# Appendix B – Collated Responses to the Client Asset Protection Survey

# Australia

# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Relevant statutes, regulations and other references

- Corporations Act 2001
- Corporations Regulations 2001
- ASIC Market Integrity Rules (ASX Market) 2010
- ASIC Market Integrity Rules (ASX 24 Market) 2010
- ASIC Market Integrity Rules (Chi-X Australia Market) 2011
- ASIC Regulatory Guide 212 *Client money relating to dealing in OTC derivatives*
- ASIC Report 316 *Report on client money handling practices in the retail derivatives sector*

### List of Relevant Acronyms (not exhaustive)

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| **ADI** | Authorised Deposit-taking Institution |
| **AFSL** | Australian Financial Services Licence |
| **AML** | Australian Market Licence |
| **APRA** | Australian Prudential Regulation Authority |

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|---|---|
| **ASIC** | Australian Securities and Investments Commission |
| **ASX** | Australian Securities Exchange |
| **ASX Clear** | ASX Clear P/L, a subsidiary of ASX Ltd that provides all clearing services for transactions entered into on ASX's financial products markets |
| **Chi-X** | Chi-X Australia is an alternate trading venue for products listed on the ASX. |
| **ASX Settlement** | ASX Settlement Pty Limited, a subsidiary of ASX that provides all settlement services for transactions entered into on ASX's financial products markets |
| **ASX 24** | The market and trading platform operated by the Australian Securities Exchange |
| **ASX Clear (Futures)** | ASX Clear (Futures) Pty Limited, the clearing house for the ASX 24 market. |
| **LEPO** | Low Exercise Price Option |
| **NGF** | National Guarantee Fund |
| **PDS** | Product Disclosure Statement |
| **SEGC** | Securities Exchange Guarantee Corporation |
| **SFE** | Sydney Futures Exchange |
| **SLF** | Surplus Liquid Funds |

## Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

The Corporations Act 2001 (the **Act**) is the primary legislation for the protection of Client Assets in Australia. The Act is supplemented by the Corporations Regulations 2001 (the **Regulations**). In this paper, a reference to a section, subsection, paragraph and subparagraph is a reference to a section, subsection, paragraph or subparagraph of the Act and a reference to a regulation is a reference to a regulation of the Regulations, unless otherwise indicated.

Australia's approach to the protection of Client Assets is broadly as follows:

(a) Part 7.8 of the Act contains the provisions for the protection of both Client Money and Client Property (Client Asset Protection Provisions). This paper will deal with the Client Asset Protection Provisions as they relate to both Client Money and Client Property, which together form Client Assets.

The Client Asset Protection Provisions are largely principles-based, aiming to protect Client Assets by:

(i) separating Client Money from those of the Investment Firm;

(ii) generally requiring that Client Assets are held on trust for the benefit of the client;

(iii) requiring that Client Assets are only used, or in the case of Client Money, withdrawn and invested as permitted under Part 7.8;

(iv) prohibiting or restricting the basis on which, Client Assets may be attached or used as security;

(v) requiring auditors to verify an Investment Firm's compliance with the Client Asset Protection Provisions in Part 7.8 in the Firm's financial records;

(vi) specifying how Client Money may be dealt with if the Investment Firm ceases to be licensed or becomes insolvent; and

(vii) imposing sanctions on an Investment Firm that fails to comply with the Client Asset Protection Provisions in Part 7.8.

Specific provisions apply to Client Money and to Client Property respectively. The Client Asset Protection Provisions do not distinguish between retail and wholesale clients.

(b) The Act does not address the treatment of Positions. This is left to contractual terms between the Investment Firm and the client.

(c) Investment Firms must comply with the Client Asset Protection Provisions. A breach constitutes an offence under the Act. As part of our supervisory functions, ASIC can seek information from Investment Firms on compliance with these provisions. Further, pursuant to section 983A, on application by ASIC, a court may order Client Money accounts be frozen if it is satisfied:

(i) there are reasonable grounds for believing there is a deficiency in the client money account (whether the account is maintained in Australia or elsewhere);

(ii) there has been undue delay, or unreasonable refusal, on the person's part in paying, applying or accounting for Client Money; or

(iii) there has been a breach of section 981B.

(d) Client Money issues do not typically arise for general securities transactions subject to exchange rules for on-exchange transactions. This is because money paid to acquire a financial product is not Client Money. To the extent that money is paid before a security is

issued (e.g. application money under an initial public offering of securities), there are particular provisions that apply to the holding of application money – in essence requiring the money to be held in a trust account and a requirement to return the application money if the product is not issued within a certain period of time.

(e) In addition, ASIC imposes further obligations on Investment Firms who are also market participants on the ASX, ASX 24 and Chi-X market. These obligations are contained within the:

(i) ASIC Market Integrity Rules (ASX Market) 2010 Part 3.5 Client Money and Property;

(ii) ASIC Market Integrity Rules (ASX 24 Market) 2010 Rule 2.2.6 Clients' Segregated Account obligations and Part 2.3 Account Reconciliation Obligations; and

(iii) ASIC Market Integrity Rules (Chi-X Market) Part 3.5 Client Money and Property.

These rules detail how market participants are required to deal with margining obligations, holding client money and holding client property.

For example, on the ASX 24 Market, a market participant is required to deposit Client Money for trading on the ASX 24 market into a clients' segregated account on the day it is received, or by the next business day. It also specifies what Client Money can be deposited, permissible investments, permitted withdrawals from the account and the requirement to maintain accounting records.

(f) In addition to complying with the statutory requirements of Part 7.8 and exchange and clearing house requirements, a person carrying on a financial services business of a type described in the definition of 'Investment Firm' must hold an appropriate Australian Financial Services Licence (**AFSL**). A condition of the AFSL is that the Licensee must comply with Australia's financial services laws. An AFSL is a licence issued by ASIC which authorises the entity (and their representatives) to provide specific financial services to clients. In this response, a reference to an Investment Firm is a reference to a person who is an AFSL holder.

(g) An Investment Firm is permitted to use Client Money that is related to derivatives as margin in accordance with section 981D.

(h) An Investment Firm is permitted to use Client Property that is related to derivatives as margin in accordance with subsection 984B(2).

a. How does your jurisdiction define the term “client assets?” If the jurisdiction uses an analogous term, please provide that term and its definition.

The Act does not define the term 'Client Assets' as such. However Subdivision A of Division 2 of Part 7.8 describes the money and property to which the Client Asset Protection Provisions will apply.

**Client Money**

Section 981A in Division 2 describes money to which the protective provisions of Division 2, Subdivision A will apply.

Under this section, Client Money is money paid to an Investment Firm in the following circumstances:

(a) the money is paid in connection with:

(i) a financial service that has been provided, or that will or may be provided, to a person (the *client*); or

(ii) a financial product held by a person (the *client*); and

(b) the money is paid:

(i) by the client; or

(ii) by a person acting on behalf of the client; or

(iii) to the Investment Firm in the Firm's capacity as a person acting on behalf of the client.

The Client Money Protection Provisions in Subdivision A of Division 2 do not apply to money paid to the extent that:

(a) the money is paid by way of remuneration payable to the Investment Firm, or the Investment Firm is entitled to deduct such remuneration from the money; or

(b) the money is paid:

(i) to reimburse the Investment Firm for payments made to acquire, or acquire an increased interest in, a financial product; or

(ii) to discharge a liability incurred by the Investment Firm in respect of the acquisition of a financial product or an increased interest in a financial product, or to indemnify the Investment Firm in respect of such a liability; or

(c) the money is paid to acquire, or acquire an increased interest in, a financial product from the Investment Firm, whether by way of issue or sale by the Firm; or

(d) the Investment Firm is a licensed trustee company, and the money is paid to the Firm in connection with traditional trustee company services provided by the Firm; or

(e) Subdivision B applies to the money. (Loan money is dealt separately in Subdivision B of Division 2. Section 982A describes money to which that subdivision applies).

Further, the Client Money Protection Provisions do not apply:

(f) to a payment if a person pays money to an Investment Firm in order for it to be deposited to the credit of a deposit product held by the person or another person with the Firm; or

(g) property other than money (e.g. share certificates). This property is dealt with as Client Property under Division 3 of Part 7.8. See further below.

### Client Property

Section 984A of Division 3 of the Act describes property to which the protection provisions of Part 7.8 will apply.

Client Property is property other than money (for example, share certificates) that is given to an Investment Firm in the following circumstances:

(a) the property is given in connection with:

(i) a financial service that has been provided, or that will or may be provided, to a person (the *client*); or

(ii) a financial product held by a person (the *client*); and

(b) the property is given:

(i) by the client; or

(ii) by a person acting on behalf of the client or for the client; or

(iii) for the benefit of the client; or

(iv) the Investment Firm is accountable for the property.

Property that is given as security for a standard margin lending facility is exempt from the client asset protection obligations of Division 3.

b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

### Client Money

The Act does not refer to or specifically address 'ownership rights'. However, it does impose fiduciary obligations on an Investment Firm in favor of the client with respect to Client Money to the extent that:

(a) the Investment Firm must operate the client money account into which all Client Money must be paid as a trust account (regulation 7.8.01(5)(a)); and

(b) hold all moneys paid into the client money account (with limited exceptions – see below) on trust for the benefit of the person who is entitled to the moneys (regulation 7.8.01(5)(c)).

This is reinforced by subsection 981H(1) which provides that money is taken to be held in trust by the Investment Firm for the benefit of the client.

These obligations may be displaced by and/or are subject to (as applicable):

(a) the Regulations (for example, regulation 7.8.01(5)(c) provides for an exception to the obligation to hold all monies paid into the account on trust for the benefit of the person entitled to the moneys if the moneys are paid to an Investment Firm under the Firm's obligation to call margins from clients under the market integrity rules, the operating rules of a licensed market or the operating rules of a licensed clearing settlement facility (**Rules**). In

this case, the Investment Firm may operate the account as either a segregated account or a trust account); and

(b) relief granted by ASIC.

**Client Property**

The Act does not refer to or specifically address 'ownership rights' with respect to Client Property. However, it does impose a fiduciary obligation on an Investment Firm to hold the Client Property in trust for the benefit of the person who is entitled to it (regulation 7.8.07(2)).

As with Client Money, these obligations may be displaced by and/or are subject to (as applicable):

(a) the Regulations (for example, under regulation 7.8.06A property given as security for a standard margin lending facility is exempt from Division 3 of Part 7.8); and

(b) relief granted by ASIC.

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

For the purposes of Divisions 2 and 3 of Part 7.8, a 'client' is a person who has been, may be or will be provided with, a financial service or who holds the financial product, in relation to:

(a) Client Money (subsection 981A(1)): money paid to the Investment Firm in connection with such financial service or financial product (but not necessarily paid by the client);

(b) Client Property (section 984A): property is given to the Investment Firm in connection with such financial service or financial product (but not necessarily by the client).

These Divisions in Part 7.8 do not distinguish between a 'retail client' and a 'wholesale client' (in effect, a sophisticated investor). This means that the obligations of the Investment Firm apply regardless of the client categorisation**.** Rather, it is the categorisation of money as Client Money and property as Client Property which attracts the Client Asset Protection Provisions.

For the purposes of ASX 24 market participants, a 'Client' is defined to mean any person, partnership or Corporation on behalf of whom the market participant enters, acquires or disposes of a futures contract or option contract; or on whose behalf the market participant proposes to enter, acquire or dispose of a futures contract or options contract; or from whom the market participants accepts instructions to do so (ASIC Market Integrity Rules (ASX 24 Market) Rule 1.4.3).

For the purposes of futures contracts traded on the ASX, 'Client' is defined to mean a person on behalf of whom the market participant deals, or from whom the market participant accepts instructions to deal, in futures contracts (ASIC Market Integrity Rules (ASX Market) Rule 3.5.8).

d. Please describe any notable exclusions from the terms "client" or "client assets."

**Client**

There are no statutory exclusions to the term 'client'. However, ASIC may grant relief from the Client Asset Protection Provisions in certain circumstances. For example ASIC may modify section 981B to enable money of clients that are resident in specified jurisdictions to be held in accounts of specified overseas financial institutions.

For the purposes of the ASX 24 clients' segregated account obligations 'Client' is defined to exclude a related body corporate as defined in the Act or a division of the market participant.

**Client Money**

Please refer to response for question 1 (a).

**Client Property**

Please refer to response for question 1(a).

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (e.g., retail versus sophisticated).*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through, e.g., informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets? No.

   a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

   b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

There are no special authorisation requirements for Investment Firms to hold Client Assets. However, as discussed above, Investment Firms must hold an AFSL to carry on a financial services business in Australia.

Prior to being issued an AFSL, applicants will be assessed to ensure that they:

(a) are competent to carry on the kind of financial services business they are applying for;

(b) have sufficient financial resources to carry on the business they are proposing; and

(c) are able to meet their other obligations as an Investment Firm (should a licence be granted).

Although Investment Firms will generally require, given the nature of their business, an AFSL with specific authorisations to deal and advise in securities and derivatives (thereby also permitting them to hold client securities), they do not require specific authorisations to hold Client Money or Client Property.

Notwithstanding this, each Investment Firm is required to comply with general licensee obligations which include, among other things, the requirement for Investment Firms to comply with the Client Asset Protection Provisions and further to that, a requirement to report significant breaches to ASIC, which may include breaches of these Provisions.

Section 912A of the Act requires AFSL holders to:

- do all things necessary to ensure that the financial services covered by the Investment Firm's AFSL are provided efficiently, honestly and fairly;
- have in place adequate arrangements for the management of conflicts of interest in relation to activities undertaken by the licensee or its representative in the provision of financial services;
- comply with conditions on the AFSL;
- comply with the financial services law (as defined under the Act);
- take reasonable steps to ensure that the Investment Firm’s representatives comply with the financial services law;
- have available adequate resources including financial, technological and human resources to provide the financial service to provide the (licensed) financial services and to carry out supervisory arrangements (this does not apply to an Investment Firm that is also supervised by the Australian Prudential Regulation Authority (**APRA**));
- maintain the competence to provide the financial services;
- ensure that the Investment Firm’s representatives are adequately trained and competent to provide the financial service;
- provide a dispute resolution system for retail clients (see section 761G for definition of retail client);
- have adequate risk management procedures in place (does not apply to an Investment Firm that is also supervised by APRA); and
- have compensation arrangements if financial services are provided to retail clients (specified under section 912B).

In addition to the requirements above, Investment Firms (excluding licensees prudentially regulated by APRA and market and clearing participants registered with the ASX, Chi-X, ASX 24 or ASX Clear) that hold Client Money or Client Property must comply with additional financial requirements.

Specifically, if at any time an Investment Firm:

(a) is required to hold money in a separate account under Division 2 of Part 7.8;

(b) holds money or other property on trust for a client or is required to do so under regulation 7.8.07(2) or otherwise; or

(c) has the power to dispose of a client's property under power of attorney or otherwise,

the Investment Firm must hold at least $50,000 in surplus liquid funds (**SLF**) unless the value of the money and property for all clients in total is less than $100,000. This does not apply to an Investment Firm who is registered as a market and clearing participant with the ASX, Chi-X, ASX Clear, or who is otherwise regulated by APRA (essentially ADIs, insurance companies and superannuation entities). The SLF requirement also does not apply to an ASX 24 and/or ASX Clear (Futures) participant who restricts their financial services business to participating in the ASX 24 market or ASX Clear (Futures) market respectively and incidental business. Investment Firms within these categories will have to comply with ASX, Chi-X, ASX 24, ASX Clear, ASX Clear (Futures) or APRA requirements, as the case may be.

Under section 989B, an Investment Firm must lodge with ASIC a true and fair profit and loss statement and balance sheet together with an auditor's report containing the information and matters required by the regulations. Pursuant to regulation 7.8.13 the auditor's report must contain a statement of the auditor's opinion of:

(a) the effectiveness of internal controls used by the Investment Firm to comply with the Client Money and Client Property provisions;

(b) whether each Client Money account required to be maintained by the Investment Firm has been operated and controlled in accordance with the Client Money protection provisions of Division 2; and

(c) whether all necessary records, information and explanations were received from the Investment Firm.

In addition to reviewing an auditor's report, ASIC also undertakes a risk-based approach to the review and testing of an Investment Firm's compliance the Client Asset Protection Provisions.

*Additional requirements for market participants*

In addition to the requirements under the Act, Investment Firms who directly execute, clear or settle securities/derivatives in relation to products traded on the market will also need to be admitted as a participant of the relevant market. As a participant of the ASX, ASX Clear, Chi-X, ASX 24 and/or ASX Clear (Futures), the Investment Firm is required to comply with the relevant ASIC Market Integrity Rules, ASX or Chi-X Operating and/ or Clearing Rules (as applicable) on an ongoing basis.

ASX 24 market participants that hold client monies are required to submit an independent audit report confirming they have suitably designed and effective internal controls to comply with the obligations in relation to clients' segregated accounts: ASIC Market Integrity Rules (ASX 24) 2.3.5.

For ASX market participants that are not recognised as principal traders, there is an annual requirement for an independent auditor's report on their financial statements and their internal control procedures designed to ensure compliance with the capital requirement.

Similarly, for ASX 24 market participants that are not recognised as principal traders, there is a requirement to submit an independent auditor's report confirming compliance with their capital requirements.

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

Yes.

**Client Money**

Paragraph 981B(1)(a) requires Client Money to be paid into an account that is:

(i) an account with an Australian ADI; or

(ii) of a kind prescribed by regulation 7.8.01(2), namely an account with an approved foreign bank or a cash management trust.

The requirement for Client Money to be kept separate from the Investment Firm's own assets is achieved through paragraph 981B(1)(b). Under this paragraph, the only money that can be paid into the client money account is (in summary):

(i) Client Money;

(ii) interest standing to the credit of the client money account;

(iii) interest on permitted investments using Client Money or the proceeds of the realisation of permitted investments;

(iv) money paid by an Investment Firm into a client money account due to the requirements of the Rules;

(v) other money permitted to be (initially) paid into the account by the Regulations, e.g. mixed money and unidentified money.

Under section 981B, an Investment Firm must pay Client Money into a client money account on the day the Firm receives it or on the next business day.

The requirement for separation of Client Money is reinforced through regulations 7.8.01(5) and 7.8.01 (11) – (14) (inclusive).

Under regulation 7.8.01(5), a client money account must be designated and operated as a trust account and, unless money has been paid to the Investment Firm pursuant to the Firm's obligations under the Rules, the Firm must hold all money paid into the account on trust for the benefit of the person who is entitled to the money. If the exception applies, the Investment Firm must still segregate Client Money from their own funds but may operate the account as a

segregated account or a trust account and may pay all Client Money into that account (i.e. even if some of the Client Money is not for the purposes of margins collected under the relevant rules). In this case, pursuant to section 981H, Client Money is taken to be held on trust for the benefit of the client except for that portion of money paid to the Investment Firm for margins required under the relevant rules.

Regulation 7.8.01(11) allows mixed money and unidentified money to be paid into a client money account. However in the case of:

(i) mixed money (i.e. money that is received by the Investment Firm as a single payment and is not wholly Client Money but includes Client Money): the Investment Firm must remove the part of the mixed money that is not Client Money as soon as practicable but within one month after the mixed money is paid into the client money account;

(ii) unidentified money (i.e. money that the Investment Firm receives as a single payment where, at the time of receipt, the Investment Firm is unable to identify whether the money is Client Money or mixed money that might include client money): the Investment Firm must identify any part of the money that is not Client Money and remove it from the client money account as soon as practicable.

ASIC has stated in 'Regulatory Guide 212 Client money relating to dealing in OTC derivatives' (**RG212** ) that the Client Money provisions of the Act do not permit an Investment Firm to deposit its own funds into a client money account by way of 'buffer' or otherwise. It is ASIC's position that buffers cannot be used by an Investment Firm as a way of ensuring that there are adequate funds in the client money account to ensure that the Investment Firm does not face a shortfall in the account when payments are made from the client money account, e.g. as a result of incorrect bank fees or other unintended or uncontrollable errors that may reduce the balance of the account.

### Client Property

Under subsection 984B(1), an Investment Firm must ensure that Client Property is only dealt with in accordance with the Regulations, the terms and conditions on which the Client Property was given to the Investment Firm and any subsequent instructions given by the client. There is provision for Client Property to be used for the purpose of meeting margin requirements for hedging (even where the relevant dealings do not pertain specifically to the client) under subsection 984B(2).

The Regulations essentially require that Client Property must be held on trust for the benefit of the person who is entitled to it. The Regulations specify different requirements for custody arrangements, the precise requirements depending on specific agreement between the Investment Firm and the client. There is no absolute requirement for the property to be held with a third party custodian or with an Australian ADI.

Under regulation 7.8.07(8) an Investment Firm must not deposit Client Property as security for a loan or advance to the Investment Firm unless:

(a) the client owes the Investment Firm an amount in connection with a transaction entered into by the Investment Firm on the client's behalf;

(b) the Investment Firm gives the client a written notice that identifies the property and states that the Investment Firm proposes to deposit it as security for a loan or advance to the Investment Firm; and

(c) the amount, or total of the amounts, that the client owes on the day of the deposit is at least the amount of the loan or advance.

Client Property so deposited must be withdrawn within one business day after the client repays its obligation and the Investment Firm must update the client every three months that the property has not been withdrawn (if the loan or advance continues).

*Additional requirements for market participants*

In addition, ASX market participants must establish one or more clients' trust accounts or clients' segregated accounts if they receive money from clients for:

- futures market transactions; and
- options market transactions over an underlying financial product which is a futures market contract: ASIC Market Integrity Rules (ASX) 3.5.2.

Chi-X market participants that receive money in connection with dealings in equity market transactions must establish one or more clients' trust accounts: ASIC Market Integrity Rules (Chi-X) 3.5.1

ASX 24 market participants must:

- deposit monies received from clients or persons acting on behalf of clients into an account maintained by the ASX 24 market participant and designated as a clients' segregated account;
- comply with rules regulating permitted deposits into and permitted withdrawals from a clients' segregated account, rules dealing with permissible investments, payments to another AFSL holder, segregation of property, and maintaining accounting records for withdrawals;
- refrain from making an agreement with a client that the client's money is not to be held or does not need to be held in a segregated account for the benefit of the client;
- not use a clients' segregated account to meet any initial or variation liabilities which relate to trading by the ASX 24 market participant on its own behalf or a related corporation;
- keep Client Property segregated from the ASX 24 market participant's own property and ASX 24 market participants must be able to liquidate Client Property as soon as practicable when required; and

- not use property held in safe custody to satisfy an ASX 24 Market Participant's debt: (ASIC Market Integrity Rules (ASX 24) 2.2.6).

a. Must the Client Assets of one client be maintained separately from those of other clients?

No.

**Client Money**

An Investment Firm is not required to maintain separate accounts for each client. Further, subsection 981B(2) allows an Investment Firm to maintain one or more client money accounts in which Client Money may be commingled. If an 'Omnibus Account' is used, regulation 7.8.05 requires that it must still be operated as a client money trust account and, subject to the exception under the Rules, hold all monies paid into the account on trust for the persons entitled to the monies.

If money required to be placed in a client money account relates to a derivative or a dealing in a derivative, the Investment Firm may use the money for the purpose of meeting obligations incurred by the Investment Firm in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the Investment Firm, including dealings on behalf of people other than the client (section 981D).

It does, however, mean that Client Money belonging to one client may be used for meeting margin obligations of other clients, exposing the client to the risk that they may not receive all the money held by the Investment Firm on their behalf in the client money account if there is a deficit in the client money account and the Investment Firm becomes insolvent or is otherwise unable to pay the deficiency.

*Additional requirements for market participants*

For ASX and Chi-X market participants, ASIC Market Integrity Rules provide that a trust account may include the property of multiple clients (ASIC Market Integrity Rules (ASX Market), Rule 3.5.1 and ASIC Market Integrity Rules (Chi-X Market), Rule 3.5.1). With respect to ASX futures transactions (or option market transactions over an underlying financial product which is a futures market contract), Client Money must be paid into a client money account and be kept segregated from the licensee's own funds. This can be either a trust account or a clients' segregated account.

With respect to ASX 24 futures transactions, Client Money must be paid into a clients' segregated account on the day it is received by the Market Participant, or the next business day (ASIC Market Integrity Rule (ASX 24 Market), 2.2.6 (c).

**Client Property**

There is no statutory requirement for Client Property of one client to be kept separate from the Client Property of other clients. The primary obligation is for an Investment Firm to only deal with Client Property in accordance with the Regulations, the terms and conditions on which the Client Property was given to the Firm and any subsequent instructions given by the client.

Notably, subsection 984B(2) allows Client Property to be used for the purpose of the Investment Firm meeting obligations incurred by it in connection with margining, guaranteeing, securing,

transferring or settling dealings in derivatives by the Firm (including dealings on behalf of people other than the client) if the financial service is or relates to a dealing in a derivative or the financial product is a derivative.

i. Are Investment Firms allowed to hold Omnibus Accounts? Yes.

See response to question 3(a) above.

Where omnibus accounts are operated by an ASX 24 market participant (e.g. on behalf of another broker), a House account and Client account are to be maintained separately at all levels (including at the Clearing and Settlement Facility level) (ASIC Market Integrity Rules (ASX 24 Market), 2.2.6(a)(iii)).

ASX and Chi-X market participants may use omnibus accounts but there are no specific rules in place about the use of Omnibus accounts, except for futures market transactions which are dealt with in a similar way to the ASX 24 requirements.

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

**Client Money**

Protection is afforded under the provisions which govern:

(a) Permitted withdrawals from the client money account;

(b) Permitted investments; and

(c) Protection from attachment.

*Permitted Withdrawals*

Under regulation 7.8.02, payments which may be made out of a client money account are:

(1) making a payment to, or in accordance with the written direction of, a person entitled to the money;

(2) defraying brokerage and other proper charges;

(3) paying to the Investment Firm money to which the Investment Firm is entitled;

(4) making a payment of monies due to an insurer in connection with a contract of insurance;

(5) making a payment that is otherwise authorised by law; and

(6) paying to the Investment Firm money to which the Investment Firm is entitled pursuant to the market integrity rules or the operating rules of a financial market.

There is also provision under regulation 7.8.02(1A) for making a payment to another Investment Firm provided the receiving Investment Firm is notified that the money has been withdrawn from Client Money and pays it into its client money account.

An Investment Firm may include broad authorisations, written directions and consent of the client which enable it to comply with its obligations under Division 2 of the Act while withdrawing Client Money from the client money account and using it for the purposes set out in the client agreement.

In addition, pursuant to section 981D, if a financial service is or relates to a dealing in a derivative or the financial product is a derivative, the Investment Firm may use the money concerned for the purpose of meeting obligations incurred by the Investment Firm in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives by the Investment Firm, including dealings on behalf of people other than the client.

This means that Client Money belonging to one client may be used for meeting margin obligations of other clients, exposing the client to the risk that they may not receive all the money held by the Investment Firm on their behalf in the client money account if there is a deficit in the client money account and the Investment Firm becomes insolvent or is otherwise unable to pay the deficiency.

In ASIC Regulatory Guides 212, ASIC states that:

(a) any permitted use of Client Money for the purposes of meeting margin payments to the Investment Firm requires that the Firm has incurred an obligation in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives (as permitted by section 981D) and does not permit the Firm to use Client Money or withdraw it from the client money account in anticipation of an obligation arising; and

(b) the amount of Client Money that is used in exercise of this right should be limited to the amount necessary to meet the Investment Firm's obligations so incurred in connection with margining, guaranteeing, securing, transferring, adjusting or settling dealings in derivatives.

*Permitted Investments*

Subject to certain exceptions to the application of the investment permissions (see below), regulation 7.8.02(2) permits the following kinds of investment in relation to a client money account:

(i) investment in any manner in which trustees are for the time being authorised by law to invest trust funds;

(ii) investment on deposit with an eligible money market dealer;

(iii) investment on deposit at interest with an Australian ADI;

(iv) the acquisition of cash management trust interests;

(v) investment in a security issued or guaranteed by the Commonwealth of a state or territory of Australia;

(vi) investment on deposit with a licensed clearing and settlement facility.

Pursuant to regulation 7.8.02(3) an Investment Firm must not invest Client Money in a way permitted by regulation 7.8.02(2) unless the money is money to which the client is entitled and the Investment Firm has obtained the client's written agreement to the following matters:

(a) the making of the investment;

(b) how earnings on the investment are to be dealt with (including whether or not the earnings are to be shared, and whether or not the earnings are to be paid into the client money account);

(c) how the realisation of the investment is to be dealt with (including whether or not the capital invested, and the proceeds of the investment, are to be deposited into the client money account);

(d) how any losses made on the investment are to be dealt with (including the circumstances in which the Investment Firm is required to pay an amount equal to the difference between the amount invested and the amount received, into the account or otherwise); and

(e) the fee (if any) that the Investment Firm proposes to charge for the investment.

The restrictions on investment do not apply to those made in accordance with the written direction of the client (regulation 7.8.02(5)).

Market practice is that the Investment Firm typically obtains the client's written agreement to the investment by including an appropriate term in the client agreement. Investment of Client Money is disclosed to clients in the Investment Firm's PDS for the relevant financial service and financial product, e.g. contracts for difference as a derivative.

*Protection from Attachment*

**Client Money**

Section 981E prohibits Client Money (both in a client money account and before or after it is paid into a client money account), other money which is in the account or investments made with Client Money from being attached or otherwise taken in execution or being made subject to set-off or charging order or to any process of a similar nature, except at the suit of a person who is otherwise entitled to the money or investment. However this does not apply to Client Money or Client Property used by the Investment Firm for margining which is typically posted to a counterparty without a lien or other security interest in favour of the client.

**Client Property**

The protection provisions of the Act which apply to Client Property are less extensive than those for Client Money.

Essentially the Client Property protection provisions require that, subject to an exception in subsection 984B(2), Client Property be only dealt with in accordance with the Regulations (which in turn govern the safe custody, registration and security arrangements for Client Property), the terms and conditions on which Client Property was given to the Investment Firm and any subsequent instructions given by the client. The exception contained in subsection 984B(2) is that if the financial service provided by the Investment Firm is or relates to a dealing

in a derivative or the financial product is a derivative, the Client Property may be used for the purpose of meeting obligations incurred by the Investment Firm in connection with margining, guarantee, securing, transferring, adjusting or settling dealings in derivatives by the Firm (including dealings on behalf of people other than the client). This means that the Client Property of one client may be used for meeting margin obligations of other clients, exposing the client to the risk that they may not receive all the Client Property held by the Investment Firm on their behalf if there is a deficit of Client Property and Client Money available to the Firm and the Investment Firm becomes insolvent or is otherwise unable to pay the deficiency.

In summary, under the regulations an Investment Firm must:

(1) deposit Client Property in safe custody at the written request of the client or notify the client of their failure to do so;

(2) if requested by the client, arrange for the body corporate that issued or made available the securities or managed investment products underlying the property, to register the Client Property in the name of a nominee controlled by the Firm;

(3) not deposit the Client Property by way of security for a loan or advance to the Investment Firm unless certain conditions are met including that the client owes the Firm an amount in connection with a transaction entered into by the firm on the client's behalf. Within one business day of repayment, the Firm must withdraw the Client Property from the deposit facility.

*Additional requirements for market participants*

If a ASX or ASX 24 market participant invests money from a clients' segregated account pursuant to paragraph 981C(a), the investment must be readily realisable and at least 50 per cent of the money invested under that section must be invested on 24 hour call terms (ASIC Market Integrity Rules (ASX Market), Rule 3.5.6 and ASIC Market Integrity Rules (ASX 24 Market), Rule 2.2.6).).

If a client does not satisfy its margin or settlement obligations the Investment Firm must pay into the clients' segregated account, the lesser of:

- the amount of the request; or
- the amount which the participant would be obliged to request from the client on the following day (ASIC Market Integrity Rules (ASX Market), Rule 3.5.7 and ASIC Market Integrity Rules (ASX 24 Market), Rule 2.2.6).

ASX 24 market participants are specifically prohibited from using client money to satisfy obligations incurred by the Investment Firm's own (or proprietary) trading in derivatives, that is, trading by the Investment Firm using its own money so as to make a profit for itself (ASIC Market Integrity Rule (ASX 24) 2.2.6(j))

Client Money belonging to one client may, however, be used by Investment Firms to meet margin obligations of other clients. This exposes the client to the risk that they may not receive back all the money held by the Investment Firm, on their behalf, in the client money account, if:

- there is a deficiency in the client money account; and
- the Investment Firm becomes insolvent or is otherwise unable to pay the deficiency.

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

The Act does not expressly require an Investment Firm to reconcile the Client Asset Account.

However, in its 'Report 316 Review of Client money handling practices in the retail OTC derivatives sector', ASIC expresses the view that effective Client Money accounting and reconciliation processes are fundamental to risk management for Investment Firms because they serve as key controls that prevent deficiencies arising in Client Money accounts. This is in the context of the requirement for AFSL holders, such as Investment Firms, to have adequate risk management systems under paragraph 912A(1)(b). ASIC also expresses the view that daily reconciliations may identify and resolve Client Money account deficiencies in a timely manner.

See also the response to question 3(b)(ii) below with regard to reconciliation requirements for market participants.

In addition, an Investment Firm must keep financial records that correctly record and explain all money received or paid by the Investment Firm in relation to a client money account and explain all money received or paid by the Investment Firm in relation to a client money account (sections 988A and 988E and regulation 7.7.11).

Further, pursuant to section 989B and regulation 7.8.13, an auditor's report lodged with an Investment Firm's financial statements must contain a statement of the auditor's opinion of:

(a) The effectiveness of internal controls used by the Investment Firm to comply with the Client Money and Client Property provisions in Divisions 2 and 3 of Part 7.8;

(b) Whether each client money account required to be maintained by the Investment Firm has been operated and controlled in accordance with the Client Money provisions; and

(c) Whether all necessary records, information and explanations were received from the Investment Firm.

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

The Act does not deal with this issue specifically. However, in practice Client Assets are fungible within Client Money and Client Property classes respectively.

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

Please see response to question 3(b)(ii)(C) below.

C) If a client has a debit balance (*i.e.*, the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

The Act regulates payments in and payments out of the client money statutory trust account. The Act does not specify how to determine what balance should be held.

For the purposes of performing daily reconciliations of Client Money, participants of the ASX, Chi-X and ASX 24 market deduct a client's debit balance in determining the amount the Investment Firm is required to hold.

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

See generally the response to question 2(b)( i) above.

Although the Act does not specify when the reconciliation is required (see however, *Additional requirements for ASX, Chi-X and ASX 24 market participants* below) generally Investment Firms conduct reconciliations daily on an aggregate basis. An Investment Firm will use their own funds to account for the deficiency however the Act does not contain any deeming provisions in this situation. See response to question 2 on authorization and financial requirements for more information.

In RG 212, ASIC states that this record keeping would include prudent reconciliation processes to ensure the accuracy of the financial records.

*Additional requirements for ASX and Chi-X market participants*

ASX and Chi-X market participants must perform a reconciliation of clients' trust accounts and segregated accounts.

In relation to clients' trust accounts this must reconcile:

- the aggregate balance held by it at the close of business on each business day in clients' trust accounts and the corresponding balance as recorded in the ASX or Chi-X market participant's accounting records; and
- the balance held by it at the close of business on the last business day of each week on trust for each person on whose behalf money is held in a trust account and the corresponding balance as recorded in the ASX or Chi-X Market Participant's accounting

records (Market Integrity Rules (ASX Market) Rule 3.5.9 or ASIC Market Integrity Rules (Chi-X Market) Rule 3.5.9).

ASX and Chi-X market participants must prepare a schedule of trust account amounts by no later than 5 business days after 31 March, 30 June, 30 September and 31 December in each year showing the respective amounts held in the Market Participant's trust account on behalf of clients together with the names of the particular client in respect of each amount (ASIC Market Integrity Rules (ASX Market) Rule 3.5.11and ASIC Market Integrity Rules (Chi-X Market) Rule 3.5.11).

In relation to clients' segregated accounts, an ASX market participant must reconcile the aggregate balance held by it at the close of business on each business day in clients' segregated accounts and the corresponding balance as recorded in the ASX market participant's accounting records (ASIC Market Integrity Rules (ASX Market) Rule 3.5.8). This requirement does not apply to Chi-X market participants

Responsible executives of ASX and Chi-X market participants (or persons authorised in writing by a responsible executive) must also sign a statement stating that the signatory believes, and has no reason not to believe, that the reconciliation is accurate in all respects (ASIC Market Integrity Rules (ASX Market) Rule 3.5.9(1)(d) and ASIC Market Integrity Rules (Chi-X Market) Rule 3.5.9(1)(d)).

ASX and Chi-X Market Participant must notify ASIC in writing within two business days if they:

- do not perform such a reconciliation in accordance with the relevant rule; or
- perform such a reconciliation which then reveals a deficiency of funds in the trust accounts.( See Rule 3.5.10 of both the ASIC Market Integrity Rules (ASX Market) and ASIC Market Integrity Rules (Chi-X Market))

An ASX market participant must also notify ASIC within two business days if reconciliation under Rule 3.5.8 of the ASX Market Integrity Rules reveals that total deposits are less than total third party client money (ASIC Market Integrity Rules (ASX Market), Rule 3.5.10(c)).

*Additional requirements for ASX 24 market participants*

ASX 24 market participants must perform a daily reconciliation of client funds by 7pm on the business day after the business day to which the reconciliation relates. The reconciliation must be of the aggregate balance held by the ASX 24 market participant in the clients' segregated account at the close of each business day and the corresponding balance in the market participant's accounting record (ASIC Market Integrity Rules (ASX 24 Market), Rule 2.3.2).

An ASX 24 market participant must notify ASIC, in writing, within 2 business days, if:

- the reconciliation has not been performed;
- the total deposits is less than total third party client money; or
- if it is unable to reconcile its clients' segregated account. (ASIC Market Integrity Rules (ASX 24 Market), Rule 2.3.4)

ASX 24 market participants also have an obligation to perform a monthly reconciliation of clients' segregated accounts and provide this to ASIC (ASIC Market Integrity Rules (ASX 24 Market), Rule 2.3.3).

ASX 24 market participants must reconcile the aggregate balance held by it in the clients' segregated account at the close of each business day and the corresponding balance in the market participant's accounting record.

The monthly reconciliation of client funds must be given to ASIC by the last business day of the calendar month following the calendar month to which the reconciliation relates. It must contain a statement signed by a Director or a person authorised in writing by a Director, stating that the signatory believes, and has no reason not to believe, that the reconciliation is accurate in all respects.

ASX 24 Market Participant are required to give to ASIC within three months of the end of the financial year, an independent audit report on compliance with client money rules (ASIC Market Integrity Rules (ASX 24 Market), Rule 2.3.5).

Preparing Client Funds Reconciliations

With respect to preparing the client funds reconciliation, a client that has a debit balance (i.e., the client owes the Investment Firm monies), such balances are deducted in determining the amount the Investment Firm is required to hold.

Top Up Requirements

Where there is insufficient client money to meet margin liabilities in the clients' segregated account, a market participant must 'top up' the clients' segregated account by the extent of any shortfall with money from the house account within five clear business days (e.g. ASIC Market Integrity Rules (ASX 24) 2.2.6(f)). Such "top up" monies may only be withdrawn in accordance with permitted withdrawal requirement and only after such monies have been received from the client by the market participant.

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

The Client Money protection provisions do not permit Investment Firms to maintain their own funds in a client money account. The requirement for Client Money to be kept separate from the Investment Firm's own assets (in relation to the client money account) is achieved through paragraph 981B(1)(b). See response to question 3 for more information.

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

See the response to questions 3(a)(ii) regarding Client Assets being maintained separately from the Investment Firm's own assets. In particular, the permissions afforded by section 981D (for Client Money) and subsection 984B(2) (for Client Property).

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

Yes. See the response to question 3(c)(i) below on re-hypothecation and ownership rights.

See further the response to permitted investments in the response to question 3(a)(ii) regarding what measures are used to protect the Client Assets of each client from losses due to the activities of other clients.

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

On 'ownership rights' generally, see the response to question 1(b), which describes the nature of these rights with respect to Client Assets.

**Client Money**

While the Act sets out the circumstances in which Client Money can be withdrawn from the client money account and what constitutes permitted use and investments, it does not address 'ownership rights'.

If an Investment Firm has the right to withdraw Client Money and use it or invest it under the client agreement, and the exercise of those rights is not prohibited under the Act, whilst the Investment Firm remains solvent and holds the AFSL, a client's rights would be limited to those arising out of the client agreement with the Investment Firm.

In the case of the Investment Firm's insolvency, Regulation 7.8.03 provides for priority of payments including to those persons who are entitled to be paid money from the account. If the money in the account is insufficient then it must be paid in proportion to the amount of each person's entitlement. See the response to question 18 below.

**Client Property**

The Act does not contain a prohibition against an Investment Firm using Client Property as security for a loan or advance for its use and benefit.

Under the Regulations an Investment Firm must:

(1) deposit Client Property in safe custody at the written request of the client or notify the client of their failure to do so;

(2) if requested by the client, arrange for the body corporate that issued or made available the securities or managed investment products underlying the property, to register the Client Property in the name of a nominee controlled by the Firm;

(3) not deposit the Client Property by way of security for a loan or advance to the Investment Firm unless certain conditions are met including that the client owes the Firm an amount in connection with a transaction entered into by the firm on the client's behalf. Within

one business day of repayment, the Firm must withdraw the Client Property from the deposit facility.

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

Adopting the interpretation of this term as described in question 3(d)(i) above, for:

(i) Client Money - the consent must be in writing e.g. by inclusion of appropriate terms in the client agreement. Refer to regulation 7.8.02(1) (a) and regulation 7.8.02(3(a);

(ii) Client Property – the only requirement for an item to be in writing arises under regulation 7.8.07(8) which requires a written notice to be given to the client by the Investment Bank which identifies the property and states that the Firm proposes to deposit the Client Property as security for a loan or advance to the Firm. Section 984B requires that Client Property be dealt with subject to the terms and conditions on which the Client Property was given to the Investment Firm and to any subsequent instructions given by the client.

*Additional requirements for ASX 24 market participants*

On the ASX 24 Market, prior to the commencement of trading for a Client, an Investment Firm must have in force, a duly signed agreement with that client containing the minimum terms.

An Investment Firm must obtain the client's prior written agreement on specified matters before investing money from a clients' segregated account: ASIC Market Integrity Rules (ASX24) 2.2.6(i) (applies to all Client Assets). This includes the following:

(a) the marking of any investment of client money;

(b) how earnings on the investment are to be dealt with;

(c) how the realisation of the investment is to be dealt with;

(d) how any losses made on the investment are to be dealt with;

(e) the fee (if any) that the market participant proposes to charge for the investment; and

(f) such investment must be readily available and at least 50 per cent on 24 hour call.

iii. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (*i.e.*, established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

On the nature of a client's 'ownership rights' see the response to question 1(b).

Rehypothecation of Client Assets is not regulated by the Act.

Client Money
As Client Money is a fungible Asset, the concept of 'ownership rights' is not easily reconciled.

It is possible a client would pursue an action against the Investment Firm for recovery of the amount due to it under, or in conjunction with, the terms of the client agreement and related transactions and services. The Act provides for priority of payments in those cases where the balance of the client money statutory trust account is insufficient to meet investor claims and the Investment Firm has become insolvent or has ceased to trade. See the response to question 22. Client Money is subject to the terms of the statutory trust established by Part 7.8 of the Act. See also the response to question 3(a)(ii) on the prohibition against Client Money being attached, set-off or used as security.

Client Property
Any hypothecation of the Client Property to the Investment Firm would be addressed under the terms of the client agreement or related document. Depending on the facts of the case, if the Investment Firm had re-hypothecated Client Property without the consent and default by the client, it is possible the client would pursue a claim against the Investment Firm for recovery of the Client Property in specie, seek compensation for the loss of the Client Asset or seek to recover the Client Asset from third parties holding the Client Asset under the re-hypothecation.

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

ASX Clear and ASX Clear Futures both require collateral provided by the Investment Firm to be held in separate accounts depending on whether it is the Investment Firm's assets or the client's assets.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction?

**Client Money**

As explained in the response to question 3 regarding what money may be deposited into a client money account, an Investment Firm must pay Client Money into a client money statutory trust account that complies with the requirements of the Act. In practice, unless relief is granted by ASIC, this means the account is held with an "Australian ADI". Note that this term may include Australian-owned banks, branches of foreign banks and foreign subsidiary banks provided appropriate authorisation has been granted by APRA.

Subsequent to paying Client Money into the client money account, provided the client has authorized and consented to it, Client Money may be withdrawn and then transferred and held in another jurisdiction.

**Client Property**

There is no prohibition against transferring or holding Client Property in another jurisdiction. However, an Investment Firm that wishes to do so must ensure that this dealing with Client Property is in accordance with the terms and conditions on which the Property was given to the Firm, any subsequent instructions of the client and the regulations (which deal with the holding of such Property on trust, depositing the Property in safe custody, registration of the Property and depositing the Property as security for a loan or an advance).

*Additional requirements for ASX and Chi-X market participants*

As noted above, Client Money must be held in a client trust account with limited institutions. The effect of this requirement is that Client Money cannot be held outside Australia unless:

- it is held with a branch of an Australian ADI; or
- specific authorisation is obtained from ASIC for a deposit of funds in an approved foreign bank.

(Rule 3.5.3 and Rule 3.5.4 in both ASIC Market Integrity Rules (ASX Market) and ASIC Market Integrity Rules (Chi-X Market)).

*Additional requirements for ASX 24 market participants*

Client Money must be deposited in a clients' segregated account. If the account is operated outside Australia and the law in force in the jurisdiction requires the account to be designated in a particular way, the Investment Firm must designate the account in that way (ASIC Market Integrity Rule (ASX 24 Market), Rule 2.2.6(a)(ii).)

There is provision for the Investment Firm to invest client money outside Australia if it is with an Approved Foreign Bank or is in accordance with a specific direction of a client (ASIC Market Integrity Rule (ASX 24 Market) Rule 2.2.6(h)).

If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

a. Client Assets transferred to or located in other jurisdictions?

The Act deals with the handling of Client Money and dealing with Client Property received from clients of the Investment Firm's Australian business, even if those clients reside in a foreign jurisdiction. The Act does not deal with Client Money or Client Property relating to an Investment Firm's foreign businesses, even if foreign laws permit its transfer to Australia.

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

For Client Assets related to the Investment Firm's Australian business, see the response to question 4(a) above. For assets that have been transferred from other jurisdictions and identified as assets in those jurisdictions, this will depend on applicable foreign law.

If so, please provide details of those requirements.

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by

Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

We understand this question to be asking if an Investment Firm in Australia can comingle its Client Money with that of a Foreign Investment Firm in the same Omnibus Account.

As explained in the response to question 3 regarding separation of assets, an Investment Firm must pay Client Money into a client money statutory trust account that complies with the requirements of Division 2 of Part 7.8. The Act places restrictions on what money may be deposited into this account, namely the client money account. Client Money of a Foreign Investment Firm would not be permitted to be paid into and therefore comingled in a client money account.

Subsequent to paying Client Money into the client money account, provided the client has authorized and consented to it, Client Money may be withdrawn and paid into another account. This account may be an Omnibus Account that could also hold money from foreign clients.

a. No statutory protections apply to Client Assets that have been subsequently deposited into an Omnibus Account with the client's consent and authority.

b. Not applicable under Australian law however regulation in the foreign jurisdiction may dictate what steps the Foreign Investment Firm must take, if any.

c. See the response to question 5b.

*Additional requirements on ASX 24 market participants*

Client Money must be deposited into a client money account as noted above. There is provision for an Investment Firm to pay client money to another Investment Firm, but in such event, the client money must be paid into a client money account (ASIC Market Integrity Rule (ASX 24 Market), Rule 2.2.6(e)).

There are no restrictions on an Investment Firm that is an Australian ADI or is part of a group with an Australian ADI from maintaining its client money account with itself or the group Australian ADI. In such event, they would still be subject to the restrictions under the client money requirements.

Where an Investment Firm chooses to operate an omnibus account (on behalf of another broker), there is a requirement that a House Account and Client Account are to be maintained separately at all levels in the chain, down to the clearing and settlement facility level, notwithstanding the

fact the investment is in another jurisdiction (ASIC Market Integrity Rule (ASX 24 Market), Rule 2.2.6(a)(iii)).

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

See the response to question 2.

A custodian would need to hold an AFSL with a specific authorization that permits the custodian to 'provide a custodial or depository service' – unless the service is an incidental part of the custodian's business.

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

The Act does not dictate the terms of the custody agreement however see further the response for question 3(a)(ii) regarding protecting Client Money from attachment. For Client Property, see response for the same question for conditions on an Investment Firm depositing the Property as security for a loan or advance to the Investment Firm (regulation 7.8.08(8)).

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

An Investment Firm offering financial products that are derivatives to retail clients must generally provide a Product Disclosure Statement (**PDS**) to the retail client before the financial product is acquired. The Act specifies the type of matters that must be included in the PDS, which amongst other things, includes details of the financial product being offered, its characteristics or features, significant benefits and any significant risks, including in relation to a client's money.

ASIC has published 'Regulatory Guide 227 Over-the-counter contracts for difference: Improving disclosure for retail investors' (**RG227**) which sets out guidelines for Investment Firms for improved disclosure to retail investors in relation to contracts for difference, margin forex and similar products. Under Benchmark 5, an Investment Firm should maintain and apply a clear policy on its use of Client Money, including whether it uses money deposited by one client to meet the margin or settlement requirements of another client.

*Additional requirements on ASX and Chi-X market participants*

ASX market participants must provide clients trading in products for first time in the ASX explanatory booklets on options, LEPOs and warrants.

ASX and Chi-X market participants must also enter into an agreement in relation to the relevant market transaction. This agreement must contain information about the execution and clearing

arrangements in place and other mandatory items provided for in the rules. The mandatory items do not specifically require information related to the protection of the client's assets but this may be included by the Investment Firm.

*Additional requirements on ASX 24 market participants*

The SFE Procedures Determinations and Practice Notes (still in force) in relation to ASIC Market Integrity Rule (ASX 24 Market) Rule 2.2.6 strongly recommends that ASX 24 market participants provide Notice 50/06 to clients.

Notice 50/06 contains a warning to clients that all client money are co-mingled in the clients' segregated account held by the ASX 24 market participant. As a result, the Notice highlights that the operation of a clients' segregated account may not protect an individual client's money in the case of a default arising from the trading of other clients. This is because individual client money is co-mingled in one clients' segregated account.

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

There is no specific mechanism for clients to opt out of the Client Asset protection provisions under the Act or ASIC market integrity rules. However, the following practices can have the effect that money that the Investment Firm is holding may not be subject to the client money protections:

(a) as noted above, an Investment Firm may withdraw Client Money from a client money account if it is entitled to the money – some Investment Firms have written their client agreements to provide that margin payments are due and payable on opening a position, such that on opening of the position, the money ceases to be client money; and

(b) an Investment Firm can obtain a written direction to make a payment out of a client money account – ASIC has indicated in RG212 that a broad authorisation may conflict with an Investment Firm's general licensee obligations.

There are different market practices as to whether an Investment Firm specifies that margin payments are due to the Investment Firm while the derivative position is open. ASIC is aware that some Investment Firms in the OTC derivatives market operate in this way.

Client Property protection would also be subject to the specific agreement between the client and the Investment Firm.

In relation to the market integrity rules, an ASX 24 market participant is prohibited from making any agreement with a client that the client's money is not to be held or does not need to be held in a segregated account for the benefit of the client (ASIC Market Integrity Rules (ASX 24 Market), Rule 2.2.6(g)).

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

In relation to reporting breaches of the Client Asset Protection Provisions, section 912D of the Act requires the Investment Firm that has breached or is likely to breach its AFSL obligations (including the obligation to ensure the Firm has available adequate resources to provide the financial services covered by the licence) to notify ASIC as soon as practicable and in any event within ten business days after it becomes aware of the breach or likely breach where that breach or likely breach is significant.

The relevant factors when determining whether or not a breach is significant are:

- The number or frequency of similar previous breaches;
- The impact of the breach or likely breach on the AFSL holder's ability to provide the financial services covered by the AFSL;
- The extent to which the breach or likely breach indicates that the AFSL holder's arrangements to ensure compliance with those obligations is inadequate; and
- The actual or potential financial loss to clients of the AFSL holder or the AFSL holder itself, arising from the breach.

(See paragraph 912D(1)(b))

In addition, ASIC imposes conditions on an AFSL holder that require it to be notified in certain circumstances (for example, regulation 7.6.04 of the regulations).

a. Does the Investment Firm report where client assets are held?

See the reference to the PDS in the response to question 7 regarding an Investment Firm's disclosure obligations.

b. Does the Investment Firm or depository report the protections applicable to such client assets?

The obligation is encumbent on the Investment Firm.

See the reference to the PDS in the response to question 7 regarding an Investment Firm's disclosure obligations.

c. Does the Investment Firm or depository report the amount of assets that are held?

The obligation is encumbent on the Investment Firm.

In each case, are such reports provided on request or periodically? If periodically, with what frequency?

See response to question 9 above.

In addition, ASX 24 market participant who holds client money are required to report the nature of Client Assets held on a monthly and annual basis. They report the amount of Client Assets held and the nature of the client's investment. The client funds reconciliation is submitted on a monthly basis, one month after the calendar month to which the reconciliation relates.

On an annual basis, an ASX 24 market participant is required to obtain an independent audit report on whether it has maintained suitably designed and effective internal controls to comply with the requirements of the clients' segregated account Rules.

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

a. Where Client Assets are held?

b. The amount of Client Assets held at a depository?

c. The safeguards applicable to Client Assets held at a depository?

ASIC conducts proactive and reactive surveillance of Investment Firms for their compliance with Australia's financial services laws. This will include a requirement that the Investment Firm provide documentary evidence of its compliance such as bank statements where Client Money is held in a foreign jurisdiction.

See also the response to question 12 below regarding the role of the auditor.

*Inspections of ASX 24 market participants*

An ASX 24 Market Participant is required to perform a daily reconciliation of client funds by 7pm the next business day. The reconciliation requires the ASX 24 Market Participant reconcile the liability owed to the client against the money held in the clients' segregated account.

An ASX 24 Market Participant is required to notify ASIC, within 2 business days if the reconciliation has not been performed, or if there is a deficit (total deposit is less than third party Client Money) or the Market Participant is unable to reconcile its clients' segregated account.

An ASX 24 Market Participant is required to submit its monthly reconciliation of client funds to ASIC by the last business day of the calendar month following the calendar month to which the reconciliation relates. ASIC reviews the client funds reconciliation to ensure it contains the required disclosure and is completed in a timely manner.

An ASX 24 Market Participant is also required to prepare and give to ASIC, an annual declaration for clients' funds. This requires an independent audit of the client monies procedures and controls.

ASIC performs ad hoc inspection of ASX 24, ASX and Chi-X market participant's Client Funds Reconciliations against supporting records to verify that client money is held in accounts designated as clients' segregated account and to determine the nature of any investment.

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

a. The amount and/or value of such Client Assets?

b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

This will depend on the basis the foreign regulator claims jurisdiction over the Foreign Investment Firm and the relevance of the Client Assets to that issue. However, it may be possible for the foreign regulator to seek ASIC's assistance under the co-operative arrangements between them to share information. Further, certain information is public pursuant to the disclosure and reporting obligations of public companies in Australia.

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

Investment Firms (other than those regulated by APRA) must notify ASIC if any event occurs that may make a material adverse change to the financial position of the Investment Firm by comparison with its financial position. This must be notified at the time of the application for an AFSL and in any case not later than 3 business days, after the Investment Firm becomes aware of the event.

Additional disclosures may also occur under the following general requirements.

First, an Investment Firm must give ASIC a written report as soon as practicable, and in any case within 10 business days of becoming aware of a significant breach (or likely significant 20 breach) of a number of its obligations, including its obligations to comply with the Client Asset protection provisions and, if the Investment Firm is not regulated by APRA, also its obligation to have adequate resources to provide the financial services covered by its licence.

Any notification of such a breach would need to describe the breach, provide details as to why the Investment Firm considered it significant, how the breach was identified, how long the breach lasted, how it has been rectified and any steps that have been, or will be, taken to ensure future compliance with the obligation.

Second, an Investment Firm must prepare true and fair profit and loss and balance sheet statements. The Investment Firm must also have these statements audited, which will involve the auditor forming a view as to whether the statements present a true and fair view. Both the accounts and the audit report must be lodged with ASIC.

The auditor of the Investment Firm is also under an obligation to notify ASIC of any contraventions or suspected contraventions of the client money provisions and client property provisions of the Act (including the regulations) to ASIC. The auditor must report to ASIC within 7 days of becoming aware of a matter, contravention or suspected contravention (section 990K).

Further, the auditor must notify in relation to any matter that, in the opinion of the auditor, "has adversely affected, is adversely affecting or may adversely affect the ability of the [Investment Firm] to meet the Investment Firm's obligations as a licensee".

*Additional requirements for ASX and Chi-X market participants*

The risk-based capital requirements applicable to securities market participants require participants to prepare and submit the following reports:

- Monthly reports, generally within two weeks of the end of the month;
- An audited annual report, generally within three months after the end of the financial year;
- Weekly (or in some situations daily) reports where the capital has dropped to less than 1.2 times the minimum required level; and
- An ad hoc report where the licence holder or ASIC (as appropriate) requests.

*Additional requirements for ASX 24 market participants*

The capital requirements applicable to futures market participants provide that they must prepare and submit the following reports:

- Monthly reports, generally within two or four weeks after the end of the month (depending on the type of participant);
- An audited annual report, generally within three months after the end of the financial year;
- A report where the capital drops below 1.5 times the minimum required level;
- A report where the capital level falls by more than 20 per cent since the previous report; and
- An ad hoc report where the licence holder or ASIC (as appropriate) requests.

13. For an Investment Firm whose financial situation is seen to have deteriorated (e.g., capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

ASIC has the power to apply to the Court for an order restraining dealings with a client money account where:

(a) there are reasonable grounds for believing that there is a deficiency in a client money account; or

(b) there has been undue delay, or unreasonable refusal, on an Investment Firm's part in paying, applying or accounting for money as required under the client money provisions.

ASIC is also able to apply for interim freezing orders. The Court is also empowered to give directions regarding the distribution of Client Money (sections 983A - 983E).

If an Investment Firm has become insolvent or has ceased to carry on its financial services business ASIC has grounds to suspend or cancel the Investment Firm's AFSL (section 915B). This power to cancel or suspend an AFSL can be exercised immediately, without ASIC being required to hold a hearing or consider submissions from the AFSL holder. As soon as practicable, ASIC must publish a notice of the action in the *Gazette* and, if the AFSL holder is a

participant in a licensed market or a licensed clearing and settlement facility, give written notice of the suspension or cancellation to the operator of the market or facility (subsection 915F(2)).

If an AFSL is suspended or cancelled, ASIC can apply to the court for an order to freeze or restrict the dealings of a person (that is, not just the AFSL holder) with accounts with a financial institution (subsection 983A(3)). It does not matter whether the account is within Australia or not.

Where an order is made under section 983A, ASIC or a person affected by the order can apply to the court for an order directing that specific amounts in the frozen account be paid to ASIC or its nominee (section 983D). This order can also include direction to ASIC or its nominee that the money be paid into a separate account, or that ASIC or its nominee are authorised to prepare a scheme for distributing the money to persons who claim and are entitled to the money, or that ASIC or its nominee prepare a scheme to apportion the money in the event that there is a shortfall relative to third party entitlement (section 983E).

As AFSL holders are generally corporations, it is open for ASIC to apply to the court (with the leave of the court) for an order to wind up the corporation on the grounds that the corporation is insolvent (section 459P). Where a company is in liquidation, it must set out, in every public document and in every negotiable instrument of the company the expression *in liquidation* (section 541).

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

An Investment Firm may be wound up, or an Administrative Officer appointed, by a creditor holding security over the Investment Firm's property. This may be different if the Investment Firm is an ADI. If it is, it would be subject to the insolvency provisions set out in the *Banking Act 1959*.

### Winding Up of Investment Firms

Investment Firms are typically companies and their winding up is dealt with under the Act. The process for winding up is the same regardless of the company being an Investment Firm or not.

A company may be wound up as follows:

(1) Court Liquidation / Winding Up - A creditor may file a winding up application in a state Supreme Court or the Federal Court of Australia for the appointment of a liquidator to a company. This is usually based on a failure to comply with a statutory demand in respect of a debt owed to a creditor although it can be based on the insolvency of the company generally or where the Act presumes that a company is insolvent. Winding up of a company usually results in a distribution of the assets of the company and the eventual deregistration of the company.

(2) Creditors Voluntary Liquidation / Winding Up – A company, by special resolution passed by its members, may appoint a liquidator. The liquidator must then convene a meeting of creditors to consider replacing the liquidator.. The liquidator takes control of the company's affairs with a view to winding it up; that is, investigating its affairs, realising company assets and distributing any available proceeds to creditors. Again, in almost all instances, the company is deregistered at the end of the liquidation process.

(3) Members Voluntary Liquidation / Winding Up – A company, by special resolution passed by its members, may appoint a liquidator. This type of winding up differs from a creditors voluntary winding up in that the company must be solvent. As a first step, a majority of directors must make a declaration of solvency. If during the winding up process it is determined that the company cannot in fact pay its debts within 12 months, the liquidator must convene a meeting of members, and then creditors, to resolve to convert the winding up to a creditors' voluntary winding up. At this meeting, creditors may replace the liquidator.

(4) Voluntary Administration (VA) – A company may appoint a voluntary administrator pursuant to section 436A of the Act where the board resolves that they are of the opinion that the company is insolvent or is likely to become insolvent at some future time and that an administrator should be appointed. The object of VA is to maximise the chances of a company, or as much as possible of its business, continuing in existence or, if that is not possible, there being a better return to creditors and members than from the immediate winding up of the company. This is achieved as follows:

(a) When appointed, the administrator assumes control of the company and the Act imposes a moratorium which stays proceedings, restricts the enforcement of security interests and otherwise protects the company's property. This gives the administrator sufficient time to investigate the company's affairs and report to the creditors regarding the company's future. The creditors then decide whether the company should execute a deed of company arrangement ("DOCA"), the VA should end or the company should be wound up;

(b) A DOCA approved by creditors must identify the property available to pay creditors' claims, the nature and duration of any moratorium period, the extent to which the company is to be released from debts, conditions for the DOCA to come into and continue in operation, the circumstances in which the DOCA terminates, the order in which property will be made available to meet creditors' claims and the day on which creditors' claims must have arisen for them to be admissible. A DOCA's terms can be adapted to the company's circumstances and can provide for:

(i) the company continuing to trade so that its business can be sold as a going concern: and/or

(ii) a restructure of the company's affairs so that it can be returned to solvency.

If a company fails to meet the terms of its DOCA, the deed administrator would seek to terminate the DOCA and, generally, wind up the company.

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

Subject to the type of winding up as noted in question 14, above the Administrative Officer is selected as follows:

(1) Court liquidation – An applicant who petitions a court to wind up a company ordinarily will seek the consent of a liquidator in the event that the petition is successful. The Court is petitioned to make a winding up order and if granted, the company is wound up by an official liquidator (that is, a registered liquidator who can take court appointments).

(2) Members Voluntary Liquidation – An Investment Firm's directors seek the consent of a person which is tabled at the meeting convened to consider the resolution to wind up the company. Members may seek the consent of an alternative person and resolve to appoint that person if they wish. Being a registered liquidator is not a requirement to act as a members voluntary liquidator.

(3) Creditors Voluntary Liquidation – An Investment Firm's directors seek the consent of a liquidator and resolve to place the company into liquidation and appoint that person to act as liquidator. Any creditor entitled to attend and vote at the meeting may obtain the consent of a replacement liquidator and seek a resolution to so replace the existing liquidator.

(4) Voluntary Administration – An administrator's consent is sought by the party that proposes to make the appointment; that is, the directors, secured creditor or liquidator (a liquidator can appoint a voluntary administrator). Importantly, at the statutory first meeting of creditors, creditors may resolve to replace the appointed administrator. Additionally, creditors may resolve to appoint a different practitioner to act as administrator of any DOCA accepted by them or, if they resolve to wind up the company, appoint a person other than the administrator to act as liquidator.

**Liquidator Qualifications**

A natural person may be registered as a Registered Liquidator with ASIC if they satisfy a number of educational and experience criteria. To act as a Voluntary Administrator, the person must be a Registered Liquidator.

The required qualifications are:

Education:

(i) Have completed a 3 year course of study in accountancy; or

(ii) Have completed a 4 year course of study in commercial law (including company law)

at a specified Australian university or tertiary education institution (subsection 1282(2)).

Or has other qualifications and experience that, in ASIC's opinion, are equivalent.

Experience:

Be experienced in winding up bodies corporate and have the necessary personal and practice capacities. Personal capacities include:

- Have worked in corporate insolvency for 5 years full time over the last 10 years.
- Have 3 years of corporate experience at a very senior level over the last 5 years.
- Worked under the supervision of a registered liquidator in Australia or an equivalently qualified overseas practitioner.
- Person has demonstrated skill and diligence and sound judgment in complex matters while working at a very senior level.

Practice capabilities relate to adequate:

- Human resourcing, including supervision and training.
- Internal control procedures.
- Operational control procedure and manuals for conducting the various forms of external administrations.
- Risk management.

16. What are the duties of the Administrative Officer?

The Administrative Officer who is a liquidator has the following main duties:

(1) Realise all company property that is capable and commercial to realise and disclaim property which is onerous. The liquidator is under an obligation to obtain market value for the company's assets and if there is no market value, to obtain the best possible price in the circumstances. The liquidator also has a related duty to preserve the company's assets.

(2) Keep books and accounts

(3) Investigate the company's affairs to identify any antecedent transactions and to investigate if it is commercial to pursue a recovery of property or compensation with respect to such transactions.

(4) Examine the circumstances which precipitated the liquidation and which may reveal improper dispositions of property and offences. Investigations may establish if the company directors and officers discharged their duties under the law and, if not, if it is commercial to pursue damages/compensation against them.

(5) Report to creditors.

(6) Distribute funds to creditors as soon as practicable in accordance with the priority provisions set out under the Act.

(7) Provide a report to ASIC detailing the results of the liquidator's investigations where the liquidator identified possible offences or the company will pay less than 50 cents in the dollar on creditor claims.

a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

Additional guidance is provided by the following:

- Insolvency Practitioners Association of Australia Code of Professional Practice.
- Australian Accounting Standards
- Individual State-based real property legislation
- Case law.

b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

An Administrative Officer owes a statutory duty of care and diligence. An Administrative Officer can also be liable under common law liable for negligence. An Administrative Officer who is negligent can also be found to be personally liable in certain circumstances.

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

a. Does the regulator continue to supervise the Investment Firm?

b. How, if at all, is the regulator involved in the process of returning Client Assets?

ASIC maintains a supervisory role of the Administrative Officer, as does the Court, and does not generally get involved in the winding up of an Investment Firm or the distribution of assets. However, ASIC reserves the right to intervene in any winding up.

Note that ASIC has the power to apply to the Court for an order restraining dealings with a client money account where:

(a) there are reasonable grounds for believing that there is a deficiency in a client money account; or

(b) there has been undue delay, or unreasonable refusal, on an Investment Firm's part in paying, applying or accounting for money as required under the client money provisions.

(c) ASIC is also able to apply for interim freezing orders. The Court is also empowered to give directions regarding the distribution of client money (sections 983A – 983E).

18. What are the requirements, if any, governing the segregation and treatment of Client Assets during the insolvency of an Investment Firm?

The Act provides for how Client Money is to be dealt with if a licensee:

(a) ceases to be licensed (including a cessation because the licensee's AFSL has been suspended or cancelled);

(b) becomes insolvent under an administration, has an administrator or receiver appointed or is subject to similar proceedings; or

(c) ceases to carry on an activity authorised by the AFSL and is paid money in relation to that activity.

If any of the above events occurs, client money is to be paid as follows:

(a) the first payment is of money that has been paid into the account in error;

(b) if money has been received on behalf of insured persons in accordance with a contract of insurance, the second payment is payment to each insured person entitled to receive money from the client money account in respect of claims that have been made and then in respect of other matters;

(c) the next payment is payment to each person who is entitled to be paid money from the client money account;

(d) if the money in the client money account is not sufficient to be paid in accordance with paragraph (a), (b) or (c), the money must be paid in proportion to the amount of each person's entitlement; and

(e) if there is money remaining in the account after payments made in accordance with the above, the remaining money is taken to be money payable to the licensee.

Note: see regulation 7.8.03(6).

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

As a general matter, there is no overarching arrangement where Client Assets of one Investment Firm may be transferred to a solvent Investment Firm. This may be different if the Investment Firm is an ADI as it would be subject to the *Banking Act 1959*.

The *Financial Sector (Business Transfer and Group Restructure) Act 1999* (Transfer of Business Act) allows for the transfer of part or all of an ADIs business to another ADI either voluntarily or compulsorily. Therefore, it is possible to transfer the assets of an insolvent ADI to a solvent ADI under the Transfer of Business Act.

For market participants, where it appears that the Investment Firm is about to fail, the market operator may also require an Investment Firm to move client positions (Rule 5160 of ASX Operating Rules and ASX 24 Operating Rules, and Rule 9.5 and 5.1 Chi-X Operating Rules).

a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

Not Applicable.

b. What factors, if any, affect the time period required to accomplish such a transfer?

Not Applicable.

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

Not Applicable.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (e.g., maximum compensation per client).

In the event of the failure of an Investment Firm, compensation arrangements are available under the Australian Market Licence (**AML**) regime where the Investment Firm is a market participant on a licensed market and the transaction took place on that licensed market. Specifically, under the AML regime, there is a requirement that an AML holder have compensation arrangements where market participants on that licensed market are effecting transactions on behalf of retail clients and clients may provide money, property, or authority over property to the market participant (section 881A). The market compensation arrangements are required to be approved by the Minister (sections 881A and 882A).

Generally speaking, an AML holder can satisfy this requirement by either having a compensation regime that is approved by the Minister, or by joining the National Guarantee Fund ('**NGF**') (sections 881A and 882A). If an AML holder seeks to satisfy the compensation regime requirements by having a regime that is approved by the Minister, the Minister must be satisfied that the compensation regime is 'adequate' before approving the regime. Amongst other things, this requires the Minister to form the view that the compensation regime will provide adequate coverage for losses (section 885B).

The losses to be covered include:

- Where a person gave money or other property, or authority over property to a person who was a participant in the market at that time or who the client reasonably believed was a participant;
- The money was given to the participant in connection with effecting a transaction or proposed transaction effected through the market;
- The effecting of the transaction constitutes or would constitute the provision of a financial service to the client as a retail client; and
- The client suffers loss, if the client gave the participant money or authority over the property, because of either:

  (i) The defalcation or fraudulent misuse of the money or other property by the participant, or

(ii) The fraudulent misuse of that authority by the participant (section 885C of the Act).

### The Securities Exchange Guarantee Corporation (SEGC)

The Act provides for the NGF to give compensation for the default of Investment Firms in on-market transactions (section 888A). The NGF is administered by the SEGC, a wholly owned subsidiary of the ASX. The NGF is intended to provide a compensation arrangement for a customer when trading via a broker on a market covered by the NGF. The circumstances in which compensation may be claimed are specified in considerable detail in the Regulations, and include claims against an insolvent dealer where that dealer has not discharged its obligations to hold property for the claimant (regulation 7.5.64). The Regulations also provide that the amount of compensation that a person is entitled to is to be determined by reference to the Regulations.

### AFSL regime

In addition, there is a requirement that where an AFSL holder is providing financial services to a retail client they are to have in place a compensation arrangement that complies with subsection 912B(2) of the Act. The purpose of this compensation arrangement is to compensate clients for breaches by the AFSL holder or their authorised representatives of their AFSL obligations.

Regulation 7.6.02AAA specifies the requirements that must be met for compensation arrangements under section 912B. This essentially states that the AFSL holder (apart from exempt licensees) must have adequate professional indemnity insurance cover and specifies the circumstances that should be taken in account in determining what would be ‘adequate’. RG 126 Compensation and insurance arrangements for AFS licensees provides guidance on how ASIC administers section 912B.

ASIC’s standard licensing conditions also make provision for an obligation to maintain professional indemnity insurance when individual circumstances warrant such a requirement. In addition, for the responsible entity of a collective investment scheme or the operator of an investor directed portfolio service it is a standard licence condition for the AFSL holder to maintain adequate professional indemnity and officers’ fraud insurance to cover the value of property held.

The retail clients of such an AFSL holder might be able to make a claim under the dispute resolution system that the AFSL holder is required to have in place (paragraph 912A(1)(g) of the Act). However, given that the AFSL holder would be insolvent, the investor is unlikely to be able to recoup their loss through this avenue even if the internal or external dispute resolution schemes found in their favour.

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. E.g., if any re-hypothecation has been entered into (or a ‘right-to-use’ exercised), please explain the client's position under the Insolvency Regime in such event.

The client money and Client Property Provisions protect client money retained in a client money account and client property that can be separately identified.

### Client Money

The Act provides for how Client Money is to be dealt with if an Investment Firm:

- ceases to be licensed (including a cessation because the Investment Firm's AFS licence has been suspended or cancelled);
- becomes insolvent under an administration, has an administrator or receiver appointed or is subject to similar proceedings; or
- ceases to carry on an activity authorised by the AFS licence and is paid money in relation to that activity.

In such event, the account is taken to be subject to a trust in favour of the person for each person who is entitled to be paid money from a client money account: regulation 7.8.03(4).

The Act specifies an order of payment and provides that Client Money is to be paid as follows:

- the first payment is of money that has been paid into the account in error;
- if money has been received on behalf of insured persons in accordance with a contract of insurance, the second payment is payment to each insured person entitled to receive money from the client money account in respect of claims that have been made and then in respect of other matters;
- the next payment is payment to each person who is entitled to be paid money from the client money account;
- if the money in the client money account is not sufficient to be paid in accordance with paragraph (a), (b) or (c), the money must be paid in proportion to the amount of each person's entitlement; and
- if there is money remaining in the account after payments made in accordance with the above, the remaining money is taken to be money payable to the Investment Firm.

Note: See regulation 7.8.03(6).

These rules override anything to the contrary in the *Bankruptcy Act* or in company law: regulation 7.8.03(7). This includes distribution of the general pool of assets described under question 21.

### Client Property

If a client has granted a rehypothecation right and the Investment Firm has exercised that right, then the client is unlikely to have any preference to the property transferred. They will be an unsecured creditor for any amounts owing, including the value of the property transferred pursuant to the rehypothecation right.

Other Client Property that is separately identifiable would fall outside of the general pool of assets and, subject to verifying ownership, the Administrative Officer would return the client property to the relevant clients.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

Not Applicable.

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

As noted under question 17 above, if there is any shortfall in the client money account, the money is paid pro rata to persons entitled. There is no basis for treating specific clients differently. Clients would then become unsecured creditors for any shortfall and distribution would be subject to the payment of expenses as described under question 26.

The Investment Firm may be liable to the imposition of a penalty of $550 for failing to comply with the relevant obligations in Part 7.8 of the Act.

Where the officers of the Investment Firm have breached their duties this may give rise to a claim for compensation under any Directors and Officers Insurance policies held.

25. If there is a shortfall, i.e., if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? E.g., is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

Please see our answer to questions 22 and 23 above.

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

Please see our answer to question 22 above for the distribution of client money.

As for the distribution of the general pool of assets, the following debts and claims must be paid in priority to all other unsecured debts and claims (section 556). The debts of a class referred to in each of the undermentioned paragraphs rank equally between themselves and are to be paid in full, unless the property of the company is insufficient to meet them, in which case they should be paid proportionately (section 559):

(a) the expenses (except deferred expenses) properly incurred by a liquidator or other relevant authority in preserving, realising or getting in property of the company, or in carrying on the company's business;

(b) if the Court ordered the winding up — the costs in respect of the application for the order (including the applicant creditor's costs in petitioning the court for the winding up (section 466));

(c) the debts incurred by a Voluntary Administrator of the company they are indemnified for under paragraph 443D(a), even if the administration ended before the relevant date, except

expenses covered by (a) above and deferred expenses — these are the debts for which the administrator is personally liable under section 443A of the Act (general debts for services rendered, goods bought, property hired, leased, used and occupied) and section 443B (payments for property used or occupied or in the possession of the company, after seven day breathing space).

(d) Repealed;

a. if the Court ordered the winding up — costs and expenses that are payable under subsection 475(8) out of the company's property — these are costs and expenses of a person making or concurring in making a report as to affairs, or other report under section 475 (usually by the company director detailing the company's assets and liabilities), and, subject to the rules, payable by the liquidator/provisional liquidator in such amounts as he considers reasonable;

b. costs and expenses payable under subsection 539(6) — being the costs of an audit of liquidators/provisional liquidators accounts, if undertaken, as fixed by ASIC;

c. any other expenses (excluding those mentioned above), except deferred expenses, (see below), properly incurred by a liquidator or other relevant authority;

d. deferred expenses as defined below, being primarily remuneration of a liquidator or other relevant authority;

e. if a committee of inspection has been appointed for purposes of the winding-up — expenses incurred by a person as a member of the committee;

(e) wages and superannuation contributions payable by the company in respect of services rendered to the company by employees before the relevant date — but subject to the limitations on excluded employees detailed below;

(f) amounts due in respect of injury compensation, being compensation the liability for which arose before the relevant date;

(g) all amounts due on or before the date of liquidation to or in respect of an employee for leave of absence, being amounts due by virtue of an industrial instrument. This applies whether the employee is remunerated by salary, wages, commission or otherwise here again excluded employees may be limited in their claims;

(h) retrenchment payments payable to employees of the company — excluded employee limitations also apply;

"*relevant date*" is defined in relation to a winding up. It means the day on which a winding up is taken to have begun. There is an exception to this statement which relates to the determination of the ``relevant date" for debts and claims which arise while a company is subject to a deed of company arrangement immediately before it goes into liquidation. Pursuant to subsection 553(1B) the ``relevant date" in these circumstances is the date on which the deed terminates.

Note that a *relevant authority*, in relation to a company, means any of the following:

(a) a liquidator or provisional liquidator of the company;

(b) if winding up began within two months after the end of a period of official management — an official manager;

(c) an administrator of the company, even if the administration ended before the winding up began;

(d) an administrator of a deed of company arrangement executed by the company, even if the deed terminated before the winding up began.

*Deferred expenses*, in relation to a company, means expenses properly incurred by a relevant authority, in so far as they consist of:

(a) remuneration, or fees for services, payable to the relevant authority; or

(b) expenses incurred by the relevant authority in respect of the supply of services to the relevant authority by:

    (i) a partnership of which the relevant authority is a member; or

    (ii) an employee of the relevant authority; or

    (iii) a member or employee of such a partnership; or

(c) expenses incurred by the relevant authority in respect of the supply to the relevant authority of services that it is reasonable to expect could have instead been supplied by:

    (i) relevant authorities; or

    (ii) a partnership of which the relevant authority is a member; or

    (iii) an employee of the relevant authority; or

    (iv) a member or employee of such a partnership

Employees are entitled to receive priority repayment if they are owed:

- any amounts which are classifiable as an expense properly incurred by a liquidator or other relevant authority in preserving, realising or getting in property of the company, or in carrying on the company's business pursuant to paragraph 556(1)(a);
- any amounts which are classifiable as a debt incurred by a voluntary administrator for which he or she is liable to be indemnified by section 443A (i.e. for services rendered) pursuant to paragraph 556(1)(c);
- any amounts classifiable as an expense properly incurred by a liquidator or other relevant authority, pursuant to paragraph 556(1)(dd);

- wages and superannuation contributions payable by the company in respect of services rendered to the company by employees before the relevant date, but not exceeding $2,000 in respect of an excluded employee attributable to non-priority days (subparagraph 556(1)(e)(1A));
- amounts due on or before the relevant date to or in respect of any employee (whether remunerated by salary, wages, commission or otherwise) for leave of absence, being amounts due by virtue of an industrial instrument (s556(1)(g)). But "excluded" employees are limited to $1,500, attributable to non-priority days (subsection 556(1B)); or
- retrenchment payments **payable**; but **—**excluded employees‖ are **not allowed to rank for any retrenchment amount** attributable to non-priority days (subparagraph 556(1)(h)(1C)).

As Client Money is held on trust, the money would be part of the moneys to be dealt with under the winding up but the order of distribution is as noted under question 17 above rather than falling to the general pool.

There is no differentiation between a domestic creditor and a foreign creditor.

