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April 2015

newsflash

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"Bankruptcy remote" regimes:

From segregation to portability

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"Segregation", "porting", "bankruptcy remote" These are some of the special features that financial services specialists come across more and more in the European reforms. At the same time, financial instability are still haunting markets, urging investors to seek for bankruptcy- remote "ports" to place their assets.

Segregation aspects

- Custodian-level segregation

Segregation is addressed in almost every piece of European legislation concerning financial services. The European legislator, aiming at safeguarding clients' assets and funds, has obliged investment firms and asset managers to take appropriate measures enabling them to segregate, at any time and without delay, the assets of each of their clients from the assets of their other clients, as well as from those of their own portfolio. For example, the Markets in Financial Instruments Directive (Directive 2004/39/EC- "MiFID 1") and its recast under Directive 2014/65/EU ("MiFID 2") oblige investment firms to keep separate accounts per client, as well as separate accounts for their own assets. Focusing on this segregation concept, the Greek law lays down protective provisions in case of omnibus account, as well. More specifically, Article 12 paras 8 to 12 of Law 3606/2007 and the Hellenic Capital Markets Commission's ("HCMC") Decision No 2/452/1.11.2007 provide that the investment firms, when holding clients' financial instruments, take all necessary measures to protect their clients' assets, especially in case of the firm's failure. Clients' assets cannot be used by the firm, except upon client's consent. Moreover, the firm's creditors cannot seize clients' assets either when those assets are owned by the clients or held by the firm on behalf of the clients, as long as clients are proven to be the beneficial owners. As a result of those segregation measures, clients' assets are bankruptcy remote and in case of initiation of insolvency proceedings against the firm such assets are distinguished and returned to the clients.

- Depositary-level segregation

Those measures enabling an easy and timely segregation between own-to-client assets and client-to-client assets are applicable to fund managers and depositaries employed for the safekeeping of clients assets and performance of oversight functions. For example, the Alterative Investment Managers Directive (Directive 2011/61/EU- "AIFMD") and its transposing Greek Law 4209/2013, as well as the new Undertakings for Collective Investments in Transferable Securities Directive (Directive 2014/91/EU-"UCITS V") extend the segregation rules to the third party-depositary entity, entrusted with the protection of clients' assets and funds. The depositary shall ensure that all financial instruments that can be registered in a financial instruments account opened in the depositary's books are held in segregated accounts so that they can be clearly identified as belonging to the fund and in essence to the clients concerned.

The purpose behind the segregation provisions has always been the protection of investors' assets in case of default of the asset management firm or its depositary.

- "Clearing"- level segregation: CCPs and Clearing Members

A segregation regime has been introduced to the clearing and settlement sector related to the EU post-trading infrastructures. The European Markets

Infrastructure Regulation [Regulation (EU) 648/2012 - "EMIR"] requires that the CCP keeps separate records and accounts enabling the distinction between the clearing member's assets and positions and those held for the account of its clients, either in the context of omnibus or client segregation accounts. Same segregation obligations are imposed on the Clearing Members in relation to their own and their clients' assets.

ATHEXClear Regulation, in line with EMIR, obliges its participating Clearing Members to keep separate records and accounts which enable them to distinguish both in clearing accounts held with ATHEXClear and their own books and records, the assets and positions held for the account of their clients from their own assets and positions. Further, Clearing Members participating in ATHEXClear are obliged to offer their clients the option between omnibus and individual client segregation.

- CSD- level segregation

Under Greek laws securities are held by the ATHEXCSD, i.e. the Greek Central Securities Depositary (CSD), on an individual segregated basis ("*end-client registration*"). Such concept is reflected by the provisions of Laws 2396/1996, 3756/2009 and the Dematerialised Securities System (DSS) Regulation, as issued for the Greek CSD by the Hellenic Capital Markets Commission (HCMC). Individual segregation aims at providing to all market factors, mainly investors and other professionals, a real protection from all related custody risks. This service is provided by the Greek CSD since 1999 not only as a means of protecting "bankruptcy remoteness" but also:

- As a facility to the issuers achieving a real transparent market for their corporate actions and operations in general.
- As a supervisory tool enabling the regulators to exercise their supervisory and monitoring powers over the securities engagements, including also anti-money laundering and taxation areas.

Taking into account the systemic importance of CSDs for the functioning of securities markets, the European Regulation on improving securities settlement in the EU and on Central Securities Depositories [Regulation (EU) 919/2014- "CSDR"] aims at harmonizing the rules relating to the operation and governance of CSDs at a European level. Concerning the topic in question, i.e. "segregation", the CSDR requires CSDs to segregate the securities accounts maintained for each participant and offer, upon request, further segregation of the accounts of the participants' clients. Both CSDs and their participants should be required to provide for both omnibus client segregation and individual clients segregation, so clients can choose the level of segregation they believe is appropriate to their needs. Last but not least, CSDs should not use on their own account any securities that belong to a participant unless explicitly authorised by that participant and should not otherwise use on their own account the securities that do not belong to them. In this regard, the CSD should require its participants to obtain any necessary prior consent from their clients (Art.38 of the CSDR and para. 42 of its Preamble). As a result, new compliance obligations are addressed to CSDs and their participants which include the disclosure to their clients of the levels of protection and the costs associated with the different levels of segregation provided, as well as the provision of those services on reasonable commercial terms. Details of the different levels of segregation shall include a description of the main legal implications of each option, as well as information on the applicable insolvency law provisions.

