NOTES / AANTEKENINGE

LEGAL ASPECTS OF MANAGING FAILURE OF A CENTRAL SECURITIES DEPOSITORY (CSD) PARTICIPANT

1 Introduction

The success of the financial market in South Africa is dependent on investor confidence and such confidence is dependent on market stability and certainty with regard to the financial risks to which market participants are exposed when trading on the financial markets. (Ministry of Justice "Press Statement by Mr HJ Coetsee MP, Minister of Justice" http://www.search.gov.za/info accessed 2009-09-29.) Even before the global meltdown impacted on South Africa, some concerns were raised that the South African legal framework pertaining to the financial market does not contain comprehensive principles regulating the procedures and legal position after the event of insolvency of a market participant. In response, Strate Limited, with the assistance of other market players, has drafted a proposed manual, the Participant Failure Manual, (Strate Limited *Participant Failure Manual* Version 3.0 30 October 2009 (hereinafter "the Manual")) regulating the event of insolvency of market participants, referred to as "Participant Failure" (the Manual is available on Strate's website http://www.strate.co.za accessed 2011-08-16).

This note aims to discuss the meaning of Participant Failure, provide an overview of the Participant Failure Manual and more importantly, discuss the impact of Participant Failure on settlement, and recommendations as proposed in the Manual.

2 Background

In terms of section 33(c) of the Securities Services Act (Act 36 of 2004 (hereinafter "the SSA")), it is the duty of Strate Limited (Strate Limited is the authorized central securities depository in South Africa (hereinafter "Strate")) to "supervise compliance by Participants with this Act and the depository rules". As a result, Strate was tasked with the drafting of a framework, the Participant Failure Manual, regulating the event of the failure of any of the participants regulated and supervised by it. The Manual outlines the procedures to ensure the settlement of trades already reported by a Failed Participant and to move the Failed Participant's clients' securities to

accounts at alternative service providers. Strate has been assisted by the JSE Ltd. These two entities (collectively referred to as the Project Stakeholders of the Manual) have been included in the development of the Manual as they have the essential skills, knowledge and expertise to develop such a framework. The input and observation of the Financial Services Board (The Financial Services Board is the regulator of financial institutions excluding banks (hereinafter "the FSB")) and the South African Reserve Bank (The South African Reserve Bank is the central bank of South Africa and also the regulator of banks (hereinafter "the SARB")) were also utilized during the further development of the Manual (*Manual* 12).

An initial draft of the Manual was published by Strate Ltd in 2006. After various iterations, Version 3.0 was released in October 2009 (*Manual* 14).

3 The meaning of participant failure

The term "Participant" refers to a Central Securities Depository Participant (CSD Participant) (see also *Manual* 5). There are currently four types of Participants, including Bank-Participants, Non-bank Participants, a Full Participant and a Corporate Participant. Bank-participants are entities who are accepted as Participants by Strate and who are also licensed as a bank under the Banks Act and whose bank activities are regulated by the Bank Supervision Department of the SARB (State Limited *Participant Failure Manual* 24). Non-bank participants are entities who are accepted as Participants by Strate and who are not licensed under the Banks Act (*Manual* 24 and 25). Full Participants are Participants who open and maintain Securities Accounts on behalf of Clients (*Manual* 25). Corporate Participants are Participants who open and maintain Securities Accounts only for securities owned by it. 11 Participants have been accepted and are currently being supervised by Strate. (*Manual* 25. These 11 participants include the following Equities Participants: ABSA Bank Limited, Computershare Limited, FirstRand Bank Limited, Nedbank Limited, Societe Generale Johannesburg Branch and The Standard Bank of South Africa Limited. It also includes the following Bonds Participants: ABSA Bank Limited, FirstRand Bank Limited, Nedbank Limited and The Standard Bank of South Africa Limited.)

In terms of the Manual, the term "failure" is limited to the financial failure or inability to pay debts of a Participant and is limited specifically to the following events: curatorship, judicial management and/or liquidation (*Manual* 14). Accordingly, "failure" will not include disaster recovery or business continuity event. A disaster recovery or business continuity event refers to the instructions given and procedures adopted by a business in response to accidents, disasters, emergencies *etc*, in order to avoid any stoppage or hindrance of the business's key operations (see *Manual* 15 and 23). A brief discussion on each of these events follows below.

3 1 Curatorship

A Bank Participant is placed under curatorship when it is unable to meet its financial obligations. Section 69(1)(a) of the Banks Act sets out the ground for a bank to be placed under curatorship and reads as follows:

> "If, in the opinion of the Registrar, any bank will be unable to repay, when legally obliged to do so, deposits made with it or will probably be unable to meet any other of its obligations, the Minister may, if he or she deems it desirable in the public interest, with the written consent of the chief executive officer or the chairperson of the board of directors of that bank, appoint a curator to the bank."