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

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|---|---|
| Corporations Act 2001 | http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/ |
| Corporations Regulations 2001 | http://www.austlii.edu.au/au/legis/cth/consol_reg/cr2001281/ |
| ASIC Market Integrity Rules (ASX Market) 2010 | http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/asic-market-integrity-rules-asx-market-2010-Feb-2011.pdf/$file/asic-market-integrity-rules-asx-market-2010-Feb-2011.pdf |
| ASIC Market Integrity Rules (ASX 24 Market) 2010 | http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-ASX24-Market-Integrity-Rules-20100708.pdf/$file/ASIC-ASX24-Market-Integrity-Rules-20100708.pdf |
| ASIC Market Integrity Rules (Chi-X Australia Market) 2011 | http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-market-integrity-rules-Chi-X-Australia-market-2011.pdf/$file/ASIC-market-integrity-rules-Chi-X-Australia-market-2011.pdf |

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| ASIC Regulatory Guide 78 *Breach reporting by AFS licensees* | http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg78.pdf/$file/rg78.pdf |
| ASIC Regulatory Guide 212 *Client money relating to dealing in OTC derivatives* | http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg212-9July2010.pdf/$file/rg212-9July2010.pdf |
| ASIC Regulatory Guide 227 *Over-the-counter contracts for difference: Improving disclosure for retail investors* | http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg227-published-12-August-2011-1.pdf/$file/rg227-published-12-August-2011-1.pdf |
| ASX Operating Rules | http://www.asxgroup.com.au/asx-operating-rules-guidance-notes-and-waivers.htm |
| ASX24 Operating Rules | http://www.asxgroup.com.au/asx-24-operating-rules-and-waivers.htm |
| ASX Clear Operating Rules | http://www.asxgroup.com.au/asx-clear-operating-rules-guidance-notes-and-waivers.htm |
| Chi-X Operating Rules | http://www.chi-x.com/resources/au/file/Chi-X%20Australia%20Draft%20Operating%20Rules%20040311.pdf |

# Brazil
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

    a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

    b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

    c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

    d. Please describe any notable exclusions from the terms "client" or "client assets."

Client asset protection is addressed both by federal laws (Law 6,024/74; Law 9,447/97 and Law 11,101/05) and regulations (several rules issued by the National Monetary Council - CMN, the Brazilian Central Bank – BCB and the Brazilian Securities and Exchange Commission – CVM).

The regulatory body in charge of the intervention, liquidation and temporary administration regimes of Investment Firms is the Brazilian Central Bank, according to provisions set forth in Law 6,024/74. The scope includes all financial institutions, encompassing a sizeable portion of Brazilian Investment Firms.

"Clients" are natural persons or legal entities that hold accounts at Investment Firms. Brazil follows a Custodial Regime, therefore the relationship between the Investment Firm and its clients with respect to Client Assets is primarily a custody arrangement under civil law. Nevertheless, in case of insolvency "Client Money" is sometimes treated as a general obligation of the Investment Firm, whereas "Securities" and "Positions" are always segregated from the pool of assets of the Investment Firm at the custodian level.

Margins placed by Clients as collateral for derivatives positions are also segregated, and can be transferred to other Investment Firms at will or in case of insolvency. On the other

hand, margins placed as collateral in loans granted by the Investment Firm to purchase Equities are not segregated from the pool of assets of the Investment Firm.

Client Assets categorized as "Securities" can be divided in two major groups, based on Law 6,385/76, art. 2. The main types of the first group are equities, corporate bonds/commercial papers, shares of mutual funds and all derivatives. On the second group are government bonds, currency spot and time/demand deposits.

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

   a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

   b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

   According CVM Instruction 89/88, only authorized financial institutions may act as custodians. Eligible financial institutions are banks, broker-dealers, exchanges and clearinghouses, according to technical and financial requirements. In order to obtain a license, the custodian must present to the relevant authority (Comissão de Valores Mobiliários (CVM), Banco Central do Brasil (BCB) or both) (i) a general description of the services that will be provided, the controls that will be implemented and the IT infrastructure, (ii) a description of its internal governance structure, (iii) a designation of the executive in charge of this service/area, (iv) a list of relevant positions of the custodian as a shareholder in public companies, (v) a presentation of the training program of its staff, (vi) copy of contracts that will be used in providing this service, (vii) a description of the internal audit program, (viii) the designation of external auditors and (ix) an auditor report concerning the

adequacy of implemented internal controls and IT infrastructure in order to perform the custodian services.

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

   a. Must the Client Assets of one client be maintained separately from those of other clients?

      i. Are Investment Firms allowed to hold Omnibus Accounts?

      ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

      Client Assets are always maintained separately at the custodian level, providing a high degree of protection from losses due to the activities of other clients.

      Derivatives and equities positions are identified at the final beneficial owner level throughout the holding chain, including the clearing and custodian levels (applicable to all "Securities" listed in Law 6,385/76, art. 2.)

      Government bonds and some corporate bonds are held in omnibus accounts, nevertheless are segregated among clients at the custodian level.

   b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

      i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

         A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

         B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

         C) If a client has a debit balance (*i.e.*, the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

      Reconciliation applies exclusively to cash maintained by clients at securities or futures brokers, and it is conducted in a client-by-client basis. Accordingly, debit cash balances in client accounts are deducted in order to determine the amount the Investment Firm is required to hold.

As for all other cases (securities, derivatives and positions), assets are kept in accounts segregated from the assets of the Investment firm. Except for cash, all client positions match automatically, needless of reconciliation.

Ever since the dematerialization of securities, fungibility is the rule rather than exception. The regime in Brazil permits Investment Firms to deliver assets that are fungible within the same asset class, as is the case for assets that have the same terms and conditions, or the same ISIN code.

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

Reconciliation must be performed on a daily basis, unless specific situation arises (e.g. risk exposure, margin calls, etc.), requiring ongoing follow up. If a deficiency is identified, the Investment Firm should it make good as soon as possible.

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

No such rules exist regarding buffer assets.

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

Not possible, since assets are held separately at the custodian level. It would be considered a violation of regulations.

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

iii. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (*i.e.*, established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

Currently there are no laws or regulations concerning rights of use or re-hypothecation of client assets. In practical terms, rights of use and re-hypothecation are not feasible, since assets posted as collateral by the client are kept in individual accounts, out of reach of the Investment Firm for its own use as collateral on proprietary positions or on positions entered into by other clients.

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

Margins placed by Clients as collateral for derivatives positions at clearinghouses or other central counterparties must be fully segregated at the final beneficial owner level.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

a. Client Assets transferred to or located in other jurisdictions?

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

If so, please provide details of those requirements.

Yes, but there are no specific provisions concerning this issue, so the local general requirements apply.

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

There are no specific rules regarding this issue; the general rule is that the final beneficial owner must be identifiable at all times.

**(a)(i)**: Local omnibus accounts are an exception to the rule, as explained before. Protections applicable to Foreign Investment Firms' Client Assets held at omnibus accounts are the same applicable to Local Investment Firms' Client Assets. There is a high degree of protection since Client Assets are always segregated, at the custodian level, from the Investment Firm's Assets and from assets belonging to other Clients, even in the case of Bonds held in omnibus accounts.

**(a)(ii):** No further steps are required to secure such protections.

**(a)(iii)**: Currently there are no laws or CVM instructions concerning reduction in protections (waiver of rights).

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

Please refer to question (2) for requirements on third party custodians. There are no limitations to the use of a custodian that is affiliated to the Investment Firm.

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

Yes, but only if authorized by the client. There are no specific requirements concerning the contractual relationship between the custodian and the Investment Firm, but general requirements of the Brazilian Civil Code apply.

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

The terms and conditions of the services provided by the financial firm or third parties (e.g. custodians) are outlined in the contracts signed by the client. There are no specific provisions concerning assets held in another jurisdiction.

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

Currently there are no laws or CVM instructions that allow an Investment Firm to waive, reduce or vary Client Asset protection requirements. Nonetheless, "opting out" of requirements for segregation of client assets is not possible since segregation is mandatory, at least at the custodian level. In-depth details of client asset segregation are outlined in the Internal Rules of the Central Securities Depository (CBLC), namely in items 113, 137.1.1, 138.2 and 138.3.

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

   a. Does the Investment Firm report where client assets are held?

   b. Does the Investment Firm or depository report the protections applicable to such client assets?

   c. Does the Investment Firm or depository report the amount of assets that are held?

   In each case, are such reports provided on request or periodically? If periodically, with what frequency?

   Reporting on Client Assets by Investment Firms is required only in cases of administrative investigation (by the Market Authority or by the SROs) or by court order. Nevertheless both the exchange (BM&FBovespa) and trade repositories (OTC organized markets like CETIP or BM&FBovespa) report all derivative open interest positions on a daily basis to the Market Authority (CVM).

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

    a. Where Client Assets are held?

    b. The amount of Client Assets held at a depository?

    c. The safeguards applicable to Client Assets held at a depository?

    In all examinations, inspections and audits performed by either CVM or Self-Regulatory Organizations, Investment Firms are assessed for compliance with asset segregation rules.

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

    b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

In these cases, general rules concerning the exchange of information between jurisdictions for enforcement purposes would apply (e.g. MMoU). For more details on omnibus accounts in Brazil, please refer to item 3.

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

Periodical financial information must be provided to relevant authorities (CVM, BCB and SROs). The clearinghouses also monitor the financial soundness of their clearing members and any anomalous situation must be timely reported to CVM and BCB. In addition, according to Section 2 of Law 6,024, an Investment Firm must notify BCB of an insolvency situation.

13. For an Investment Firm whose financial situation is seen to have deteriorated (e.g., capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

For that purpose, BCB may adopt administrative measures according to Law 6,024, including injunctions, investigatory and sanctioning procedures, and restriction of activities. In case of a formal recognition of insolvency, BCB may take control of the firm, by removing members of the board and top management and appointing an external administrator ("Administrative Officer").

If the Investment Firm is an exchange or clearinghouse member, part of this function may be performed by these institutions, acting as assistants to BCB.

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

Rules applicable to insolvent Financial Firms are set out in Law 6,024/74, and are applicable to all Investment Firms (art. 52).

The process by which an Investment Firm enters the status of "insolvent" or "bankrupt" can be initiated: (i) *ex-officio* by the Central Bank; (ii) by requisition of the managers or (iii) by the Exchange (art. 52, §1).

BCB may initiate the administrative intervention *ex officio* in the following situations: (i) presence of any financial situation that may compromise the stability, liquidity and the protection of the Investment Firm creditors, (ii) whenever detected any serious law violations, (iii) when any serious loss faced by the Investment Firm changes considerably and in an abnormal way the risk offered to its creditors and (iv) when

within 90 days of a cancelation of the license of an Investment Firm, its dissolution process has not been initiated.

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

    Administrative Officers is assigned by the Central bank (Law 6,024, art. 5). There are no minimum qualifications an Administrative Officer must have, but usually a BCB employee of a former (retired) BCB employee with experience in financial markets is selected.

16. What are the duties of the Administrative Officer?

    a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

    b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

    The Administrative Officer must safeguard the interests of the investors as well as manage the assets and liabilities of the Investment Firm in order to drive the liquidation process (if that should be the case.)

    He/she must (i) gather all books, records and documents of the Investment Firm, (ii) prepare updated financial statements of the Investment Firm, listing all available assets, including those that are held by third parties. Within 60 days from the intervention date, the Administrative Officer must present a report to BCB addressing (i) the financial situation of the Investment Firm, (ii) any violation of laws and regulations that were identified, (iii) a proposition of additional measures that should be adopted.

    The Administrative Officer has broad powers of management and liquidation, particularly those to check and to classify credits, to propose judicial demands and to represent the entity in and out of the Courts.

    There is not any special protection from liability for the administrator or liquidator. The Administrative Officer has personal responsibility under negligence standards.

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

    a. Does the regulator continue to supervise the Investment Firm?

    b. How, if at all, is the regulator involved in the process of returning Client Assets?

    Yes. As the Administrative Officer is appointed by the BCB (the relevant authority in this case) and has a duty to report any developments on a periodical

basis or whenever the situation requires, the regulator is able to supervise the intervention process very closely.

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

There are no specific rules on that matter. General segregation rules apply during the insolvency of an Investment Firm.

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

    a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

    b. What factors, if any, affect the time period required to accomplish such a transfer?

Asset transfer must be instructed by the client and authorized by the Administrative Officer, but chances are that the transfer process will be carried out with ease.

There are no provisions addressing the minimum or maximum period of time, but it must be done without undue delay. Usually the most relevant factors that affect the time period required to accomplish such a transfer are the quality of internal controls of the Investment Firm, and whether any misuse of client assets has been detected. These aspects would demand further work by the Administrative Officer, in order to assure that the appropriated assets are transferred to clients.

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

Unless inappropriate distribution is detected by the Administrative Officer, there is no such risk.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

Currently there are two compensation schemes in place:

(i) "Fundo Garantidor de Créditos" (FGC): it is a deposit guarantee system, that applies to (a) demand deposits or deposits drawn on prior notice, (b) deposits in checking accounts, (c) savings account deposits, (d) time deposits, with or without the issuance of certificates, (e) deposits in accounts not drawable by means of checks and which are used for the registration and control of flows of funds for the purpose of paying salaries, wages, retirement payments, pension payments and other similar obligations, (f) bills of exchange, (g) real estate bills, (h) mortgage bills and (i) real estate credit bills. The payout polices are set per person or account (some restrictions apply) and the

coverage is limited to R$ 70,000 (approximately USD 35,000, at the current exchange rate – Sept 1st, 2012). It applies to all financial institutions that offer these investment alternatives, namely banks, savings and loans and financial institutions in the real estate segment. Furthermore, there is a special protection scheme for one type of time deposit called "Depósitos a Prazo com Garantia Especial do FGC - DPGE", provided by the FGC, which coverage limit is R$ 20,000,000 (approximately USD 10,000,000, at the abovementioned exchange rate). The rules concerning the FGC are issued by the National Monetary Council (Resolution n. 4.087/2012), but it is structured as a private non-profit Civil Association.

(ii) "Mecanismo de Ressarcimento de Prejuízos" (MRP): it is another protection scheme, but with a more limited approach. It applies only to Investment Firms with direct access to the Brazilian exchange (BM&FBovespa), with equal coverage limit of R$ 70,000 (approximately USD 35,000, at the current exchange rate – Sept 1st, 2012) per person, upon filing a formal complaint to the SRO of the Exchange (BSM). The assets classes under protection are those listed in the exchange (securities and derivatives).

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

    There are no such circumstances, please refer to question 3.d.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

    For these circumstances, there are no specific protection regimes under the Brazilian law. Foreign provisions would be applicable.

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

    No, there is no differentiation between clients but this situation would result in (i) an enforcement procedure conducted by the relevant authorities (BCB, CVM or both), and (ii) civil actions and/or (iii) criminal investigation.

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

    As previously stated, clients retain legal ownership of the assets held by the Investment Firm in individual accounts. This mechanism is applicable to Securities, Positions and Margins placed as collateral for derivatives positions (whether in Cash or Securities.) If there is a shortfall, claims in relation to such assets are preferred,

whereas claims on Client Money deposited at the Investment Firm rank *pari passu* with other unsecured creditors.

In other words, comprehensive asset recovery in relation to amount claimed is the norm for securities held in a CSD. Cash deposited at the Investment Firm (or placed as collateral in loans granted by the Investment Firm to purchase Equities) are not segregated from the pool of assets of the Investment Firm, and recovery will depend on the recovery ratios applicable to all unsecured creditors.

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

Please refer to question 25.

There is no distinction between domestic and foreign clients, but foreigners must appoint a legal representative in the country in order to deal with administrative matters concerning assets distribution.

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

Law 6,385/76, the "Securities Act" (free translation into English)

http://www.cvm.gov.br/ingl/indexing.asp

Law 6,204/76, applicable to insolvent Financial Firms (in Portuguese)

http://www.planalto.gov.br/ccivil_03/leis/L6024.htm

# Canada
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

*Assets include cash, securities and certain other property such as segregated insurance funds. As per the Ontario Securities Act, this is the definition of a security:*

*"security" includes,*

*(a) any document, instrument or writing commonly known as a security,*

*(b) any document constituting evidence of title to or interest in the capital, assets, property, profits, earnings or royalties of any person or company,*

*(c) any document constituting evidence of an interest in an association of legatees or heirs,*

*(d) any document constituting evidence of an option, subscription or other interest in or to a security,*

*(e) a bond, debenture, note or other evidence of indebtedness or a share, stock, unit, unit certificate, participation certificate, certificate of share or interest, preorganization certificate or subscription other than,*

*(i) a contract of insurance issued by an insurance company licensed under the Insurance Act, and*

*(ii) evidence of a deposit issued by a bank listed in Schedule I, II or III to the Bank Act (Canada), by a*

*credit union or league to which the Credit Unions and Caisses Populaires Act, 1994 applies, by a loan corporation or trust corporation registered under the Loan and Trust Corporations Act or by an association to which the Cooperative Credit Associations Act (Canada) applies,*

*(f) any agreement under which the interest of the purchaser is valued for purposes of conversion or surrender by reference to the value of a proportionate interest in a specified portfolio of assets, except a contract issued by an insurance company licensed under the Insurance Act which provides for payment at maturity of an amount not less than three quarters of the premiums paid by the purchaser for a benefit payable at maturity,*

*(g) any agreement providing that money received will be repaid or treated as a subscription to shares, stock, units or interests at the option of the recipient or of any person or company,*

*(h) any certificate of share or interest in a trust, estate or association,*

*(i) any profit-sharing agreement or certificate,*

*(j) any certificate of interest in an oil, natural gas or mining lease, claim or royalty voting trust certificate,*

*(k) any oil or natural gas royalties or leases or fractional or other interest therein,*

*(l) any collateral trust certificate,*

*(m) any income or annuity contract not issued by an insurance company,*

*(n) any investment contract,*

*(o) any document constituting evidence of an interest in a scholarship or educational plan or trust, and*

*(p) any commodity futures contract or any commodity futures option that is not traded on a commodity futures exchange registered with or recognized by the Commission under the Commodity Futures Act or the form of which is not accepted by the Director under that Act,*

*whether any of the foregoing relate to an issuer or proposed issuer; (“valeur mobilière”)*

*A security also includes a commodity futures contract and commodity futures options as defined under the Ontario Futures Act:*

> *"commodity futures contract" means a contract to make or take delivery of a specified quantity and quality, grade or size of a commodity during a designated future month at a price agreed upon when the contract is entered into on a commodity futures exchange pursuant to standardized terms and conditions set forth in such exchange's by-laws, rules or regulations; ("contrat à terme sur marchandises")*
>
> *"commodity futures option" means a right, acquired for a consideration, to assume a long or short position in relation to a commodity futures contract at a specified price and within a specified period of time and any other option of which the subject is a commodity futures contract; ("option sur contrat à terme sur marchandises")*

b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

*The client has full ownership interest for any unencumbered cash maintained in its investment account with the member firm (cash in the account due to short selling is excluded). It also has full ownership interest over the securities which have been fully paid for. These securities will be required to be put in segregation and be shown as such on the client's statement of account. Provincial Securities Acts require those firms acting as custodians to hold these securities in a separate location without lien or charge. This protects customers by preventing the member firm from using these securities for other purposes.*

*Fully paid for securities can also be held in safekeeping where the member firm acts as the client's custodian, similar to a bank safety deposit box. A written agreement needs to be in place between the member firm and the client and these securities will be shown as held in safekeeping on the client's monthly statement of account.*

*If the client has a margin account, a proper margin agreement needs to be signed between the member firm and the client. This margin agreement protects the firm for financing customer purchases. This agreement gives the firm the legal right to place a lien on securities*

*not fully paid for and to use these unpaid securities as collateral to finance the position. If the client fails to meet a margin call, the member firm may liquidate the security in the account and apply the proceeds to satisfy the client's indebtedness. The client will gain back full ownership over the securities when it is fully paid for.*

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

*Any individual or entity that opens an account with the member firm and for which services are rendered is considered a client.*

d. Please describe any notable exclusions from the terms "client" or "client assets."

*No exclusions*

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

*Yes – dealer members are registered with the provincial securities commissions in the category of investment dealers.*

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

*Yes – all dealer members must comply with the rules of IIROC and the securities commissions. IIROC is a self-regulatory organization recognized by the securities commissions which has been delegated oversight responsibilities of this category of securities registrant.*

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

*Not applicable*

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

a. Must the Client Assets of one client be maintained separately from those of other clients?

*For securities held registered in client name and held pursuant to a safekeeping agreement – they must be held in trust on a client by client basis.*

*For securities held in nominee name – they are aggregated on a security by security basis and held in bulk segregation for customers. Note that securities are generally held in nominee name.*

*IIROC rules require that for securities held in bulk segregation on behalf of customers that they be held at specified acceptable securities locations pursuant to a written custodial agreement and that such securities are held free of any liens and encumbrances and can be readily returned on demand.*

*The term bulk segregation is used for securities that are registered in the firm's name or its nominee name. Securities in bulk segregation accounts can be moved freely, because they are always in negotiable form. Under a bulk segregation system, in which firm inventory and customer asset holdings of the firm may be commingled, fully paid customer securities and excess margin securities must be separately identifiable as segregated on the records of the firm, including stock records, customer ledgers, and statements of accounts.*

*Example: Clients A and D together own 375 shares and these securities are fully paid. The quantity held in segregation at the custodian shows 175 shares. The shortfall or segregation deficiency is 200 shares. The firm must immediately take corrective action by looking through its record for 200 shares that can be moved into a segregation account on behalf of the 2 clients. The securities owned by these client accounts are "commingled" into one segregation box account or location. <u>This is what is meant by bulk segregation.</u>*

***Bulk Segregation Calculation***

*Not all client securities held by a member firm are fully paid. If the firm carries margin accounts (margin accounts are accounts in which Dealers Members offer clients to extend credit to their customers to leverage the purchase of securities. They can offer credit*

*up to the amount of loan value of the securities in the account. The loan value is determined by using a margin rate that is established under Rule 100) , or clients fail to settle trades, the quantity of securities owned by clients need not all be segregated by the firm. The segregation calculation becomes more complex as it is determined on a client-by-client basis.*

*In accordance with IIROC Rules 2000.4 and 2000.5, all member firms are required to determine the securities to be segregated at least twice a week. Member firms must also do a daily review of compliance with segregation requirements for clients' securities according to the latest determination under Rule 2000.6, with a view to identifying any deficiency in segregated securities and correcting the deficiency.*

*The triggers for identifying customer segregation requirements are driven by net loan value in the account of a customer. The net loan value in a customer account is calculated as:*

***[Loan value of all long security positions including non-marginable securities (market value – margin amount) minus the loan value of all short positions (market value + margin) plus the credit money balance minus debit money balance in the account]***

*Rule of thumb:*

- ***When the net loan value is greater than zero, segregation is required.***

*This means that there is an amount of fully paid or partially paid securities that is required to be set aside so that the firm does not use the amount of securities required to be segregated for any purpose.*

- ***When the net loan value is equal to zero, segregation is not required.***

*This means that there is no amount of fully paid or partially paid securities that is required to be set aside and the firm can use all securities in the account for any purpose.*

- ***When the net loan value is less than zero, desegregation is allowed.***

*This means that there is no fully paid or partially paid securities that is required to be set aside. In fact, to the extent that any securities have been segregated, the firm may choose to desegregate them in order to free them for any purpose.*

*For example, assume the following customer money and security position to illustrate simple segregation calculation:*

| | | |
|---|---|---|
| *Money balance* | *$75,000* | *debit* |
| *Long Securities market value*<br>*50,000 XYZ @ $5.00* | *$250,000* | |
| *Loan value (50% margin)*<br>*(Note: loan value per share $2.50)* | *$125,000* | |

*1. The loan value required to be segregated equals:*

*Net loan value – client debit balance = $125,000 – $75,000 = $50,000*

*2. Segregation share requirement:*

$$\frac{\text{Segregation dollar requirement}}{\text{Loan value per share}} = \frac{\$50{,}000}{\$2.50} = 20{,}000 \text{ shares}$$

*This analysis shows up on a report usually called the "Segregation Allocation Report." This report goes by different names, depending on the EDP service bureau used by the member firm.*

*The following is an example of information shown on a segregation deficiency report for any given security:*

*Security # 123*
*XYZ Corporation*

| *Customer A/C* | *Last Transaction* | *Held in Segregation* | *Required to Segregate* |
|---|---|---|---|
| *0123* | *06/13/96* | *20,000* | *20,000* |
| *1432* | *05/01/96* | *30,000* | *30,000* |
| *0987* | *07/10/96* | *50,000* | *50,000* |
| *1639* | *07/25/96* | *150,000* | *200,000* |
| | *Total* | *250,000* | *300,000* |
| | ***Net deficiency:*** | ***50,000*** | |

*The net deficiency of 50,000 represents the shortfall in the number of shares that should be held in a segregated box account as calculated based on the segregation algorithm performed for each customer account for this particular security.*

### *Detailed Segregation Examples*

*The following are two additional detailed examples of segregation calculations.*

### *EXAMPLE 1 - Customer account statement*

| *Cash Balance Dr <Cr>* | *Holdings* | *Quantity* | *Price ($)* | *Loan Rate* | *Market Value ($)* | *Loan Value ($)* |
|---|---|---|---|---|---|---|
| *762* | *A Co.* | *10* | *2.00* | *50%* | *20.00* | *10.00* |
| | *B Co.* | *<20>* | *35.00* | *150%* | *<700.00>* | *<1050.00>* |
| | *C Co.* | *100* | *37.00* | *50%* | *3700.00* | *1850.00* |
| | *D Co.* | *400* | *1.00* | *0* | *400.00* | *0* |
| | *E Co.* | *800* | *1.45* | *0* | *1160.00* | *0* |
| | *F Co. Bond* | *2000* | *95.00* | *90%* | *1900.00* | *1710.00* |
| | | | | | ***Security Loan Value*** | ***2520.00*** |
| *Net Loan Value = Total Loan Value - Debit Balance = 2520 – 762 = 1758* | | | | | | |

*Assume the segregation sequence as selected by the firm sequence is equities (lowest market price to highest) and then debt (lowest market price to highest).*

### *Segregation calculation*

| *Security* | *Total Loan Value by security ($)* | *Net loan value remaining after deducting security loan amount to segregate ($)* | *Loan value to segregate [loan amount divided by loan value of one share]* | *Quantity Required to Segregate* |
|---|---|---|---|---|
| | | *NLV = 1758* | | |
| *D Co.* | *0* | *0* | *0* | *400** |
| *E Co.* | *0* | *0* | *0* | *800** |
| *A Co.* | *10* | *1758 - 10 = 1748* | *10 / 1 = 10* | *10* |
| *C Co.* | *1,850* | *1748 - 1748 = 0* | *1748 / 18.5* | *95* |
| *F Co.* | *1,710* | *0* | *0* | *0* |

** Non-marginable securities must be segregated to the extent that the account is not under-margined.*

### *EXAMPLE 2 - Customer account statement*

| *Cash Balance Dr <Cr>* | *Holdings* | *Quantity* | *Price ($)* | *Loan Rate* | *Market Value ($)* | *Loan Value ($)* |
|---|---|---|---|---|---|---|
| *2500* | *H Co.* | *100* | *5.00* | *50%* | *500.00* | *250.00* |
| | *I Co.* | *150* | *7.00* | *50%* | *1050.00* | *525.00* |
| | *J Co.* | *200* | *10.00* | *50%* | *2000.00* | *1000.00* |
| | *K Co. Bond* | *2500* | *100%* | *90%* | *2500.00* | *2250.00* |
| | | | | | ***Security Loan Value*** | ***4025.00*** |
| *Net Loan Value = $4025.00 - $2500.00 = $1525.00* | | | | | | |

*Assume the segregation sequence as selected by the firm sequence is equities (lowest market price to highest) and then debt (lowest market price to highest).*

### *Segregation calculation*

| *Security* | *Loan Value by security ($)* | *Net loan value remaining after deducting security loan amount to segregate ($)* | *Loan value to segregate [loan amount divided by loan value of one share]* | *Quantity Required to Segregate* |
|---|---|---|---|---|
| | | *NLV = 1525* | | |
| *H Co.* | *250.00* | *1525 – 250 = 1275* | *250 / 2.50* | *100* |
| *I Co.* | *525.00* | *1275 – 525 = 750* | *525 / 3.50* | *150* |
| *J Co.* | *1000.00* | *750 – 750 = 0* | *750 / 5.00* | *150* |
| *K Co. Bond* | *2250.00* | *0* | *0* | *0* |

*In terms of segregation in a commodity account, IDA (predecessor of IIROC) had issued a notice in 1993 stating that:*

*The purpose of this notice is to remind member firms of the treatment of segregation of client securities for commodity accounts on the same basis as all other client accounts held by a member.*

*Segregation requirements for securities held for margin purposes for commodity accounts must be segregated on behalf of clients to the extent that the client has excess margin in its commodity account. Member firms must monitor the trading activities and margin requirements for all commodity positions held on a client-by-client basis.*

*Where margin deposits at a clearing corporation or at a correspondent broker include client fully paid or excess margin securities, such securities should be placed in segregation for the client in accordance with IIIROC Rule 2000. These client securities, usually T-Bills, must not be allowed to be used as margin deposits to satisfy a clearing corporations or correspondent brokers margin requirements for all open commodity futures/option contract positions held by the firm or its undermargined*

*client commodity accounts.*

*In order to satisfy any margin deposit requirement at a clearing corporation or correspondent broker, a firm may use its own funds, securities, client future margin receipts or securities of undermargined accounts.*

*To the extent that trades in future contracts are communicated to a correspondent broker for execution on a fully disclosed basis, the firm must ensure that any client excess margin securities held by the correspondent broker are being monitored and segregated in accordance with IIIROC Rule 2000.*

***General Restrictions***

*As per IIROC Rule 2000.8, it would be a serious offense to knowingly create or increase a segregation deficiency:*

*2000.8. In complying with its obligation to segregate client securities in accordance with Rules 17.3 and 2000, each Dealer Member shall ensure that:*

*(a) A segregation deficiency is not knowingly created or increased;*

*(b) No securities held by the Dealer Member are delivered against payment for the account of any client if such securities are required to satisfy the segregation requirements of the Dealer Member in respect of any client;*

*(c) All free securities (i.e. fully paid and unencumbered securities which have not been sold or are not required for margin) received by the Dealer Member shall be segregated.*

*Firms are required to have good systems in place to prevent any breach in the segregation requirements.*

***Corrective Action for Segregation Deficiencies (IIROC Rule 2000.9)***

*If there is a requirement for segregation, the member must immediately take the appropriate action required to settle the segregation deficiency. This would include in order of priority:*

- *Call loan: the member must call back the securities from call loan the next business day following the determination of the deficiency.*
- *Securities loan: the member must call back the securities from a stock loan or arrange to borrow the securities of the same issue type to cover the deficiency.*

- *Short inventory: if there is an inventory short position, the firm must immediately buy in or borrow the securities to cover the deficiency. The firm must have controls in place to prevent this occurrence, as any prolonged deficiency would constitute a violation of the criminal code.*
- *Fails: if there is a fail and the member has not received the securities within 15 business days of settlement, the member must borrow the securities of the same issue or buy in the securities.*
- *Stock dividends and stock splits: if the securities have not been received within 45 business days, a confirmation must be obtained. If no confirmation is received, the position must be transferred to a difference account.*
- *Difference account: each member must maintain a difference account. If the securities recorded in the difference account have not been obtained by the member within 30 days, the member must borrow the securities of the same class or series or must buy in the securities.*

***IIROC Segregation Rule References***

*The IIROC rule references for each of the main components in calculating segregation deficiencies or excess margin by security is as follows:*

***Segregation Requirements***

- *Bulk Segregation Calculation (IIROC Rule 2000.5)*
- *Frequency of Calculation (IIROC Rule 2000.6)*
- *Internal controls (IIROC Rule 2600, Policy 3, Statements 4 and 5)*

***Segregation Locations***

- *Acceptable external locations (IIROC Rule 2000.1)*
- *Acceptable internal locations (IIROC Rule 2000.2)*
- *Internal Controls (IIROC Rule 2600, Policy 3, Statements 4 and 5)*

***Segregation Deficiencies/Excess***

- *Correction of Segregation Deficiency (IIROC Rules 2000.8-9)*
- *Internal Controls (IIROC Rule 2600, Policy 3, Statements 4 and 5)*

***Priority for Segregation and Desegregation***

*IIROC Rule 2000.5 permits a member firm to select among the securities carried for the client account which securities to segregate or desegregate (as the case may be). The determination of the requirement to segregate or desegregate is based on the settlement date positions and the money balance of customer accounts.*

*Most member firms, through their EDP service provider, set procedures for sequencing and prioritizing the segregation of securities. This gives a member firm flexibility to segregate securities that have a low loan value before securities with a high loan value. This is important, because the firm, in funding its day-to-day operations, can more easily bank high-quality securities than lower-quality securities. For example, it may want to segregate equities in a customer account before debt, or desegregate government guaranteed debt securities before equity securities. The same holds true for segregating low-unit-value securities before high-unit-value securities.*

*Another important rule is that securities that must be segregated on a settlement date basis, but sold by the member firm on behalf of a customer, must remain segregated until one business day before the settlement date. Securities segregated for a client may not be removed from segregation as a result of the purchase of any securities by the client until the settlement date. For example, if a client sells a security today to settle three business days from now, the security must remain in segregation until one day before the settlement date. Otherwise, it provides an opportunity for a firm to desegregate the securities on the trade date and use them for another purpose, such as a call loan, until the settlement date. This is in contravention of the criminal code. The reverse also holds true: a purchase of a security that is unpaid should not result in the lien of a member firm against other fully paid securities of the client, leaving an opportunity to desegregate the securities before the settlement date.*

### *Implications for Short Sales*

*It is illegal for a member firm to short an inventory position and use client fully paid securities to settle. A segregation deficiency is created if a member enters into an obligation to sell a security which it does not own for a client for full payment. To resolve this deficiency, the firm must:*

1. *Immediately borrow the same securities in sufficient quantity to satisfy the segregation deficiency.*

2. *If the securities cannot be borrowed, then the firm must segregate securities "in kind" or equivalent cash for the same value and properly execute trust documents with the client.*

*The latter option may be prohibitive from an administrative standpoint. To avoid segregation deficiencies created by a firm short selling inventory to a client, proper internal controls should be implemented. This involves co-ordination between the retail sales force and the traders responsible for the firm inventory positions before executing a client order.*

### *Internal Control Standards*

*Given the importance of the rules involving segregation of client fully paid and excess margin securities as set out in IIROC Rules 17.3 and 17.3A, the SROs introduced minimum standards of internal controls over the segregation of client securities. Many of the industry guidelines established in 1985 were codified into regulation format in 1994 as IIROC Rule 2600, Policy 3, Statements 4 and 5.*

*IIROC Rule 2600, Policy 3, Statement 4, sets out the following minimum policies and procedures:*

1. *At least twice weekly the information system produces a report of items requiring segregation.*
2. *Items requiring segregation are placed in "acceptable securities locations" as defined in the regulation on a timely basis.*
3. *Written custodial agreements with applicable regulatory provisions exist for securities held at acceptable securities locations.*
4. *Only authorized personnel move securities into or out of segregation box or physical locations.*
5. *There is regular supervisory review of compliance with segregation requirements for clients' securities and of the completeness and accuracy of segregation reports.*
6. *If a segregation deficiency exists, the most appropriate and expeditious action prescribed by regulation to settle the deficiency is taken.*
7. *Management has set reasonable guidelines so that any material segregation deficiency is reported to senior management on a timely basis.*
8. *At least annually there is a documented supervisory review of firm policies and procedures to identify and correct any divergence from regulatory requirements.*

***Approach to cash segregation***

*Generally speaking, a Dealer Member may use client cash in the normal course of its business up to a certain limit based on a firm's financial position. The free credit limit for a firm is Net Allowable Assets times a factor of 8, plus Early Warning Reserve times a factor of 4. The factors of 8 and 4 are commensurate with the leverage ratios established for financial institutions under the Basel Accord.*

*Excess free credit balances must be segregated in the form of government securities with a term of one year or less, or in the form of cash in a trust account with an Acceptable Institution.*

*The approach to cash segregation, referred in the IIROC Rules as free credit segregation, is defined in IIROC Rule 1200 which stipulates:*

> *1200.1. For the purposes of this Rule 1200, "free credit balances" shall mean:*
>
> *(a) For cash and margin accounts - the credit balance less an amount equal to the aggregate of (i) the market value of short positions, and (ii) margin as required pursuant to the Rules on those short positions; and*

*(b) For commodity accounts - the credit balance less an amount equal to the aggregate of (i) margin required to carry open futures contracts and/or futures contract option positions, (ii) less any equity in such contracts, (iii) plus any deficits in such contracts, provided that such aggregate amount may not exceed the dollar amount of the credit balance.*

*1200.2*

*1200.2. Each Dealer Member which does not keep its clients' free credit balances segregated in trust for clients in an account with an acceptable institution separate from the other monies from time to time received by such Dealer Member shall legibly make a notation on all statements of account sent to its clients in substantially the following form:*

*Any free credit balances represent funds payable on demand which, although properly recorded in our books, are not segregated and may be used in the conduct of our business.*

*1200.3*

*1200.3. No Dealer Member shall use in the conduct of its business clients' free credit balances in excess of the aggregate of the following amounts:*

*(a) Eight times the net allowable assets of the Dealer Member; plus*

*(b) Four times the early warning reserve of the Dealer Member.*

*Each Dealer Member shall hold an amount at least equal to the amount of clients' free credit balances in excess of the foregoing either (a) in cash segregated in trust for clients in a separate account or accounts with an acceptable institution; or (b) segregated and separate and apart as the Dealer Member's property in bonds, debentures, treasury bills and other securities with a maturity of less than one year of or guaranteed by the Government of Canada, a province of Canada, the United Kingdom, the United States of America and any other national foreign government (provided such other foreign government is a member of the Basle Accord).*

*1200.4*

*1200.4. Dealer Members shall determine at least weekly the amounts required to be segregated in accordance with Rule 1200.3.*

*1200.5*

*1200.5. Dealer Members shall review on a daily basis compliance with Rule 1200.3 against the latest determination under this Rule 1200 of amounts to be segregated with a view to identifying and correcting any deficiency in amounts of free credit balances to be segregated.*

*1200.6*

*1200.6. In the event that a deficiency exists in amounts of free credit balances required to be segregated by a Dealer Member, the Dealer Member shall expeditiously take the most appropriate action to rectify the deficiency.*

i. Are Investment Firms allowed to hold Omnibus Accounts?

*Yes, however IIROC dealers are only permitted to operate omnibus accounts on a fully paid basis. It is not permitted to operate omnibus accounts on margin. Omnibus account means an account carried by or for a Dealer Member in which the transactions of two or more persons are combined and effected in the name of a Dealer Member without disclosure of the identity of such persons. It is the opposite of a fully disclosed account.*

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

*As stated above, margin omnibus accounts are not permitted. This eliminates the risk of one client financing the activities of another in such an account type.*

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

*No. The Dealer member is required to hold the specific security asset class deposited or fully paid for by each client.*

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

*Dealer members disclose in their stock record every client that holds a position for a specific security asset class. The aggregate of all such holdings are held at an acceptable internal or external securities location which is reconciled on a monthly basis through security count or third party custody record.*

C) If a client has a debit balance (i.e. the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold?

*<u>Securities:</u> Yes – securities required to be segregated in a margin account are calculated based on the total loan value of all securities held in the account (minus the account debit balance) divided by the loan value of the security. The priority or sequencing of which securities are segregated or desegregated first is typically driven by the lowest to highest loan value of securities in the account. For further details, please see answer to II.3. a above. IIROC Rule 2000.5 permits a dealer member to select among the securities carried for the client account which securities to segregate or desegregate (as the case may be). The determination of the requirement to segregate or desegregate is based on the settlement date positions and the money balance of customer accounts. Most Dealer members, through their EDP service provider, set procedures for sequencing and prioritizing the segregation of securities. This gives a Dealer member flexibility to segregate securities that have a low loan value before securities with a high loan value. This is important, because the Dealer member, in funding its day-to-day operations, can more easily bank high-quality securities than lower-quality securities. For example, it may want to segregate equities in a customer account before debt, or desegregate government guaranteed debt securities before equity securities. The same holds true for segregating low-unit-value securities before high-unit-value securities.*

Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

*<u>Funds</u>: No. As per Statement D of Form 1, the Dealer member is required to do a calculation to see if there is a required amount of free credits to be segregated. The calculation is:*

*Amount required to segregate:*

*Line 1: Net allowable assets (line B6 of Form 1) multiplied by 8* _____

*Line 2: Early Warning reserve (line C12 of Form 1) multiplied by 4* _____

*Line 3: Free credit limit (line 1 plus line 2)* _____

*Less client free credit balances:*

*Line 4: Dealer Member's own* _____

*Line 5: Carried for Type 3 introducers* _____

*Line 6: Amount to segregate (nil if line 3 exceeds line 4 plus line 5)*
*=========*

*As per Rule 1200.1, free credit balances mean:*

*(a) For cash and margin accounts – the credit balance less an amount equal to the aggregate of (i) the market value of short positions, and (ii) margin as required pursuant to the Rules on those short positions; and*

*(b) For commodity accounts – the credit balance less an amount equal to the aggregate of (i) margin required to carry open futures contracts and/or futures contract option positions, (ii) less any equity in such contracts, (iii) plus any deficits in such contracts, provided that such aggregate amount may not exceed the dollar amount of the credit balance.*

*As per Rule 1200.2, each Dealer member which does not keep its client's free credit balances segregated in trust for clients in an account with an acceptable institution separate from the other monies from time to time received by such Dealer member shall legibly make a notation on all statements of account sent to its clients in substantially the following form: " Any free credit balances represent funds payable on demand which, although properly recorded in our books, are not segregated and may be used in the conduct of our business."*

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

*Dealer members are required to calculate segregation requirements at least twice weekly (any day selected by dealer member)...*

*The reconciliation of securities held at external locations must be performed monthly.*

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

*The segregation calculation must be performed at least twice weekly. Segregation deficiencies must be immediately corrected by the next business day.*

*Corrective actions include buying in the securities or borrowing to meet segregation requirements on a security by security class.*

*The reconciliation of securities held in segregation to external custodians must be completed within 30 days following month-end after which a capital charge against the Dealer member's regulatory capital is applied based on the market value of unreconciled positions representing a loss to the Dealer member.*

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

*As per Question 3biiB above, corrective actions include buying in the securities or borrowing to meet segregation requirements on a security by security class should a deficiency be found. Segregation deficiencies must be corrected by next business day.*

*Systemic deficiencies in the timely segregation of customer securities represent a material breach of IIROC rules and result in enforcement action against the firm. A systemic deficiency is not defined in the Rules. However, it would mean that there would be recurring problems in doing the segregation appropriately.*

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

*No – IIROC rules do not permit the segregation of customer specific asset class securities in kind. The firm cannot put its own inventory into a client account. However, under a bulk segregation system, in which firm inventory and customer assets holdings of the firm may be commingled, all assets are looked at together and once the required amount to be held in segregation is in fact in segregation, there is no segregation deficiency. The firm can buy-in or borrow securities to cover an under-segregated position.*

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

*No – all customer securities required to be held in segregation cannot be used to meet the obligations of the firm or other customers.*

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

*Yes – it is not permitted to use customer fully paid or excess margin securities (excess margin: loan value amount exceeding the debit balance in a margin account) to encumber or hypothecate or lend. This would represent a material breach of IIROC rules and cause for enforcement action against the Dealer member. On the other hand, if the securities are not required to be in segregation, that is if they are not fully paid or there is no excess margin, then the Dealer member may use those securities in the normal course of business and may use those securities in financing transactions.*

*As per IIROC Rule 27, whenever a client is indebted to a Dealer member, such Dealer member shall have the right from time to time, in its discretion, to raise money on such securities and to carry such securities in its general loans, and to pledge and re-pledge such securities in such manner and to such reasonable amount and for such purpose as it may deem advisable. Those details are usually part of the Margin Agreement which is part of the account opening package.*

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

*If the client securities are not fully paid for, there is no ownership right over these unpaid securities. If the client has a margin account, a proper margin agreement needs to be signed between the member firm and the client. This margin agreement protects the firm for financing customer purchases. This agreement gives the firm the legal right to place a lien on securities not fully paid for and to use these unpaid securities as collateral to finance the position. If the client fails to meet a margin call, the member firm may liquidate the security in the account and apply the proceeds to satisfy the client's indebtedness. The client will gain back full ownership over the securities when it is fully paid for. The client's consent over the use by the Dealer member to do financing transaction with the unpaid securities comes in the form of the client signing the margin account agreement.*

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

*The client's consent over the use by the Dealer member to do financing transaction with the unpaid securities comes in the form of the client signing the margin account agreement.*

iii. How are the ownership rights of a client over its client assets changed or affected when the investment firm uses or re-hypothecates such assets without such client's consent?

*The Dealer member cannot do financing transactions with unpaid securities without having in place a proper margin account agreement signed by the client.*

Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (i.e. established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

*When a security is fully paid for, the Dealer member is required to put it into segregation as per IIROC Rule 2000. If the Dealer member declares bankruptcy, CIPF would cover, within limits, the client's fully paid for securities, whether or not they had been put into segregation by the IIROC Dealer member.*

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

*Yes - the central counterparty must track security holdings by Dealer member. The Dealer member in turn maintains records of the individual customer holdings.*

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

a. Client Assets transferred to or located in other jurisdictions?

*IIROC has specific criteria for custodians which must qualify as "acceptable securities locations" both domestic and in foreign jurisdictions. The custody arrangement must be in writing and preserve the legal rights of custody of customer securities.*

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

*Yes – the same segregation requirements and custody requirements apply.*

c. If so, please provide details of those requirements.

*The security location must qualify as "acceptable securities locations". This includes those entities considered suitable to hold securities on behalf of a Member, for both inventory and client positions, without capital penalty, given that the locations meet the requirements outlined in the segregation rules of IIROC.*

*Specifically, the requirement for a written custody agreement outlining the terms upon which such securities are deposited and including provisions that no use or disposition of the securities shall be made without the prior written consent of the Member and the securities can be delivered to the Member promptly on demand.*

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

*Foreign Investment Firms are allowed to open an omnibus account with an IIROC Dealer member. However, there is no CIPF protection afforded to investment firms, and its customers, dealing with an IIROC Dealer member on an omnibus basis.*

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

*See response in a. There is no CIPF protection offered for such assets.*

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

*Not applicable. See response in a.*

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

*The regime in our jurisdiction permits client assets to be held by third party custodians, including any affiliate of the Dealer member, given that the third*

*party custodian can be defined as an acceptable securities location. Are referred to as "acceptable securities locations" entities considered suitable to hold securities on behalf of a Member for both inventory and client positions, without capital penalty. The locations must meet the requirements outlined in the segregation rule and the notes and definitions of Form 1, including, but not limited to, the requirement for a written custody agreement outlining the terms upon which such securities are deposited.*

*Acceptable securities locations include the following:*

*Depositories and Clearing Agencies*

*(a) Acceptable Institutions which in their normal course of business offer custodial security services; or*

*(b) Subsidiaries of Acceptable Institutions provided that each such subsidiary, together with the Acceptable Institutions, has entered into a custodial agreement with the member containing a legally enforceable indemnity by the Acceptable Institution in favor of the Member covering all losses, claims, damages, costs and liabilities in respect of securities and other property held for the Member and its clients at the subsidiary's location.*

*Acceptable Counterparties – with respect to security positions maintained as a book entry of securities issued by the Acceptable Counterparty and for which the Acceptable Counterparty is unconditionally responsible.*

*Banks and Trust Companies otherwise classified as Acceptable Counterparties – with respect to securities for which they act as transfer agent and for which custody services are not being provided ( in such case, a written custody agreement is not required).*

*Mutual Funds of their Agents – with respect to security positions maintained as book entry of securities issued by the mutual fund and for which the mutual fund is unconditionally responsible.*

*Regulated entities.*

*Foreign institutions and securities dealers that satisfy the following criteria:*

*the paid-up capital and surplus according to its most recent audited balance sheet is in excess of Cdn. $150 million as evidenced by the audited financial statements of such entity;*

*in respect of which a foreign custodian certificate has been completed and signed in the prescribed form by the Member's board of directors or authorized committee thereof;*

*provided that:*

*a formal application in respect of each such foreign location is made by the Member to the relevant joint regulatory authority in the form of a letter enclosing the financial statements and certificate described above; and*

*the Member reviews each such foreign location annually and files a foreign custodian certificate with the appropriate joint regulatory authority annually.*

*And such other locations which have been approved as acceptable securities locations by the Joint Regulatory Body having prime jurisdiction over the Member.*

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

*As per IIROC Rule 2000.1 Segregation Requirements – Acceptable external locations, securities held beyond the physical possession of the Dealer Member may be segregated and held in trust for customers of a Dealer Member, or segregated and held by or for a Dealer Member, as the case may be , in acceptable securities locations, provided that the written terms upon which such securities are deposited and held beyond the physical possession of the Dealer Member include provisions to the effect that*

*i. No use or disposition of the securities shall be made without the prior written consent of the Dealer Member;*

*ii. Certificates representing the securities can be delivered to the Dealer Member promptly on demand or, where certificates are not available and the securities are represented by book entry at the location, the securities can be transferred either from the location or to another person at the location promptly on demand; and*

*iii. The securities are held in segregation for the Dealer Member or its customers free and clear of any charge, lien, claim or encumbrance of any kind in favor of the depository or institution holding such securities.*

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

*Dealer members must provide a monthly customer statement showing securities held in segregation, whether they are held at a domestic or foreign custodian. Dealer members are required to disclose on customer statements and confirmations that they are members of CIPF.*

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

   *No opt out possible.*

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

   a. Does the Investment Firm report where client assets are held?

      *There is no report required to be filed concerning where client assets are held. However, under Rule 200 for minimum books and records, the Dealer member is required to maintain at all times a securities record reflecting for each security all long and short positions carried for the Dealer Member's account or for the account of customers, showing the location of all securities long and the offsetting position to all securities short and in all cases the name or designation of the account in which each position is carried.*

   b. Does the Investment Firm or depository report the protections applicable to such client assets?

      *As per Rule 29.1, each Dealer member shall include on the front of each confirmation and account statement sent to a customer the CIPF official symbol, and shall also include in legible print on each confirmation and account statement sent to as customer the CIPF official explanatory statement which reads: "Customers' accounts are protected by the Canadian Investor Protection Fund within specified limits. A brochure describing the nature and limits of coverage is available upon request".*

   c. Does the Investment Firm or depository report the amount of assets that are held?

      *Client net equity is reported on Schedule 10 of Form 1 on a monthly basis. Client net equity is defined as the total value of cash, securities and other acceptable property owed to the client by the Dealer member less the value of cash, securities, and other acceptable property owned by the Client to the Dealer member. However, there is no reporting for the amount of securities held at custodians. This information is detailed in the securities record mentioned above in response to a.*

   In each case, are such reports provided on request or periodically? If periodically, with what frequency?

   *Securities records would be provided on request during regular field examinations. As for the filing of the audited Form 1 in which client net equity is indicated, this is produced annually.*

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

    a. Where Client Assets are held?

    *During regular field examinations done by the Financial & Operations Compliance personnel, we ensure that custodians meet the definition of acceptable securities locations. The custody agreements in place between the Dealer member and the custodian is also looked at to ensure minimum regulatory provisions are included, as required per Rule 2000.*

    *On a test basis, we select a sample to review monthly position reconciliations for evidence of the Dealer member's review and approval. We also ensure adequate capital has been provided for unresolved differences over 20 business days.*

    b. The amount of Client Assets held at a depository?

    *During regular field examinations, tests are done on the securities record and custodians' reconciliations are looked at, as stated above in answer to a.*

    c. The safeguards applicable to Client Assets held at a depository?

    *During regular field examinations, new custodial agreement are looked at to ensure the minimum regulatory provisions are included. There are also tests conducted on the segregation of securities.*

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

    *The foreign regulator could request from the Foreign Investment Firm to consult the monthly statement of account received from the Dealer member. This monthly statement will show the detailed securities of all the clients comingled into one account opened under the Foreign Investment Firm's name.*

    b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

    *There is no CIPF protection afforded to Foreign Investment Firms, and its customers, dealing with an IIROC Dealer member on an omnibus basis.*

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

*All Dealer members provide a regulatory financial report showing on their capital adequacy on a monthly basis and audited regulatory report on an annual basis. The annual report also requires a special compliance procedure report by the auditors testing for compliance in respect to regulatory segregation of customer asset rules.*

*Dealer members must maintain risk adjusted capital greater than zero at all time. Also, the Dealer members need to advise IIROC as soon as they become aware that they are designated in early warning as defined in IIROC Rule 30. The Dealer member must deliver immediately to IIROC a letter describing the circumstances which gave rise to the early warning designation, an outline of the proposal to rectify the problems identified and an acknowledgement that the Dealer member applies the restrictions imposed on them by IIROC.*

*There is no requirement to inform the marketplace unless there is a breach of capital adequacy rules in which case the market is notified after a disciplinary notice is published.*

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*, capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

*IIROC has established early warning thresholds. If such thresholds are triggered – the firm is restricted from certain business activities and frequency of regulatory reporting increases. The restrictions are elevated based on the severity of the thresholds triggered. If a firm becomes capital deficient they must immediately correct the situation within 2 business days or result in suspension of membership which would lead to insolvency proceedings.*

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

*Any Dealer member which fails to meet IIROC capital adequacy requirements is suspended. IIROC issues a public notice announcing the suspension and the fact that privileges of membership, including dealing with the investing public, are withdrawn.*

*Where IIROC suspends a Member, the provincial Commissions where the dealer is registered must also suspend the registration. Usually, upon request from the Administrative Officer, the Commissions will permit liquidating trades in customer accounts.*

*Pursuant to an agreement between IIROC and the Canadian Investor Protection Fund (CIPF) which is a fund created to provide customer protection for financial losses incurred from the insolvency of any IIROC Dealer member, IIROC must notify CIPF immediately of any situations that could result in CIPF having to compensate customers.*

*IIROC will advise CIPF of its suggested plan of action.*

***Where no payment from CIPF anticipated***

*If both IIROC and CIPF are satisfied that client assets can be transferred to another IIROC Member without payment from CIPF, and there is a Member that will accept the accounts, then IIROC will oversee this process without any assistance from CIPF.*

*In this event CIPF's procedures require it to place advertisements in national and local newspapers, similar to the following:*

*On <<date>>, the Investment Industry Regulatory Organization of Canada announced that it had suspended the membership of <<Dealer member>>). <<Dealer Member>> has ceased dealing with the public and customer accounts were transferred to <<dealer member 2>> on <<date>>.*

*The Canadian Investor Protection Fund/Fonds canadien de protection des épargnants ("CIPF") understands that <<dealer member>> has ceased business but does not have complete information as to its financial status. However, customers with accounts at <<dealer member>> who have suffered or may suffer financial loss solely as a result of <<dealer member>> being or becoming insolvent may be eligible for coverage for such losses by CIPF to prescribed limits. Such losses must result from the failure of <<dealer member>> to return or account for securities, cash balances, commodities, futures contracts, segregated insurance funds or certain other property acquired or held by <<dealer member>> in an account for customers. Losses that do not result from the insolvency of <<dealer member>> such as losses arising from changing market values of securities, unsuitable investments or the default of an issuer of securities are not eligible for CIPF coverage.*

***Where payment from CIPF anticipated***

*Where it appears that CIPF will be required to advance monies, IIROC will suspend the Dealer member and CIPF will ask the Court to appoint a trustee in bankruptcy in accordance with Part XII of the Canadian Bankruptcy and Insolvency Act.*

*Part XII is bankruptcy legislation that can only be used for Canadian Securities Firms. CIPF is specifically mentioned as a body that can petition a securities firm into bankruptcy. CIPF may request the Commissions permit liquidating trades in customer accounts.*

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

    *If required, CIPF request the Court appoint a trustee in bankruptcy from one of the major accounting firms in Canada. The trustee will then, under the direction of CIPF, petition the Court for bankruptcy proceedings against the Dealer member. The key objective is to transfer client assets as quickly as possible so the selection is based on the following criteria:*

    - *The ability of the trustee to deal with the size and complexity of the bankrupt Dealer Member.*
    - *The trustee must be licensed in Canada to act as a trustee*
    - *CIPF must satisfy itself that the trustee is free from conflicts with the Dealer Member.*
    - *Experience with Part XII of the Bankruptcy Act and knowledge of the Canadian Investment Industry.*

16. What are the duties of the Administrative Officer?

    a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

       *CIPF maintains staff to assist the trustee. The primary objective is to move customer assets as quickly as possible. To do this, it must determine the resources it must advance, in accordance with its policies, to transfer customer assets. CIPF has developed an insolvency procedures manual to assist prospective trustees.*

       *Part XII contains specific procedures for administering a bankrupt securities firm which includes a requirement that the trustee consult with CIPF on the administration of the bankruptcy and permits CIPF to designate an inspector. The Act also sets out how losses will be allocated to customers and what assets can be used to satisfy such losses before CIPF's coverage is required. For example, where there is a shortfall in customer assets, the Dealer member's inventory will be used to satisfy those losses before CIPF is required to advance funds.*

    b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

       *Generally trustees are not liable for any act unless it is a result of gross negligence or willful misconduct.*

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

a. Does the regulator continue to supervise the Investment Firm?

*No – CIPF assumes full responsibility in the dissolution of the Dealer member.*

b. How, if at all, is the regulator involved in the process of returning Client Assets?

*Not involved – the process is fully assumed by CIPF.*

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

*None officially but in practice, same as going concern*

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

*Yes – the first order of business is to find another IIROC Dealer Member prepared to assume the book of customer business and transfer the customer assets. This process is assumed by CIPF and trustee.*

a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

*See answer to question 14 where a trustee is not appointed.*

*Transfer of customer accounts is top priority. The speed depends on many factors*

- *The state of the books and records*
- *The availability of another Dealer Member to take the accounts – trustee may have a responsibility to maximize estate assets and may need to auction accounts.*
- *The compatibility of the receiving Dealer members system with the bankrupt's. If they are compatible, a "bulk transfer "can be done – if not, accounts may have to be transferred "one by one". Compatibility of systems is a factor considered in deciding which Dealer Member the accounts will be transferred to.*

b. What factors, if any, affect the time period required to accomplish such a transfer?

*As above. If assets available to be distributed to customers, as set out in the Bankruptcy Act, are not sufficient to satisfy all customer claims, creating a shortfall, the shortfall, under Canadian bankruptcy law, is allocated over all customers in proportion to their client net equity. The customer would then be compensated by CIPF in accordance with CIPF's coverage policy. This allocation reduces the probability that any customer will have a loss that exceeds CIPF's coverage.*

*CIPF speeds up the transfer process by settling the agreed on losses directly with the trustee rather than with each customer. What this means is that*

- *CIPF determines the difference between the assets available to settle customer claims and the assets required to settle customer claims is known*
- *The difference is adjusted for claims not eligible for CIPF coverage, for example, directors of the bankrupt company, those causing the insolvency – all of which are set out in the coverage policy*
- *CIPF provides funding of the adjusted difference to the trustee. That funding, with assets recovered from the estate, permits the trustee to transfer client accounts in full. The customer would not necessarily know that CIPF has provided funding.*

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

*Canadian bankruptcy law permits the trustee to recover preferential payments made prior to bankruptcy. However, to the extent that assets to which a customer was entitled were withdrawn prior to insolvency – without complications of conflict of interest or inside information – there should be little risk to customers of having to return the assets. These assets would be covered by CIPF in any event.*

*There is a $1 million coverage limit for losses in a customer's General Account and each Separate Accounts (see below). This includes losses of securities, commodity and futures contracts, segregated insurance funds and cash and excludes losses in market value.*

*General Accounts*

*Regular accounts of a customer are combined to determine the assets of the customer's general account. For example, the interest of a customer in an account of a personal holding company, or that is held on a joint or shared ownership basis, shall be treated as part of the General Account of a customer.*

*Separate Accounts*

*Each account of a customer held in the capacity or circumstance set out below shall be considered a Separate Account of the customer. Unless otherwise indicated below, each Separate Account held by a customer in the same capacity or circumstance shall be combined or aggregated so as to constitute a single Separate Account.*

*Are considered Separate Accounts:*

- *Registered Retirement Plans*
- *Registered Education Savings Plans*

- *Testamentary Trusts*
- *Inter-vivos Trusts and Trusts imposed by law*
- *Guardians, Custodians, Conservators, Committees, etc.*
- *Personal holding Corporations: Accounts of corporations controlled by a customer provided that the beneficial ownership of a majority of the equity capital of the corporation is held by persons other than the customer, as might be the case in a corporation created pursuant to an estate freeze.*
- *Partnerships: Accounts of partnerships controlled by a customer provided that the beneficial ownership of a majority of the equity interests in the partnership is held by persons other than the customer.*
- *Unincorporated Associations or Organizations: Accounts of unincorporated associations or organizations controlled by a customer provided that the beneficial ownership in a majority of the assets of the association or organization is held by persons other than the customer.*

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

    *As discussed above, the role of CIPF is to administer the insolvency proceedings of the Dealer member and provide protection for customer asset losses up to $1 million per customer.*

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

    *Certain customers are excluded from CIPF coverage, but are still entitled to distribution from the trustee – i.e. CIPF does not top up any shortfall.*

    *Customers not covered are:*

    *i) a Member of a sponsoring SRO of CIPF or any other dealer registrant such as a securities dealer, mutual fund dealer, limited market dealer or futures commission merchant, or a foreign securities dealer registered with a Canadian securities regulatory authority or foreign equivalent;*

    *ii) an institution, securities dealer or other person, and its customers, dealing with a Member of an SRO on an omnibus basis (being an account in which the transactions of two or more persons are combined without the disclosure to the Member of the identity of the persons);*

    *iii) a clearing corporation;*

*iv) any person who owns in aggregate five percent or more of the capital of the insolvent Member consisting of equity securities of any class and/or subordinated debt of the Member;*

*v) a general partner or director of the insolvent Member;*

*vi) a limited partner with a participation of five percent or more in the net assets or net profits of the insolvent Member;*

*vii) a person with the power to exercise a controlling influence over the management or policies of the insolvent Member;*

*viii) a person who caused or materially contributed to the insolvency of the Member;*

*ix) a person who did not deal at arm's length with the insolvent Member or with a person who is excluded as a customer, or*

*x) a customer of a foreign approved participant of an SRO which is not considered by the Board of Directors to be a Member of an SRO. Such participants include foreign dealers or other organizations regulated in recognized jurisdictions, without a place of business in Canada, and who do not deal with customers in Canada except as permitted by applicable Canadian securities legislation.*

*In addition, customers are not covered for financing transaction with the Dealer Member*

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

*"Where the laws and circumstances prevailing in a foreign jurisdiction may restrict the transfer of securities from the jurisdiction and the Member is unable to arrange for the holding of client securities in the jurisdiction at an acceptable securities location, the Member may hold such securities at a location in that jurisdiction if (a) the Member has entered into a written custodial agreement with the location as required hereunder and (b) the client has consented to the arrangement, acknowledged the risks and waived any claims it may have against the Member, in a form approved by the Joint Regulatory Authority. Such a consent and waiver must be obtained on a transaction by transaction basis."*

*In any event – this does not affect CIPF coverage – the Member would be required to provide capital.*

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

*No, clients are not treated differently. The bankruptcy acts creates a customer pool of assets that is distributed to all customers. The pool includes all cash, securities whether belonging to customers or the firm and whether segregated or not segregated and various other assets. Customers share in that pool based on their client net equity so there is no tracing of lost property to specific clients.*

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

    *Canadian bankruptcy rules create two pools of assets for distribution – a customer and general. The customer pool includes all customer assets and more (e.g. inventory, cash) and is used to pay customers,( and the trustee if general fund not able to do so). Any shortfall in customer pool is allocated to all customers based on their client net equity and is compensated by CIPF in accordance with its policies.*

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

    *The bankruptcy act only distinguishes between customers and deferred customers. Deferred customers are generally those that contributed to the insolvency and must be found by the Court to be deferred. Other than that, there is no distinction between customers for distribution of the customer pool. If there is a shortfall in the pool however, CIPF does have customers whose shortfall it does not cover. These include directors of the insolvent corporation, omnibus accounts. A full list is found in our coverage policy.*

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

*See IIROC Rule Book*

*IIROC Rule 17.1 – Dealer member minimum capital requirement*

*IIROC rule 17.3A – Dealer member segregation of customer assets requirement*

*Rule 30 – Early Warning System*

*IIROC Rule 2000 – Segregation Requirements*

*Rule 2600 - Internal Control Policy Statement 5 and 6 - Safeguarding of customer assets*

*IIROC Form 1 – Notes to general instructions (definition of acceptable securities location)*

*IIROC Form 1 – Audit Report on Compliance for Segregation of Securities*

*IIROC Rule 41 – Canadian Investor Protection Fund*

*CIPF-IIROC Industry Agreement (non-public document)*

*See CIPF web site - www.cipf.ca*

*Part XII of the Bankruptcy and Insolvency Act : http://canlii.org/en/ca/laws/stat/rsc-1985-c-b-3/latest/rsc-1985-c-b-3.html*

For Ontario's *Securities Act* and *Commodity Futures* Act: http://www.osc.gov.on.ca/en/SecuritiesLaw_index.htm

# France
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

    a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

In the present answer, "client assets" refers to "financial instruments" and "client money". "Financial instruments" include both "financial securities" (hereafter "securities") and "financial contracts", as defined as follows in the French Monetary and Financial Code:
*"Article L. 211-1. - I. - Financial instruments include both financial securities and financial contracts.*
*II. - Financial securities include:*
*1. Equity securities issued by joint-stock companies*
*2. Debt securities, with the exception of bills of exchange and interest-bearing notes*
*3. Units or shares in undertakings for collective investment*
*III. - Financial contracts, also referred to as "term contracts", are financial term contracts that appear on a list established by decree."*

In the present answer, "client money" includes "funds received from the public", defined by Article L. 312-2 of the French Monetary and Financial Code (see below) as well as funds received by investment firms for the purpose of financial transactions:

*Article L. 312-2. Funds which an entity accepts from a third party, in particular in the form of deposits, with the right to use them for its own account subject to its returning them shall be deemed to be funds received from the public. (…)."*

    b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

The client has the ownership rights over his financial instruments held by a custody account-keeper in a securities account. Such financial instruments must be strictly identified on an individual account and the custody account-keeper is not allowed to use those securities without the client's express consent.

Financial instruments are materialized by an entry on the account of the client and are presumed to be owned by the client under whose name the account is maintained (Article R. 211-1 of the Monetary and Financial Code and Articles 322-1 et s. of the AMF General Regulation).

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

The term 'Client' is not defined is French legislation. It is in practice understood in line with the MIFID definition: "Client means any natural or legal person to whom an investment firm provides investment and/or ancillary services", custody being an ancillary service under MiFID. It is understood similarly for banking services including the holding of cash deposits.

The different types of client (professional vs non professional) should be understood in the light of this definition.

*Cf. the 2011 IOSCO Survey (p.4 of Appendix B on France):*
"The Order of 2 July 2007 which transposed MiFID applies to:

- "professional customer": a customer who possesses the experience, knowledge and skills to make his own investment decisions and adequately evaluate the risks incurred (Article L. 533-16 of the Monetary and Financial Code). These customers can require to be treated in the same way as "non-professional customers" and the investment firms can accept to provide them with a higher level of protection (in accordance with the modalities set by the AMF GR);
- "non-professional customer": a customer other than a professional customer.

There are a few specific provisions in the AMF General Regulation (AMF GR) that apply to investment service providers differently according to the nature of their client (professional or non professional). These provisions aim at ensuring additional protection to non professional clients or waiving some obligations towards professional clients.

Moreover, the French legal framework also refers to the concept of "qualified investor".
"Qualified investors" are defined in Article L. 411-2 II of the Monetary and Financial Code, as "*an individual or an entity possessing the expertise and resources required to apprehend the risks inherent in transactions in financial instruments. The list of investor categories recognized as qualified is determined by decree*." This list is detailed in Articles D. 411-1 and D. 411-2 of the same code. According to Article D. 411-3, the status of qualified investor is optional for certain categories (which include individuals).

For FMIs, the following terms are used rather than "client":

For payment systems, securities settlement systems and their operators (the CSDs):

- "participants": defined in Article 2 of Directive 98/26/EC on Finality: "shall mean an institution, a central counterparty, a settlement agent, a clearing house or a system operator" (transposed in Article L. 330-1 Monetary and Financial Code)
- "indirect participants": shall mean an institution, a central counterparty, a settlement agent, a clearing house or a system operator with a contractual relationship with a participant in a

system executing transfer orders which enables the indirect participant to pass transfer orders through the system, provided that the indirect participant is known to the system operator"

For CCPs:
EMIR (cf. infra) refers to:

- "clearing members: "means an undertaking which participates in a CCP and which is responsible for discharging the financial obligations arising from that participation"
- "client": "means an undertaking with a contractual relationship with a clearing member of a CCP which enables that undertaking to clear its transactions with that CCP"

d. Please describe any notable exclusions from the terms "client" or "client assets."

They are no such exclusion in French law.

In answering the remaining questions:

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

There is no special blanket "authorization" but only certain entities listed in Article L. 542-1 of the Financial and Monetary code may act as custodians or administrators of financial instruments. These are:
1. Legal entities for the securities they issue through public offerings;

2. Credit institutions established in France;

3. Investment firms established in France;

4. Legal entities whose members or partners are indefinitely and jointly liable for their debts and commitments, provided that such members or partners are institutions or companies referred to in 2 and 3 which are authorised to provide administration or custody for financial instruments;

5. Legal entities established in France having as their primary or sole purpose the custody or administration of financial instruments;

6. The institutions referred to in Article L. 518-1 (i.e. the French Treasury, the Bank of France); 7. As provided for in the GR of the AMF, credit institutions, investment firms and legal entities having as their primary or sole purpose the custody or administration of financial instruments which are not established in France.
The persons referred to in 1 are subject, in regard to their financial instrument custody or administration activities, to the control and sanctions of the AMF. The persons referred to in 2 to 5 are subject, in regard to their financial instrument custody or administration activities, to the laws and regulations, the rules of supervision and the sanctions laid down for investment service providers by the Financial and monetary code. Persons referred to in 2 and 3 are subject, in regard to their financial instrument custody or administration activities, to an authorisation issued in connection with their approval. Persons referred to in 5 are subject to the rules of approval laid down for investment firms by the Financial and monetary code. Persons referred to in 7 must be subject in their State of origin to rules governing the custody or administration of financial instruments and supervision equivalent to those applied in France. The AMF exercises, in relation to such persons, the powers of supervision and sanction stipulated for investment service providers in the Financial and monetary code, taking the supervision carried out by the proper authorities of each State into account.

In practice, French custodians are either the issuers of the relevant (registered) securities, or are regulated and supervised as investment service providers. Only banks (not investment firms) are, strictly speaking, allowed to hold client money (investment firms must either deposit client money in a bank or use such money to purchase qualifying money market funds).

In order to provide investment services, including custody services, investment service providers must obtain authorisation by the ACP. Prior to granting approval to an investment firm, the ACP verifies that (Article L. 532-2 of the Monetary and Financial Code):

- Its registered office and its principal administrative establishment are in France;

- It has, in view of the nature of the service it wishes to provide, sufficient initial capital as determined by the Minister for the Economy as well as suitable and sufficient financial resources;

- It has indicated the identities of its direct or indirect shareholders, natural persons or legal entities, who have a qualified equity holding, as well as the amount of their holdings; the ACP assesses the status of those shareholders in regard to the necessity of guaranteeing sound and prudent management of the investment firm.

- Its policy is determined by at least two persons possessing the necessary respectability and competence and adequate experience for that function;

- It has a legal form suitable for the business of an investment firm;

- It has an activities schedule for each of the services it intends to offer which specifies the manner in which it envisages providing the investment services concerned and indicates the type of transactions envisaged and its organisational structure.

The Committee may attach to the approval granted special conditions intended to maintain the balance of the company's financial structure. It may also make the awarding of approval subject to compliance with undertakings given by the applicant firm. The committee may refuse to grant approval if performance of the supervisory function in relation to the applicant firm is likely to be impeded either by the existence of links of capital or direct or indirect control between the company and natural persons or legal entities, or by the existence of laws or regulations of a State outside the European Economic Area which one or more of those legal entities or natural persons are governed by.

The investment firm must meet the conditions of its approval at all times.

Note however that the holding (or not) of funds by an investment firm is a characteristic to be mentioned in the program of activities (included in the accreditation package) which is examined by the AMF (for opinion to the ACP) and the ACP during the procedure of authorization.

In addition, investment firms holding funds for their customers are required to comply with the Order of 2 July 2007 relating to the segregation of customer funds.

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

See the previous answer. In addition, there is a specific minimum requirement regarding minimum capital set at 3.8 million euros (Regulation CRBF n° 96-15).

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

The ACP supervises the compliance of investment firms with the regulatory framework relating to the segregation of funds held for the customers (i.e. Order of 2 July 2007). In this respect, the investment firms are required to make sure that their auditors report at least once a year to the ACP on the compliance of the measures taken with respect the regulatory requirements. If, pursuant to a foreign regulation similar to the one set forth in the Order of 2 July 2007, certain funds held for customers must be segregated specifically, verification of the requirements of the Order shall be extended to include verification of such specific provisions.

The General Secretariat of the ACP supervises, on a quarterly and sub-consolidated basis, (i) the amounts of customers' funds to be segregated by investment firms, and (ii) the eligible assets held by investment firms and deposited with custodians.

The ACP may object to the inclusion of certain assets or the exclusion of certain liabilities when implementing the provisions of the Order if it considers that such assets or liabilities do not satisfactory meet the conditions contained in the regulations or that their inclusion or exclusion is liable to distort assessment of the effective capacity to repay customers' funds.

The ACP may, under exceptional circumstances, allow an investment firm subject to the Order of 2 July 2007 time to bring its situation into compliance with the regulatory provisions.

The AMF also supervises compliance by investment service providers and custodians of all laws and regulations applicable to them and summarized in this survey.

Article L. 621-7 of the Financial and Monetary Codes defines the AMF regulatory powers with regards to investment service providers and the conditions in which they comply with their obligations (see IV of Article L. 621-7), as well as with regards to the custody and administration of financial instruments (see VI of Article L. 621-7°).

The AMF has the power to conduct controls (see Article L. 621-9) in these entities to check that they comply with their obligations and to take sanctions if they do not (see Article L. 621-15, II).

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

    a. Must the Client Assets of one client be maintained separately from those of other clients?

As regards the funds of investment firms' customers: No. However, they must be either deposited in an account maintained by a bank, or used to purchase qualifying money market funds (see below).

As regards financial instruments: Yes. See above Articles 322-17 and 322-4 of the AMF GR. In addition, as per Article 313-13 of AMF GR, investment service providers must keep such records and accounts as are necessary to enable them at any time and without delay to distinguish assets held for one client from assets held for other clients, and from their own financial instruments.

When the custody account-keeper uses the services of an agent, as provided for in Article 322-39, it must ensure that the same segregation is made on the books of the agent.

Administered registered financial instruments must be held in book entry form with the issuer in the name of the owner, in accordance with the information provided by the custody account-keeper that administers the instruments.

i. Are Investment Firms allowed to hold Omnibus Accounts?

There is no specific regulatory requirement on this issue regarding client money. Please note however that in accordance with the Article 3, title II of the Order of 2 July 2007, investment firms are required to deposit all of the funds of their clients on one or more accounts opened specially for this purpose, separately identified from any other account used to hold funds belonging to the investment firm, with one or more of the following institutions:
– central bank;
– credit institution authorised in a Member State of the European Community or another Member State of the European Economic Area;
– bank authorised in a third country;
– "qualifying money market fund".

Investment firms subject to the Order of 2 July 2007 should at any moment be able to produce a justification of their compliance with this obligation.

With regard to the investment service provider's accounting procedures which ensure the safe accounting and safeguarding of the clients assets in financial instruments: See the developments below on Articles 322-1 and following of the AMF GR.

The following material is taken from the French answers to Question 14(ii) of the FSB survey on client asset protection:

- Client money held by credit institutions (deposits)

Credit institutions are not subject to the principle of segregation due to the nature of their activities which is receiving [money from] clients, recorded as liabilities.

The absence of segregation of client money has no impact on the identification of client assets since the amounts due to each client are recorded as liabilities. It has no direct impact on the transfer to a third party. It does not slow down the speed of money recovery nor its amount thanks to the deposit guarantee scheme, up to100 000 euros (above, recovery may be delayed or may fail, since depositors rank *pari passu* with the claims of other unsecured creditors).

- Client money held by investment firms

There are specific rules in relation relating to client money held by investment firms. They are contained in an order of 2 July 2007.

Protection of [client money]:
The [money] of clients that an investment firm holds must be deposited in [a credit] institution [, in a central bank or in a qualified monetary market fund] within a specific account. (…) [Cf. article 3 of the order of 2 July 2007]
The branches whose head office is located in another Member State are subject to the regulatory requirements relating to the information to be provided to clients (title IV of the Order of 2 July 2007).
Investment firms have to reconcile regularly between their accounts and the register of the [entity where the money is deposited]. They are also required to report to the ACP on a quarterly basis and provide clients with all the relevant information. (…).

This segregation of client money eases the identification of client money. It is likely to ease the transfer to a third party and it ensures, as a principle, a quick and total money recovery. Moreover, in case of unavailability of the funds, the securities guarantee scheme guarantees recovery up to 70 000 euros.

- Financial instruments owned by the client

Protection of financial instruments:
Pursuant to MiFID article 13.7 transposed at article L533-10, 6, [investment service providers] must, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the [investment service provider] 's insolvency, and to prevent the use of a client's instruments on own account except with the client's express consent.

This principle is further detailed in the implementing directive of MiFID (European directive 2006/73/EC of 10 August 2006) transposed in the AMF GR (Articles 313-13 to 313-17 and Article 314-39), as follows:

**Article 313-13**
Investment services providers must comply with the following obligations to safeguard their clients' rights in relation to the financial instruments belonging to the clients:
1° They must keep such records and accounts as are necessary to enable them at any time and without delay to distinguish assets held for one client from assets held for other clients, and from their own financial instruments.
2° They must maintain their records and accounts in a way that ensures their accuracy, and in particular, their correspondence to the financial instruments held by clients.
3° They must conduct periodic reconciliations between their internal accounts and records and those of the third parties with whom the clients' financial instruments are held.
4° They must take the necessary steps to ensure that any client financial instruments deposited with a third party can be identified separately from the financial instruments belonging to the investment services provider by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection;
5° They must introduce adequate organisational arrangements to minimise the risk of loss or diminution of clients' assets or of rights in connection with those financial instruments resulting from misuse of the financial instruments, fraud, poor administration, incorrect record-keeping or negligence.

Moreover, according to article 322-4 of AMF GR, a custody account-keeper must in all circumstances meet the following obligations:
1° The custody account-keeper does its utmost to safeguard the financial instruments in its custody and, to this end, ensures that all financial instruments and movements affecting them are booked in strict accordance with applicable rules and procedures. The custody account-keeper also does its utmost to facilitate the exercise of rights attached to financial instruments in its custody.
2° The custody account-keeper may not make any use of the financial instruments and attached rights in its custody, nor transfer title thereto, without the express consent of the holder. The custody account-keeper organizes its internal procedures to ensure that any movement affecting the financial instruments it holds in custody on behalf of third parties is justified by a properly recorded transaction in a third-party account.
3° The custody account-keeper has an obligation to return any financial instruments held in book entry form on its books.
If such instruments exist only in book-entry form, the custody account-keeper responsible for making those entries transfers the instruments to the custody account-keeper that the account holder designates. Such transfer is carried out as quickly as possible provided the account holder has fulfilled his own obligations."

Its obligation to segregate securities which belong to collective investment schemes from those which belong to its clients and those which belong to it stems from article 322-17 of the AMF GR.

As regards CSDs:

Currently, as stated in Terms and conditions Book I of Euroclear France, the customer securities are protected from theft, loss or misuse since the records maintained enable the identification of the customer's holding of securities at any time and without delay.

As regards segregation, the CSD maintains records that identify the assets of each client and enables them to segregate their own assets from those of their own clients.
Article 322-4 3° of the AMF GR foresees that custody account keepers also have the obligation to make sure that their own assets are segregated from those of their clients in the books of the central securities depository.

As regards CCPs:

There is no obstacle to segregation in French law which is provided for contractually in the CCP terms and conditions.

When EMIR comes into force, segregation will be provided for in Article 39 indents 1 to 7. In particular, Article 39-1 of EMIR provides: "A CCP shall keep separate records and accounts that shall enable it, at any time and without delay, to distinguish in accounts with the CCP the assets and positions held for the account of one clearing member from the assets and positions held for the account of any other clearing member and from its own assets".

The obligation of segregation eases the identification of the assets. It is likely to ease their transfer to a third party and the speed of their recovery. As regards the amount to recover, it is a very favorable factor since it helps ensuring the localization of assets and the identification of the rights on these assets.

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

As regards funds, the existing measure to prevent this risk is embedded in the segregation rule that prohibits netting the accounts receivable from customers (the losses of a customer will render its account debtor) with accounts payable (see response to question 3. b. i. C).

As pointed out in the answer to the question 2 b), the ACP may also object to the inclusion of certain assets or the exclusion of certain liabilities.

With regards to financial instruments, the custody account-keeper must in all circumstances do its utmost to safeguard the financial instruments in its custody and, to this end, ensure that all financial instruments and movements affecting them are booked in strict accordance with applicable rules and procedures. It may not make any use of the financial instruments and attached rights in its custody, nor transfer title thereto, without the express consent of the holder.