It is apparent that the Greek Capital Market will have to confront the dilemma of extending or not the application of omnibus accounts to residents as well. There is no straightforward answer to this question, since several legal and operational aspects of such a transposition should be taken into account. For example, omnibus accounts should be reconciled with an end-client registration regime. The latter is

necessary in view of the efficient and transparent operation of corporations, mainly related to corporate actions, as well as to the protection of the investors' property in securities in all respects.

In relation to Greek government bonds, the dematerialized securities system of the Bank of Greece (BoG) also applies a generic concept of omnibus client segregation accounts, in accordance with Law 2198/1994 and the relevant BoG Regulation. In principle, such System is also subject to the prudential provisions of CSDR; however it is exempt from the authorisation and supervision requirements, from certain organizational requirements and from capital and investment policy requirements. ATHEXCSD as an operator-participant of the aforementioned System of the Bank of Greece is entitled to hold Greek government bonds in its Dematerialized Securities System (DSS). To this extent, the DSS service of the "end-client segregation" is available under the existing regulations to the Greek government bonds as well.

Right of asset re-use: "Clients' consent?"

Following Lehman Brothers default case and other relevant cases, a broad discussion opened with respect to the securities/collaterals' right of use or re-use scenarios.

At a European level, rules on asset re-use and clients' consent vary a lot: they range from total prohibition of re-use to the re-use upon a simple consent. MiFID 1 permits the re-use of clients' assets by investment firms for the latter's own account or for the account of another client upon client's consent and on the basis of the conditions agreed with the client. Respectively, the Greek law 3606/2007 implements MiFID 1 under the same re-use approach. Such consent is also a pre-requisite of re-use in the AIFMD regime and the respective Greek law 4209/2013. It provides for *"the prior consent of the AIF or the AIFM acting on behalf of the AIF"* to enable the depositary re-use the fund's (clients') assets for its own account.

On the contrary, UCITS V explicitly excludes the option of the re-use of assets in custody by the depositary for its own account. Re-use, in this case, is permitted exclusively for the account of the UCITS and for its own benefit only subject to respective conditions (e.g. instructions by the management company, high-quality liquid collateral received by the UCITS etc.).

"Ex lege" separation from the depositary's bankruptcy estate

Interestingly, UCITS V has also adopted explicit provisions stating that in the event of insolvency of the depositary and/or of any third party located in the Union to which custody of assets has been delegated; the assets held in custody are unavailable for distribution among or for the benefit of creditors of such depositary/ third party. Such a straight forward provision seems to be a reasonable consequence of the above-mentioned prohibition towards depositaries to re-use clients' assets.

Similar provisions are included in the Greek Banking Law 4261/2014 (implementing Directive 2013/36/EU- "CRD IV") for banks acting as depositaries, as well as in Law 3606/2007 (transposing MiFID) in relation to investment firms. More specifically, Banking Law 4261/2014 explicitly provides, in Article 145 paras 3&4, that financial instruments owned by the bank's clients and held by the bank on behalf of its clients, directly or indirectly, are excluded from the bankruptcy estate, in case of the bank's failure. At the same time, Art. 23 paras 3&4 of Law 3606/2007 mandate that in case of an investment firm failure, financial instruments and cash owned by clients and/or held by the investment firm, directly or indirectly, on behalf of its clients are excluded from the investment firm's bankruptcy estate. It is notable that this bankruptcy remote regime relates to the segregation implementation as the re-use concept is not prohibited under the aforementioned Greek legislation.

"Portability" as a further step?

Despite the "pros" of the asset segregation and the respective exclusion from the bankruptcy estate, an investor's property may be delayed to be returned due to the formalities of the insolvency proceedings including court decisions, appointment of bankruptcy trustee, recording of the bankruptcy estate, extraction of third parties assets etc. This means that, in practice, investors are not in the position to make use of their assets when the insolvency proceedings are initiated, up until their assets are extracted from the bankruptcy estate.

In order to circumvent those lengthy procedures, EMIR, has adopted straight forward provisions in relation to the "automatic" transfer of assets from one entity e.g. a defaulting Clearing Member in EMIR to another transferee Clearing Member. For the purposes of avoiding contagion risks in the operation of a market and the financial system as a whole, EMIR introduces the concept of "portability". As a prerequisite for the portability to be triggered by the CCP, clients need to have appointed- in advance- an alternative transferee- clearing member, to whom the CCP will transfer the clients' assets and positions. Only in case this process fails, either because a replacement is not appointed or declines to become party to replacement contracts, the CCP will have to liquidate the assets and positions held by the defaulting clearing member for the account of its client.

The Greek example: ATHEXClear Regulation

ATHEXClear has aligned its Regulation with EMIR porting provisions. Thus, in case of a Clearing Member's default in relation to its clearing and settlement obligations, ATHEXClear delegates the management of clients' account (or accounts), including a transfer of relevant collateral, to another Clearing Member. ATHEXClear Regulation further provides that for the above delegation to take place a prior contractual agreement is required between the transferee- Clearing Member and the Client or Clients of the transferor-Clearing Member, in case of client or omnibus segregation accounts respectively.

Conclusion

Despite the plethora of provisions, protection of clients' assets remains an issue of the EU regulators' agenda. The balance between a proper segregation and a client's protection in case of its assets' re-use is still under discussion. Besides, porting procedures under the existing EU regulation offer protection in very specific cases related only to assets and positions held for the account of clearing members.

In view of these new securities holding practices Investment firms and credit institutions, acting as custodians will have to model their own solutions in terms of serving their clients' needs and face competition.

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