The appointment of a curator is governed in terms of section 69 of the Banks Act and the curator's duties and powers are set out in sections 69(2)(A)-69(6)(B) of this Act. It is important to note that section 69(6)(B) states that a curator of a bank is bound by sections 35A, 35B and 46 of the Insolvency Act (46 of 1936 (hereinafter "the Insolvency Act")) as if the curator were a trustee of an insolvent estate and the bank were an insolvent or a sequestrated estate as contemplated in sections 35A, 35B and 46.

The appointment of a curator has three consequences. Firstly, the entire control of the bank is vested in the appointed curator, subject to the supervision of the Registrar of Banks. A second consequence is that any other person vested with the management of the affairs of that bank shall be divested thereof. In the third instance, the curator must recover and take possession of all the assets of the bank (s 69(2)(A); and see also *Manual* 15).

In terms of section 46 of the Insolvency Act, the trustee of an insolvent estate may elect to have any set-off which occurred up to six months prior to insolvency set aside, in circumstances where such set-off did not occur within the ordinary course of business. In addition, upon insolvency, the insolvent estate vests in the trustee, with no set-off being possible in respect of any debt owing between the insolvent and creditors. Thus, post-insolvency set-off is prohibited and the creditors claiming such set-off against the insolvent estate are treated as concurrent creditors and must prove their claims accordingly (Anonymous "Post-Insolvency Set-off: South Africa Moves Towards International Best Practice" http://www.deneysreitz.co.za/index.php/tools/print/post_insolvency_set_off_south_africa_moves_towards_international_best_pract/news accessed 2009-09-22). However, section 46 makes provision for two exclusions where set-off shall in fact be effective and binding on the trustee of the insolvent estate. The first exclusion relates to set-off which takes place between an exchange or a market participant as defined in section 35A and any other party in accordance with the rules of such an exchange. The second exclusion relates to set-off which takes place under an agreement defined in section 35B.

Section 35A sets out the legal position concerning transactions on an exchange in which the insolvent party is a market participant. Section 35A(1)

of the Insolvency Act defines a "market participant" as an authorized user, a participant, a client or a settling party as defined in section 1 of the SSA or any other party to a transaction.

Section 35A can be summarized as follows: Firstly, section 35A(2) provides that in the event of the insolvency of a market participant, the exchange or any other market participant concerned, in respect of obligations owed to it, may elect to terminate such transaction and the trustee of the insolvent estate is bound by such election. Secondly, section 35A(3) provides that any consequential claim is limited to the amount due as at the date of termination under the rules of the exchange (in terms of s 35A(1) "exchange rules" refers to "exchange rules and depository rules as defined in section 1 of the Securities Services Act, 2004"). Lastly, section 35A(4) provides that the trustee of an insolvent participant is bound by the rules and practices of the exchange concerned, providing for the:

(a) netting of a market participant's position; or

(b) set-off in respect of transactions concluded by a market participant; or

(c) opening and closing of a market participant's position,

if, in terms of such rules and practices, the transaction is to be settled on a date after the sequestration, or settlement of the transaction is overdue on the date of sequestration (Sharrock, Smith and Van der Linde *Hockly's Insolvency Law* 8ed (2006) 89).

In terms of section 35A(5) of the Insolvency Act, section 341(2) of the Companies Act, 1973, as well as sections 26, 29 and 30 of the Insolvency Act, are not applicable to property disposed of in accordance with the rules of an exchange. Section 341(2) of the Companies Act provides that "[e]very disposition of its property (including rights of action) by any company being wound-up and unable to pay its debts made after the commencement of the winding-up, shall be void unless the Court otherwise orders" (in terms of s 1 of the Insolvency Act, a "disposition" is defined as "any transfer or abandonment of rights to property and includes a sale, lease, mortgage, pledge, delivery, payment, release, compromise, donation or any contract therefore, but does not include a disposition in compliance with an order of court"). In terms of the Companies Act, 1973 (s 348) the winding-up of a company by the Court is deemed to commence at the time of the presentation to the Court of the application for the winding-up. Should property disposed of in accordance with the rules of an exchange not have been excluded from section 35A, this would have had a significant impact on the settlement of securities by Strate.

The above provisions would still seem to be applicable in respect of winding-up of an insolvent company despite the provisions of the Companies Act, 2008 (Act 71 of 2008 came into operation on 1 May 2011 (hereinafter "Companies Act, 2008"). In accordance with section 9(1) of Schedule 5 of the Companies Act, 2008, despite the repeal of the previous Act, until the date determined by the Minister by notice in the Gazette, Chapter 14 of the 1973 Act continues to apply with respect to the winding-up and liquidation of

companies under the 2008 Act, as if the 1973 Act had not been repealed, subject to sub-items (2) and (3). In terms of sub-item (2), section 348, for example, would not apply to the winding-up of a solvent company, except to the extent necessary to give effect to the provisions of the 2008 Act (Chapter 2, Part G). If there is a conflict between the 1973 and 2008 Acts that continues to apply in terms of sub-item (1) and a provision of the 2008 Act with respect to a solvent company, the provision of the 2008 Act prevails. Since this article deals with failure of a CSD Participant and not the winding-up of a solvent company, the provisions of the 1973 Act would continue to apply.