It must organize its internal procedures to ensure that any movement affecting the financial instruments it holds in custody on behalf of third parties is justified by a properly recorded transaction in a third-party account (see AMF GR, Article 322-4).

It must also ensure that, barring any legal or regulatory provision to the contrary, any movement of financial instruments affecting the account of an account holder is carried out only on the instruction of that account holder, his representative, or, in certain cases such as inheritances, an authorised third party (see AMF GR, Article 322-6).

There are also the prohibitions and rules to prevent "lending from the box" i.e. unauthorized securities lending whereby one client's securities would be used to settled another client's trade (see 2° of Article 322-4 and Articles 322-32 to 322-35 of AMF GR).

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

As regards the funds of investment firms' customers, the amount to be segregated shall be calculated by adding together the following items (see Articles 4, I & II called "the segregation rule", Order of 2 July 2007):
– the credit balance of customers' cash accounts;
– sums deposited with the investment firm subject to this Order by customers, in order to cover and guarantee transactions related to the provision of investment services and all other sums used to carry out these transactions or resulting from these transactions;
– among all accounts tracking current transactions linked to the accounts or sums, sums due to customers but not yet credited to their accounts and, for transactions where delivery versus payment applies.

The following sums shall be deducted from that amount: sums credited to customer accounts or to accounts tracking their current transactions and transactions awaiting collection by the investment firm.

As for securities, there is also a requirement that investment service providers conduct periodic reconciliations between their internal accounts and records and those of the third parties with whom the clients' financial instruments are held (Article 313-13 of AMF GR).

In addition, the accounting system for financial instruments must implement procedures for ongoing verification of the accuracy of available asset account balances, with the aid of documentation of the corresponding assets provided by the central depository, the custody account-keepers having custody of the financial instruments, and the legal persons that issued them by means of a public offer of securities. Any discrepancy must be substantiated. (AMF GR Article 322-30).

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

There is no such a requirement. Client assets are fungible, in particular securities (fully dematerialized).

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

As far as customers' funds are concerned, investment firms are required to conduct reconciliation on an aggregate basis, in accordance with Article 3 of the Order of 2 July 2007.

Moreover, Article 5 of the Order provides that investment firms "must regularly reconcile their accounts and internal registers with those of third parties with whom those assets are held".

Beyond the approximation which is made on an aggregate basis, the regulatory framework requires investment firms to have an audit trail up to the individual customer account (internal registers).

C) If a client has a debit balance (i.e. the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

No. The accounts receivable (debit balance) of the customer cannot be deducted from the credits. Sums already reflected in the books of the investment firms and submitted by customers cannot be deducted from the customers' funds to segregate on the grounds that they are owed by customers to the investments firm (e.g. funds used to cover transactions with deferred settlement).

No. One client's net debit balance does not reduce the firm's obligations with respect to the required funds to be held on deposit for net credit balances of other clients.

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

Regarding funds, reconciliation is required to be conducted regularly (e.g. on a daily basis).

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

There are no regulatory requirements on this issue. Note, however, that the date of reconciliation to provide to the ACP in regulatory reporting is the last day of the quarter.

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

The funds deposited in an investment firm by clients are not part of the assets of the investment firm. Should securities be missing (in case of a fraudulent use by the custodian for instance), the depositor of such securities is covered by the Securities Deposit Guarantee Fund.

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

No. There is no "buffer".

**Answer to question b) with regards to financial instruments**: see above, AMF GR Article 313-13, as further detailed by Articles 322-17 to 322-31:

For the purpose of ascertaining and monitoring the rights of account holders, financial instrument accounts must be kept according to the rules of double-entry book-keeping. The terminology of these accounts and the operating rules applicable to them are specified in an AMF instruction. For purposes of control, this terminology classifies financial instruments belonging to collective investment schemes, to other clients and to the custody account-keeper itself into distinct categories. An ordinary individual financial instrument account must not be in debit on the settlement date of any instrument sold therefrom.

The custody account-keeper must establish procedures to:
1° identify any trade or disposal that could lead to a debit balance on the financial instrument account at the settlement date;
2° prevent the occurrence of such debit balance.

Transactions are recorded on the books of account as soon as the custody account-keeper has knowledge of them.

When transactions remain to be confirmed between the custody account-keeper and its counterparties, the corresponding commitments are recorded in off-book entries if they do not give rise to entries on the books of account.

Accounting provides all information needed to manage the settlement of transactions.

Every book entry is justified either by:
1° a written document, or
2° unalterable electronic data.

In respect of holders of accounts in administered registered financial instruments, the authorised intermediary serving as custody account-keeper must at all times be able to show that the book entries for such holdings correspond exactly to those on the books of the issuing entity. A daily record is kept of changes in registered owner that have not been transmitted to the central depository within the required time limit and are still to be transmitted.

Processing procedures are organised in such a way as to ensure complete entry, reliability and safeguarding of basic data, in particular data relating to account holders, financial instruments held in custody, counterparties and corporate actions and events affecting such instruments.

The processing system is able to produce the following documents for each of the financial instruments held in custody:
1° record of movements in the financial instruments;
2° record of financial instrument accounts opened under all classes of the chart of accounts.

These records are retained for the period required by applicable regulations (usually 5 years).

The custody account-keeper establishes an audit trail linking the cash and securities entries corresponding to a given transaction, by means of either common references or rules of administration.

The accounting system for financial instruments is designed to provide evidence of the overall balance in each financial instrument on the basis of the balances in each holder's account and the balances on transactions in progress (balance audit trail) and to allow reconstruction of each balance from the detailed transactions that gave rise to it (book entry audit trail). Such justifications may be performed on a daily basis.

The accounting system for financial instruments is organised to enable verification of the accuracy of the processing procedures.

For each financial instrument, the following are checked daily:
1° Equality between the total of all credit entries to accounts and the total of all debit entries;
2° Balance between accounts with credit balances and accounts with debit balances.

The accounting system for financial instruments is also organised to enable verification of the data by means of appropriate procedures.

The accounting system for financial instruments implements procedures for ongoing verification of the accuracy of available asset account balances, with the aid of documentation of the corresponding assets provided by the central depository, the custody account-keepers having custody of the financial instruments, and the legal persons that issued them by means of a public offer of securities. Any discrepancy is substantiated.

The date on which receipt or delivery of financial instruments is normally expected is recorded. The recorded date takes into account the specific characteristics of cross-border transactions.

For all of the financial instruments concerned, a report on net fails in financial instruments and in cash is provided daily to the department with operating responsibility for counterparty payment and settlement transactions.

For the purposes of this Article, net fails include:
1° Transactions that have not been agreed within the scheduled time period.
2° Pending deliveries and payments relating to transactions that have been "agreed" with the counterparties but have not been completed within the scheduled time period.

The report on net fails is broken down by counterparty, and each line of the report shows the originally scheduled settlement date.

Confirmation by the counterparties of identified net fails in financial instruments or in cash is sought on a regular basis.

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

Not as far as funds are concerned.

As far as financial instruments are concerned and as explained above, there are rules that prevent this since custodians may not make any use of the financial instruments and attached rights in custody, nor transfer title thereto, without the express consent of the holder. In addition, the custody account-keeper must organize its internal procedures to ensure that any movement affecting the financial instruments it holds in custody on behalf of third parties is justified by a properly recorded transaction in a third-party account.

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

As regards the funds held by investment firms for their customers, investment firms, or any other party holding such client assets (with the exception of "qualifying money market fund"), are not allowed to invest, encumber, rehypothecate, stock-lend, or otherwise deal with the client assets. "Qualifying money market funds" are required, in order to achieve their primary objective (maintain the net asset value of the undertaking either constant at par – net of earnings – or at the value of the investors' initial capital plus earnings), to exclusively invest in high-quality money market instruments with a maturity or residual maturity of no more than 397 days, or for which regular yield adjustments in accordance with the annual maturity is 60 days. It may also achieve this objective by additionally investing in deposits with credit institutions.

The ACP (see Article 9 of Order of 2 July 2007) may object to the inclusion of certain assets or the exclusion of certain liabilities when implementing the provisions of this Order if it considers that such assets or liabilities do not satisfactorily meet the conditions contained in the regulations or that their inclusion or exclusion is liable to distort assessment of the effective capacity to repay customers' funds.

The conditions in which an investment service provider may use its client's financial instruments are set by the AMF GR (Article 313-17 as well as Article 322-4 2°).

Article 313-17:
I. - Investment services providers may not enter into arrangements for securities financing in respect of financial instruments held by them on behalf of a client or otherwise use such financial instruments for their own account for the account of one of their other clients, unless the client has given his prior express consent for the use of the instruments on specified terms, as evidenced, in the case of a retail client, by his signature or an equivalent alternative mechanism.
The use of that client's financial instruments must be restricted to the specified terms to which the client has consented.
II. - Investment services providers may not enter into arrangements for securities financing transactions in respect of financial instruments held by them on behalf of a client in an omnibus account maintained by a third party, or otherwise use financial instruments held in such an account for their own account or for the account of another client unless at least one of the following conditions is met:
1° Each client whose financial instruments are held on an omnibus account must have given consent in accordance with I.
2° The investment services provider must have systems and controls to ensure that only financial instruments belonging to clients who have given prior consent in accordance with I are so used.

The investment services providers' records shall include data on the client on whose instructions the financial instruments have been used and on the number of financial instruments used belonging to each client who has given his consent, so as to enable the allocation of any loss of financial instruments

Article 322-4:

2° The custody account-keeper may not make any use of the financial instruments and attached rights in its custody, nor transfer title thereto, without the express consent of the holder. The custody account-keeper organises its internal procedures to ensure that any movement affecting the financial instruments it holds in custody on behalf of third parties is justified by a properly recorded transaction in a third-party account.

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

Under French law, only the terms "right of use" are specified. The term "re-hypothecation" is not used.

The legal concept corresponding to the "right of use" stems from Article L. 211-38 III of the French Monetary and Financial Code implementing the financial collateral directive n° 2002/47/EC of 6 June 2002:

*"Article L. 211-38 III. - The deed providing for the sureties referred to in paragraph I may specify the circumstances in which the beneficiary of those sureties may use or dispose of the relevant property and rights, on condition that he return equivalent property or rights to the grantor. The sureties concerned then relate to the equivalent property or rights thus returned as if they had been established on the same equivalent property or rights from the outset. The said deed may allow the beneficiary to offset his liability to return equivalent property or rights against the financial obligations in respect of which the sureties were established, when they have become due.*

*Equivalent property or rights shall be taken to mean:*

*1° In relation to cash: a sum of the same amount in the same currency.*

*2° In relation to financial instruments: financial instruments from the same issuer or debtor, forming part of the same issue or the same category, having the same denomination, denominated in the same currency and having the same designation, or other assets, when the parties so provide, in the event of a fact occurring which concerns or affects the financial instruments that constitute the guarantee.*

*For property or rights other than those referred to in paragraphs 1 and 2, the same property or rights shall be returned."*

It is thus the right, contractually agreed with the pledgor, for a pledgee to use the pledged assets which belong to the pledgor.

As a consequence, in the present answer, any reference to re-hypothecation is understood as a synonym of reuse.

It should also be noted that strictly speaking, in France, the right of use provided by Article L. 211-38 III only concerns assets which are pledged, to the exclusion of assets ceded temporarily as collateral. Indeed, in case of transfer of ownership, there is no need to benefit from a "right of use", since

ownership automatically includes a right of use (as ownership is legally composed of rights of "*usus*", "*abusus*" and "*fructus*").

For the purpose of the present survey, we generally use the expression "right of use" in its broad sense, i.e. a right stemming either from Article L. 211-38 III or from ownership.

If the client has given a right of reuse to the investment firm and the firm has exercised the rights to reuse, the client has lost his ownership right on the asset. This means that the client has a claim on equivalent securities. In case of failure of the firm, the client is therefore one creditor among others.

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

This is addressed by Article 322-4 of the AMF GR:

2° The custody account-keeper may not make any use of the financial instruments and attached rights in its custody, nor transfer title thereto, without the express consent of the holder. The custody account-keeper organises its internal procedures to ensure that any movement affecting the financial instruments it holds in custody on behalf of third parties is justified by a properly recorded transaction in a third-party account."

Therefore, as regards investment service providers, the use of financial instruments is authorized only with the prior express consent of the holder. In case of a retail client, it is specified that this consent must be evidenced by his signature or an equivalent alternative mechanism.

See also the above answer.

iii. How are the ownership rights of a client over its client assets changed or affected when the investment firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (i.e. established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

If a client has given a right of reuse to the investment firm, in application of Article 313-17 of the GR of the AMF, in case the firm has not exercised its rights to reuse, the client still has an ownership right on his assets.
When the client has not given a right of reuse to the investment firm, the client keeps its ownership rights on its assets.
Therefore, there is no difference regarding the rights on the securities by the client, which still has a restitution right over them.

If the client has given a right of reuse to the investment firm and the firm has exercised the rights to reuse, the client has lost its ownership right on the asset. It means that the client has a claim on

equivalent securities. In case of failure of the firm, the client is therefore one creditor among others.

Should the firm use/reuse the client's securities without the client's consent and therefore in breach of the regulations, there are two situations:

i) if the firm is solvent, the rights of the client are not impacted;

ii) if the firm is insolvent, the client loses its ownership rights and becomes an unsecured creditor of the firm (the client may also benefit from the statutory investor compensation scheme).

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

At present, AMF General Regulation (Art. 541-23 4th indent) states that "The funds deposited by clearing members with the clearing house to cover their commitments are invested in liquid assets with little risk of principal."

Under Article 47 of EMIR[1] (entering into force in January 2013):
1. Financial instruments posted as margins or as default fund contributions shall, where available, be deposited with operators of securities settlement systems that ensure the full protection of those financial instruments. Alternatively, other highly secure arrangements with authorised financial institutions may be used.

2. Cash deposits of a CCP shall be held through highly secure arrangements with authorised financial institutions or, alternatively, through the use of the standing deposit facilities of central banks or other comparable means provided for by central banks.

3. Where a CCP deposits assets with a third party, it shall ensure that the assets belonging to the clearing members are identifiable separately from the assets belonging to the CCP and from assets belonging to that third party by means of differently titled accounts on the books of the third party or any other equivalent measures that achieve the same level of protection. A CCP shall have prompt access to the financial instruments when required.

In addition, Article 39 of EMIR requires that each CCP offers the choice between omnibus client segregation and individual client segregation:

"1. A CCP shall keep separate records and accounts that shall enable it, at any time and without delay, to distinguish in accounts with the CCP the assets and positions held for the account of one clearing member from the assets and positions held for the account of any other clearing member and from its own assets.

[1] REGULATION (EU) No 648/2012 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

2. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions of that clearing member from those held for the accounts of its clients ('omnibus client segregation').
3. A CCP shall offer to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions held for the account of a client from those held for the account of other clients ('individual client segregation'). Upon request, the CCP shall offer clearing members the possibility to open more accounts in their own name or for the account of their clients.
4. A clearing member shall keep separate records and accounts that enable it to distinguish both in accounts held with the CCP and in its own accounts its assets and positions from the assets and positions held for the account of its clients at the CCP.
5. A clearing member shall offer its clients, at least, the choice between omnibus client segregation and individual client segregation and inform them of the costs and level of protection referred to in paragraph 7 associated with each option. The client shall confirm its choice in writing.
6. When a client opts for individual client segregation, any margin in excess of the client's requirement shall also be posted to the CCP and distinguished from the margins of other clients or clearing members and shall not be exposed to losses connected to positions recorded in another account.
7. CCPs and clearing members shall publicly disclose the levels of protection and the costs associated with the different levels of segregation that they provide and shall offer those services on reasonable commercial terms. Details of the different levels of segregation shall include a description of the main legal implications of the respective levels of segregation offered including information on the insolvency law applicable in the relevant jurisdictions.
8. A CCP shall have a right of use relating to the margins or default fund contributions collected via a security financial collateral arrangement, within the meaning of Article 2(1)(c) of Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements ( 1 ) provided that the use of such arrangements is provided for in its operating rules. The clearing member shall confirm its acceptance of the operating rules in writing. The CCP shall publicly disclose that right of use, which shall be exercised in accordance with Article 47.
9. The requirement to distinguish assets and positions with the CCP in accounts is satisfied where:
(a) the assets and positions are recorded in separate accounts;
(b) the netting of positions recorded on different accounts is prevented;
(c) the assets covering the positions recorded in an account are not exposed to losses connected to positions recorded in another account.(...)"

Also, the investment firm that is a member of the CCP will be required to open a specific account for the clearing of transactions of the customers. The clearing house will then calculate margin calls separately between the own account and third party account.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

    a. Client Assets transferred to or located in other jurisdictions?

Yes, for both client money and financial instruments.

Article 5 of the Order of 2 July 2007 requires that, when sums are deposited with a credit institution authorized by a Member State of the European Community or another Member State of the European Economic Area or a bank authorized in a third country, they may be paid into sight or time accounts. The account name shall mention the appropriation of the sums deposited in compliance with the provisions of the Order of 2 July 2007. Investment firms must also regularly reconcile their accounts and internal registers with those of third parties with whom these assets are held. That supposes the Regime has to be the same in another jurisdiction concerning holding of clients' funds. Moreover, the investment firms have to distinguish, in their quarterly reports provided to the ACP, between the funds deposited with (i) credit institutions which have been authorized in a member State of the European Community or the European Economic Area, (ii) banks authorized in a third country and (iii) funds in a "qualifying money market fund".

With regards to financial instruments, the relevant regulations are Articles 313-15 and 313-16 of AMF GR (see above). The separate identification is governed by the general rules regarding the identification of client's assets (see above answers).

In addition, Article 322-45 sets the following rules with regards to the safety of assets held in another jurisdiction:
The security of financial instruments held in custody outside France, for the account of customers and through the medium of an agent as referred to in Article 322-39, is ensured by a signed agreement between the custody account-keeper and the agent. This agreement specifies or provides for, inter alia:
1° The terms and conditions under which account(s) will be kept in the name of the custody account-keeper on the books of the agent;
2° The obligation of the agent to provide as quickly as possible all information relating to movements on the account(s) of the custody account-keeper, as well as periodic reports on the financial instruments on deposit;
3° Implementation of the requirement mentioned in the seventh paragraph of Article 322-4 (segregation);
4° Observance of local practices.

In addition, the ACP considers that this is outsourcing and therefore that the corresponding regulation applies.

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

c. If so, please provide details of those requirements.

The Order of 2 July 2007 requires that, if pursuant to a foreign regulation similar to the one set forth in this Order, certain funds held for customers must be segregated specifically, verification of the requirements of the Order shall be extended to include verification of such specific provisions.

For financial instruments, the separate identification is governed by the general rules regarding the identification of client's assets (see above answers).

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by

Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

II 4

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

II 4

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

Regarding financial instruments, omnibus accounts are not allowed in France. The principle is that all accounts are individually titled (except at CSD level and at other intermediary levels that do not confer ownership rights). See the answers to Question 3 above.

Regarding client money, see also the answers to Question 3 above.

The following further explanation may be helpful. If a non-French bank/investment firm holding client securities asks a French bank/investment firm to hold them on its behalf, the French entity will open a dedicated account for the securities of the clients of the foreign entity (the account will not contain the securities of anyone else). On request, the French entity will open a dedicated account for each of the clients of the non French entity. This will enhance the level of protection but will be more costly.

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

See the answers to Question 2 above on the licensing of custodians.

As already mentioned, subject to the accounting provisions set forth in Article 322-17 of the AMF General Regulation, the custody account-keeper must ensure that the assets of its customers, including those of any collective investment scheme for which it is custodian, are segregated from its own assets on the books of any central securities depositories of which it is a member.

When the custody account-keeper uses the services of an agent, as provided for in Article 322-39, it ensures that the same segregation is made on the books of the agent (article 322-4 of the AMF GR).

**Articles 313-14 to 313-16 of the AMF GR relate to sub-depositing** and provide for the following:

Investment services providers using a third party to hold their clients' financial instruments must exercise all due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements made by said party for the holding of those financial instruments. They must take into account the expertise and market reputation of the third party, as well as any legal or regulatory requirements or market practices related to the holding of those financial instruments that could adversely affect clients' rights.

If investment services providers use a third party to hold their clients' financial instruments and that third party is located in another country that has specific regulations and supervision regarding the holding of financial instruments on behalf of another person, then those investment services providers must choose a third party that is subject to the specific regulations and supervision and do so in accordance with the provisions contained in the above paragraph.

Investment services providers may not use a third party to hold their clients' financial instruments if that third party is located in a State that is not party to the European Economic Area agreement that does not regulate the holding of financial instruments on behalf of another person, unless one of the following conditions is met:
1° The nature of the financial instruments or of the investment services connected with those instruments requires them to be deposited with a third party in the State that is not party to the European Economic Area agreement.
2° If the financial instruments are held on behalf of a professional client, that client makes a written request to the investment services provider to have them held with a third party in the State that is not party to the European Economic Area agreement.

In addition, the AMF GR provides that when the custody account-keeper appoints an agent or engages a third party as described in Articles 322-39 and 322-40, it conducts an assessment of the resources and procedures employed and the risks incurred. This assessment is available for review by the AMF.

The liability of the custody account-keeper to the holder of a financial-instrument account is not affected by the appointment of another custody account-keeper as agent or by the engagement of a third party to provide technical resources.

However, when a custody account-keeper holds financial instruments issued under foreign law in custody for the account of a qualified investor as defined by applicable law and regulations, the custody account-keeper may agree to share liability with that investor.

A decision issued by the highest French Court in commercial matters (Cour de Cassation, Com., 4 May 2010, n°09-14187) recently confirmed the effectiveness of the requirement that a depositary has to return the client assets even when the depositary had delegated the custody to a third party.

The impossibility (save in very limited circumstances i.e. non-French assets and qualified investors) to escape the strict obligation to return assets is a very strong protection likely to ease the transfer to a third party. It guarantees immediate recovery and improves the chance to maximize the amount to recover.

The property rights recognized at the investor's account level combined with the obligation imposed to the custody account keeper to segregate its financial instruments from those held for the account of its clients guarantees (except in the case of a fraud) the restitution of client assets even in case of

insolvency. This is strengthened by the maintaining of the obligation to return its clients assets even in the case of sub-custodianship.

The segregation obligation is of the utmost importance since it is a prerequisite to the identification of client assets and therefore their transfer to a third party if needed.

The speed and amount of the client asset recovery would depend on the contractual arrangements made and principally re-use agreements which explain the ring fencing of those agreements in the French Law.

In the case of unavailability of client assets, the French Monetary and Financial code sets up a securities guarantee scheme (Articles L. 322-1 and following) that ensures that client securities will be returned (up to 70 000 euros).

As regards client money, investment firms are required to deposit all of the funds of their clients with one or more or the following institutions: central bank, credit institutions authorized in a member State of the European Community or another Member State of the European Economic Area, bank authorized in a third country and "qualifying money market fund".

Note that a "qualifying money market fund" means a collective investment undertaking as defined or subject to supervision, and, if applicable, authorised by an authority under the national law of a Member State of the European Community or another Member State of the European Economic Area, and that meets the following conditions:
i. its primary investment objective must be to maintain the net asset value of the investment firm either constant at par (net of earnings) or at the value of the investors' initial capital plus earnings;

ii. to achieve its primary investment objective, it must invest exclusively in high-quality money market instruments with a maturity or residual maturity of no more than 397 days, or for which regular yield adjustments in accordance with the annual maturity are made, and for which the average weighted maturity is 60 days. It may also achieve this objective by additionally investing in deposits with credit institutions;

iii. it must provide liquidity through same say or next day settlement. A money market instrument shall be considered to be of high quality if it has been awarded the highest credit rating by all competent rating agencies that have rated the instrument. An instrument that has not been rated by a competent agency shall not be considered to be of high quality.
The Order of 2 July 2007 also requires that in the event that the funds of the investment firm's clients are not deposited with a central bank, the investment firm must exercise extreme care, diligence and competence when selecting, appointing and conducting a periodical assessment of the credit institution, authorized bank in a third country or money market fund where these funds are deposited and of the provisions governing the holding of these funds. The investment firm must take into account the expertise and the reputation of these institutions and money market funds on the market, as well as any legal or regulatory requirement or market practice linked to the holding of clients' funds, which might have an adverse impact on clients' rights. In addition, clients have the right to oppose their funds being invested in a qualifying money market fund.

For financial instruments, Articles 313-14 to 313-16 of the AMF GR (see above) as well as Articles 322-39 and following relate to sub-depositing and provide for the following:

The custody account-keeper may appoint another entity as its agent for performing all or part of the tasks related to its custodial activity. When the custody account-keeper appointing an agent is not an issuing entity, such agent must be another custody account-keeper.
A custodial agency agreement is drawn up between the two parties (principal and agent). This agency agreement specifies, inter alia:
1° The tasks entrusted to the agent;
2° The respective responsibilities of the principal and the agent;
3° The procedures to be implemented by the principal to ensure oversight of the operations carried out by the agent.
Where an agent is responsible for keeping the client accounts of the principal on an individual basis, that agent shall ensure that the principal is following the procedures established pursuant to the second sub-paragraph of Article 322-18. If the agent finds that these procedures have not been implemented, it shall not proceed with settlement.
However, if the agent is unable to prevent completion of settlement because of technical factors relating to the operation of the settlement system, it shall ensure that no financial instrument belonging to clients is used for such purpose without the express agreement of those clients as called for in point 2° of Article 322-4.
The custody account-keeper may, simultaneously with a custodial agency agreement or independently of such agreement, engage a third party to provide it with technical resources.

When the custody account-keeper appoints an agent or engages a third party as described in above, it conducts an assessment of the resources and procedures employed and the risks incurred. This assessment is available for review by the AMF.

The liability of the custody account-keeper to the holder of a financial-instrument account is not affected by the appointment of another custody account-keeper as agent or by the engagement of a third party to provide technical resources. However, when a custody account-keeper holds financial instruments issued under foreign law in custody for the account of a qualified investor as defined by applicable law and regulations, the custody account-keeper may agree to share liability with that investor.

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

Pursuant to Article 322-42 of the AMF GR, relations between the custody account-keeper and the service providers assuming the functions of broker-dealer or clearer for the same investor are governed by conventions or contracts that specify the obligations of each party, so that any disputes over settlement or adjustment of securities transactions can be resolved as efficiently as possible.

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

With respect to financial instruments and in accordance to Article 314-39 of AMF GR, investment service providers holding financial instruments shall provide their clients with such of the following information as is relevant:

1° The investment services provider shall inform the retail client of the fact that the financial instruments or client money of that client may be held by a third party on behalf of the investment services provider and of the responsibility of the investment services provider for any acts or omissions of the third party and the consequences for the client of the insolvency of the third party.
2° Where financial instruments of the retail client may, if permitted by applicable foreign law, be held in an omnibus account by a third party, the investment services provider shall inform the client of this fact and shall provide a prominent warning of the resulting risks.
3° Where it is not possible under applicable foreign law for a retail client's financial instruments held with a third party to be separately identifiable from the proprietary financial instruments of that third party or of the investment services provider, the latter shall provide a prominent warning of the resulting risks.
4° The investment services provider shall inform the client in cases where accounts that contain financial instruments or client money belonging to that client are or will be subject to the law of a jurisdiction other than that of a State party to the European Economic Area agreement and shall indicate how the rights of the client relating to those financial instruments or client money may differ accordingly.
5° The investment services provider shall inform the client about the existence and the terms of any security interest or lien which the provider has or may have over the client's financial instruments or client money, or any right of set-off it holds in relation to those instruments. Where applicable, it shall also inform the client of the fact that a custodian may have a security interest or right of set-off in relation to those instruments.
6° An investment services provider, before entering into securities financing transactions in relation to financial instruments held by it on behalf of a retail client, or before otherwise using such financial instruments for its own account or the account of another client, shall in good time before the use of those instruments provide the retail client, in a durable medium, with clear, full and accurate information on the obligations and responsibilities of the investment services provider with respect to the use of those financial instruments, including the terms for their restitution, and on the risks involved.

The agreement between the custody account-keeper and the account holder specifies the manner in which the account-holder is provided with statements showing the nature and number of financial instruments held in the account.

The AMF GR also states that the custody account-keeper must inform each holder of a financial instrument account as quickly as possible (i) of events affecting the account holder's rights in respect of the financial instruments in custody, whenever the account-keeper has reason to believe the account holder is unaware of them, (ii) of executed trades or other movements in the financial instruments or cash held in the account holder's name.

With respect to client money, investment firms are required to communicate to their "non-professional" clients (see above definition) or potential clients the following information on the maintenance of client money:
a)

- when funds are invested in a qualifying money market fund, the possibility of them being held by a third party in the name of the investment firm as well as the responsibility carried by the latter, according to the national law of the country under consideration, for any action or omission of the third party, or its possible insolvency and its consequences for the client;

- in the other cases, the holding of these client money by a third party in the name of the investment firm as well as the responsibility carried by the latter, according to the national law of the country under consideration, for any action or omission of the third party, or its possible insolvency and its consequences for the client;

b) The cases in which the accounts mentioned are or will be governed by a law other than the national law of a Member State of the European Community or another Member State of the European Economic Area, by specifying to what extent the rights of the client are affected;

c) The existence or conditions of any security interest or lien that the investment firm has or could have over the client money of the client, or of any right of set-off it holds in relation to client money. If necessary, the investment firms shall inform the client that a custodian may have a security interest or lien, or a right of set-off in relation to client money.

Investment firms are also required to communicate to their professional clients or potential clients the information under b) and c).

The investment firms shall provide the clients for whom they hold client money with a statement of these client money at least once a year on a durable medium, unless the same information is available in another periodical information notice, notably the statement of financial instruments set out in the AMF GR.

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

The waiver of the segregation requirement is not authorized under French law.

The only form of waiver allowed relates to the restitution requirement. With respect to non French securities held for a qualified investor, the parties may agree to share liability, as mentioned above. It is also possible for certain professional collective investment schemes to share liability for the restitution of assets with the investment service provider that holds them in custody.

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

- Client money held by credit institutions

On a permanent basis, credit institutions have to report to the ACP the global amount of client deposits held, and moreover there is a dedicated reporting on deposits eligible to the Deposit Guarantee Scheme. Financial firms must also provide any information to the ACP upon request when circumstances require.

- Client money held by investment firms

As regards client money held by investment firms, each investment firm must ensure that its statutory auditor makes a report to the ACP at least annually on the adequacy of the measures taken to comply with the provisions on safeguarding of the client money (Article 7 of the Order of 2 July 2007).

Required disclosures are provided to the ACP in the framework of accounting reports and internal control reports. In this respect, the investment firms are required to report on a quarterly basis, quantitative information relating to the amounts of client money to be segregated.

- Financial instruments held by custody account-keepers

According to Article 313-17-1 of the AMF GR, each custody account-keeper shall ensure that its statutory auditor makes a report to the AMF at least annually on the adequacy of the measures taken by the firm to comply with the provisions on safeguarding of the client financial instruments.

Required disclosures are provided to the ACP in the framework of accounting reports and internal control reports. In this respect, the investment firms are required to report on a quarterly basis, quantitative information relating to (i) the amounts of client money to be segregated and (ii) the amounts of financial instruments eligible for the Investor Compensation Scheme. In addition, custody account-keepers report annually to the AMF on the scale of their custody activities and whether they have outsourced any of these activities.

a. Does the Investment Firm report where client assets are held?

No. As far as French securities held in an account maintained in France are concerned, the question regarding the location of client assets is likely to be relevant in France only if fraud is suspected, since the final client's securities account materializes ownership, this activity is highly regulated and most French custody account-keepers will have an account with the French CSD (Euroclear France). Concern about the location of client assets is more likely where non-French securities are involved, especially where they are held in a third country where regulation and supervision may not be adequate.

b. Does the Investment Firm or depository report the protections applicable to such client assets?

See the information provided above on annual audits of the effectiveness of safeguards regarding Client Assets (distinguishing between client money and financial instruments belonging to clients).

We are not sure what is meant by "depository" (here and elsewhere). If the question refers to depositaries of collective investment schemes, custody account-keepers report annually to the AMF on the number of CIS for which they act as depositary.

c. Does the Investment Firm or depository report the amount of assets that are held?

In each case, are such reports provided on request or periodically? If periodically, with what frequency?

Investment firms/custody account-keepers report quarterly to the ACP. See the answers provided above.

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

    a. Where Client Assets are held?

    b. The amount of Client Assets held at a depository?

    c. The safeguards applicable to Client Assets held at a depository?

Both the ACP and the AMF undertake inspections relating to Client Assets. Both custody account-keepers, especially the largest of such institutions, and the French CSD (Euroclear France) are subject to periodic inspections. Such inspections will generally focus on compliance with accounting rules and procedures, as well as segregation requirements.

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

    b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

Such requests will be handled on the basis of the applicable Memorandum of Understanding between the French and foreign regulators.

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

Such information is provided to the ACP in the framework of accounting reports and internal control reports. See above.

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*¸ capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

The principle is that the client money held by an investment firm, as well as client financial instruments held either by a bank or an investment firms, are not part of the assets of the entity. They are not concerned by the insolvency procedure or actions to be undertaken by the ACP with respect to the financial situation of the investment firm.

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

In accordance with the Article L.613-18 of the Monetary and Financial Code, the appointment of a provisional administrator is made either at the request of the management, if it is no longer able to exercise its functions normally, or at the initiative of the ACP, if the management of the institution can no longer be carried out in normal conditions, or if a sanction has been imposed. Note that the definition of insolvency applicable to non banking institution is the "inability to pay its accrued liabilities with its available assets" (Article L. 631-1 of the French Commercial Code).

Except in cases where reorganization or liquidation proceedings are initiated, the ACP, after determining that securities are unavailable because a member institution is unable to return securities held for reasons that may be related to its financial situation and that it appears unlikely that the securities will be returned soon, shall, after seeking the opinion of the AMF, ask the deposit guarantee fund to intervene under the terms of the first paragraph of Article L. 322-2 of the Monetary and Financial Code and shall notify the member institution that it has been struck off (see Article 7, Title III of Regulation n°99-14 relating to the guarantee of securities held on the behalf of the intermediaries).

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

See answer 14. Note also that the provisional administrators are appointed by taking into account the same considerations as those used by the ACP when assessing the fit and properness of the senior managers appointed by the investment firm.

16. What are the duties of the Administrative Officer?

The provisional administrators have the full powers (transferred from the senior managers in the wake of their appointment) relating to the legal entity's administration, management and representation.

The obligation of the provisional administrators is also to provide solicited information to the judge, the ACP and the Prosecutor. They also have the obligation of consulting the debtors, auditors and the representative of creditors so as to help the recovery of the investment firm.

a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

The provisional administrators have to comply with their judicial mission (assistance, supervision, administration) and the legal and contractual obligations as managers at the head of the firm.

b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

Under the administrators' own liability, the applicable regime is that of a strict liability due to misconduct incompatible with their duties.

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

The ACP does not intervene directly in the insolvency proceedings.

Note however that the judicial reorganisation and liquidation procedures cannot be initiated in relation to an investment firm until the ACP's opinion has been obtained (Article 613-27 of the Monetary and Financial Code). In the event of judicial liquidation proceedings being instituted or ordered, the ACP appoints a liquidator who draws up an inventory of the assets and gives effect to the liquidation and the redundancies (Article 613-29 of the Monetary and Financial Code).

a. Does the regulator continue to supervise the Investment Firm?

Yes, the investment firm is required to comply with the Regulations and Laws that the ACP and AMF supervise.

b. How, if at all, is the regulator involved in the process of returning Client Assets?

Indirectly (see previous answers).

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

The Monetary and Financial Code provides that, in case of insolvency of a custody account-keeper, the resolution authority verifies that the securities held by the central depository on the custody account-keeper's account are sufficient to allow compliance with its obligations vis-à-vis its account holders (Article L. 211-10).

Where the number of securities at the custody account-keeper level is insufficient, the resolution authority may proceed with a proportional repartition of the securities between the concerned account holders. The remaining securities are brought into the resolution proceedings.

The account holders might ask for the transfer of the received securities to an account held by another custody account-keeper.

Concerning the particular case of the central counterparties, the AMF GR provides that the operating rules of central counterparties include rules that, should a clearing member fail to fulfill its obligations with regard to the settlement of market transactions or to the security deposits referred to in Article 541-23, and in particular should it be the subject of any of the proceedings under Title II of Book VI of the Commercial Code (insolvency law), the clearing house can:
1° liquidate some or all of the commitments or positions taken by the defaulting clearing member for its own account, in the market conditions prevailing at the time. Subsequent to such liquidation, the clearing house can, if necessary, settle its remaining claims on the clearing member by means of the margin or other security deposits lodged by that member;
2° transfer the positions of the defaulting clearing member's clients, together with the associated assets or guarantees, to another clearing member.

EMIR (which enters into force in January 2013) provides for portability in Article 39:
10. Assets refer to collateral held to cover positions and include the right to the transfer of assets equivalent to that collateral or the proceeds of the realisation of any collateral, but does not include default fund contributions."

See also the answers to Question 6 above, especially regarding the client's property rights.

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

No, but there is work undertaken on that issue.

See also the answers provided above on EMIR and its provisions regarding CCPs.

a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

b. What factors, if any, affect the time period required to accomplish such a transfer?

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

The honoring of any prior claim to clients before the beginning of an insolvency procedure is prohibited. In principle, any such a distribution would be null and void.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

Pursuant to Article 11 of MiFID transposed in Financial and Monetary Code by the Order of July 2007, investment firms (Article L532-2, 6) and portfolio management firms authorized by the AMF (L532-9, 6) must be a member of an investor-compensation scheme as provided by the European directive 97/9/EC of 3 March 1997 on investor-compensation schemes.. The purpose of this mechanism is to compensate investors in the event of their financial instruments or their cash deposits being unavailable when they are linked to an investment service, to clearing or to financial instrument custody.

The claims of investors guaranteed are those relating to any financial instruments held on an investor's behalf that the member institution is required to return under the legal and contractual conditions that apply, especially with regard to clearing. This includes cash deposits with a member institution that is not a credit institution, including deposits made to guarantee or cover positions taken on a market in financial instruments, when such deposits relate to an investment service or to the clearing or custody of financial instruments provided by such institution.

The limit on compensation per investor is 70,000 euros. It applies to all of the same investor's assets with the same guarantee scheme member institution, irrespective of the number of accounts, their location on the territory of the French Republic or in the European Economic Area (subject to certain conditions).

Note that securities deposited by credit institutions, investment firms, insurance undertakings, collective investment organizations, pension organizations and funds are excluded from the guarantee (for more details, please refer to Regulation n°99-14).

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

Under French law, only the terms "right of use" are specified. The term "re-hypothecation" is not used. The legal concept corresponding to the "right of use" stems from article L. 211-38 III of the French Monetary and Financial Code implementing the financial collateral directive n° 2002/47/EC of 6 June 2002:"*Article L. 211-38 III. - The deed providing for the sureties referred to in paragraph I may specify the circumstances in which the beneficiary of those sureties may use or dispose of the relevant property and rights, on condition that he return equivalent property or rights to the grantor. The sureties concerned then relate to the equivalent property or rights thus returned as if they had been established on the same equivalent property or rights from the outset. The said deed may allow the beneficiary to offset his liability to return equivalent property or rights against the financial obligations in respect of which the sureties were established, when they have become due.*

*Equivalent property or rights shall be taken to mean:*

*1° In relation to cash: a sum of the same amount in the same currency.*

*2° In relation to financial instruments: financial instruments from the same issuer or debtor, forming part of the same issue or the same category, having the same denomination, denominated in the same currency and having the same designation, or other assets, when the parties so provide, in the event of a fact occurring which concerns or affects the financial instruments that constitute the guarantee.*

*For property or rights other than those referred to in paragraphs 1 and 2, the same property or rights shall be returned."*

It is thus the right, contractually agreed with the pledgor, for a pledgee to use the pledged assets which belong to the pledgor.

As a consequence, in the present answer, any reference to re-hypothecation is understood as a synonym of reuse. It should also be noted that strictly speaking, in France, the right of use provided by article L. 211-38 III only concerns assets which are pledged, to the exclusion of assets ceded temporarily as collateral. Indeed, in case of transfer of ownership, there is no need to benefit from a "right of use", since ownership automatically includes a right of use (as ownership is legally composed of rights of "*usus*", "*abusus*" and "*fructus*"). For the purpose of the present survey, we generally use the expression "right of use" in its broad sense, i.e. a right stemming either from article L. 211-38 III or from ownership.

- **Client money**
  - Client money held by credit institutions: YES

Article L. 312-2 of the Monetary and Financial Code provides that "*Money which an entity accepts from a third party, in particular in the form of deposits, with the right to use them for its own account subject to its returning them shall be deemed to be money received from the public*[2]." The receipt of money from the public is a banking transaction (Article L. 311-1 of the Monetary and Financial Code), which requires a banking license.

As a consequence, credit institutions can use deposits, without limit since they become the owner of the client money. The depositor (whether professional or not) has only a claim vis-à-vis the credit institution.

  - Client money held by investment firms (principle): NO

As regards the client money held by investment firms for their customers, investment firms, or other party holding client assets (with the exception of "qualifying money market fund"), are not allowed to invest, encumber, rehypothecate, stock-lend, or otherwise deal with the client assets.

"Qualifying money market funds" are required, in order to achieve their primary objective (maintain the net asset value of the undertaking either constant at par – net of earnings – or at the value of the investors' initial capital plus earnings), to exclusively invest in high-quality money market

2 However, the following shall not be deemed to be funds received from the public:

1. Funds received or left in an account by a partnership's named or limited partners, members or shareholders holding at least 5% of the share capital, directors, members of the Executive Board or the Supervisory Board or executives, and likewise funds deriving from equity loans;

2. Funds which a firm receives from its employees, subject to the amount thereof not exceeding 10% of its equity. Funds received from employees by virtue of special laws are not taken into account for the calculation of this threshold

instruments with a maturity or residual maturity of no more than 397 days, or for which regular yield adjustments in accordance with the annual maturity is 60 days. It may also achieve this objective by additionally investing in deposits with credit institutions.
The ACP (see article 9 of Order of 2 July 2007) may object to the inclusion of certain assets or the exclusion of certain liabilities when implementing the provisions of this Order if it considers that such assets or liabilities do not satisfactorily meet the conditions contained in the regulations or that their inclusion or exclusion is [likely] to distort assessment of the effective capacity to repay [client money].

Thus, except in the case of qualifying money market funds, there is no possibility for investment firms to use client money.

- Client money held by financial firms as collateral (specific case): NO in principle but YES if agreed

Client money granted as collateral may be subject to a right of reuse, for instance in the framework of article L. 211-38 of the Monetary and Financial Code (implementation of the Financial Collateral Directive), which enables the constitution of collateral in cash and authorises a contractual right of reuse. This means that a financial firm holding client money as collateral to its benefit may, depending on contractual arrangements, have a right of use on this client money. If its client does not comply with its financial obligation, the financial firm will be authorized to keep the money. On the contrary, if the client complies with its financial obligation, the financial firm will have to return the same amount in the same currency (art. L. 211-38, III, 3°).

- **Financial instruments: NO in principle but YES if agreed**

  - NO, the principle is the prohibition for financial firms to use financial instruments since they are still owned by the client.

    - ✓ This is the case for custody account keepers

As regards the regulation of [custody account keepers], the AMF GR's main principles are the following (see Articles 322-4 and following):
- [Custody account keepers] **must safeguard the financial instruments in its custody.** It is important to note that under French law, the holder of the financial instruments owns them. This is in contrast to certain countries where he is considered as a « creditor » (créancier) of the [custody account keeper].
- [Custody account keepers] must ensure that **no use is made of those instruments other [than] what the accountholder instructs.** This ensures among other things that the custody account [keeper] must ensure that the securities of one client are not used to settle the trades of another client, a process known as « lending from the box » or unauthorized securities lending.

*Appendix B on France of the 2011 IOSCO Survey mentions:*
"- the obligation for [custody account keepers] to return any financial instruments held in book-entry form on their books contained in the AMF GR. This is also the case when the [custody account keeper] has recourse to subcustodians. This is an "obligation de résultat" (strict liability).
- the prohibition to make use of instruments other than what the accountholder instructs. This ensures that the custody account [keeper] must ensure that the securities of one client are not used to settle the trades of another client, a process known as "lending from the box" or unauthorized

securities lending. There are also rules to prevent this. In particular, as per Article 322-18 of AMF GR: "An ordinary individual financial instrument account shall not be in debit on the settlement date of any instrument sold therefrom. The custody account-keeper shall establish procedures to:

1° identify any trade or disposal that could lead to a debit balance on the financial instrument account at the settlement date;
2° preventing the occurrence of such debit balance."

- ✓ This is the case for investment services providers (cf. below, Article 313-17 of the AMF GR).

- o <u>YES IF AGREED. The following exceptions give a right of use under strict conditions:</u>

  - ✓ As regards custody account keepers, the use of financial instruments is authorized only with the express consent of the holder.

Cf. Article 322-4 of the AMF GR:
2° The custody account-keeper may not make any use of the financial instruments and attached rights in its custody, nor transfer title thereto, without the express consent of the holder. The custody account-keeper organises its internal procedures to ensure that any movement affecting the financial instruments it holds in custody on behalf of third parties is justified by a properly recorded transaction in a third-party account."

- ✓ As regards investment service providers, the use of financial instruments is authorized only with the prior express consent of the holder. In case of a retail client, it is specified that this consent must be evidenced by his signature or an equivalent alternative mechanism.

The conditions in which an investment service provider may use its client's financial instruments are set by the AMF GR (art. 313-17 as well as art. 322-4 2°).
Art 313-17:
I. - Investment services providers may not enter into arrangements for securities financing in respect of financial instruments held by them on behalf of a client or otherwise use such financial instruments for their own account or for the account of one of their other clients, unless the client has given his prior express consent for the use of the instruments on specified terms, as evidenced, in the case of a retail client, by his signature or an equivalent alternative mechanism.
The use of that client's financial instruments must be restricted to the specified terms to which the client has consented.
II. - Investment services providers may not enter into arrangements for securities financing transactions in respect of financial instruments held by them on behalf of a client in an omnibus account maintained by a third party, or otherwise use financial instruments held in such an account for their own account or for the account of another client unless at least one of the following conditions is met:
1° Each client whose financial instruments are held on an omnibus account must have given consent in accordance with I.
2° The investment services provider must have systems and controls to ensure that only financial instruments belonging to clients who have given prior consent in accordance with I are so used.
The investment services providers' records shall include data on the client on whose instructions the financial instruments have been used and on the number of financial instruments used belonging to

each client who has given his consent, so as to enable the allocation of any loss of financial instruments."

- **Financial instruments: specific case of FMIs**

  - ✓ As regards CSDs : No.

CSDs have no right of use (they do not receive collateral as principal).

  - ✓ As regards CCPs: Yes.

The right for re-use is provided for CCPs by law (Article L. 440-7 of the Monetary and Financial Code) and in the AMF GR (Article 541-23: "The funds deposited by clearing members with the clearing house to cover their commitments are invested in liquid assets with little risk of principal.")

In EMIR (which will be applicable as from January 2013), the right of use is defined in article 9: "A CCP shall have a right of use relating to the margins or default fund contributions collected via a security financial collateral arrangement provided that the use of such arrangements is foreseen by its operating rules. The clearing member shall confirm its acceptance of the operating rules in writing. The CCP shall publicly disclose this right of use. This right shall be exercised in accordance with Article 47 (which states: "A CCP shall invest its financial resources only in cash or in highly liquid financial instruments with minimal market and credit risk. A CCP's investments shall be capable of being liquidated rapidly with minimal adverse price effect." …and "Financial instruments posted as margins or as default fund contributions shall, where available, be deposited with operators of securities settlement systems that ensure the full protection of those financial instruments. Alternatively, other highly secure arrangements with authorised financial institutions…").

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

Clients are not supposed to be affected by their permission to allow their assets to be held in another jurisdiction. Investment firms are required to exercise the utmost care, diligence and competence when selecting, appointing and conducting a periodical assessment of the institution where these assets are deposited and of the provisions governing the holding of the assets. In addition, the obligation to return the securities applies also in the case of outsourcing (except if an agreement has taken place when the client is a professional client).

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

If an investment firm fails to comply with the requirements, the investors are covered by the Securities Deposit Guarantee Fund.

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how

are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

In accordance with the Article L. 211-6 of the Monetary and Financial Code, in the event of a judicial reorganisation or liquidation procedure being initiated against the book-keeping institution, the receiver or the liquidator, acting jointly with the provisional administrator or liquidator, if any, appointed by the ACP, shall verify, for each financial instrument individually, that the number of securities held in a current account with a central custodian or with another intermediary on behalf of the defaulting intermediary, regardless of the nature of the accounts opened with them, is sufficient to enable the intermediary to meet its obligations towards the holders of the rights in the financial instruments registered in its books. In the event of the number of securities held being insufficient, an allocation of securities shall be made among the holders of the rights in proportion to the securities made available, financial instrument by financial instrument; their owners may arrange to have them credited to an account kept by another intermediary or by the issuing legal entity.

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

See answer to question 25.

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

Order of 3 July 2007 relating to the segregation of funds of investment firms' customers:
**http://inbdf/gb/supervi/telechar/regle_bafi/20070702_order3.pdf**

Regulation n°99-14 of 23 September 1999, relating to the guarantee of securities held on the behalf of investors by credit institutions and investment firms, intermediaries authorized by the *Conseil des Marchés Financiers* and members of clearing houses having their registered office on the territory of the French Republic
**http://inbdf/gb/supervi/telechar/regle_bafi/Regulation_99_14.pdf**

**AMF General Regulation, Title III:** **http://www.amf-france.org/documents/general/7553_1.pdf**

**Financial and Monetary Code:** **http://www.legifrance.gouv.fr/affichCode.do?cidTexte=LEGITEXT000006072026&dateTexte=20091111**
**(please note that this is the link to the French version as the English version is not up to date).**

# Germany
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

The German Banking Act (Kreditwesengesetz – KWG) contains regulations for all credit institutions and financial services institutions (an investment firm as defined above is always considered a credit institution or financial services institution according to the KWG). The KWG contains regulations for the capital requirements for such firms as well as the licensing requirements and the organizational requirements for such firms.

The Safe Custody Act (Depotgesetz – DepotG) contains provisions to protect investors (retail and institutional investors) who entrust tradable securities to a credit institute for safekeeping. In order to protect investors and their securities the DepotG provides for different forms of safekeeping (e.g., collective deposit and individual safekeeping). Furthermore, in addition to the right to separation the DepotG provides for further mechanisms to protect investors against the risks of third party safekeeping (e.g. section 4 DepotG – restricted claim of rights to pledge or retention).

The DepotG applies to shares, parts in mining companies , interest and dividend coupons and talons, debentures to bearer or transferable by endorsement, and other transferable securities except banknotes and paper money, section 1 (1) DepotG.

The DepotG applies to all kinds of credit institutions, but not for other financial intermediaries as these are not permitted to hold assets at present. The German transformation act for the EU-AIFM-Directive will enable financial services institutions to acquire a licence for the custody of assets of OGAW and AIFM funds. This new financial service will be covered by the MiFID regulations. Therefore the following explanations for credit institutions also cover such future licences of financial services institutions.

The Official Requirements regarding Safe Custody Business (hereinafter referred to as the Depot-Bek. - Amtliche Anforderungen an das Depotgeschäft - Bekanntmachung über die Anforderungen an die Ordnungsmäßigkeit des Depotgeschäfts und der Erfüllung von Wertpapierlieferungsverpflichtungen vom 21.12.1998) distinguish between different types of securities safekeeping accounts:

The Depot A (Eigendepot) (no. 10 (4) a Depot-Bek.) contains the own securities of the depositing credit institute and the securities of the clients which are liable without limitation as pledge for the third party custodian's receivables to him (sections 12 (4) and 13 DepotG) plus the securities owned by the intermediate depositary pursuant to sections 19-21 DepotG.

The Depot B (Fremddepot) (no. 10 (4) b Depot-Bek.) contains securities which are deposited by a credit institute or which are purchased for that credit institute and are unmortgaged kept safe for the client of the intermediate depositary with the third party custodian.

The Depot C (Pfanddepot) (no. 10 (4) c Depot-Bek.) contains the securities which the intermediate depositary has pledged to the third party custodian in accordance with an authorization pursuant to section 12 (2) DepotG.

The Depot D (Sonderpfanddepot) (no. 10 (4) d Depot-Bek.) contains securities which are pledged to the third party custodian under specification of the corresponding client number by an intermediate depositary pursuant to section 12 (3) DepotG. A Depot D is to be kept for each individual client.

Securities can be traded anyhow (e.g., exchange-traded or over-the-counter). Regarding the safekeeping of securities there are no differences between both models of trading.

For investment funds, the German Investment Act (Investmentgesetz - InvG) applies to "clients" (and does not distinguish between "retail clients" or "professional clients") and to all kinds of credit institutions, but not for other financial intermediaries as these are not permitted to hold assets. For further details on the scope of application see response to question 1. a..

Sections 20 et seqq. of the InvG and the official circular letter 6/2010 WA regarding duties and responsibilities of the custodian according to sections 20 et seqq. InvG – Rundschreiben 6/2010 WA zu den Aufgaben und Pflichten der Depotbank nach den §§ 20 ff. InvG (Rundschreiben Depotbank) provide regulations with regard to despositary banks.

With regard to investment funds, according to section 24 para. 1 InvG the depositary bank must place the securities and certificates of deposit belonging to the fund in a blocked securities custody account (a blocked securities custody account is a custody account which is subject to certain restrictions with respect to the right of disposition). It may entrust the securities for safekeeping only to the following institutions:

1. a central securities deposit bank within the meaning of section 1 para. 3 of the German Custody Act (DepotG),
2. another domestic credit institution which has a license to operate custody business pursuant to section 1 para. 1 sentence 2 no. 5 in conjunction with section 32 of the German Banking Act,

3. a foreign investment firm which is authorized to carry on the business of safekeeping pursuant to Annex I Section B no. 1 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1, L 45, 16.2.2005, p. 18) as amended , or

4. another foreign custodian which fulfills the requirements of section 5 para. 4 sentence 1 of the Custody Act (DepotG) accordingly.

According to section 24 para 2 German Investment Act (InvG) the depositary bank is entitled and obliged to transfer balances held in blocked accounts to blocked accounts with credit institutions having their registered office in a Member State of the European Union or another Contracting State to the Agreement on the European Economic Area if the management company instructs the depositary bank to do so. The balances may also be transferred to blocked accounts with credit institutions with their registered office in non-EEA states whose prudential rules are considered by the Federal Supervisory Authority as equivalent to those laid down in European Community law.

All such transfers of clients' assets to admissible custodians outside the German jurisdiction must be subject to no. 3. (4) Depot-Bek. This means all foreign custodians have to declare, accept and guarantee that they will treat as and deliver the assets on first demand as assets of the client and will not claim any pledges, retainers or similar rights with regard to the client of the first German custodian. These restrictions apply accordingly to all other custody relations outside the InvG.

The legal situation will change when the transformation act of the EU-AIFM-Directive takes effect in 2013, the InvG will completely be replaced by the Kapitalanlagegesetzbuch (KAGB).

a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

In Germany, there is no general legal definition of the term "client assets" or an analogous term thereof. However, there are definitions with regard to the scope of application of different kind of laws which contain regulations for client assets.

For example, the term "deposit" is described in the German Banking Act (KWG) and further clarified in a BaFin circular. "Merkblatt – Hinweise zum Tatbestand des Depotgeschäfts", as of 2012/09/09.

The German Investment Act ( InvG**)** only applies to client assets in terms of a domestic investment asset pool, insofar as it is formed as a separated asset pursuant to section 2 (2) InvG or an investment stock company pursuant to section 2 (5) InvG, see section 1 InvG. The InvG does not provide special or deviating rules for client assets other than the DepotG.

The DepotG applies to shares, interest and dividend coupons and talons, debentures to bearer or transferable by endorsement, and other transferable securities except banknotes and paper money, section 1 (1) DepotG.

b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

Clients have full ownership rights on any of their client assets other than client`s money, whilst they have a claim on their client money. For further details see response to question 3., below.

When settling a securities transaction in Germany, the Bank is required, if the securities are eligible for collective safe custody with the German central depository (Clearstream Banking AG), to provide the customer with co-ownership of these collective securities deposits (section 6 (1) DepotG). In case of insolvency of the depositary, the depositor is entitled to claim segregation and the return of the securities. The securities are not a part of the insolvency assets (section 47 German Insolvency Code (Insolvenzverordnung - InsO) of the investment firm.

If securities are not eligible for collective safe custody, the customer shall be provided with sole ownership of the securities. The Bank is required to keep these securities for the physically segregated from its own holdings and from those of third parties (section 2 (1) DepotG). In case of insolvency of the depositary, the depositor is also entitled to claim segregation.

Investment funds which are managed by a management company are asset pools without legal personality. Pursuant to section 30 para. 1 sentence 1 InvG, the investment fund may be held by the investors in direct co-ownership (co-ownership solution) or through the management company acting as owner (trust solution).

A creation of a sub-custody relation outside the German jurisdiction by the German Custodian is only permissible in case the client gets a legal position vs. each of the foreign custodians which is equivalent the co-ownership or sole ownership according to the DepotG.

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

In Germany, there is no general legal definition of the term "client" or an analogous term thereof. However, within the scope of the German Securities Trading Act (Wertpapierhandelsgesetz – WpHG), section 31a WpHG defines "clients" as all natural or legal persons, an investment firm is bringing its investment service to.

The Safe Custody Act (DepotG) applies to retail and institutional investors, both terms are not legally definition.

Also the German Investment Act (InvG) does not distinguish between retail or professional clients, there are no legal definitions.

d. Please describe any notable exclusions from the terms "client" or "client assets."

There are no notable exclusions from the terms "client" or "client assets". For the scope of application of the DepotG and the InvG please see response to questions 1. and 1. a..

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

The DepotG and the MiFID rules apply to all kind of clients assets, there are at present no special rules for custodians acting under the InvG.

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

The DepotG and the MiFID rules apply irrespective of the model of buying or selling an asset to all clients assets held by custodians, accept money.

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

The DepotG and the MiFID rules apply to all kind of clients of custodians, there are at present no special rules for custodians acting under the InvG.

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

There are no informal arrangements between governmental entities and / or governmental entities and the relevant supervised enterprises. All relevant restrictions are provided in parliamentary acts, statutory instruments and official circulars of the supervisory authorities.

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

   a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

Anyone wishing to provide banking transactions or financial services in Germany commercially or on a scale which requires a commercially organized business undertaking, generally requires a license from the BaFin , section 32 (1) KWG. The safe custody business is a banking transaction pursuant to section 1 (1) sentence 2 no. 5 of the KWG. When taking effect the transformation act of the EU-AIFM-Directive will enable financial services institutions to acquire a special custody licence for OGAW and AIFM funds. The safe custody business comprises in any case the safekeeping and / or managing of securities clients assets for others.

Initial and ongoing requirements:

The BaFin may grant authorization only if the following mandatory conditions are met. The resources needed for business operations, in particular sufficient initial capital, must be available in Germany, section 33 1 sentence 1 no. 1 of the KWG. The institution must have trustworthy senior managers who have the necessary professional qualifications and work for it not merely in an honorary capacity, section 33 (1) sentence 1 nos. 2, 4 and 5 of the KWG. The financial services institution's head office must be domiciled in Germany, section 33 (1) sentence 1 no. 6 of the KWG. The ongoing requirements correspond to the initial requirements, which also comprise the duty of the German custodian to care for a client's legal position equivalent to the sole or co-ownership provided for in the DepotG and Depot-Bek.

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

Not applicable.

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements.

The Regime in the German jurisdiction generally requires that client assets must be maintained separately from the assets of an investment firm. Customers may waive this restriction. Details are given in § 14a Wertpapierdienstleistungs- Verhaltens- und Organisationsverordnung (WpDVerOV). Specifically:

a. Must the Client Assets of one client be maintained separately from those of other clients?

i. Are Investment Firms allowed to hold Omnibus Accounts?

The deposit business within the meaning of section 1 (1) sentence 2 no. 5 KWG can be provided in different forms. Generally, the securities are entrusted to a bank for central depository of securities (collective deposit) unless the depositor has required the individual safekeeping.

In the case of collective deposit, the depositary may keep safe securities unseparated from its own assets of the same kind or of such of third parties or entrust those to a third party for collective depositing only when the depositor has given express and written consent, section 5 (1) sentence 2 DepotG. The depositary may entrust the securities to a third party, in the majority of cases a bank for central depository of securities, for collective depositing. In case of individual safekeeping, the depositary must keep safe securities separately from other assets and under an externally recognizable designation of the depositor, section 2 DepotG.

In the scope of the DepotG investment firms are not allowed to hold omnibus accounts. Securities of one client cannot be affected by activities of other clients. Also see response to question 1. b. above.

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

See answer to a.i.

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

The amount (and type) of assets to be held must correspond exactly with the amount of the client assets deposited with the investment firm.

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

Generally the depositary is required to hold the specific securities deposited by the clients. However, the following exceptions should be mentioned:

- The safekeeper can be authorized to take possession of securities or assign the property to a third party, section 13 (1) DepotG. Thereupon the safekeeper is only bound to return securities of the same kind. The authorization must be given expressly and in writing for the several depositing transaction. This authorization must not refer to other documents nor must it be connected with other authorizations of the safekeeper, section 13 (1) sentence 3 DepotG. The authorization has to reflect that by the exercise of the authorization the property assigns to the safekeeper or a third party and that the depositor only has an in personam claim of delivery a certain kind and amount of securities, section 13 (1) sentence 2 DepotG.

From the time the safekeeper exercises his right of taking possession of securities or assigning the property to a third party, the regulations of chapter 1. DepotG do no longer apply, section 13 (2) DepotG.

- Section 15 (1) DepotG allows for a special safekeeping. Depositor and depositary may agree that the ownership shall directly pass to the depositary or a third party and the depositary is only obligated to return securities of the same type. In such a case the depositor loses the protection granted by the DepotG (e.g., right to separation). Section 10 allows another special safekeeping (Deposit with the Right to Change). The depositary is entitled to return securities of the same type in exchange for the deposited securities.

- As already mentioned above (see response to question 1. c. above), pursuant to the DepotG a client (depositor) is generally the owner (or co-owner with regard to collective securities deposits) of the assets he has placed in safe custody. In case of insolvency of the depositary, the depositor is entitled to claim segregation and the return of the securities. The securities are not part of the insolvency assets (Section 47 German Insolvency Code (InsO)). As regards securities in sub-custody with a foreign depositary pursuant to no. 3. (4) of the Depot-Bek the German depositary has to ensure that the depositor obtains a legal status equivalent to that provided by the DepotG. This will also apply to custodians of OGAW and future AIFM funds.

  As regards assets where the depositor has agreed, prior to the insolvency proceedings, either i) to transfer full or partial title of its securities to either the investment firm or the third-party depository or ii) to give the investment firm or the third-party depository other rights in rem, the DepotG provides for the following: If these securities have been (re)hypothecated to the investment firm´s lienors, and these have liquidated the hypothecated securities, a settlement procedure pursuant to Section 33 DepotG ensures the equal distribution of certain separate funds (including securities not (re)hypothecated) pursuant to section 33 (2) DepotG. These are the only cases where the client might receive assets that are different to the assets that were originally placed with the depositary.

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

The depositary is required to issue a securities account statement at least once a year. The securities account statements are created and sent to the clients normally in the first month of the year.

The Depot-Bek. [3] contains in no. 11 requirements regarding the reconciliation of the Deposit Account. Pursuant to no. 11 (2) Depot-Bek. the securities account statements must include the following information: securities entrusted to the credit institute individually with their nominal amount or number, the exact name of the security type including the information about the characteristics and form of safekeeping. The clients must be able to understand how they own their securities. These requirements also apply to contractual claims (e.g., purchase and delivery of securities).

The securities account statement of a third party safekeeper also has to include whether the securities are kept in the Depot A (Eigendepot), in the Depot C (Pfanddepot) or in the Depot D (Sonderpfanddepot), the latter identified with the respective customer ID. For definition of these depots see response to question 1. and no. 10 (4) Depot-Bek.

The securities account statement has to be accepted by the depositor. Exceptionally, an acceptation is not necessary if certain functions (e.g., depositing, executing of client orders) are separated exactly of each other.

C) If a client has a debit balance (*i.e.*, the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

In the scope of the DepotG there are no specific requirements regarding this issue. Investment firms have included in their general terms and conditions a stipulation stating that the client grants the investment firm a lien on valuables of any kind (e.g., shares in a collective deposit) which, in the course of banking business, may come into the possession or power of disposition of the investment firm through acts of the client or of third parties for account of the client.

One client`s net debit balance does not reduce the investment firm`s obligations with respect to the total required funds on deposit for net credit balances of other clients.

[3] Official Requirements regarding Safe Custody Business, hereinafter referred to as the Depot-Bek., (Amtliche Anforderungen an das Depotgeschaft - Bekanntmachung über die Anforderungen an die Ordnungsmäßigkeit des Depotgeschäfts und der Erfüllung von Wertpapierlieferungsverpflichtungen vom 21.12.1998).

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

The depositary is required to issue a securities account statement at least once a year. The securities account statements are created and sent to the clients normally in the first month of the year. For further details, see response to question 3. b. i. B).

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

The depositary is required to issue a securities account statement at least once a year. The securities account statements are created and sent to the clients normally in the first month of the year.

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

Depositaries are not required to make good any deficiency from their own funds.

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

Within the scope of the DepotG there is no rule which investment firms permit or encourage to maintain any of their own assets in Client Asset accounts (e.g., as a "buffer").

In the case of collective deposit, the depositary may keep safe securities unseparated from its own assets of the same kind or of such of third parties when the depositor has given express and written consent, section 5 (1) sentence 2 DepotG. Also see response to question 3. a. i. above.

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

In the scope of the DepotG: The investment firm cannot use client assets of one client for meeting obligations of other clients.

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

On the EU level, MiFID (Directive n. 2004/39/EC) prohibits the use of clients' funds (except for credit institutions), but specifies that when the full ownership of the client's assets is transferred to the prime broker for the purposes of securing

the client's obligations, such assets are no longer regarded as belonging to the client. For details see §§ 34 a WpHG, 14a WpDverOV.

In Germany investments firms are only allowed to use financial instruments which are held for clients under the regulations of the DepotG for own account or for account of another clients under exactly defined requirements which have been accepted by the clients. The DepotG provides an extensive protection in case of the insolvency of the safekeeper or illegal disposes (section 32 and 34 DepotG). This protection does not interfere if investment firms accept securities in connection with their activities.

The depositary may pledge securities or shares in a collective deposit only by virtue of an authorization and only in connection with a granting of credit to the depositor and only to another depositaries, section 12 (1) sentence 1 DepotG. The authorization must be given expressly and in writing for the several depositing transaction. This authorization must not be included in the terms and conditions of the depositary. The authorization must not refer to other documents. A depositary with authorization to pledge securities or shares in a collective deposit may pass the authorization as given on to another person, section 12 (5) DepotG.

By way of exception of section 12 DepotG, the depositary may pledge securities and shares in collective deposit by virtue of an express and written authorization as collateral for his liabilities arising transactions at a stock exchange which is subject to a legal supervision to that stock exchange, or to the institution to which that stock exchange is attached, or to the organisation which with legal rights empowered by that stock exchange and restricted in its business to the settlement of transactions under the supervision of that stock exchange, provided that as there are liabilities of the depositor with the depositary resulting from a transaction of the depositor and the depositary which is substantially identical, section 12a sentence 1 DepotG.

The depositary is required to ensure with the pledgee that the securities or shares in a collective deposit pledged in connection with the pledgee's liabilities in accordance with section 12a (1) DepotG may only be forfeited up to the amount of the liabilities of the depositor to the depositary in accordance with section 12a (1) DepotG.

The depositary is liable for a default by the pledge as it is for its own default; this liability may not be restricted by agreement, section 12a (2) sentence 2 DepotG.

The safekeeper can be authorized to take possession of securities or assign the property to a third party, section 13 (1) DepotG. Thereupon the safekeeper is only bound to return securities of the same kind. The authorization must be given expressly and in writing for the several depositing transaction. This authorization must not refer to other documents nor must it be connected with other authorizations of the safekeeper, section 13 (1) sentence 3 DepotG. The authorization has to reflect that by the exercise of the authorization the property assigns to the safekeeper or a third party and that the depositor only has an in

personam claim of delivery a certain kind and amount of securities, section 13 (1) sentence 2 DepotG.

From the time the safekeeper exercises his right of taking possession of securities or assigning the property to a third party, the regulations of chapter 1. DepotG do no longer apply, section 13 (2) DepotG.

With respect to investment funds under the scope of the German Investment Act (Investmentgesetz - InvG) the following should be mentioned:

With respect to national law, the management company is allowed to transfer securities to a third party (securities borrower) for the account of the fund against a customary consideration for a limited or unlimited period of time only subject to the provision that the securities borrower must return to the management company for the account of the fund securities of the same type, quality and amount (securities loan) if this is provided for in the fund rules (section 54 para. 1 InvG). Securities loans may only be granted to a securities borrower to the extent that the quoted price of the securities to be transferred together with the quoted price of the securities which have already been transferred to the securities borrower as a securities loan for the account of the fund does not exceed 10 per cent of the value of the fund; If no particular date is stipulated for the repayment of the securities loan, the management company must be entitled to terminate the loan at any time; the time limit for repayment by the securities borrower must not exceed five exchange days. If a date is stipulated for the repayment of the securities loan, repayment must be due after 30 days at the latest. The quoted price of the securities to be transferred for a specified period of time together with the quoted price of the securities which have already been transferred as a securities loan for the account of the fund for a specified period of time must not exceed 15 per cent of the value of the fund.

The management company may only transfer securities pursuant to section 54 para. 1 InvG if, prior to or in return for the transfer of the securities for the account of the fund, it has ensured that it was granted sufficient collateral by way of money payment or a pledge or assignment of deposits or by way of a pledge or assignment of securities or money market instruments pursuant to section 54 para. 2 sentences 2 to 5 InvG and section 54 para. 3 InvG. The deposits granted by disposition pursuant to sentence 1 must be denominated in Euro or the currency in which the units of the fund were issued and must be maintained with the depositary bank or, with its consent, in blocked accounts with other credit institutions which have their registered office in a Member State of the European Union or another Contracting State to the Agreement on the European Economic Area or with a credit institution with its registered office in a non-EEA state pursuant to section 49 sentence 2 half-sentence 2 InvG, or may be invested in money market instruments within the meaning of section 48 InvG in the currency of the deposits; the investment in money market instruments in the currency of the deposits may also be made by way of a repurchase agreement pursuant to section 57 InvG. With the consent of the depositary bank, the securities assigned as collateral pursuant to section 54 para. 2 sentence 1 InvG may be held in custody

with a suitable credit institution. The income from the investment of the collateral shall be due to the fund. Securities to be pledged must be held in custody with a suitable credit institution. Debt securities shall be suitable as collateral if they are admitted by the European Central Bank or the German Central Bank as collateral for the credit transactions referred to in Article 18.1 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank of 7 February 1992 (Federal Law Gazette 1992 II p. 1299); shares shall be suitable if they are admitted to trading on an organised market within the meaning of section 2 para. 5 of the Securities Trading Act. Securities which are issued by the securities borrower or by an enterprise which is part of the same group shall not be suitable as collateral unless they have the form of mortgage bonds or municipal bonds.

The amount of the collateral shall be determined taking particular account of the economic circumstances of the securities borrower. The collateral must not be less than the collateral value plus a customary surcharge. The management company must demand the provision of further collateral without undue delay if, on the basis of the determination on each exchange day of the collateral value and the collateral received or of a change in the economic circumstances of the securities borrower, it shows that the collateral is no longer sufficient.

Furthermore, in Germany, for money market funds (MMFs) and UCITS, deposits may be (re)invested in money market instruments denominated in the respective currency of the deposits; or (re)invested in money market instruments by way of repurchase agreements (section 54 para 2 sentence 2 InvG).

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

The affect or the change on the ownership`s rights depend on the situation given.

E.g. from the time the safekeeper exercises his right to which the depositor has authorized him (section 13 (1) DepotG, see for details response to question 3. b. i. A) and 3. d) of taking possession of securities or assigning the property to a third party, the regulations of chapter 1. DepotG do no longer apply, section 13 (2) DepotG. By assigning the property to a third party, the client loses his ownership rights over the assigned asset.

As set out in my response to question 3. d., above, securities lending according to section 54 InvG is an example for using assets of a fund. However, the words "lending", "loan" or "borrower" used above, are in some ways misleading as the transaction is in fact an absolute transfer of title against an undertaking to return equivalent securities.

For further details see response to question 3. d..

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a

client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

The investment firm needs an express and written authorization. For details see response to question 3. d..

iii. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (*i.e.*, established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

This question concerns civil law matters and is not within BaFin's remit.

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

There are no legal requirements for clearing houses or other central counterparties to maintain the separate identification of collateral posted by an investment firm for its client positions. Eurex Clearing AG requires clearing members to transfer proprietary funds for both client and proprietary positions. Under its clearing conditions clearing members have to ask clients to transfer collateral equivalent to the one transferred by the clearing member to Eurex, but no segregation of assets is required at the clearing member level. Any margin segregation requirements at that level are determined by the laws applicable to the relevant clearing member and its arrangements with its clients. Germany has implemented MiFID (directive 2004/39/EG) and therefore requires investment firms by law to segregate client money as well as client assets. The legal obligation to segregate does not apply to most German clearing members, however, since most of them are deposit-taking credit institutions which, are exempt from the segregation requirement.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

a. Client Assets transferred to or located in other jurisdictions?

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

If so, please provide details of those requirements.

Investment firms are generally permitted to transfer to, or hold Client Assets in, another jurisdiction.

Collective security-deposit banks may deposit transferable securities for collective deposit with a foreign depositary in the course of the mutual keeping of accounts entered into for an establishment of international securities-giro-transactions, according to § 5 Abs. 4 DepotG provided that:

1.) the foreign depositary carries out in its state of residence the functions of a collective security-deposit bank and is subject to a public supervision or an equivalent supervision protecting the investor,

2.) the depositary obtains in relation to the collective deposit by such a depositary a legal status equivalent to that provided by Safe Custody Act (DepotG),

3.) no prohibition of the state of residence of such depositary inhibits the claim by the collective-security deposit bank against the depositary of delivery of transferable securities and

4.) the transferable securities are fungible and admitted for collective deposit by the collective-security deposit bank in the course of their mutual keeping of accounts.

No. 3 (4) Depot-Bek.:

All foreign custodians which are not authorized as national Collective security-deposit bank have to meet the requirements of No. 3 (4) Depot-Bek. in connection with section 5 (4) sentence 1 no. 2 DepotG: the foreign financial firm or the foreign safekeeper has to comment to the German financial firm a so called three-point-statement ("Drei-Punkte-Erklärung"). The same applies to custodians under InvG: see chapter IV. no. 4 Rundschreiben Depotbank (official circular letter 6/2010 WA regarding duties and responsibilities of the custodian according to sections 20 et seqq InvG – Rundschreiben 6/2010 WA zu den Aufgaben und Pflichten der Depotbank nach den §§ 20ff InvG), because DepotG and Depot-Bek apply to this custody business as well.

In the scope of the DepotG there are no specific requirements which require investment firms to preserve the separate identification of client assets transferred to or located in other jurisdictions or client assets that have been transferred to the investment firm from other jurisdictions and that have been identified as client assets in those jurisdictions, except the above mentioned requirement of the "Drei-Punkte-Erklärung" which shall create a legal status of the client with regard to local law equivalent to sole or co-ownership according to the DepotG..

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

Within the scope of the DepotG there is no distinction between client assets from domestic clients and client assets belonging to foreign clients.

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

To the Foreign Investment Firm`s Client Assets the same protections are applicable as to domestic Investment Firm`s Client Assets.

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

There is no need to take any steps for Foreign Investment Firms to secure such protections for its Clients Assets. If German law, i. e. DepotG and Depot-Bek., applies to the custody agreement, the foreign customers benefit from the same protections as a domestic customer.

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

Neither clients nor Foreign Investment Firms can reduce such protections. For further details please refer to response to question 8.

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

The depositary is entitled to deposit securities under its name with another depositary, section 3 (1) sentence 1 DepotG. Pursuant to no. 3 (1) sentence 1 of the Official Requirements concerning the Safe Custody Business credit institutions are only entitled to deposit securities with another credit institutions. The qualifications of the third party custodian are equivalent to the qualifications of the (intermediate) depositary.

Securities may be kept with an affiliate of the investment firm, section 3 (1) sentence 2 DepotG.

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

The safekeeping has to be made under the name of the intermediate depositary. Accordingly, the escrow (custody) agreement is closed between intermediate depositary and third party custodian.

The (intermediate) depositary may pledge securities or shares in a collective deposit only by virtue of an authorization and only in connection with a granting of credit to the depositor and only to another depositaries, section 12 (1) sentence 1 DepotG. A (intermediate) depositary with authorization to pledge securities or shares in a collective deposit may pass the authorization as given on to another depositary (third party custodian), section 12 (5) DepotG.

No. 3 (4) Depot-Bek. in connection with section 5 (4) sentence 1 no. 2 DepotG: the foreign financial firm or the foreign safekeeper which act as intermediary and / or sub custodian has to comment to the German financial firm a so called three-point-statement ("Drei-Punkte-Erklärung"). The same applies to custodians under InvG: see chapter IV. no. 4 Rundschreiben Depotbank (official circular letter 6/2010 WA regarding duties and responsibilities of the custodian according to sections 20 et seqq InvG – Rundschreiben 6/2010 WA zu den Aufgaben und Pflichten der Depotbank nach den §§ 20ff InvG), because DepotG and Depot-Bek apply to theis custody business as well.

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

No. 3 (4) Depot-Bek. in connection with section 5 (4) sentence 1 no. 2 DepotG: The German Custodian entrusting a foreign financial firm or the foreign safekeeper has to take care that all such foreign firms accept the so called three-point-statement ("Drei-Punkte-Erklärung"). The same applies to custodians under InvG: see chapter IV. no. 4 Rundschreiben Depotbank (official circular letter 6/2010 WA regarding duties and responsibilities of the custodian according to sections 20 et seqq InvG – Rundschreiben 6/2010 WA zu den Aufgaben und Pflichten der Depotbank nach den §§ 20ff InvG), because DepotG and Depot-Bek apply to theis custody business as well. If this requirement is not met it has to inform the client of any such circumstances if it not able to choose another foreign custodian for the assets.

The "Forwarding of information" is laid down in no. 16 of the Special Conditions for Dealings in Securities (Sonderbedingungen für Wertpapiergeschäfte). If information concerning the customer's securities is published in the "Wertpapier-Mitteilungen" (information system) or if the bank is provided with such information by the issuer or by its foreign depository/intermediate depository, the bank is required to inform the customer thereof, to the extent that such information may materially affect the customer's legal position and notification of the customer is necessary in order to safeguard the customer's interests, no. 16 of the Special Conditions for Dealings in Securities (Sonderbedingungen für Wertpapiergeschäfte).

The Special Conditions for Dealings in Securities have the character of general terms and conditions. Accordingly, the nature of that information is "contractual".

According to Section 23 a KWG an institution which conducts banking business or provides financial services shall inform customers who are not institutions in its price list of its membership of a scheme to safeguard the claims of depositors and investors (guarantee scheme). In addition, prior to commencing a business relationship, the institution shall inform customers who are not institutions about the guarantee provisions, including the scope and amount of the guarantee, in writing in an easily comprehensible form. If deposits and other repayable funds are not guaranteed, the institution shall draw attention to this fact in its general terms and conditions, in its price list and in a prominent position in the contract documents prior to commencing

a business relationship, unless the repayable funds are securitised by Pfandbriefe, municipal bonds or other debt securities which fulfill the conditions of Article 52 (4) sentences 1 and 2 of the UCITS Directive 2009/65/EG. Furthermore, upon request, information must be available on the terms and conditions of the guarantee scheme, including the requisite formalities for asserting compensation claims.

For investment funds, according to section 19b InvG – to the extent that the management company has the license to provide individual asset management within the meaning of section 7 para. 2 no. 1 – it must inform the clients concerned which are not institutions in a suitable manner of its participation in a scheme for the protection of claims of the clients (protection scheme); section 23a para. 1 sentences 2 and 5 and para. 2 of the Banking Act (KWG) shall apply accordingly.

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

For investment funds, the German Investment Act does neither contain any provision that allows clients to 'opt out' of certain protections, e.g., requirements for segregation of client assets, nor provisions according to which the client might make a choice that would change the nature of the protection afforded to those assets in the event of the resolution or insolvency of the management company/investment company/depositary bank. With respect of the right to securities loan, however, please refer to response to question 3. d. above.

The requirements of the DepotG cannot be waived by an agreement, they are not optional. With respect to pledging securities or the authorization of a safekeeper to take possession of securities or assign the property to a third party, please refer to response to question 3. d. above.

