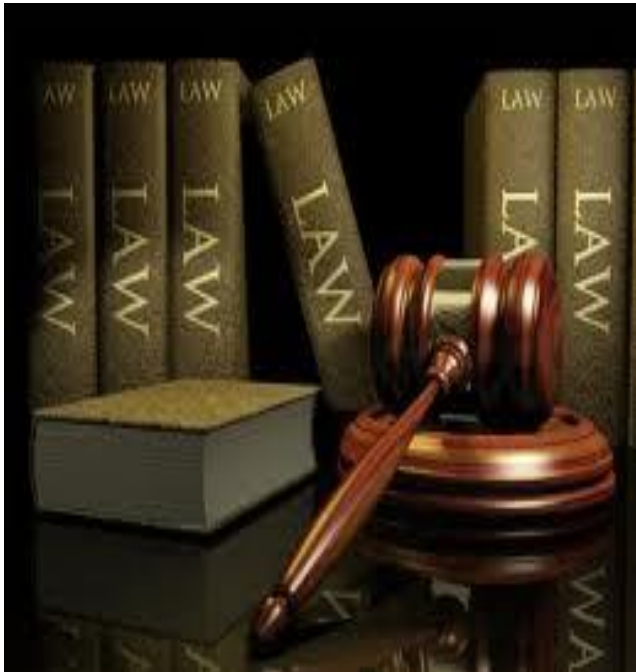
Legal Consequence



- 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

# UNIDROIT art 25(5)

Declaration



- 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

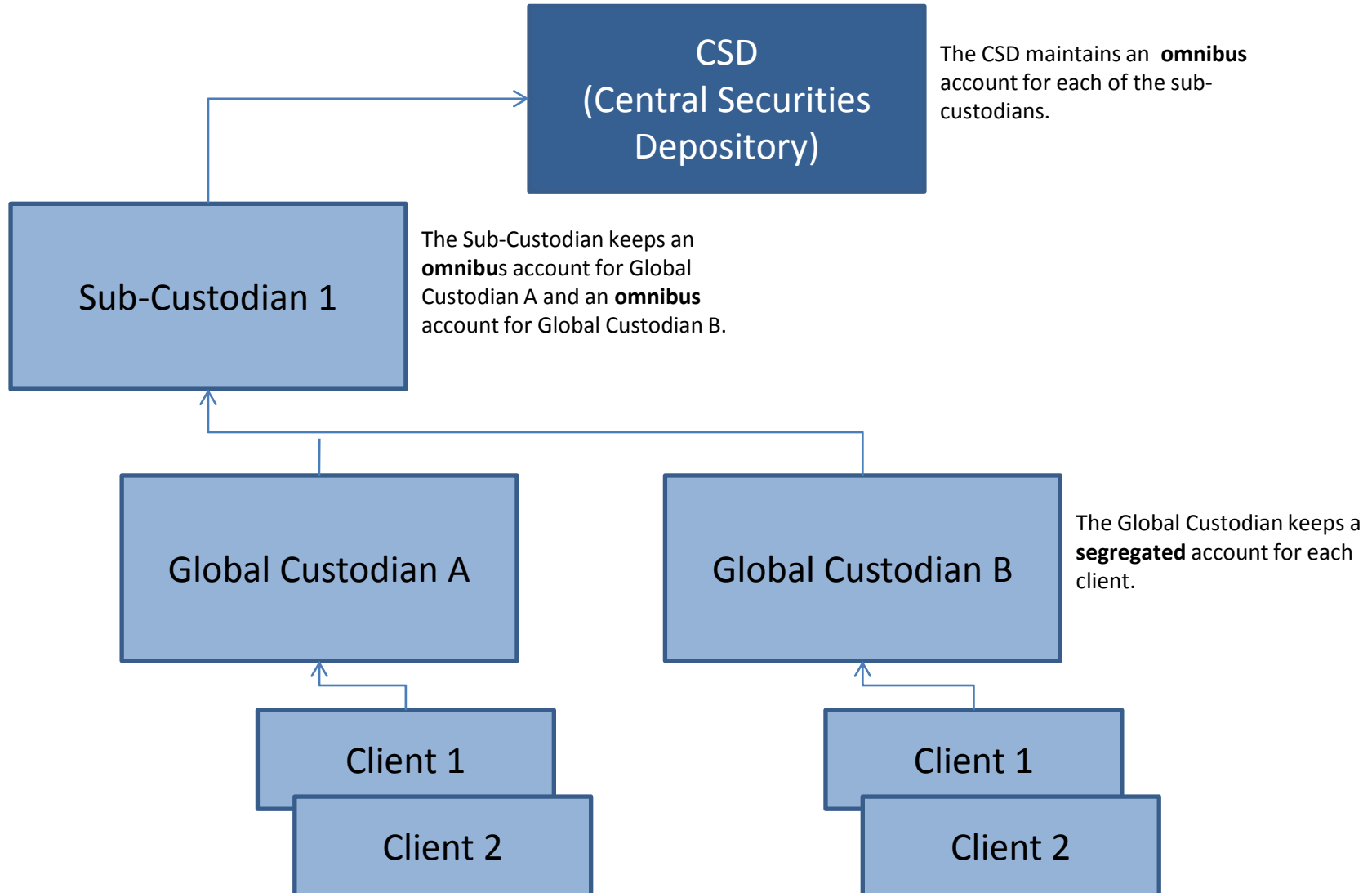


- Consequential systemic risk if no proper segregation and allocation
  - What are associated risks/benefits of choosing a particular account holding structure?
- Are accounts in CSDs segregated or held on omnibus level?