It is important to note that the fact that a bank is placed under curatorship, does not necessarily imply that the bank qualifies as a "Failed Participant", as the bank, subject to the terms of the curator's appointment, continues to conduct its normal day-to-day business and under certain circumstances curatorship may also lapse (Act 78 of 1998; and s 69(10) sets out the two possible grounds where curatorship will lapse, being the issue by the Minister of written notification to that effect to the curator or the winding-up of the bank in terms of section 68 of the Banks Act). A bank will only be regarded as a "Failed Participant" and the procedures contained in the Manual will only commence once the curator:

- declares that he/she will no longer honour the cash obligations of the bank; and
- decides to terminate the banking licence (*Manual* 14).

It is important to note that current legislation (these include the Curatorship Guidelines, the SSA, the Banks Act and the Insolvency Act) makes no provision for the appointment and role of Strate, or its representative, as Failure Manager in the case of the curator making the declaration stated above. Nor does it recognize the existence of the Manual (*Manual* 15). Therefore, the current legislation will have to be amended. The question which now arises is to what extent the legislation is to be amended.

Firstly, what will the relationship be between the curator and the Failure Manager? Should the Failure Manager replace the curator and divest him/her of their duties and powers as stipulated in the Banks Act, this will clearly be a contradiction to the authority given to the SARB as lead regulator of all Banks (see par *Manual* 21).

Secondly, will the Failure Manger also be bound by sections 35A and 46 of the Insolvency Act as a curator in terms of the Banks Act? In order to ensure this, section 39(2) of the SSA will first of all have to be amended. Section 39(2) of the SSA currently states that the depository rules (the Strate Rules), are "binding on the central securities depository, a participant, an issuer of securities deposited with the central securities depository and their officers and employees, and clients". Accordingly, the SARB, FSB and the JSE Ltd are not bound by the CSD Rules. In effect these regulators will not be bound, nor will their legislative frameworks be affected, by the Manual when it is incorporated into the legal framework of Strate. This will lead to the

absurd situation where the Banks Act, as administered by the SARB, will not be applicable to the Failure Manager and by implication, sections 46, 35A and 35B will not apply to a Failure Manager. It is evident that the relationship between the curator and the Failure Manager needs to be clearly stated in the amended legislation as well as the role of the Failure Manager in relation to sections 46, 35A and 35B of the Insolvency Act.

3 2 Judicial management (Business Rescue)

The Manual, in its current version, refers to the appointment of a judicial manager to a Non-bank Participant who is on the verge of financial failure. The effect of judicial management is that the management of the Non-bank Participant is placed under the control of the judicial manager who attempts to rescue the business of the Non-bank Participant from ultimate financial failure. Should the judicial manager not be able to return the company to solvency, he may recommend to the court that the Non-bank Participant be wound up.

However, it is important to note that with the advent of the Companies Act, 2008, the judicial management system will be replaced with what is referred to as "business rescue".

"Business rescue" is defined in section 128(1)(b) of the Companies Act, 2008 as –

> "proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for –
>
> (i) the temporary supervision of the company, and of the management of its affairs, business and property;
>
> (ii) a temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and
>
> (iii) the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis or, if it is not possible for the company to so continue in existence, results in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company."

A business rescue practitioner will be appointed in the event where a company finds itself "financially distressed" (s 128(1)(f) of the Companies Act defines the term "financially distressed" in reference to a particular company at any particular time as – (i) it appears to be reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuing six months; or (ii) it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months). A business rescue practitioner will be appointed to oversee a company during business rescue proceedings and not a judicial manager (s 128(1)(d) of the Companies Act, 2008). Companies may either voluntarily initiate business rescue proceedings (in terms of s 129 of the Companies

Act, 2008) or the court may order to begin rescue proceedings (in terms of s 131 of the Companies Act, 2008).

Unlike curatorship of a Bank Participant, the procedures contained in the Manual will commence at the time that the judicial manager (business rescue practitioner) is appointed and has agreed to accept Strate, or its representative, as Failure Manager (*Manual* 16-17).

It is submitted that although the Manual refers to "replacement legislation" when it refers to the Companies Act, 1973, any later version of the Manual should be amended accordingly so as to reflect the amendments posed by the Companies Act, 2008 (*Manual* 5). The relationship between the judicial manager and the Failure Manager should be clearly stated, similar to the relationship between the Failure Manager and curator, as stated above.

3 3 Liquidation

Bank Participants as well as Non-bank Participants may be liquidated. Liquidation refers to the process whereby an entity is dissolved/wound-up. Section 68 of the Banks Act regulates the appointment of a liquidator to a Bank Participant and the Companies, 1973, together with the Insolvency Act, regulates the liquidation of a Non-bank Participant. As stated above, since this paragraph deals with the liquidation of a Failed Participant, the provisions of the Companies Act, 1973 would continue to apply.