According to section 34a (1) of the Securities Trading Act (WpHG), the following waive of rights is possible:

Investment services enterprises which have no authorization to conduct deposit business within the meaning of section 1 (1) sentence 2 no. 1 of the Banking Act (KWG) shall without undue delay segregate client money held in safe custody, which they accept in connection with an investment service or ancillary service, from the money of the enterprise and from other clients' money in a trustee account with credit institutions, enterprises within the meaning of section 53b (1) sentence 1 of the Banking Act or comparable institutions domiciled in a third country and authorized to conduct deposit business, a central bank or a qualifying money market fund until the money is used for its intended purpose. A client may, by way of individual contractual stipulation, give any other instruction in respect of the segregation of client money if he has been informed of the protective purpose of the segregation of client money.

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

For example, according to section 44 InvG the management company must present an annual report for each fund as at the end of each fiscal year. The annual report must contain a report on the activity of the management company during the preceding fiscal year and all material information which allows investors to make a judgment about such activity and the results of the fund. With respect to the required report of information and data on the holding of client assets by the management company the annual report must contain the information set out in section 44 para. 1 nos.1-5 as for example:

A statement of assets regarding the assets belonging to the fund and the liabilities arising from borrowings, repurchase agreements, securities loan transactions and the other liabilities. The assets must be listed according to type, nominal amount or number, price and quoted price. The portfolio of securities must be divided into securities admitted to trading on an exchange, securities admitted to or included in an organised market, recently issued securities which are to be admitted to trading on an exchange or to be admitted to an organised market or included in such market, other securities pursuant to section 52 para. 1 nos. 1 and 3 InvG and certificated money market instruments as well as borrower's note loans, provided that a further division in accordance with appropriate criteria, taking account of the investment policies, according to percentages of the value of the fund must be carried out. For each item in the statement of assets, its percentage of the value of the fund must be stated. For each item of the securities, money market instruments and investment fund units, the purchases and sales effected during the reporting period must also be stated according to nominal amount or number. The value of the fund must be stated. It must be stated to what extent assets belonging to the fund are subject to rights of third parties.

According to section 44 para. 5 InvG the auditor must submit the annual report on the auditing of the fund without undue delay after conclusion of the audit to the Federal Supervisory Authority.

There is no special regulation in the DepotG.

According to section 36 German Securities Trading Act (WpHG) there is a yearly audit of responsibilities with respect to the security deposit business of financial firms. There is no special reporting of information and data on the holding of client assets to the BaFin mentioned in the WpHG.

Moreover, all credit institutions in Germany have to declare on their balance sheet any liabilities with regard to their customers (section 21 para. 2 Kreditinstituts-Rechnungslegungsverordnung –RechKredV).

a. Does the Investment Firm report where client assets are held?

   Section 44 InvG does not require to report where client assets are held. In general see above 3. b. i. B).

b. Does the Investment Firm or depository report the protections applicable to such client assets?

Section 44 InvG does not require reporting the protections applicable to client assets. In general see above 3. b. i. B).

c. Does the Investment Firm or depository report the amount of assets that are held?

According to section 44 (1) no. 1 InvG the value of the fund must be stated.

In each case, are such reports provided on request or periodically? If periodically, with what frequency?

The reports are provided annually.

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

a. Where Client Assets are held?

Annual audits must be made independent accountants according to §§ 29 KWG, 36 WpHG and §§ 56 – 59 Prüfberichtsverordnung (PrüfBV)

b. The amount of Client Assets held at a depository?

Annual audits must be made independent accountants according to §§ 29 KWG, 36 WpHG and §§ 56 – 59 PrüfBV.

c. The safeguards applicable to Client Assets held at a depository?

Annual audits must be made independent accountants according to §§ 29 KWG, 36 WpHG and §§ 56 – 59 PrüfBV.

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

a. The amount and/or value of such Client Assets?

The law applicable to custodian agreements is, at present, not harmonized by the EU. The Commission works on a respective Directive, which is expected to be consulted in 2013. Therefore a foreign supervisor may only use MiFID rules, Art. 32 MiFID.

According to MiFID and § 3 Abs. 1 Satz 2 DepotG a branch office of a foreign EU custodian, if it is regarded as investment firm, is supervised by BaFin. The home supervisor of the foreign custodian may cooperate with BaFin according to MiFID rules. In case of a third country custodian and supervisor cooperation is possible on the basis of a bilateral or multilateral administrational cooperation agreement between supervisors.

b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

See above.

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

    Investment firms must notify BaFin of a fall in the initial capital below the minimum capital requirements as well as of a loss amounting to 25% of the liable capital according to section 24 (1) KWG. BaFin must also be notified immediately in case of insolvency or overindebtedness of a firm pursuant to section 46b (1) KWG.

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*¸ capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

    In case of a fall in the initial capital below the minimum capital requirements BaFin may revoke the firm's license to provide banking business or investment services (section 35 (2) KWG). In case the firm's own funds fail to satisfy the requirements of the KWG for adequate own funds, BaFin may prohibit or limit the withdrawals by the proprietors or partners, the distribution of profits and the granting of loans, section 45 KWG. In case of danger concerning the discharge of an institution's obligations to its creditors, and especially the safety of the assets entrusted to it, BaFin may take temporary measures to avert the danger, such as the issuance of instructions on the management of the institution's business, the prohibition of the taking of deposits or funds or securities of customers and the granting of loans, prohibition other activities or appointment of supervisors (section 46 KWG). In case of danger of a collapse of a bank because of insolvency and when such a collapse is expected to have serious negative impact on other financial market actors or the financial market, the regulator may transfer client assets from the insolvent bank to a solvent bank within the rules of a restructuring regime.

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

    If an investment firm becomes insolvent or overindebted, the managers must report this fact without delay to BaFin. BaFin will then file a petition for the initiation of insolvency proceedings over the institution's assets at the competent district court if it has reason to believe that the firm is indeed insolvent or overindebted. This is regulated in section 46b (1) KWG. The competent court will then issue a decision whether formal insolvency proceedings are commenced. Other entities which are not licensed by BaFin are obliged to file a petition for the initiation of insolvency

proceedings before the competent court themselves, if they become insolvent or overindebted.

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

    The Administrative Officer is selected by the competent court. The officer must be independent and possess adequate experience.

16. What are the duties of the Administrative Officer?

    a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

       The duties of the Administrative Officer are set out in the German Insolvency Code (InsO).

    b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

       The Administrative Officer is subject to personal liability for all breaches of his duties for which he is culpable. He is culpable, if he/she does not act with the diligence of a scrupulous insolvency administrator. When employing former employees of the debtor, the officer is solely responsible for the oversight and decisions of major importance unless these persons are evidently unsuited (section 60 InsO).

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

    See answer to question 14.

    a. Does the regulator continue to supervise the Investment Firm?

       Yes.

    b. How, if at all, is the regulator involved in the process of returning Client Assets?

       BaFin is not involved in this process.

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

    In the insolvency process of the safekeeper, there will be a clearing method between the depositors that have entrusted securities or parts of a collective deposit to the safekeeper, who has pledged those securities or parts of a collective deposit in accordance with section 12 (2) DepotG to his pledge, section 33 DepotG. Also see response to question 3. b. i. A).

When settling a securities transaction in Germany, the Bank is required, if the securities are eligible for collective safe custody with the German central depository (Clearstream Banking AG), to provide the customer with co-ownership of these collective securities deposits (section 6 (1) DepotG). In case of insolvency of the depositary, the depositor is entitled to claim segregation and the return of the securities. The securities are not a part of the insolvency assets (section 47 Insolvency Code).

If securities are not eligible for collective safe custody, the customer shall be provided with sole ownership of the securities. The Bank is required to keep these securities for the physically segregated from its own holdings and from those of third parties (section 2 (1) DepotG). In case of insolvency of the depositary, the depositor is also entitled to claim segregation.

For further details see response to question 26 below.

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

The Regime generally focuses on returning Client Money and client Securities to clients. Similarly, Client Positions are liquidated and valued. However, under the provisions of the Restructuring Act, client assets may be transferred from an insolvent bank to a solvent bank. It covers the cases of such a transfer with and without client consent.

a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

b. What factors, if any, affect the time period required to accomplish such a transfer?

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

When settling a securities transaction in Germany, the Bank is required, if the securities are eligible for collective safe custody with the German central depository (Clearstream Banking AG), to provide the customer with co-ownership of these collective securities deposits (section 6 (1) DepotG). In case of insolvency of the depositary, the depositor is entitled to claim segregation and the return of the securities. The securities are not a part of the insolvency assets (section 47 Insolvency Code).

If securities are not eligible for collective safe custody, the customer shall be provided with sole ownership of the securities. The Bank is required to keep these securities for the physically segregated from its own holdings and from those of third parties (section 2 (1) DepotG). In case of insolvency of the depositary, the depositor is also entitled to claim segregation.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

There are several protection schemes in Germany which compensate certain clients in case of insolvency of a financial institution:

- 2 Statutory Deposit Guarantee Schemes (DGS)
- 2 Voluntary DGS and
- 1 Statutory Investor Compensation Scheme.

All schemes pay compensation independently from insolvency proceedings and hereby accelerate the transfer of value to clients.

1. Statutory DGS:

The statutory protection for deposits with credit institutions is governed by the provisions of the Deposit Guarantee and Investor Compensation Act (Einlagensicherungs- and Anlegerentschädigungsgesetz – EAEG) which expresses the minimum scope of harmonisation according to the EU Directive on Deposit Guarantee Schemes (94/19/EC).

There is one scheme for private banks and one scheme for public banks (Compensation Scheme of German Banks -*Entschädigungseinrichtung deutscher Banken GmbH* – and Compensation Scheme of the Association of German Public Sector Banks -*Entschädigungseinrichtung des Bundesverbandes Öffentlicher Banken Deutschlands GmbH* –). All deposit taking credit institutions with their registered offices in Germany are mandatory members[4]. DGS are subject to supervision by BaFin.

Insured deposits are credit balances which result from funds left in an account or from intermediate positions within the scope of the business operations of an institution and which are repayable by the same under statutory or contractual provisions (e.g. giro, savings balance, call money, time deposits). Deposits also include claims which the institution has securitized by issuing a certificate (e.g. registered bonds), although not bearer or order debt securities and liabilities arising from own bills. That means that conventional bonds and certificates as well as structured products are not protected.

DGS protect basically private depositors (individuals/private persons, partnerships, registered associations, foundations, associations of residential property owners) and small enterprises.

[4] EU branches are not included in the German DGS because they have equivalent systems according to the EU Directive on Deposit Guarantee Schemes (94/19/EC).

Compensation is payable if a member institution is no longer able to repay deposits or there has been a so-called moratorium for six weeks (section 46a (1) nos. 1 - 3 KWG). It is limited by law to the equivalent of 100,000 EUR of the deposits per customer and bank. Insofar as the DGS meets a compensatee´s claim to compensation, the latter´s claims are transferred to the DGS which asserts them in the insolvency proceeding.

2. Voluntary DGS:

Most private banks in Germany additionally are members of the Deposit Protection Fund of the Association of German Banks (*Einlagensicherungsfonds des Bundesverbandes deutscher Banken e.V.* - ESF). The statutory compensation regulations for German banks are supplemented by this voluntary private scheme. The ESF guarantees deposits per creditor up to an amount equaling 30% of the liable capital of the institution in question. Since 2010 the guarantee amount for new members is limited to up to 250,000 EUR for a period of three years (after that ESF examines if a higher protection - depending on the risk profile of the bank - is possible).

Public banks also have a voluntary protection scheme, the Voluntary Guarantee Fund of the Association of German Public Sector Banks (*Einlagensicherungsfonds des Bundesverbandes Öffentlicher Banken Deutschlands e.V.*) that provides additional security for deposits. The fund protects non-bank deposits exceeding the amount of 100,000 EUR guaranteed by statutory protection schemes.

Both voluntary schemes are not subject to supervision by BaFin.

3. Investor Compensation Scheme

The statutory protection for liabilities to the creditor arising from securities transactions with financial services institutions is also governed by the provisions of the Deposit Guarantee and Investor Compensation Act (EAEG) which expresses the minimum scope of harmonisation according to the EU Directive on Investor Compensation Schemes (97/9/EC). All financial services institutions which have been granted authorisation to provide certain financial services and which are registered in Germany are mandatory members[5]. The Scheme is subject to supervision by BaFin.

The compensation procedure generally equates to the procedure of the statutory DGS. Compensation is payable if a member institution is no longer able to meet liabilities arising from securities transactions. Notwithstanding the amount of the claim to compensation is limited by law to 90 per cent of the liabilities arising from securities transactions and the equivalent of 20,000 EUR.

4. Schemes Safeguarding the Viability of their Member Institutions

Besides the compensation schemes there are two schemes safeguarding the viability of their member institutions (Joint Liability Scheme of the German Savings Bank Association and Guarantee Scheme of the Federal Association of German Cooperative

[5] EU branches are not included in the German DGS because they have equivalent systems according to the EU Directive on Deposit Guarantee Schemes (94/19/EC).

Banks). They protect their member institutions themselves, in particular safeguard their liquidity and solvency, and have at their disposal the requisite funds. Those schemes were designed to prevent insolvencies of their member institutions. Therefore they do not possess any instruments to compensate clients' assets in resolution scenarios.

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

    The treatment depends on whether or not the client agreed, prior to the insolvency proceedings, 1) to transfer full or partial title of its Securities to either the Investment Firm or the third-party depository or 2) gave the Investment Firm or the third-party depository other rights in rem. If Client Securities have been (re)hypothecated to the Investment Firm´s lienors, and these have liquidated the hypothecated securities, a settlement procedure pursuant to section 33 Safe Deposit Act ensues, with the goal of equably distributing certain separate funds pursuant to Section 33 (2) Safe Deposit Act. For further details regarding possible differences due to pre-insolvency permissions, see Question 26 below.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

    The German compensation schemes (see response to question 21 above) are not applicable if assets are held by firms domiciled outside Germany or the European Union.

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

    German investment firms automatically become member of one of the legal compensation schemes (see response to question 21 above) when they are licensed to provide banking business or financial services.

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

    If claims by clients should exceed resources of the Investor Compensation Fund the German Compensation Scheme can demand additional contributions from its member firms. In case of further need the Fund also can take out a loan. Also a mixed variant composed of taking out a loan by the Fund and collecting additional premiums from member institutions is possible. The Fund itself decides about possible pro rata compensation and the order of disbursement.

    Concerning claims against the Investment Firm itself, the distribution of the firm´s assets follow general insolvency regulations (for details of the applicable laws, which do not fall under BaFin´s remit, see question 26 below).

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

In the insolvency process, the claims of clients are ranked above to those of other creditors, section 32 DepotG.

The following claims will be settled in preference to claims of all other insolvency creditors out of a segregated mass. Preferred are claims of:

1. principals to whom the ownership or co-ownership of securities has not been transferred to at the moment of commencement of insolvency proceedings although their obligations under the securities' transaction towards the commission agent have been fully settled; that also applies where the commission agent has not purchased the securities at the moment of commencement of the insolvency proceedings yet;

2. depositors, pledgers and principals whose ownership or co-ownership has been infringed illegally by the depositary, pledge or commission agent or their employees provided the former have fully settled their obligations towards the insolvent out of the securities' transaction;

3. the creditors under nos. 1. and 2. where the non-settled amount of their obligations mentioned above does not exceed at the moment of commencement of the insolvency proceedings 10 per cent of the value of the delivery claim of securities and if following a demand by the insolvency administrator they have completely settled such obligations.

That also applies in the case of insolvency of a dealer acting of his own account from whom securities were bought an in a insolvency of a com-mission agent who executes the order to buy or exchange securities acting on his own account.

The German Insolvency Regime does not rank domestic creditors above foreign creditors.

In the insolvency process of the safekeeper, there will be a clearing method between the depositors that have entrusted securities or parts of a collective deposit to the safekeeper, who has pledged those securities or parts of a collective deposit in accordance with section 12 (2) DepotG to his pledge, section 33 DepotG. Also see response to question 3. b. i. A).

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

Translations of the DepotG, WpHG, EAEG and the KWG are attached. I would like to give notice though that these are not translations of the most current versions of these regulations as these are not yet available in English. They should suffice to provide a broad overview over the applicable German regulations.
Regulations mentioned above:

- German Banking Act (Kreditwesengesetz – KWG)
- German Safe Custody Act (Depotgesetz – DepotG)
- Official Requirements regarding Safe Custody Business (Depot-Bek.) - Amtliche Anforderungen an das Depotgeschaft - Bekanntmachung über die Anforderungen an die Ordnungsmäßigkeit des Depotgeschäfts und der Erfüllung von Wertpapierlieferungsverpflichtungen vom 21.12.1998)
- German Investment Act (Investmentgesetz - InvG)
- official circular letter 6/2010 WA regarding duties and responsibilities of the custodian according to sections 20 et seqq. InvG – Rundschreiben 6/2010 WA zu den Aufgaben und Pflichten der Depotbank nach den §§ 20 ff. InvG (Rundschreiben Depotbank)
- German Insolvency Code (Insolvenzverordnung - InsO)
- German Securities Trading Act (Wertpapierhandelsgesetz – WpHG)
- Special Conditions for Dealings in Securities (Sonderbedingungen für Wertpapiergeschäfte)
- Deposit Guarantee and Investor Compensation Act (Einlagensicherungs- und Anlegerentschädigungsgesetz - EAEG)
- Kapitalanlagegesetzbuch (KAGB)
- Merkblatt – Hinweise zum Tatbestand des Depotgeschäfts", as of 2012/09/09
- Wertpapierdienstleistungs- Verhaltens- und Organisationsverordnung (WpDVerOV)
- Kreditinstituts-Rechnungslegungsverordnung (RechKredV)
- Prüfberichtsverordnung (PrüfBV)

# Hong Kong
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

Our Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("the Code of Conduct") require Investment Firms to ensure client assets are adequately safeguarded and properly accounted for. The Securities and Futures (Client Money) Rules (Chapter 571I of the Laws of Hong Kong) ("Client Money Rules") and the Securities and Futures (Client Securities) Rules (Chapter 571H of the Laws of Hong Kong) ("Client Securities Rules") further require client money and client securities received or held in Hong Kong by Investment Firms to be properly segregated in designated trust accounts maintained by the Investment Firms. These Rules permit Investment Firms to deliver client money and client securities for settling the client's outstanding trades or meeting the client's obligations to the Investment Firm. With a specific or standing authorization by the client, Investment Firms may deal with client money and client securities according to the client's instruction, subject to certain restrictions set out in the aforesaid Rules.

a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

The term "client assets" is defined in the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) ("SFO").

"Client assets" means client securities and collateral and client money.

Client securities

In relation to a licensed corporation[6] ("LC"), means any securities (other than securities collateral) (i) received or held by or on behalf of the LC; or (ii) received or held by or on behalf of any corporation which is in a controlling entity relationship with the LC, which are so received or held on behalf of a client of the LC or in which a client of the LC has a legal or equitable interest.

In relation to a registered institution[7] ("RI"), means any securities (other than securities collateral) (i) received or held by or on behalf of the RI, in the course of the conduct of any regulated activity for which the RI is registered; or (ii) received or held by or on behalf of any corporation which is in a controlling entity relationship with the RI, in relation to such conduct of the regulated activity, which are so received or held on behalf of a client of the RI or in which a client of the RI has a legal or equitable interest.

Client collateral

It means securities collateral[8] and other collateral[9].

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6 "licensed corporation" means a corporation which is granted a licence under section 116 or 117 of the SFO.

7 "registered institution" means an authorized financial institution which is registered under section 119 of the SFO, e.g. a bank. While the authority over LCs lies with SFC, the oversight of RIs is delegated to the Hong Kong Monetary Authority ("HKMA") in connection with supervision, complaints handling and carrying out investigations and regulated under the SFO and the Banking Ordinance (Chapter 155 of the Laws of Hong Kong). RIs are subject to the provisions of the SFO (including its subsidiary legislation) in the same way as LCs with respect to the protection of client assets. However, to avoid regulatory overlap, RIs are not subject to the Client Money Rules as it is not appropriate for RIs to segregate client money from the other deposits which they maintain in the course of their banking business.

8 "securities collateral",

(a) in relation to a LC, means any securities deposited with, or otherwise provided by or on behalf of a client of the LC to, the LC; or any other intermediary or person, which are so deposited or provided (i) as security for the provision by the LC of financial accommodation, or (ii) to facilitate the provision by the LC of financial accommodation under an arrangement that confers on the LC a collateral interest in the securities; or

(b) in relation to a RI, means any securities deposited with, or otherwise provided by or on behalf of a client of the RI to, the RI, in the course of the conduct of any regulated activity for which the RI is registered; or any other intermediary or person, in relation to such conduct of the regulated activity, which are so deposited or provided (i) as security for the provision by the RI of financial accommodation, or (ii) to facilitate the provision by the RI of financial accommodation under an arrangement that confers on the RI a collateral interest in the securities.

9 "other collateral",

(a) in relation to a LC, means any property (other than securities or money) deposited with, or otherwise provided by or on behalf of a client of the LC to, the LC; or any other intermediary or person, which is so deposited or provided (i) as security for the provision by the LC of financial accommodation, or (ii) to facilitate the provision by the LC of financial accommodation under an arrangement that confers on the LC a collateral interest in the property; or

(b) in relation to a RI, means any property (other than securities or money) deposited with, or otherwise provided by or on behalf of a client of the RI to, the RI, in the course of the conduct of any regulated activity for which

Client money

In relation to a LC, means any money (i) received or held by or on behalf of the LC; or (ii) received or held by or on behalf of any corporation which is in a controlling entity relationship with the LC, which is so received or held on behalf of a client of the LC or in which a client of the LC has a legal or equitable interest, and includes any accretions thereto whether as capital or income.

In relation to a RI, means any money (i) received or held by or on behalf of the RI, in the course of the conduct of any regulated activity for which the RI is registered; or (ii) received or held by or on behalf of any corporation which is in a controlling entity relationship with the RI, in relation to such conduct of the regulated activity, which is so received or held on behalf of a client of the RI or in which a client of the RI has a legal or equitable interest, and includes any accretions thereto whether as capital or income.

b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

Sections 4 and 5 of the Client Money Rules and the Client Securities Rules respectively require the Investment Firm to ensure that client assets which are received or held in Hong Kong are deposited in safe custody in a segregated account which is designated as a trust account or client account. These assets so segregated by the Investment Firm do not form part of the assets of the Investment Firm and remain subject to a trust in favour of the client.

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

d. Please describe any notable exclusions from the terms "client" or "client assets."

Under the SFO, "client", in relation to an intermediary[10], means a person for whom the intermediary ("first intermediary") provides a service the provision of which

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the RI is registered; or any other intermediary or person, in relation to such conduct of the regulated activity, which is so deposited or provided (i) as security for the provision by the RI of financial accommodation, or (ii) to facilitate the provision by the RI of financial accommodation under an arrangement that confers on the RI a collateral interest in the property.

[10] "intermediary" means a licensed corporation or a registered institution.

constitutes a regulated activity[11]. "Client" includes another intermediary that deposits securities, money or any property as collateral with the first intermediary and, in connection with a leveraged foreign exchange contract, does not include a recognized counterparty[12].

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

Investment Firms are permitted to hold client assets unless the Securities and Futures Commission ("SFC") requires otherwise, for example, by imposing a condition on its licence prohibiting it from holding client assets.

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

[11] "regulated activity" under the SFO means any of the regulated activities specified in Part 1 of Schedule 5 to the SFO, which are:
Type 1 : dealing in securities;
Type 2 : dealing in futures contracts;
Type 3 : leveraged foreign exchange trading;
Type 4 : advising on securities;
Type 5 : advising on futures contracts;
Type 6 : advising on corporate finance;
Type 7 : providing automated trading services;
Type 8 : securities margin financing;
Type 9 : asset management; and
Type 10 : providing credit rating services.

[12] "recognized counterparty" means (i) an authorized institution as defined in section 2(1) of the Banking Ordinance (Chapter 155 of the Laws of Hong Kong); (ii) in relation to a particular transaction conducted by a corporation licensed for Type 3 regulated activities, another corporation which is also so licensed; or (iii) an institution prescribed by the Securities and Futures (Recognized Counterparty) Rules (Chapter 571B of the Laws of Hong Kong) made under section 397(1) of the SFO for the purposes of this definition as a recognized counterparty.

Not applicable.

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

The SFC supervises Investment Firms which hold client assets mainly through the following regulatory requirements and measures:

- the Client Money Rules and the Client Securities Rules stipulate statutory requirements on the manners in which client money and client securities may be held / handled by Investment Firms;
- the Securities and Futures (Keeping of Records) Rules (Chapter 571O of the Laws of Hong Kong) require Investment Firms to keep such accounting and other records as are sufficient to (i) account for all client assets that they receive or hold; (ii) enable all movements of such client assets to be traced through their accounting systems and, where applicable, stock holding systems; (iii) reconcile, on a monthly basis, any differences in their balances or positions with other persons, including their associated entities, clearing houses, custodians and banks, etc. and show how such differences were resolved, and (iv) demonstrate compliance by them with specified sections (including payment of client money and deposit/registration of client securities and securities collateral) of the Client Money Rules and the Client Securities Rules, and that they have systems of control in place to ensure compliance with all such provisions;
- the Code of Conduct and Guidance Notes[13] issued by the SFC supplement the law with practical guidelines for Investment Firms holding / handling client assets;
- the law[14] requires Investment Firms to appoint auditors to conduct annual audit and review of controls and compliance of the Investment Firms and submit their reports to the SFC;
- the SFC may appoint auditors under sections 159 or 160 of the SFO to examine the books and records of an Investment Firm in certain circumstances, e.g. if the SFC has received an auditor report on a matter that, in the opinion of the auditor, constitutes on the part of the Investment Firm a failure to comply with prescribed requirements under the Client Money Rules or Client Securities Rules;
- the SFC is given wide powers under the SFO to supervise Investment Firms' activities (including conducting onsite inspection of Investment Firms' books and records) and investigate into misconducts and offences.

[13] Namely (i) Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission and (ii) Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules

[14] Sections 153 and 156 of the SFO and the Securities and Futures (Accounts and Audit) Rules (Chapter 571P of the Laws of Hong Kong)

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

Yes, the Client Money Rules and Client Securities Rules require client assets which are received or held in Hong Kong to be maintained separately from the own assets of Investment Firms.

In respect of client money received or held in Hong Kong, Investment Firms are required to establish and maintain in Hong Kong segregated accounts with banks[15] for deposit of such money within one business day of receipt. In case non-client money is held in a segregated account, the Investment Firm is required to withdraw the non-client money from the segregated account within one business day of becoming so aware.

In respect of client securities or securities collateral received from clients, an Investment Firm shall ensure that, as soon as reasonably practicable, such securities are registered in the name of the relevant client or deposited in safe custody in a segregated account established and maintained in Hong Kong with

(i) a bank;

(ii) an approved custodian (currently, only the Hong Kong Securities Clearing Company Limited is approved custodian); or

(iii) another Investment Firm licensed for dealing in securities.

Securities collateral received by an Investment Firm may also be registered in the name of the Investment Firm, or deposited in an account in the name of the Investment Firm with a bank, an approved custodian, or another Investment Firm licensed for dealing in securities.

a. Must the Client Assets of one client be maintained separately from those of other clients?

No.

i. Are Investment Firms allowed to hold Omnibus Accounts?

Yes, Investment Firms are allowed to hold client assets in Omnibus Accounts.

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

Under the Client Money Rules and Client Securities Rules, Investment Firms are generally not permitted to use a client's money and client

[15] In all the answers to this survey, the word "bank" refers to an "authorized institution" as defined in section 2 of the Banking Ordinance of Hong Kong.

securities for settling obligations of another client. Investment Firms are further required under the Code of Conduct and Guidance Notes to institute adequate controls to safeguard client assets and ensure client assets are properly accounted for.

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

The amount of Client Assets that a firm is required to segregate should be calculated on a client-by-client basis.

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

An Investment Firm is required to hold assets of the same type and description as those deposited by the client.

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

Investment Firms are required to reconcile their client asset records with custodians' statements / bank statements. The reconciliation can be done on an aggregate basis.

C) If a client has a debit balance (*i.e.*, the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

Investment Firms are not required to segregate client money held by it for settling the client's outstanding trade or indebtedness to the firm. If the client money is for meeting settlement or margin obligations to the Investment Firm that would fall due within 2 business days or is for repaying an existing indebtedness due to the firm (such as margin loan), the segregation requirement does not apply to the client money so received or held.

An Investment Firm can offset credit and debit balances for the same client. It cannot offset credit and debit balances across different clients in the calculation of the amount of Client Assets that a firm is required to segregate.

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

Investment Firms should perform the reconciliation on a daily basis.

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

An Investment Firm must make sure that Client Assets are properly segregated from proprietary assets within one (1) day after receipt. Therefore, an Investment Firm must complete the reconciliation for the day of receipt (e.g., Day X) before the end of the next day (e.g., Day X+1).

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

If the firm identifies any deficiency in the amount of client money or client securities that should be held in a segregated account, it should make good the deficiency as soon as possible and the payment or securities deposited into the segregated account will be deemed client money or client securities (as the case may be).

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

No, Investment Firms are not permitted to maintain a "buffer" by depositing its own money / securities into a segregated account.

Section 10 of the Client Money Rules requires an Investment Firm which becomes aware that it is holding an amount of non-client money in a segregated account to pay that amount of money out of the segregated account within one business day of becoming so aware.

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

No.

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

Under sections 4 & 5 of the Client Money Rules, client money received or held by an Investment Firm may be paid in accordance with the client's specific, one-off direction in writing or the client's standing authority. However, an Investment Firm shall not pay client money in accordance with a client's standing authority if to do so would be unconscionable or such authority authorizes payment to an account in Hong Kong of the Investment Firm or its affiliated company which is

not a segregated account. An Investment Firm is also forbidden to pay client money to any member of the staff of the firm or its affiliated company.

Under section 6 of the Client Securities Rules, an Investment Firm may deal with client securities or securities collateral received from a client in accordance with a specific, one-off written direction or standing authority given by the client. However, the Investment Firm is forbidden to deal with such securities in accordance with a client's standing authority if to do so

(i) would be unconscionable;

(ii) would result in transfer of such securities to any member of the staff of the firm or its affiliated company; or

(iii) except as permitted under sections 7 to 9 of the Client Securities Rules (please see details below), would result in transfer of such securities to an account in Hong Kong of the Investment Firm or its affiliated company other than a segregated account (in the case of securities collateral, also an account in the name of the Investment Firm) as specified in section 5 of the rules, or otherwise result in the Investment Firm or its affiliated company having the benefit or use of such securities.

Under sections 7 to 9 of the Client Securities Rules, with a client's standing authority,

(i) an Investment Firm licensed or registered for dealing in securities or licensed for securities margin financing may repledge securities collateral with a bank (in the case of Investment Firm licensed for securities margin financing, it may also repledge securities collateral with another Investment Firm which is licensed for dealing in securities) for financial accommodation provided to the Investment Firm, subject to a cap on the amount of securities collateral that can be repledged by the firm;

(ii) an Investment Firm licensed or registered for dealing in securities may deposit securities collateral with a recognized clearing house or another Investment Firm licensed or registered for dealing in securities as collateral for the discharge and satisfaction of the Investment Firm's settlement obligations and liabilities;

(iii) an Investment Firm licensed or registered for dealing in futures contracts may deposit securities collateral with a recognized clearing house or another Investment Firm licensed or registered for dealing in futures contracts as collateral for the discharge and satisfaction of the Investment Firm's settlement obligations and liabilities;

(iv) an Investment Firm licensed or registered for dealing in securities may apply client securities or securities collateral pursuant to a securities borrowing and lending agreement.

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

If a client has granted the Investment Firm the right to use or re-hypothecate his assets, the ownership rights of the client over its assets would be subject to the terms and conditions of the client's grant. The court may (a) characterise a security interest with a right of re-hypothecation as being a title transfer arrangement; or (b) interpret such a security interest as having an implied right for the Investment Firm to acquire full legal and beneficial interest automatically upon a disposal (and a corresponding obligation on the Investment Firm to return equivalent securities in due course).

If the court characterizes a security interest with a right of re-hypothecation as a title transfer arrangement, the client has no proprietary interest in the collateral, but merely a conditional contractual right against the Investment Firm for re-delivery of assets. If the court interprets such a security interest as having an implied right for the Investment Firm to acquire full interest upon a disposal, the client is the beneficial owner of the assets delivered as collateral.

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

A client's consent should be in writing, in one-off direction or standing authority. A standing authority shall specify a validity period not exceeding 12 months and may be renewed upon expiry.

iii. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (*i.e.*, established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

If a client does not grant the Investment Firm any right to use or re-hypothecate his assets, according to sections 4 and 5 of the Client Money Rules and the Client Securities Rules respectively, the Investment Firm is required to hold the client assets in a segregated account which is designated as a trust account or client account. These assets so segregated remain subject to a trust in favour of the client. If the Investment Firm uses or re-hypothecates the client assets without the client's consent, the client would, in principle, have the right to trace and recover his assets. This conclusion is based on a line of authorities including C.A. Pacific Securities Limited (HCCW 36-37/98) and Re Diplock [1948] Ch. 465.

If the Investment Firm, in breach of the relevant statute, rule or regulation, uses or re-hypothecates its client assets without such client's consent, the Investment Firm would have criminal liability on conviction. But it does not affect the client's right to its assets. The client could commence a civil action to trace and recover his assets which were held by the Investment Firm in trust for him. If there is a shortfall of client assets, the client who does not recover all his assets can apply to the court to wind up the Investment Firm and he will rank as an unsecured creditor in the liquidation in respect of the shortfall.

The SFC has established an Investor Compensation Fund to provide a measure of compensation to clients of an intermediary licensed or registered for Types 1, 2 or 8 Regulated Activity who suffer loss by reason of a default committed by the intermediary in connection with securities or futures contracts listed or traded on the Stock Exchange of Hong Kong and Hong Kong Futures Exchange. The compensation payable is limited to HK$150,000.

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

   The futures and options clearing houses in Hong Kong require their participants to maintain separate collateral accounts with the clearing houses for client positions and proprietary positions.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction?

Yes, an Investment Firm is permitted to transfer to, or hold Client Assets belonging to clients in our jurisdiction in, another jurisdiction.

The Client Money Rules and the Client Securities Rules require segregation of client money and client securities which are received or held in Hong Kong in a segregated account maintained in Hong Kong. Client's authorization in the form of a written direction or standing authority must be obtained if the client's money or securities received or held in Hong Kong is to be transferred outside Hong Kong unless the transfers are required for the purposes of meeting settlement or margin requirement on behalf of the client.

In addition, the Investment Firm should, in the handling of client transactions and client assets, act to ensure that client assets are accounted for properly and promptly. Where the Investment Firm or a third party on behalf of the Investment Firm is in possession or control of client assets, the Investment Firm should ensure that client assets are adequately safeguarded. Where a client's assets are received or held overseas, additional risk disclosures should be provided to the client informing the client that such client's assets may not enjoy the same protection as that conferred by

the Client Money Rules and the Client Securities Rules on client assets held or received in Hong Kong[16].

If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

a. Client Assets transferred to or located in other jurisdictions?

Investment Firms are required to ensure client assets are adequately safeguarded and keep proper records to account for all client assets received or held by them. Where client assets are transferred to or located in other jurisdictions, Investment Firms are required to segregate, as far as practicable, such client assets from their own assets.

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

Investment Firms are required to segregate client money transferred from other jurisdictions to Hong Kong in segregated bank account. Regarding client securities transferred from other jurisdictions and fallen outside the scope of application of the Client Securities Rules[17], Investment Firms are required to segregate, as far as practicable, such securities from their own assets.

If so, please provide details of those requirements.

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

Yes, an Investment Firm is permitted to hold Client Assets of Foreign Investment Firm in an Omnibus Account together with other client assets.

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

Such Client Assets are entitled to the same protection as that conferred on other client assets received or held by the Investment Firm in Hong Kong.

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

Not applicable (see response to 5(a) above).

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

[16] General Principle 8 and Paragraph 11.1 of the Code of Conduct.

[17] The Client Securities Rules only apply to securities listed or traded on the Stock Exchange of Hong Kong Limited and interests in collective investment schemes authorized by the SFC.

The Foreign Investment Firm is subject to the same Client Asset protection requirements as other clients of the Investment Firm. Clients of an Investment Firm are not permitted to waive any of the Client Asset protection requirements.

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

   a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

      Under section 4 of the Client Money Rules, Investment Firms are required to maintain segregated accounts for holding client money received or held in Hong Kong with banks.

      Under section 5 of the Client Securities Rules, Investment Firms are only permitted to maintain segregated accounts for holding client securities and securities collateral in Hong Kong with a bank, an approved custodian, or another Investment Firm licensed for dealing in securities.

      Under section 164 of the SFO, client assets of an Investment Firm may be received or held in Hong Kong by an associated entity[18] of the Investment Firm. An associated entity of an Investment Firm is required to comply with the Client Money Rules and the Client Securities Rules except where the associated entity is a bank, which is not subject to the Client Money Rules.

   b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

      There is no regulatory requirement concerning the custody agreement between intermediary and custodian.

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

   Where a client's assets are received or held overseas, Investment Firms are required under Paragraph 11.1(b) of the Code of Conduct, to provide additional risk disclosures to the client informing the client that such client assets may not enjoy the same protection as that conferred by the SFO, the Client Money Rules and the Client Securities Rules on client assets held or received in Hong Kong.

[18] An associated entity, as defined in Schedule 1 to the SFO, is a corporation that has a controlling-entity relationship with an Investment Firm and holds in Hong Kong clients assets of the Investment Firm.

Investment firms that repledge clients' securities collateral to banks for financial accommodation are required to (i) provide to their securities margin clients a risk disclosure statement about the risk of providing an authority to the firm to repledge the client's securities collateral upon the provision and subsequent renewal of the authority; and (ii) disclose to their securities margin clients upon account opening and in the monthly client statements that the firm repledges clients' collateral. *(Per Schedule 1, Item 9 (a) to (c) in Schedule 5 to the Code of Conduct and section 11(3A)(d) of the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules)*

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

Clients are not permitted to waive any of the Client Asset protection requirements. However, because an Investment Firm is permitted, with client consent, to re-hypothecate or otherwise use Client Securities, such Client Securities may become unavailable to the client upon the Investment Firm experiencing insolvency.

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

a. Does the Investment Firm report where client assets are held?

Yes. Investment Firms are required to report in the analysis of client assets in the financial returns how much client money and client securities are held by it and the amount of client funds segregated and distribution of the client securities by the locations specified in the financial returns, e.g. banks, clearing house, other investment firms. For client securities held in other locations, Investment Firms are required to specify the locations and purposes of the dispositions.

b. Does the Investment Firm or depository report the protections applicable to such client assets?

Yes. An Investment Firm is required to notify the SFC in writing upon becoming aware that it does not comply with sections 4(4) (provision for a written confirmation of the renewal of the standing authority to client), 5 (requirement for deposit or registration of client securities and securities collateral) or 10(1) (limitations on the treatment of client securities and securities collateral) of the Client Securities Rules and sections 4(1) or (4) (requirement for designation of segregated account and payment of client money into segregated account) or 5(1) (requirement for payment of client money out of segregated accounts) of the Client Money Rules within one business day thereafter.

Section 56 of the Securities and Futures (Financial Resources) Rules (Chapter 571N of the Laws of Hong Kong) ("FRR") requires an Investment Firm to submit financial returns, which include an analysis of client assets, to the SFC on a monthly basis.

In addition, under section 156 of the SFO and the Securities and Futures (Accounts and Audit) Rules (Chapter 571P of the Laws of Hong Kong) ("Accounts and Audit Rules"), an Investment Firm is required to submit to the SFC on an annual basis, financial returns, which include an analysis of client assets, made up to the last day of each financial year together with an auditor's opinion as to, among other things, whether the financial returns so submitted are correctly compiled from the records of the Investment Firm.

An Investment Firm is also required under paragraph 12.5 of the Code of Conduct to notify the SFC immediately upon any material breach, infringement of or non-compliance with any laws, rules, regulations, and codes administered or issued by the SFC, the rules of any exchange or clearing house of which it is a member or participant, and the requirements of any regulatory authority which apply to the Investment Firm, or where it suspects any such breach, infringement or non-compliance whether by itself or persons it employs and appoints to conduct business with clients.

c. Does the Investment Firm or depository report the amount of assets that are held?

Yes. Please refer to Answer 9a above.

In each case, are such reports provided on request or periodically? If periodically, with what frequency?

The analysis of client assets is provided to the SFC in the financial returns submitted by Investment Firms on a monthly basis.

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

a. Where Client Assets are held?

b. The amount of Client Assets held at a depository?
c. The safeguards applicable to Client Assets held at a depository?

Under sections 153 and 156 of the SFO and the Accounts and Audit Rules, an Investment Firm is required to appoint an auditor to conduct annual audit and review on its controls and compliance with the Client Money Rules and the Client Securities Rules and submit an auditor's report to the SFC. The auditor's report shall contain the auditor's opinion as to, among other things, (a) whether each of the financial returns (including an analysis of client assets) made up to the last day of each financial year is correctly compiled from the records of the Investment Firm; (b) whether the Investment Firm had systems of control in place that were adequate to ensure compliance with the Client Money Rules and the Client Securities Rules during the financial year; and (c) whether the Investment Firm has complied with the Client Money Rules and the Client Securities Rules during the financial year.

Under sections 159 and 160 of the SFO, the SFC may appoint an auditor to examine and audit the accounts and records of an Investment Firm in certain circumstances, e.g. upon receiving an auditor report on a matter that, in the opinion of the auditor,

constitutes on the part of the Investment Firm a failure to comply with the prescribed requirements under the Client Money Rules and the Client Securities Rules. The SFC has the authority under section 180 of the SFO to conduct onsite inspection on Investment Firms and their associated entities and require the production of records and documents from Investment Firms and their associated entities, and make inquiries concerning such records and documents in order to ascertain whether such firms are or have been complying with specified requirements, including those relating to client assets.

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

    b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

    The SFC is a signatory to the IOSCO MMoU (Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information) which facilitates information exchange and mutual assistance between securities regulators.. Moreover, the SFC has entered into a number of bilateral MoUs and other written cooperative arrangements with securities regulators outside Hong Kong.

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

    Under section 146(1) of the SFO, an Investment Firm shall as soon as reasonably practicable notify the SFC by notice in writing if it becomes aware of its inability to meet the regulatory capital requirements stipulated in the FRR.

    In addition, an Investment Firm is required under section 55 of the FRR to notify the SFC in writing as soon as reasonably practicable and in any event within one business day of becoming aware of specified circumstances, for example, its liquid capital falls below 120% of the minimum required level.

    An Investment Firm is also required under Paragraph 12.5 of the Code of Conduct to notify the SFC immediately upon the happening of material events, such as insolvency or bankruptcy of the firm, the making of any receiving order or arrangement with creditors, suspension or revocation of any regulatory licence or

approval in connection with the firm's business, material failure or defects in the firm's operation or systems etc.

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*, capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

Under section 146(5) of the SFO, where the SFC reasonably believes that an Investment Firm is unable to maintain, or to ascertain whether it maintains, regulatory capital in accordance with the minimum requirements set out in the FRR, the SFC may by notice in writing suspend the Investment Firm's licence or permit the Investment Firm to carry on any regulated activity for which it is licensed, subject to such conditions as may be imposed by the SFC. In addition, under sections 204 to 205 of the SFO, the SFC may, through the issuance of a restriction notice, restrict the firm's business and / or the firm's ability to deal with client assets and its own property. Furthermore, under sections 212 and 213 of the SFO, the SFC may petition for an Investment Firm to be wound up (details please see Answer 14 below), apply to court for appointment of administrator, and issuance of injunction or other orders.

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

The Court of First Instance has jurisdiction to wind up any company formed and registered under the Companies Ordinance (Chapter 32 of the Laws of Hong Kong) ("CO") (section 176 of the CO) and any unregistered company (section 326 of the CO). The winding up provisions and procedures of the CO apply to Investment Firms as they do to any other company that can be wound up under the CO.

There are three types of liquidation: compulsory winding-up, creditors' voluntary winding-up and members' winding-up.

Compulsory winding-up

The application for winding up of a company by the court may be made by a creditor, a shareholder, the company itself or relevant government officials (e.g. the Financial Secretary or the Registrar of Companies).

The SFC also has power under section 212 of the SFO to apply to the Court of First Instance to wind up any corporation (not just an Investment Firm) which the Court has jurisdiction to wind up. It must appear to the SFC that it is desirable in the public interest that the corporation should be wound up. The ground for such application is that it is "just and equitable" that the corporation be wound up. The winding-up

procedures under the CO are applicable regardless of whether or not the company is an Investment Firm. Upon presentation of the petition, the SFC may also apply under section 193 of the CO for the appointment of provisional liquidators if the assets of the Investment Firm or the assets it controls appear to be at risk.

Once the petition is presented to the Court and served on the relevant parties, the petitioner must advertise a notice of the petition in the gazette and in one circulating English newspaper and one circulating Chinese newspaper. Prior to the hearing of the petition, the petitioner also has to obtain a certificate of procedural compliance from the High Court Registrar. If there is no opposition at the first hearing, a master in open court will grant a winding up order against the company with the Official Receiver to act as provisional liquidator. If the petition for winding–up is disputed, the hearing will be adjourned and fixed before a company judge for argument.

Creditors' voluntary winding-up
The directors of a company, realizing that there may be no real prospects of the company meeting the demands of creditors, call an extraordinary general meeting when members may resolve, by a special resolution, to wind up the company. The liquidation is deemed to have commenced upon passing of the special resolution.

Members' voluntary winding-up

The majority of the directors of a company may resolve at a meeting called for that purpose to have the company wound up and that one of them should make a statement in the form specified by the Companies Registry ("CR") and file the same with the CR under section 228A of the CO. Liquidation of the company is deemed to have commenced at the time of delivery of the statement to the CR.

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

Compulsory winding-up
The Official Receiver ("OR") will act as liquidator *ex officio* from the time the winding-up order is made by the Court. The OR may summon separate meetings of the creditors and contributories of the company to appoint another individual as liquidator in its place. The Court may also appoint a liquidator at the time of making the winding up order.

Creditors' voluntary winding-up
The members and creditors of the company will provide nominations for the liquidator separately and in the event of any conflict the creditors' nomination will take precedence. The appointment of a liquidator will be sanctioned by a majority in value of those attending and voting at the creditors' meeting.

Members' voluntary winding-up

The liquidator is appointed by the members of the company. His/her appointment will be formalized by way of an ordinary resolution passed by the members at a general meeting at which the resolution to wind up the company is also passed.

In both types of voluntary winding-up, the Court has the power to appoint or replace a liquidator.

In cases where the SFC presents a petition under section 212 of the SFO and applies for the urgent appointment of provisional liquidators prior to the winding up hearing, the SFC will propose that the court appoint one or two nominated insolvency practitioners to act as provisional liquidators.

Qualification of Administrative Officer

There is no legal requirement for liquidators to be licensed or else approved, and they do not need to hold a particular professional qualification. Therefore, anyone may be appointed as a liquidator by providing such security as may be required by the OR. In practice, appointed liquidators and provisional liquidators tend to be insolvency practitioners such as accountants, solicitors or similar professionals. In compulsory liquidations, the OR operates 2 panels whereby insolvency work is contracted out to private sector insolvency practitioners. Panel members have to be suitably qualified (i.e. accountants or solicitors) and have a certain level of experience in insolvency work. The criteria are higher for the Panel which deals with the more complex and high value liquidations.

16. What are the duties of the Administrative Officer?

The Administrative Officer must conduct an investigation into the company's affairs with a view to uncovering and collecting in the company's assets, settling the validity and quantum of creditors' claims and identifying the reasons for the company's insolvency. He must then exercise his discretion in the administration of the assets of the company and distribute those assets amongst the company's creditors according to the ranking set out in the CO. The Administrative Officer is also obliged to assist the OR and any person who is entitled to inspect the books or papers of the company.

a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

The powers and duties of the Administrative Officer are contained in the CO and the Companies (Winding-Up) Rules (Chapter 32H of the Laws of Hong Kong) set out procedural details for Administrative Officer. Though not mandatory, the Hong Kong Institute of Certified Public Accountants has issued coordinated Insolvency Guidance Notes which indicate best practice for insolvency practitioners and explain in detail their duties and responsibilities. There are various guides issued by the High Court of Hong Kong, such as Procedural Guide for Taxation / Determination of Bills of Provisional Liquidators or Liquidators by Masters and Procedural Guide for Taxation of Bills in Liquidation (other than bills of Provisional Liquidators or Liquidators) before Taxing Officers.

b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

As regards compulsory liquidation by the court, a liquidator is under the supervision of the Court and the OR. Under section 205 of the CO, prior to the release of a liquidator, the court may make such order as it thinks just, charging the liquidator with the consequences of any act or default which he may have done or done contrary to his duty. The CO also provides that liquidators shall be liable to pay fines for failure to comply with certain provisions of the CO.

A liquidator (i.e. an Administrative Officer) can be liable for negligence, default, breach of duty or breach of trust. However, under section 358 of the CO, if the liquidator has acted honestly and reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, the court may relieve him, either wholly or partly, from his liability on such terms as the court may think fit. As such, an Administrative Officer is not subject to strict liability.

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

a. Does the regulator continue to supervise the Investment Firm?

Under section 195(1) of the SFO, when an Investment Firm goes into liquidation or is ordered to be wound up, the SFC is entitled to revoke or suspend its licence. However, this step is generally not taken until completion of the insolvency proceeding or the return of Client Assets and until this stage the Investment Firm therefore remains under the SFC's supervision.

b. How, if at all, is the regulator involved in the process of returning Client Assets?

The SFC does not involve itself in the liquidation of the Investment Firm and the distribution of Client Assets. These processes will be undertaken by the liquidator. The SFC will maintain an oversight of the progress of these processes.

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

An Investment Firm must still comply with the segregation and treatment of Client Assets as required under the Client Money Rules and the Client Securities Rules during the insolvency of an Investment Firm.

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

    In general, the Administrator would arrange return of client assets to the respective clients according to their instructions. The SFC may facilitate such transfer by explicitly permitting such transfer in the restriction notice issued to the Investment Firm in financial distress

    a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

       The insolvent Investment Firm would require the client's consent and the SFC's consent before making such transfer. The time required for securing such consents would depend on the circumstances of individual case.

    b. What factors, if any, affect the time period required to accomplish such a transfer?

       The amount of time needed for accomplishing a transfer of client position or client assets to a solvent Investment Firm would depend on the circumstances of individual case, such as the time required for opening an account with the transferee investment firm by the client, the availability of the client to give consent to the transfer etc..

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

    There does not appear to be such a risk.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

    An investor compensation fund is established for compensating investors for their losses in their investment in securities or futures contracts listed or traded in Hong Kong due to default committed by Investment Firms or their associated persons. It is based on a per-investor compensation limit of HK$150,000 for trading securities and futures contracts respectively. Only qualifying clients of an Investment Firm, which exclude institutional investors, are eligible to claim compensation in line with the objective of the compensation fund to provide a safety net for retail investors. Details of the requirements are set out in the Securities and Futures (Investor Compensation – Compensation Limit) Rules (Chapter 571AC of the Laws of Hong Kong) and the Securities and Futures (Investor Compensation – Claims) Rules (Chapter 571T of the Laws of Hong Kong).

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into

(or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

Generally, permissions granted by clients pre-bankruptcy would not have impact on the client's position except that the return of client assets that have been re-hypothecated or lent to a third party by the Investment Firm pre-bankruptcy may be subject to fulfillment by the Investment Firm of its liabilities to the third party.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

Generally, there is no impact on the client's position, though the return of client assets held in another jurisdiction may be subject to the local requirements of that jurisdiction and the manner in which their assets are held. The Client Money Rules and Client Securities Rules do not apply to Client Assets held outside Hong Kong according to section 3 of the Client Money Rules and the Client Securities Rules.

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

Client Asset protection requirements are set out in sections 4-11 of the Client Money Rules and sections 4-12 of the Client Securities Rules. If the SFC considers that it is desirable in the public interest/interest of the investing public, it may, pursuant to sections 204 and 205 of the SFO, issue a restriction notice in respect of the non-compliance. The restriction notice prohibits the Investment Firm carrying out any regulated activities and dealing with client assets and its own assets. In conjunction with a restriction notice, the SFC may also, pursuant to section 213(2)(d) of the SFO, apply to Court for the appointment of an administrator to administer the property of the Investment Firm and return Client Assets to clients. Further, under sections 12 and 13 of the Client Money Rules and the Client Securities Rules respectively, if an Investment Firm fails to comply with Client Asset protection requirements, it is liable on conviction to a fine of $10,000 to $1,000,000 and to imprisonment for 6 months to 7 years, depending on the seriousness of the offence. Further, the Investment Firm could be disciplined (e.g. licence revocation or suspension) for non-compliance. There is no distinction between different classes of clients in the application of the client asset protection requirements.

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

If there is a shortfall of securities, there is a line of authorities[19] which has generally directed that the available securities be distributed pari passu among the clients who have a claim to them. Depending on the facts, a distinction may be drawn between

[19] C.A. Pacific Securities Limited (HCCW 36-37/98); Re Forluxe Securities Ltd (unreported, HCCW 310 &311/1998), Re Chark Fung Securities Co Ltd (unreported, HCCW 362/1998) and Re Tiffit (Hong Kong) Ltd ([2007] 1 HKLRD 267)

cash clients and margin clients, the former having priority but clients in the same class sharing pari passu among themselves.[20] The same method is also used to allocate the available cash. However, in a case of misappropriation of Client Assets[21], the Court of First Instance indicated that where the records of the Investment Firm are sufficiently accurate to enable the Administrative Officer to identify which clients' securities have been taken, it would not be appropriate to follow the pari passu principle. Instead, the loss will fall on the identified clients.

As regards whether clients take in priority to general unsecured creditors, see Answer 26 below.

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

Under sections 4 and 5(1) of the Client Money Rules and Client Securities Rules respectively, the Investment Firm shall ensure that the Client Assets are deposited in safe custody in a segregated account which is designated as a trust account or client account. These assets so segregated by the Investment Firm do not form part of the assets of the Investment Firm and are not available for distribution to creditors upon insolvency of the Investment Firm. However, if there is a shortfall of Client Assets, clients who do not recover all their Client Assets will rank as unsecured creditors in the liquidation in respect of the shortfall. The Regime does not distinguish between domestic and foreign creditors of the Investment Firm.

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

**Securities and Futures Ordinance:**

http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CurAllEngDoc*496*100*-568#568

**Securities and Futures (Client Securities) Rules:**

http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CurAllEngDoc*496*100*568.9#568.9

**Securities and Futures (Client Money) Rules:**

http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CurAllEngDoc*496*100*568.10#568.10

[20] C.A. Pacific, ibid.
[21] Re Great Honest Investment Company Ltd & Others (unreported HCMP 2251/2007 per Barma J)

**Securities and Futures (Financial Resources) Rules:**

http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CurAllEngDoc*496*100*568.15#568.15

**Securities and Futures (Accounts and Audit) Rules:**

http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CurAllEngDoc*496*100*568.17#568.17

**Securities and Futures (Keeping of Records) Rules:**

http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CurAllEngDoc*496*100*568.16#568.16

**Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules:**

http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CurAllEngDoc*496*100*568.18#568.18

**Securities and Futures (Investor Compensation – Compensation Limit) Rules:**

http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CurAllEngDoc*568.27*100*568.30#568.30

**Securities and Futures (Investor Compensation – Claims) Rules:**

http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CurAllEngDoc*496*100*-568.21#568.21

**Banking Ordinance:**

http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CurAllEngDoc*155*100*155#155

**Companies Ordinance:**

http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CurAllEngDoc*32*100*32.1#32.1

**Companies (Winding-up) Rules:**

http://www.legislation.gov.hk/blis_ind.nsf/WebView?OpenAgent&vwpg=CurAllEngDoc*1*100*-32.8#32.8

**Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission:**

http://en-rules.sfc.hk/en/display/display.html?rbid=3527&element_id=1868

**Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission:**

http://en-rules.sfc.hk/en/display/display.html?rbid=3527&element_id=162

**Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules:**

http://en-rules.sfc.hk/en/display/display.html?rbid=3527&element_id=2446

**Insolvency Guidance Notes issued by the Hong Kong Institute of Certified Public Accountants:**

http://app1.hkicpa.org.hk/ebook/index.php

# India
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

    a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

    **"client assets" means funds, securities and positions held on behalf of client by a investment firm.**

    b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

    **The investment firms are required to settle the funds and securities of the clients within 24 hours of the pay out received from the stock exchanges. In case the shares/funds of the clients are held in the books of investment firms based on their consent, the same is required to be held in the fiduciary capacity on behalf of the client.**

    c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

    **A client is one who is registered with the investment firm for the purpose of dealing in the securities.**

    d. Please describe any notable exclusions from the terms "client" or "client assets."

    **As mentioned above "client assets" include funds, securities and positions.**

    **Further, there are no exclusions as on date in the definition of terms.**

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

**There is no difference in treatment based on client asset category**

**All the equity products are exchange traded and the stipulations given below are applicable to exchange traded products**

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

**No special authorization viz. a specific form of license or registration is required to hold Client Assets. However, investment firm is required to obtained consent from their clients in case the shares/funds of the clients are held in the books of investment firms. In such case, the assets in the books of investment firm are required to be held in the fiduciary capacity on behalf of the client.**

**The compliance of above requirements is verified by SRO and SEBI during inspections of books of investment firm.**

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

**Yes.**

a. Must the Client Assets of one client be maintained separately from those of other clients?

**Yes.**

i. Are Investment Firms allowed to hold Omnibus Accounts?

**No**

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

**Regulation 17 of SEBI (Stock Broker and Sub-Brokers) Regulations, 1992 and SEBI circular SMD/SED/CIR/93/23321 dated November 18, 1993- The money/securities deposited by the client should be kept in a separate account distinct from the firm's own account or account of any other clients**

**SEBI circular MRD/DoP/SE/Cir- 11/2008 dated April 17, 2008: The investment firms should have adequate systems and procedures in place to ensure that client collateral is not misused and should also maintain records to ensure proper audit trail of use of client collaterals.**

**Thus, the assets of a client are not affected due to losses of other clients.**

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account.

For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

**The client assets are fungible between or within the asset classes**

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

**On client by client basis**

C) If a client has a debit balance (i.e. the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold?

**Yes**

Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

**No**

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

**SEBI circular MIRSD/SE/CIR-19/2009 dated December 3, 2009: The client account is required to be reconciled on continuous basis at the choice of the clients and at least once in a month or quarter, as per the choice of the client.**

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

**The question is not clear. However, it may be mentioned that the clients would get their dues in full**

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

**No. The money/securities deposited by the client should be kept in a separate account distinct from the firm's own account or account of any other clients**

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client?

**No**

If so, how?

**SEBI circular MRD/DoP/SE/Cir- 11/2008 dated April 17, 2008: There should be adequate systems and procedures in place to ensure that client assets are not used for any purposes other than meeting the respective client's margin requirements / pay-in.**

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets?

**Yes**

If so, please describe.

**SEBI circular MRD/DoP/SE/Cir-11/2008 dated April 17, 2008: It is required to maintain records to ensure proper audit trail of use of client collateral. There should be adequate systems and procedures in place to ensure that client assets are not used for any purposes other than meeting the respective client's margin requirements / pay-in.**

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

**As regards i and ii above, in India, clients assets cannot be used or re-hypothecated by an investment firm.**

iii. How are the ownership rights of a client over its client assets changed or affected when the investment firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (i.e. established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

**In India, clients assets cannot be used or re- hypothecated by an investment firm.**

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

**The clearinghouses/clearing corporations are required to maintain separate identification of client positions and margin at Investment Firm level. The investment firm is required to submit a list of client codes, names of the clients, client wise margin amount collected by it from the client and paid to the clearing member which in turn is paid to the Clearing House/Clearing Corporation. The investment firm is also required to submit to the clearing member the details of the margin amount due and paid by it to the Clearing**

**House/Clearing Corporation for the purpose of meeting margin requirements.**

**The above reporting details are verified by clearing houses during the course of the inspection of the investment firm.**

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:
   a. Client Assets transferred to or located in other jurisdictions?
   b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?
   c. If so, please provide details of those requirements.

   **No. Investment firms are required to hold the assets of the clients in our jurisdiction**

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,
   a. What protections are applicable to the Foreign Investment Firm's Client Assets?
   b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?
   c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

   **No**

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

   **Yes, In case of institutional clients**

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

   **The custodians are required to obtain certificate of registration from SEBI in terms of SEBI (Custodian of Securities) Regulations, 1996. They are required to meet the eligibility criteria as specified in the regulations in terms of net worth, infrastructure, key personnel and fit and proper criteria.**

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

**Regulation 17 of SEBI (Custodian of securities) regulations, 1996: Every custodian of securities shall enter into an agreement with each client on whose behalf it is acting as custodian of securities and every such agreement shall provide for the following matters namely**

- ***the circumstances under which the custodian of securities will accept or release securities/monies from the custody account;***
- ***the circumstances under which the custodian of securities will receive rights or entitlements on the securities of the client;***
- ***the circumstances and the manner of registration of securities in respect of each client; and details of the insurance, if any, to be provided for by the custodian of securities.***

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

**Please refer to the reply to query 3(c) & (d) above.**

**Further, SEBI circular MIRSD/SE/CIR-19/2009 dated December 3, 2009: The client account is required to be reconciled on continuous basis at the choice of the clients and at least once in a month or quarter, as per the choice of the client. Investment firm is also required to send a periodical statement of accounts to clients on a prescribed interval of time.**

**Further, investment firm do not hold client assets in another jurisdiction.**

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

**Investment firm has to comply with the requirements as mentioned in the answer to the query no 5 above.**

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

investment firms are required to report to

a. Does the Investment Firm report where client assets are held?

b. Does the Investment Firm or depository report the protections applicable to such client assets?

c. Does the Investment Firm or depository report the amount of assets that are held?

**YES**

In each case, are such reports provided on request or periodically? If periodically, with what frequency?

**The reports are provided both periodically as well as on request.**

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

    a. Where Client Assets are held?

    b. The amount of Client Assets held at a depository?

    c. The safeguards applicable to Client Assets held at a depository?

**The audits of regulatory requirements of client's assets are carried out by investment firm through an independent auditor on an half yearly basis. Further, Self-Regulatory Organizations conducts annual inspections to verify the same. Inspections are also conducted by regulator which are risk based.**

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

    b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

**Omnibus accounts cannot be opened in India.**

**Regulation 17 of SEBI (Stock Broker and Sub-Brokers) Regulations, 1992 and SEBI circular SMD/SED/CIR/93/23321 dated November 18, 1993 states that the money/securities deposited by the client should be kept in a separate account distinct from the firm's own account or account of any other clients.**

**Foreign regulators can approach Indian regulators for accessing/verifying the details mentioned in (a) and (b) in terms of IOSCO MOU, if any entered between the countries.**

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

**Regulation 16 of the SEBI (stock Brokers and Sub-brokers) Regulations, 1992: The regulations prescribe the net worth requirement for obtaining the**

**certificate of registration. Also on ongoing basis, the firm has to submit to the concerned stock exchange a half-yearly certificate from an auditor confirming the net worth. The networth of investment firm is closely monitored by the stock exchanges.**

**Regulation 18A of the SEBI (stock Brokers and Sub-brokers) Regulations: Every stock broker has to appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions, etc., issued by SEBI or the Central Government and for redressal of investors' grievances. The compliance officer is required to immediately and independently report to SEBI any non-compliance observed by him.**

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*, capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

**Regulation 16 of the SEBI (stock Brokers and Sub-brokers) Regulations, 1992 requires that a minimum net worth requirement for obtaining the certificate of registration. Also on ongoing basis, the firm has to submit to the concerned stock exchange a half-yearly certificate from an auditor confirming the net worth. The networth and financials of investment firm is closely monitored by the stock exchanges and suitable risk containment measures are taken as warranted. As mentioned earlier, the assets of clients are kept in a separate account and hence these would not be affected in case of fall in capital of the firm.**

## Post-Insolvency

***Answers to all the questions pertaining to 'post-insolvency' are consolidated in a 'note' given below.***

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

16. What are the duties of the Administrative Officer?

    a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

    a. Does the regulator continue to supervise the Investment Firm?

    b. How, if at all, is the regulator involved in the process of returning Client Assets?

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

    a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

    b. What factors, if any, affect the time period required to accomplish such a transfer?

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

**Note**

**Declaration of default: Administrative supervision by the Stock Exchanges in India**

**A trading member may be declared a defaulter by the stock exchanges if among other things he is unable to fulfill his obligations. The procedure followed by the exchanges after declaration of the defaulter are enumerated in Chapter XII of the National Stock Exchange Bye-laws and Bye-laws 316, 326 & 400 of Bombay Stock Exchange){www.nseindia.com, www.bseindia.com}. The said procedure includes settling the claims of the clients from the assets of the firm and then out of Investor Protection Fund.**

**In case of certain eventualities, there are provisions in the SEBI Act and the regulations to protect the interest of the investors. SEBI can freeze the accounts of the investment firms and ensure that the assets of the clients are protected. SEBI can also seek the appointment of an Administrator to look into the affairs of the affected firm.**

**Further, the registration certificate of the investment firm is liable to be cancelled by SEBI in case it is declared defaulter by the stock exchange, declared insolvent and in case the order for winding up has been passed by the court.**

**Further, SEBI vide circular dated October 28,2004 has provided for the Investor Protection Fund /Customer Protection Fund at the stock exchanges as a mechanism to compensate the clients in case of default.**

**There are also specific Acts which deal with Bankruptcy, Liquidation and insolvency issues viz. the Indian Companies Act, 1956, the Sick Industrial Companies (Special Provisions) Act, 1985 ("SICA"), Recovery of Debts Due to Banks and Financial Institutions Act, 1993, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, the Indian Contract Act, 1872, the Indian Civil Procedure Code, 1908, Provincial Insolvency Act, 1920 and other substantive and procedural laws for recovery proceedings. As regards recovery of dues is concerned, Recovery of Debts Due to Banks and Financial Institutions Act, 1993, SRFAESI Act and CPC are the main laws under which recovery proceedings are initiated.** ***For all the acts refereed above pls refer http://www.vakilno1.com/bareacts***

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

**www.sebi.gov.in**

**www.nseindia.com**

**www.bseindia.com**

# Italy
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

    a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

    The term "Client Assets" includes both financial instruments and funds (i.e.: Client Money) pertaining to clients. See Article 22 of Legislative Decree no. 58/1998 (hereinafter, the "**Consolidated Law on Finance**") in footnote 3. See also the definition of "client assets" set out in Title V, Section I, para. 3 of the Bank of Italy Regulation of August 4, 2000 (hereinafter, the "**Bank of Italy Regulation on Investment Firms**"), according to which "assets" means "funds and financial instruments".

    Financial instruments are defined in accordance with MiFID under art. 1(2) of the Consolidated Law on Finance as meaning:

    a) securities;

    b) money market instruments;

    c) units in collective investment undertakings;

    d) options, futures, swaps, futures contracts on interest rates and other derivative contracts linked to securities, currency, interest rates or returns, or other derivatives, financial indices or measures that may be settled by the physical delivery of the underlying asset or by cash payment of differentials;

    e) options, futures, swaps, interest rate swaps, and any other derivative contracts on commodities, settlement of which is by payment of the differentials in cash, or at the discretion of one of the parties, except in cases where such option is the result of default or other event leading to cancellation of the contract;

f) options, futures, swaps and other derivative contracts on commodities, the settlement of which may be by physical delivery of the underlying asset and which are traded on a regulated market and/or multilateral trading systems;

g) options, futures, swaps, forward contracts and other derivative contracts on commodities, the settlement of which may be by physical delivery of the underlying asset, other than those indicated in paragraph f), that have no commercial purpose, and with the characteristics of other derivatives, taking into consideration, amongst other things, whether they are cleared and executed through recognised clearing houses or whether they are subject to regular margin calls;

h) derivatives for the transfer of credit risk;

i) financial contracts for difference;

j) options, futures, swaps, futures contracts, swaps, futures contracts on interest rates and other derivative contracts related to climatic variables, transport rates, emission levels, inflation rates or other official economic statistics, settled by cash payment of differentials or at the discretion of one of the parties, except in cases where such option is the result of default or other event leading to cancellation of the contract and other derivative contracts on assets, options, bonds, indices and measures other than those indicated in previous paragraphs, with the characteristics of other derivative financial instruments, taking into consideration, amongst other things, whether are traded on a regulated market or multilateral trading systems, whether they are cleared and executed through a recognised clearing house or whether they are subject to regular margin calls

b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

Technically, clients have full ownership right (and not simply a claim) on their Client Assets (including Client Money) placed with an Investment Firm other than a bank. If the Investment Firm is a bank, clients have full ownership right on any of their Client Assets other than Client Money, whilst they have a claim on their Client Money, since banks acquire the ownership of the Client Money placed with them pursuant to Article 1831 of the Italian Civil Code.

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

The definition of the term "*client*" is provided for by Article 26, par. 1, letter c), of Consob Regulation no. 16190 of 29 October 2007 ("**Consob Regulation on intermediaries**") - implementing the provisions on intermediaries of the Consolidated Law on Finance. In particular, "*client*" means "*any natural or legal person to whom an investment firm provides investment and/or ancillary services*". The definition of "client" reproduces the one given by Directive 2004/39/EC (Markets in Financial Instruments Directive, "**MiFID**").

Moreover, Article 26, para. 1, letters d) and e) of Consob Regulation on Intermediaries define the terms "*retail client*" and "*professional client*", implementing the definitions given by MiFID. In particular, "*retail client*" is defined as "*the client who is neither professional nor a qualified counterparty*[22]", whereas "*professional client*" means a client meeting the requirements of Annex 3 of Consob Regulation on Intermediaries, which provides that the possession of experience, knowledge and expertise to make its own investment decisions and properly assess the risks characterize the category and can be presumed for some entities, expressly indicated, or can be assessed on request[23].

d. Please describe any notable exclusions from the terms "client" or "client assets."

As mentioned below, there are some differences in the rules applying to Investment Firms other than banks and to banks providing investment services in respect of the protection of Client Assets.

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

22 The definition of "*qualified counterparty*" is provided by Article 58, para. 1 and 2, of Consob Regulation on Intermediaries, which read as follow: "*1. Qualified counterparties shall be those customers to whom order execution and/or own account trading and/or receipt and transmission of orders services are provided, defined as such in Article 6, paragraph 2*-quater, *letters d1), d2), d3) and d5) of the Consolidated Law on Finance.*
*2. Qualified counterparties shall also be companies meeting the requirements of Annex 3, part I, paragraphs (1) and (2) not already indicated under par. 1, to which the aforementioned services are provided, and companies classified as such pursuant to article 24, paragraph 3 of Directive 2004/39/EC, by the law of the home Member State in which they are registered or are subject to identical terms and conditions in the non-EU home State in which they are registered. From such counterparties the intermediaries shall obtain explicit confirmation, in general terms or in relation to each transaction, of their consent to be treated as qualified counterparties*".

23 The definition of "professional client" covers also public professional clients meeting the requirements of the regulations issued by the Minister for the Economy and Finance pursuant to Article 6, para. 2-sexies of the Consolidated Law on Finance.

(2) *You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

Investment Firms are required to hold Client Assets in individual accounts separately from their own assets and from the assets of other clients (see also response to question 3 below), pursuant to Article 22 of the Consolidated Law on Finance[24].

This regime triggers a so-called "true asset segregation", since for each client the financial instruments held by banks, and the financial instruments and funds held by Investment Firms other than banks, shall be treated as separate and segregated assets: creditors of the Investment Firm or of other clients do not have any actions against such separate assets.

The provision has been further implemented by Title V of the Bank of Italy Regulation on Investment Firms, as amended on October 29, 2007, in order to specify the rules applicable to the handling of Client Assets. This regime dictates requirements on proper book-keeping, use, deposit and sub-deposit (including rules on selection and monitoring of sub-custodians) of financial instruments and funds deposited by each client (see responses to questions below). The regime implements the provisions set forth in MiFID and in the Commission Directive 2006/73/EC (implementing MiFID as regards organizational requirements and operating conditions for investment firms, "**MIFID Implementing Directive**"). Investment Firms shall satisfy stringent duties in the selection and monitoring of custodians and sub-custodian. The sub-custody of the Client Assets is without prejudice to the liability of the Investment Firm towards the clients.

Client Money shall be held only through duly authorized banks: Investment Firms other than banks which receive Client Money are under a duty to open a "third party" omnibus account with a bank or with the central bank within 1 day of receipt. This third party bank account shall be separated from the accounts where the Investment Firm deposits its own assets (under Italian law, the receiving bank or central bank is named "**custodian**").

Investment Firms are also subject to recordkeeping obligations, and rules of conduct requiring them to adopt all measures to safeguard the right of customers

[24] Article 22 of the Consolidated Law on Finance reads as follows (unofficial translation): "*1. In providing investment and non-core services, the financial instruments and funds of individual customers held in whatever capacity by an investment firm, asset management company, harmonized management company or financial intermediary entered in the register provided for in Article 107 of the Consolidated Law on Banking and the financial instruments of individual customers held in whatever capacity by a bank shall be separate assets for all intents and purposes from those of the intermediary and from those of other customers. Actions in respect of such assets may not be brought by creditors of the intermediary or on behalf of such creditors, nor by creditors of the custodian or the sub-custodian, if any, or on behalf of such creditors. Creditors of individual customers may bring actions up to the amount of the assets owned by such customers.*
*2. Legal and court-ordered set-off shall not apply to accounts where financial instruments or funds are deposited with third parties and agreements may not be made for their set-off against claims of the custodian or the sub-custodian on the intermediary or the custodian.*
*3. Unless customers have agreed in writing, an investment firm, asset management company, harmonized management company or financial intermediary entered in the register provided for in Article 107 of the Consolidated Law on Banking or a bank may not use, on its own behalf or on behalf of third parties, financial instruments belonging to customers which it holds in any capacity. Nor an investment firm, asset management company, harmonized management company or financial intermediary entered in the register provided for in Article 107 of the Consolidated Law on Banking may use, on its own behalf or on behalf of third parties, liquid balances belonging to customers which it holds in any capacity*".

on their assets, disclose relevant information to clients and prospective clients, and avoid preferential treatments of one client over another (see Article 21 of the Consolidated Law on Finance and relevant implementing provisions under Consob Regulation on Intermediaries and Consob and the Bank of Italy Regulation of October 29, 2007 ("**Regulation on Internal Organization**")). These rules implement the provisions set forth in MiFID and in the MiFID Implementing Directive.

Managers of collective investment schemes, including hedge funds, shall deposit the assets of the CIS with a depository bank, pursuant to Articles 36(2) and 38 of the Consolidated Law on Finance. The appointment of the depositary bank shall be approved by the Bank of Italy, which shall verify that independency, experience, capital and organizational requirements provided for under Chapter VIII, Title V of the Bank of Italy Regulation of May 8, 2012 (the "**Regulation on Asset Management**") are met.

The commingling of Client Assets is criminally sanctioned pursuant to Article 168 of the Consolidated Law on Finance[25].

The administration of financial instruments by central depositories is also subject to stringent regulation. Central depositories, settlement services, guarantee systems, clearing houses and central counterparties are authorized and supervised by the Bank of Italy and Consob and regulated under the Consolidated Law on Finance and the Consob and Bank of Italy Regulation of February 22, 2008 (hereinafter, the "**Regulation on Central Depositories**").

Special provisions to ensure restitution of Client Assets are provided for in case the Investment Firm is declared insolvent or is otherwise put into special administration or compulsory administrative liquidation. These provisions are contemplated in Title IV, Chapter 2 of the Consolidated Law on Finance and applied under the supervision and direction of the Bank of Italy.

Moreover, Client Assets are protected through mandatory investor compensations schemes. According to Article 59 of the Consolidated Law on Finance, in fact, an Investment Firm may be authorized provided that it adheres to a duly recognized investor compensation scheme.

## Pre-Insolvency

[25] Article 168 of the Consolidated Law on Finance reads as follows: "*Unless the act constitutes a more serious offence, any person who, in providing investment services or activities or collective asset management services or custody for the financial instruments or funds of a collective investment undertaking, with a view to obtaining an undue profit for himself or for others, violates the provisions governing the separation of assets and thereby causes injury to clients shall be punished by imprisonment for between six months and three years and by a fine of between 500.165 euro and 103.291 euro*".

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

   Yes. Not all Investment Firms are authorized to hold, even temporarily, Client Assets. Safekeeping and administration of Client Assets is an ancillary service under MiFID. A firm must specify in its application for authorization whether it intends to hold Client Assets. As mentioned below, to be authorised as Investment Firms, firms intending to hold Client Assets are required to comply with special capital requirements according to the Bank of Italy Regulation on Investment Firms.

   a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

      To be authorised as Investment Firms, firms intending to hold Client Assets must satisfy higher initial and on-going capital requirements (minimum 1 million €) than those applicable to Investment Firms which do not hold Client Assets (minimum 385,000 €), pursuant to Chapter 1, Title II of the Bank of Italy Regulation on Investment Firms.

      Moreover, to be authorised as an Investment Firm, a company shall satisfy initial and ongoing requirements on governance, internal organization, internal compliance and controls, operational conducts, in accordance with the provisions implementing MiFID.

   b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

      N/A.

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

   a. Must the Client Assets of one client be maintained separately from those of other clients?

      Yes, pursuant to Article 22 of the Consolidated Law on Finance (see footnote 3) and Title V, Section II, of the Bank of Italy Regulation on Investment Firms, Client Assets held by the Investment Firm for one client must be maintained separately from the Client Assets held for any other client and from the Investment Firm's own assets.

      For each Client, the Investment Firm must keep separate evidence of the Client Assets on the basis of the type of service/activity provided and maintain evidence of the relevant (if any) custodians and sub-custodians.

For each transaction on Client Assets, the Investment Firm must keep record of the relevant execution date, contractual settlement date and actual settlement date. These records must be promptly updated on an ongoing basis, so as to ensure that in each moment there is clear and certain evidence of each client position. As mentioned below, the Investment Firm must conduct, on a regular basis, reconciliations between its internal accounts and records and those of any custodian and sub-custodian by whom the Client Assets are held (see Title V, Section II, para. 1 of the Bank of Italy Regulation on Investment Firms).

i. Are Investment Firms allowed to hold Omnibus Accounts?

In the relationships between the client and the Investment Firm, the Investment Firm shall maintain separate, individual evidence of the Client Assets for each of its Client. This means that Investment Firms must hold Client Assets in the name of the individual client. Omnibus accounts are only permitted in the relationship between the Investment Firm and a third party custodian/depositary (e.g. where the Securities are sub-deposited, for instance, with a central depository or where the Client Money are held through a bank, see below).

As mentioned in the answer to question 2, Client Money shall be held only through duly authorized banks. Investment Firms other than banks are under a duty to deposit all Client Money, within 1 day of receipt, in a "third party" omnibus account to be opened with a bank or with the central bank. This third party account shall be separated from the accounts where the Investment Firm deposits its own assets. See Title V, Section I, para. 2 and 5 of the Bank of Italy Regulation on Investment Firms.

Moreover, according to Title V, Section I, para. 1 and 3 of the Bank of Italy Regulation on Investment Firms, Investment Firms may sub-deposit client financial instruments in an omnibus accounts with a third party provided that the client gives its consent. If the client is a professional client, an oral agreement will suffice.

The Investment Firm must exercise due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements for the holding and safekeeping of those financial instruments, in accordance with the provisions of Title V, Section I, para. 4 of the Bank of Italy Regulation on Investment Firms, reproducing the provisions of the MiFID Implementing Directive. See also responses to questions 4, 5 and 6, below.

The use of financial instruments held in an omnibus account by the Investment Firm is subject to specific conditions, as mentioned in response to question 3, d below.

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

As mentioned, Investment Firms must hold Client Assets in the name of the individual client. Set off between positions (both in money and in financial instruments) of different clients is prohibited under Article 22 of the Consolidated law on Finance and Title V, Section II, para. 1, of the Bank of Italy Regulation on Investment Firms. This rule shall apply also in connection with margin transactions. Investment Firms are prohibited from using the assets of one client to cover margins or transactions of other clients.

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

The amount (and type) of assets to be held must correspond exactly with the amount of the Client Assets deposited with the Investment Firm.

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

Client Money (funds/cash) is a fungible asset. Financial instruments having the same ISIN code are also fungible among themselves, since they incorporate exactly the same rights, terms and conditions and they can substituted among each others. In some cases, financial instruments may not be fungible with other assets. For instance, certain non-listed financial instruments are identified by paper-based certificates that the Investment Firm must keep in custody (directly or through a sub-custodian; in all cases, sub-custody is without prejudice to the liability of the Investment Firm towards its client).

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

Reconciliation is carried out by Investment Firms on a client-by-client basis (see Title V, Section II, para. 1, of the Bank of Italy Regulation on Investment Firms) and on an aggregate basis for each asset class they hold (see Articles 32 and 36 of the Regulation on Central Depositories). See also response to question 3, b, ii, A) below.

C) If a client has a debit balance (*i.e.*, the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

If a client has a debit balance (i.e., the client owes the Investment Firm), the Investment Firm is required to contribute from its own resources. As mentioned in other answers, given the principle of true asset segregation, the obligations to other clients cannot be affected (i.e.: the offsetting between clients is not permitted in Italy, since Client Assets have to segregated on a client by client, individual basis).