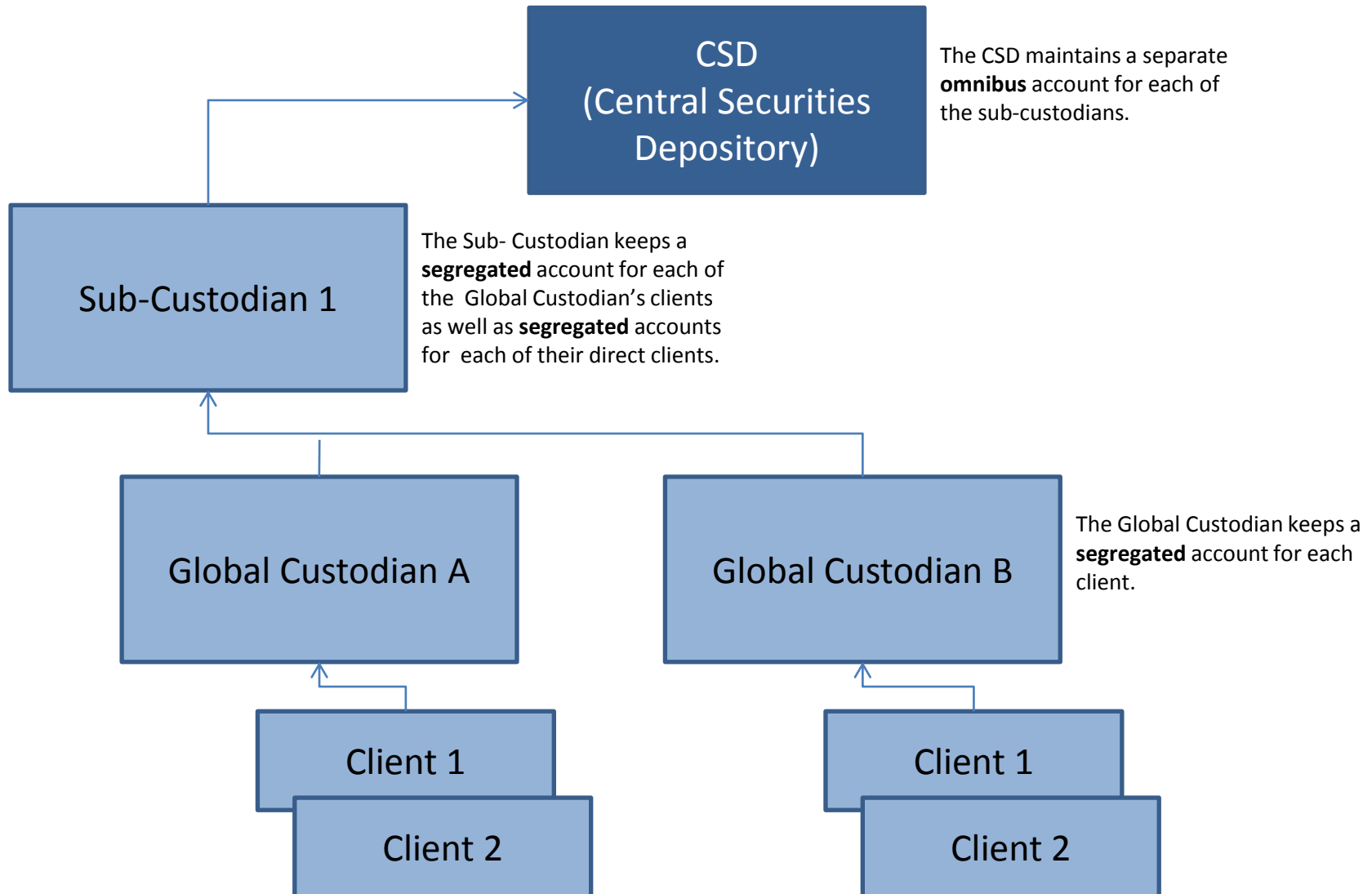
# Account Holding Models (1)