Liquidation of a Bank Participant has the effect that all cash with the bank, excluding securities, forms part of the assets of the bank and any depositors may prove claims against such assets (cash) in the normal course events (*Manual* 17). Liquidation of a Non-bank Participant has the effect that, firstly, the directors are divested of the control of the company. Secondly, the assets, excluding securities, of the Non-bank Participant are placed under the control of the liquidator, and lastly, the Non-bank Participant may continue only business activities necessary for the winding-up of the company (*Manual* 17). The Failure Manager will be appointed once a liquidator has been appointed to wind down the business of the Failed Participant.

It is submitted that, similar to curatorship and judicial management, the relationship between the Failure Manager and the liquidator will have to be stipulated in amended legislation. It is evident that the legislation to be amended include, *inter alia*, section 68 of the Banks Act. The Manual should also be amended as to provide for the promulgation of the Companies Act, 2008.

4 Managing participant failure

4 1 Client failure

The Manual states that a Client's failure is not included in the definition of "Participant failure". Even though the possibility exists that the failure of a Client could ultimately cause or trigger the failure of a Participant, the Manual does not include any procedures to cater for the failure of a Client of a Participant (*Manual* 19).

4 2 Multiple failures

The Manual acknowledges that the global meltdown during 2008 highlighted the domino effect of systemic risk; that is, the possibility that the failure of one entity could cause the subsequent failure of another entity. This domino effect has the ability to extent to the failure of one of Strate's Participants leading to the subsequent failure of another Participant. In the case of such an event, the Manual provides that the proposed procedures as contained in the Manual will be followed for both failed entities. Accordingly, no additional or amended procedures are envisaged in the Manual (*Manual* 19).

4 3 The meaning and responsibilities of the failure manager

The term "failure manager" is defined by the Manual as a "Strate representative or representatives who oversee the securities operations of a Failed Participant on behalf of the curator, liquidator or judicial manager" (*Manual* 6). (It is important to note that before the appointment can be made of Strate, or its representative, as the failure manager of a Failed Participant, an endorsement by the FSB and the SARB must first of all be made authorizing Strate or its representative to act as a failure manager as provided for in the Manual. The Project Stakeholders are in the process of requesting such authorization. The responsibilities associated with the appointment of Strate or its representative as the failure manager will be performed independently from its functions in terms of s 33(c) of the SSA.)

In terms of the Manual, the management of the failure process will include the following responsibilities to be carried out by the Failure Manager. Firstly, the Failure Manager must "[o]versee the finality of the settlement of transactions in the settlement timeline immediately following the declaration of a Participant Failure as defined" (*Manual* 13). Secondly, it must "[o]versee the migration of Client Securities Accounts to a new service provider after Clients have opened these accounts" (*Manual* 13). Lastly, it must "[o]versee the processing of Corporate Actions (Equities and Bonds) and Capital Events Money Market)" (*Manual* 13).

It is important to note that, before the appointment of Strate, or its representative, as the Failure Manager of a Failed Participant can be made, an endorsement to this effect must be made by the FSB and the SARB

(*Manual* 13). The Project Stakeholders are in the process of requesting such authorization and it is anticipated that relevant Regulations in support of the Manual will need to be promulgated as well as necessary amendments to the Curatorship guidelines (*Manual* 13). Currently the CSD Rules do not provide for the appointment of Strate, or its representative, as Failure Manager. Therefore, the CSD Rules will have to be amended to provide for the event where a Failure Manager is appointed, as well as the scope of the powers of such a Failure Manager (*Manual* 13, 17, 121 and 122). The current CSD Rules do provide for the appointment of an interim manager under conditions of imminent danger (Rule 3.9.1.). However, it is unclear whether this provision could be interpreted to include the appointment of a Failure Manager (Action item 1 in *Manual* 120).

The Manual correctly states that the responsibilities of the appointment of Strate, or its representative, as a Failure Manager will be performed independently from its functions in terms of section 33(c) of the SSA (*Manual* 13). These functions include the termination of participation by a Participant. As such, termination is a separate procedure and would not be dealt with in terms of the Manual, but in terms of CSD Rule 3.10.1.1. (CSD Rule 3.10.1.1 provides that "[t]he Controlling Body may terminate the participation of a Participant in terms of the Act under the following circumstances: the Participant is placed under curatorship, judicial management, or a liquidator is appointed, whether provisionally or finally, or the Participant makes a compromise or arrangement with its creditors".)

4 4 The Participant Failure Crisis Committee

According to the Manual, a Participant Failure Crisis Committee (PFCC) will be constituted on announcement of curatorship, judicial management (business rescue), or on the application for liquidation of any Participant and will oversee the operational aspects of the management of a Participant Failure (See *Manual* 45-47).

The PFCC will ensure that the actions required by the Participant Failure Manual are executed and adhered to, and it will monitor and report on the status of the management of the Participant Failure to the Strate Crisis Committee (*Manual* 45). Currently, the Strate Crisis Committee Plan does not provide for a notification to constitute the PFCC and therefore, the necessary amendments will need to be made in this regard as per action item 12 in the Manual (*Manual* 122; and see also *Manual* 46).