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

Reconciliation on a client-by-client basis shall be carried out on a regular basis, also taking into account the frequency and volumes of the executed transactions (see Title V, Section II, para. 1, of the Bank of Italy Regulation on Investment Firms). Furthermore, according to Article 36 of the Regulation on Central Depositories, within one day from the date of registration, Investment Firms shall check for each type of financial instrument that the balance of their own account at the central depository, or the sum of the balances of their own accounts at the central depositories, coincides with the balance of their own accounts as kept by themselves and that the sum of the balances of the customer accounts at the central depositories coincides with the sum of the balances of the customer accounts they keep. The internal control function of the Investment Firm must verify compliance with the law.

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

See above.

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

If irregularities or deficiencies are discovered, the Board of Directors and the Board of Supervisors of the Investment Firm must be promptly informed. In its turn, the Board of Supervisors of the Investment Firm has a duty to inform Consob and the Bank of Italy of any such irregularity (see Article 8 of the Consolidated Law on Finance and implementing provisions in the Regulation on Internal Organization).

In any event, under general civil law, the client would have a claim against the Investment Firm if his assets, including Money, were not properly booked or held. The Investment Firm would be liable towards the client to pay damages.

Moreover, the commingling of Client Assets is criminally sanctioned pursuant to Article168 of the Consolidated Law on Finance (see footnote 4).

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

An Investment Firm is not permitted nor encouraged to maintain any of its own assets in a Client Asset Account.

If the reconciliation reveals an excess, this would be considered as an irregularity. If client accounts and records are kept properly, there should be no excess.

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

No. As mentioned, Investment Firms are prohibited from using Client Assets for meeting the obligations of other clients (see Article 22(3) of the Consolidated Law on Finance).

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

Yes. Investment Firms are prohibited from making use of client financial instruments on their behalf or on behalf of third parties, unless the client has given his written consent. Moreover, Investment Firms other than banks are prohibited from making use of Client Money on their behalf or on behalf of third parties, unless the client has given specific consent (see Article 22(3) of the Consolidated Law on Finance).

Pursuant to Title V, Section II, para. 1, of the Bank of Italy Regulation on Investment Firms, reproducing the provisions of the MiFID Implementing Directive, if the client is a retail one, the consent shall be expressed in writing and the relevant client agreement shall indicate the name of the counterparty, the type of transactions that may be carried out, the relevant security rights and the liabilities of the parties.

Moreover, the Investment Firm cannot use financial instruments held in an omnibus account unless at least one of the following conditions is met: (i) each client whose financial instruments are held together in an omnibus account has given prior express consent (it is not mandatory to acquire the prior express consent from a professional client); (ii) the Investment Firm must have in place systems and controls which ensure that only financial instruments belonging to clients who have given prior express consent are so used.

The Investment Firm shall keep evidence of any transactions executed on the Client Assets and shall inform the client of such transactions and relevant remunerations.

The records of the Investment Firm shall include details of the client on whose instructions the use of the financial instruments has been effected, as well as the number of financial instruments used belonging to each client who has given his consent, so as to enable the correct allocation of any loss.

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

All Client Assets belong to respective clients, regardless to whether or not any "right of use" was exercised by the Investment Firm. See also response to question 22.

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

As mentioned above, if the client is a retail client, the consent shall be expressed in writing and the relevant client agreement shall indicate the name of the counterparty, the type of transactions that may be carried out, the relevant security rights and the liabilities of the parties (see Title V, Section II, para. 1, of the Bank of Italy Regulation on Investment Firms).

iii. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (*i.e.*, established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

As stated above, the use (including re-hypothecation) of Clients Assets is subject to the Client's specific consent. All Client Assets belong to respective clients, regardless to whether or not any "right of use" was exercised by the Investment Firm. See also response to question 22.

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

Clearing houses and central counterparties (as well as central depositories) are under a duty to register any Client Position, including the collateral posted on behalf of a client, in a separate omnibus account of the Investment Firm, called "third party" account (all the assets deposited in this omnibus account belong to

Clients and not to the Investment Firm). This collateral is therefore kept separate from any collateral posted by the Investment Firm on his own account.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

   a. Client Assets transferred to or located in other jurisdictions?

   As mentioned in response to question 1, Clients Money shall be held through a custodian, which shall be a duly authorized bank. The custodian can be located in a foreign jurisdiction. The account with the custodian shall be opened in the name of the Investment Firm, and shall indicate that the Money belong to third parties. The client shall mature interests on the Money (the amount shall be determined contractually). These interests shall be separated from the interests earned by the Investment Firm on its own money (see Title V, Section II, par. 2, of the Bank of Italy Regulation on Investment Firms).

   Moreover, as mentioned in response to question 3, a, i), Investment Firms are permitted to sub-deposit client financial instruments with a third party (which can be located in another jurisdiction), provided that the client has given his consent (in written form if the client is retail).

   These financial instruments must be held in a "third party" account, i.e.: an omnibus account opened in the name of the Investment Firm and indicating that the assets belong to third parties. The third party account shall be kept separately from the one where the Investment Firm deposits its own assets.

   Investment Firms are required to keep evidence of the name of the sub-custodians where the client financial instruments are held, relevant nationality and whether it belongs to the same group.

   See also response to questions 5 and 6 below.

   b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

   If so, please provide details of those requirements.

   Yes. It applies, *mutatis mutandis*, the same rule as above: the Investment Firm shall register Client Assets in an omnibus account, indicating that the assets belong to third parties.

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

   a. What protections are applicable to the Foreign Investment Firm's Client Assets?

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

As indicated in response to Question 4, the custodian of the Client Money and the sub-custodian of client financial instruments can be located in another jurisdiction. In any case, Investment Firms are required to preserve the separate identification of the Client Assets held with the custodian or sub-custodian.

Investment Firms must exercise all due skill, care and diligence in the selection, appointment and periodic review of the custodian of Client Money and any sub-custodian of client financial instruments and the arrangements for the holding of the Client Assets. They must take into account the expertise and market reputation of such third parties with a view to ensuring the protection of clients' rights, as well as any legal or regulatory requirements or market practices related to the holding of Client Assets that could adversely affect clients' rights.

Moreover, Investment Firms are responsible to periodically monitor the custodian and any sub-custodian in a view of ensuring that they are effective and reliable in maintaining separate identification of these third party assets. The deposit with a third party is without prejudice to the Investment Firm's liability to return the assets to the client.

See also response to question 6 below.

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

Title V, Section I, para. 4 of the Bank of Italy Regulation on Investment Firms, reproducing the provisions of the MiFID Implementing Directive, sets forth the following rules apply to the selection of the sub-custodian of client financial instruments:

- if the safekeeping of financial instruments for the account of another person is subject to specific regulation and supervision in a jurisdiction where an Investment Firm proposes to deposit client financial instruments with a third party, the Investment Firm must deposit those financial instruments in that jurisdiction with a third party which is subject to such regulation and supervision;

- when the foreign jurisdiction does not regulate the holding and safekeeping of financial instruments for the account of another person, the sub-deposit is admitted only provided that: (i) the deposit is necessary in view of the

particular financial instrument or the service provided, or (ii) the client is a professional one and has consented in writing to deposit the financial instruments with a third party in that jurisdiction.

As mentioned in response to questions 1 and 4, Clients Money shall be held through a custodian, which shall be a duly authorized bank.

Moreover, as mentioned in response to question 2, a, not all Investment Firms are authorised to hold, even temporarily, Client Assets. In order to get authorized, higher capital requirements shall be met. Investment Firms which are not authorized to hold Client Assets shall put in place appropriate arrangements to ensure that the Client Money and Securities are deposited directly by the client with an authorized Investment Firm. The Bank of Italy shall be informed of these arrangements (see Section II, para. 5, of the Bank of Italy Regulation on Investment Firms).

The custodian of Client Money and the sub-custodian of client financial instruments may be an affiliate of the Investment Firm, provided that the conditions outlined above are met.

Furthermore, for all types of collective investment schemes domiciled in Italy, including hedge funds, managers are required to appoint an independent custodian where the Securities and Money shall be deposited (see Article 36, para. 2 and 4, and Article 38 of the Consolidated Law on Finance). The custodian must be an authorized EU bank (so called depositary bank) subject to ongoing supervision by the Bank of Italy. The appointment of the depositary bank shall be approved by the Bank of Italy, which shall verify that relevant requirements provided for under Title IV, Chapter III, par. 2 of the Regulation on Asset Management are met. In particular, the depositary bank must satisfy experience, capital (100 million €) , organizational and independency requirements and shall act in the interests if unit-holders. The appointment of a bank as a depository is prohibited when the chairman of the board of directors, the managing director, the general manager or the members of the managing committee of the asset management company or the investment company vest one of the following role in the bank: (i) chairman of the board of directors, managing director or general manager; (ii) person responsible of a unit in the bank. An affiliate of the asset management company may be appointed as depositary bank only where the aforesaid independence conditions are met.

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

As mentioned (see response to question 3, d), as a general rule, the custodian is prohibited from placing lien, charges or other encumbrance on Client Assets, unless the client has consented to them. If the client is a retail one, the agreement between the Investment Firm and the client shall specify the type of charge that may be placed on the Client Assets, the relevant counterparty and liabilities of the parties. The Investment Firm shall ensure that the sub-custodian complies with the

terms and conditions agreed with the client, the sub-custody shall be without prejudice to the Investment Firm's liability towards the client. The Investment Firm shall keep evidence of any transactions executed on the Client Assets and shall inform the client of such transactions relevant remunerations (see Title V, Section II, para. 1, of the Bank of Italy Regulation on Investment Firms).

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

Retail clients must be informed on the arrangements that Investment Firm has undertaken to protect the Client Assets before the agreement with the Investment Firm is executed (see Article 27, 29 and 30 of Consob Regulation on Intermediaries).

In particular, according to Article 29, para. 1, lett. g), of Consob Regulation on Intermediaries, the Investment Firm which holds Client Assets shall provide retail clients with a summary description of the methods implemented to guarantee their protection. Pursuant to the following lett. h), the Investment Firm shall also inform retail clients or potential retail clients of the investor compensation system or relevant deposit guarantees, with a summary description of the cover terms.

Moreover, pursuant to Article 30, para. 2, of Consob Regulation on Intermediaries, the Investment Firm which holds Client Assets shall inform retail clients of any possibility that financial instruments or sums of money pertaining to that clients may be held by a third party on behalf of the intermediary, and the liability assumed, in compliance with applicable national law, with regard to any act or omission by said third party and of the consequences that the insolvency of the latter may bring upon the client.

Where financial instruments of the retail client may be held in an omnibus account by a third party, the Investment Firm shall inform the client of this fact and shall provide clear warning of the risks that may derive therefrom (see Article 30, para. 3, of Consob Regulation on Intermediaries).

Where accounts containing Client Assets may be subject to non-EU legislations, the Investment Firm must provide information of this circumstance and indicate to what extent the rights of the client over such assets may be influenced (see Article 30, para. 4, of Consob Regulation on Intermediaries).

The Investment Firm must also inform the client of the existence and terms of any right of guarantee or privileges that the Investment Firm, or sub-depository, shall claim or may claim with regard to the Client Assets, or any related right to compensation that may exist (see Article 30, para. 5, of Consob Regulation on Intermediaries).

Prior to using, on its own account or on behalf of another client, financial instruments held on behalf of a retail client, the Investment Firm must, in a timely manner and in hard copy, provide the retail client with a clear, complete and accurate information on the obligations and liabilities of the Investment Firm in relation to the use of such financial instruments, including the terms for restitution of the instruments and related risks.

As mentioned in previous responses, the client must consent to the use of the assets and to the deposit with a custodian or sub-custodian (in case of retail client, the consent must be in writing). Moreover, in case the client has given consent to the use of his assets by the Investment Firm or custodians/sub-custodians, the Investment Firm shall inform the client of the transactions executed on his assets and relevant remuneration.

The failure by an Investment Firm to comply with the above provisions is administratively sanctioned as a breach of conduct of business rules and gives rise to civil liability towards the client.

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

Clients cannot opt out the protection regime, including the true segregation regime and rules on the appointment of custodians and sub-custodians, described in the above. Information to be given to retail clients is more extensive than to professionals. Clients may give their consent to the “right of use” and to the sub-custody of Assets.

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

a. Does the Investment Firm report where client assets are held?

Yes. The investment firm must report to the regulator about client financial instruments, by distinguishing whether such financial instruments are held by the Investment Firm itself (if authorised to provide the ancillary service of custody of Client Assets) or deposited or sub-deposited with a third party. The data are divided per investment service. In case of deposit/sub-deposit with a third party, there is also an indication of the type of custodian/sub-custodian and its residence.

Moreover, the Investment Firm must report to the regulator about Client Money, by distinguishing whether Client Money is temporarily held by the Investment Firm (if authorised to provide the ancillary service of custody of Client Assets) or deposited with a custodian. The data are divided per investment service. There is also an indication of whether or not the custodian is a bank or another entity.

An investment firm must also report to the regulator on its exposure toward the third party with whom Client Assets are deposited within the information provided in relation to credit risks.

b. Does the Investment Firm or depository report the protections applicable to such client assets?

Yes, see above.

c. Does the Investment Firm or depository report the amount of assets that are held?

See response to question 9, a.

In each case, are such reports provided on request or periodically? If periodically, with what frequency?

The reports are provided periodically on a quarter basis.

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

a. Where Client Assets are held?

b. The amount of Client Assets held at a depository?

c. The safeguards applicable to Client Assets held at a depository?

The Bank of Italy and Consob may require authorised Investment Firms to communicate data and information and to transmit documents and records in the manner and within the time limits they establish (see Article 8 of the Consolidated Law on Finance). They can also carry out inspections and investigations and Consob, within the scope of its competences, can exercise all the powers provided for under Article 187-octies.

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (i.e., of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

a. The amount and/or value of such Client Assets?

b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

Investment Firms are licensed intermediaries subject to prudential regulation. Investment Firms shall comply with reporting requirements, so that the Bank of Italy and Consob exercise ongoing supervision on the Investment Firms' own funds, financial position and ability to carry on business. Consob and the Bank of Italy may also obtain information and perform on-site inspections on Investment Firms. Failure to provide information to the regulators is administratively sanctioned pursuant to

Article 187-*quinquiesdecies* of the Consolidated Law on Finance, and criminally sanctioned pursuant to Article 170-*bis* of the Consolidated Law on Finance and Article 2638 of the Italian Civil Code.

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*¸ capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

As mentioned, Investment Firms are all prudentially supervised; regulators can take several actions to protect Client Assets.

According to Article 7 of the Consolidated Law on Finance, the Bank of Italy and Consob have the power to: a) convene the directors, members of the board of auditors and managers; b) order the convening of the governing bodies and set the agenda for the meeting; and c) proceed directly to convene the governing bodies where the competent bodies have not complied with their order issued. The Bank of Italy may, for stability purposes, issue specific provisions/decisions to deal with prudential issues, and may prohibit or restrict, where necessary, the provisions of services, activities, transactions by the Investment Firm or its branches, as well as prohibit the distribution of profits or the liquidation of assets. The Bank of Italy and Consob may also order the suspension or temporary limitation of the issue or redemption of units or shares of collective investment schemes.

According to Article 51 of the Consolidated Law on Finance, the Bank of Italy and Consob may order Investment Firms to put an end to any irregularities and prohibit persons, branches or establishments of an Investment Firm from engaging in new transactions, where there is a risk of prejudice to investors and in case of urgency.

According to Article 53 of the Consolidated Law on Finance, the Chairman of Consob may, in situations of danger for customers or markets, suspend the bodies of the Investment firms as a matter of urgency and appoint a provisional administrator to take over its management where serious administrative irregularities or serious violations of laws, regulations or bylaws are found. The appointment of the provisional administrator shall be for a maximum of sixty days. In the performance of his or her duties, the provisional administrator shall be a public official. The Chairman of Consob may establish special safeguards and limitations on the management of the Investment Firm.

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

The insolvency proceedings applicable to Investment Firms are regulated under Articles 56 (special administration) and 57 (compulsory administrative liquidation) of the Consolidated Law of Finance and corresponding provisions of the Banking Law. The proceedings are directed by the Bank of Italy and are different from those generally applicable to unregulated entities. These proceedings do not necessarily involve an insolvency situation: they may also apply to solvent Investment Firms that have seriously violated the law, as better explained below.

Nonetheless, if the Investment Firm is insolvent, the insolvency shall be judicially declared by the bankruptcy court upon a petition from the Administrative Officers (if already appointed), the creditors of the Investment Firm, or the public prosecutor. The insolvency is declared after having heard the Bank of Italy and the legal representatives of the Investment Firm.

If the insolvency is declared, the general rules of bankruptcy law aimed at protecting claimants and relevant ranking shall be applicable to the liquidation of the Investment Firm, including claw-back actions (see Article 82 of the Consolidated Banking Law and Article 202 of the Royal Decree 267/1942, hereinafter the "**Bankruptcy Law**").

The proceedings may be of two types:

- special administration, which consists in the dissolution of the boards of the Investment Firm where: a) serious administrative irregularities or serious violations of laws, regulations or bylaws governing its activity are found; b) serious capital losses are expected; or c) the dissolution of the boards was requested by the board of directors, an extraordinary meeting of shareholders or the provisional administrator appointed by Consob Chairman (see response to previous question). The proceeding is temporary, since pursuant to Article 70(5) of the Consolidated Banking Law, it shall last up to 1 year; the Bank of Italy may issue prorogations of two months. At the end of the proceeding, the Investment Firm may continue the business or be subjected to the compulsory administrative liquidation (see Article 75(3) of the Consolidated Banking Law);

- compulsory administrative liquidation, which consists in the withdrawal of the authorization and the liquidation (winding-up) of the Investment Firm where: a) the administrative irregularities or the violations of laws, regulations or bylaws are exceptionally serious; b) the losses of the Investment Firm are exceptionally serious; or c) the liquidation was requested by the board of directors, an extraordinary meeting of shareholders or the provisional administrator appointed by Consob Chairman (see response to previous question), the Administrative Officers of the special administration mentioned above, or the ordinary liquidators.

The opening of the two proceedings is declared by decree of the Minister for the Economy and Finance, who acts upon a proposal from the Bank of Italy or Consob. The decree is published in the Italian Official Gazette.

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

    The Administrative Officers (both in case of special administration and compulsory administrative liquidation) are appointed by the Bank of Italy. The Officers may be also revoked and replaced by the Bank of Italy. The Officers shall satisfy propriety requirements established under the Ministry of Treasury Decree no. 161 of 28 March 1998, implementing Article 26 of the Consolidated Banking Law (see Article 71(6) of the Consolidated Banking Law).

16. What are the duties of the Administrative Officer?

    a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

       The Administrative Officers are subject to the Bank of Italy's direction. Their general duties and functions are established by law (see Article 72 and ff. of the Consolidated Banking Law for the special administration and Article 84 and ff. of the Consolidated Banking Law for the compulsory administrative liquidation).

       In particular, the Administrative Officer in the special administration shall manage the Investment Firm, ascertain assets and liabilities, remove irregularities and take any action in the interest of the clients.

       The Administrative Officer in the compulsory administrative liquidation is responsible to liquidate the assets of the Investment Firm and restitute the Client Assets to the clients.

       In both proceedings, an oversight committee (appointed by the Bank of Italy) shall monitor and assist the Administrative Officers. The Bank of Italy may establish special precautions and obligations that the Administrative Officers shall comply with.

    b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

       The Administrative Officers shall be treated as public officers and shall be personally liable for the failure to comply with the Bank of Italy's directions (see Articles 72(1)(4) and 84(1)(3) of the Consolidated Banking Law). Civil law actions against the Administrative Officers shall be subject to prior authorization by the Bank of Italy (see Articles 72(9) and 84(6) of the Consolidated Banking Law).

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

    a. Does the regulator continue to supervise the Investment Firm?

Yes, the Bank of Italy continues to supervise the Investment Firm and, as mentioned, has the power to direct the proceeding of special administration and compulsory administrative liquidation.

b. How, if at all, is the regulator involved in the process of returning Client Assets?

The Bank of Italy shall supervise that the Client Assets are returned in accordance with the provisions of law. The Bank of Italy shall approve the allotment plan whereby the assets are distributed among the clients, pursuant to Article 92 of the Consolidated Banking Law.

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

During the insolvency of an Investment Firm segregation shall always be maintained, whatever measure the Administrative Officers may adopt for winding-up purposes (transfer of assets and liabilities or continuation of the exercise of the undertaking).

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

Yes. Formalities to make the transfer are simplified compared to ordinary regime. The transfer needs to be authorised by the Bank of Italy. See below.

a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

According to Article 90(2) of the Consolidated Banking Law, the transfer of assets to third parties shall be authorized by the Bank of Italy and agreed upon with the oversight committee. The transfer may be effected at any stage of the proceeding, including prior to the statement of liability.

The formalities to perfect the transfer are simplified. Instead of notifying it to each counterparty according to general law, the transfer shall be published on the Italian Official Gazette and entered in the Company Register, pursuant to Article 58 of the Consolidated Banking Law.

b. What factors, if any, affect the time period required to accomplish such a transfer?

As mentioned, the transfer may be accomplished at any time and stage of the proceeding.

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

In case the Investment Firm is declared insolvent by the bankruptcy court, assets are protected through the general bankruptcy claw-back actions, pursuant to Article 67 of the Bankruptcy Law. This Article is applicable pursuant to Article 82(3) of the Consolidated Banking Law and Article 203 of the Bankruptcy Law.

In particular, the claw-back regime provides that the Administrative Officer can revoke the following transactions, unless the party dealing (the party contracting with the insolvent company in the transactions challenged by the customer) is able to demonstrate that it was not aware of the state of insolvency of the bankrupt:

• Any transaction entered into for consideration, but not on arm's length terms, by the bankrupt during the one year prior to the declaration of bankruptcy. The law specifies that a transaction will be assumed to be not on arm's length terms when the value of the assets transferred, value given or the obligations assumed by the bankrupt exceeds by more than one fourth the value of what the bankrupt has received in exchange.

• Any discharge of due and payable obligations made through unusual means of payment (such as, for instance, the transfer of goods to a creditor to discharge a payment obligation) during the one year prior to the bankruptcy declaration.

• Any pledge or mortgage voluntarily granted by the bankrupt during the one year prior to the declaration of bankruptcy as security for pre-existing debts that were not due and payable as of the date of grant of the relevant security.

• Any pledge and mortgage granted by the bankrupt during the six months prior to the declaration of bankruptcy as security for pre-existing debts that were due and payable as of the date of grant of the relevant security.

The following payments and transactions can be revoked by the Administrative Officer, provided that: (i) the Administrative Officer is able to prove (also through circumstantial pieces of evidence and reasonable assumptions) that the third party was aware of the insolvency of the bankrupt party when the payment was made or when the transaction was entered into, and (ii) they have been made or entered into during the six months prior to the bankruptcy declaration:

(a) payments of due debts made through normal means of payment;

(b) pledges and mortgages granted as security for debts (including third party's debts) arising simultaneously with the grant of the security; and/or

(c) any other transaction for consideration.

The following transactions cannot be subject to claw-back actions: payments for goods and services in the bankrupt party's ordinary course of business (if not otherwise unusual), remittances to a bank account not materially and permanently reducing the indebtedness to the bank, sales at fair market price of real estate used by the purchaser as his residence, deeds, payments and securities carried out or granted to implement judicially sanctioned agreements with creditors or under a judicial moratorium.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

As mentioned in previous responses, Client Assets are protected through mandatory investor compensation schemes. This regime implements the provisions of the EU Investor Compensation Schemes Directive.

The organization and functioning of the schemes are established by Regulation of the Ministry of Finance, having heard the Bank of Italy and Consob (see Regulation no. 485/1997). The Bank of Italy, having heard Consob, shall coordinate the operation of these investor compensation schemes with the proceeding of compulsory administrative liquidation (see Article 59 of the Consolidated Law on Finance).

The investor compensation schemes shall be recognized by the Ministry of Finance, provided that they fulfill the applicable requirements. The aim is to protect investors against the risk of losses in the event of an Investment Firm's inability to repay money or return assets held on behalf of their clients.

More in details, the cover shall be provided for claims arising out of an investment firm's inability to:

- repay money belonging to investors and held on their behalf in connection with investment business, or

- return to investors any instruments belonging to them and held, administered or managed on their behalf in connection with investment business.

The schemes shall cover up to € 20,000 for each client[26].

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

No, clients shall not be treated differently based on their pre-bankruptcy permissions. In principle, all Client Assets belong to respective clients, regardless to whether or not any "right of use" was exercised by the Investment Firm or relevant custodians/sub-custodians. In case the claims by clients exceed resources dedicated to paying such claims, the clients will be satisfied on a pro rata basis and for the remaining amount will concur with unsecured creditors (see response to question 23 below).

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[26] According to Article 4, par. 3 and 4, of Regulation no. 485:
*3. The claims of the following categories of persons shall not be eligible for payment by compensation systems:*
*a) investors who have been condemned for crimes referred to in Articles 648-bis and 648-ter of the penal code [*money laundering*];*
*b) investors who contributed to the insolvency of the intermediary, as ascertained by the bodies responsible for the insolvency procedure;*
*c) banks, Italian securities investment firms, financial companies referred to in Title V of the Consolidated Law on Banking, investment firms, insurance companies, collective investment undertakings and pension funds;*
*d) international organizations, government departments and local authorities;*
*e) companies belonging to the same group as the intermediary;*
*f) shareholders who hold, through nominees or otherwise, at least 5 per cent of the intermediary's capital;*
*g) directors, managers, members of the board of auditors of the intermediary or of other companies belonging to the same group as the intermediary who were in office in the last two financial years;*
*h) spouses and persons related by consanguinity within the fourth degree to persons specified in subparagraphs a), b), c), f) and g).*
*4. Transactions carried out through nominees by persons referred to in paragraphs 3f) and 3g) shall not be eligible for any compensation whatsoever.*

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

In principle, clients should not be affected, considering that their assets are segregated and Investment Firms are responsible for the selection and monitoring of the foreign sub-custodians pursuant to the above-mentioned provisions of Italian law. Moreover, the appointment of a sub-custodian is without prejudice to the liability if the Investment Firm towards the clients. Therefore, in normal circumstances clients are protected. However, as a matter of fact, clients may be affected if both the Investment Firm and the foreign sub-custodian are insolvent and failed to comply with segregation related requirements.

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

According to Article 91(2)(3) of the Consolidated Banking Law, where the rules on segregation of the Investment Firm's assets from those of clients are complied with, but the segregation among individual clients is not complied with or the Securities are not sufficient to effect all the restitutions, the Administrative Officer shall, where possible, effect pro rata restitutions or liquidate the Securities belonging to clients and allot the proceeds on the same pro rata basis.

If the rules concerning the segregation of the Investment Firm's assets from the Client Assets (as a whole) are not complied with, clients are treated as unsecured creditors for the whole. If the rules on segregation among individual clients are not complied with, clients shall be treated as unsecured creditors for the part of their rights which has not been satisfied on a pro rata basis.

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

The rule in case the client claims exceed resources shall be pro rata distribution of Client Assets pursuant to Article 91(2) of the Consolidated Banking Law (see response to question 22 above).

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

Client Assets are registered in a special separate section of the statement of liabilities of the Investment Firm (see Article 86(6) of the Consolidated Banking Law) and subject to restitutions pursuant to Article 91(1) of the Consolidated Banking Law. When segregation rules are not complied with the provisions of Article 91(2)(3) applies (see previous responses). Technically, clients are the owners (and not creditors) of the assets deposited with the Investment Firm, therefore the restitution in their favor takes place with priority compared to the liquidation of the remaining

assets to (secured and unsecured) creditors. The remaining assets of the Investment Firm are liquidated according to the ranking generally applicable in any bankruptcy proceedings. The priorities are indicated under Article 111 of the Bankruptcy Law, i.e., secured creditors shall rank with priorities on unsecured creditors.

In the end, our insolvency regime does not rank domestic creditors above foreign creditors.

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

Statutes are attached to the accompanying email.

# Japan
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

   In Japan, the protection of client assets is ensured mainly by four tools under the Financial Instruments and Exchange Act (FIEA). One is segregation requirement for an investment firm under which its client assets should be stored separately from the firm's own assets. Another tool is Investor Protection Fund which will compensate client assets in case of insolvency of an investment firm. The third one is annual checks of the status of segregation by external auditors. The last one is our continuous supervision of investment firms through which we will check the status of the firm's management of client assets.

   a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

      Paragraph 3 of Article 79-20 of the Financial Instruments and Exchange Act (FIEA) defines the assets of "general customers" which are entitled to receive compensation by Investor Protection Fund in case an investment firm becomes insolvency as follows.

      - Money or securities which are placed by general customers for transactions of exchange-traded securities derivatives or for margin transactions.
      - Money or securities which are placed by general customers for transactions of securities.

   b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

      Placing client assets with the investment firm itself does not change the nature of client's ownership, which remains in the client.

   c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

Paragraph 1 of Article 79-20 of the FIEA defines "general customers" which are entitled to receive compensation by Investor Protection Fund in case of insolvency of an investment firm. This excludes sovereigns, local governments and qualified institutional investors with adequate experience and knowledge of investment.

d. Please describe any notable exclusions from the terms "client" or "client assets."

The money or securities which are placed by general customers for OTC derivative transactions are excluded from the definition of "client assets" defined above. As to the exclusions from the definition of clients, please see the answer to question c.

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

   a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

   Only firms registered with the Prime Minister under the FIEA are allowed to conduct financial instruments business in Japan. Minimum entry requirements including minimum capital/deposits, "fit and proper" rules for officers, adequate internal controls and risk management systems and sufficiency of resources will apply to investment firms. On an ongoing basis, investment firms must maintain those requirements.

   b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description

of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

Yes. Client assets which are placed to an investment firm when the firm provides its intermediary services of securities transactions and exchange-traded derivatives transactions or margin transactions should be segregated from the firm's own assets pursuant to Articles 43-2 and 43-3 of the FIEA. In addition, under Paragraph 3, Article 43-2 of the FIEA, an investment firm should be subject to an external audit regarding the status of segregation of client's assets.

a. Must the Client Assets of one client be maintained separately from those of other clients?

No.

i. Are Investment Firms allowed to hold Omnibus Accounts?

Yes.

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

An investment firm is required to store its client assets at least in a way which it can identify each client's assets under the FIEA. In this sense, losses due to the activities of other clients will never affect each client.

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

Investment firms are required to hold specific assets deposited by each client and return them as they are under the FIEA.

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

Reconciliation should be conducted on a client-by-client basis under the FIEA.

C) If a client has a debit balance (i.e. the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

Yes, a client's debit balance will reduce the Investment Firm's obligation with the client under the FIEA. However, a client's net debit balances will not reduce the firm's net credit balances of other clients under the FIEA.

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly)

We do not have any specific requirement stated in the FIEA.

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

NA

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

No. It is not allowed for investment firms.

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

No. We do not have such requirements. .

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

Yes, if a client gives consent to the use of his or her assets by a firm.

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

Yes. Written consent of a client is required for an investment firm to use securities posted by the client under Article 43-4 of the FIEA.

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

The ownership rights will be changed by the use or re-hypothecation of client assets by an investment firm.

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a

client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

Written consent of a client is required for an investment firm exercising such rights on the client's securities under Article 43-4 of the FIEA. The document which proves the client's consent should be stored in records pursuant to Article 46-2 of the FIEA and Article 157 of the Cabinet Office Ordinance on Financial Instruments Business, etc.

iii. How are the ownership rights of a client over its client assets changed or affected when the investment firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (i.e. established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

If the firm goes bankrupt, the right of clients to their assets which the firm uses or re-hypothecate will be categorized into the general claims to the firm under our civil law and thus there is possibility that those assets are not returned to clients even in the case where the clients did not give consent to the re-use or re-hypothecation by the firm.

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

In Japan, investment firms are required to post margins to clearing houses separately for their own positions and for their clients' positions.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

a. Client Assets transferred to or located in other jurisdictions?

Yes.

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

Yes.

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign **Investment** Firms") in an Omnibus Account (that includes Client Assets from domestic clients)?

Yes.

If so,

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

Clients' assets will be at least stored in a manner where a firm can identify each client's assets.

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

NA

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

NA

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

As for client's cash, the investment firm has to put it into a third party custodian licensed in Japan. As for securities, we do not have any specific requirements on the party who stores them on behalf of investment firms.

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

After the Lehman's crisis, JFSA asked all the investment firms in Japan to take appropriate actions such as the deletion of LIEN terms if any through Japan Securities Dealers Association in June, 2011.

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

Pursuant to Article 46-4 of the FIEA, investment firms are required to disclose to the public the documents which explain the status of business operation and property of the investment firms every business year. The items which should be stated in the documents are raised in Article 174 of the Cabinet Office Ordinance. Based on item (iv), (b) of the article, the firms are required to disclose the volume or amounts of client assets and how each type of those assets is stored or managed to the public regardless of whether clients assets are stored domestically or in other jurisdictions. Investment firms are required to submit a report written by external auditors on the segregation of assets of clients to the JSDA (Japan Securities Dealers Association).

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

   If a client gives consent to a firm's reuse or re-hypothecation of his or her assets, segregation requirements will not apply to those assets. Written consent of a client is required for the firm to re-use or re-hypothecate his or her assets.

9. Are Investment Firms your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

   a. Does the Investment Firm report where client assets are held?

   b. Does the Investment Firm or depository report the protections applicable to such?

   c. Does the Investment Firm or depository report the amount of assets that are held?

   In each case, are such reports provided on request or periodically? If periodically, with what frequency?

   Based on Article 56-2 of the FIEA, investment firms are required to report such data to the Japan FSA on a monthly basis.

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

    a. Where Client Assets are held?

    b. The amount of Client Assets held at a depository?

    c. The safeguards applicable to Client Assets held at a depository?

    The Securities and Exchange Surveillance Commission (SESC), an inspection and investigation arm of the FSA as well as JSDA (Japan Securities Dealers Association) will check the firm's status of management of its client assets in its examination on a regular basis. In addition, also checks the status on a regular basis. In addition, under Paragraph 3, Article 43-2 of the FIEA, an investment firm should be subject to an external audit regarding the segregation of client's assets.

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

b. The protections actually applicable to such Client Assets, in light of steps taken by the Foreign Investment Firm to secure or to reduce such protections?

Where there is an applicable memorandum of understanding between the relevant regulators, the foreign regulator could request information from the domestic regulator through that memorandum of understanding. By law the FSA can share information with overseas regulators, and it has entered into arrangements of cross-border supervisory cooperation with a number of countries. Additionally, the FSA is a signatory of IOSCO MMOU, which covers enforcement cooperation. Regardless of documentation, as long as equivalence of confidentiality obligation is assured, confidential information can be provided by the FSA.

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

Investment firms are required to maintain records and calculate their own capital adequacy ratio. They are also required to prepare quarterly financial reports which are provided to the FSA and published. These reports include capital adequacy, total assets, clients' assets outstanding and cash positions. In addition, they must provide a monthly risk management report (containing financial information, balance sheet and capital adequacy calculation) to the FSA or the Local Finance Bureau but they do not make this publicly available. If capital adequacy ratio of an investment firm falls below a ratio of 140%, it is required to prepare and submit daily notifications to the FSA of its financial position. If its capital adequacy ratio falls below 120 percent, the FSA will order a firm to submit the plan for specific measures to maintain or improve the ratio ("corrective action").

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*, capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

In cases where the net assets of an investment firm fall to less than 50 million yen, the FSA may rescind the firm's registration or authorization, or order suspension of all or part of its business by specifying a period not exceeding six months.

In addition, in cases where the capital-to-risk ratio of an investment firm is less than 100 percent, if the FSA finds it necessary and appropriate for the public interest or protection of investors, it may order the suspension of all or part of its business by specifying a period not exceeding three months, within the limit necessary. In cases where the FSA has ordered the suspension of all or part of its business and if it finds that the capital-to-risk ratio of firm on the day when three months have passed since the day of the order continues to be less than 100 percent and that the status of the capital-to-risk ratio of the firm is not likely to recover, it may rescind the registration of the firm.

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

    Currently, we do not have a bankruptcy regime specifically applied to investment firms. Likewise other corporates, Civil Rehabilitation Act, Corporate Reorganization Act or Bankruptcy Act will apply to them. Only in a bankruptcy process of under the Bankruptcy Act, the regulator can file for bankruptcy of a firm. However, responding to the FSB's Key Attributes for Effective Supervision, the Financial System Council, which is an advisory panel to the Minister of Financial Affairs, has considered the necessity for a new resolution regime for non-bank financial institutions. According to their final report, it has concluded that reflecting the global trends, it is necessary to establish a framework for orderly resolution regime of financial institutions including investment firms, in order to address risks that may spread across financial markets. Based on their conclusions, appropriate establishment of a new framework will be prepared by JFSA.

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

    The court will select the Administrative Officer for bankruptcy proceedings. There is no particular qualification for an Administrative Officer.

16. What are the duties of the Administrative Officer?

    a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

       Under Paragraph 1, Article 85 of Bankruptcy Act, an administrator should perform his/her duties with due care of a prudent manager. We do not have any further specific guidelines for clarifying these duties.

       The Administrative Officer exercises his/her duty based on insolvency legislation.

    b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

       When an administrator fails to fulfill the duty of diligence, he or she will be liable for compensation of damages under the Paragraph 2 of the act.

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

a. Does the regulator continue to supervise the Investment Firm?

When there are concerns about inability to pay of an investment firm, the FSA will issue a business improvement order together with rescinding a registration of an investment firm or issuing a business suspension order. For example, when Lehman Brothers Holdings Inc., the parent company of Lehman Brothers Japan Inc. went bankrupt, the FSA issued business improvement order of which the details are as follows.

- Get hold of information on its investors and their assets deposited precisely.
- Preserve assets deposited by investors and not use up its property unreasonably.
- Take full measures for investor protection with considering fair treatment among investors.
- Try to keep every investors informed appropriately about the retention of deposited assets, and consider appropriate actions for investors.

b. How, if at all, is the regulator involved in the process of returning Client Assets?

The FSA will issue a business improvement order, with which we require the firm for smooth return of its client assets.

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

As explained before, when there are concerns about inability to pay of an investment firm, the FSA will issue a business improvement order for client protection together with rescinding a registration of an investment firm or issuing a business suspension order. The FSA will supervise the firm in order to check whether the firm meets the request stated in the order.

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

No.

a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

Consent of each client will be required for the accomplishment.

b. What factors, if any, affect the time period required to accomplish such a transfer?

The same above will be a major factor.

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

Under Article 52 of FIEA, when there are concerns about inability to pay of an investment firm, the FSA will issue a business improvement order together with rescinding a registration for the investment firm or issuing a business suspension order. Through such order, the FSA will ask the firm to preserve assets deposited by investors and not use up its property unreasonably.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

Please refer to the response to Question 1.

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

In our bankruptcy process, a client's assets which are re-hypothecated will be categorized into general claims to an investment firm.

However, the client will be protected to some extent by the following means. When a client gives consent to an investment firm concerning its re-use of his/her securities placed in the firm as collateral, section 3, paragraph 2 of article 43-2 of the FIEA requires the investment firm to put the money equivalent to the current price of the securities used as collateral by the firm into a custodian bank licensed in Japan for the purpose of returning the client's assets in case of insolvency of the firm. In this sense, the client is protected.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

When liquidating Japanese subsidiary of Lehman Brothers Securities, it was found out that LIEN was attached to the securities which belong to the clients of the subsidiary. Under the LIEN, other group affiliates could exercise the rights on the securities in case of insolvency of the group. Such transaction was done when the Japanese subsidiary posted its client assets to the London operation. This threatened and delayed the return of client assets.

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

If segregation requirements are not fulfilled by an insolvent investment firm and if Investor Protection Fund finds it difficult for the firm to smoothly return some of client assets, the Fund will compensate the clients concerned up to 10 million yen and the loss which is not covered by the compensation by the Investor Protection Fund will be shared among those clients proportionally.

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

    In such case, there is no priority distribution for clients.

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

    In the insolvency process, each client's assets should be returned promptly to the client if those assets are segregated from a firm's own assets. In our solvency regime, there is no difference in treatment between domestic creditors and foreign creditors.

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

English version of FIEA is uploaded on the following link.

http://www.fsa.go.jp/en/refer/legislation/index.html

The link to our inspection manual for investment firms is as follows.

http://www.fsa.go.jp/sesc/kensa/kensa.htm#02

# Korea
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to

engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

   a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

Any financial investment product or money that has been deposited into the client's investment account as a result of trading through a financial investment business entity.

   b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

Client assets are the sole property of the client. In order to protect client assets from a financial investment business entity's default, etc., client's deposits are deposited in a financial securities company while securities belonging to clients must be deposited in Korea Securities Depository.

   c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

Under the Financial Services and Capital Markets Act(FSCMA), client's are deemed to be the counterparty of a financial investment business entity in a transaction of financial investment product and are categorized into "professional investor" and "ordinary investor."

"Professional investor" means an investor who has an ability to take risks accompanying the investment in light of the expertise that it possesses in connection with financial investment instruments, the scale of assets owned by it, etc., and who falls under any of the following subparagraphs: Provided, That a financial investment business entity shall give consent to a professional investor prescribed by Presidential Decree when the investor notifies the financial investment business entity in writing of its willingness to be treated as an ordinary investor, unless there is a justifiable ground otherwise, and such investor shall be treated as an ordinary investor when the financial investment business entity gives such consent.

1. State;
2. The Bank of Korea;
3. Financial institutions specified by Presidential Decree;
4. Stock-listed corporations: Provided, That trading over-the-counter derivatives with a financial investment business entity shall be limited to cases where an investor notifies the financial investment business entity in writing of its willingness to be treated as a professional investor; and
5. Other persons specified by Presidential Decree.

The term "Ordinary investor" means any investor other than professional investors.

d. Please describe any notable exclusions from the terms "client" or "client assets."

N/A

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g., *retail versus sophisticated)*

In our jurisdiction, different laws and regulations are applied according to the categories of Client Assets, Models of trading, and categories of clients.

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g., *informal arrangements between governmental entities.*

In general, the differences are:

1. **According to the categories of client assets** : client's deposits are to be deposited and managed separately from the financial investment business entity's assets and are to be kept in a financial securities company. Client's securities which were obtained as a result of the trading of financial investment products and any other transactions are to be kept at the Korea Securities Depository.

2. **According to the models of trading**: for transactions that occur in the exchange, trading is possible with multiple parties whereas for transactions that occur outside the exchange(i.e., over-the-counter) only two parties (i.e., one seller and one purchaser) may enter into contract.

3. **According to the categories of clients** : For ordinary investors, a financial investment business entity must obtain information about the investment purpose, status of property, experience in investment, etc. of these investors before recommending an investment. A financial investment business entity must not recommend an ordinary investor to make an investment if the investment is deemed unsuitable for the investor in light of the investment purpose, status of experience in investment, etc. However, this requirement is not applicable when dealing with professional investor.

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

Financial securities company which holds the investment deposits of its clients must receive an authorization from the Financial Services Commission. Meanwhile, the Korea Security Depository which holds the securities of investors is a quasi-government entity established pursuant to the Financial Services and Capital Markets Act Art.294 as the sole entity to operate as a central securities depository under the charge of the Financial Services Commission.

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

Any person who intends to obtain authorization as a financial securities company must meet all the following requirements: (1) the person is required to be a stock company under the Commercial Act; (2) Equity capital is required to be not less than 2 billion won and to exceed a minimum amount of 50 billion won; (3) business plan is required to be proper and sound; (4) the person is required to have human resources, data-processing equipment, and other physical facilities sufficient to protect investors and run businesses; (5) an executive is required not to fall under any of the subparagraphs of Article 24; (6) A major shareholder is required to have sufficient contribution capacity, sound financial status and social standing; and (7) the person is required to establish a system to prevent conflict of interest.

* Art.24 Qualification of Executives : No person who falls under any of the following subparagraphs shall become an executive of a financial investment business entity (including a person falling under Article 401-2 (1) 3 of the Commercial Act who is prescribed by Presidential Decree; hereafter the same shall apply in this Article), and an executive shall lose his/her office if he/she falls hereunder after taking the office:
1. A minor, an incompetent, or a quasi-incompetent;
2. A person declared bankrupt, not yet reinstated;
3. A person for whom five years have not elapsed since the completion (or deemed completion) of, or exemption from, a sentence of imprisonment without prison labor or heavier punishment, pronounced against him/her, or payment of a fine for negligence or greater, imposed upon him/her pursuant to this Act, other finance-related Acts and subordinate statutes specified by Presidential Decree (hereafter referred to as finance-related Acts and subordinate statutes in this Article) or finance-related Acts and subordinate statutes of a foreign country (referring to Acts and subordinate statutes of a foreign country, similar to this Act or any finance-related Acts and

subordinate statutes; hereafter the same shall apply in this Article);
4. A person against whom a sentence of suspension of imprisonment without labor, or greater punishment, was pronounced and who is still under a period of suspension;
5. A person who was once an executive or an employee of a corporation or company whose business authorization, authorization or registration was revoked pursuant to this Act, other finance-related Acts and subordinate statutes, or finance-related Acts and subordinate statutes of a foreign country (limited to a person who is directly or substantially liable for the occurrence of the cause or event that gave rise to the revocation as specified by Presidential Decree) and for whom five years have not elapsed since such revocation;
6. A person for whom five years have not elapsed since he/she was removed or dismissed pursuant to this Act, other finance-related Acts and subordinate statutes, or finance-related Acts and subordinate statutes of a foreign country;
7. A person against whom a notice was given that he/she should, as a retired executive or employee, have been subjected to a disposition of demand for removal or dismissal pursuant to this Act or other finance- related Acts and subordinate statutes if he/she was in service or in employment at the time of such notice, and for whom five years have not elapsed since such notice was delivered (or seven years since the date of his/her retirement or resignation, in cases where the period of five years after the date of such notice exceeds the period of seven years after such retirement or resignation);
8. A person prescribed by Presidential Decree as likely to undermine the protection of investors or sound trade practice

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

N/A

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

Yes, client assets must be maintained separately from the assets of a financial investment business entity. Client's deposits must be identified and kept as client assets. Client's securities must be kept in the Korea Securities Depository and identified as client's securities.

a. Must the Client Assets of one client be maintained separately from those of other clients?

Yes, client assets of one client must be maintained separately from those of other clients. The assets are maintained according to each client's customer accounts.

i. Are Investment Firms allowed to hold Omnibus Accounts?

Yes, an account which the asset deposited is of an assessed value of less than 100,000 won and which there have not been any trades and deposit/withdrawal for the last six months may be separately maintained as an omnibus account.

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

As client's accounts are managed separately according to each client, there is no possibility of loss occurring due to the activities of other clients.

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

Reconciliation of client asset account, as part of internal control, is done on a regular basis.

i) How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

Financial investment business entities are required to maintain separately its proprietary property, trust account, and client accounts. Accounting of these assets is to be done separately as well.

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

The investment firm must hold the specific assets deposited by the client.

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

It depends on the investment firm's internal control standards.

C) If a client has a debit balance (i.e. the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

In our previous answer, we noted that client's debit balance is not deducted in determining the amount the investment firm is required to hold. Similarly, the net debit balance is not reduced from the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients.

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

It depends on the investment firm's internal control standards.

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

It depends on the investment firm's internal control standards.

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

Financial investment business entities are required to maintain separately its proprietary property, trust account, and clients' accounts. Accounting of these assets is to be maintained separately. Any deficiency from the investment business entity's own funds is to be "made good" using its own asset.

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

Financial investment business entities are required to maintain separately its proprietary property, trust account, and clients' accounts. Accounting of these assets is to be maintained separately. The financial investment business entity's own assets are prohibited from being transferred to a client's account.

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

Financial investment business entity may use client assets of one client if it receives consent from the client.

As noted above, it must receive client's consent.

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

A financial investment business entity may, with client's consent, have the right to use the entrusted securities of its client or provide it as a third-party collateral.

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

There is no change in the ownership rights of a client.

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

The investment firm must receive prior comprehensive consent from its client.

iii. How are the ownership rights of a client over its client assets changed or affected when the investment firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its

client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (i.e. established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

Use or re-hypothecation of client's assets without the client's consent may constitute as embezzlement or misappropriation. The person/firm will be subject to not more than 10 years of imprisonment or a penalty not exceeding KRW 30,000,000 (about USD27,000) . Civil remedy may be also available to the client for the amount of the assets that have been used or re-hypothecated, attorney's fees, etc.

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

N/A.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

Holding client's assets in another jurisdiction can be categorized into two instances: (1) client purchases securities listed in a foreign country through a financial investment business entity or (2) client wishes to hold securities purchased in our jurisdiction in another jurisdiction.

In the first case, the securities are held in the foreign jurisdiction's depository. In this case, the securities are held in an account under the Korea Securities Depository (KSD). The KSD maintains and holds accounts separately according to each financial investment business entity and the financial investment business entity holds the account separately according to each of its clients. In the second case, the securities must be held in the KSD unless doing so would otherwise conflict with the laws/regulations of the foreign jurisdiction.

a. Client Assets transferred to or located in other jurisdictions?

Please refer to the answers noted above.

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

Financial investment business entities do not differentiate between domestic/foreign client's assets. All client assets are held and maintained separately according to each client's account.

If so, please provide details of those requirements.

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

In general, securities received as a result of trading foreign securities through a financial investment entity must be held in a foreign depository appointed by the Korea Securities Depository among the foreign depositaries designated and publicly notified by the Financial Services Commission.

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

To protect such clients, foreign depositories which can hold these assets are restricted to a depository that is established to perform the similar functions of KSD and which is under the regulatory supervision of the foreign jurisdiction's government or regulatory authority.

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

Please refer to the answers noted above.

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

N/A

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

Client's securities can only be held by the KSD; no third party custodians are allowed to hold such assets. However, client's deposits (referring to money deposited by investors in connection with trading of financial investment instruments and other transactions) must be held in a financial securities company. Also, client's deposits may be held in business entities that run a financial investment business concurrently and is among one of the following entities:

(1) Banks

(2) The Korea Development Bank

(3) The Industrial Bank of Korea

(4) Insurance companies

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

As noted above, third party custodians are prohibited from holding clients' assets. Among business entities that run a financial investment business concurrently and is bank, KDB, IBK, or an insurance company may hold clients' deposits.

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

Except in cases where there has been a merger of the financial entity where clients' assets were deposited, placing a lien, charge or encumbrance is prohibited.

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

Pursuant to the Act on Real Name Financial Transactions and Guarantee of Secrecy, unless there is an exception, the disclosure of clients' information is strictly prohibited. Exceptions include: (1) client gives written consent to request for disclosure, (2) pursuant to a court order, (3) required to submit tax data under tax-related Acts, etc.

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

Client's asset protection laws/regulation/requirements cannot be waived. It is applicable to all clients.

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

Financial investment entities are required to submit their business report which includes the deposited assets of all of its clients to the regulators(FSC/FSS).

a. Does the Investment Firm report where client assets are held?

Unless an exception applies, client assets are held in KSD and/or financial securities companies.

b. Does the Investment Firm or depository report the protections applicable to such client assets?

No. As protections of client assets are mandated by the relevant laws and regulations.

c. Does the Investment Firm or depository report the amount of assets that are held?

Yes. Financial investment entities are required to submit their business report which includes the deposited assets of all of its clients to the regulators(FSC/FSS). These include the total amount of assets held by the investment firm/depository.

In each case, are such reports provided on request or periodically? If periodically, with what frequency?

The reports are to be submitted periodically – monthly and quarterly.

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

Regulators may inspect and examine the business/operation of KDS and financial securities companies.

a. Where Client Assets are held?

b. The amount of Client Assets held at a depository?

c. The safeguards applicable to Client Assets held at a depository?

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

N/A.

a. The amount and/or value of such Client Assets?

b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

Pursuant to FSCMA Art.418, in a case falling under any of the following subparagraphs, a financial investment firm shall report thereon to the Financial Services Commission in accordance with Presidential Decree:

1.Where the trade name is changed;

2.Where any material matter prescribed by Presidential Decree in the articles of incorporation is changed;

3.Where any executive is appointed or dismissed (including resignation);

4.Where the largest shareholder is changed;

5.Where the portion of stocks held by a major shareholder or its specially-related persons is changed in excess of 1/100 of the total number of outstanding stocks with voting rights;

6.Where part of the financial investment services falling under any of Articles 6 (1) 1 through 6 (1) 3 and 6 (1) 6 is transferred or acquired;

7.Where part of the financial investment services falling under any of Articles 6 (1) 4 and 6 (1) 5 is transferred or acquired;

8.Where part of the financial investment services falling under any of Articles 6 (1) 1 through 6 (1) 3 and 6 (1) 6 is discontinued;

9.Where part of the financial investment services falling under any of Articles 6 (1) 4 and 6 (1) 5 is discontinued;

10.Where any branch or business office is newly established or closed;

11.Where the location of the head office is changed;

12.Where the business of the head office, branch, or any other business office is suspended or resumed; or

13.Others prescribed by Presidential Decree as necessary for the protection of investors or sound trade practice.

* Article 6:

(1) The term financial investment business in this Act means activities conducted continuously or repeatedly for the purpose of earning a profit, which shall fall under:

1. Investment trading business;

2. Investment brokerage business;

3. Collective investment business;

4. Investment advisory business;

5. Discretionary investment business; or

6. Trust business.

* Presidential Decree Article 371 (Matters Subject to Reporting)

(2) The term important matters specified by Presidential Decree in subparagraph 2 of Article 418 of the Act means matters falling under any of the following subparagraphs:

1.Matters concerning business purposes;

2.Matters concerning general meeting of shareholders and board of directors, and other matters concerning governance of the company;

3.Matters concerning stocks issued by the company; and

4.Other matters specified and publicly notified by the Financial Services Commission as those related to protection of investors.

(3) The term as prescribed by Presidential Decree in subparagraph 13 of Article 418 of the Act means cases falling under any of the following subparagraphs:

1.Where capital is increased;

2.Where a financial investment business entity has been subjected to a punishment under Part Ⅹ (Articles 443 through 449) of the Act;

3.Where a financial investment business entity becomes a party to a lawsuit that may significantly affect the business of the financial investment business entity;

4.Where an application for bankruptcy has been filed against the relevant financial investment business entity or where a cause of dissolution occurs;

5.Where an application for commencement of rehabilitation proceedings under the Debtor Rehabilitation and Bankruptcy Act is filed, a decision on commencement of rehabilitation proceedings is made, or a decision on commencement of rehabilitation proceedings becomes ineffective;

6.Where a financial investment business entity has been subject to a disposition against default on tax payment or to a punishment on account of violation of a taxation-related Act and subordinate statutes;

7.Where a financial investment business entity has made a direct overseas investment under the Foreign Exchange Transactions Act or installed an overseas sales office or any other overseas office;

8.Where a financial investment business entity has established or closed down a domestic office (applicable only to a domestic office of a foreign financial investment business entity);

9.Where a financial investment business entity defaults on payment for cheques or bills issued by it or current account transaction with banks are suspended or banned;

10.Where a cause or event specified and publicly notified by the Financial Services Commission occurred in relation to an overseas local corporation, an overseas branch, an overseas office, etc. of a financial investment business entity;

11.Where a cause or event specified and publicly notified by the Financial Services Commission occurred in relation to the head office of a foreign financial investment business entity (applicable only to a foreign financial investment business entity that has installed a domestic branch or any other domestic sales office); and

12.Where there occurred any other cause or event specified and publicly notified by the Financial Services Commission as one that may significantly affect business management, property, etc. of a financial investment business entity.

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*, capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

Pursuant to the Act on the Structural Improvement of Financial Industry Art 10., regulators may make a timely corrective measure.

* Act on the Structural Improvement of Financial Industry Art. 10 (Timely Corrective Measures)

(1) Where any financial institution′s financial status falls short of the standards referred to in paragraph (2),such as its equity ratio failing to meet the specified standards, or it is deemed evident that a financial institution′s financial status falls short of the standards referred to in paragraph (2) due to the occurrence of any major financial scandal or accrual of non-performing loans, the Financial Services Commission shall recommend, request or order the financial institution concerned or the executives of such financial institution to take the following measures or order it to furnish its implementation plan in order to prevent insolvency, and promote the sound management of such financial institution:

1.Admonition, warning, reprimand or salary reduction in relation to the financial institution concerned and its executives and employees;

2.Capital increase or capital deduction, disposal of property holdings or reduction in stores and downsizing;

3.Ban on acquisition of high-risk assets, such as non-fulfillment of obligations or price fluctuations, or restriction on the receipts at exorbitantly high interest;

4.Suspension of executives′ performance of duties or appointment of management supervisors acting for executives′duties;

5.Amortization or consolidation of stocks;

6.Suspension of all or part of business;

7.Merger or third-party takeover of the financial institution concerned;

8.Transfer of business or contracts related to financial transactions, such as deposits or loans (hereinafter referred to as″transfer of contracts″);

9.Other measures equivalent to those listed in subparagraphs 1 through 8,which are deemed necessary to improve any financial institution′s financial soundness.

(2)Where the Financial Services Commission intends to take measures pursuant to paragraph (1)(hereinafter referred to as ″timely corrective measures″), it shall in advance determine and notify the standards and details thereof.

(3) Where it is found that any financial institution temporarily falling short of the standards referred to in paragraph (2) can meet the standards within a short period or it is deemed that any ground equivalent thereto exists, the Financial Services Commission may delay the timely corrective measures for a specified period.

(4)In determining the standards referred to in paragraph (2),the Financial Services Commission may take the following measures likely to cause serious property damage to a financial institution or its stockholders, only where the financial institution is insolvent, its financial status falls grossly short of the standards referred to in paragraph (2),and it is deemed evident that good order in credit or the rights and interests of depositors are likely to be impeded:

1.Suspension of all business;

2.Transfer of all business;

3.Transfer of all contracts;

4.Order to amortize the total stocks;

5.Other measures equivalent to those under subparagraphs 1 through 4.

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

The law/regulation and process in which a financial investment business entity enters into the status of "insolvent" or "bankruptcy" is the same as that of a non-financial investment company. Once a petition is filed with the court, whether or not the entity satisfies the requirements to enter into such status is reviewed and a court decree is issued accordingly.

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

The court appoints the Administrative Officer. Under the law, there is no specific qualification requirement for the Administrative Officer. Also, once a lawyer/counselor is appointed, the financial investment business entity may appoint a financial expert recommended by the Financial Services Commission.

16. What are the duties of the Administrative Officer?

Fiduciary duty, duty to be neutral, duty to report, etc. and if a loss occurs the administrative officer may be subject to joint liability.

a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

N/A

b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

Breach of its duty may lead to the administrative officer being jointly liable for any losses or harm caused by such breach.

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

Any bankrupt/ insolvent entity is solely under the supervision of the bankruptcy court. However, a bankrupt/insolvent financial investment business entity may be required to notify or submit statements to the Financial Services Commission.

a. Does the regulator continue to supervise the Investment Firm?

N/A. Please refer to the answers above.

b. How, if at all, is the regulator involved in the process of returning Client Assets?

N/A. Please refer to the answers above.

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

Unless there is priority ownership (collateral, etc.) among assets or the relevant laws/regulations specifically provides for the segregation of the assets, client assets may be mixed with other assets.

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

N/A

a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

N/A

b. What factors, if any, affect the time period required to accomplish such a transfer?

N/A

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

Client assets that were lawfully returned are not subject to avoidance power.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

To deal with cases where client's deposits cannot be returned fully, the financial investment business entity is required to separately deposit assets in the amount equaling to that of client's deposits in a financial securities company. The Korea Deposit Insurance Corporation provides protection to client's deposits up to 50 million won.

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

N/A

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

N/A

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

The executive of a financial investment business entity may be subject to the following measures taken by the FSC:

1. Request for dismissal;

2. Suspension from office for up to six months;

3. Disciplinary warning;

4. Cautionary warning;

5. Caution; or

6.Other measures prescribed by Presidential Decree as necessary to correct or prevent violation.

The Financial Services Commission may demand a financial investment business entity take any of the following measures against any of its employees responsible:

1. Removal;

2. Suspension of his/her duty for six months or less;

3. Salary reduction;

4. Reprimand;

5.Warning;

6. Caution; or

7.Other measure prescribed by Presidential Decree as necessary for correcting or preventing such violation.

When the Financial Services Commission takes a measure against an executive or employee of a financial investment business entity or demands such a financial investment business entity to take a measure against any of its executives or employees, it may also take another measure against a person responsible for control and supervision or demand such a measure: Provided,

That such measure may be mitigated or exempted if the person responsible for control and supervision has exercised reasonable care in control of and supervision over the executive or employee.

Specific clients are not treated differently.

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

Unless the client did not set its priority among other creditors, the assets are distributed pro-rata.

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

Unless it is a special bond which is given priority pursuant to the relevant laws/regulations, all creditors are subject to pro-rata distribution. Also, there is no differential treatment (i.e., "rank") between domestic and foreign creditors.

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

The laws and regulations provided in this survey refers to the Financial Services and Capital Market Act and its enforcement decree unless otherwise stated in the answers.

All the relevant laws and regulations, except for bankruptcy law, can be found in the English website of the Financial Supervisory Commission or Financial Supervisory Services:

FSC website: http://www.fsc.go.kr/eng/lr/lr0101.jsp

FSS website: http://english.fss.or.kr/fss/en/laws/securities.jsp

# Mexico
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

Mexico doesn't have a specific protection scheme or protection fund for Investment firms (Casas de Bolsa), but it has been implemented a very strict regulation to separate, safeguarded and properly accounted client assets, and in case of insolvency financial authorities encourage transferring client assets to another investment firm. The regulation has incorporated almost all international standards such as: accounting principles, capital, risk management, internal controls, external auditors, anti-money laundry procedures, liquidity, ordering assignment in capital markets, DEA regulation, etc. With the recent sub-prime crisis arose some misleading selling practices and suitability as consequence we are working on improving this regulation.

The regulatory entity in charge of the supervision, regulation, intervention, suspension and liquidation of investment Firms is the National Banking and Securities Commission.

For Banks there is a complete protection scheme for deposits, regulated by special entity called Instituto de Protección al Ahorro Bancario (IPAB).

a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

Actually Mexico doesn't have a specific definition for client assets, but the following definition of securities can be used as an analogous term.

Securities, shares, stocks, debentures, bonds, warrants, certificates, promissory notes, bills of exchange and other negotiable instruments, or unnamed nominees, whether registered or not in the registry, which may circulate in the securities markets that referred to herein, which are issued in series or in mass and represent the social capital of a corporation, an aliquot of a good or participation in a credit union or any credit right individual, in terms of national legislation or applicable foreign.

b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

Clients keep all the rights and benefits from the assets placed within the investment firm.

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

Clients are defined in 3 categories: qualified, institutional and general public investor.

Qualified investor: the person who usually has the income, assets or the qualitative characteristics that the Commission established by general provisions.

Institutional investor, the person under federal laws such considered or financial institution, including when acting as trustees under trusts under the laws considered as institutional investors.

Public investor: the one that doesn't correspond to the previous categories.

d. Please describe any notable exclusions from the terms "client" or "client assets."

None notable exclusions are used for client or client assets.

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

Yes

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

In order to organize and operate Investment Firm requires authorization of the National Banking and Securities Commission (from now on Commission). By their nature, these authorizations will be untransferable and they will not imply certification on the solvency of the entity.

The requirements that an Investment Firm required to comply are, among other:

- Shareholder list
- Status project
- Shareholders information, Board of Members and executive positions.
- Coherent lines of responsibility
- Business Plan
- Audit Committee
- Manuals
- Guidelines and procedures to perform all its activities
- Minimum capital stock fully paid
- Risk management and risk unit
- Internal control procedures
- IT systems, security and control
- Protection of client assets

Ongoing requirements are related on the ratio of the capital of the Investment firm to the capital requirement. The regulator can require a deteriorating Brokerage firm to take or to abstain from taking multiple actions, including modification of business activities. Authorities could suspend or forbid activities if brokerage firms: a) don't have the infrastructure and internal controls to provide services and activities according to legal requirements, b) don't fulfill initial requirements to begin operations, c) make activities different to the one authorized in his social object, d) don't accomplish necessary requirements to realize specific operations defined in regulation, e) realized operations with possible conflict of interests in the detriment of them clients or operations forbidden by law or related regulation, f) frequently don't fulfill financial authorities requirements in his auditing faculties, g) operate with values not registered in National securities register, except in cases regulated in law, h) do operations with securities out of the market violating law, i) declared by authority in bankruptcy status and finally j) errors in accounting records or without records from the operations made by entity.

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

Always is required an authorization.

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

Yes, client assets must be maintained completely separated from other clients or investment firm's assets.

According to Mexican securities law the client assets must be registered in different accounts from the Investment Firm's assets account in an authorized Deposit securities institute.

a. Must the Client Assets of one client be maintained separately from those of other clients?

   Yes, the client assets must be perfectly separated and identified client by client with all the information requested by law and regulation.

   i. Are Investment Firms allowed to hold Omnibus Accounts?

      Yes, in Mexico global or Omnibus accounts are permitted, which are managed by: investment firms (broker dealers), banks, foreign entities and mutual funds, where transactions of different clients must be registered following their instructions individually and anonymous.

   ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

      The client assets are managed separately; in non-circumstances allow covering transactions or margins with other client assets.

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

   The broker dealers have to reconcile assets for each client showing all assets and liabilities, income, expense, and capital accounts. Then the amount of assets to be held reflects exactly the same amount assets deposited with the investment firm

   i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

      All client assets are segregated in a depositary institution or clearinghouse; each position is valuated applying a price vector which is provided by an authorized independent entity.

      A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

         Cash is fungible; securities are not in general, only with the exception when they incorporate exactly the same rights, terms and conditions and they can substitute among each other's.

      B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

Client by client and then on an aggregate basis for each asset class, afterwards segregated in local, foreign and proprietary positions. In other words is done on an aggregate basis, but securities firm needs to keep records reflecting the positions of each client.

C) If a client has a debit balance (i.e. the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

Only with cash. Exists a netting process between debit and credit money balance, if after process keeps a debit process, it remains till account has enough credit cash to deduct. A debit balance could not be deducted from the total amount required to hold on deposit by the Investment Firm for net credit balances of other clients.

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

Daily basis

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

The reconciliation takes place on line, because markets and systems count with this function. Nonetheless could be done next business day.

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

There are two alternatives:

Securities firm can make good any deficiency from its own funds with respect to client orders or instructions. Afterwards charges administrative and financial costs to clients.

Securities firm can default to markets due to client's deficit either resources or securities, then firm has to assume different costs impose by depositary institution or compensation entity, transferring all these costs to client account. In general this alternative hasn't been used.

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

Not allowed, isn't recommended

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

Not allowed by Law

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

The only way to apply is through specific client authorization or due to court order. The restrictions can be written in the contract between intermediary and client.

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

Unless otherwise agreed, the investor keeps all ownership rights and benefits over its client assets, when the Investment Firm re-hypothecates or uses with his consent.

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

Through the performance of a contract, that must be part of the record that the Investment Firms holds for every client.

iii. How are the ownership rights of a client over its client assets changed or affected when the investment firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (i.e. established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

It is forbidden by Law for the Investment Firms, to dispose client's resources or his assets for other purposes than those ordered or contracted with him. The violation of this implies a penalty of five to fifteen years in prison, but if the Investment Firm compensates the damage caused to the client, there are significant reductions in the penalties outlined above.

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

There's no imposition to clearinghouses or central counterparties to separate client collaterals.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

Yes, is allowed either transfer or hold client assets in another jurisdictions.

a. Client Assets transferred to or located in other jurisdictions?

The requirement to allocate client in other jurisdictions only applies, if a sub-custody contract exists.

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

Not regulated by current laws.

c. If so, please provide details of those requirements.

N/A

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

Have the same level of protection as any assets deposited in the Investment Firm.

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

Not regulated by current laws.

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

Not regulated by current laws.

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

Third party custodians are permitted; they have to be either commercial banks or investment firms that act as custodian locally, then they need to establish an agreement with a depositary institution. For foreign transactions custodians should be financial intermediaries registered or licensed in their respective jurisdictions.

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

Once licensing is approved the entity present a general process related with services (custody) that will be provided, internal controls and IT infrastructure.

In order to organize and operate as depositary institution is necessary Federal Government authorization, which will be provided by Ministry of Finance and the opinion of National Banking and Securities Commission (CNBV)

The depositary institution's orders can be done by Central Bank, Investment firms, commercial banks, pension funds, mutual funds, insurance and bonding companies, financial groups, stock exchanges, clearinghouses (central counterpart).

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

There is no specific requirement by regulation only a contractual basis.

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

Investment Firms are required to inform to clients compensation schemes, product risk, financial information if is available, account statement in a monthly basis showing security positions or through internet in a daily basis (when this service is offered by the firm), terms and conditions of the services. We don't have specific requirements for assets held in another jurisdiction.

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

There is no option to do it. Mexico doesn't count with a protection scheme for investment firms. On the contrary for banks there is a deposits protection scheme through an institution called IPAB.

However, because an Investment Firm is permitted, with client consent, to re-hypothecate or otherwise use Client Assets, such Client Assets may become unavailable to the client upon the Investment Firm experiencing insolvency.

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

a. Does the Investment Firm report where client assets are held?

In México there is only one institution performing depository activities named S.D. Indeval, S.A. de C.V., Institución para el Depósito de Valores (INDEVAL).

b. Does the Investment Firm or depository report the protections applicable to such client assets?

Investment Firms must confirm that all securities they have transacted are effectively deposited in INDEVAL. Also, must inform the depository institution about the transactions held during the day.

Investment Firms will always be responsible for the transaction performed by their clients.

c. Does the Investment Firm or depository report the amount of assets that are held?

Investment Firms must send to the National Banking and Securities Commission a list with all the allocations of transactions carried out. The list must be sent in the day of their liquidation.

Indeval, Mexico's Depositary Institute, must send every day to the National Banking and Securities Commission, the data base that includes the assets that are held.

In each case, are such reports provided on request or periodically? If periodically, with what frequency?

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify:

a. Where Client Assets are held?

There is only one institution performing depository activities in México, the S.D. Indeval, S.A. de C.V., Institución para el Depósito de Valores (INDEVAL). Therefore there is no need to verify where client assets are held.

Also surveillance visits are performed in order to verify the infrastructure and internal controls of the Depositary Institute.

b. The amount of Client Assets held at a depository?

In the National Banking and Securities Commission there are internal procedures to make sure that investors deposited tenure corresponds to the one that the Investment Firm is reporting in the statements.

c. The safeguards applicable to Client Assets held at a depository?

Its CNBV responsibility the supervision through surveillance activities and the enforcement of preventive and corrective measures, as of requiring information to INDEVAL in order to examine it and verify if transactions carried out by Investment Firms and credit institutions satisfy the legal framework.

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

a. The amount and/or value of such Client Assets?

Based on the MOUs that have been signed, the foreign regulators may ask us for information regarding the amount and/or value of client assets, that information is requested to the Mexican Investment Firms and then provided to the foreign regulator to perform the verifications they consider appropriate

b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

The surveillance activities carried out by this Commission are of general application, so there is no distinction based on the clients' origin, such as the segregation assets from the ones that the Investment Firm owns, reconciling them from those deposited in Indeval, and the bans about operating client assets for different purposes from the authorized by them.

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

In a periodical basis depending upon information, it can be in a daily, weekly, monthly or quarterly basis to relevant authorities.

In the case that the investment firm is listed in the stock exchange (Bolsa Mexicana de Valores), has to comply with all requirements for issuers related with disclosure information with relevant events.

All investment firms are subject to prompt corrective actions where in specific capital level (100%) or ability carry on business must notify to CNBV and follow different corrective measures and present for its approval a recovering plan.

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*, capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

There is a very completely prompt corrective actions scheme. The scheme has established 4 categories:

Category 1, requirement capital ratio <= 80%

Category 2, requirement capital ratio > 80% but <= 100%

Category 3, requirement capital ratio >100% and <= 120%

Category 4, requirement capital ratio > 120%

Depend on the category the CNBV has established different preventive and corrective measures. In preventive measures here are the most important:

- To abstain to celebrate operations whose accomplishment generates that its index of capital consumption is located by above of the 100%.
- To suspend the payment of dividends to the shareholders, as well as any mechanism or act that imply transference of patrimonial benefits.
- To suspend the programs of acquisition of representative investment firm's shares.

- To defer the payment from interests and, in case of considering it necessary, of calling off the payment of principal or call to conversion of subordinated debentures.
- To both suspend to the payment of the compensations or extraordinary bonuses to CEO and second hierarchy
- To grant additional loans to credit related lending.

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

    There are 15 cases where authorities can ask for a revocation license, some are related with firm's insolvency and bankruptcy. Also the CNBV has chance to enter in an intervention process when stability, solvency or liquidity put at risk client assets or creditors.

    The petition for bankruptcy can be filed by firm's regulator, creditors of the firm's, shareholders and investment firm have the rights to ask a declaration of insolvency, but in all of these cases the petition is filed only by Ministry of Finance.

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

    There might be different steps before going into liquidation or dilution and then revocation of the entity.

    The possibilities are:

    a) Activities suspension for irregularities detected by CNBV

    b) Administrative Intervention due to also irregularities detected which can put at risk (sustainability, solvency and liquidity). Administrative Inspector is assigned with duties and functions established by law, the Investment firm will be managed by him, solve irregularities and take any action in the interest of the clients.

    c) Bankruptcy is presented by Ministry of Finance, an administrative officer also is assigned by it

    Once some these possibilities take place and irregularities haven't been solved the liquidation of the entity is the next step. The administrative officer can be selected either by shareholders or Ministry of Finance.

The administrative officer can be either a commercial bank or an investment firm or SAE (government agency for liquidating companies or selling assets) or individual or companies with experience in liquidation financial entities.

If a person is elected, it is necessary to comply with some requirements established by law such as experience, credit worthiness, etc.

16. What are the duties of the Administrative Officer?

    a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

    The guidance that the Administrative Officer is as follows:

    a) Elaborate an integral report of financial situation of the Firm. Depend upon the outcome, he can call a bankruptcy.

    b) Present to Ministry of Finance all the procedures in place to transfer all the client assets (securities) and cash and a timeframe to do it.

    c) Adopt a working plan which contains measures and procedures to liquidate or transfer liabilities or client assets to another investment or commercial bank as maximum one year later he took the position as an Administrative Officer.

    d) Receive assets pending and pay liabilities. The Administrative Officer must separate and perform delivery or transfer of client assets or client cash.

    e) Call to shareholders‟ assembly for the conclusion of his duties and present a liquidation process report for their approval.

    f) In case of not getting shareholders' approval of previous point request to the court.

    g) Exercise legal actions in order to determine economic responsibilities and delimitate responsibilities.

    h) Absent to buy for him or others properties belong to investment firm

    In summary he has to liquidate in orderly manner firm's assets and reimburse as much as he can, creditors' rights.

    b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

    The Administrative Officer and Administrative inspector is completely subject to personal liability for failure to properly perform his or its duties by Securities and Banking Law.

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

    a. Does the regulator continue to supervise the Investment Firm?

Yes, but in specific issues either liquidation or Bankruptcy. Nonetheless the CNBV has the right to revoke the license of the investment firm when this procedures start.

b. How, if at all, is the regulator involved in the process of returning Client Assets?

Intervention Process

The administrative inspector reports all the time to CNBV but he has all legal powers in its ample sense.

Bankruptcy process

The Commission is involved exclusively in transferring or delivering either assets or cash to clients and the agenda established by Administrative Officer and judge approval once he listen Ministry of Finance's opinion.

Liquidation process

The Commission is involved in transferring or delivering either assets or cash to client and the timetable to consider and applicable sanctions. See answer 16, d).

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

Administrative Intervention: The regulator would supervise the inspector-manager, including any efforts that the inspector-manager makes to transfer Client Assets.

Liquidation: The regulator would attempt to facilitate any transfer of Client Assets that the Administrative Officer, the Ministry of Finance, and the court deem appropriate.

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

The financial authorities either facilitate or encourage the transferring

In liquidation is one year since the Administrative Officer takes his position. In bankruptcy there's no time but Commission ask mention in the previous questions need to check timetable.

b. What factors, if any, affect the time period required to accomplish such a transfer?

If assets aren't enough to return to clients

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

The clients are protected only because they go first in line with all the creditors as often as they have documents to show position of their investments.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

    In Mexico there is no protection fund.

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

    There are not.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

    No circumstances.

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

    The only protection exists is that they go first, but in case of deficit the Administrative Officer can call a bankruptcy procedure.

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

    As mention in previous question Administrative Office can call a bankruptcy procedure. There is a priority to clients and then unsecured or subordinate creditors.

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

    See answer 25. There are no distinctions among foreign or domestic creditors.

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

# The Netherlands

# 2013 Survey of Regimes for the Protection, Distribution and/or transfer of Client Assets

## General introductory remarks

- The main rules for investment firms operating in the Netherlands to protect clients' assets (i.e. financial instruments and client money) are included in the Dutch Act on Financial Supervision ('Wet op het financieel toezicht'). More detailed rules on this topic are elaborated in secondary legislation ('Besluit gedragstoezicht financiële ondernemingen' and 'Nadere Regeling gedragstoezicht financiële ondernemingen') under the Act on Financial Supervision (FSA). The relevant articles pertaining to asset protection of these three layers of rules and regulations are attached as annex to this survey.

- In the further elaboration of client asset protection in Dutch financial law, as detailed below in our response, the detailed rules mainly apply to shares and bonds. At the moment no *specific* requirement exists in Dutch financial law beyond this general requirement for protection of clients with positions in derivatives as included in the Act on Financial Supervision.

- Please note that we will answer the following questions from the perspective of individual investors who buy or sell securities for their personal account, and not for another company or organization (also described as 'Retail Client' in Article 4 of the Directive 2004/39/EC of The European Parliament and of the Council of 21 April 2004 on markets in financial instruments (MiFID))

- We understand that the survey aims to collect information across jurisdictions of client asset protection at the level of intermediaries. Intermediaries may engage in the value chain in various capacities (as trading members, as clearing members and/or as admitted institutions to the central securities depository). Each of these capacities may require slightly different and/or additional rules and regulations pertaining to the protection of client assets. The focus of our response to this survey is on the capacity of intermediaries as trading members. From a European perspective this means that the MiFID-rules are a major point of reference for the way rules on the protection of client assets are implemented in Dutch financial law.

- Due to the functional split in the regulatory framework of responsibilities for financial supervision in the Netherlands, the AFM is responsible for supervision of conduct of business of all financial firms, operating in the Netherlands. De Nederlandsche Bank (DNB) is responsible for prudential supervision of all financial firms operating in the Netherlands. Where deemed appropriate in the responses to this survey, we explicitly refer to this role of DNB.

## Context

1a) Client Assets can under Dutch law be described as Moneys and Financial instruments. The term Financial Instrument is used in Article 4, section 1 (17) of the Directive 2004/39/EC of The European Parliament and of the Council of 21 April 2004 on markets in financial instruments (MiFID): *Financial instrument: means those instruments specified in Section C of Annex I;*

Article 4, section 1 (17) and Section C of Annex 1 MiFID is implemented in Dutch law in the Financial Supervision Act (FSA).

**Article 1.1 FSA**

*Financial Instruments*:

(a) Transferable securities;
(b) Money-market instruments;
(c) Units in collective investment undertakings;
(d) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;
(e) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);
(f) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;
(g) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;
(h) Derivative instruments for the transfer of credit risk;
(i) Financial contracts for differences;
(j) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognized clearing houses or are subject to regular margin calls.

1b) In short the nature of the client's ownership rights can be described as follows:
The client assets placed with the investment firm is a deposit of securities into a Wge pool, which results in the replacement of the investor's right of ownership with a right of co-ownership in the 'community of property'(gemeenschap), formed by the Wge pool.

More specifically: The majority of Dutch financial instruments are admitted to the system of securities custody of the *Dutch Securities Giro Transfer and Administration Act* (Wge). The Wge created a three-tiered pyramid-shaped securities custody structure. The top of the pyramid is formed by the so-called 'giro pool' (girodepot), which is administered by the CSD. The CSD's participants are co-owners in that pool, in proportion to the securities of the same kind which they administer. Thus, securities of different issues form different pools, and as many (giro) pools exist as there are securities admitted to the system. The securities that are administered by the participants form so-called 'participant pools' (verzameldepots), the second tier of the pyramid. Pursuant to Article 12, section 2 Wge, investors are co-owners of these pools, in proportion to the securities to which they are entitled. They form the third and last tier of the Wge pyramid.

Especially for securities that are not eligible for admittance to the Wge system and securities that are located abroad, there is the so-called VABEF system of 'simplified administration and custody of securities'. The ownership of securities is transferred to a depository, a special purpose vehicle that is separated from the institution with which investors hold their securities accounts. The insolvency risk of that vehicle is minimized, as its articles of association exclude any form of commercial activity,

while the account provider is liable for its administration. Moreover, the sole purpose of such a vehicle is holding the securities in the vehicle and the supervision of their functioning.