## Omnibus Accounts



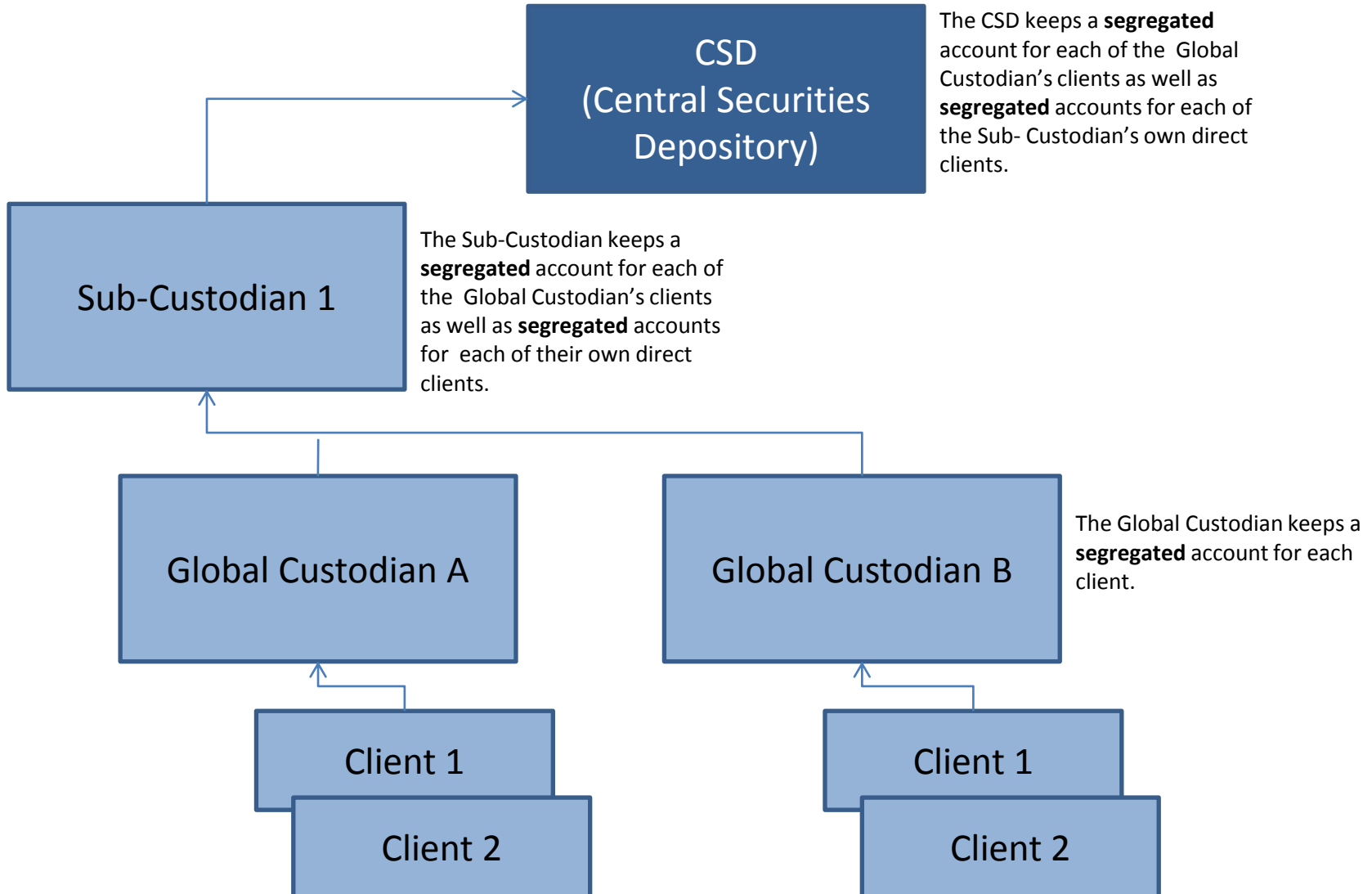
## Account Holding Models (2)

### Segregated Accounts



# Account Holding Models (3)

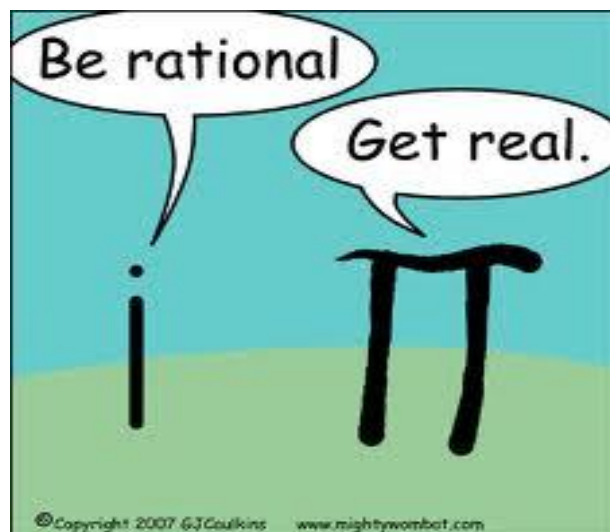
## Designated Segregated Accounts



# 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



- Dr Maria Vermaas: Head of Legal and Regulatory Division, Strate, South Africa [mariav@strate.co.za](mailto:mariav@strate.co.za)