It is important to note the line of escalation or reporting from the PFCC. Once the PFCC has reported to the Strate Crisis Committee, it will be the responsibility of the Chief Executive Officer of Strate to report to the Securities Registrar, who will in turn liaise with the Capital Markets Department (CMD) of the FSB (hereinafter "the CMD"). The CMD will have to decide whether to convene the FSB Market Crisis or Self-Regulatory Organisation Incidents Committee, who respectively report to the Financial Sector Contingency Forum (FSCF) (hereinafter "the FSCF"). This line of

reporting is not currently provided for in either the FSCF Guidelines on Failure Management, nor in the Terms of Reference of the Strate Crisis Committee and Market Crisis Committee of the FSB. This means that amendments are necessary to cater for new reporting lines (see *Manual* 46; and see also Action items 8-10 on *Manual* 122). During a crisis, the reporting lines would have to be very clear as time may be of the essence.

In terms of the Manual, the role of the FSCF will include, *inter alia*, the preparation of certain communications to the general public. In the event of a failure of a Bank Participant, the FSCF will in most likelihood always prepare such media communications (*Manual* 48). In respect of the failure of a Non-bank Participant, these communications would generally be made by the liquidator or judicial manager (now business rescue practitioner). However, depending on the severity of the event, the FSCF may also be required to prepare such communications (*Manual* 48). Strate will need to determine the requirements of the FSCF with regards to media releases in order to ensure that the Strate Crisis Committee and the Market Crisis Committee of the FSB comply with these requirements, should they become responsible for communication with the media. It should also be noted that the extent to which the Manual provides for this escalation procedure is limited to Participant Failure. The Manual does not deal with the position should the failure of a Participant have potential systemic implications. It is submitted that this position should be clearly catered for and amendments to this effect should be made. In the case of a Bank-Participant, one would assume that in the case of systemic risk, the SARB would be the lead regulator and that this aspect should not be left in the hands of the Failure Manager.

As noted above, the responsibilities associated with the appointment of Strate, or its representative, as the Failure Manager will be performed independently from its functions in terms of section 33(c) of the SSA. These functions may include the termination of participation by a Participant where the Participant is placed under curatorship, judicial management or a liquidator is appointed. In such a case, the termination will not be dealt with in terms of the Manual, but separately in terms of CSD Rule 3.10.1.1 (CSD Rule 3.10.1.1 states that "[t]he Controlling Body may terminate the participation of a Participant in terms if the Act under the following circumstances: the Participant is placed under curatorship, judicial management, or a liquidator is appointed, whether provisionally of finally, or the Participant makes a compromise or arrangement with is creditors").

4 5 Stakeholder roles and responsibilities

Should one of the Participants within the financial market fail, not only the Failed Participant will be affected, but all the stakeholders involved. Stakeholders should, therefore, take measures to ensure failures are managed in the least disruptive and efficient manner. Accordingly, the Manual attributes to stakeholders the following roles and responsibilities to the following stakeholders:

(a) Strate, or its representative, in its capacity as Failure Manager, will have to carry out the responsibilities pertaining to the Failure Manager as discussed above.

(b) As a Failure Manager, Strate, or its representative will, however, not assume any liabilities of the Failed Participant, but merely assist the curator, liquidator or judicial manager (business rescue practitioner) to continue the custody and settlement operation of the Failed Participant. Strate will, despite the operation of the Manual, continue to supervise the compliance of its Participants in terms of section 33 of the SSA and the Rules and Directives of Strate.

(c) The JSE Ltd Settlement Authority will have certain roles and responsibilities in respect of the equities market, the Yield-X market and the bond exchange market. In the equities market, during the failure period, the JSE Settlement Authority (the JSE Ltd Settlement Authority is defined in s 1 of the JSE Equity Rules as "the person or persons appointed by the JSE to manage the settlement of transaction in equity securities effected through the JSE equities-trading system in terms of the rules and directives") for the equities market will have to monitor and manage settlement of "On-Market transactions" (On-Market transactions refer to transactions in uncertificated securities which are concluded through the exchange (JSE Ltd) for settlement through the CSD) and ensure the settlement of transactions in accordance with the JSE Ltd and Strate Rules and Directives (*Manual* 21). In the Yield-X market, the JSE Ltd Settlement Authority for the Yield-X market will have to monitor and manage settlement of On-Market transactions and ensure the settlement of transactions in accordance with the Yield-X and Strate Rules and Directives (in terms of s 2 of the JSE Yield-X Rules, the JSE Settlement Authority is defined as the "person or persons appointed by the JSE to manage the settlement of transactions in bonds effected through the Yield-X trading system in terms of the Yield-X Rules and Directives and the Strate Rules and Directives"). The same applies to the JSE Settlement Authority (the JSE Settlement Authority is defined in the BESA Rules as "the person or persons appointed by the JSE to manage the settlement of transactions in bonds affected through the BESA trading system in terms of the BESA Rules and Directives and the Strate Rules and Directives") of the BESA market in terms of the BESA and Strate Rules and Directives (*Manual* 21 and 22).