1c) Our jurisdiction (Article 1.1. FSA) does not use the term 'Client' (as used in Article 1, section 10 MiFID), but uses the term 'Consumer' which means any natural person, not acting in business or by profession, to whom an investment firm provides investment services.

1d) Under Dutch law derivatives are not eligible for admittance to the Wge system or the VABEF system. The consequence is that until now there is no system in the Netherlands that can preserve the retail investor's property rights with regard to derivatives that are placed with an Investment firm.

## Pre-Insolvency

2) First of all, an important distinction must be made between investment firms which also act as a credit institution (and therefore hold a license granted by the Dutch Central Bank) and investment firms which do not act as a credit institution.

Firms of the last category only advise customers with regard to their portfolios and pass transactions on. The actual holding of assets is done by a credit institution. In that perspective, credit institutions have additional requirements. This will be explained in more detail below.

Investment firms which are not credit institutions
In the applicable articles from our financial act (more specifically, 6:15 and 6:16 from the Further Regulations on the Supervision of the Conduct of Financial Enterprises pursuant to the Act on Financial Supervision) the following is stated:

Concerning the financial instruments and moneys of clients an investment firm will take such measures that the rights of those clients are adequately protected. The measures serve to prevent that financial instruments and moneys are used by the investment firm for own account transactions. An investment firm may comply with the requirement above if:

a. the moneys and financial instruments belonging to a client and to which the services of the investment firm pertain, are held on one or more credit institution accounts in name of the client

b. no money accounts or financial instruments accounts of the investment firm are used for the transactions performed in name of and for account of the client; and

c. the written authorization given by the client to the investment firm is expressly limited to the authority to dispose of the moneys and financial instruments meant under a), to the extent necessary for providing the investment services to the client.

Furthermore, when an investment firm also takes care of the broker-activities, the financial instruments account of the client is only credited or debited, if the amount to be received or paid pursuant to the financial instruments note is simultaneously debited or credited to the designated money account of the client.
This means that an Investment Firm is not directly allowed to hold Client Assets. Only a credit institution (holding a license granted by the Dutch Central Bank) is allowed to hold Client Assets. The moneys and financial instruments belonging to a client and to which the services of the investment firm pertain, are held on one or more credit institution accounts in name of the client.

Investment firms which are credit institutions

An investment firm holding a licence granted by the Dutch Central Bank (*de Nederlandsche Bank*) to conduct banking activities, complies with the requirement to protect the assets from clients in the case that

- an agreement with the client is made, stipulating at least that the financial instruments account of the client held with the credit institution is only credited or debited, if the amount to be received or paid pursuant to the financial instruments note is simultaneously debited or credited to the designated money account of the client

- the financial instruments are saved in one of the underlying two constructions:
  a. the financial instruments are held and managed in accordance with the Securities Bank Giro Transactions Act.
  b. the financial instruments are held by a depository and this depository fulfill additional requirements. One of the most important requirements is that this depository is not allowed to employ any other activity than keeping the financial instruments.

3a) **I** If an investment firm receives money from a client it is required to place it on a bank account with the central bank, a licensed bank or an authorized money market fund (article 165b of the *Besluit Gedragstoezicht Financiële Ondernemingen*). Investment firms are allowed to hold omnibus accounts in the Netherlands.

An investment firm offering investment services of order execution or asset management to clients, can comply with the principle of article 6:14 of the Act on Financial Supervision by entering into an agreement with its client, containing the following provisions at a minimum (article 6:16 of the *Nadere Regeling gedragstoezicht financiële ondernemingen)* :

- Client money and financial instruments, belonging to the client in the context of the services provided, are held in one or more accounts in the name of the client at a bank;

- Crediting and debiting of the client account, administrating the financial instruments, will only take place on a delivery-versus-payment-basis vis-à-vis the client account, administrating the client money;

- The investment firm is solely authorized to transfer client money and financial instruments if this is deemed necessary for conducting the investment services for the client.

**II** Article 165 of the *Besluit Gedragstoezicht Financiële Ondernemingen* requires every investment firm to keep all information and accounts related to a client up-to-date to enable the investment firm at any time distinguishing client money and financial instruments, held for a client, from client money and financial instruments for other clients and from its own money and financial instruments. The remainder of this article formulates additional measures for the investment firm to achieve the objective of administrative segregation.

3b) Investment firms have to administer information and accounts of clients in such way that they are always correct and correctly reflect the assets (money and financial instruments) of clients (article 165, paragraph 1, sub b of the*)*. The investment firm is under the legal duty to review on a regular basis whether the money and financial instruments of clients, held by third parties, is aligned with the administration of the investment firm itself (article 165, paragraph 1, sub c – e of the*)*.

Timing issue for reconciliation: The obligations, included in article 165, paragraph 1, sub c of the *Besluit Gedragstoezicht Financiële Ondernemingen* (i.e. review on a regular basis) refer to the timing issue for reconciliation.

An investment firm is not permitted to maintain any of their own assets in a client asset account (article 165, paragraph 1, sub a and c of the *Besluit Gedragstoezicht Financiële Ondernemingen).*

3c) Articles 4: 87 of the Act on Financial Supervision require that the investment firm takes appropriate measures to protect the interests of each client. The investment firm enters into an (written) agreement with each client which will form the sole basis for providing its services (article 4:89 of the Act on Financial Supervision).

3d) We refer to the answer to question 22.

3e) The regime for central counterparties pertaining to segregation (and portability) of assets and positions vis-à-vis its clearing members and clients of these clearing members, is part of article 39 of EU Regulation 648/2012 on OTC derivatives, central counterparties and trade repositories (a.k.a 'EMIR') which came into force in August 2012, but will only become effective in early 2013. Upon request, the CCP shall offer clearing members the possibility to open more accounts in their own name or for the account of their clients. Subsequently, the clearing member shall offer its clients at least the choice between omnibus client segregation and individual client segregation.

4 Investment firms are permitted to transfer to or hold Client Assets in another jurisdiction. In general, a distinction can be made between assets that are kept in a Dutch 'giro' pool, administered at the CSD, and assets that are actually kept in foreign countries (at (sub)custodians).

In both cases there are two options to actually hold the assets, namely the system of the Dutch Securities Giro Transfer and Administration Act (Wge) and the system of depository.

This means that it is possible to scale foreign kept assets under the scope of the Dutch Securities Giro Transfer and Administration Act (Wge). Yet, this is only applicable when additional requirements are fulfilled. Therefore, common practice is to use the depository system.

We would like to remark that Client Asset protection is more difficult to guarantee, if not impossible, in the situation that the actual Assets are held in a foreign country because this is not in the span of control of the AFM (as a Dutch supervisor).

5 Investment firms are permitted to hold Client Assets in an Omnibus Account, including Client Assets deposited by Investment firms in other jurisdictions and Client Assets of domestic clients. In general, a distinction can be made between assets that are kept in a Dutch 'giro' pool, administered at the CSD, and assets that are kept in foreign countries (at (sub)custodians). The Dutch rules do not differ in protection for foreign clients and domestic clients.

In both cases there are two options to actually hold the assets, namely the system of the Dutch Securities Giro Transfer and Administration Act (Wge) and the system of depository.

This means that it is possible to scale foreign kept assets under the scope of the Dutch Securities Giro Transfer and Administration Act (Wge). Yet, this can only be applicable when additional requirements are fulfilled. Therefore, the more common way is to use the depository system.

6a) The regime in the Netherlands for the safe keeping of client assets by investment firms allows for these assets to be held by third party custodians, subject to certain (mandatory) conditions. This regime includes the option to keep client' assets with affiliates (see below).

Article 4:87, paragraph 1 of the Act on Financial Supervision requires any investment firm (among others) to take adequate measures to protect the client' rights pertaining to client assets

and client money. Furthermore, this article requires investment firms to prevent the usage of client assets (for own account of the investment firm), provided explicit consent has been given by the client.

Article 4:87, paragraph 2 of the Act on Financial Supervision creates the legal basis for secondary legislation in the area of clients' assets protection.

Article 165a of the *Besluit Gedragstoezicht Financiële Ondernemingen* (secondary legislation under the Act on Financial Supervision) states that any investment firm, that holds client' assets with a third party, applies proficiency, carefulness and awareness in the selection, appointment and periodic review of the third party.

Article 6:14 of the *Nadere Regeling Gedragstoezicht Financiële Ondernemingen* (a third layer of secondary legislation) underlines the principle takes such measures that the rights pertaining to financial instruments and money of clients are sufficiently protected.

Articles 6:17 and 6:18 of this secondary legislation specify that safe-keeping of client' assets by investment firms and banks in the legal form of a Dutch subsidiary (either so-called securities giros and custody vehicles) is permitted, provided a number of conditions will be met pertaining to (a.o.): own capital, a limited scope of activities, re-conciliation, annual report, an explicit guarantee by the 'parent' investment firm and administrative organization requirements). Other forms of asset protection (including the ones with foreign vehicles) are subject to individual approval by the AFM, according to article 6:20 of the *Nadere Regeling Gedragstoezicht Financiële Ondernemingen.*

6b) For the specific requirements pertaining to the custody agreement between the intermediary and custodian, we refer to the explanation given under Q6a with regard to the articles 6:17 and 6:18 of the *Nadere Regeling Gedragstoezicht Financiële Ondernemingen.*

7) According to article 58b BGfo an Investment Firm that holds financial instruments or funds of the client (e.g. a credit institution) is obliged to give the client a brief description of the measures it has taken to protect these financial instruments or funds, as well as an outline of the guarantee scheme applicable to the firm.

Furthermore clients have to sign an agreement between the client, the investment firm and a credit institution in order to have their assets assigned to this credit institution. In addition an investment firm may lend financial instruments of clients, provided that the client gives his express written permission to do so, the investment firm informs the client of the risks and provides sufficient guarantees for the protection of the client.

8) There is no option for clients to differ among the amount of protection they get.

9) In article 165D *Besluit Gedragstoezicht financiele ondernemingen* (secondary legislation under the Act on Financial Supervision) is stated that a credit institution which holds client assets is obliged to send an annual report from an external auditor (an *assurance rapport*) to the Dutch Authority for the Financial Markets in which the topics concerning the protection of Clients Assets are addressed. This is a description on an abstract basis, and therefore it does not tell anything about the number of client assets that are held. The report is the proof that the credit institution is in control over the topics concerning the protection of Clients Assets. The external auditor needs to assess whether the business operations are in design and implementation in line with the rules concerning the protection of Clients Assets.

Such reports are provided annually.

10) The protection of clients assets is part of the responsibilities of our supervision. The AFM takes measures on a risk-oriented basis. In that perspective, the current situation on the (European) Financial Markets increases the awareness at the AFM of the importance that investment firms comply with the rules of protection of Client Assets.

For that reason, all the investment firms acting under the supervision of the AFM are required to disclose information with regard to the protection of client assets. This information is gathered through a so-called self-assessment that each firm has to respond to. This self-assessment is an elaborate list of questions which provides information about these firms in a consistent manner.

As stated in question 2, an important distinction has to be made to investment firms which also act as a credit institution and the ones which do not. From our risk-oriented perspective, the first category requires more attention since these firms hold client assets for other investment firms as well as their own clients. If an investigation takes place, the following topics are addressed:

- How are the assets being held? Does the firm act in accordance with the Securities Bank Giro Transactions Act or does it use a depository. If so, does this depository meet the additional requirements (i.e. no additional activities are allowed other than holding the assets)?

- Does the credit institution comply with the requirement to protect the assets from clients by concluding an agreement with the client, stipulating at least that the financial instruments account of the client held with the credit institution is only credited or debited, if the amount to be received or paid pursuant to the financial instruments note is simultaneously debited or credited to the designated money account of the client?

- Does the credit institution possess an adequate administration, to the amount that individual assets can be related to individual clients?

- Does the bank distinguish between professional clients (non-depot clients, or clients who do can give orders without holding the actual securities) and non-professional clients (depot clients, clients who cannot give orders when they do not possess the actual securities)?

11) If a foreign supervisor wants to verify certain data or information at a branch of a foreign investment firm, operating in the Netherlands, the following is in order:

Chapter 1.3.2 of the Act on Financial Supervision covers the cooperation and exchange of confidential information with other EU supervisory authorities. The supervisor from another Member State can verify the data or information, needed for its supervisory role, after informing the AFM. The supervisor of the other Member State can request the AFM to verify data or information, needed for its supervisory role, in an on-site inspection. The AFM will do so or will invite the other authority to make the verification (articles 1:56 and 1:56b of the Act on Financial Supervision). The AFM may only refuse the request on a limited number of grounds (granting the request is against Dutch sovereignty/public order, existence of pending legal procedures or a final verdict for the same facts and in relation to the same entity).

Chapter 1.3.3 of the Act on Financial Supervision covers the cooperation with non-EU supervisory authorities for the exchange of confidential information. In this case, provision of confidential information is only permitted if equivalent safeguards exist in the non-EU jurisdiction with regard to confidentiality and the provision of information fits within the scope of supervisory tasks by the non-EU authority.

12) Both investment firms and credit institutions are under prudential supervision by the Dutch Central Bank (*De Nederlandsche Bank*). Both need to report to the Dutch Central Bank on regular bases about their financial position.

Furthermore an investment firm is obliged to notify the AFM in the case that there has been an incident. Material changes in the financial position can be an incident (the term 'incident' is a principle and in the *Besluit Gedragstoezicht financiele ondernemingen* it is explained as follows: "*action or event that poses a serious threat to the honest and ethical conduct of the business of a financial enterprise"*).

13) The AFM can take actions when they are notified (e.g. by the Investment Firm or by the Dutch Central Bank) that the financial situation is deteriorated. Both investment firms and credit institutions are under prudential supervision of the Dutch Central Bank. They report to the Dutch Central Bank on a regular basis.

The AFM can decide to oblige (give an instruction to) the Investment Firm to adhere to a particular line of conduct. The Dutch Central Bank may also issue an instruction to a financial institution where it detects signs of a development that may jeopardize the equity capital, solvency or liquidity of that financial enterprise. (Article 1:75 FSA).

Furthermore the AFM (or DNB) can decide to appoint one or more persons as Administrative Officer if the Investment Firm has failed to comply to a given instruction, or if the violation of the Investment firm seriously jeopardizes the adequate operation of the financial enterprise, or if the violation of the Investment Firm seriously jeopardizes the interests of clients (with the exception of professional investors).

The Dutch Central Bank may decide to appoint one or more persons as Administrative Officer with regard to all or certain bodies or representatives of a financial enterprise where it detects signs of a development that may jeopardize the equity capital, solvency or liquidity of that financial enterprise if the Investment Firm has failed to comply to a given instruction or if urgent intervention is required.

## Post-Insolvency

14) According to the Dutch Bankruptcy Act (*Faillissementswet*) bankruptcy (*faillissement*) can be petitioned for by one or more of the creditors of the debtor (involuntary filing), by the debtor himself (voluntary filing), or in the exceptional case the public interest requires it, by the public prosecutor. A bankruptcy proceeding can also be opened following a suspension of payments proceeding or a debt rescheduling scheme.

A bankruptcy can be petitioned in the Netherlands before the district court of (i) the place of the debtor's residence or domicile in the Netherlands, (ii) if the debtor has moved out of the Netherlands, the last known place of domicile of the debtor in the Netherlands and (iii) if the debtor does not have a place of domicile in the Netherlands, but does conduct a business or enterprise in the Netherlands, the place where the debtor has an office. (Companies are domiciled at the place of their incorporation and registration with the Commercial Register (*Handelsregister*). The official domicile of the company is designated in its Articles of Association.)

Any creditor, even a foreign creditor, may file a bankruptcy petition. All debtors, including natural persons, companies and other legal entities (such as foundations and associations) and commercial partnerships, may be adjudicated bankrupt.

There is no legal obligation for a debtor to file a bankruptcy petition. The legal ground for bankruptcy adjudication is that the debtor has ceased to pay his debts" (i.e. is in a state of "equitable insolvency"). A creditor requesting the bankruptcy of a debtor has to provide evidence of the fact that he has a claim against the debtor, that the debtor is unable to pay his debts and that

there is at least one other creditor. At least one of the debts of the creditors has to be currently due and payable.

If a petition for bankruptcy is granted by the district court, the district court will appoint a bankruptcy trustee/Administrative Officer (*curator*) and one of the members of the courts as a supervisory judge (*rechter-commissaris*). The court order opening the proceeding must, without delay, be published by the Administrative Officer in the Official Gazette (*Nederlandse Staatscourant*). There is a legal assumption that after publication everybody is aware of the existence of the insolvency proceedings.

Besides the bankruptcy proceeding, there are two different types of proceedings which may be commenced under the Dutch Bankruptcy Act:

- Suspension of payments (*surséance van betaling*), whereby the debtor is given temporary relief against its creditors in order to reorganise and continue its business, and ultimately to satisfy part of the creditors' claims; this can be granted to most companies and legal entities and to natural persons carrying out a business or practising an independent profession. Suspension of payments can only be granted by the court at the request of a debtor, not at the request of a creditor. There is no legal obligation for the debtor to request a suspension of payments. The court automatically and immediately grants a provisional suspension of payments to a debtor who anticipates that he will not be able to continue to meet his liabilities as they become due. During the period of suspension of payments the debtor's business will be managed by the debtor and a court appointed administrator jointly.

- A debt rescheduling scheme (*schuldsanering*), in which the debtor's assets are liquidated for the benefit of his creditors and the debtor must make a maximum effort to generate funds to repay his creditors in a period of three years, with the objective to give the debtor the possibility of a 'fresh start'; this is only open to natural persons. If a debt rescheduling scheme is granted, the district court will appoint an administrator (*bewindvoerder*) and a supervisory judge (*rechter-commissaris*), who supervises the actions of the administrator.

15) An Administrative Officer (*curator*) is appointed by the district court. The Administrative Officer is usually a member of the local bar (i.e. lawyer). Accountants or other experts may assist the Administrative Officer (after consultation with the magistrate). The Administrative Officer acts under the general supervision of the supervisory judge.

Some Dutch regional courts have established guidelines for the appointment as Administrative Officer, by which is determined whether a lawyer can be placed on the list of eligible Administrative Officers in bankruptcy (*curatorlijst*). For example, the member of the local bar should be working as a lawyer for at least one year, should at least have successfully completed specific courses on bankruptcy law, and should have sufficient relevant experience level and affinity in bankruptcy.

16) The Administrative Officer is charged with the administration and liquidation of the bankrupt's estate. Immediately upon his appointment, the Administrative Officer must take any necessary steps to preserve the estate. All creditors' actions and claims are automatically stayed. After consultation with the supervisory judge, the Administrative Officer will decide whether or not he will temporarily continue any of the bankrupt's business. This is done only if clearly favourable business prospects exist. If the business activities are not continued, the Administrative Officer may sell the assets provided that this does not contravene any special security interests belonging to a creditor. The law provides that realisation of assets takes place by public auction, but that the Administrative Officer may realise assets by private contract with the approval of the supervisory judge (which the Administrative Officer usually does).

The Administrative Officer has special statutory authority to terminate leases and employment contracts. He also has the power to invoke the *actio pauliana* if the rights of recourse on the debtor's assets have been prejudiced by legal acts performed by the debtor without obligation, and the right to institute a claim against the management board or directors of a bankrupt company.

Every three months the Administrative Officer must file a public report concerning the debtor's assets and liabilities at the court registry.

16a) The Administrative Officer is subject to the supervision of the supervisory judge. For certain acts, the Administrative Officer needs the authorisation of the supervisory judge, e.g. conducting legal proceedings, terminating employment and rental contracts and realisation of assets by private contract.

In certain cases the supervisory judge can, at the request of the debtor or a creditor, order the Administrative Officer to perform a specific act or to refrain from performing an intended act. The court has the power to dismiss the Administrative Officer at the request of the supervisory judge, a creditor or a debtor.

Furthermore, a working group of supervisory-judges in bankruptcy (RECOFA) has established some guidelines on bankruptcy and suspension of payment. These guidelines should ensure that the transparency of the activities of the Administrative Officer is increased.

16b) An Administrative Officer in bankruptcy can be personally liable – as opposed to being liable in capacity of trustee, which is in effect a liability of the estate – to a third party

who has suffered a loss due to the Administrative Officer's conduct in that capacity, if the Administrative Officer has acted contrary to the specific and objective care standard that 'a trustee should act in a way that can be reasonably expected of a sufficiently knowledgeable and experienced trustee who performs his task conscientiously and with dedication'.[27] The legal basis of such personal liability of the Administrative Officer vis-a-vis a third party is tort (*onrechtmatige daad*).

17) The Netherlands Authority for the Financial Markets (AFM) may – in derogation of its duty of confidentiality – supply confidential data or information obtained in the performance of its duties under the Financial Supervision Act to (in short) a judge, an administrator and a trustee in the case of a financial undertaking has been declared bankrupt.

There are, however, limitations. Firstly, confidential information cannot be provided in case it could become contrary to the interests that the Financial Supervision Act seeks to protect. Secondly, confidential information cannot be provided if the information is obtained from another supervisor or a foreign regulator and that supervisor or regulator disagrees with to provide the information.

Furthermore, in respect of its minimal role, the AFM has made documents available in order to help Administrative Officers within bankruptcy proceedings. For example, the AFM has provided a document by which the Administrative Officer can request the AFM to withdraw the license of a bankrupt Investment Firm. In its decision to withdraw a licence of an Investment Firm, the AFM may also stipulate that the financial enterprise must wind up its business, either fully or in part, within a period to be specified by the AFM. During the winding-up, whether or not

[27] See e.g. Dutch Supreme Court's ruling of April 19, 1996 (*Maclau*) NJ 1996, 727, s. 3.6. In Dutch: "Een curator behoort te handelen zoals in redelijkheid mocht worden verlangd van een over voldoende inzicht en ervaring beschikkende curator die zijn taak met nauwgezetheid en inzet verricht".

stipulated by the supervisor, the financial enterprise or the bankruptcy liquidator of the Investment Firm shall be classified as a 'licensed enterprise'.

17a) After a licence withdrawal, the AFM (in principle) does not continue to supervise the Investment Firm.

17b) The AFM is basically not involved in the process of (actual) returning Client Assets.

However, as stated above, The AFM supervises compliance with rules on the protection of Client Assets. Accordingly, in the case of the bankruptcy of *Van der Hoop Bankiers N.V.* (2005), the AFM stated that in respect of the shares and bonds the segregation was well organised. With respect to the derivative positions of clients of Van der Hoop the AFM believed that there was no adequate method for separation of the assets of Van der Hoop.

Furthermore, in the Van der Hoop case, Clients were, under the Deposit Guarantee Scheme (*depositogarantiestelsel*) of De Nederlandsche Bank (DNB), eligible for compensation up to a maximum of € 20,000 and in fact received twice this protection from the scheme.

18) During the Insolvency of the Investment Firm the Administrative Officer is charged with the administration and liquidation of the bankrupt's estate and may take any necessary action to preserve the estate. View the answer to question 19.

19) The transfer of Assets from an Investment Firm which has become bankrupt or insolvent, to a solvent Investment Firm, also called 'porting', is not common practice within the Netherlands. However, with regard to derivatives the local Central Counter Party, LCH Clearnet S.A., has certain rules (Clearing Rule Book) which allows porting under French law. See article 4.5.2.4 (4) under (v) Clearing Rule Book which allows LCH Clearnet to take measures it deems necessary in case of an event of default:

*(….)*

*if LCH. Clearnet SA estimates that such measures are necessary as regards the need to act promptly, LCH. Clearnet SA will have the right, but not the obligation, to decide in accordance with French law:*

*to transfer to another Clearing Member the Non-House Positions registered in the name of the Defaulting Clearing Member, and/or (…)*

The steps to be taken to accomplish such a transfer depend entirely form the circumstances of the case. In any case, we believe such a transfer has to be accomplished very quickly because of the margins paid by the various parties that are involved and the obligation to provide (more) margin could be raised significantly during the day.

20) Clients could be at risk of having to return Client Assets in case of pauliana. See answer to question 16. The Administrative Officer has the power to invoke the action pauliana if the rights of recourse on the debtor's assets have been prejudiced by legal acts performed by the debtor without obligation.

21) Besides the asset separation scheme, there are two other protective measures in case of loss of Client Assets in the Netherlands: (i) the deposit guarantee scheme and (ii) the investor compensation scheme.

(i) The deposit guarantee scheme *(depositogarantiestelsel)*

The Dutch Central Bank (DNB) fully guarantees 100,000 euro of savings per account holder per bank. This is the basis of the deposit guarantee scheme. If a bank, at which you have up to 100,000 euro in savings, goes bankrupt, the DNB will refund you the entire amount. In the case of joint accounts held by two people, this refund applies per person.

In order to be eligible for this refund, the deposit scheme does have to apply to your bank. Banks established in the Netherlands which have a licence from the DNB are covered by the deposit guarantee scheme. Banks which are established in the European Union, Norway, Iceland or Lichtenstein and which operate in the Netherlands from a branch are covered by the deposit guarantee scheme of their country of origin.

(ii) The investor compensation scheme (*beleggerscompensatiestelsel*)

The investor compensation scheme protects private individuals and 'small' businesses which, on the grounds of an investment service, have entrusted money or financial instruments (for example securities or options) to a licensed bank or investment firm. The investor compensation scheme provides for a refund to a maximum of € 20,000 per person.

The AFM checks whether investment firms and banks comply with the rules for asset separation. These rules are intended to ensure that if an investment firm (for example a portfolio manager) or bank goes bankrupt, clients' investments and/or money are separated from the assets of the investment firm or bank. This avoids a situation in which clients' investments are lost in the bankrupt assets of the investment firm or bank. If an investment firm or bank does not observe the asset separation rules, the investor compensation scheme may apply.

22) In case of bankruptcy, re-hypothecation of client’s financial instruments to a third party could be undesirable. A risk exists when a client has fulfilled its obligations with regard to the credit institution (by which his pledging will lapse); while at the same time the credit institution has re-pledged these financial instruments to a third party. The financial institution then has to fulfill its obligations in respect of the third party, before the pledge can become void. In this case, the client remains dependent on the credit institution, and in case of a bankruptcy of this credit institution problems could arise. In that case the credit institution will not be able to fulfill its obligations to a third party. The pledge will then be foreclosed by the third party (*separatist*) and in that case clients of the credit institution will not receive anything. The client will be treated as a general creditor under bankruptcy law. In case of unauthorized re-hypothecation, the client would have a claim against the Investment Firm for unauthorised use of its assets in violation of the agreement as stipulated by law. In most cases this risk does not appear due to the wording contained in the general conditions of services relating to financial instruments as agreed between the credit institution and its clients.

Accordingly, in the opinion of the AFM, the re-hypothecations of rights of the client by the credit institution is in principle not allowed, unless the client has explicitly authorized (in a separate clients agreement), the client has been pointed to the risks and the investment firm has provided sufficient safeguards for the protection of the client according to the (Dutch) rules on protection of Client Assets.

23) --

24) If an Investment Firm fails to comply with Client Asset Protection requirements it violates the Dutch Law, more specifically article 4:87 FSA, which can be reason for the AFM to, for instance, impose an administrative fine to the Investment Firm. Such a decision shall be made public by the AFM, if this has become irreversible by law, unless publication of the decision is or might be considered contrary to the object of the supervision of compliance.

25) If there is a shortfall, under Dutch Law there is a pro rata distribution of Client Assets (art. 27 Wge).

26) Our insolvency regime does not rank domestic creditors above foreign creditors. In principal creditors rank equally. In the case that creditors are ranked above other creditors this is mainly for the reason that they hold security rights such as mortgage or pledge.

## Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

# Annex

**Unofficial translation of relevant provisions from the Act on Financial Supervision *(Wet op het financieel toezicht)***

**Section 4:87**

**1.** An investment firm that holds financial instruments belonging to a client shall take adequate measures:

a. to protect the client's rights to those financial instruments; and

b. to prevent the use by the investment firm of those financial instruments for its own account, except with the client's express permission.

**2.** An investment firm that holds funds belonging to a client shall take adequate measures:

a. to protect the client's rights to those funds; and

b. to prevent the use by the investment firm of those funds for its own account.

**3.** Further rules may be laid down by or pursuant to a Decree in respect of:

a. the measures to protect the client's rights and to prevent the use of financial instruments or moneys belonging to the client; and

b. the manner in which the investment firm may obtain the client's permission to use the client's financial instruments for its own account.

**4.** A tied agent may not hold financial instruments or moneys belonging to a client.

**Section 4:89**

**1.** An investment firm shall open a file with regard to each client, containing documents describing the mutual rights and obligations of the investment firm and the client.

**2.** An investment firm shall conclude a contract with each client, which contract shall be recorded on paper or on another durable medium and be included in the file referred to in Subsection (1). This contract shall constitute the exclusive basis for the investment services which the investment firm provides to the client and shall in any event set out the mutual rights and obligations of the client and the investment firm.

**3.** Further rules shall be laid down by Decree as regards the content of the contract.

**4.** Subsections (2) and (3) shall not apply to the provision of investment services to professional investors.

**5.** The rights and obligations referred to in Subsections (1) and (2) may be described by means of a reference to other documents or pieces of legislation.

**Section 4:90**

**1.** An investment firm shall promote the interests of its clients in an honest, fair and professional manner when providing investment services or ancillary services, shall act in an honest, fair and professional manner when performing investment activities and shall refrain from actions that are detrimental to the integrity of the market.

**2.** Rules shall be laid down by Decree as regards the processing of orders and the payment or receipt of commission in providing investment services or ancillary services.

**Unofficial translation of relevant provisions of the Dutch Decree on the Supervision of the Conduct of Financial Enterprises pursuant to the Act on Financial Supervision (*Besluit Gedragstoezicht financiële ondernemingen Wft*)**

**Section 165**

T**1.**T An investment firm:

a. shall keep all the necessary records and accounts enabling it immediately at any time to distinguish the financial instruments and funds held for a client from financial instruments and funds held for other clients and its own financial instruments and funds;

b. shall keep the records and accounts referred to in Subsection (a) in such a way, that they are always accurate and in any event reflect the financial instruments and funds held for clients;

c. shall check at regular intervals whether the records and accounts referred to in Subsection (a) correspond to those of any third parties that may hold these financial instruments and funds;

d. shall ensure that the financial instruments of clients that are held by a third party in accordance with Section 165a are distinguishable from the financial instruments belonging to the investment firm itself and from the financial instruments belonging to the third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection;

e. shall ensure that the client funds held in accordance with Section 165b are held in an account or accounts that is or are distinguishable from all the accounts used for holding funds belonging to the investment firm itself;

f. shall take appropriate organizational measures in order to keep to a minimum the risk of loss or reduction of the financial instruments and funds of clients, or their rights to these financial instruments or funds, on account of misuse of financial instruments and funds, fraud, mismanagement, the keeping of inadequate information or negligence.

T**2.**T The Netherlands Authority for the Financial Markets shall lay down rules concerning:

a. the measures to protect the client's rights and to prevent the use of the client's financial instruments or funds as referred to in Section 4:87(1) and (2) of the Act; and

b. the manner in which the client's consent as referred to in Section 4:87(1)(b) may be obtained for the use of the client's financial instruments by the investment firm at the latter's own expense.

**Section 165a**

T**1.**T An investment firm holding financial instrument for a client in an account with a third party shall apply the necessary competence, care and vigilance in the selection, designation and periodic review of the third party and of the regulations for holding and taking custody of the financial instruments concerned. In doing so, the investment firm shall take account of the expertise and market reputation of the third party involved, and of all the statutory obligations or market practices relating to the holding of these financial instruments that may have a detrimental effect on the client's rights

T**2.**T If the custody of financial instruments at another person's expense is subject to specific regulations in a jurisdiction in which an investment firm wants to hold these financial instruments of clients with a third party, the investment firm shall not hold these financial instruments in that jurisdiction with a third party that is not subject to the supervision of compliance with these rules.

T**3.**T An investment firm shall not hold financial instruments for a client with a third party in a non-Member State where the holding and custody of financial instruments at another person's expense is not subject to rules, unless:

a. the nature of the financial instruments or of the investment services relating to these instruments requires them to be held by a third party in that state; or

b. where it concerns financial instruments held for a professional investor, the latter requested the investment firm in writing to hold these instruments with a third party in that state.

**Section 165b**

T**1.**T An investment firm that receives funds from a client shall immediately pay these funds into one or more accounts with:

a. a central bank;

b. a bank that has been granted a license as referred to in the Recast Banking Directive;

c. a bank that has been granted a license in a non-Member State to conduct the business of a bank;

d. an approved money market fund.

T**2.**T Subsection (1) shall not apply to investment firms that have been granted a license to conduct the business of a bank.

T**3.**T For the purpose of Subsection (1), opening words and (d), an approved money market fund shall be understood to mean an approved money market fund within the meaning of Article 18(2) of the Directive implementing the Markets in Financial Instruments Directive.

T**4.**T If the investment firm does not hold funds with a central bank, it shall apply the necessary competence, care and vigilance in the selection, designation and periodic review of the bank or the money market funds where the funds are deposited, and of the regulations for holding the funds concerned. In any event the investment firm shall take account of the expertise and market reputation of the bank or the money market fund in order to protect the rights of its clients, and of all the statutory obligations or market practices relating to the holding of client funds that may have a detrimental effect on the client's rights.

T**5.**T An investment firm that intends to hold funds with an approved money market fund shall have an internal complaints procedure in place under which clients can object to this.

**Section 165c**

T**1.**T An investment firm shall not enter into agreements regarding securities financing transactions in respect of financial instruments which it holds for a client, and shall not use such financial instruments in other ways at its own expense or at the expense of another of its clients, unless:

a. the client has granted its express prior approval to the use of the financial instruments under specified conditions, which can be demonstrated in the case of a non-professional investor by means of the latter's signature; and

b. the financial instruments of this client's are used exclusively under the specified conditions with which the client has approved.

T**2.**T An investment firm shall not enter into agreements regarding securities financing transactions in respect of financial instruments which it holds for a client in an omnibus account with a third party, and shall not use such financial instruments in other ways at its own expense or at the expense of another client, unless, without prejudice to Subsection (1):

a. the client has granted its express prior approval; or

b. the investment firm has systems and monitoring facilities in place which ensure that the financial instruments concerned belong to clients that have granted their express prior approval. Subsection (1)(a) shall apply accordingly to the granting of approval.

T**3.**T The investment firm's records shall include particulars about the client with whose approval the financial instruments were used, and about the number of financial instruments used belonging to every client that granted its approval, so as to ensure that any losses are allocated correctly.

**Section 165d**

An investment firm as referred to in Section 4:87(1) and (2) of the Act shall provide the Netherlands Authority for the Financial Markets once a year with an external auditor's report on the investment firm's compliance with Sections 165 to 165c.

**Unofficial translation of relevant provisions from the Dutch Further Regulations on the Supervision of the Conduct of Financial Enterprises pursuant to the Act on Financial Supervision (*Nadere regeling gedragstoezicht financiële ondernemingen Wft*)**

**§ 6.5. Rules concerning the protection of the rights, financial instruments or moneys of the client**

**Section 6:14**

**1.** Concerning the financial instruments and moneys of clients an investment firm will take such measures that the rights of those clients are adequately protected.

**2.** The measure meant in the first subsection serves to prevent that financial instruments and, insofar as it does not concern an investment firm which holds a license granted by the Dutch Central Bank (de Nederlandsche Bank) to conduct the business of a bank or a supervisory status certificate granted by the Dutch Central Bank to conduct the business of a financial institution, moneys are used by the investment firm for own-account transactions.

**3.** Contrary to the second subsection, an investment firm may lend financial instruments of clients, provided that the client gives his express written permission to do so, the investment firm informs the client of the risks and provides sufficient guarantees for the protection of the client.

**Section 6:15**

**1.** An investment firm which renders the investment service meant under a) of the definition of providing investment services in section 1:1 of the Act or investment management as meant under a) of the definition of investment management in section 6:1, may comply with the requirement meant in section 6:14, if:

a. the moneys and financial instruments belonging to a client and to which the services of the investment firm pertain, are held on one or more credit institution accounts in name of the client;

b. no money accounts or financial instruments accounts of the investment firm are used for the transactions performed in name of and for account of the client; and

c. the written authorisation given by the client to the investment firm is expressly limited to the authority to dispose of the moneys and financial instruments meant under a), to the extent necessary for providing the investment services to the client.

**2.** ‘Written’ in the first subsection, under c), is also taken to mean ‘electronically’ as meant in section 15d(3), Book 6, of the Dutch Civil Code, if:

– the agreement is accessible to the parties;

– the authenticity of the agreement is sufficiently guaranteed;

– the time of conclusion of the agreement can be established with sufficient certainty, and

– the identity of the parties can be ascertained with sufficient certainty.

**3.** This section does not apply to investment firms which hold a licence granted by the Dutch Central Bank (de Nederlandsche Bank) to conduct the business of a bank or a supervisory status certificate granted by the Dutch Central Bank to conduct the business of a financial institution.

**Section 6:16**

**1.** An investment firm providing an investment service as meant under b) or c) of the definition of proving an investment service in section 1:1 of the Act, may comply with the requirement meant in section 6:14 by concluding an agreement with the client that at least provides that:

a. the moneys and financial instruments belonging to a client and to which the services of the investment firm pertain, are held on one or more credit institution accounts in name of the client;

b. the financial instruments account of the client is only credited or debited, if the amount to be received or paid pursuant to the financial instruments note is simultaneously debited or credited to the designated money account of the client; and

c. the investment firm is only authorised to dispose of the moneys and financial instruments meant under a) to the extent necessary for providing the investment services to the client.

**2.** This section does not apply to investment firms which hold a licence granted by the Dutch Central Bank (de Nederlandsche Bank) to conduct the business of a bank or a supervisory status certificate granted by the Dutch Central Bank to conduct the business of a financial institution.

**Section 6:17**

An investment firm which provides an investment service as meant under a) of the definition of providing an investment service in section 1:1 of the Act, may comply with the requirement meant in section 6:14, if an agreement is concluded under which the account meant under d) of the definition of providing an investment service in section 1:1 of the Act, and the money account held for the client are managed by an investors giro service which complies with the following conditions:

a. the investors giro service is a legal entity under Dutch law;

b. any person who represents the giro service pursuant to its articles of association or regulations or determines its day-to-day policy, will be sufficiently knowledgeable in connection with the conduct of the business of the giro service and must be sufficiently independent from the directors of the investment firm mentioned in the opening lines. The reliability of the persons meant in the preceding sentence and of the persons who are directly or indirectly authorised to appoint or dismiss those persons must also be beyond doubt.

c. persons who perform work for the giro service may not be employed by the business unit of the investment firm that performs transactions in financial instruments or has such transactions performed;

d. the giro service performs no other activities than holding the moneys and financial instruments belonging to the clients and managing the accounts meant at the beginning of this section;

e. the sum of all cash claims and financial instruments of all the clients collectively equals the sum of the balances of the accounts held for the clients as mentioned at the beginning;

f. the moneys and financial instruments meant under d) are held in one or more accounts with a credit institution in name of the investors giro service, the giro service making a strict administrative distinction between the moneys meant at the beginning of this subsection and the moneys belonging to the giro service;

g. transactions for the account of the client are only effected, if there is a sufficient balance on the account held in name of that client with the giro service;

h. the Netherlands Authority for the Financial Markets may gather or order to gather all information from the giro service that is necessary for the proper performance of its statutory duties and powers;

i. the giro service's compliance with the obligations is guaranteed by the investment firm.

j. the giro service only acts in the interests of the clients of the investment firm on whose behalf financial instruments and moneys are held by the giro service;

k. the investors' giro service is liable to the clients for any damage suffered by them, in so far as this damage was caused by imputable non-compliance with its obligations;

l. the giro service provides for proceedings, should the giro service announce its intention to cease its operation;

m. the giro service organises its operations in such a way that this guarantees a controlled and sound conduct of its business, in accordance with sections 31(1), (2) and (3), 31(b), 35(1), (2) and (4) and 165(1) a) to c) of the Supervision Decree;

n. within six months of the end of the financial year the giro service will submit its annual accounts to the Netherlands Authority for the Financial Markets as meant in section 361(1), Book 2, of the Dutch Civil Code, accompanied by a statement concerning the fairness, issued by the auditor as meant in section 393(1), Book 2, of the Dutch Civil Code. The auditor is not in the employ of the giro service or the investment firm offering the accounts meant at the beginning;

o. the giro service has an equity capital of at least 125,000 euros;

**Section 6:18**

An investment firm holding a licence granted by the Dutch Central Bank (*de Nederlandsche Bank*) to conduct the business of a bank, may comply with the requirement meant in section 6:14 by concluding an agreement with the client, stipulating at least that the financial instruments account of the client held with the credit institution is only credited or debited, if the amount to be received or paid pursuant to the financial instruments note is simultaneously debited or credited to the designated money account of the client and:

a. if the financial instruments are subject to the Securities Bank Giro Transactions Act, the financial instruments are held and managed in accordance with the Securities Bank Giro Transactions Act; or

b. the financial instruments are held by a depository and the following conditions have been met:

- the depository firm is a legal entity under Dutch law;
- any person who represents the depository firm pursuant to its articles of association or regulations or determines its day-to-day policy, will be sufficiently knowledgeable in connection with the conduct of the business of the depository firm. The reliability of the persons meant in the preceding sentence and of the persons who are directly or indirectly authorised to appoint or dismiss those persons must also be beyond doubt;
- persons who perform work for the depository firm may not be employed by the business unit of the investment firm, holding a licence to conduct the business of a bank granted by the Central Dutch Bank, that performs transactions in financial instruments;
- the depository firm performs no other activities than the safe keeping of financial instruments;
- the depository firm has an equity capital of at least 125,000 euros;
- the sum of the units in financial instruments held by clients equals the sum of the financial instruments held by the depository firm for clients;
- the fulfillment of the obligations of the depository firm is guaranteed by the investment firm;
- the Netherlands Authority for the Financial Markets can make all the enquiries at the depository firm, or have others make these enquiries, that in the opinion of the Netherlands Authority for the Financial Markets are necessary for the proper performance of its statutory duties and powers;
- the depository firm only acts in the interests of the clients of the investment firm on whose behalf financial instruments and moneys are deposited with the depository firm;
- the depository firm is liable to the clients for any damage suffered by them, in so far as this damage was caused by imputable non-compliance with its obligations;
- the depository firm provides for proceedings, should the depository firm announce its intention to cease its operation; and
- the depository firm organises its operations in such a way that this guarantees a controlled and sound conduct of its business, in accordance with sections 31(1), (2) and (3), 31(b), 35(1), (2) and (4) and 165(1) a) to c) of the Supervision Decree

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# Pakistan
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

## Definitions.

(1) "Administrative Officer" refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) "Client Assets" means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "Positions" are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "Securities" are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "Client Money" refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) "Investment Firm" means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) "Omnibus Account" means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) "Regime" refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

## Context

1. **Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.**

   a. **How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.**

The term Client Assets is not a defined term in our Jurisdiction, however the client securities and client cash are analogous terms used for Client Assets. The term "client asset" has however been used in General Regulations of Stock Exchanges the term clients' assets have been used in the Regulation 41 of Stock Exchange General Regulations that deals with segregation of clients' assets by the brokers/ investment firm.

Definition of securities as provided under the Securities and Exchange Ordinance 1969 is:

*"security" includes-*

*(i) any stock, transferable share, scrip, Modaraba Certificate, note, debenture, debenture stock, participation term certificate, bond, investment contract, forward or futures contract, and pre organization certificate or subscription, and, in general, any interest or instrument commonly known as a "security" and, any certificate of deposit for, certificate of interest or participation in, temporary or interim certificate for, receipt for , or any warrant or right to subscribe to or purchase, any of the foregoing but does not include currency or any note, draft, bill of exchange or banker's acceptance or any note which has a maturity at the time of issuance of not more than twelve months, exclusive of days of grace, or any renewal thereof whose maturity is likewise limited;*

*(ii) any Government security as defined in the Securities Act, 1920*

*(iii) any bonus entitlement voucher issued by the State Bank of Pakistan in accordance with any scheme announced by the Commission*

   b. **What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?**

A client has full ownership right on any money/cash maintained by him with the investment firm. The Client Securities held by Investment Firm are registered in the name of the client, and clients retain beneficial ownership of these securities at all times. CDC ACT 1997 requires the Investment Firm to ensure that client securities are held in a segregated sub-account.

A sub-account is an account maintained, as part of the Main Account of a participant (Investment

Firm), in the name of a sub-account holder (Client) so as to record the title of the sub-account holder to any book-entry securities entered in such sub-account. Even though the shares are placed in a participant sub account, it does not compromise any ownership rights/benefits of the shareholder, such as dividend, bonus etc.

These securities will be required to be put in segregation and be shown as such on the client's statement of account in order to protect the clients/customers from the Investment Firm using these securities for other purposes.

Furthermore, clause 18 of terms and conditions of the standardized account opening form for individual states that the Participant should ensure due protection to the Sub-Account Holder regarding rights to dividend, right shares or bonus shares etc. in respect of transactions routed through him and not do anything which may be harmful to the interest of the Sub-Account Holder with/from whom it may have had transactions in securities.

**c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.**

An analogous term for "Client" is defined in Investors' Protection Fund Regulations of stock exchanges of our jurisdiction that is reproduced hereunder:

*"Investor means a person, not being Member (Investment Firm), his agent or representative, who has purchased or sold any of the securities listed at the Exchange."*

Further the term sub-account holder is also analogous to the term "Client" which is defined in the CDC Act, 1997 as any individual or entity that operates an account with the Investment Firm for custody of securities in demat form

*(28) "sub-account holder" means a person in whose name a sub-account is opened and maintained by a participant with a central depository and is operated by that participant.*
*Moreover, the term "investor" has also been used for clients as stipulated in Default Regulations of the Exchange.*

**d. Please describe any notable exclusions from the terms "client" or "client assets."**

None

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*
*b. Models of trading (e.g., exchange-traded versus over-the-counter).*
*c. Categories of clients (*e.g.*, retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. **Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?**

Yes, an investment firm cannot deal in business of effecting transactions in securities unless it has acquired the membership of a stock exchange, is registered with the SECP and comply with the requirements of Brokers and Agents Registration Rules, 2001.

Further, to hold Client Assets an investment firm also needs to have Participant Account with the Central Depository Company of Pakistan Limited (CDC) that cannot be opened until such time the firm obtains Clearing Member (CM) status with National Clearing Company of Pakistan Limited (NCCPL)).

a. **If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?**

When a brokerage firm is registered with the SECP, the broker must comply with all the applicable laws/regime such as the Securities and Exchange Ordinance 1969, Securities and Exchange Rules 1971, Brokers and Agents Registration Rules, 2001, Regulations of the Stock Exchanges, Regulations of the National Clearing Company of Pakistan Limited, CDC Regulations and The Central Depository ACT, 1997.

The investment firm is required to renew its broker registration annually from the SECP on the recommendations/endorsement of concerned stock exchange. Investment firms or brokers are also required to provide biannually Net Capital Balance Certificate duly audited by the auditors to the Exchange as well as to SECP. Moreover, corporate investment firms having paid up capital more than Rs.7.5 million, are also required to submit annual audited accounts to SECP.

Furthermore, offsite and onsite surveillance and inspections of brokerage/Investment Firms are held regularly by SECP to ensure compliance with prevalent laws. Identification of any noncompliance to applicable rules and regulations, or any deteriorated financial position, to such an extent that the SECP is of the opinion that his continuance in securities business shall not be in the interest of investors; the SECP holds the right to cancel, suspend or decline renewal of the Investment Firm's registration.

b. **If special authorization is not required, how, if at all, is this activity supervised by a regulator?**

N/A

3. **Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:**

Yes, the Investment Firms are required to ensure that the assets belonging to their clients are kept separated from the assets of the Investment Firms,, in separate sub-accounts maintained for each investor. CDC Regulations also requires holding these securities in a separate account.

*As per Regulation 4.19.2 of CDC Regulations Each Participant/*Investment Firm *are required to ensure that the Book-entry Securities owned by the Participant himself are not entered in any Group Account or Sub- Account(s) maintained by the Participant on the CDS.*

Also clause 6 of Standardized Account opening form (for individual) confirms that The Book entry Securities owned by the Sub-Account Holder shall be exclusively entered in the Sub-Account of such Sub-Account Holder.

Further, General Regulations of Karachi Stock Exchange provide as under;

41. SEGREGATION OF CLIENTS' ASSETS BY THE BROKERS

*(1) The Brokers shall ensure that the assets belonging to their clients are kept separated from the assets of the Broker. For this purpose, the Broker shall maintain;*

*(a) a separate bank account which will include all the fund deposits of their clients along with record/breakdown of clients' balances.*

*(b) separate sub-accounts under his Participant Account in Central Depository System (CDS) for each of his clients to maintain the custody of margins deposited by the clients in the form of securities and securities bought for clients.*

*(c) a Collateral Account under his Participant Account in CDS for all clients. This account shall be used exclusively for instances where outstanding payment has not been received from clients in respect of securities purchased on their behalf and relevant purchase obligation is to be settled.*

*In such cases, the Broker will be allowed to transfer the securities on the respective settlement date from the respective sub-account to the Collateral Account for a maximum period of three (3) settlement days only to the extent of the transaction volume for which the client's payment is outstanding for whatsoever reason and comply with relevant requirements contained in the CDC Regulations.*

*The Broker shall, in addition to the electronic reporting of such transfers through ways and means as specified by the Exchange report the Exchange in writing explaining the reason for utilizing the Collateral Account and / or for holding client's securities immediately after such transfer. The notice from the Broker will be accompanied with following documents:*

*(i) Non-payment notice served on the client through courier, personal delivery method, facsimile, email or properly recorded telephone line, advising him to make payment by the close of banking hours on the next business day after the settlement day and notifying that, otherwise the Broker shall have a right to dispose of the required securities to cover the shortfall in the client's account at client's risk and cost;*

*(ii) Client's sub-account and Collateral Account Activity Report of movement date and;*

*(iii) Documentary evidence substantiating the genuineness and circumstances of the reason for non-payment by the client which may include failure of client to pay in time due to non-clearance of client's cheque, any natural calamity, law and order situation, non or delayed functioning of an automated procedure, e.g., NIFT.*

*Provided that for a particular client, the Broker is allowed to transfer securities from the subaccount of client to the Collateral Account only once in a calendar month.*

*(2) Except as permitted above, the clients' funds and securities shall not be used by the Broker for any purpose other than as authorized by the client in writing in the manner and procedure prescribed by the Exchange and/or CDC. The Broker shall be obliged to maintain and furnish documentary evidence to substantiate the compliance with the above regulations as and when required by the Exchange.*

*(3) On the basis of documents mentioned under Sub-Clause 1(c) above, the Exchange shall determine if the requisite documents substantiate the transfer of client's securities by the Broker and shall maintain a database of such transfers. Exchange may also carryout enquiry and/or special audit in relation to non-compliance with this regulation.*

*(4) In case of non-compliance on the part of the Broker, as mentioned in Sub-Clause 1(c) above, is established, after enquiry and providing opportunity of hearing, the Broker shall be liable to pay penalty of 1.0% of the market value of securities moved, subject to a maximum penalty of Rs. 50,000/.*

*Provided that warning may be issued once on the first instance of non-compliance by the Broker subsequent to implementation of automated settlement mechanism.*

*(5) Where non-compliance of sub-clause 2 and 3 by a Broker is established, the Exchange may, after providing an opportunity of being heard to the broker, impose penalty on such broker in the manner provided in sub-clause 4 above.*

Moreover, segregation of sub-accounts is ensured through system audits conducted by stock exchanges and inspection of the Investment Firms by the SECP. The SECP's inspection manual mentions that '*Select sample of Clients and ensure that separate CDC Sub Account have been opened by the Broker and margin payments to Brokers have been made through cross cheque in favor of "Clients Margin Account'*

**a. Must the Client Assets of one client be maintained separately from those of other clients?**

Yes, assets of each client are required to be maintained separately, as mentioned above.

**i. Are Investment Firms allowed to hold Omnibus Accounts?**

No, the investment firms are not allowed to hold/maintain Omnibus Accounts. In Pakistan a Direct Holding System is functional where all securities are kept in the name of the beneficial owners. The Group account facility or omnibus accounts were discontinued in 2005.

**ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?**

Considering the unauthorized pledge of clients' securities against margin demands of other clients, the concept of client level margining was introduced in 2009 under which stock exchanges only accept pledge of securities from the sub-account of respective client to the extent of his/her exposure or proprietary accounts of Investment Firm.

In case of default of Investment Firm, securities pledged from sub-accounts of clients are utilized up to their respective exposures. Since the clients' securities are maintained in separate subaccounts, therefore, losses of one client would have no impact on the assets of other clients.

Further to cater for the irregularities in manual transfers of securities in settlement process of market based transactions by Investment Firms, automated clearing and settlement process was implemented in 2010 whereby securities are moved directly from sellers sub-account or house account (for client and proprietary trades respectively) to buyers sub-account or house account in the CDS.

**b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:**

No reconciliation is held between the Investment Firm and the Depository, however, Reconciliation is conducted on client by client basis by the investment firm at the end of the day and a daily transaction statement of each client is given to the clients respectively, reflecting their daily trade in the Market.

Furthermore, the client can have access to their trading details through SMS alert system of CDC and UIN Information System (UIS) of NCCPL.

Moreover, according to the CDC Regulations every Participant should send within 10 days of end of each quarter to all Sub-Account Holders maintaining Sub-Accounts under the control of such Participant Holding Balance statements showing the number of every Book-entry Security entered in every such Sub-Account as of the end of the preceding quarter.

There is no specific requirement for preparation of reconciliation by Investment Firm in respect of clients' assets, however, under the CDC Regulations 13.6.1 "*Each Account Holder shall, for each Business Day, verify the activity taking place during that Business Day with reference to any Handling of Book-entry Securities entered in any Holding forming part of the Account Family of the Account Holder and shall immediately report in writing any of his concerns in that regard to the CDC by the End of Day on the next succeeding Business Day.*"

**i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?**

**A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?**

Currently there is no requirement of holding/calculation of particular amount/type of assets by an Investment Firm.

**B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?**

Reconciliation is conducted on an aggregate basis by Investment Firm with respect to daily net settlement positions, however, daily transactions statement/trade confirmation of each client is given to the clients respectively, by the Investment Firm reflecting their daily trade in the Market.

In order to facilitate the sub-account holders to check their custody position, CDC also provides Interactive Voice Response, Internet/Web access and Short Messaging Service (SMS) services which allows investors to access their account related information.

According to the CDC Regulations, every Participant should send within 10 days of end of each quarter to all Sub-Account Holders maintaining Sub-Accounts under the control of such Participant/Investment Firm a Holding Balance statement showing the number of every Book entry Security (ies) entered in every such Sub-Account as end of the preceding quarter.

Such Holding Balance statements shall be generated from the CDS and shall be sent to the Sub-Account Holders including to the email addresses of the Sub-Account Holders notified to the Participants by them. CDC may, at its discretion, directly send Holding Balance statements to the Sub-Account Holders in the manner and to the extent that CDC thinks reasonably necessary from time to time.

**C) If a client has a debit balance (i.e. the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?**

One client's net debit balances does not reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients. Investment Firm of each stock exchange is required to maintain minimum net capital balance at all times as determined in accordance with Securities and Exchange Rules, 1971 and this requirement is used to determine the maximum allowable exposure limit under the Risk Management Regulations of the respective stock exchange. While computing net capital balance, debit balance of a client in not netted off with credit balance of another client.

The onus of collecting debts from its clients is delegated to the investment firm itself, hence if a client leaves a debit balance on its accounts it is solely the duty of the Investment Firm to collect it from the client or liquidate the holdings of that client in order to maintain the margin of the account, failure to collect the debit balance from the client, the investment firm is then obligated to pay the debit balance from its own funds.

**ii Timing issues:**

**A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).**

Reconciliation is conducted daily on an aggregate basis and any clients/ account holder may reconcile his account balance statement that is required to be forwarded to the client on quarterly basis with the Investment Firm as and when he/she desires.

**B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).**

Reconciliation is conducted by the day end by the Investment Firm. Under CDC Regulations, each investment firm will verify for each business day the activity taking place during that business day with reference to any handling of book-entry securities.

**C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?**

Yes, Clearing and settlement requirements are applicable to the broker and incase of no payment by the client, the broker is liable to pay from its sources as and when required. Payment made by the investment firm on behalf of the client to the clearing company would be considered as Client Money by the clearing company.

**iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?**

` No

**c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?**

No, an investment firm cannot use client securities of one client to meet obligations of another, due to the reason that client securities are required to be held in segregation and cannot be used for such purposes.

**d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.**

Yes, investment firm is restricted to invest, lend, pledge/handle or otherwise use client assets unless it is authorized by the client through the Standardized Account opening form to carry out the pledge/handling in favor of respective stock exchange against exposure on his/her behalf or through a specific authorization in writing to do so. CDC Act 1997 mentions that a participant will not create any pledge over any book-entry securities in any account of its client without the authorization of the sub-account holder/client concerned. Section 24 of CDC Act prohibits mishandling of clients assets including pledging.

**i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?**

The client retains its beneficial ownership rights on the pledged securities, however, the only compromise that he will not be able to freely transfer or move the pledge securities, as the securities are locked in a pledge account

**ii. How is a client's consent to permit an Investment Firm to use or rehypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?**

The consent of the client is demonstrated through signing a specific authorization or the agreement which is part of the standardized account opening form with the investment firm, allowing the investment firm to pledge the client's securities on its behalf. The evidence of a client's consent given to the investment firm for pledging of its securities is in the shape of a contractual agreement, which is also referred to as an Investor Account Opening Form prescribed under General Regulations of the Karachi Stock Exchange.

**iii. How are the ownership rights of a client over its client assets changed or affected when the investment firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (i.e. established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?**

Not allowed, the said practice is strictly prohibited and if a broker is found non-compliant strict action is initiated under the applicable laws. CDC Act stipulates;

A participant is not allowed to create a pledge over any book-entry securities entered in any subaccounts maintained under his account with the central depository without the authorization of the sub -account holder concerned. Failure to comply with any provision of the CDC Regulations can result in fines and penalties, as mentioned below:

Under CDC Act 1997 Punishment and adjudication of fine or penalty.-

(1) A fine for any offence under, or contravention of any provisions of, this Act may be adjudged and imposed by any member of the Authority.

(2) The fine as aforesaid shall be imposed after giving the person concerned an opportunity to show cause why he should not be punished for the alleged offence or contravention and, if he so requests, after giving him a reasonable opportunity of being heard personally or through such person as may be prescribed in this behalf.

(3) Where imprisonment is provided for any offence under, or contravention of any provisions of, this Act, it shall be adjudged by a court not inferior to that of a court of session.

For redressal of the matter, the client may approach Securities and Exchange Commission of Pakistan (SECP) through the relevant stock exchange whose registered Investment firm has misused assets of such client. The SECP is authorized to request the court for taking cognizance of offences committed by the Investment firm. Alternately such client may directly approach court of law for breach of contract in respect of securities entrusted to the investment firm.

**e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?**

Each client or sub-account holder is provided with a Unique Identification Number (UIN) that establishes a traceable link between the executed trades and the investor at the stock exchange as details of his/her sub-account are also available in UIN system. With the implementation of client level margining system, margin demands against exposures are calculated on the client level basis

and system only accepts securities as collateral from the sub-account of such client to the extent of his/her respective exposure. This system prevents the misuse of clients' securities entered in sub-accounts by the Investment Firms.

4. **Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:**

No investment firms are not permitted to hold or transfer Client Assets in any other jurisdiction.

a. **Client Assets transferred to or located in other jurisdictions?**

Not applicable

b. **Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?**

Not applicable

**If so, please provide details of those requirements.**

5. **Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,**

   a. **What protections are applicable to the Foreign Investment Firm's Client Assets?**
   b. **What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?**
   c. **What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?**

6. **If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:**

   a. **Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?**

Foreign investors are allowed to trade in the securities quoted on the Stock Exchanges in Pakistan and they are required to open up a Special Convertible Rupee Account (SCRA) with any designated bank for this purpose. Foreign investors also open separate sub-accounts with designated banks for the custody of securities issued in demat form. Any banking company having minimum short term

credit rating of A3 within the meaning of the Banking Companies Ordinance, 1962 may apply for admission as custodian clearing member (CCM) with the NCCPL.

**b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.**

As stated above, custodians only get registered with NCCPL and trades executed by Investment Firm on behalf of foreign investors are shifted to respective CCM through institutional delivery system for clearing and settlement of such trades. As such no agreement is executed between Investment Firm and CCM.

**7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?**

An Investment Firm is required to provide information relating to custody and movement of securities to the respective client only. However clients information may also be disclosed to any person authorized under CDC Act 1997 (please refer section 20 and 21 of CDC Act 1997).

**8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?**

The terms and condition of account opening form stipulate the client protection rights and are standardized for all participants and clients, and therefore cannot be changed or waived.

**9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:**

**a. Does the Investment Firm report where client assets are held?**

No

**b. Does the Investment Firm or depository report the protections applicable to such client assets?**

No

**c. Does the Investment Firm or depository report the amount of assets that are held?**

No

**In each case, are such reports provided on request or periodically? If periodically, with what frequency?**

If any information is required the regulator has the authority to call for such information at any point of time.

**10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify**

**a. Where Client Assets are held?**

**b. The amount of Client Assets held at a depository?**

**c. The safeguards applicable to Client Assets held at a depository?**

The stock exchange-SRO monitors investment firm's compliance to the requirement for protection of client assets through system audit of the firms. Further, the SECP also undertake inspection of investment firms to ensure their compliance to the client asset protection regime.

Below is a sample of some of the relevant inspection checks:

- Check order has been placed by the Client from telephonic recording or other media
- Order confirmation has been issued to him within 24 hours
- Pledge have been marked from Client's CDC Account
- Mark to Marked margins have been deposited by the Clients from "Clients' Margin Bank Account
- Margin call has been initiated in writing
- Settlement has been taken place into Client's CDC Account and/or Client Bank Account
- Contract Name has been issued in the name of client and not the agent

Further Chapter 13 of the CDC Regulation mentions that, if any information is required by CDC from a Participant or, as the case may be, CDC is required to inspect the Records of any Participant, CDC may, by notice, require such Participant to provide such information or, as the case may be, permit CDC to inspect any Records.

**11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify**

**a. The amount and/or value of such Client Assets**

Not applicable

**b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?**

Not applicable

**12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial**

**position or ability to continue to carry on business? What is the nature of such required disclosures?**

An investment Firm specifically does not have to report any information regarding its inability to continue its business or any other material changes in its financial position. However, the concerned stock exchange is constantly monitoring the Investment Firms compliance with the Exposure Limits and the availability of Margin pursuant to its regulations. Furthermore, it is obligatory upon Investment firms to get their accounts and Net Capital Balance audited by a certified chartered accountant and submit the report to SECP bi-annually. Moreover, as mentioned at Para-2(a) above the Corporate Brokerage House/Investment Firm having paid up capital of at least Rs.7.5 million are required to submit their audited financial statements to SECP.

13. **For an Investment Firm whose financial situation is seen to have deteriorated (*e.g.*¸ capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?**

Incase at any point of time, the Net Capital Balance of an Investment Firm falls below a certain threshold (Rs. 2.5 million) the membership of an Investment Firm to carry out brokerage business will be suspended and will remain suspended until the net capital balance is increased. The reason for doing so is to safeguard the client securities in the sub-accounts of the Participant. The SECP is also empowered to suspend the registration of an Investment firm where its financial position has deteriorated to such an extent that the SECP is of the opinion that its continuance in securities business shall not be in the interest of investors.

## Post-Insolvency

14. **Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?**

Under Chapter 19 of the NCCPL Regulations, an Investment Firm will be treated as Insolvent:

(a) If the Investment Firm fails to perform its obligations or determines that it is unable to do so;

(b) in the event of the entry of a decree or order by a Court having jurisdiction in the premises adjudging the NCC Participant bankrupt or insolvent or approving as properly filed a petition seeking reorganization, arrangement, adjustment (otherwise than by way of amalgamation) or composition of or in respect of the NCC Participant under or any applicable Federal or Provincial law or appointing a receiver, liquidator, assignee, trustee, (or other similar official) of the NCC Participant or of any substantial part of his property or ordering the winding up or liquidation of the NCC Participant or of his affairs, or

(c) the institution by the NCC Participant of proceedings, as the case may be, to be wound-up or to be adjudicated as bankrupt or insolvent, or

(d) Upon the consent by Investment Firm to the institution of bankruptcy, insolvency or winding up proceedings against it, or

(e) Upon the filing of a petition or consent in seeking reorganization or relief under or any applicable Federal or Provincial law, or

(f) Upon the consent to the filing of any such petition, or to the appointment of a receiver, liquidator, assignee, trustee, (or other similar official) of the NCC Participant or of any substantial part of its property, or

(h) the admission by Investment Firm in writing of its inability to pay its debts generally as they become due, or

This process of insolvency of an Investment Firm is different from the process used for other entities. The investment firm initially goes through the process of default as referred in the Default Management Regulations of the Exchange, whereas any other entity has to follow the procedure laid down in Part XI of the Companies Ordinance 1984.

Under the Default Management Regulations a Default Management Committee is constituted by the concerned stock exchange. The Committee recovers all moneys, securities and other assets due or deliverable to the Defaulter by any other Member (in respect of any transactions), securities and/or Cash/Bank Guarantee remained unutilized with NCCPL after squaring-up initiated, membership card and office(s) within the Exchange premises, if any, in the control of the Exchange.

After the assets of the investment firm are liquidated and distributed, the Investment Firm can still be taken up for winding up, under Part XI of the Companies Ordinance 1984. The said winding up may be done either-

(i) by the Court; or
(ii) voluntary; or
(iii) subject to the supervision of the Court.

**15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?**

As such there is NO such concept of appointing an Administrative Officer during insolvency or when a member of stock exchange defaults, however when a firm/company is required to file for winding up under provisions of the Companies Ordinance 1984, a liquidator is appointed by the Court, from amongst persons recommended by the Commission, a panel of persons from whom it shall appoint a provisional manager or official liquidator of a company ordered to be wound up by the Court. However, in case of Investment Firm voluntary winding up liquidator is appointed by the company in general meeting.

**16. What are the duties of the Administrative Officer?**

Since there is NO Administrative Officer, a liquidator appointed by the court has the following duties:

(a) to institute or defend any suit, action, prosecution or other legal proceeding, civil or criminal, in the name and on behalf of the company;

(b) to carry on the business of the company so far as may be necessary for the beneficial winding up thereof;

(c) to pay any classes of creditors in full;

(d) to make any compromise or arrangement with creditors or persons claiming to be creditors, or having or alleging themselves to have any claim, present or future, certain or contingent, ascertained or sounding only in damages against the company, or whereby the company may be rendered liable;

(e) to compromise all calls and liabilities to calls, debts and liabilities capable of resulting in debts, and all claims, present or future, certain or contingent, ascertained or sounding only in damages, subsisting or supposed to subsist between the company and a contributory or alleged contributory or other debtor or person apprehending liability to the company, and all questions in any way relating to or affecting the assets or the winding up of the company, on such terms as may be agreed, and take any security for the discharge of any such calls, debt, liability or claim and give a complete discharge in respect thereof:

(f) to sell the movable and immovable property and things in action of the company by public auction or private contract, with power to transfer the whole thereof to any person or company or to sell the same in parcels

**a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?**

Not Applicable

**b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?**

None

**17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?**

**a. Does the regulator continue to supervise the Investment Firm?**

**b. How, if at all, is the regulator involved in the process of returning Client Assets?**

Yes, the concerned Stock Exchange nominates eligible candidates to be part of the Default Management Committee, once the Committee is formed they are in charge of liquidating and disposing off the insolvent members assets and then distributing those assets amongst clearing houses, exchanges, members and clients.

*The Default Management Regulation Stipulates that:*

*(d) While disposing of the collaterals, in the form of margin eligible securities, cash and/or bank guarantee, of clients of a Member kept as margin, the Exchange shall have the absolute discretion to liquidate such collaterals in preference to others to meet the obligations of Exchange/ NCCPL.*

*Upon receipt of copy of NCCPL Final Notice, the Exchange shall serve a final notice to the suspended Member calling upon the suspended Member to pay the liabilities stated in the NCCPL notice within the time allowed in said notice.*

**18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?**

The Investment Firm is prohibited from using the services of CDS, which means that the firm has no access to any accounts including house account and/or any of its client's sub-account. The reason for barring the investment firm from any sort of control over its account is to safeguard the sub-account holders/clients.

**19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?**

Yes, The CDC offers its sub-account holders to transfer their securities from sub-account of a restricted Participant account to a sub-account of any other Participant account or even move it to an investor account. Subject to conducting verification and authentication of the sub-account

*Chapter 15 of CDC Regulations mention that a Sub-Account Holder, having a Sub-Account controlled by the Participant, by notice to CDC in terms of and in accordance with the Procedures requires that the Book-entry Securities entered in the Holding Balance of his Sub-Account be moved to the Holding Balance of his Sub-Account controlled by another Participant or to his Investor Account with CDC, as the case may be, then CDC may, in accordance with the Procedures, upon giving seven (7) Business Days' notice to such Participant of CDC's intention to do so, comply with the notice received from the Sub-Account Holder.*

**a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?**

To make such a transfer, the client need to send an application to the CDC, requesting it to transfer securities from his sub-account to another sub-account of a different Participant account. As mentioned in the clause above it should primarily take 7 days to make the transfer, after the sub-account holder imitates the request.

**b. What factors, if any, affect the time period required to accomplish such a transfer?**

The factor that would affect the above mentioned time period would be conducting investigations on the authenticity of the sub-account holder. As per General Regulations of the Exchange this procedure would involve a chartered accountant who would go through all the transactions ever made and other account details to confirm whether the sub-account holder is not related to the banned Participant or acted as an associate to the Participant.

**20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?**

None

**21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).**

Karachi Stock Exchange (KSE) maintains Investors' Protection Fund (IPF) for providing maximum relief to the investors and allows disbursement of Rs. 75 million per investment firm from IPF for satisfaction of claims of aggrieved investors in case of default/expulsion of such Firm. In case claims of investors determined against the defaulting Member exceed the amount available (Rs.75 million) for settlement of such claims of investors shall be satisfied on a pro-rata basis.

The Default Regulations also specifies that in case the investors' claims admitted by the Exchange against a Member/investment firm are more than the amount of surplus as mentioned in this Regulation, all the claims will be satisfied on pro-rata basis. The claims still remaining unsatisfied after pro-rata sharing will then be paid from the Investors Protection Fund in accordance with the KSE Investors Protection Fund Regulations.

Furthermore, Regulations relating to Investors Protection Fund prescribe as under:

*In case the investors' claims admitted by the Exchange against a Member are more than the amount available out of sale proceeds of assets under control of the Exchange in accordance with the relevant Regulations, all the claims will be paid on prorate basis. The claims still remaining unsatisfied after pro-rata sharing will then be paid from the Fund by utilizing up to aggregate amount of Rs. 75 million, in the following order of priority, whereby the per claimant distribution shall, in any case, not exceed the amount of claim:*

*(a) Initial Disbursement of up to a maximum of Rs. 500,000/- equally per claimant among all claimants by utilizing 50% of maximum allowable contribution i.e. Rs. 37.5 million. Such disbursement shall either be made to satisfy all claims or, if insufficient to settle all claims, be disbursed equally among all the claimants.*

*(b) Remaining amount to be disbursed by utilizing balance 50% of maximum allowable contribution i.e. Rs.37.5 million plus any unutilized portion of Fund as stated at (a) above. In case, such amount of Fund is insufficient to satisfy all such claims in full, then pro-rata distribution will be made.*

**22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.**

Clients are not treated differently based on permissions they have granted pre-bankruptcy. As discussed above, securities pledged from sub-accounts of clients are utilized up to their outstanding

exposures and losses of clients cannot be allocated to other clients of defaulted investment firm. The clients who have authorized the investment firm in writing may lose right to reclaim such securities. The claims still remaining unsatisfied after pro-rata sharing will then be paid from the Investor Protection Fund by utilizing up to aggregate amount of Rs. 75 million in accordance with methods and procedures prescribed in the Regulations relating to Investor Protection Fund.

**23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?**

Not applicable

**24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?**

If any investment firm is found indulged in misuse of clients assets, stock exchange and SECP have powers to suspend/expel such investment firm after carrying out an investigation/ enquiry. All clients are treated equally, in case the investors' claims admitted by the Exchange against a suspended/expelled investment firm are more than the amount of proceeds of its assets, all the claims will be satisfied on pro-rata basis. (Default Management Regulations)

**25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?**

In case the investors' claims admitted by the Exchange against an investment firm are more than the amount of surplus as mentioned in the Default Management Regulation, all the claims will be satisfied on pro-rata basis. The claims that still remain unsatisfied after pro-rata sharing will then be paid from the Investor Protection Fund in accordance with the KSE Investors Protection Fund Regulations. (Default Management Regulation)

**26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?**

No, all clients local and foreign are treated equally according to the procedure mentioned above. (Default Management Regulation)

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

- Securities and Exchange Ordinance 1969 http://www.secp.gov.pk/corporatelaws/pdf/SEORDINANCE1969-amended-%20till-2012.pdf

- SECP ACT 1997 http://www.secp.gov.pk/corporatelaws/pdf/secpact1997_2012.pdf

- Brokers and Agents Registration Rules 2001 http://www.secp.gov.pk/corporatelaws/pdf/BrokersAndAgentsRegistrationRules2001(2).pdf

- National Clearing Company Limited Regulations http://www.nccpl.com.pk/about_us/pdf/20-07-2012-NCCPL%20Regulations-SECP%20Letter-July%2023,%202012.pdf

- Central Depository Act 1997 http://www.secp.gov.pk/corporatelaws/pdf/1997_1.pdf

- Central Depository Company Regulations http://cdcpakistan.com/Downloads/CDCPL%20REGULATIONS.pdf

- Default Management Regulations of the Stock Exchange http://www.kse.com.pk/

- General Regulation of the Stock Exchange http://www.kse.com.pk/

- Risk Management Regulation http://www.kse.com.pk/

- Standardized Investor Account Opening Form http://www.cdcpakistan.com/Downloads/Investor%20Account%20Opening%20Package%20-%20Individual.pdf

- Margin Trading Regulation http://www.kse.com.pk/

# Poland
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

   a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

**ANSWER: There is no legal definition of client asset however client asset are composed of the account of the financial instruments and the client funds.**

   b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

ANSWER: **The issue of ownership rights is not per se defined however the ownership rights with respect to client assets are guaranteed by the Act on Trading in Financial instruments and the appropriate decree of the Ministry of Finance. Under the a. m Regulation as a general rule an investment firm holding client asset is not allowed to use for its own account or the account of the third party client asset. The matter of ownership is explicitly regulated by the general rules resulting from Civil Code. In terms of the rules of interest rate of the client money hold by an investment firm it s to be stated that it is regulated by the agreement between client and the investment firm.**

   c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

**ANSWER: The term Client is defined under the decree of the Ministry of Finance on the terms and conditions of providing investment services (…) as individual, legal person or an entity which does not legal personality which has concluded with investment firm an agreement for conducting of the investment services. The category of clients are also defined in the Act on Trading in Financial Instruments. The categorisation reflects the client categories as mentioned in MIFID Directive i.e. professional client, retail clients and eligible counterparty.**

   d. Please describe any notable exclusions from the terms "client" or "client assets."

**ANSWER: does not concern**

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

**ANSWER: The ownerships rights are guaranteed both for the financial instruments account belonging to client as well as for the client funds.**

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

**ANSWER: Yes**

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

**ANSWER: Investment firm which is going to provide custodian services (safekeeping and administration of financial instruments for the account of client) is obliged to meet the conditions regarding the capital requirements, regulatory requirements, fit and proper test, technical and organizational solutions, scope of activities (detailed), providing business plan.**

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

**ANSWER: Does not concern**

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

a. Must the Client Assets of one client be maintained separately from those of other clients?

**Answer: Yes**

i. Are Investment Firms allowed to hold Omnibus Accounts? Yes

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

**ANSWER: The regulatory measures (i. e Regulation of the Ministry of Finance on the term and conditions for providing of investment services by investment firm …) has been enacted particularly to protect client assets. Under this Regulation an investment firm is not allowed to use the client funds and the financial instruments on his own account or on the account of the other clients. The same concerns also the investment firm which provides custodian services.**

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example: Point b requires clarification.

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

C) If a client has a debit balance (*i.e.*, the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

**Answer: No**

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

**ANSWER: No**

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

**ANSWER: Investment firm generally cannot use (invest, encumber) the client asset (client funds). However it is possible after receiving prior written (retail clients) or explicit (professional client) consent to use its financial instruments by investment firm . It concerns the transactions mentioned in art. 2 point 10 of the Commission Regulation 1287/2006.**

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent? Point i requires clarification.

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets? Answer in point d)

iii. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (*i.e.*, established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator?

**Answer: Primarily the commission is able to impose some sanctions on investment firm for violation rules in terms of client assets and it is proportionate to the scale of the violation.**

**In terms of client rights the clients are able to demand from firm any compensation for damages suffered under general rules implying from civil law.**

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

**Answer: There is accounting system allowing on the separation of the concrete positions held by the members of the clearinghouses but not includes the clients of the members of the clearinghouses.**

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction?

**Answer: Yes**

If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

**Answer: There is such possibility provided that a foreign entity provide custodian services in a country which legal system regulates custodian services on the account of the third party and provided that in particular a foreign entity possess some appropriate experience, knowledge and licenses allowing the provision of safekeeping and administration of financial instruments for the account of client) .**

a. Client Assets transferred to or located in other jurisdictions?

**Answer: Yes, however if the conditions regarding the standard of the holding of client asset (i.e. separate holding and administration of the client asset from the asset of investment firm and asset belonging to the third party) are not fulfilled the client must be informed about it and give the express written consent for that.**

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

**Answer: there is additional other provision as indicated in point a above.**

If so, please provide details of those requirements.

**Answer: There is under § 27.1.5 of the Regulation of the Ministry of Finance on term and conditions of providing of investment services by investment firm requirement that holding of client assets including financial instruments and client money by the other entity takes into account provided that this entity ensure holding and administering of the client asset separately from the asset of the entity and the asset of an investment firm.**

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

**YES within an omnibus account.**

a. What protections are applicable to the Foreign Investment Firm's such Client Assets?

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

   a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

**Answer: There is a special category of the custodian banks which under art. 119 of the act on trading in financial instruments are allowed to provide custodian services after obtaining special permission granted by Polish Financial Supervision Authority. The bank providing custodian services is obliged to submit in particular application for authorization which include personal detail of a members of management board and supervisory board, information on the amount of own funds,.**

**The client asset may be kept by the entity having special license for providing such activity e.g. investment firm , foreign investment firms, custodian banks etc.**

   b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

**Answer: An investment firm is obliged to provide to clients information regarding measures on investor protection (in particular client assets) and basis information on systems which guarantee security of the client assets.**

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

**Answer: There is no existing regulation in this context.**

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets?

**Answer: The information concerning client asset are required under information regulation of the Ministry of Finance. The scope of the information is referring to the amount of the client assets and the number of the account of the client. It is submitted monthly.**

   a. Does the Investment Firm report where client assets are held?

**Answer: No, however there is strictly limited by the Act on Trading in Financial Instruments number of category of institutions where client assets (client money) can be deposited.**

b. Does the Investment Firm or depository report the protections applicable to such client assets?

**Answer: On annual basis there is submitted to the PFSA a report on the way of execution requirements on protections on client assets. It is provided by an independent auditors which evaluate a completion of standard with regard to protection of client assets**.

c. Does the Investment Firm or depository report the amount of assets that are held

**Answer: Yes**

In each case, are such reports provided on request or periodically? If periodically, with what frequency? There are provided periodically. It includes monthly or annually period.

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

a. Where Client Assets are held?

**Answer: It is conducted through desk based inspections and basically through on site inspections.**

b. The amount of Client Assets held at a depository?

**Answer: It is conducted through desk based inspections and basically through on site inspections.**

c. The safeguards applicable to Client Assets held at a depository?

**Answer**: **It is conducted through desk based inspections and basically through on site inspections.**

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

a. The amount and/or value of such Client Assets?

b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

c. Foreign regulator can request an investment firm

**Answer: Foreign regulator can request our regulator provided that there is some suitable MOU on exchange of information between regulators.**

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or

ability to continue to carry on business? What is the nature of such required disclosures?

**Answer: An investment firm is obliged to provide to regulator monthly report on financial positions, completion of capital requirements, client's assets on the accounts and the investment firms' assets on the account.**

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*¸ capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

**Answer: There is a few possibilities: regulator is able to limit or to ban the activity provided by an investment firm when investment firm does not meet the financial provisions regarding the conducting of investment services . In some particular circumstances there is also possible to block the of the account of investment firm under art. 39 of the act on capital market supervision dated on 29 July 2005.**

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

    **Answer: Generally with regard to the post insolvency process there is the provision of the act on trading in financial instruments which states that in case of insolvency of an investment firm the client money deposited at an investment firm in connection with a providing of investment services are not a part of bankrupt estate. Moreover the client asset including also financial instruments is protected by the compensation scheme.**

    **An investment firm enters the status of insolvent or bankrupt under the insolvency law which as such is outside of the remit of PFSA. However PFSA is to be notified about the submitting to the insolvency court the file concerning the insolvency of the investment firm. Investment firm is also required to submit to PFSA report concerning opening of the winding up procedure of the investment firm.**

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

    **Answer: This matter is outside of the PFSA'S remit. Insolvency procedure in conducted within the remit of insolvency court.**

16. What are the duties of the Administrative Officer?

    a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

    a. Does the regulator continue to supervise the Investment Firm?

    b. How, if at all, is the regulator involved in the process of returning Client Assets?