The JSE Ltd Surveillance Division (this division supervises compliance of authorized users (as defined in Article Two) with the SSA and the Rules and Directives of the JSE Ltd. It is important to note that with the merger of the JSE Ltd and BESA, BESA's Market Regulation Division was integrated into the Surveillance Division; and the regulation relating to the trading aspects of cash bonds and binary options now falls within the JSE Surveillance Division) will have the responsibility of transferring the affected Authorised Users' Accounts to another Participant, to ensure the continuity of business of the affected Authorised Users and the

effective safeguarding of the securities held by the Failed Participant (*Manual* 20).

(d) The Manual makes an assumption and states for purposes of the Manual that the SARB has undertaken to "manage" the failure of any bank in the payments arena. This statement may be interpreted to mean that the SARB will provide the necessary liquidity on behalf of the failed bank (a failed Bank Participant or the Clearing Bank of a Non-bank Participant) to ensure that all cash settlements through the South African Multiple Option Settlement System (SAMOS) are effected for settlements due to occur on the day of failure (*Manual* 30 and 50). However, this will be contrary to the SARB's communicated policy stance in relation to lender-of-last-resort that, in order to prevent "moral hazard" it will not act in a way so as to allow any of the banks to believe that the SARB will always bail out banks who fail.

5 The impact of participant failure on settlement

The paragraphs below discuss the following questions raised regarding Participant Failure:

Firstly, what is the impact of Participant Failure on settlement and what is the impact on the securities account held by the Failed Participant? Furthermore, does settlement in fact take place and do the securities held by the Failed Participant in its securities accounts fall within the scope of the Failed Participant's assets or is it excluded? These questions are examined with reference to the time line of the date of failure.

5 1 Settlements on date of failure

The Manual states that it is current practice that curatorship of a bank is announced after close of business and due to announcement taking place after hours, settlements due for the following day will be difficult to apprehend (*Manual* 30). Therefore, the Manual provides that no failure actions will take place as settlement will occur on such following day (*Manual* 30). This provision is supplemented by the fact the SARB has undertaken to "manage" the failure of any bank in the payments arena by honouring the payment obligations of the Failed Participant on the date of failure so as to ensure that all settlements which are due to occur on that date are concluded as normal (*Manual* 30).

In this regard it is important to note section 8 of the NPS Act (see *Manual* 33 and s 8 provides for Netting agreements and Netting Rules). Section 8(2) provides that should a system participant (a "system participant" in terms of the NPS Act refers to a member of the payment system management body) be wound up or placed under judicial management (this term will have to be amended to "business rescue" as explained above), or should a curator be appointed to a system participant,

> "any provision contained in a written netting agreement to which that system participant is a party, or any netting rules and practices applicable to the system participant, is binding upon the liquidator, judicial manager or curator, as the case may be, in respect of any payment or settlement obligation –
>
> (a) which has been detained through netting prior to the issue of the winding-up order or judicial management order or the appointment of the curator, as the case may be; and
>
> (b) which is to be discharged on or after the date of the winding-up order, judicial management order or the appointment of the curator, as the case may be, or the discharge of which was overdue on the date of the winding-up order, judicial management order or appointment of the curator, as the case may be."

Accordingly, section 8 of the NPS Act has the effect that securities transactions in the form of written netting agreements, already in the clearing and settlement system, must be settled, despite curatorship, judicial management or liquidation. The Manual's provision relating to settlements on date of failure, therefore, correctly corresponds with section 8 of the NPS Act.

5 2 Settlements following the date of failure

With regard to settlements following the date of failure, a distinction is made between the impact of a Participant Failure on securities and the impact on cash. This distinction is made due to the fact that the legal positions with regard to securities and payment are different.

With the regard to securities, the current legal position is that securities (these securities can be equities, bonds or money markets) held by a Participant is held in the capacity as an agent and accordingly are not trapped within a Failed Participant. The securities are "ring-fenced and do not form part of the pool of assets of the failed entity" and are, therefore, "freely transferable" (*Manual* 31).

This is, however, not the position of cash at a Failed Bank Participant or Failed Clearing Bank of a Non-Bank Participant, as cash is regarded as being trapped within such Failed Participant's assets and by implication are not freely transferable. This is the position as section 69(2)(a) of the Banks Act states that the curator of a bank must take possession of all assets of the bank, which are inclusive of cash (the term "cash" includes all cash deposited with the bank before and after the appointment of a curator).

The problem which accordingly arises is that, as securities are freely transferable, one would expect all sale transactions to settle following the date of failure if the securities are available. However, this would also result in payment of the sale proceeds to the Failed Participant where it will be trapped and not be accessible to the Client until the Bank Participant is put into liquidation or wound-up (the term "cash" includes all cash deposited with the bank before and after the appointment of a curator). It should, however, be noted that cash already in the NPS system is not trapped and settlement will take place accordingly (*Manual* 33).

In order to address this unfortunate situation, the Manual recommends the following procedures which will be discussed in turn:

- the transfer of securities from a Failed Participant to other Participants; and
- the re-routing of cash proceeds from settled sale transactions, collateral and Corporate Actions / Capital Event related cash receipts.