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

    a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

    b. What factors, if any, affect the time period required to accomplish such a transfer?

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

# Romania
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

# Response from the Romanian National Securities Commission (CNVM)

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

    a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

**The term "client assets" is not explicitly defined in the Romanian capital market legislation, however it includes the funds (money) and the financial instruments belonging to the client.**

**Financial instruments means those instruments specified in Section C of Annex I of the Directive 2004/39/EC on markets in financial instruments (MiFID), implemented in the Romanian legislation in article 2 para. (1) point 11 of the Law 297/2004 on capital market with the following amendments:**
**a) Transferable securities;**
**b) Money-market instruments;**
**c) Units in collective investment undertakings;**
**d) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;**
**e) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);**
**f) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;**
**g) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in C.6 and not being**

**for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognized clearing houses or are subject to regular margin calls;**
**h) Derivative instruments for the transfer of credit risk;**
**i) Financial contracts for differences;**
**j) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognized clearing houses or are subject to regular margin calls.**

b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

**In accordance with the provision of art. 24 para. (2) and (3) of the Law no. 297/2004 on capital market, with the following amendments, the creditors of an intermediary (investment firm or credit institution) may not use, under any circumstances, the investors assets, including in case of insolvency proceedings. An intermediary may not use the financial instruments of a client for the purpose of trading on own account or on account of another client, unless the client gives its prior written consent. A client's funds can be used to perform transactions on their own only by credit institutions.**
**The investor assets are exempt from the enforcement by seizure, if against the broker was started foreclosure proceedings**

**Also, in accordance with provision of art. 118 of the Regulation no. 32/2006 on investment services, with the following amendments:**
**"(1) …where S.S.I.F. holds financial instruments or funds belonging to retail clients, it shall provide those retail clients or potential retail clients with the information specified in paragraphs (2) to (7) as is relevant.**
**(2) The S.S.I.F. shall inform the retail client or potential retail client where the financial instruments or funds of that client may be held by a third party on behalf of the S.S.I.F. and of the responsibility of the S.S.I.F. under the applicable national law for any acts or omissions of the third party and the consequences for the client of the insolvency of the third party.**
**(3) Where financial instruments of the retail client or potential retail client may, if permitted by national law, be held in an omnibus account by a third party, the S.S.I.F. shall inform the client of this fact and shall provide a prominent warning of the resulting risks.**
**(4) The S.S.I.F. shall inform the retail client or potential retail client where it is not possible under national law for client financial instruments held with a third party to be separately identifiable from the proprietary financial instruments of that third party or of the S.S.I.F. and shall provide a prominent warning of the resulting risks.**

**(5) The S.S.I.F. shall inform the client or potential client where accounts that contain financial instruments or funds belonging to that client or potential client are or will be subject to the law of a jurisdiction other than that of a Member State and shall indicate the extent to which the rights of the client relating to those financial instruments may be affected.**
**(6) An S.S.I.F. shall inform the client about the existence and the terms of any security interest or lien which the firm has or may have over the client's financial instruments or funds, or any right of set-off it holds in relation to those instruments or funds. Where applicable, it shall also inform the client of the fact that a depository may have a security interest or lien over, or right of set-off in relation to those instruments or funds.**
**(7) An S.S.I.F., before entering into securities financing transactions in relation to financial instruments held by it on behalf of a retail client, or before otherwise using such financial instruments for its own account or the account of another client, shall in good time before the use of those instruments provide the retail client, in a durable medium, with clear, full and accurate information on the obligations and responsibilities of the S.S.I.F. with respect to the use of those financial instruments, including the terms for their restitution, and on the risks involved."**

**In relation to assets held by an investment firm, clients retain beneficial ownership of the assets at all times, and they are protected in the ease of insolvency of the investment firm. This is not the case however, when clients transfer assets to the investment firm under full title transfer collateral agreements (both client money and assets).**

**Arrangement of measures 5/2008:**

**"The following actions are considered fraudulent practices:**

**a) loan, pledge or collateral on behalf of an intermediary / client, while using a client financial instruments without his prior written consent;**
**b) loan or collateral on behalf of an investment firm using funds belonging to a client;**
**c) disposal or direct/indirect use of a client financial instruments or rights without the express written consent of the client;**
**d) direct or indirect disposal of a client funds or rights made by an investment firm;**
**e) obligations' coverage arising from transactions made in the account of an intermediary / client using the financial instruments of a client without his prior express written authorization;**
**f) obligations' coverage arising from transactions in a client account / investment firm using funds belonging to a client. "**

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

**In accordance with the provisions of para. (2) art. 2, letters f)-h) of the CNVM Regulation no. 32/2006, with the following amendments:**
***f) client* – any natural or legal person to whom an S.S.I.F. provides investment and/or ancillary services;**
***g) professional client* – any client meeting the criteria laid down in Annex no. 8;**

***h) retail client* – the client who is not a professional client;**

**In accordance with the provisions of Annex no. 8 of the CNVM Regulation no. 32/2006, with the following amendments, professional clients means:**

**Art. 1 – Categories of clients regarded as professional clients**
**(1) The professional client refers to the client who has the experience, knowledge and ability required to take investment decisions and assess the risks involved. In order to be regarded as professional client, the client shall be included in the categories referred to in paragraph (2) and shall meet the criteria mentioned at the same paragraph.**
**(2) The following categories of clients shall be regarded as professional clients for all investment services and financial instruments defined in accordance with Law no. 297/2004:**
**a) Entities which must be authorised and regulated to operate on financial markets. The following list includes all the authorised entities which carry out activities such as those mentioned above: entities authorised in Romania or in a Member State in accordance with a EU Directive, entities authorised or regulated in Romania or in a Member State which are not subject to a EU Directive and entities authorised and regulated by a non Member State:**
**1. credit institutions;**
**2. investment firms;**
**3. other financial institutions authorised or regulated;**
**4. insurance companies;**
**5. UCITS and their management firms;**
**6. pension funds and their management firms;**
**7. traders;**
**8. other institutional investors.**
**b) Firms which meet two of the following requirements:**
**1. aggregate balance sheet: EUR 20,000,000**
**2. net turnover: EUR 40,000,000**
**3. equity: EUR 2,000,000.**
**c) National and regional governments, public institutions which manage public debt, central banks, international and supranational institutions, such as the World Bank, the International Monetary Fund, the European Central Bank, the European Investment Bank and other similar international organisations.**
**d) Other institutional investors whose main activity refers to investing in financial instruments, including entities which deal with securing assets or with other financial transactions.**

d. Please describe any notable exclusions from the terms “client” or “client assets.”

**None**

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

**Yes.**

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

**If an investment firm intends to provide the service of safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management it has to be authorized by CNVM. The initial capital of the investment firm will be at least 125.000 euro. Also, the investment firm shall draw up and submit to CNVM rules and procedures on the separate recording of client financial instruments and funds.**

b.If special authorization is not required, how, if at all, is this activity supervised by a regulator?

**NA**

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

**In accordance with the provisions of art. 90 of the CNVM Regulation no. 32/2006, with the following amendments:**

**(1) The investment firm shall separately record in its accounting system the funds belonging to its clients and shall use with the settlement bank an account opened in its own name and an account opened on behalf of its clients. At the same time, the financial instruments of its clients shall be recorded in separate accounts from the accounts of the S.S.I.F.**

**(2) The investment firm shall not act in such a way so that to endanger or shall not be deemed to endanger or cause to endanger the funds and/or the financial instruments of its clients or the regulated market where it deals and shall ensure that its investment agents and other employees shall not act as such.**
**(3) Investment firms shall, under any conditions, meet the following requirements:**
**a) to ensure the safekeeping of the financial instruments held on behalf of their clients;**
**b) not to make use of any of the financial instruments held on behalf of their clients or of their associated rights and not to transfer these instruments without the express consent of their clients;**
**c) to return to its clients, at the latter's request, the financial instruments and funds held on their behalf.**
**(4) The investment firm authorised to provide the investment service of "safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management" shall be responsible for the payments and settlements in connection with the financial instruments belonging to its clients."**

**In accordance with the provisions of article 6 para. (6) of the CNVM Regulation no. 5/2010, intermediaries authorized to perform the investment service of safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management should elaborate internal procedures and internal control mechanisms, to be reviewed annually, regarding:**
**- The use of robust back-office procedures, including the double entry system, according to which, for each credit/debit of the beneficiary account should be a corresponding operation of debit/credit of the counterparty account providing/receiving the securities, procedures which should identify at any time and without delay the securities' holdings of a personal client;**
**- Registration, record and necessary account keeping, in order to distinguish, at any time and without delay, between the assets held by a client and the assets held by any other client and from its own assets;**
**- Daily checking of their own records performed by the intermediaries in order to certify that the aggregate holdings of their customers correspond with the intermediaries registered positions in the global accounts open with other intermediaries or central depository systems;**
**- Daily reconciliation by participants in a central depository, of all customers' individual sub-accounts and house account, respectively the securities holdings and related tasks, highlighted in their own back-office systems with global accounts open in central depository systems;**
**- the adequate protection of the clients' assets, including the including situation in which securities are deposited through several intermediaries in a chain of custody and ensuring that those procedures, to the extent relevant, are applicable to all intermediaries that are in higher positions in the chain of custody.**

**Also, according to CNVM Decision no. 1075/21.11.2012, investment firms must withdraw on a daily basis the amount of money representing its commissions from the clients' accounts. The investment firm may keep certain amounts of money in the clients' accounts only if this money will be used to settle possible debit positions of the clients.**

a. Must the Client Assets of one client be maintained separately from those of other clients?

**The client's money is maintained in one or more bank accounts. The number of bank accounts opened by the intermediary in order to hold clients' money depends on the bank exposure indicator. At the level of back office and accounting papers, the intermediary maintains separately records of each client's assets.**

i. Are Investment Firms allowed to hold Omnibus Accounts?

**Yes, investment firms are allowed to hold client assets in Omnibus accounts, but they have to keep records in their back-office system so that they are able, at any time and without delay, to identify the assets of a client from the assets of any other client and from their (investment firms) own assets.**

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

**In accordance with the provisions of article 94 of the CNVM Regulation no. 32/2006, with the following amendments:**
**The investment firm shall not enter into arrangements for securities financing transactions in respect of financial instruments held by it on behalf of a client, or otherwise use such financial instruments for its own account or the account of another client of the investment firm unless the following conditions are met:**
**a) the client must have given his prior express consent to the use of the instruments on specified terms, as evidenced, in the case of a retail client, by his signature or equivalent alternative mechanism;**
**b) the use of that client's financial instruments must be restricted to the specified terms to which the client consents.**
**The investment firm shall not enter into arrangements for securities financing transactions in respect of financial instruments which are held on behalf of a client in an omnibus account maintained by a third party, or otherwise use financial instruments held in such an account for its own account or for the account of another client unless, in addition to the conditions set out in the paragraph mentioned above, at least one of the following conditions is met:**
**a) each client whose financial instruments are held together in an omnibus account must have given prior express consent in accordance with the above mentioned paragraph letter a);**
**b) the investment firm must have in place systems and controls which ensure that only financial instruments belonging to clients who have given prior express consent in accordance with the above mentioned paragraph, letter a) are so used.**

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account.

For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

**The amount of client money that a firm is required to hold in bank accounts should exceed the sum of positive individual client balances and the additional margined transaction requirements. The amount the Investment Firm must offset the sum of negative individual client balances.**

| | **Bank/Back-office** | **(yy/mm/dd) 1** | **(yy/mm/dd) 2** | **…** | **(yy/mm/dd) j** |
|---|---|---|---|---|---|
| A | (bank)[1] account | | | | |
| B | (bank)[2] account | | | | |
| | … | | | | |
| I | (bank)[i] account | | | | |
| J | **TOTAL in bank accounts** | | | | |
| K | Difference 1: **J-M** | | | | |
| L | Difference 2: **K-N** | | | | |
| M | **total of positive individual client balances** | | | | |
| N | **total of negative individual client balances** | | | | |

**if K is:**
**-a positive number, then the company hold in these accounts all the clients money plus a part of its own money; the amount of money the company hold in the clients accounts must exceed the total of negative individual client balances;**
**- a negative number, then the company use the money of some clients to settle the trades of other clients; in our legislation this is considered fraudulent practice.**

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

**Client money is fungible. The financial instruments are fungible within asset classes (e.g. an ordinary share of a company didn't carry an identification number.**

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

**In accordance with the provisions of article 8 of the CNVM Regulation no.5/2010, the participants in the central depository system are required to daily reconcile all the individual customer sub-accounts and the house account, respectively the securities holdings and related tasks, highlighted in their own back-office systems with global accounts open in central depository systems, so as to comply with the following:**
**TOTAL FINANCIAL ASSETS PER ISIN = FINANCIAL ASSETS AFFECTED BY TASKS + FINANCIAL ASSETS FREE OF CHARGES.**

C) If a client has a debit balance (i.e. the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

**The amount the investment Firm is required to hold must offset the sum of negative individual client balances.**

**The total required funds on deposit for net credit balances clients cannot be reduced with one client's net debit balances.**

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

**Participants in the central depository system are required to reconcile daily all the customers' individual sub-accounts and house account.**
**In accordance with the provisions of article 4 and 5 of the CNVM Arrangement of measures 5/2009, intermediaries are required to perform daily, into the computer record system, the reconciliation of funds or financial instruments holdings registered in each client account and on its own account by verifying the compliance between the obligations and the funds and/or financial instruments holdings recorded in the respective accounts.**
**Intermediaries are required to highlight in the IT system the balances of the clients accounts, including the settlement date.**

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

**With regard to financial instruments, CSD (central securities depository) participants have to reconcile the information registered in their back-office systems with the information registered in the CSD system on a daily basis, by the end of the settlement day.**

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

**Client`s assets (financial instruments) can be used by an intermediary, investment firm or a credit institution in order to guarantee the transactions on own account or on other client`s**

**account only if there is a preliminary written agreement of the client whose financial instruments are used. This agreement should be concluded for each operation.**
**Client`s assets (funds) can be used in order to guarantee the transactions on own account only by the credit institutions registered as intermediary in the CNVM Register.**

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

**See response in c.**

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

**If a client agrees to full title transfer of its assets to the firm in certain circumstances and the firm exercises its rights to take full ownership of assets in accordance with its client agreement, this will result in those assets being moved out of the client assets regime for the period during which the firm exercises full ownership rights. The consequence of this is that, if a firm fails during that period, the client will rank as a general creditor of the firm in relation to those assets.**

**However, a security financial collateral arrangement would usually mean that the client retains beneficial interest in the assets until such time as the condition in the agreement allowing the firm to exercise its security right is met.**

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

**In accordance with the provisions of article 16 of the CNVM Regulation no.5/2010, all operations regarding the securities lending will be based a standard contract and its additional acts. The additional acts shall be drafted as follows:**
**a) preliminary to the introduction of the selling order into the trading system in case of application of the prevalidation mechanism of the financial instruments;**
**b) the latest on the date of the settlement in accordance with the settlement term, in case of the mechanism without prevalidation of the financial instruments.**
**For the situations when the securities lending operations as well as the guarantee operations are carried out by an intermediary and its client or a client of another intermediary or between 2 clients of an intermediary/ies, a standard lending contract (made of a standard contract and additional acts) shall be used and drafted in accordance with the GMSLA standard lending contract adjusted to the Romanian legislation and in compliance with the following provisions:**
**a) the standard contract shall contain at least clauses related to :**
**- the parties of the contract;**

**- the object of the contract;**
**- the rights and the obligations of the contract parties;**
**- the volume/maximum value of the securities that can be lent to a client depending on the intermediary rules for risk administration;**
**- the type of the guarantees that can be used for guaranteeing the securities lending;**
**- the way of setting, assessment and execution of the guarantees;**
**- the way of rending the lent securities and guarantees;**
**- the situation of non-reimbursement of the securities at the maturity;**
**- the way of exercise, by the contracting parties, of the rights related to the ownership rights over the lent securities and, as the case may be, over the securities set as financial guarantee with ownership transfer;**
**- provisions related to the way of closing the contract, inclusive the situations when the lent securities are excluded from the list of securities eligible for securities lending operations;**
**b) for each operation of lending securities, an additional act will be drafted that will contain at least clauses regarding:**
**- the contracting parties;**
**- the object of the contract;**
**- the type, the number, the nominal value and the market value of the lent securities, by specifying the issuer and ISIN code;**
**- the type and the value of the assets accepted for guaranteeing the lending;**
**- the period of the securities lending;**
**- the tariffs and the commissions paid by the beneficiary of the securities lending.**

iii. How are the ownership rights of a client over its client assets changed or affected when the investment firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (i.e. established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

**As set out in our response to (i) above, where a client agrees to transfer full title to custody assets to a firm and firm has exercised its rights to take full ownership of custody assets in keeping with its client agreement (i.e. with the client's consent) the custody assets are removed from the client assets regime (and the protections thereof) for the period that the firm exercises those rights. It is that contractual agreement between client and firm that allows the client asset regime protections to be disapplied for that period. Therefore, if a firm takes full ownership over custody assets and uses them without the agreement of the client to whom the assets belong, in our view, the client asset regime should continue to apply to those assets. If the firm has used the assets as its own the client/insolvency practitioner may attempt a tracing exercise.**

**The intermediaries authorised to provide investment services and management companies, which manage individual investment portfolios, must be members of the Investment Compensation Fund.**

**The purpose of the Fund is to compensate investors, in compliance with the conditions set out in the Capital Market Law (Law no. 297/2004, with the following amendments) and with C.N.V.M. regulations, if Fund members fail to return the funds and/or the financial instruments owed by or belonging to investors, which have been held on their behalf for providing investment services or managing individual investment portfolios. "Investor" refers to any person which has entrusted a Fund member with funds or financial instruments in order to provide investment services.**

**The Fund shall compensate the investors in any of the following situations:**

**a) C.N.V.M. has acknowledged that, for the time being, from its point of view, an intermediary or a management company that manages individual investment portfolios, for reasons directly linked to their financial situation, is not able to meet its obligations resulted from investors' claims and furthermore, there is no possibility for it to meet these obligations in the shortest time possible;**

**b) the competent legal authority, for reasons directly or indirectly linked to the financial situation of a Fund member, has issued a final decision that has as a result the suspension of investors from the possibility of exercising their rights as regards the resolution of their claims against the said company.**

**(2) The compensation shall be granted for the rights resulted from the failure of a Fund member to:**

**a) repay the investors' funds held on their behalf in connection with their investment activities;**

**b) return to the investors any financial instrument that belongs to them and is held and managed on their behalf in connection with their investment activities.**

**The Fund compensates the investors equally and fairly up to 20,000EUR.**

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

**In accordance with the provisions of art. 152 of the CNVM Regulation no. 13/2005 on the authorisation and functioning of the central depository, the clearing houses and central counterparties:**

**The clearing house/central counterparty shall be organised so that to ensure the carrying out of the following operations:**
**a) registration to the margin accounts, in the name of the clearing members of the derivatives traded on regulated markets/alternative trading systems;**

**b) keeping the records of the derivatives registered, of open positions, according to underlying assets and maturities; records are kept for each clearing member, to its own account, to the accounts of the non-clearing members for which it provides clearing and settlement and to the account of that clearing member's clients;**
**c) daily carrying out of the transfer of premiums in the case of options registered, by crediting or and, respectively, debiting margin accounts;**
**d) keeping the records of contributions to the guarantee fund;**
**e) adjusting, during the session, margin accounts by recording the favourable or unfavourable differences resulted form marking to market;**
**f) supervising margin maintenance for open positions;**
**g) daily issuance and sending, for each clearing member, of a report on the derivatives registered, open positions exiting on its name, the amount in the margin account, the balance, the profit or loss recorded, premiums paid and cashed, as well as commissions debited from the margin account for the operations performed as a result of marking to market, after the closing of the trading session but before the opening of the next trading session;**
**h) sending, after each trading session, where appropriate, of the margin call for clearing members and monitoring the margin account updating;**
**i) monitoring and ensuring the exercise of options and the closing of positions at maturity in accordance with the specifications of the derivatives;**
**j) any other specific operations set out in its own regulations.**

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

a. Client Assets transferred to or located in other jurisdictions?

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

If so, please provide details of those requirements.

**In accordance with the provision of article 92 of the CNVM Regulation no. 32/2006, with the following amendments:**

(1) **An investment firm may deposit the financial instruments held on behalf of its clients into an account or accounts opened with a third party. The investment firm shall act with competence, impartiality and professional diligence in the selection, appointment and periodic review of the third party and of the measures necessary for holding and safekeeping of those financial instruments.**
(2) **In the application of the provisions mentioned on paragraph (1), the investment firm will take into consideration separately, the experience and market reputation of the third party and any legal requirements or market practices related to the holding of those financial instruments that could affect clients' rights.**

(3) **If the safekeeping of financial instruments belonging to the account of another person is an activity subject to regulation and supervision in a jurisdiction where the investment firm intends to use a third party for providing this service, the investment firm shall not delegate this activity to a third party that is not subject to regulation and supervision in that jurisdiction.**

(4) **The investment firm cannot deposit financial instruments held on behalf of its clients to a third party from a non-member State which does not regulate the holding and safekeeping of the financial instruments belonging to another person, unless one of the following condition is meet:**

**a) the nature of the financial instruments or investment services in relation to those which must be deposited to a third party from a non-member State;**

**b) The financial instruments are hold on behalf of a professional client, and the client request to the investment firm, on writing, to keep the financial instruments to a third party from a non-member State.**

**The Romanian investment firms are permitted to transfer to, or hold Client Assets belonging to clients in another jurisdiction with the fulfillment of the above mentioned legal provisions.**

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

As regard client assets protections rules there is no differentiation in the Romanian legislation between client assets held for domestic or overseas clients.

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

**See response in point 4.**

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

**In accordance with the provision of art. 118 of the Regulation no. 32/2006 on investment services, with the following amendments:**
**"(1) …where S.S.I.F. holds financial instruments or funds belonging to retail clients, it shall provide those retail clients or potential retail clients with the information specified in paragraphs (2) to (7) as is relevant.**
**(2) The S.S.I.F. shall inform the retail client or potential retail client where the financial instruments or funds of that client may be held by a third party on behalf of the S.S.I.F. and of the responsibility of the S.S.I.F. under the applicable national law for any acts or omissions of the third party and the consequences for the client of the insolvency of the third party.**
**(3) Where financial instruments of the retail client or potential retail client may, if permitted by national law, be held in an omnibus account by a third party, the S.S.I.F. shall inform the client of this fact and shall provide a prominent warning of the resulting risks.**
**(4) The S.S.I.F. shall inform the retail client or potential retail client where it is not possible under national law for client financial instruments held with a third party to be separately identifiable from the proprietary financial instruments of that third party or of the S.S.I.F. and shall provide a prominent warning of the resulting risks.**
**(5) The S.S.I.F. shall inform the client or potential client where accounts that contain financial instruments or funds belonging to that client or potential client are or will be subject to the law of a jurisdiction other than that of a Member State and shall indicate the extent to which the rights of the client relating to those financial instruments may be affected.**
**(6) An S.S.I.F. shall inform the client about the existence and the terms of any security interest or lien which the firm has or may have over the client's financial instruments or funds, or any right of set-off it holds in relation to those instruments or funds. Where applicable, it shall also inform the client of the fact that a depository may have a security interest or lien over, or right of set-off in relation to those instruments or funds.**
**(7) An S.S.I.F., before entering into securities financing transactions in relation to financial instruments held by it on behalf of a retail client, or before otherwise using such financial instruments for its own account or the account of another client, shall in good time before the use of those instruments provide the retail client, in a durable medium, with clear, full and accurate information on the obligations and responsibilities of the S.S.I.F. with respect to the use of those financial instruments, including the terms for their restitution, and on the risks involved."**

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

**Clients may not choose to waive or reduce any of the client assets protection requirements.**

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

   a. Does the Investment Firm report where client assets are held?

**On a monthly/quarterly basis (depending on the level of their initial capital), investment firms must report to the Competent Authority the names of the banks where its client's money are held.**

**Also, during the enforcement proceedings, the investment firm is obliged to present to the representative of CNVM statements of account issued by the credit institutions where the client money are held and records of clients account.**

   b. Does the Investment Firm or depository report the protections applicable to such client assets?

   c. Does the Investment Firm or depository report the amount of assets that are held?

**See response to letter a) above.**

   In each case, are such reports provided on request or periodically? If periodically, with what frequency?

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

   a. Where Client Assets are held?

   b. The amount of Client Assets held at a depository?

   c. The safeguards applicable to Client Assets held at a depository?

**As regard the money, we request the audited entity to provide account statements issued by the bank where this firm open its accounts and compare them with the company's balance sheet. As for the financial instruments, we request the audited company to provide account statements issued by the custodian bank. As you can see, in all cases we use a third party confirmation.**

**In addition, CNVM also receive, on a periodic basis, the external / internal auditors reports and the compliance department reports which contain certain aspects on this issues.**

**We would like to mention also the provision of art. 2 para. (5) of the Law no. 297/2004, with the following amendments in accordance to which, in order to perform its supervisory activity, C.N.V.M. may:**
**- verify the modality of fulfilling the legal and statutory attributions and obligations of managers, directors, chief executive officers, as well as of other persons linked to the activity of the regulated or supervised entities;**
**- conduct controls at the premises of the entities regulated and supervised by C.N.V.M.;**
**- hear any person in connection with the activities conducted by the entities regulated and supervised by C.N.V.M.**

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

    b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

**In this case the provisions of art. 56 to 63 of the Directive 2004/39/EC are applicable, as they have been implemented in the CNVM Regulation no. 32/2006, with the following amendments (title VI).**

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

**In accordance with the provisions of article 9 of the Law no. 297/2004, with the following amendments, an investment firm must comply with the conditions for authorisation, with prudential and capital adequacy requirements as laid out by this law and by C.N.V.M. regulations, during the time it carries out its activities, and shall notify or first submit for authorisation, as the case may be, any change in its organisation and functioning in compliance with the provisions of C.N.V.M. regulations.**

**The intermediaries authorised by CNVM shall submit their financial statements as well as their periodic reports (article 23 of the above mentioned law).**

**In accordance with the provisions of article 153 para. (1), to the purpose of supervision by C.N.V.M. of the activities undertaken by the S.S.I.F., the latter shall submit to C.N.V.M. the following statements and documents:**
***a)* monthly, quarterly or half-yearly financial statements, as appropriate, prepared and transmitted to C.N.V.M. in accordance with the regulations issued for the application of *Government Emergency Ordinance no. 99/2006 on credit institutions and capital adequacy;***
**b) "report on borrowings, margin purchases and short sales" prepared in accordance with Annex no. 7, within maximum 10 days from the close of the reporting month or within maximum 24 hours from the request by C.N.V.M.;**
**c) "report on derivatives transactions" prepared in accordance with Annex no. 7, within maximum 10 days from the close of the reporting month or within maximum 24 hours from the request by C.N.V.M.;**
**d) half-yearly report, within the legal term set out by C.N.V.M. regulations, which shall include the half-yearly financial statements made up of balance sheet, profit and loss account, equity statement and cash flow statement;**
**e) annual report, within the legal term set out in C.N.V.M. regulations, which shall include:**
**1. annual financial statements made up of balance sheet, profit and loss account, equity statement, cash flow statement, accounting policies and notes;**
**2. management report;**

**3. financial auditor report;**
**f) internal auditor report, which shall be transmitted together with the report referred to in point e);**
**g) report on the revenues of the S.S.I.F. (detailed on categories of investment services) and the purpose of expenses, as well as the report on revenues (detailed for each category of investment services) and the purpose of expenses for each secondary premises, which shall be transmitted together with the report referred to in point e).**

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*, capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

**Whether an investment firm financial situation is deteriorating the CNVM can take the following actions :**

**- to require the firm to raise new capital,**

**- to require the firm to return client assets,**
**- to apply the following sanctions**:
**a) warning;**
**b) fine;**
**c) complementary sanctions, applied as the case may be:**
**1. suspension of authorisation;**
**2. withdrawal of authorisation;**
**3. temporary prohibition from carrying our certain activities and services.**
**- to enforce trustee in bankruptcy procedures if it has acknowledged that an authorised entity is about to become insolvent or if any of this entity's administrators, executive directors or auditors are guilty of:**
**a) breaching the provisions of this law or the regulations issued by C.N.V.M., which has caused or may cause significant damages or which jeopardises the well functioning of the capital market;**
**b) breaching any condition or restriction laid down in the authorisation;**
**c) inadequate management of financial instruments and funds belonging to investors.**
**If C.N.V.M. decides on the entity's winding up, the proceedings shall be applied.**

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

16. What are the duties of the Administrative Officer?

a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

    a. Does the regulator continue to supervise the Investment Firm?

    b. How, if at all, is the regulator involved in the process of returning Client Assets?

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

    a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

    b. What factors, if any, affect the time period required to accomplish such a transfer?

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

**In this case are applicable the provisions of TITLE IX ”TRUSTEE IN BANKRUPTCY AND WINDING UP” of the Law no. 297/2004, with the following amendments:**

**”Chapter I**
**General provisions**

**Art. 264**
**(1) C.N.V.M. shall enforce trustee in bankruptcy procedures if it has acknowledged that an authorised entity is about to become insolvent or if any of this entity’s administrators, executive directors or auditors are guilty of:**
**a) breaching the provisions of this law or the regulations issued by C.N.V.M., which has caused or may cause significant damages or which jeopardises the well functioning of the capital market;**
**b) breaching any condition or restriction laid down in the authorisation;**
**c) inadequate management of financial instruments and funds belonging to investors**
**(2) If it acknowledges major malfunctioning, C.N.V.M. may require the dissolution of the authorised entities’ Boards.**

**Chapter II**
**Trustee in bankruptcy procedures applied to the entities authorised by C.N.V.M.**

**Art. 265**
**(1) Trustee in bankruptcy procedures shall be carried out by a specialised natural or legal person appointed by C.N.V.M.**
**(2) The decision regarding the enforcement of trustee in bankruptcy proceedings shall be published in the C.N.V.M. Bulletin and in two national daily newspapers.**
**Art. 266**
**(1) The trustee is fully entrusted with the powers of the Board of the authorised entity under trustee in bankruptcy proceedings.**
**(2) The trustee shall establish measures for the preservation of the assets and the collection of claims to the interest of the investors and of other creditors.**
**(3) The voting rights of the shareholders as regards the appointment and revocation of administrators, the rights to receive dividends, the activity of the Board and of the internal auditors as well as the right to receive payment for their activity are suspended during trustee in bankruptcy proceedings.**
**Art. 267**
**(1) Within maximum 60 days from his appointment, the trustee shall submit to C.N.V.M. a written report on the financial situation of the authorised entity and shall annex documents on the valuation of the entity’s assets and liabilities, the situation of the claims collection, the cost of asset maintenance and the situation of debt liquidation.**
**(2) Within 15 days from receiving the report of the trustee, C.N.V.M. shall decide, if necessary, on the extension of the trustee’s activity, for a limited period of time.**

**(3) If his activity is extended, the trustee shall submit to C.N.V.M. the assessment of the authorised entity's financial situation, on a monthly basis.**
**Art. 268**
**(1) If C.N.V.M. acknowledges, based on the report of the trustee, that the authorised entities have recovered from a financial point of view and meet prudential supervision requirements, according to C.N.V.M. regulations, the trustee in bankruptcy proceedings shall cease.**
**(2) The decision to cease trustee in bankruptcy proceedings shall be published in accordance with the provisions laid down in art. 265 paragraph (2).**
**Art. 269**
**(1) If the conditions referred to in art. 268 are not met, C.N.V.M. shall not decide on the extension of the trustee's activity and the authorisation of the regulated entity shall be withdrawn, while C.N.V.M. may either start the winding up procedures or inform the competent court in order to open the legal reorganisation and bankruptcy proceedings.**
**If the legal reorganisation and bankruptcy proceedings are opened, the conditions laid down in Law no. 85/2006 regarding the insolvency proceeding.**
**(2) The court competent to settle the request of C.N.V.M. regarding the opening of the legal reorganisation and bankruptcy proceedings against authorised entities is the Tribunal of the district where that entity has its registered office.**
**(3) The provisions of Government Ordinance no. 10/2004 regarding the legal reorganisation and bankruptcy proceedings of credit institutions, to the extent of their compatibility, shall also be applied to the authorised entities under trustee in bankruptcy proceedings and whose authorisation has been withdrawn by C.N.V.M. The phrase "debtor credit institutions" in the law mentioned above refers to "entities authorised by C.N.V.M.", and the phrase regarding the "National Bank of Romania" refers to "C.N.V.M.".**
**(4) For the purposes of this chapter "insolvency" means the situation of the authorised entity in one of the following situations:**
**a. inability to pay due debts by using own funds;**
**b. withdrawal of the authorisation of regulated entity, in accordance with this law and C.N.V.M. regulations as a result of the inability of the authorised entity under special trustee in bankruptcy proceedings to recover financially.**
**(5) The appointment of the trustee by the tribunal shall be made with the agreement of C.N.V.M.**
**(6) In order to perform their duties which involve the application of certain regulations issued by C.N.V.M., the tribunal, the bailiff and the trustee may require the opinion of C.N.V.M. as authority in charge of regulating and supervising the capital market.**
**(7) The bankruptcy proceedings shall be closed when the bailiff has approved the final report, when all the funds or the assets of the authorised entity undergoing bankruptcy have been distributed and the funds which have not been claimed were deposited with the State Treasury. Following a request by the bailiff, the tribunal shall decide on the closing of the legal reorganisation and bankruptcy proceedings. The decision shall be communicated in writing and/or via the press in at least two national daily newspapers, to all the debtor's creditors, to the Trade Register Office, to C.N.V.M. and to the trustee.**
**The amounts left, if any, shall be paid in to the state budget after 5 years.**

**Chapter III**
**Winding up**
**Art 270**
**(1) If C.N.V.M. decides on the entity's winding up, the proceedings shall be applied in accordance with the procedure established by the legislation applicable to the dissolution and winding up of companies and by C.N.V.M.**
**(2) The trustee for the entity's winding up shall be appointed by C.N.V.M."**

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

**Below is the links only to the law and regulations mentioned in our responses, for which an English version is available on the CNVM website. For the other regulations only the Romanian version is available.**

**http://www.cnvmr.ro/pdf/legi/en/Law-297-2004.pdf**

**http://www.cnvmr.ro/pdf/regulamente/en/Regulation-13-2005.pdf**

**http://www.cnvmr.ro/pdf/regulamente/en/Regulation-32-2006.pdf**

# Singapore
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

The rules and regulations on Client Assets are detailed in the Singapore Securities and Futures Act (Cap. 289) ["SFA"] and the Singapore Securities and Futures (Licensing and Conduct of Business) Regulations (Rg. 10) ["SFR"].

Under the SFA, Investment Firms conducting regulated activities are required to deposit client moneys and assets into a trust or custody account maintained with specified financial institutions in Singapore. The regulated activities under the SFA include dealing in securities, trading in futures contracts, fund management and providing custodial services for securities ["Regulated Activities"].

a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

Section 103A of the SFA read together with regulation 15 of the SFR provides for the definition of Customer money and Customer assets. For the purposes of this survey, we have used the term "Client money" and "Client assets" to reflect "Customer money" and "Customer assets" respectively.

Client money refers to money received from, or on account of the client in respect of the Regulated Activities or in the course of business of the Investment Firm, but does not include

- money which is to be used to reduce the amount owed by the client to the Investment Firm;
- money which is to be paid to the client or in accordance with the client's written direction;
- money which is to be used to defray the investment firm's brokerage and other proper charges; and
- money which is to be paid to any other person entitled to the money.

Client assets means securities and assets (other than money), including Government securities and certificates of deposits, that are beneficially owned by a customer of the Investment Firm.

b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

The moneys and assets in the trust account and custody account, respectively, are held on trust by the Investment Firm for its clients.

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

Under the SFA, for the purposes of Client assets, "customer" refers to (i) a person on whose behalf the Investment Firm carries on or will carry on any Regulated Activities; or (ii) any other person with whom the Investment Firm, as principal enters or will enter into transactions for the sale or purchase of securities or futures contracts, or in connection with leveraged foreign exchange trading. For the purposes of this survey, we have used the term "Client" to reflect "Customer".

However, "Client" does not include:
(a) the Investment Firm in carrying out any regulated activity for its own account;

(b) an officer, an employee or a representative of the Investment Firm; or

(c) a related corporation of the Investment Firm with respect to an account belonging to and maintained wholly for the benefit of that related corporation.

d. Please describe any notable exclusions from the terms "client" or "client assets."

Please refer to 1(a) and 1(c) above.

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients* (e.g., *retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

An Investment Firm which holds a capital markets services ["CMS"] licence under the SFA is permitted to hold Client Assets.

Client Moneys

In particular, regulations 16 and 17 of the SFR provides that the Investment Firm is required to deposit client moneys into a trust account maintained with a specified financial institution, namely a bank, merchant bank or finance company licensed in Singapore. Regulation 18 provides that the Investment Firm is required to obtain an acknowledgement from the specified financial institution that:

- the moneys in the trust account are held on trust by the CMS licensee for its clients and the specified financial institution cannot exercise any right of set-off against moneys owed by the Investment Firm to the specified financial institution; and
- the account is designated as a trust account or customers' account, which must be distinguished and maintained separately from any other account in which the Investment Firm deposits its own moneys.

Client Assets

Regulations 26 and 27 of the SFR provide that the Investment Firm shall deposit the client assets in a custody account maintained a specified financial institution or with any of the following institutions:

- a depository agent, only in relation to securities deposited into the Singapore Central Depository system;
- an approved trustee for a collective investment scheme in respect of assets under the collective investment scheme; or
- a firm holding a CMS licence to provide custodial services for securities.

Regulations 17 and 27 of the SFR provide that subject to the client's prior written consent, the Investment Firm may deposit moneys or assets received on account of

its client which are denominated in a foreign currency in a trust or custody account maintained with a custodian outside Singapore. Such a custodian must be licensed to conduct banking business or to act as custodian in the country where the account is maintained.

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

Please refer to the response to Q1(a) on the licensing requirements.

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

a. Must the Client Assets of one client be maintained separately from those of other clients?

Pursuant to section 104 of the SFA read with regulation 16 and 26 of the SFR, an Investment Firm is required to segregate its own money and assets from its Client Assets. Moneys and assets received by the Investment Firm on account of its customers may be commingled and deposited in the same trust or custody account.

i. Are Investment Firms allowed to hold Omnibus Accounts?

Yes, moneys and assets received by the Investment Firm on account of its customers may be commingled and deposited in the same trust or custody account.

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

The Investment Firm is not permitted to use the moneys received on account of a particular client in the trust account as margin or guarantee for, or to secure any transaction of, or to extend the credit of, any person other than that client.

Pursuant to regulation 23 of the SFR, the investment firm may advance sufficient money to a Client's trust account from its own funds to prevent the client's trust account from being under-margined or under-funded.

(a) Pursuant to regulations 37 and 39(1) of the SFR, the Investment Firm is required to maintain separate records of the individual Client's interest in the moneys and assets that have been commingled. On a daily basis, for futures contracts and leveraged foreign exchange trading activities, the Investment Firm is required to compute and reconcile:

(i) the total amount of moneys / assets deposited in its clients' trust / custody accounts;

(ii) the total amount of its clients' moneys / assets required to be deposited in trust / custody accounts; and

(iii) the amounts of the Investment Firm's residual interest in the trust / custody accounts.

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

Client money which is deposited in an omnibus account would be fungible amongst all clients of the Investment Firm. As for Client assets, the Investment Firm is required to hold the specific assets deposited by the Client.

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

Please refer to our response to Q2(a)(ii). Client Assets is computed and reconciled on a client-by-client basis even though Client money is deposited in an omnibus account.

C) If a client has a debit balance (i.e. the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

The amount that the Investment Firm is required to hold as Client Assets exclude the amount that is owed by the Client to the Investment Firm including amounts used to defray the Investment Firm's brokerage and other proper charges.

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

Daily computation and reconciliation of the Client moneys and Client assets maintained in trust and custody accounts is required of the Investment Firm conducting regulated activities in respect of trading in futures contracts and leveraged foreign exchange trading.

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

The computation referred to in Q2(b)(ii)(A) above should be completed before noon of the next business day.

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

The Investment Firm may pay an advance of its own funds ["Advance"] into the Client's trust account to prevent the trust account from being under-margined or under-funded at all times or to ensure the continued maintenance of that trust account.

The Investment Firm may reimburse itself of the Advance and interest/returns arising from such moneys as long as this reimbursement does not result in the account being under-margined or under-funded.

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

Please see Q2(a)(ii) and Q2(b)(ii)(C) above.

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

The Investment Firm cannot use Client Assets of one Client to meet the obligations of another Client.

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

The Investment Firm may only deal with the Client moneys and Client assets as provided under regulations 20, 21, 31, 32, 33, 34 and 35 of the SFR. A summary is as follows:

<u>1) Investment of moneys received on account of Clients:</u>
The Investment Firm may invest moneys received on account of its Clients in any Government securities; any debt instrument of the government of the country of the securities/futures market or securities/futures exchange on which the Investment Firm normally transacts its business. The Investment Firm shall keep proper record of such transactions.

<u>2) Withdrawal of Client assets from trust/custody account:</u>
Withdrawal of Client moneys and Client assets from a trust or custody account is restricted to the specified purposes as provided under the SFR. Examples include making a payment to any other person or account in accordance with the written direction of the Client and defraying Investment Firm's brokerage and other proper charges.

3) Lending of client securities:
The Investment Firm which lends out securities belonging to a Client or arrange for a custodian to lend out securities belonging to a Client must explain the risks involved to the client (unless the Client is an accredited investor), and obtain the Client's written consent. The Investment Firm must also enter into an agreement with the Client, setting out the terms and conditions for the lending of the securities and disclose such terms and conditions to the Client.

Additionally, in respect of any securities lent, the Investment Firm must obtain from the borrower collateral which must have a value of not less than 100% of the market value of the securities lent, unless the Client is an accredited investor and the securities are lent to persons who are accredited investors.

4) Mortgage of client assets

The Investment Firm may mortgage, charge, pledge or hypothecate Client assets together if and only if the sum of the claims to which these client assets are subject as a result of such mortgage, charge, pledge or hypothecation does not exceed the aggregate amounts owed by the Clients to the Investment Firm.

i. How are the ownership rights of a Client over its Client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

As hypothecation of Client assets is subject to agreements between the Investment Firm and its' Client, the rights of a Client will depend on the terms and conditions of his agreement with the Investment Firm.

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

In respect of the lending of Client securities, the Investment Firm must explain the risks involved to the Client and obtain the Client's written consent. The Investment Firm is also required to disclose the terms and conditions of the loan arrangement to the Client.

iii. How are the ownership rights of a client over its client assets changed or affected when the investment firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (i.e. established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

If the Investment Firm uses Client assets without the Client's consent or where such use is not in accordance with the requirements of the SFA, the ownership of such Client assets (which should have been held in trust in favour of the Client under the requirements of the SFA) would rightfully be traced to the Client.

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

Under section 62 of the SFA, where the Investment Firm has notified the designated clearing house that the moneys or assets are deposited or paid for or in relation to a contract of a Client of the member, the designated clearing house shall:

(i) ensure that such moneys/assets are deposited in a trust/custody account to be held for the benefit of Clients of the member and disposed of or used only in relation to contracts of Clients of the member;

(ii) ensure that such moneys/assets are kept separate from all moneys/assets received by the designated clearing house which are not deposited or paid for or in relation to contracts of Clients of those members;

(iii) keep books for moneys/assets deposited in relation to the contracts of Clients of one firm separate from the books for moneys/assets deposited in relation to contracts of clients of another firm.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

In respect of the Client moneys and Client assets denominated in a foreign currency, the Investment Firm is permitted with the Client's prior consent, to deposit such moneys and assets in a trust or custodian account maintained with a foreign custodian. The foreign custodian must be licensed to conduct banking business or, in the case of the Client assets, to act as a custodian, in the country where the account is maintained.

a. Client Assets transferred to or located in other jurisdictions?

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

If so, please provide details of those requirements.

The same requirements for identification and protection of Client Assets apply to the Investment Firm regardless of whether the Assets are located in Singapore or other jurisdictions, or whether the Assets belong to Clients in Singapore or other jurisdictions.

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

   Investment Firms in Singapore are required to hold the Client Assets of Foreign Investment Firms in trust, and are permitted to hold them in Omnibus Accounts with other Client moneys/Client assets.

   a. What protections are applicable to the Foreign Investment Firm's Client Assets? The regulatory requirements and protection under the SFA/SFR similarly applies to Client Assets of Foreign Investment Firms.

   b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

      If the Foreign Investment Firm is an affiliate of the Singapore Investment Firm, the Foreign Investment Firm would need to designate its account opened with the Singapore Investment Firm as a Client account that is not maintained for the benefit of that related Foreign Investment Firm. Please also refer to our response to Q1 on definition of "Client".

   c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

      The SFA and SFR do not provide for a waiver of rights.

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

   a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

      Please refer to the response for Q1(a) above. Client Assets may be kept with an affiliate of the Investment Firm if the affiliate is itself a specified financial institution.

   b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

      Before placing its Client assets in a custody account with a custodian, the Investment Firm has to agree with the custodian in writing certain terms and conditions, including that the account being designated as that of the client or Clients; the custodian shall hold and record the assets in accordance with the Investment Firm's instructions; the records shall identify the assets as belonging

to the Client of the Investment Firm and the assets shall be kept separate from any asset belonging to the Investment Firm or to the custodian.

The custodian shall not claim any lien, right of retention or sale over any asset standing to the credit of the custody account, except —
(i) where the Investment Firm has obtained the Client's written consent and notified the custodian in writing of the written consent; or
(ii) in respect of any charges as agreed upon in relation to the administration or custody of the assets.

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

The following requirements apply:

(i) An Investment Firm which provides custodial services to its Clients is required to notify the Clients of the terms and conditions in respect of the custodial services;

(ii) An Investment Firm which assists its Clients to deposit their assets with another custodian is required to disclose to its Clients the terms and conditions agreed with the custodian before depositing the Clients assets in a custody account;

(iii) An Investment Firm which lends out Client securities as mentioned in the response to Q2(d) is required to explain the risks involved to the Client (unless the Client is an accredited investor) and obtain the Client's written consent; and

(iv) An Investment Firm which rehypothecates client securities has to abide by the terms and conditions in the Client agreement and custody agreement;

(v) An Investment Firm which deposits Client moneys and Client assets with a foreign custodian as mentioned in the response to Q4 is required to obtain the Client's prior written consent;

(vi) An Investment Firm which provides futures trading and leveraged foreign exchange trading is required to furnish a risk disclosure statement to the Client prior to account opening on, amongst others, the need to familiarize himself with the protection accorded to the Client asset deposited for foreign transaction, particularly in a firm's insolvency.

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

In general, the SFA and the SFR do not provide for any situation or condition under which Clients may waive the requirements.

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

An Investment Firm which is the holder of a CMS licence must report on a quarterly basis, the amount of money segregated in a trust account.

The information to be reported includes the amount and location of segregated funds, and be found via the following link:

http://www.mas.gov.sg/~/media/resource/legislation_guidelines/securities_futures/forms/SF_FMR_Form_1.ashx

a. Does the Investment Firm report where client assets are held?

Yes, please refer to response to Q8 above.

b. Does the Investment Firm or depository report the protections applicable to such client assets?

No.

c. Does the Investment Firm or depository report the amount of assets that are held?

Yes, please refer to response to Q8 above.

In each case, are such reports provided on request or periodically? If periodically, with what frequency?

Please refer to response to Q8 above.

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

a. Where Client Assets are held?

b. The amount of Client Assets held at a depository?

c. The safeguards applicable to Client Assets held at a depository?

MAS has the power to inspect the books of an Investment Firm who is the holder of a CMS licence under the SFA. In addition, as part of the annual auditors' report, the external auditor of an Investment Firm who is the holder of a CMS licence is required to confirm, inter-alia that the licensee has complied with the trust account requirements under the SFA and maintained proper records in relation to the safe custody of Client securities and Client assets.

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

    b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

    The foreign regulator may request assistance from the MAS and MAS may respond to the request subject to satisfaction of the conditions set out in the SFA.

    The foreign regulator may also inspect the books of the CMS licensee, subject to the satisfaction of the conditions set out in the SFA.

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

    Under the Singapore Securities and Futures (Financial and Margin Requirements For Holders of Capital Markets Services Licences) Regulations ["SF(FMR)R"], an Investment Firm which is the holder of a CMS licence must notify MAS and the approved exchange or designated clearing house of which the Investment Firm who is the holder of a CMS licence is a member when its
    (i) base capital falls below the base capital requirement; or
    (ii) financial resources fall below the total risk requirements or 120% of total risk requirements.

    The Investment Firm is also required to immediately inform MAS of any matter which may adversely affect its financial position to a material extent.

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*, capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

    For the scenarios under the SF(FMR)R mentioned in Q10, MAS may direct the Investment Firm who is the holder of a CMS licence to, inter-alia, transfer all or part of any client's positions, securities margins, collateral, assets and accounts to another Investment Firm who is the holder of a CMS licence; operate its business in such manner and on such conditions as MAS may impose; or to cease carrying on all or part of its business.

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

The provisions of the Singapore Companies Act (Cap. 50) ["CA"]apply to all companies in Singapore (unless expressly excluded), including Investment Firms. Our responses below focus on the requirements under the Singapore Companies Act and on the processes of liquidation and judicial management.

Judicial Management
The petition for judicial management of a company can be filed by the company or its creditors. The judicial manager attempts to rehabilitate the company or preserve all or part of its business of the company, if this better serves the interests of the creditors.

Winding up
A petition for winding up of the company can be filed by the company, its creditors or the company's judicial manager.

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

Judicial management:
Where the company or its creditors consider that the company is or will be unable to pay its debts, and there is a reasonable probability of rehabilitating the company; or of preserving all or part of its business as a going concern; or that otherwise the interests of creditors would be better served than by resorting to a winding up, an application may be made to the Singapore Court for an order that the company should be placed under the judicial management of a judicial manager.

In any application for a judicial management order, the applicant shall nominate a public accountant, who is not the auditor of the company, to act as its judicial manager. The Singapore Court may reject the nomination of the applicant and appoint another person in his stead. The Minister in charge of the CA may himself nominate a person to act as a judicial manager if he considers that the public interest so requires and in such a case the minister may be heard in support of his nomination and for this purpose be represented. Where a person is appointed by the Singapore Court or nominated by the Minister to act as a judicial manager that person need not be a public accountant.

Winding up:

For a creditors' voluntary winding up filed by the company, the company will appoint a liquidator subject to the preference of the company's creditors at a meeting of the company's creditors.

Any person who does not fall within a class of persons declared by the Minister in charge of the CA to be approved liquidators for the purposes of that Act, may apply to the Minister to be approved as a liquidator for the purposes of that Act. The Minister, if satisfied as to the experience and capacity of the applicant, may approve such person as a liquidator for the purposes of that Act.

If no liquidator is appointed, the Official Receiver ["OR"] shall summon separate meetings of the creditors and contributories of the company for the purpose of determining whether or not an application is to be made to the Singapore Court for appointing a liquidator in the place of the OR. The Singapore Court may make any appointment of an approved liquidator to be the liquidator of the company; in a case where a liquidator is not appointed by the Singapore Court, the OR shall be the liquidator of the company. The OR has control of all liquidators (such as those appointed by the members or creditors in voluntary winding up) and is the default liquidator of a company when no other liquidators have been proposed in a voluntary winding up.

16. What are the duties of the Administrative Officer?

a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

Judicial management:
The judicial manager of a company shall do all such things as may be necessary for the management of the affairs, business and property of the company; and shall do all such other things as the Singapore Court may order. He is also required to submit a statement of proposals on the management of the company within 60 days of the judicial management order.

Winding up:

The liquidator shall use his discretion in the management of the affairs and property of the company and the distribution of its assets. The powers and duties of the liquidator are expressly provided in the CA. The liquidator may appoint a solicitor to assist him in his duties and may apply to the Court for directions in relation to any particular matter arising under the winding up.

b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

Judicial management:
At any time when a judicial management order is in force, a creditor or member of the company may apply to the Singapore Court for an order on the ground that the company's affairs, business and property are being or have been managed by the

judicial manager in a manner which is or was unfairly prejudicial to the interests of its creditors or members generally or specifically; or that any actual or proposed act or omission of the judicial manager is or would be so prejudicial.

On an application for such order, the Singapore Court may make such order as it thinks fit for giving relief in respect of the matters complained of.

Winding up:
The Singapore Court shall take cognizance of the conduct of liquidators, and if a liquidator does not faithfully perform his duties and observe the prescribed requirements or the requirements of the Singapore Court or if any complaint is made to the Singapore Court by any creditor or contributory or by the OR in regard thereto, the Singapore Court shall inquire into the matter and take such action as it thinks fit.

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

    a. Does the regulator continue to supervise the Investment Firm?

    b. How, if at all, is the regulator involved in the process of returning Client Assets?

MAS will continue to supervise the Investment Firm as long as it is licensed by MAS.

MAS will work with the relevant parties, including the OR, if necessary.

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

The requirements set out in the SFA and the SFR, such as the deposit of customer's moneys in a trust account (regulation 16 of the SFR) would apply during the insolvency of an Investment Firm as long as the Investment Firm is still licensed under the SFA.

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

    a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

    b. What factors, if any, affect the time period required to accomplish such a transfer?

Under the SF(FMR)R, when MAS is notified by an Investment Firm who is the holder of a CMS licence or becomes aware that the base capital of an Investment Firm who is the holder of a CMS licence has fallen below the minimum requirement; or the financial resources of the Investment Firm who is the holder of a CMS licence have fallen below 120% of its total risk requirements, MAS may require the Investment Firm who is the holder of a CMS licence to transfer all or part of any

client's margins, collateral, assets and accounts to another Investment Firm who is the holder of a CMS licence.

There will be close monitoring to ensure that the transfer is done without undue delay.

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

In relation to a company which is being wound up, there are express provisions provided in the CA against transactions giving an undue preference, transactions at an undervalue, and fraudulent trading. Notwithstanding, the laws relating to the distribution of the assets of a person on insolvency, bankruptcy or winding up shall not interfere with finality of settlement of securities in accordance with the business rules of a designated clearing house.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

Under the Singapore Deposit Insurance Scheme, if a bank under the Scheme fails, the bank client's eligible accounts (which include deposits held in trust and client accounts on behalf of individual clients) are aggregated and insured up to S$50,000, net of the bank client's liabilities to the bank.

More information can be found at https://www.sdic.org.sg/

In addition, an Approved Exchange is required to set up a fidelity fund under the Singapore SFA. The fund is to be applied for the purpose of compensating any person (other than an accredited investor) who suffers a pecuniary loss because of a defalcation committed:

a) in the course of, or in connection with, a dealing in securities or trading in futures contract by a member of the Approved Exchange or an agent of the member;
b) in relation to any money or property received by the member or its agent for or on behalf of any person; or by the member either as the sole trustee or as trustee with any other person, or by its agent as trustee or for or on behalf of the trustees of that money or property.

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

This would depend on the terms and conditions of the Client's agreement with the CMS licensee.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

In a liquidation of the Investment Firm, the liquidator would claim the assets back from the foreign custodian for distribution to the clients. The return of such moneys and assets are subjected to the relevant laws and regulatory requirements in those jurisdictions.

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

A failure to comply with Client Asset protection requirements would amount to a breach of the requirements, subject to the appropriate regulatory action. MAS may take the necessary action to aid the recovery process.

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

Client Assets held in trust accounts belong to the customers, and creditors are not entitled to claim from the Client Assets. There is recent case authority which held in the particular winding up that the interim distribution of moneys to Clients be based on an equitable tracing principle. That is, a Client's entitlement to the available Client segregated moneys is determined on the basis of his respective contribution and interest in the available moneys as can be allocated and identified. As such, Clients whose moneys attributable to them but yet to be recovered by a liquidator would not receive any distribution as such unrecovered moneys would not be available in the Client accounts. Please note that decision of the High Court of Singapore which we have cited above would not be binding on subsequent cases of a failed investment firm and each case would be decided on its own facts and merits.

In the winding up of a company, the priority for payment of debts for creditors is expressly provided in the CA. Preferential creditors such as employees are paid ahead of other unsecured debts. All creditors of equal rank are paid pari passu in equal proportions.

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

    Please refer to the response to Q24 above.

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

**Acts**

1) Singapore Banking Act (Cap. 19)

2) Singapore Companies Act (Cap. 50)

4) Singapore Securities and Futures Act (Cap. 289)

http://statutes.agc.gov.sg/

**Regulations:**

1) Singapore Securities and Futures (Licensing and Conduct of Business) Regulations (Rg. 10)

2) Singapore Securities and Futures (Financial and Margin Requirements for Holders of Capital Markets Services Licences) Regulations (Rg. 13)

http://www.mas.gov.sg/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/Securities-Futures-and-Funds-Management.aspx

**Website**:

1) Singapore Deposit Insurance Corporation

https://www.sdic.org.sg/

# Spain

# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

    a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

Client assets is not a defined term in the Spanish Securities Markets Act (Ley 24/1988, del Mercado de Valores). Client assets are both, financial instruments and client money. Client money is any currency that a firm receives or holds for, or on behalf of, a client in connection with its investment business. Article 2 of Spanish Securities Markets Act establishes a definition of financial instruments as:

"1. Transferable securities issued by public or private persons or entities and grouped in issues. A transferable security will be defined as any patrimonial right, regardless of its name, which, because of its own legal configuration and system of transfer, is susceptible to being traded in a generalised impersonal way in a financial market.

For the purposes of this Act, the following will be considered to be transferable securities:

a) Shares of companies and transferable securities equivalent to shares, and any other type of transferable security giving entitlement to acquire shares or securities equivalent to shares through conversion or exercise of the rights inherent to them.

b) Participation shares ("*cuotas participativas*") of savings banks and "association participation shares" of the *Confederación Española de Cajas de Ahorros*.

c) Bonds, debentures and similar securities representing part of a debt claim, including those which are convertible or exchangeable.

d) Mortgage covered bonds, mortgage bonds and mortgage participations.

e) Asset-backed securities.

f) Units and shares in UCITS.

g) Money market instruments, i.e. categories of instruments which are normally traded on the money market, such as treasury bills, certificates of deposit and commercial paper, except those issued on a unique basis and excluding instruments of payment deriving from preceding commercial transactions that do not involve the capture of repayable funds.

h) Preference shares.

i) Territorial covered bonds.

j) Warrants and any other derivative transferable security giving the right to acquire or sell any other transferable security or giving the right to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities, credit risk or other indices or measures.

k) Any others which the law or regulations define as a transferable security.

l) Bonds of internationalization[28].

2. Options, futures, swaps, forward rate agreements and any other derivative contract relating to securities, currencies, interest rates or yields, or other derivative financial instruments, financial indices or financial measures which may be settled physically or in cash.

3. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event).

4. Options, futures, swaps, and any other derivative contract relating to commodities that can be settled by physical delivery provided that they are traded on a regulated market and/or a multilateral trading facility (MTF).

5. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that can be settled by physical delivery not otherwise mentioned in the preceding section of this article and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard, inter alia, to whether they are cleared and settled through recognised clearing houses or are subject to regular margin calls.

6. Derivative instruments for the transfer of credit risk.

7. Financial contracts for differences.

8. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in the preceding sections of this article, which have the characteristics of other derivative financial instruments, having regard, inter alia, to whether they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls…"

b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

Custody assets held by a firm may be registered in the name of the client, or the name of the firm when the assets are recorded in jurisdictions where "omnibus" accounts are permitted, but clients retain beneficial ownership of the assets at all times.

In the event of a firm insolvency, the Spanish Act 32/2011 has introduced a new article 12 bis within the Securities Markets Act about the right of withdrawal in the event of insolvency of the entities responsible for book-keeping or participants in the record-keeping system, and the pro rata rule.

In the event of insolvency of an entity responsible for the accounting of securities represented by book entries or of an entity participating in the record-keeping system, the holders of securities recorded in those registers will have the right to withdraw the securities registered in their name and to request their transfer to another entity.

The insolvency judge and the insolvency administrators will safeguard the rights deriving from the settlement operations under way at the time that the entity responsible for the accounting of securities by book entries or the member entity of the record-keeping system declares insolvency, according to the rules on clearing, settlement and record-keeping.

In any case, when the securities with the same International Securities Identification Number (ISIN) separated from the estate of the insolvent party are insufficient to completely fulfil the rights of the registered holders of the securities with the same ISIN, the shortfall will be distributed pro rata among all holders without prejudice to their right to claim for indemnity from the entity for the value of the part not paid in securities, which must be paid in money.

Where there are limited rights  or liens of any other kind on the securities, and without prejudice to agreements between the guarantor and the beneficiary of the guarantee, once the pro rata rule has been applied, such liens shall be understood to be apply to the result of the pro rata rule and the debt claims for the part not paid in securities.

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

Client is not a defined term in the Spanish Securities Markets Act but it means a person, individual and legal to whom a firm (which includes banks and investment firms) provides, intends to provide or has provided a services.

d. Please describe any notable exclusions from the terms "client" or "client assets."

None

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

Yes, because apart from banks, there are four types of investment firm: a) Sociedades de valores (Broker-dealers), b) Agencias de valores (Brokers), c) Sociedades gestoras de carteras (Portfolio management companies) and d) Empresas de asesoramiento financiero (Financial advisory firms) and the last two (Portfolio management companies and Financial advisory firms) cannot provide the ancillary service of safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management.

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

Apart from the types of licenses abovementioned, there is not special authorization required. Investment Firms that meet capital requirements (minimum initial capital of 300.000 euros and ongoing requirements foreseen in Capital Requirements Directive) can hold clients money and financial instruments, if that investment services are authorized. The Investment Firm must have adequate and proportionate internal procedures to control clients assets.

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

Standard procedures are applied by the Spanish Securities Commission to review clients assets, such a confirmation by financial intermediaries, clients, reconciliations, etc.

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

a. Must the Client Assets of one client be maintained separately from those of other clients?

i. Are Investment Firms allowed to hold Omnibus Accounts?

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

Client Assets have to be maintained separately from the assets of the Investment Firms. If client assets are hold in “omnibus” accounts, MiFID requires to ensure that client assets are kept

separately from the firm's assets. Accordingly, the firm is required to keep such records and accounts as are necessary to enable it, at any time and without delay, to distinguish client assets held for one client from client assets held for any other client, and from its own money. Investment firms must maintain its records and accounts in a way that ensures their accuracy, and in particular their correspondence to the client money held for clients.

Article 70 ter of Spanish Securities Markets Act provides:

1. "f) Take the appropriate measures to protect the financial instruments entrusted to them by clients and avoid improper use thereof. In particular, they may not use client financial instruments for their own account except with the client's express consent. They must also keep an effective separation between the company's securities and financial instruments and those of each client. The undertaking's internal records must make it possible to ascertain, at any time and without delay, and particularly in the event of the undertaking becoming insolvent, each client's position in terms of securities and pending transactions.

Once insolvency proceedings have commenced against a securities depository, the National Securities Market Commission, without prejudice to the powers of the Bank of Spain, may immediately transfer, to another undertaking authorised to perform this activity, the securities deposited in clients' names, even if those assets are deposited at third entities in the name of the undertaking providing the depository service. For these purposes, both the competent judge and the bodies involved in the insolvency proceedings shall provide the entity to which the securities are to be transferred with access to the documentation and the accounting and computer entries necessary to make the transfer effective. The insolvency proceedings shall not prevent the clients who own the securities from receiving the cash generated by the exercise of their economic rights or their sale."

2. "c) Take the appropriate measures, in connection with the securities and funds entrusted to them by clients, to protect their rights and avoid improper use of the securities. Undertakings may not use clients' funds for their own account apart from exceptional cases that may be established by secondary legislation, and only with the client's express consent. The undertaking's internal records must make it possible to ascertain each client's position in terms of funds at any time and without delay, and particularly in the event of the undertaking becoming insolvent."

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

As this regards and for the purposes of safeguarding clients' rights in relation to financial instruments and money belonging to them, investment firms must comply with the following requirements:

(a) they must keep such records and accounts as are necessary to enable them at any time and without delay to distinguish assets held for one client from assets held for any other client, and from their own assets.

(b) they must maintain their records and accounts in a way that ensures their accuracy, and in particular their correspondence to the financial instruments and funds held for clients.

(c) they must conduct, on a regular basis, reconciliations between their internal accounts and records and those of any third parties by whom those assets are held.

(d) they must take the necessary steps to ensure that any client financial instruments deposited with a third party are identifiable separately from the financial instruments belonging to the investment firm and from financial instruments belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection.

(e) they must take the necessary steps to ensure that client funds deposited in a central bank, a credit institution or a bank authorised in a third country or a qualifying money market fund are held in an account or accounts identified separately from any accounts used to hold funds belonging to the investment firm.

(f) they must introduce adequate organisational arrangements to minimise the risk of the loss or diminution of client assets, or of rights in connection with those assets, as a result of misuse of the assets, fraud, poor administration, inadequate record-keeping or negligence.

In case of insolvency, as a general rule, securities and financial instruments of any type of clients are segregated from financial intermediaries positions. On the other hand, in spite of individual accounts, money may not be segregated from the rest of creditors and it may depend on the judge consideration. However, money accounts are covered by the ICS up to the limit of 100.000 euros. These rules apply to every type of securities or financial instruments, no matter if it is traded on a regulated market or not (OTC).

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

We do not need a calculation, the sum of total clients money and financial instruments must be held in separate accounts.

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

See answer 1.b.

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

Both, on an aggregate and on a client-by-client basis.

C) If a client has a debit balance (*i.e.*, the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold?

Yes, this debit must be deducted.

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

Reconciliations must be performed as often as necessary.

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

No, total amount of clients assets must be held in segregated accounts. Apart from that, Investment Firms must maintain an additional 10 per 100 of all short term credits (liquidity coefficient).

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

See answer 3.a.

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

iii. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets without such client's consent? What is the basis for that conclusion (*i.e.*, established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

See answer 1.b.

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

CCPS or CH must held recorded any collateral posted to any financial instruments.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

   a. Client Assets transferred to or located in other jurisdictions?

   b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

   If so, please provide details of those requirements.

Investment firms must take the necessary steps to ensure that client funds or securities deposited in a third country are held in an account identified separately from any accounts belonging to the investment firm.

If the safekeeping of financial instruments for the account of another person is subject to specific regulation and supervision in a jurisdiction where an investment firm proposes to deposit client financial instruments with a third party, the investment firm cannot deposit those financial instruments in that jurisdiction with a third party which is not subject to such regulation and supervision. Additionally, investment firms cannot deposit financial instruments held on behalf of clients with a third party in a third country that does not regulate the holding and safekeeping of financial instruments for the account of another person.

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets deposited in an Omnibus Account by Investment Firms in other jurisdictions ("Foreign Investment Firms")? If so,

   a. What protections are applicable to such Client Assets?

   b. What steps, if any, must the Foreign Investment Firm take to secure such protections for such Client Assets?

   c. What steps may the Foreign Investment Firm take that will reduce such protections? What is the impact if the Foreign Investment Firm takes such steps?

See answer 4.

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

   a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

   b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

See answer 4.

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

If the investment firms holds clients financial instruments or money, they must provide retail clients or potential retail clients with such of the following information:

a) A summary description of the steps which it takes to ensure their protection, including summary details of any relevant investor compensation or deposit guarantee scheme which applies to the firm.

b) Inform the retail client or potential retail client where the financial instruments or funds of that client may be held by a third party on behalf of the investment firm and of the responsibility of the investment firm for any acts or omissions of the third party and the consequences for the client of the insolvency of the third party.

c) Where financial instruments of the retail client or potential retail client may be held in an omnibus account by a third party, the investment firm shall inform the client of this fact and shall provide a prominent warning of the resulting risks.

d) The investment firm shall inform the retail client or potential retail client where it is not possible under national law for client financial instruments held with a third party to be separately identifiable from the proprietary financial instruments of that third party or of the investment firm and shall provide a prominent warning of the resulting risks.

e) The investment firm shall inform the client or potential client where accounts that contain financial instruments or funds belonging to that client or potential client are or will be subject to the law of a jurisdiction other than that of a Member State of the EU and shall indicate that the rights of the client or potential client relating to those financial instruments or funds may differ accordingly.

f) An investment firm shall inform the client about the existence and the terms of any security interest or lien which the firm has or may have over the client's financial instruments or funds, or any right of set-off it holds in relation to those instruments or funds. Where applicable, it shall also inform the client of the fact that a depository may have a security interest or lien over, or right of set-off in relation to those instruments or funds.

g) An investment firm, before entering into securities financing transactions in relation to financial instruments held by it on behalf of a retail client, or before otherwise using such financial instruments for its own account or the account of another client, shall in time, before the use of those instruments, provide the retail client, in a durable medium, with clear, full and accurate information on the obligations and responsibilities of the investment firm with respect to the use of those financial instruments, including the terms for their restitution, and on the risks involved.

Investment firms must provide professional clients with the information referred in paragraph e) and f) in time, before the provision of the service concerned.

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

A retail client, who meets some particular requirements in terms of experience, knowledge and portfolio, can waive specific protections for retail customers (opting out), in such case no protection of compensation scheme is applied to their assets (treated as professional), and vice versa, professionals can ask to be treated as retail (opting in). On both cases, it should be made in writing.

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

   a. Does the Investment Firm report where client assets are held?

   b. Does the Investment Firm or depository report the protections applicable to such client assets?

   c. Does the Investment Firm or depository report the amount of assets that are held?

   In each case, are such reports provided on request or periodically? If periodically, with what frequency?

On a monthly basis, Sociedades de valores (Broker-dealers) and Agencias de valores (Brokers) report information to the securities regulator about clients financial instruments. The report does not specify in which intermediaries are deposited the clients securities or cash, apart from the intermediary itself. The total amount of clients financial instruments and money are reported.

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

    a. Where Client Assets are held?

    b. The amount of Client Assets held at a depository?

    c. The safeguards applicable to Client Assets held at a depository?

No Self-Regulatory Organizations have powers to conduct inspections, examinations or audits.

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

    b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

Deposit of clients assets in Spain must be recorded on behalf of the client or clients, no "omnibus" accounts are permitted.

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

A firm would be required to notify the Spanish Securities Market Commission of any material changes in their financial position or ability carry on business. This does not have to be communicated to the market. Investment Firms must apply for a recovery plan if capital fall below 20 per 100 of its capital requirements.

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*¸ capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

Whether a firm´s financial situation is deteriorating or it drops below minimum capital thresholds, the Securities Market Commission will consider what is the appropriate course of action in the particular circumstance. The most usual orders are to require the firm to raise new capital, remove the firm's licenses, require the firm to transfer business, return client assets or enter insolvency proceedings.

See answer 12.

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

Any of the described persons, Investment Firm, Securities Market Commission or creditors can apply a judge for insolvent procedures.

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

The administrator is appointed by the Court based in the Securities Market Commission proposal and must have proper qualifications and experience on insolvency procedures.

16. What are the duties of the Administrative Officer?

    a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

Insolvency Practitioners have to transfer clients assets, if it have not been made previously by Regulator, and have to propose to the Court a distribution of the remaining assets to creditors.

b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

Insolvency Practitioners who are appointed as administrators or liquidators have total personal liability.

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

a. Does the regulator continue to supervise the Investment Firm?

Yes, the Investment Firm remains an authorised person and is still subject to supervision by the Securities Market Commission till its license is revoked.

b. How, if at all, is the regulator involved in the process of returning Client Assets?

The Securities Market Commission is not directly involved in the process of returning Client Assets, that is the role for the administrator or liquidator. The Court may ask the Securities Market Commission advice on matters related to the securities market.

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

See answer 1.b.

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

b. What factors, if any, affect the time period required to accomplish such a transfer?

Yes, see answer 1.b. The Securities Market Commission can order the transfer of Client Assets.

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

The Court is able to determine the date that looks back to the insolvency procedure.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

In case of insolvency, as a general rule, securities and financial instruments of any type of clients are segregated from financial intermediaries positions. On the other hand, in spite of individual accounts, money may not be not segregated from the rest of creditors and it may depend on the judge consideration. However, money accounts are covered by the Investors Compensation

Scheme (ICS) up to the limit of 100.000 euros. These rules apply to every type of securities or financial instruments, no matter if it is traded on a regulated market or not (OTC).

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

Investment firms cannot enter into arrangements for securities financing transactions in respect of financial instruments held by them on behalf of a clients, or otherwise use such financial instruments for their own account or the account of another client of the firm, unless the following conditions are met:

(a) the client must have given his prior express consent to the use of the instruments on specified terms, as evidenced, in the case of a retail client, by his signature or equivalent alternative mechanism;

(b) the use of that client's financial instruments must be restricted to the specified terms to which the client consents.

Additionally, investment firms cannot enter into arrangements for securities financing transactions in respect of financial instruments which are held on behalf of a client in an omnibus account maintained by a third party, or otherwise use financial instruments held in such an account for their own account or for the account of another client unless, in addition to the conditions set out in the previous paragraph 1, the following conditions are met:

(a) each client whose financial instruments are held together in an omnibus account must have given prior express consent in accordance with point (a) of previous paragraph;

(b) the investment firm must have in place systems and controls which ensure that only financial instruments belonging to clients who have given prior express consent in accordance with point (a) of previous paragraph are so used.

The records of the investment firm shall include details of the client on whose instructions the use of the financial instruments has been effected, as well as the number of financial instruments used belonging to each client who has given his consent, so as to enable the correct allocation of any loss.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

See answer 22.

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

See answer 1.b. pro rata criterion applies to instruments of the same category.

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets,

are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

Pro rata distribution criteria is applied.

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

There is not distinction about domestic or foreign creditors. Clients whose securities or money are not fully paid can apply to the ICS. If the amount held by the client is above 100.000 euros (amount covered by ICS) the client will be categorized as normal creditor.

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

Securities Markets Act 24/1988.

Insolvency Law 22/2003.

# Turkey
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

    a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

    *Client assets are defined as money, securities and positions which are held or controlled by authorized investment firms for investment purposes on behalf of their clients. Client assets include the cash and convertible foreign exchange in investors accounts and all the returns and rights gained through these accounts, as well as securities such as stocks, government bonds and treasury bills, participation certificates of mutual funds, gold and other valuable items having the determined standards, and assets those may be specified by the Board. All the positions related to the forex trading and derivative transactions are also included in the client assets.*

    b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

    *In our jurisdiction, most capital market instruments, including stocks, bonds, mutual funds and warrants are dematerialized and centrally registered at the level of beneficial owner in a central securities depository, named "Central Registry Agency" (CRA).*

    *In this respect, investors open investment accounts in their names at Central Registry Agency participant investment firms in order to invest in capital market instruments, and the instruments they acquire as a result of their trades are deposited in the accounts opened by CRA. By this way, clients have the facility to control their accounts through the electronic system of the Central Registry Agency.*

    *The ownership rights arising from the dematerialized instruments can be used by the participants and owners of capital market instruments through the services supplied by the CRA, such as dividend*

*distributions and redemptions, rights issues, participation to general assembly meetings, pledges.*

*Client assets in cash are hold in a bank account opened in the name of the investment firm, but these assets shall be kept separately from the assets of the investment firm. Every client has a cash account by the investment firm and client assets in cash are kept in these segregated accounts. The proceeds of the client assets in cash deposited in a bank account in the name of the investment firm shall be distributed to the accounts proportionately.*

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

*Clients are individuals or legal entities who open accounts by investment firms for investment purposes through signing contracts.*

*Currently, there is no final legislation or rule that have been adopted on client categorization; but the draft is underway. After the new Capital Markets Law enter into force, our related draft will be adopted. According to this regulation, clients will be separated into two groups as individual and professional depending on certain qualifications.*

d. Please describe any notable exclusions from the terms "client" or "client assets."

*There is no notable exclusion from the terms "client" and "client assets". However, the payables to related persons even if they are clients, are subject to a different regime in the post-solvency period. The related persons are defined to include shareholders, members of the board of directors or board of auditors, personnel authorized to sign and their spouses, blood relatives and relatives by marriage including the third degree.*

In answering the remaining questions:

*(1)* Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:

a. Categories of Client Assets;

b. Models of trading (e.g., exchange-traded versus over-the-counter).

c. Categories of clients (e.g., retail versus sophisticated)

*(2)* You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through, e.g., informal arrangements between governmental entities.

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

*According to the current regulations, investment firms which are licensed to conduct capital market activities by the CMB, do not need to be specifically authorized to hold client assets. However, in the draft Capital Market Law which is expected to enter into force in 2012, safekeeping and administration of client assets for the account of clients is defined as an investment service and will be subject to special authorization.*

a. If special authorization is required, what requirements (both initial and ongoing) are an Investment Firm required to comply with to hold such authorization?

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

*As mentioned above, in Turkey, most capital market instruments, including stocks, bonds, mutual funds and warrants are dematerialized and centrally registered at the level of the beneficial owner in a central securities depository, named "Central Registry Agency" (CRA). By this way, clients have the facility to control their accounts through the electronic system of the CRA.*

*Client assets as cash are deposited in a bank account by the investment firm in its own name but kept separately from its own assets and recorded to segregated client accounts within the investment firm.*

*Cash collaterals of clients related to derivatives traded on TURKDEX, forex transactions and collaterals related to borrowing and lending of securities for the transactions executed on Securities Lending and Borrowing Market which is operated by the ISE Settlement and Custody Bank (Takasbank) shall be kept in Takasbank on a client basis.*

*The accounts of investment firms are subject to independent auditing on a 6-month basis. Besides, general ledger and capital adequacy reports of the investment firms are audited in detail by the CMB every 6 months. These audits include the verification of availability of the client assets.*

*Furthermore, on the occasions of on-site inspections, the expert personnel of the CMB check the presence of client assets and the consistency of the records of the investment firm and those of the custodian.*

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description

of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

*Yes, under our legal framework, client accounts must be clearly defined for the names of the clients and said accounts cannot be used for any other purposes by the investment firms. According to the Article 47 of the Capital Market Law, selling or creating a pledge or using in whatever manner for the benefit of someone other than the owner, capital market instruments, cash or other assets of any kind which are consigned or delivered physically or by registration to investment firms, is defined as a crime and the people accused to commit this crime shall be punished with a prison sentence of from two to five years and a heavy pecuniary fine.*

*For the details of the maintenance of client assets separate from those of the investment firm, see the answer given to the question 1-b.*

a. Must the Client Assets of one client be maintained separately from those of other clients?

*As mentioned above, dematerialized instruments must be deposited in the accounts which are opened on a client-by-client basis by CRA. Therefore, these instruments are subject to a full-segregation. Every client may monitor her assets by checking her account by the CRA.*

*Client assets as cash are deposited in a bank account by the investment firm in its own name in a single account, however these assets must be recorded to segregated client accounts within the investment firm.*

i. Are Investment Firms allowed to hold Omnibus Accounts?