With regard to the transfer of securities from a Failed Participant, the Manual provides that the CSD Rules 3.10.2 and 3.10.3, which provide for the migration of Client securities following the termination of a Participant's acceptance by Strate, are the procedure to be adopted (*Manual* 28 and 32).

Accordingly, all securities accounts of a Failed Participant must be transferred to other Participants, in accordance with its Clients' instructions, or may be transferred in the absence of such Clients' instructions, if such instructions have not been received within 30 days from notice of the Participant's failure given to the Client. With regard to the re-routing of cash proceeds from settled sale transactions, collateral and Corporate Actions- / Capital Event-related cash receipts, the Manual recommends that the cash proceeds from the settlement of such sale transactions should be diverted away from the failed entity using temporary cash suspense accounts opened specifically for this purpose (*Manual* 31.)

The Manual assumes that Strate, or its representative, acting as the Failure Manager, will be permitted to open two cash bank accounts with another bank or banks, other than the Failed Bank Participant or Clearing Bank of the Non-Bank Participant. These accounts will be termed respectively the "Cash Suspense Account" and the "Corporate Suspense Account".

A "Cash Suspense Account" is defined in the Manual as "a temporary cash account opened at a Bank (other than a Bank being the Failed Participant) to which cash, stemming from the settlement of securities transactions or cash collateral in terms of securities lending returns and/or deposit of New-Cash, is posted" (*Manual* 4). This account will be used as the recipient of all re-routed cash proceeds from the settlement of sale transactions and cash collateral proceeds for securities lending returns, from the date after failure, in order to prevent the cash from being trapped in the failed bank (*Manual* 34).

A "Corporate Action Suspense Account" is defined in the Manual as "a temporary cash account opened at a Bank (other than a Bank being the Failed Participant) to which cash, stemming from a Corporate Action or Capital Event, is posted" (*Manual* 5). This account will be used for all Corporate Action (the Manual defines a "Corporate Action" as "an action taken by the Issuer or any third party, that results on changes to the capital structure or financial position of the Issuer of a security, that affect any of the securities issued by an Issuer, and which affect the Beneficial Owner on uncertificated securities in terms of an entitlement") and Capital Event (the

Manual defines "Capital Event" as "a Money Market security Corporate Action") related payments (*Manual* 34).

It is important to note that the proposed re-routing of cash to these two separate banks accounts may not be permitted by current legislation (Manual 34). The SARB will have to amend its Curator Guidelines in order to provide that a curator will be bound to re-route settlements resulting in cash to a Cash Suspense Account or Corporate Action Suspense Account (*Manual* 123). It remains to be seen if and when the Curatorship Guidelines will be amended.

Currently, the curator's main duty is to conduct the management of the Bank in such a manner as the Registrar may deem to best promote the interest of the creditors of the Bank concerned and of the banking sector as a whole (s 692(B)(a) of the Banks Act). Therefore, the curator is under no obligation to re-route settlements resulting in cash to a Cash Suspense Account or Corporate Action Suspense Account. The Manual correctly states the legal framework of Strate also needs to be amended to accommodate these bank accounts, as currently, there are no provisions in its legal framework which supports such a proposal (see Action item 14 on *Manual*).

The question, however, remains whether or not the National Payment System Department (hereinafter "NPSD") of the SARB will in fact support and permit the re-routing of cash as proposed by the Manual. Currently, sections 5(3) and (4) of the NPS Act states that settlement is final and irrevocable and no settlement in terms of a settlement instruction which has been finally and irrevocably effected may be reversed or set aside. Accordingly, no re-routing of cash is permissible and re-routing would be contrary to the provision of final and irrevocable settlement. At this stage no certainty exists with regards to the decision of the NPSD. However, the Manual assumes that the NPSD will permit payments to be re-routed to and from the Failed Participant using the two cash suspense accounts (*Manual* 50).

6 Future developments and recommendations

The Legal Division of Strate is in the process of reviewing existing legislation and the new Financial Markets Bill (August 2011 – hereinafter "the FMB") to ensure the legal enforceability of the Manual in the interest of effective implementation thereof in the event of a Participant Failure.

In view of the new FMB, the following need to be noted on the legislative amendments proposed in the Manual:

- Provision needs to be made for the Registrar's approval for the promulgation of Rules and appointment of Strate, or its representative, as Failure Manager (Action items 1 and 7 on *Manual* 120 and 122 respectively). The FMB does not specifically refer to the role of Strate as failure manager but refers in general terms to the fact that the CSD "may

do all other things that are necessary for, incidental or conducive to the proper operation of a central securities depository and that are not inconsistent with this Act (s 30(u)).

- The Manual states that the Curatorship Guidelines, the SSA, the Banks Act and the Insolvency Act will need to be amended in order to provide for the relationship between the curator, liquidator, business-rescue practitioner as the case may be, and the Failure Manager (Action item 6 on *Manual* 121). This would still be required since the FMB does not clarify this relationship. The FMB does, however, provide that any transfer or other interest in securities that has been effective against third parties is effective against the insolvency administrator and creditors in any insolvency proceeding.
- The Master of the High Court should endorse and acknowledge the existence of the Manual in relation to the appointment of the business rescue practitioner or liquidator (Action item 5 on *Manual* 121).
- The appointment and role of Strate, or its representative, as Failure Manager must be endorsed by the FSB and SARB. These regulators may be required to promulgate subordinate legislation in support of the Manual and the SARB may have to make the necessary amendments to the Curatorship Guidelines (Action items 3 and 15 on *Manual* 121 deal with the position of the SARB; and Action item 2 on *Manual* 120-121 deals with the FSB).
- The CSD Rules will have to be amended to provide for the appointment of Strate, or its representative, as Failure Manager. In this regard a decision must be taken on amending the current CSD Rules which provide for the appointment of an interim manager under conditions of imminent danger (Action item 1 on *Manual* 120; and see also Action item 6 on *Manual* 121).
- The Strate Crisis Committee Plan will need to be amended to provide for the establishment of the PFCC on notification (Action item 8 in *Manual* 122; and Action item 12 in *Manual* 122).
- The reporting lines from the Failure Manager to the FSCF must be provided for in the FSCF Guidelines on failure management as well as in the Terms of Reference of the Strate Crisis Committee and Market Crisis Committee of the FSB (Action item 10 and 12 in *Manual* 122). The Policy document explaining the FMB also envisages the FSB being the lead regulator. In addition, a Council of Financial Regulators falling outside of the scope of the FMB has been set up to co-ordination between financial sector regulators. The Financial Stability Oversight Committee will coordinate on managing of risks to financial stability and will jointly be chaired by the Governor of the Reserve Bank and the Minister of Finance (*Reviewing the Regulation of Financial Markets in South Africa* August 2011 24). Hopefully this will lead to further clarity on the escalation procedure in the event where failure of a Participant leads to potential

systemic risk. The Manual deals with the escalation procedure but no detail is provided on how it would deal with systemic risk.

- The SARB has to clarify whether or not its undertaking to "manage" the failure of a bank can be interpreted to mean that it will always provide the necessary liquidity to a failed bank (Action item 5 in *Manual* 121).
- Strate will have to encourage the SARB to ensure that the necessary amendments are made to the Curator Guidelines to provide for the opening and re-routing of cash to Cash Suspense Accounts or Corporate Action Suspense Accounts (Action item 6 in *Manual* 121; and Action item 3 in *Manual* 122). The FMB provides that the Rules must provide for the administration of securities held for own account or on behalf of a client by a participant, including the settlement of unsettled transactions, under insolvency proceedings in respect of that participant (s 35(v); and this provision may be sufficiently wide to empower the CSD to make Rules to allow for re-routing, but it is not wide enough to bind the SARB).
- Clarity is needed on re-routing of cash and the apparent contradiction with the principles of finality and irrevocability of payments settlement as provided for in section 5 of the NPS Act (Action item 6 in *Manual* 121).
- The FMB contains certain provisions that would pave the way for new CSD Rules to overcome some of the above issues. In terms of the FMB the Rules must provide for the authority of, and manner in and circumstances under which –
  - A central securities depository may limit the revocation of any settlement instruction given by a participant or client; or
  - a central securities depository, participant or client may revoke any settlement instruction on the commencement of insolvency proceedings, but prior to settlement (see s 35(u)).
- The FMB also provides that the CSD Rules are binding on the CSD, its participants, external CSDs, issuers of securities deposited with that CSD or any other person that has a CSD account with the CSD, and on their officers, employees and clients and participants.

7 Conclusion

In this article, the meaning of Participant Failure is discussed, an overview of the Participant Failure Manual is provided and the impact of Participant Failure on settlement as proposed by the Manual is likewise examined. Issues of uncertainty are highlighted, as well as an overview given of the necessary amendments to existing legislation proposed in the Manual, in order to provide for the effective implementation of the Manual within the legal framework pertaining to the financial market.

Of utmost importance is the discussion of the impact of Participant Failure on settlement and the securities account held by the Failed Participant. The authors submitted that settlements on the date of failure would in fact occur

and no failure actions would take place. Whether or not such settlement will be supported by the SARB, who may or may not honour the payment obligations of the Failed Participant on the date of failure, is an issue to be negotiated between Strate and the SARB and enabled by legislation. The SARB has been very careful in recent years not to contribute towards moral hazard and to create a situation where banks may come to the conclusion that they are "too big to fail".

Settlements after date of failure will result in the adoption of various procedures taken by Strate, or its representative, as Failure Manager. The procedures include the transfer of securities from a Failed Participant to other Participants and the re-routing of cash proceeds from settled sale transactions, collateral and Corporate Actions / Capital Event related cash receipts. It was also noted that legislative changes will need to be effected in order for the Manual to be implemented within the settlement securities legislative framework.

The authors submit that the position of the Failure Manager is far from clear. Even with the publication of the new Financial Markets Bill, it remains to be seen how this new "creature" will be incorporated into the existing legal framework. Whatever construct is followed, it is hoped that the implementation will be done in such a way as to mitigate the consequences of Participant Failure and to minimize, if not prevent, systemic risk.

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