*Investment firms are allowed to hold omnibus accounts only in activities as white labels of other investment firms, related to forex trading and intermediation to trading in foreign markets. According to our regulation on forex trading, investment firms may only be white labels of investment firms established in Turkey and authorized by the CMB.*

*In these activities, investment firms accept orders as representatives and transmit such orders to other institutions to be executed. The trades are recorded in an omnibus account opened by the market-maker institution, and distributed to client accounts opened by the white label investment firm.*

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

*Investment firms shall not use assets of a client for the benefit of another client, such as hypothecating a client's assets for the loan of another client. In this aspect, in the independent audits and on-site inspections executed by the CMB, distribution of proceeds of assets to client accounts,*

*correspondence of loans used by clients and the assets collateralized for these loans are examined.*

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

*Investment firms are obliged to send monthly reports to their clients regarding their accounts. In these monthly reports, all trades, assets and/or liabilities and overall of the clients must be properly shown. Clients may object to the information laid in these reports.*

*In addition, according to our regulation on internal control systems of investment firms, Serial: V, No: 65 "Communiqué On Principles Regarding The Internal Auditing Systems Of Brokerage Houses", investment firms shall determine a procedure about reconciling with their clients. In this procedure, issues such as the timing, manner and medium of reconciliations shall be specified.*

*Furthermore, if an investment firm's capital market activities are permanently stopped by the Board at its own will, that investment firm is obliged to reconcile with its clients and return all of the client assets. Assets of the clients with whom the investment firm could not reconciled with, shall be kept in the Settlement and Custody Bank.*

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

*As mentioned above, in Turkey, most capital market instruments, including stocks, bonds, mutual funds and warrants are dematerialized and centrally registered at the level of beneficial owner in CRA. By this way clients have the facility to control their accounts through the electronic system of the CRA.*

*Client assets as cash are deposited in a bank account by the investment firm in its own name but kept separately from its own assets and recorded to segregated client accounts within the investment firm.*

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

*Reconciliation is conducted on a client-by-client basis. Investment firms send reports to their clients in which the overall state of each client account is present. Clients examine these reports and confirm the information laid in the reports; they sign them and send back to the investment firm.*

C) If a client has a debit balance (i.e. the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

*For the cash accounts, netting can be made only on a client-by-client basis. For the margin accounts, also this netting is forbidden.*

*No, a client's debit balance would not reduce the firm's obligations with respect to the total required funds for credit balances of other clients. The netting cannot be made on total basis. For example, according to the provisions of the CMB of Turkey, investment firms shall keep the records of the monetary results of the transactions of the clients to a current account. However this account shall not be netted on total basis, in can only be netted on client basis that, the debit balance of this account reveals the amount clients owe to the investment firm and the credit balance of it reveals the investment firm's obligations to the clients. Investment firms are obliged to keep the amount equal to the credit balance of such account as liquid assets, to be able pay to the clients when demanded.*

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

*The timing of the reconciliation shall be specified in the internal control procedures of the investment firms and may be stated in the framework agreement concluded between the investment firm and the client.*

*On the other hand, account statements shall be sent to clients monthly.*

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

*Account statements shall be sent to the clients in seven days following the related month.*

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

*In the case of an existence of a deficiency in client assets due to the fault of the investment firm, investment firm may be required to make good the deficiency. Such a decision can be taken by the arbitrators or the Court.*

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

*The assets of the investment firms and those of the clients shall be separated. Investment firms are not required or encouraged to maintain any of their own assets in a client asset account.*

d. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

*No, investment firms cannot use client assets for meeting obligations of another client.*

d.Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

*According to Serial:V,Number:46 "Communiqué On Principles Regarding Intermediary Activities and Intermediary Institutions" client assets shall be kept separately from the assets of the investment firm and investment firms cannot use the capital market instruments and the cash assets of a client for their own benefit or for the benefit of third parties.*

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

*In our regime, in the case of a client's giving consent to an investment firm permitting re-hypothecation of his/her assets, general provisions of property law pertinent to encumbrances apply.*

*To illustrate, upon the consent of a client, if an investment firm hypothecates the stocks of its client as collateral for a loan for own benefit and fails to repay the loan, the creditor may exercise its rights arising from the property law on hypothecated assets.*

*However, if the consent of the client is for borrowing and lending operations of the capital market instruments, special provisions apply.*

*According to the Serial: V, No: 65 "Communiqué on Principles Regarding the Internal Auditing Systems Of Brokerage Houses", investment firms can undertake borrowing and lending of capital market Instruments by signing a contract with their clients.*

*Within the borrowing and lending period, if the issuing corporation pays dividend or interest for the borrowed capital market instruments prior to their delivery , related payments shall be made to the lender by the borrower within the framework of the provisions of the contract of*

*engagement. Prior to delivery of shares sold short to the lender, if rights issues and bonus issues of shares due to capital increase by the issuing corporation occur, the obligations of parties shall be determined freely under the provisions of the contract of engagement.*

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

*A client's consent to permit an investment firm to use her assets must be stated in a written form. In borrowing and lending of capital market instruments a contract of engagement shall be signed between the parties.*

iii. How are the ownership rights of a client over its client assets changed or affected when the investment firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (i.e. established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

*Pre-insolvency or bankruptcy, where a client consents to the investment firm's re-hypothecating his/her assets, general provisions of property law related to encumbrances will apply.*

*Generally, where an investment firm hypothecates a client's stock as collateral for repayment of the investment firm's loan (and subsequently fails to repay the loan), the creditor may exercise rights arising from the property law on hypothecated assets.*

*However, upon the complaint of the client or recognition of the state by the CMB, the investment firm would be inspected in the frame of the Article 47-A-5 of the Capital Market Law, on capital market institutions' using client assets for own benefit. According to the Article 47-A-5 of the Capital Market Law, authorized persons of investment firms who sell or create a pledge or use in whatever manner for the benefit of themselves or someone else, client assets shall be punished with a prison sentence and a heavy pecuniary fine.*

*A client, whose assets are used or re-hypothecated without his/her consent, may file a debt case against the investment firm and his/her loss would be remedied with the decision of the court.*

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

*In Turkey, for the derivative instruments which are traded on the Turkish Derivatives Exchange, TURKDEX, Takasbank is assigned as the Clearing House. Takasbank executes clearing and settlement by a Mark to Market Process which is performed daily on related account basis. So as a central counterparty, Takasbank collects and valuates collaterals client-by-client and interrelates the trades and the collaterals on an account basis.*

*In forex transactions, Takasbank does not act as a central counterparty, however investment firms are obliged to keep the collaterals of the clients in the segregated accounts opened by Takasbank.*

*Furthermore, collaterals related to borrowing and lending of capital market instruments for the transactions executed on Securities Lending and Borrowing Market which is operated by Takasbank are also deposited in Takasbank.*

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:
    a. Client Assets transferred to or located in other jurisdictions?
    b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?
    c. If so, please provide details of those requirements.

*According to the Article 52 of the Communiqué on Principles Regarding Intermediary Activities and Intermediary Institutions, investment firms can undertake intermediation of securities and other capital market instruments in foreign markets of either by becoming member of an exchange or an organized market abroad or through intermediary institutions authorized in accordance with the legislation of the related country.*

*Within the scope of the intermediation in trading in foreign markets, investment firms may hold client assets in a foreign investment firm authorized by the competitive authority of the related jurisdiction. In this case, clients must fully be informed of the state and the legislation and protection they are subject to.*

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,
    a. What protections are applicable to the Foreign Investment Firm's Client Assets?
    b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

*In Turkey, foreign investment firms open omnibus accounts with the domestic investment firms and the Central Registry Agency to trade on the Istanbul Stock Exchange (ISE) and TURKDEX.*

*Foreign investment firms are required to provide written confirmation that they will provide information on the identities of the customers on behalf of whom the transactions are to be made.*

*However, foreign investment firms avoid giving information on details of the identity of their clients.*

*Omnibus accounts are subject to protection on a total basis.*

*A foreign regulator with jurisdiction over foreign investment firms holding client assets in Turkey may request information on such client assets from investment firms in Turkey or the CMB within the frame of Memorandum of Understanding signed between the authorities if it exists, or on the grounds of reciprocity.*

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

*As mentioned above, in Turkey, most capital market instruments, including stocks, bonds, mutual funds and warrants are dematerialized and centrally registered in CRA.*

*Client assets as cash are deposited in a bank account by the investment firm in its own name but kept separately from its own assets and recorded to segregated client accounts within the investment firm.*

*Cash collaterals of clients related to derivatives traded on TURKDEX, forex transactions and collaterals related to borrowing and lending of securities shall be kept in Takasbank on a client basis.*

*Takasbank is a user-owned, sector specific, non-deposit taking investment bank, with the ISE as the largest shareholder and regulated and supervised by the CMB on the basis of Capital Market Law.*

*The Central Registry Agency is a private legal entity established under the CML. CRA provides registry and post trading services for equities, corporate debt securities, warrants, ETFs and mutual funds for all beneficiary owners. The Central Dematerialized System (CDS) is the main system of the CRA.*

*Takasbank and the CRA has full creditworthiness.*

*A lien or encumbrance, on the client assets held in these institutions, can only be placed upon a court decision.*

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

*According to the Serial: V, No: 46 "Communiqué on Principles Regarding Intermediary Activities and Intermediary Institutions", investment firms must conclude a framework agreement with their clients prior to providing investment services as sales and purchase, portfolio management, investment consultancy, repo and reverse repo agreements, intermediation in sales of derivative instruments, margin trading, lending and borrowing of securities and short sales. The minimum aspects to be included in this agreement shall be determined by the Board. According to the Resolution of the Executive Board of CMB on framework agreements, these agreements must include disclosures related to the protection of clients assets.*

*If the client assets are hold in a foreign jurisdiction due to trading in foreign markets, the rights and liabilities of the client as well as the scope of the protection in the involved foreign jurisdiction must be disclosed in the framework agreement.*

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

*Currently, there is no final legislation or rule that have been adopted on client categorization but the draft legislation is underway and it will be adopted after the new Capital Markets Law enters into force. According to the draft regulation, clients will be separated into two groups depending on certain qualifications as individual and professional. Individual and professional clients will be subject to different protection requirements.*

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

   a. Does the Investment Firm report where client assets are held?

   b. Does the Investment Firm or depository report the protections applicable to such client assets?

   c. Does the Investment Firm or depository report the amount of assets that are held?

In each case, are such reports provided on request or periodically? If periodically, with what frequency?

*According to "Serial No:V, No:34 Communiqué on Principles Regarding Capital and Capital Adequacy of Brokerage Houses", investment firms are obliged to send their capital adequacy reports to the CMB in the periods determined by the Board. Currently, investment firms electronically send their general ledger and reports related to the capital adequacy requirements on a weekly basis. In these reports, the amount of the client assets and where they are held are shown.*

*Furthermore, the accounts of investment firms are subject to independent auditing on a 6-month basis. These audits include the verification of availability of the client assets.*

*On the occasions of the audits of the accounts of the investment firms in detail every 6 months and on-site inspections, the expert personnel of the CMB check the presence of client assets and the consistency of the records of the investment firm and those of the custodian.*

*Additionally, the custodian of the collaterals related to forex trading, the Takasbank sends periodical reports on forex accounts to the CMB.*

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

    a. Where Client Assets are held?

    b. The amount of Client Assets held at a depository?

    c. The safeguards applicable to Client Assets held at a depository?

    *See the answer to the question 9.*

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

    b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

    *In Turkey, foreign investment firms open omnibus accounts by the domestic investment firms and Central Registry Agency in order to trade on Istanbul Stock Exchange (ISE) and TURKDEX.*

    *According to our regulations on investment services and prevention of money laundering, investment firms are obliged to request from foreign investment firms*

*to provide with a written commitment that they would provide information on the identities of the customers on behalf of whom the transactions are to be made. However, foreign investment firms avoid giving information on details of the identity of their clients.*

*In this case, omnibus accounts are subject to protection on a total basis.*

*A foreign regulator with jurisdiction over foreign investment firms holding client assets in Turkey may request information on such client assets from investment firms in Turkey or the CMB within the frame of Memorandum of Understanding signed between the authorities if exists, or on the grounds of reciprocity.*

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

*According to "Serial:V, No:34, Communiqué on Principles Regarding Capital and Capital Adequacy of Brokerage Houses" investment firms shall calculate, the risk provision envisioned in the and are obliged to prepare the mentioned tables in the calculation period determined by the Board, to submit these to the Board in the envisioned period and to file these in their headquarters.*

*In case own funds, initial capital or liquidity requirements fall below the minimum amounts mentioned in this Communiqué or in case the borrowing ratio surpasses the ratio envisioned in the Communiqué, they shall immediately notify the state to the CMB.*

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*¸ capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

*According to the Article 46 of Capital Market Law, The Capital Market Board is authorized to request the strengthening of the financial situations within a suitable period that shall be given in case it is determined that the financial structure of a capital market institution has become weakened significantly; to restrict or remove the signature authorities of the employees of such institution; to take the needed measures in case it is determined that the needed measures are not taken by these institutions within this period that is given or their financial situations have become weakened to the extent that they shall not be able to meet their commitments, to stop temporarily the operations of these institutions without giving any period of time or to stop them permanently and remove their authorities; to make a decision for gradual liquidations in case these measures do not produce results and to request direct bankruptcy without gradual liquidation or when needed following the conclusion of liquidation.*

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

    *As mentioned in the answer of the previous question, The Capital Market Board is authorized to request the strengthening of the financial situations within a suitable period that shall be given in case it is determined that the financial structure of a capital market institution has become weakened significantly; to restrict or remove the signature authorities of the employees of such institution; to take the needed measures in case it is determined that the needed measures are not taken by these institutions within this period that is given or their financial situations have become weakened to the extent that they shall not be able to meet their commitments, to stop temporarily the operations of these institutions without giving any period of time or to stop them permanently and remove their authorities; to make a decision for gradual liquidations in case these measures do not produce results and to request direct bankruptcy without gradual liquidation or when needed following the conclusion of liquidation.*

    *The objective of gradual liquidation is to liquidate the cash payments and the delivery obligations of capital market instruments to the customers due to the capital market operations carried out in the framework of the Capital Market Law by setting aside the amount obtained by transforming the assets to in kind or cash according to their attributes. Process is different from other financial institutions and in the decision and operations of gradual liquidation, the provisions related to liquidation in the Turkish Commercial Code, the Execution and Bankruptcy Law and the other legislation shall not be applied. The principles and method of application for gradual liquidation of intermediary institutions shall be set forth in a regulation promulgated by The Capital Market Board.*

    *The assets of the capital market institutions, the authority of which has been permanently removed, shall not be transferred to third persons, or used as security, or listed as guarantees, and shall not be attached, and all the legal actions for collection of debts which have been started shall automatically be stopped from the date The Capital Market Board decides to remove the authority until it is announced that the gradual liquidation procedures have been completed and from the time of registration to the judgment by the court of the request for bankruptcy, in case direct bankruptcy is requested or following gradual liquidation, excluding transactions that shall be made by The Capital Market Board and the Investors' Protection Fund in the framework of gradual liquidation.*

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

*A decision may be made by the Board for the gradual liquidation of investment firms, the authorities of which have been removed in accordance with subparagraph (h) of the first paragraph of Article 46 of the Capital Market Law. The liquidation operations of these institutions shall be carried out by the Investors' Protection Fund.*

*After a decision is made for gradual liquidation, the duties and authorities of the legal organs of the investment firm shall be carried out by the Fund until the liquidation is concluded.*

*The Investors' Protection Fund having legal entity has been established with the objective of meeting the liquidation expenses and to carry out the functions provided above in accordance with the principles envisioned in Capital Market Law with respect to intermediary institutions for which a gradual liquidation or bankruptcy decision is made and, on the condition that the provisions of the Banking Law are reserved, the banks in the scope of paragraph (a) of Article 50 of Capital Market Law the operations of which are stopped by a decree of the Council of Ministers, to cover the cash payment and share delivery obligations arising from share transactions for their customers due to capital market operations and transactions in which they engaged. All investment firms are required to participate in this Investors' Protection Fund.*

*The Fund shall be managed and represented by CRA that is in charge of keeping records of capital market instruments, in accordance with the provisions of the Capital Market Law. Decision making body of the Fund is the decision making body of CRA. The Fund-related activities and transactions shall be managed and executed by a separate unit to be organized in CRA.*

16. What are the duties of the Administrative Officer?

*Payments by the intermediary institution for which a gradual liquidation decision is made shall be stopped and as of the date of this decision all its assets may be used only by the Fund. The Fund shall determine the assets and liabilities of the intermediary institution. The cash debts in the scope of the obligations that should be liquidated shall be calculated over the total principal capital and accrued interests at the date of the decision of gradual liquidation; with respect to the obligation to deliver capital market instruments, in cases where it cannot be delivered in kind, the debt shall be calculated based on the market value on the date the delivery went into default otherwise the day that the decision is made for gradual liquidation. The rights and obligations arising from contracts with maturity dates after the date of the decision for the gradual liquidation of the intermediary institution shall be determined as of their maturity dates. Legal default interest shall be applied at the rate envisioned in the third paragraph of Article 2 of Law No. 3095 Related to Legal Interest and Default Interest as of the maturity date of term debts and as of the date of the gradual liquidation decision for the other debts. In accordance with the legislation, guarantees given by the intermediary institution are also taken into consideration in the assets account.*

*The Fund shall determine the real holders of rights and the amounts of their receivables which are in the scope of liquidation of the intermediary institution based*

*on the records kept by the Board, the records of the intermediary institution, the records of other official and private institutions related to these organizations and other reliable information and documents. In case there is the existence of the conditions described in Articles 278, 279 and 280 of the Execution and Bankruptcy Law, an annulment lawsuit may be opened by the Fund.*

a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

   *See the answers to the questions 14-16.*

b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

   *The Investors' Protection Fund shall prepare and issue monthly reports containing a detailed breakdown of The Investors' Protection Fund properties and assets by types thereof, and information about intermediary institutions in liquidation process and the collections and payments in connection therewith, and shall submit these monthly reports to The Capital Market Board.*

   *Furthermore, The Board is authorized to inspect and audit the accounts and transactions of the Fund and to request all kinds of information and documents from the Fund in relation therewith. Depending on the results of inspection and audit, the Board may request the Fund to take certain actions, and if required, may demand the Minister, to whom the Board reports, to transfer the Fund management to the Board.*

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

    a. Does the regulator continue to supervise the Investment Firm?

       *After taking the decision of gradual liquidation of an investment firm, CMB notify to Central Registry Agency, Istanbul Stock Exchange, the Takasbank and to Investors' Protection Fund for initiation and conduct of the liquidation procedures.*

       *Upon a gradual liquidation decision, all functions, duties and powers of legal bodies of the intermediary institution, such as general assembly of shareholders, board of directors and board of auditors, shall be assumed, performed and used by The Investors' Protection Fund in proxy until completion of the liquidation process. In the course of liquidation, no appointment shall be made by The Investors' Protection Fund to board of directors or to board of auditors of the intermediary institution, nor shall its general assembly of shareholders be convened during the progressive liquidation process. At the date of advertisement about completion of the progressive liquidation process, all legal bodies of the intermediary institution on duty as of the date of the progressive liquidation decision shall resume their functions, duties and powers, without any further formality or transaction.*

b. How, if at all, is the regulator involved in the process of returning Client Assets?

*The Investors' Protection Fund shall determine the real holders of rights and the amounts of their receivables which are in the scope of liquidation of the intermediary institution based on the records kept by the Capital Markets Board, the records of the investment firm, the records of other official and private institutions related to these organizations and other reliable information and documents.*

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

*As stated above, The Capital Market Board is authorized to request the strengthening of the financial situations within a suitable period that shall be given in case it is determined that the financial structure of a capital market institution has become weakened significantly; to restrict or remove the signature authorities of the employees of such institution; to take the needed measures in case it is determined that the needed measures are not taken by these institutions within this period that is given or their financial situations have become weakened to the extent that they shall not be able to meet their commitments, to stop temporarily the operations of these institutions without giving any period of time or to stop them permanently and remove their authorities; to make a decision for gradual liquidations in case these measures do not produce results and to request direct bankruptcy without gradual liquidation or when needed following the conclusion of liquidation.*

*So, during the insolvency period the investment firm cannot make any operation on the client assets.*

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

*For use in cash payments and in delivery of capital market instruments, The Investors' Protection Fund shall within 6 months at the latest following the date of the gradual liquidation decision, prepare and issue a schedule of creditors showing the names of creditors and the amounts of their receivables.*

*As of the 30th day following the advertisement date of the schedule of creditors, distribution of the capital market instruments kept in safe custody on behalf of the customers shall be started. To this end, the capital market instruments kept in safe custody on behalf of the customers shall be compared and reconciled separately in individual accounts, and as a result, shall be delivered to the rightful owners thereof solely for settlement of the outstanding obligations to those account holders or shall alternatively be transferred to their bank accounts upon and in line with their demands.*

*A decision may be made by The Capital Market Board to transfer to another institution the management of portfolios that are managed by an intermediary institution which has become bankrupt or insolvent, including mutual funds and investment company portfolios. The process depends on the number and the size of the portfolios.*

b. What factors, if any, affect the time period required to accomplish such a transfer?

*The factors can be stated as;*

- *Number of clients,*

- *Complexity of the Investment Firm and the degree of ease for collecting necessary data for making client asset list,*

- *Clients' application process for their assets to The Investors' Protection Fund,*

- *Process of deciding which client assets are in the scope of The Investors' Protection Fund and thus payable by The Investors' Protection Fund,*

- *In case of controversy between Investment Firm and creditors, money transfer can be blocked because of given customer assets as collateral by the Investment firm*

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

*In our capital market legislation and legal insolvency proceeding, there is requirement for the clients to return assets (or the values thereof) that were distributed to the them prior to the insolvency proceeding.*

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

*As mentioned above, The Investors' Protection Fund having legal entity has been established with the objective of meeting the liquidation expenses and to carry out the functions provided above in accordance with the principles envisioned in Capital Market Law with respect to intermediary institutions for which a gradual liquidation or bankruptcy decision is made and, on the condition that the provisions of the Banking Law are reserved, the banks in the scope of paragraph (a) of Article 50 of Capital Market Law the operations of which are stopped by a decree of the Council of Ministers, to cover the cash payment and share delivery obligations arising from share transactions for their customers due to capital market operations and transactions in which they engaged. All intermediary institutions are required to participate in this Fund.*

*At the beginning of the gradual liquidation, first of all the capital market instruments shall be distributed to the holders of the rights in the customer settlement accounts. With this objective, the capital market instruments that are settled in the customer account are compared as of the separate accounts and shall be used only for meeting the obligations to these account holders. For the holders of settlement accounts who have enough to meet what is owed in the account or who do not have any shares, a total of 63,70.,00 Turkish Lira of their cash and share receivables (for the year 2012) shall be paid by the Fund without waiting for the conclusion of the liquidation. However, for those who appear to be creditors of the same institution in the opinion of the Fund who have acted together with the institution, payment is made in the proportion to their receivables provided that it does not exceed the above total. Advance payments shall not be made from the Fund to shareholders, members of the board of directors or board of auditors, personnel authorized to sign and their spouses, blood relatives and relatives by marriage including the third degree, who appear to be debtors of the intermediary institution subject to gradual liquidation. The total payment that shall be made in accordance with this paragraph shall be increased at the rate of the revaluation coefficient that is announced every year.*

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

*After the gradual liquidation process begins, all of the payments of the investment firms are stopped and nobody other than the Investors Protection Fund has the power of disposal on the assets of the investment firm. The purpose of the gradual liquidation is to liquidate cash payments and the delivery obligations of capital market instruments to the clients due to the capital market activities. In this process, all of the client assets, not differing for the clients' who have granted permission to the investment firm are subject to the same regime.*

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

*As mentioned in the answer to the question 4, within the scope of the intermediation in trading in foreign markets, investment firms may hold client assets in a foreign investment firm authorized by the competitive authority of the related jurisdiction.*

*In this case, clients must fully be informed of the state and the legislation and protection they are subject to.*

*Currently, client assets which are held in foreign jurisdictions for the purposes of trading in foreign markets are not in the scope of the Investors Protection Fund. These assets are subject to the provisions of the relevant jurisdiction.*

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

*According to the Article 47 of the Capital Market Law, selling or creating a pledge or using in whatever manner for the benefit of someone other than the owner, capital market instruments, cash or other assets of any kind which are consigned or delivered physically or by registration to investment firms, is defined as a crime and the people accused to commit this crime shall be punished with a prison sentence of from two to five years and a heavy pecuniary fine.*

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

    *In case the assets of the Fund are not sufficient to meet the needs, then dues that shall be paid for subsequent years shall be paid on account up to one per thousand of the monetary amount of the share transaction volumes for the previous year shall be paid temporarily. If the dues received from intermediary institutions are not sufficient to meet the needs, then an advance shall be given to the Fund by the Istanbul Stock Exchange for the remaining portion.*

    *The Fund, after making the advance payments, shall continue the gradual liquidation of the intermediary institution. The liquidation balance of the receivables from the holders of the rights in the scope of the objective of the liquidation shall be used for the payment of the receivables which are not completely met. However, if the liquidation balance is not sufficient to meet all of these receivables, then payments shall be made by pro rata distribution. After all of these receivables are met, then from the remaining portion, first of all the public receivables and from the remaining amount, the receivables arising from the advances made by the Fund and the liquidation expenses shall be paid. The balance is distributed to the other creditors. If the assets of the intermediary institution are not sufficient to meet the receivables of the holders of rights in the scope of the objective of liquidation, the payments made from the Fund and the liquidation expenses, then the Fund, with the concurrence of the Board, may request the bankruptcy of the intermediary institution.*

    *According to the provisions of the Capital Market Law it is not envisaged a priority among classes of clients.*

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

    *Claims of clients related to capital market activities are ranked prior to other creditors in the insolvency process. Insolvency regime does not differ between domestic and foreign creditors.*

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to

available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

*Capital Markets Law*

*Serial:V, Number:46 "Communiqué On Principles Regarding Intermediary Activities and Intermediary Institutions"*

*Serial No:V, No:34 Communiqué on Principles Regarding Capital and Capital Adequacy of Brokerage Houses"*

*Serial: V, No: 65 "Communiqué On Principles Regarding The Internal Auditing Systems Of Brokerage Houses"*

*Regulation on Investors Protection Fund*

*Regulation on Principles and Procedures of Progressive Liquidation of Intermediary Institutions*

*The regulations can be accessed from the website of the CMB. www.cmb.gov.tr*

# United Kingdom
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

# Response from the UK's Financial Services Authority (August 2012)

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

The protection of client assets has been a cornerstone of the UK regulatory regime since 1988. The client assets regime consists of two aspects of protection. The first relates to client money, which applies to a firm that receives money from or holds money for, or on behalf of, a client in the course of, or in connection with its MiFID and/or its designated investment business, in respect of any investment agreement entered into, or to be entered into, with or for a client. As a unified regulator, the client money protections extend to General Insurance Intermediaries. The client money protections are based on English trust law principles as expounded in the FSA's Client Assets sourcebook (CASS) sourcebook. The second aspect is the protection of client assets, which applies to a firm when it holds financial instruments belonging to a client in the course of its MiFID business; and/or when safeguarding and administering non-MiFID investments.

The fundamental principle governing the whole regime is that a "firm must arrange adequate protection of clients' assets when it is responsible for them"29. This is generally achieved at a high level by requiring that a firm must, when holding safe custody assets or client money, make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the firm's insolvency, and to prevent the use of safe custody assets or client money on the firm's own account (as implemented in MiFID articles 13(7) and 13(8)). Further the firm must introduce adequate organisational arrangements to minimise the risk of the loss or diminution of client assets, or of rights in connection with client assets, as a result of misuse of client assets, fraud, poor administration, inadequate record-keeping or negligence (as implemented in article 16(1)(f) of the MiFID implementing Directive).

[29] FSA Principle for Business 10

In the event of an insolvency of an investment firm client money is held on trust (and therefore separate from the general estate of the firm) and is distributed back to clients in accordance with the CASS rules.

In relation to assets held by an investment firm, clients retain beneficial ownership of the assets at all times, and in the event of an insolvency can trace these assets or have a pro rata share of an omnibus account of securities. This is not the case however, when clients transfer assets to the investment firm under full title transfer collateral agreements (both client money and assets) and also if they grant rights of use (re-hypothecation) of assets. Both arrangements are permitted under MiFID and the UK regime and allow sophisticated clients to select an appropriate risk return for themselves.

Client asset protections do not seek to prevent a firm from failing, but they do attempt to ensure that wherever possible, assets and money belonging to clients of a firm are not used by the firm itself and in the event of the firm's insolvency are safe from claims by the general creditors of the firm's estate. The protections cannot prevent loss from occurring, but aim to achieve a timely distribution of client assets. Retail customers have access to an insurance fund if a shortfall does occur.

a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

"Client assets" is not a defined term in the UK regime, however, it is generally used to mean both custody assets (as defined below) and client money (as defined below), unless otherwise specified.

Custody assets: (a) a security or contractually based investment (these categories are very wide and include for example, shares, units, options, futures, CFDs and interests in these investments) held for or on behalf of a client; (b) any other asset which is or may be held with one of the investments listed in (a) held for, or on behalf of, a client.

Client money: money of any currency that a firm receives or holds for, or on behalf of, a client in the course of, or in connection with, its investment business/agreements; and to which the client money rules apply.

b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

Custody assets: Broadly speaking, custody assets held by a firm may be registered in the name of the client, a nominee company, or even the name of the firm, but clients retain beneficial ownership of the assets at all times. In the event of a firm insolvency, the client has claim on specific assets, an insolvency practitioner can trace these assets.

Any distribution of custody assets depends on the factual scenario. In the event of a shortfall, clients have a claim as unsecured creditors of the general estate, and, if eligible, would be able to claim against the Financial Services Compensation Scheme (FSCS) if they suffered loss.

Client money: client money is received and held by a firm on trust for its clients. In the event of a firm failure, all client money held by a firm on behalf of its clients is pooled. That pool of client money is then shared rateably amongst the clients with a claim on the pool in accordance with their interests in it.

Any shortfall in that client money pool (i.e. there is insufficient client money in the pool to meet all client claims) is shared rateably amongst the clients. Clients will have claims as unsecured creditors of the firm's general estate in relation to any shortfall and, if eligible, would be able to claim against the Financial Services Compensation Scheme (FSCS) if they suffered loss.

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

Client: a person (including an individual and legal person such as corporate entity) to whom a firm (which includes banks and investment firms) provides, intends to provide or has provided a service in the course of carrying on a regulated activity. The definition of 'Client' will also include other regulated firms, including affiliates or other group entities.

d. Please describe any notable exclusions from the terms "client" or "client assets."

None

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

If firms intend to hold client money or client assets a firm has to apply for this to be added to its permission under the Financial Services and Markets Act 2000 (FSMA) Regulated Activities Order (RAO).

Permission to hold client money: The starting point is that an authorised firm is able to hold and control client money. Although unless a firm applies to hold client money and we consider them fit and proper to do so, we prevent firms from holding client money by imposing a standard requirement that they cannot hold and control client money.

Client assets (custody): Following MiFID, there are a number of activities which a firm may undertake, when holding clients' assets depending upon their businesses. Generally, investment firms would usually have the following activities within their permission:

Safeguard and administering investments (RAO article 40);
Dealing in investments as principle (RAO article 14);
Dealing in investments as agent (RAO article 21); and
Managing investments (RAO article 37).

As an investment firm which acts as a custodian cannot be an Exempt MiFID firm or Exempt CAD, a person who holds either client money or securities in relation to MiFID business will fall to be at least a BIPRU €125k firm as we set out in Q61 of PERG 13 and in the BIPRU sourcebook. Both the client money and custody regime can apply simultaneously.

On application to hold client money or assets, we typically would require the:

A) Firm to set out how the client monies are held (e.g. in a segregated bank account established in accordance with the CASS rules, with the monies held under the Statutory Trust)

B) Whether or not the client money account is held with an appropriate bank that meets the requirements of CASS 7.4.7 R – 10 R (article 18(3) of the MiFID Implementing Directive)

C) We ask the firm to confirm that they have read and understood the relevant client money rules under CASS.

The FSA has increased its supervisory focus on the protection of CASS since Lehman Brothers entered insolvency in September 2008. Accordingly, CASS is a key risk for the FSA which is monitored on the risk-based FSA's risk dash-board, and is a risk that is addressed through individual firm supervision and on a thematic basis.

b.If special authorization is not required, how, if at all, is this activity supervised by a regulator?

NA

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

   a. Must the Client Assets of one client be maintained separately from those of other clients?

      i. Are Investment Firms allowed to hold Omnibus Accounts?

Client Assets have to be maintained separately from the assets of the Investment Firms. An approach is to hold client assets in Omnibus Accounts, as the key requirement under MiFID is to ensure that client assets are kept separately from the firm's assets. Accordingly, the firm is required to keep such records and accounts as are necessary to enable it, at any time and without delay, to distinguish client assets held for one client from client assets held for any other client, and from its own money (article 16(1)(a) of the MiFID implementing Directive). Further, a firm must maintain its records and accounts in a way that ensures their accuracy, and in particular their correspondence to the client money held for clients (article 16(1)(b) of the MiFID implementing Directive).

      ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

As discussed above, the UK requires firms, on a continuous basis to arrange adequate protection of clients' assets and be able to account for all of those assets at any given point in time. We understand that this question relates to the potential losses caused in the client money pool by derivatives trading clients. The UK has always adopted a single pool method of pooling client money. This has the benefits of cost and efficiency (because it is the administratively simplest system for firms to implement and maintain, for example in relation to records); it is easier to calculate client entitlements to the client money pool; any shortfall is shared equitably across all clients with no preference payments; and it should allow a timely distribution. However, the single pool method results in the risk of each clients risk being shared by all clients. This exposes a low risk customer to the investment risks assumed by consumers with a larger appetite for risk.

We consider that once the limits of the single pooling method are understood, the model is not fundamentally flawed for the majority of firm insolvencies. The FSA last consulted on these rules in 2000 and it was found that the cost benefit analysis (CBA) supported the conclusion that the single pooling method was the most efficient. We now understand that IT systems have developed sufficiently that the CBA may now support a more sophisticated pooling method where the risk profile of clients can be accurately mapped to different pools. The FSA is considering consulting upon the distribution rules in due course.

Assets (other than money) should be distributed in accordance with the trust under which they are held. It is understood that if there are shortfalls clients may share pro-rata in the losses per stockline but this is not prescribed by the CASS rules.

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

**Client money requirement:**

CASS 7 Annex 1: The client money requirement is either:

(1) the sum of, for all clients:

(a) the individual client balances calculated in accordance, excluding:

(i) individual client balances which are negative (that is, debtors); and

(ii) clients' equity balances; and

(b) the total margined transaction requirement calculated in accordance with the margined transaction requirement; or

(2) the sum of:

(a) for each client bank account:

(i) the amount which the firm's records show as held on that account; and

(ii) an amount that offsets each negative net amount which the firm's records show attributed to that account for an individual client; and

(b) the total margined transaction requirement calculated

**Client assets reconciliation:**

Internal reconciliation of safe custody assets held for clients:

CASS 6.5.4 G (1) Carrying out internal reconciliations of the safe custody assets held for each client with the safe custody assets held by the firm and third parties is an important step in the discharge of the firm's obligations under CASS 6.5.2 R, and where relevant,1 SYSC 4.1.1 R and SYSC 6.1.1 R.

(2) A firm should perform such internal reconciliations:

(a) as often as is necessary; and

(b) as soon as reasonably practicable after the date to which the reconciliation relates;

to ensure the accuracy of the firm's records and accounts.

(3) Reconciliation methods which can be adopted for these purposes include the 'total count method', which requires that all safe custody assets be counted and reconciled as at the same date.

(4) If a firm chooses to use an alternative reconciliation method (for example the 'rolling stock method') it needs to ensure that:

(a) all of a particular safe custody asset are counted and reconciled as at the same date; and

(b) all safe custody assets are counted and reconciled during a period of six months.

CASS 6.5.5 R: A firm that uses an alternative reconciliation method must first send a written confirmation to the FSA from the firm's auditor that the firm has in place systems and controls which are adequate to enable it to use the method effectively.

Reconciliations with external records

CASS 6.5.6 R: A firm must conduct on a regular basis, reconciliations between its internal accounts and records and those of any third parties by whom those safe custody assets are held.

[Note: article 16(1)(c) of the MiFID implementing Directive]

CASS 6.5.7 G: Where a firm deposits safe custody assets belonging to a client with a third party, in complying with the requirements of CASS 6.5.6 R, the firm should seek to ensure that the third party will deliver to the firm a statement as at a date or dates specified by the firm which details the description and amounts of all the safe custody assets credited to the account, and that this statement is delivered in adequate time to allow the firm to carry out the periodic reconciliations required in CASS 6.5.6 R.

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

Client money is fungible.

Generally, specific assets would have to be held for clients if the clients entered a specific custody agreement to that effect. More commonly however, we understand that most clients sign custody agreements that allow equivalent securities to be held. For example, a client could enter an agreement with an investment firm whereby they purchase a share in company A, and have that dematerialized share registered within their own name within CREST. Alternatively, the share could be registered in a company nominee name and held in an omnibus account in CREST. Within the omnibus account, the securities are fungible, but only to the extent that an equivalent share would have to be returned (i.e. a share of the same value in the same company, but not the share necessarily with the same individual share identification number).

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

**Client money:**

Client money requirements state that internal reconciliations have to be undertaken of records and accounts of the entitlement of each client for whom the firm holds client money with the records and accounts of the client money the firm holds.

Further, a firm must conduct, on a regular basis, reconciliations between its internal accounts and records and those of any third parties by whom client money is held (CASS 7.6.9 R; MiFID article 16(1)(c) of the MiFID implementing Directive).

**Client assets:**

Please see 3b

C) If a client has a debit balance (*i.e.*, the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

**Reduced client money requirement option**

"CASS Annex 7 A

18.

(1) When, in respect of a client, there is a positive individual client balance and a negative client equity balance, a firm may offset the credit against the debit and hence have a reduced individual client balance for that client.

(2) When, in respect of a client, there is a negative individual client balance and a positive client equity balance, a firm may offset the credit against the debit and hence have a reduced client equity balance for that client.

19. The effect of paragraph 18 is to allow a firm to offset, on a client by client basis, a negative amount with a positive amount arising out of the calculations, and, by so doing, reduce the amount the firm is required to segregate for that client."

For the avoidance of doubt, one client's net debit balance (or an aggregate of client' net debit balances) cannot be used by the firm to reduce the total funds the firm is required to have on deposit for its clients collectively.

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

MiFID states that reconciliations must be performed as often as necessary (article 19(1)(c) of the MiFID Implementing Directive). However, for the vast majority of firms we supervise, we consider this requirement to require firms to conduct a daily reconciliation in accordance with CASS 7 Annex 1. CASS 7 Annex 1 is the standard client money calculation.

B) When is such reconciliation required (*e.g.*, noon of the following business day, the tenth business day of the following month).

By the close of the following business day.

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

**Client money:**

Reconciliation discrepancies

CASS 7.6.13: When any discrepancy arises as a result of a firm's internal reconciliations, the firm must identify the reason for the discrepancy and ensure that:

(1) any shortfall is paid into a client bank account by the close of business on the day that the reconciliation is performed; or

(2) any excess is withdrawn within the same time period (but see CASS 7.4.20 G and CASS 7.4.21 R).

CASS 7.6.14: When any discrepancy arises as a result of the reconciliation between a firm's internal records and those of third parties that hold client money, the firm must identify the reason for the discrepancy and correct it as soon as possible, unless the discrepancy arises solely as a result of timing differences between the accounting systems of the party providing the statement or confirmation and that of the firm.

CASS 7.6.15: While a firm is unable to resolve a difference arising from a reconciliation between a firm's internal records and those of third parties that hold client money, and one record or a set of records examined by the firm during its reconciliation indicates that there is a need to have a greater amount of client money or approved collateral than is in fact the case, the firm must assume, until the matter is finally resolved, that the record or set of records is accurate and pay its own money into a relevant account.

Notification requirements

CASS 7.6.16: A firm must inform the FSA in writing without delay:

(1) if it has not complied with, or is unable, in any material respect, to comply with the requirements in CASS 7.6.1 R, CASS 7.6.2 R or CASS 7.6.9 R;

(2) if having carried out a reconciliation it has not complied with, or is unable, in any material respect, to comply with CASS 7.6.13 R to CASS 7.6.15 R.

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a “buffer”)? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

If it is prudent to do so to ensure that client money is protected, a firm may pay into a client bank account money of its own, and that money will then become client money for the purposes of the client money chapter of CASS.

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

An investment firm cannot use the assets of one client for meeting an obligation of another client, unless the investment firm has a right to use. Please see below (answer d for further detail).

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

The CASS regime allows market participants varying degrees of participation and protection as appropriate. This is diagrammatically shown below. The first example on the left is most appropriate for retail clients and represents the full application of CASS, including segregation of assets that are held on a statutory trust basis. The second example represents re-hypothecation or a 'right-to-use' over a client's assets. The exercise by a Prime Broker (PB) of a 'right-to-use' over a client's assets removes those assets from the protection the CASS regime offers. Assets which have yet to be re-hypothecated, or have been re-hypothecated and returned to the client segregated accounts, fall within the protections offered by the CASS regime. Re-hypothecation in the UK is a contractual and regulatory hybrid between full segregation and an opt-out from the CASS rules. The final option represents a full title transfer of a client's assets (under recital 27 to MiFID, implemented by CASS 6.1.6 R) to the PB which removes them from the CASS regime, and results in those clients ranking as general creditors in the event of the insolvency of the PB.

**Scope of client asset protections**

| Pure custody<br><br>(CASS 6.2.1 R) | Re-hypothecation<br><br>(CASS 3.1.7 G) | Full title transfer of collateral<br><br>(CASS 6.1.6 R) |
|---|---|---|
| Segregation of client assets and money from that of the firms. Full compliance with the client asset sourcebook. Client has a claim over the trust assets in the event of the firm's insolvency. | Segregation of client assets from that of the firms, until the firm elects to re-hypothecate the assets consistent with agreed limits in the TOBA.<br>To the extent assets are re-hypothecated, the client is an unsecured creditor in the event of the firm's insolvency. | Full title in collateral transfers from the client to the firm.<br>Assets cease to be client assets and the client is an unsecured creditor in the event of the firm's insolvency. |

The UK has a large and active leveraged securities financing market that utilises re-hypothecation extensively.

**Stock lending:**
CASS 6.4.2 G: Firms are reminded of the client's best interests rule, which requires the firm to act honestly, fairly and professionally in accordance with the best interests of their clients. An example of what is generally considered to be such conduct, in the context of stock lending activities involving retail clients is that:

(1) the firm ensures that relevant collateral is provided by the borrower in favour of the client;
(2) the current realisable value of the safe custody asset and of the relevant collateral is monitored daily; and
(3) the firm provides relevant collateral to make up the difference where the current realisable value of the collateral falls below that of the safe custody asset, unless otherwise agreed in writing by the client.

CASS 6.4.3 R: Where a firm uses safe custody assets as permitted in this section, the records of the firm must include details of the client on whose instructions the use of the safe custody assets has been effected, as well as the number of safe custody assets used belonging to each client who has given consent, so as to enable the correct allocation of any loss (article 19(2) of the MiFID implementing Directive).

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

If a client agrees to full title transfer of its assets to the firm in certain circumstances and the firm exercises its rights to take full ownership of assets in accordance with its client agreement, this will result in those assets being moved out of the client assets regime for the period during which the firm exercises full ownership rights. The consequence of this is that, if a firm fails during that period, the client will rank as a general creditor of the firm in relation to those assets.

However, a security financial collateral arrangement would usually mean that the client retains beneficial interest in the assets until such time as the condition in the agreement allowing the firm to exercise its security right is met.

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

Investment firms must agree with their clients the terms on which they are to use their assets, or the conditions placed on full title transfer. This is a contractual agreement, and generally can form part of the terms of business or agreements clients sign-up to.

New rules that came into force 2011, require prime brokers to set out clearly in a separate annex in the client agreements a summary of the agreed right to use of custody assets (CASS 9.3 prime brokerage agreement disclosure annex).

iii. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (*i.e.*, established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator?

As set out in our response to (i) above, where a client agrees to transfer full title to custody assets to a firm and firm has exercised its rights to take full ownership of custody assets in keeping with its client agreement (i.e. with the client's consent) the custody assets are removed from the client assets regime (and the protections thereof) for the period that the firm exercises those rights. It is that contractual agreement between client and firm that allows the client asset regime protections to be disapplied for that period. Therefore, if a firm takes full ownership over custody assets and uses them without the agreement of the client to whom the assets belong, in our view, the client asset regime should continue to apply to those assets, that is, they should still be held on trust by the firm for the client. If the firm has used the assets as its own the client/insolvency practitioner may attempt a tracing exercise.

Similarly, if a firm uses client money without the consent of the client to whom the money belongs, this money would still be subject trust and in the event of the firm's insolvency the client would be entitled to claim on the client money pool.[30]

In the event of the firm's insolvency, the client would usually be reliant on the insolvency practitioner to represent its interests in resolving issues relating to misuse of its assets and money. However, on a business as usual basis, in the event that the firm misused a client's assets and the client had suffered loss, the client could potentially sue the firm for breach of contract or negligence.

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

The client assets regime does not extend to clearing houses or exchanges, but they are required to account separately for assets held on behalf of members' clients.

[30] The Lehman Brothers International (Europe) (In Administration) Supreme Court Judgment found that the requirement to pool all client money on the occurrence of a primary pooling event also applies to client money held in house accounts and that participation in the notional client money pool is not dependent on the actual segregation of client money.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

Broadly speaking, yes an investment firm in the UK can hold assets belonging to UK clients in another jurisdiction. This is governed by CASS 6.3.4 R:

(1) A firm must only deposit safe custody assets with a third party in a jurisdiction which specifically regulates and supervises the safekeeping of safe custody assets for the account of another person with a third party who is subject to such regulation.

(2) A firm must not deposit safe custody assets held on behalf of a client with a third party in a country that is not an EEA State (third country) and which does not regulate the holding and safekeeping of safe custody assets for the account of another person unless: (a) the nature of the safe custody assets or of the investment services connected with those safe custody assets requires them to be deposited with a third party in that third country; or (b) the safe custody assets are held on behalf of a professional client and the client requests the firm in writing to deposit them with a third party in that third country.

This reflects a requirement from MiFID.

a. Client Assets transferred to or located in other jurisdictions?

Firm are required to keep such records and accounts as are necessary to enable it, at any time and without delay, to distinguish client assets held for one client from client assets held for any other client, and from its own money (article 16(1)(a) of the MiFID implementing Directive).

This includes assets located in another jurisdiction.

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions?

If so, please provide details of those requirements.

The UK regime does not differentiate between assets held within the UK or other jurisdictions.

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

The UK client assets rules do not differentiate between client assets held for UK or overseas clients.

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

NA (see response to 5(a))

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

Foreign Investment Firm will be treated equally as all clients (see responses to 3(d) on right to use and rehypothecation).

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

CASS 6.3 Depositing assets and arranging for assets to be deposited with third parties

CASS 6.3.1 R: (1) A firm may deposit safe custody assets held by it on behalf of its clients into an account or accounts opened with a third party, but only if it exercises all due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements for the holding and safekeeping of those safe custody assets.

(1A) A firm which arranges the registration of a safe custody investment through a third party must exercise all due skill, care and diligence in the selection and appointment of the third party.

(2) A firm must take the necessary steps to ensure that any client's safe custody assets deposited with a third party, in accordance with this rule are identifiable separately from the applicable assets belonging to the firm and from the applicable assets belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection.

(3) When a firm makes the selection, appointment and conducts the periodic review referred to under this rule, it must take into account:

(a) the expertise and market reputation of the third party; and

(b) any legal requirements or market practices related to the holding of those safe custody assets that could adversely affect clients' rights.

(4) A firm must make a record of the grounds upon which it satisfies itself as to the appropriateness of its selection of a third party as required in this rule. The firm must make the record on the date it makes the selection and must keep it from the date of such selection until five years after the firm ceases to use the third party to hold safe custody assets belonging to clients.

[Note: articles 16(1)(d) and 17(1) of the MiFID implementing Directive]

CASS 6.3.2 G: In discharging its obligations under this section, a firm should also consider, together with any other relevant matters:

(1) once a safe custody asset has been lodged by the firm with the third party, the third party's performance of its services to the firm;

(2) the arrangements that the third party has in place for holding and safeguarding the safe custody asset;

(3) current industry standard reports, for example Financial Reporting and Auditing Group (FRAG) 21 report or its equivalent;

(4) the capital or financial resources of the third party;

(5) the credit rating of the third party; and

(6) any other activities undertaken by the third party and, if relevant, any affiliated company.

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

CASS 6.3.5R and 6.3.6R below came into force on 1 April 2012:

CASS 6.3.5R: Subject to CASS 6.3.6 R, in relation to a third party with which a firm deposits safe custody assets belonging to a client, a firm must ensure that any agreement with that third party relating to the custody of those assets does not include the grant to that party, or to any other person, of a lien or a right of retention or sale over the safe custody assets, or a right of set-off over any client money derived from those safe custody assets.

CASS 6.3.6 R: A firm may conclude an agreement with a third party relating to the custody of safe custody assets which confers on that party, or on another person instructed by that party to provide custody services for those assets, a lien, right of retention or sale, or right of set-off in favour of that party or that other person only if that lien or right:

(1) is confined to those safe custody assets held in an account with that third party or that other person and extends only to properly incurred charges and liabilities arising from the provision of custody services in respect of safe custody assets held in that account; or

(2) arises under the operating terms of a securities depository, securities settlement system or central counterparty in whose account safe custody assets are recorded or held, and provided that it does so for the purpose only of facilitating the settlement of trades involving the assets held in that account; or

(3) arises in relation to those safe custody assets held in a jurisdiction outside the United Kingdom, provided that:

(a) it does so as a result of local applicable law in that jurisdiction or is necessary for that firm to gain access to the local market in that jurisdiction; and

(b) in respect of each client to which those assets belong, either:

(i) the firm has taken reasonable steps to determine that holding those assets subject to that lien or right is in the best interests of that client; or

(ii) where a client is a professional client, the firm is instructed by that client to hold those assets in that jurisdiction notwithstanding the existence of that lien or right.

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

Firms are required to disclose to clients their arrangements relating to the protection of client assets. For example, firms would have to include within their terms of business agreements (ToBAs) details surrounding their placement of client money and custody provisions. Similarly, firms are required to provide statements to clients, at least, on an annual basis under MiFID.

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

A client may only opt out of client asset protections, through the full title transfer collateral agreement mechanism noted at question 3.d above, if they are sophisticated (i.e. generally professional clients under the MiFID classification scheme) and that the full title transfer collateral agreement is in their best interests.

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

   a. Does the Investment Firm report where client assets are held?

   b. Does the Investment Firm or depository report the protections applicable to such client assets?

   c. Does the Investment Firm or depository report the amount of assets that are held?

   In each case, are such reports provided on request or periodically? If periodically, with what frequency?

Rules introduced in 2011 require all firms that hold client money and/or custody assets in connection with investment business to be categorised as:

- CASS Large firm, where client money held exceeds £1 billion and/or custody assets exceeds £100 billion;
- CASS Medium firm, where it is not a CASS Large firm, but client money held exceeds £1 million and/or custody assets exceeds £10 million; and

- CASS Small firm, where it is not a CASS Large or CASS Medium firm, but holds client money and/or custody assets.

Annual reporting is applicable to all of these firms and requires them at the start of each year to report their highest client money and assets holding for the previous year, or the highest projected client money and assets holdings if they have not previously held.

All CASS Large and Medium firms are required to provide a monthly Client Money and Assets Return - "CMAR" - that contains information on the following:

- Highest/lowest balances of client money and assets held
- Auditor arrangements
- CFTC Part 30 Exemption arrangements
- Reconciliations – timings, methods used and discrepancies
- Client money calculations – allocated/unallocated balances and discrepancies.
- Segregation of client money and assets – segregation methods used/details of third parties
- Record keeping & breaches – trust/acknowledgement letters, client money accounts and notifiable CASS breaches.
- Outsourcing/offshoring arrangements – nature of arrangements, details of service providers.

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

    a. Where Client Assets are held?

    b. The amount of Client Assets held at a depository?

    c. The safeguards applicable to Client Assets held at a depository?

Firms are required to send out notification and receive acknowledgement letters from third parties where client money is placed (CASS 7.8.1 R and CASS 7.8.2 R). They are required to undertake regular external reconciliations (CASS 6.5.6 R and CASS 7.6.9R), and promptly rectify any discrepancy. If a firm is unable to rectify or make good a discrepancy, they are required to notify the FSA without delay (CASS 6.15.13 R and CASS 7.6.16 R).

In mid 2010, the FSA launched the a dedicated Client Assets Unit (around 40 individuals today and growing). The Unit is a multi-disciplinary specialist unit with risk, policy and supervision specialists focused on the client assets regime. The unit utilises a combination of firm self-reporting (including CMAR), external auditor reporting and whistle blowing to assess risks in firms and industry trends. It utilises a supervision inspection program, sector thematic reviews and independent specialist reviewers ('section 166 reviews') to examine firms.

Furthermore, external independent auditors are required to provide to the FSA an annual reasonable assurance report on the adequacy of the client assets systems and compliance as at the period end.

Rules introduced in 2011, require investment firms to appoint an individual within their firm the responsibility for oversight of the firm's operational compliance with the client assets rules, and reporting to the firm's governing body and the FSA. For CASS Large and CASS Medium firms, this function is a 'controlled function' to be undertaken by an 'approved person' (would be subject to application to FSA and potential FSA interview). For CASS Small firms, the individual has to be a director or senior manager performing a significant influence function, though the function is not a controlled function. A significant influence function is, broadly speaking, a function which involves the person responsible for its performance exercising a significant influence over the conduct of a firm's regulated activities.

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

    b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

Where there is an applicable memorandum of understanding between the relevant regulators, the foreign regulator could request information from the domestic regulator through that memorandum of understanding.

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

A firm would be required to notify the FSA of any material changes in their financial position or ability carry on business. This does not necessarily have to be communicated to the market. Dependent upon the risk profile of the firm in question, the disclosure would be communication under the FSA's 'close and continuous' supervision, to a firm's supervisory team, or by notification if a smaller firm. The firm would be required to explain its position and to provide plans for recovery or wind-down.

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*¸ capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

Whether a firms financial situation is deteriorating or it drops below minimum capital thresholds, the FSA will consider what is the appropriate course of action in the particular circumstance. The most usual orders the FSA would make are to require the firm to raise new capital, remove

the firm's permissions, require the firm to transfer business, return client assets or enter insolvency proceedings.

The Client Asset regime is not designed to prevent firms from entering insolvency, but is focused upon ensuring the best possible return of client assets.

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

In the UK, investment firms generally enter an administration process, rather than a liquidation. Under the UK regime there are three statutory objectives of administration:

1. rescuing the company as a going concern, which should be taken to mean retaining as much as possible of its business;

2. achieving a better result for the creditors as a whole than would be likely in an immediate winding-up, for example by sale of the business(es) or its assets. This objective can only be pursued where rescue is not reasonably practicable, or where it would give a better outcome for creditors than objective 1;

3. realising the company's property so as to make a distribution to one or more secured or preferential creditors. This objective can only be pursued where it is not reasonably practicable to achieve either of objectives 1 or 2. Usually the Directors of the firm would apply to court to make an administration order. Alternatively, if the firm is being liquidated, the firm's creditors apply to court for a winding-up order.

Administrators can be appointed by the Court or by the company, the directors or the holder of a qualifying floating charge.

In February 2011 the Investment Banking Special Administration Regulations 2011 (the "SAR") came into force. The SAR can be applied to UK incorporated firms that undertake investment business activity – specifically those which are authorised to deal in and/or safeguard and administer investments, and which actually hold client assets. A court can appoint an administrator over such an entity, on the application of various parties including the FSA or the investment bank's directors, if such entity becomes insolvent.

An administrator then has three objectives:

- To ensure the return of client assets as soon as is reasonably practicable;
- To ensure timely engagement with market infrastructure bodies (to facilitate the operation of their default rules) and the Authorities (to facilitate the Authorities taking action to minimise the disruption of businesses and the markets); and

- To either rescue the investment firm as a going concern or wind it up in the best interests of creditors.

The FSA can direct an insolvency practitioner to prioritise one of these objectives over another.

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

The administrator is either appointed by the Court, by the company or the FSA (in accordance with SAR). The administrators have to pass relevant join insolvency examinations to become a licensed Insolvency Practitioner and be a member of the Insolvency Practitioners Association (IPA).

16. What are the duties of the Administrative Officer?

    a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

Insolvency Practitioners licensed by the IPA have to comply with the Statements of Insolvency Practice and take into account Guidance issued by it. Further guidance can be found through the IPA, and other UK sources, such as UK insolvency service. In addition Insolvency Practitioners have to comply with the relevant statutes and statutory instruments.

    b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

Insolvency Practitioners (IPs) who are appointed as administrators or liquidators have total personal liability.

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

    a. Does the regulator continue to supervise the Investment Firm?

Yes, the investment firm remains an authorised person and is still subject the FSA Handbook.

    b. How, if at all, is the regulator involved in the process of returning Client Assets?

The FSA is not directly involved in the process of returning Client Assets – that is the role for the administrator or liquidator. However, the FSA exerts regulatory influence over the insolvency however to ensure an efficient and orderly return of assets and, if the firm is subject to SAR, can direct the insolvency practitioner to prioritise one of the SAR objectives over another

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

The client assets regime continues to apply to the Investment Firm during the insolvency - until it ceases to conduct regulated activities and its permissions are canceled.

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

    a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

The FSA would form a view of the transfer in light of supervisory, policy and legal issues and act accordingly. The FSA would ensure that the transfer appropriately protected client assets, and ensured the fair treatment of customers. Steps may involve the firm applying for waivers of certain rules before the transfer could be affected. The FSA responds quickly to such requests if necessary.

    b. What factors, if any, affect the time period required to accomplish such a transfer?

Factors would include the size of the firm, amounts involved, number of clients and internal resourcing requirements.

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

Client assets and money form part of trust property. If client assets or monies were returned before insolvency, this would not be considered to be a preference payment.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

The FSCS is the UK's compensation fund of last resort for customers of authorised financial services firms. The FSCS may pay compensation if a firm is unable, or likely to be unable, to pay claims against it. This is usually because it has stopped trading or has been declared in default. The FSCS will declare a firm in default if:

(1) it has received at least one eligible claim against it, and the customer has made a financial loss;

(2) it is satisfied that the firm is unable, or likely to be unable, to pay claims against it. We will investigate the firm's financial position to establish this.

The scheme covers both individual clients and small businesses if they have invested with an FSA authorised firm performing regulated activities. Designated investment business is insured up to a maximum of £50,000 per client per firm.

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

If a client has transferred title to the firm, or granted a right-to-use and the firm has exercised that right, i.e. re-hypothecated those assets, then the client will rank as a general creditor to the firm.

Client assets which are subject to the full regime, are held on trust and are therefore separate from the general estate of the firm and are distributed back to clients.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

Clients are not affected to the extent that return of assets may be delayed during complex cross-border insolvencies. Where clients have asked for assets to be held in jurisdictions which are perceived to offer less protection – the firm should give the client full disclosure of those risks.

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

The client money regime creates a statutory trust upon the receipt of client money. The result of which is that clients have an entitlement to the client money pool as soon as the firm receives the client money.

The client assets should be traceable and returned to clients. If a firm misapplies, looses, or simply holds to few assets there will be a shortfall (see below).

In either case, the client would have a breach of trust claim against the firm.

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

Client money is distributed on a pro rata (pari passu) basis. Shortfalls can be claimed against the FSCS as described above.

Any distribution of client assets depends on the factual scenario. If assets are held in a pooled omnibus account they would be distributed on a pro rata basis to the extent that an individual's assets cannot be traced. If however, assets were segregated on behalf of one client and there was a shortfall – that client would have a claim as unsecured creditor of the general estate, and would be able to claim against the FSCS if they suffered loss.

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

The UK does not distinguish between domestic and foreign clients. Trust property and client assets are held separate from the firm's and therefore never forms part of the general estate. This segregation allows the trust property to be distributed before administration dividends.

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

http://fsahandbook.info/FSA/html/handbook/CASS

# United States – CFTC
# 2013 Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

**CFTC Overview:**

Every Investment Firm holding Client Assets is a futures commission merchant ("FCM"), and is required to keep all such assets in accounts segregated (or set aside) for the benefit of clients. As discussed further below, the Investment Firm is required to, at all times, have sufficient Client Assets in segregated accounts to meet all obligations to clients, without deduction for client accounts in deficit.[31] The Investment Firm is, however, permitted to treat segregated accounts (or set-aside accounts) on an omnibus basis, *i.e.*, Client Assets are not segregated for each client.

An Investment Firm maintains separate "account classes" (as Answer 25 describes further below) for, *inter alia*, (1) clients trading domestic futures (*i.e.*, futures traded on a contract market designated as such by the CFTC), (2) clients trading foreign futures (*i.e.*, futures traded on contract markets located outside the United States), and (3) cleared swaps customer collateral. In the event that an Investment Firm becomes subject to bankruptcy proceedings, there is no discrimination in distribution of Client Assets, however, between clients who are U.S. citizens and those who are not.

The provisions of the U.S. Bankruptcy Code related to commodity futures (Subchapter IV of Chapter 7, 11 U.S.C. §761-767) and the regulations promulgated by the CFTC (17 C.F.R. Part 190) are designed to promote the prompt transfer of client positions and associated Client Assets from an insolvent Investment Firm to a solvent Investment Firm. Client Assets in each "account class" are distributed *pro rata* among the client claims for that "account class," with each client claim receiving the same percentage economic distribution, regardless of the form of Client Assets deposited.

[31] As discussed below, slightly different requirements apply to Client Assets in accounts set aside for customers – i.e., accounts for foreign futures.

In 2012, pursuant to Section 724 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the CFTC adopted final regulations which impose requirements on FCMs and derivatives clearing organizations ("DCOs") regarding the treatment of cleared swaps customer contracts (and related collateral), and made conforming amendments to the CFTC's Bankruptcy Rules[32] for FCMs under the Commodity Exchange Act ("Act"). Specifically, these rules (also known as the "Legally Segregated Operationally Commingled Model") provide individualized protection for such collateral. They require that cleared swaps customer collateral be segregated from the FCM's own property pre-bankruptcy. In addition, they permit the cleared swaps collateral of all FCM cleared swaps customers to be kept together pre-bankruptcy in one account. The rules, to the extent applicable, parallel the regulations governing the segregated accounts in which FCMs currently hold futures customer collateral pre-bankruptcy. However, they require DCOs to track the positions and related collateral attributable to cleared swaps customers on an individualized basis.

The rules also provide that following an FCM's bankruptcy, where there is a shortfall in the cleared swaps customer account due to a cleared swaps customer loss that exceeds both the cleared swaps customer's collateral and the FCM's ability to pay, the DCO may only use the collateral attributable to the cleared swaps customers whose portfolios of positions at the DCO suffered losses to meet the loss, and then only to the extent of each such customer's share of the loss. Thus, all collateral attributable to cleared swaps customers whose portfolios of positions gained or were "flat" (neither gained nor lost), and the remaining collateral attributable to cleared swaps customers whose portfolios of positions lost, would be immediately available for transfer. The compliance date for these regulations is November 14, 2012.

a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

**CFTC Response:**

Client Assets refers to customer funds, positions, securities, or other property held on behalf of clients by an FCM. These assets can be used to margin, secure and guarantee commodity futures and swaps transactions. The CFTC's regulatory scheme distinguishes between "account classes" for (a) domestic and (b) foreign exchange-traded futures positions and associated

[32] *See* 17 C.F.R. Part 190.

collateral, and (c) cleared swaps customer contracts and related collateral.

b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

**CFTC Response:**

When a client places its assets with an Investment Firm, the client transfers title to those assets to the firm. However, if the Investment Firm becomes insolvent, all clients share pro rata, by account class, in Client Assets, based on the amount of each client's claim.

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

**CFTC Response:**

Client refers to a customer (i.e., any natural person, corporation, general partnership, limited partnership, limited liability company, trust or other legal organization whose commodity or swaps account is carried by an FCM).

d. Please describe any notable exclusions from the terms "client" or "client assets."

**CFTC Response:**

The definition of "client" excludes the types of accounts included under the definition of proprietary account. Proprietary accounts include the firm's own account and so-called "noncustomer" (i.e., affiliated) accounts such as the accounts of an FCM's directors, stockholders, officers, account executives, certain other employees, certain relatives of the preceding persons, and affiliated companies.

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

**CFTC Response:**

Yes, any Investment Firm holding Client Assets for the purpose of securing commodity futures and cleared swap transactions is an FCM, and pursuant to Section 4d(a)(1) (for futures) and Section 4d(f) of the Commodity Exchange Act (the "Act"),[33] must register with the CFTC. The CFTC has delegated certain of its registration responsibilities to the National Futures Association ("NFA"), a self-regulatory organization ("SRO").[34]

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

**CFTC Response:**

In order for an Investment Firm to operate as an FCM, it must meet minimum capital requirements. Pursuant to CFTC regulation ("Regulation") 1.17,[35] such Investment Firm must maintain, at all times, adjusted net capital equaling or exceeding the greatest of the following:

- $1,000,000;

[33] 7 U.S.C. §§6d(a)(1), 6(d)(f).

[34] An SRO is an exchange or registered futures association (*i.e.*, the National Futures Association) that enforces financial and sales practice requirements for their members. The term "Designated Self-Regulatory Organization" ("DSRO") refers to the SRO that is primarily responsible for a specific Investment Firm that is an FCM. If such Investment Firm is a member of more than one SRO, all relevant SROs may decide among themselves which of them will be primarily responsible for that Investment Firm, and that SRO will be appointed the DSRO for that Investment Firm.

[35] 17 C.F.R. §1.17.

- The minimum amount of net capital required by the NFA;
- A risk-based capital computation equal to the sum of (i) 8% of the margin requirements of clients (whether or not affiliated with the Investment Firm); and
- For an Investment Firm also registered as a securities broker or dealer, the amount of capital required by the Securities Exchange Commission.

Further, in order for an Investment Firm to operate as an FCM, it must demonstrate moral and operational fitness. It may so demonstrate by taking the following actions, among others:

- disclosing information regarding the organization of its business, including information concerning any holding company and/or branch offices;
- disclosing criminal or regulatory actions;
- nominating contact persons for issues concerning membership, accounting arbitration, compliance, and enforcement; and
- submitting procedures and materials relating to the following for approval:
    - (i) anti-money laundering; (ii) business continuity; (iii) electronic order routing systems; (iv) promotional materials; (v) supervision of associated persons; and (vi) handling of client complaints.

Specifically with respect to Client Assets:

- During the FCM registration process, an Investment Firm may demonstrate operational fitness by submitting for approval its procedures for maintaining the segregation (or

separation) of Client Assets in accordance with applicable Sections of the Act and the Regulations (as such Sections and Regulations are described further below).

- In order for such Investment Firm to operate as an FCM, it must deposit Client Assets with a third-party depository (e.g., a bank, trust company, clearing organization, or another Investment Firm that is an FCM) in an account that clearly identifies such assets as "Client Assets."
- The Investment Firm must also obtain a written acknowledgment from its third-party depository stating that such depository was informed that the funds deposited within the account entitled "Client Assets" (i) belong to clients of the Investment Firm, (ii) are being held to support transactions in commodity futures or cleared swaps, and (iii) are being held in accordance with applicable Sections of the Act and the Regulations (as such Sections and Regulations are described further below).

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

**CFTC Response:**

Not Applicable.

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

**CFTC Response:**

Yes.

- *Futures.* Section 4d of the Act and Regulation 1.20[36] require that an Investment Firm segregate (i) proprietary assets from (ii) Client Assets

[36] 17 C.F.R. §1.20.

securing commodity futures transactions ("Futures") executed on a designated contract market ("DCM").

- *Foreign Futures.* Regulation 30.7[37] requires that an Investment Firm set aside from its proprietary assets an amount sufficient to cover or satisfy all of its current obligations to clients that are (i) located within the United States and (ii) transacting in commodity futures or options listed on a foreign board of trade ("Foreign Futures").
    - Regulation 30.7 may permit an Investment Firm to set aside a lesser amount of Client Assets to cover its current obligations to clients that are (i) located outside of the United States and (ii) transacting in Foreign Futures. However, as further described in Answers 25 and 26, in the event that the Investment Firm becomes subject to bankruptcy proceedings, such clients will share the Client Assets allocated to the Foreign Futures "account class" equally with clients that are (i) located in the United States and (ii) transacting in Foreign Futures.
- *Cleared Swaps.* Section 4d(f) of the Act and Part 22 of the Regulations[38] require that an FCM segregate (i) proprietary assets from (ii) Client Assets securing swaps cleared on a DCO ("Cleared Swaps").

a. Must the Client Assets of one client be maintained separately from those of other clients?

i. Are Investment Firms allowed to hold Omnibus Accounts?

**CFTC Response:**

Yes. Section 4d of the Act and Regulation 1.20 permit an Investment Firm to hold Client Assets securing Futures in an Omnibus Account (the "Futures Omnibus Account"). Regulation 30.7 permits an Investment Firm to hold Client Assets securing Foreign Futures in an Omnibus Account (the "Foreign Futures Omnibus Account"), provided that the Foreign Futures Omnibus Account is separate from the Futures Omnibus Account. As discussed above, Section 4d of the Act and Part 22 of the Regulations

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[37] 17 C.F.R. §30.7.

[38] 7 U.S.C. §6d(f), 17 C.F.R. §§22.1 *et. seq.*

permit an Investment Firm to hold Client Assets securing Cleared Swaps on an omnibus basis. However, such assets are protected on an individual basis.

ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

**CFTC Response:**

- *Futures and Foreign Futures.* As Answer 25 states below, if a shortfall (as such term is defined below) exists, then clients with Client Assets in the same Omnibus Account as the client whose losses caused the shortfall will share such losses on a *pro rata* basis. Therefore, the best method of preventing such sharing of loss is to ensure, in the first instance, that an Investment Firm will not permit a client to accumulate losses that would be sufficient to cause the default and insolvency of the Investment Firm. Currently, a DCM is required, under Core Principle 11, to conduct financial surveillance of Investment Firms, to, *inter alia*, ensure that the capital of such Investment Firms is appropriate to cover client exposures to Futures.

- *Cleared Swaps.* Although client assets securing cleared swaps may be held in an omnibus account, such assets receive individualized protection in bankruptcy. As discussed above in Answer 1, following an FCM's bankruptcy, where there is a shortfall in the cleared swaps customer account due to a cleared swaps customer loss that exceeds both the cleared swaps customer's collateral and the FCM's ability to pay, the DCO may only use the collateral attributable to the cleared swaps customers whose portfolios of positions at the DCO suffered losses to meet the loss, and then only to the extent of each such customer's share of the loss. Thus, all collateral attributable to cleared swaps customers whose

portfolios of positions gained or were "flat" (neither gained nor lost), and the remaining collateral attributable to cleared swaps customers whose portfolios of positions lost, would be immediately available for transfer.

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

**CFTC Response:**

- *Futures Omnibus Account.* Pursuant to Section 4d of the Act, an Investment Firm is required, at all times, to hold sufficient Client Assets in the Futures Omnibus Account to pay all clients transacting in Futures with credit balances.

- *Foreign Futures Omnibus Account*. Pursuant to Regulation 30.7, an Investment Firm is required, at all times, to hold sufficient Client Assets in the Foreign Futures Omnibus Account to cover or satisfy all of its current obligations to clients that are (i) located within the United States and (ii) transacting in Foreign Futures (the "Secured Amount"). Further, if an Investment Firm decides to hold, in the Foreign Futures Omnibus Account, Client Assets for clients that are (i) located outside the United States and (ii) transacting in Foreign Futures, then such Investment Firm is required, at all times, to hold Client Assets equalling or exceeding the greater of:

  - the sum of (i) the Secured Amount and (ii) an amount sufficient to cover or satisfy all current obligations of the Investment Firm to clients that are (A) located outside of the United States and (B) transacting in Foreign Futures; and

  - the sum of (i) the Secured Amount and (ii) an amount that is required, by the

Regime of the relevant depository or clients, to be held separately for clients that are (A) located outside of the United States and (B) transacting in Foreign Futures.

- *Cleared Swaps.* Pursuant to Section 4d of the Act and Part 22 of the Regulations, an Investment Firm is required, at all times, to have sufficient Client Assets, in specified locations and/or the Cleared Swaps Customer Account, to pay all clients transacting in Cleared Swaps with credit balances.

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

**CFTC Response:**

In general, Client Assets are fungible. If an Investment Firm becomes subject to bankruptcy proceedings, a client can apply for return of "specifically identifiable property," which is generally comprised of property held to facilitate physical settlement of a *bona fide* hedging transaction. Pursuant to Regulation 190.08(d), an Administrative Officer would usually return such "specifically identifiable property" only if the client provides in cash the amount necessary to result in the client suffering the same *pro rata* loss as other clients.[39]

B) How is the reconciliation conducted (*e.g.*¸ on an aggregate basis, or a client-by-client basis)?

**CFTC Response:**

Investment Firms perform reconciliations on an aggregate basis.

[39] 17 C.F.R. §190.08(d).

C) If a client has a debit balance (i.e. the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

**CFTC Response:**

No. If a client has a debit balance, the Investment Firm must maintain in the relevant Omnibus Account or Cleared Swaps Customer Account an amount at least equal to such balance from its own capital.

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

**CFTC Response:**

Investment Firms must perform daily reconciliations.

B) When is such reconciliation required (e.g., noon of the following business day, the tenth business day of the following month).

**CFTC Response:**

Investment Firms must perform reconciliations for each business day by noon on the following business day.

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

**CFTC Response:**

Yes, if the reconciliation shows a deficiency in Client Assets, the Investment Firm must immediately make good such deficiency. Any amount that the Investment Firm deposits in the relevant Omnibus Account or Cleared Swaps Customer Account would be considered Client Assets.

Further, the Investment Firm must immediately report, pursuant to Regulation 1.12(h), the existence of a deficiency to the CFTC.[40] As a practical matter, all Investment Firms maintain a cushion of their own assets in the Futures Omnibus Account, the Foreign Futures Omnibus Account, and the Cleared Swaps Customer Account, to avoid deficiencies in Client Assets and the attendant reporting obligation.

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

**CFTC Response:**

Yes. *See* Answer 3(b)(ii)(C) above. Neither the Act nor the Regulations require an Investment Firm to remove any excess assets.

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

**CFTC Response:**

Section 4d of the Act and Regulation 1.20 prohibit the Investment Firm from using the Client Assets of one client in the Futures Omnibus Account to meet the obligations of another client. Regulation 22.2(d)(1) provides a similar prohibition regarding the use of Client Assets of a Cleared Swaps Customer.[41] Regulation 30.7 does not contain a similar prohibition, because Regulation 30.7 does not, at this

[40] 17 C.F.R. §1.12(h).

[41] 17 C.F.R. §22.2(d)(1).

time, require an Investment Firm to hold, at all times, sufficient Client Assets in the Foreign Futures Omnibus Account to pay all clients transacting in Foreign Futures with credit balances.

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

**CFTC Response:**

Investment Firms are permitted to (a) post customer collateral upstream, with a central counterparty (specifically, for Futures and Cleared Swaps, a DCO) or an upstream clearing broker, and (b) rehypothecate or invest, pursuant to CFTC regulation, collateral or Client Assets posted by customers, so long as the requisite value of collateral remains in segregation at all times. In the latter case, the Investment Firm is permitted to change the *form* of customer collateral that is protected, not the value.

**Restrictions on Use and Rehypothecation of Client Assets**

- *Futures Omnibus Account.* Pursuant to Section 4d of the Act, an FCM may invest Client Assets in the Futures Omnibus Account only "in obligations of the United States, in general obligations of any State or of any political subdivision thereof, and in obligations fully guaranteed as to principal and interest by the United States, such investments to be made in accordance with such rules and regulations and subject to such conditions as the Commission may prescribe." Regulation 1.25[42] sets forth permitted investments for Client Assets in the Futures Omnibus Account. Regulation 1.25 further sets forth specified requirements with respect to permitted investments that are

[42] 17 C.F.R. §1.25.

designed to minimize exposure to credit, liquidity, and market risks.

- *Foreign Futures Omnibus Account.* Neither the Act nor the Regulations place restrictions on the ability of an FCM to invest Client Assets in the Foreign Futures Omnibus Account. However, the FCM has an incentive to invest such Client Assets conservatively, because the FCM is required to immediately make good and to report a deficiency in such Client Assets.

- *Cleared Swaps.* Regulation 22.2(e)(1)[43] permits an FCM to invest Client Assets or other property constituting Cleared Swaps Customer Collateral in accordance with Regulation 1.25. Such collateral is treated the same as Client Assets subject to segregation pursuant to Section 4d(a) of the Act.

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

**CFTC Response:**

As stated above, an Investment Firm is permitted to rehypothecate or invest Client Assets in a limited set of instruments so long as the Firm maintains in segregation the value necessary to repay all clients with positive (i.e., credit) balances in full. However, this does not result in any change to the client's ownership rights: In the event of insolvency, the client remains entitled to a pro rata share of the Client Assets, based on the client's allowed claim.

[43] 17 C.F.R. §22.2(e)(1).

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

**CFTC Response:**

Not Applicable.

iii. How are the ownership rights of a client over its client assets changed or affected when the investment firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (i.e. established by statute or regulation, established by prior judicial decision, based on interpretation of the regulator)?

**CFTC Response:**

Pursuant to Section 766(h) of the Bankruptcy Code, a client remains entitled to a pro rata share of the value of its Client Assets (*i.e.*, the client's allowed claim) in an Investment Firm insolvency.

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

**CFTC Response:**

- *Futures Omnibus Account.*

  - Section 4d(b) of the Act states that "[i]t shall be unlawful for any person, including but not limited to any clearing agency…and any depository, that has received any money, securities, or property for deposit in [the Futures Omnibus Account], to hold, dispose of, or use any such money, securities, or property

as belonging to the depositing futures commission merchant or any person other than the customers of such futures commission merchant."

- Additionally, Regulation 1.20 states that "[a]ll customer funds received by a clearing organization from a member of the clearing organization to purchase, margin, guarantee, secure, or settle the trades, contracts, or commodity options of the clearing member's commodity or option customers as the result of trades, contracts or commodity options so carried shall be separately accounted for and segregated as belonging to such commodity or option customers."

- Further, Regulation 1.20 requires that:

  - the DCO deposit Client Assets with a third-party depository (*i.e.*, a bank or trust company) in an account that clearly identifies such assets as "Client Assets" from the Futures Omnibus Accounts of FCMs, which assets are segregated in accordance with Section 4d of the Act and Regulation 1.20;

  - the DCO obtain a written acknowledgment from its third-party depository (i.e., a bank or trust company) stating that such depository was informed that such Client Assets (i) belong to clients of FCMs, (ii) are being held to support Futures, and (iii) are being held in accordance with Section 4d of the Act and Regulation 1.20.

- *Cleared Swaps Customer Collateral.*

- Similar requirements apply pursuant to Section 4d(f) of the Act and Part 22 of the Commission's Regulations for Cleared Swaps Customer Collateral. Specifically, a DCO must:
  - deposit Client Assets with a third-party depository, whether located in the United States or in another jurisdiction, in an account that clearly identifies such assets as "Cleared Swaps Customer Collateral", which assets are segregated in accordance with Section 4d(f) of the Act and Part 22 of the CFTC's Regulations; and
  - obtain a written acknowledgment from its third-party depository,[44] whether located in the United States or in another jurisdiction, confirming that such depository was informed that such Cleared Swaps Customer Collateral (i) belong to clients of FCMs, (ii) are being held to support Cleared Swaps, and (iii) are being held in accordance with Section 4d(f) of the Act and the regulations thereunder.
- Further, Regulation 22.3(c) prohibits Cleared Swaps Customer Collateral from being commingled with the money, securities, or other property belonging to the DCO and any FCM and other categories of funds received from an FCM on behalf of clients, including Client Assets in the Futures and Foreign Futures Omnibus Accounts.[45]

- *Foreign Futures Omnibus Account.*

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[44] An acknowledgment letter need not be obtained from a DCO that has made effective, pursuant to the section 5c(c) of the Act and regulations promulgated thereunder, rules that provide for the segregation of Cleared Swaps Customer Collateral, in accordance with all relevant provisions of the Act and the regulations thereunder. *See* 17 C.F.R. §22.5(c).

[45] 17 C.F.R. §22.3(c).

- Regulation 30.7 does not specifically impose requirements on clearing organizations to maintain the separate identification of Client Assets from the Foreign Futures Omnibus Account. However, as Answer 5 states, Regulation 30.7 does require:

  - each FCM to deposit such Client Assets with a third-party depository, including a DCO, in an account that clearly identifies such assets as "Client Assets" from the Foreign Futures Omnibus Account, which assets are set aside in accordance with Regulation 30.7; and

  - each FCM to obtain a written acknowledgment from such third-party depository, including a clearing organization, stating that such depository was informed that such Client Assets (i) belong to clients of the FCM, (ii) are being held to support Foreign Futures, and (iii) are being held in accordance with Regulation 30.7.

- Further, Regulation 30.7 generally prohibits Client Assets in the Foreign Futures Omnibus Account from being "commingled with the money, securities or property of such futures commission merchant, with any proprietary account of such futures commission merchant, or used to secure or guarantee the obligations of, or extend credit to, such futures commission merchant or any proprietary account of such futures commission merchant." Such prohibition would extend to the activities of clearing organizations.

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does

the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

**CFTC Response:**

Yes, Investment Firms are generally permitted to transfer to, or hold Client Assets in, other jurisdictions, pursuant to: (i) Regulation 1.49 with respect to Client Assets in the Futures Omnibus Account; (ii) Regulation 30.7 with respect to Client Assets in the Foreign Futures Omnibus Account, and (iii) Regulation 22.9 with respect to Client Assets in the Cleared Swaps Customer Account.[46]

a. Client Assets transferred to or located in other jurisdictions?

**CFTC Response:**

a) *Futures Omnibus Account.* Pursuant to Regulation 1.20, the Investment Firm must:

- deposit Client Assets with a permitted third-party depository, whether located in the United States or in another jurisdiction, in an account that clearly identifies such assets as "Client Assets" from the Futures Omnibus Account, which assets are segregated in accordance with Section 4d of the Act and Regulation 1.20; and
- obtain a written acknowledgment from its third-party depository, whether located in the United States or in another jurisdiction, confirming that such depository was informed that such Client Assets (i) belong to clients of the Investment Firm, (ii) are being held to support Futures, and (iii) are being held in accordance with Section 4d of the Act and Regulation 1.20.

[46] 17 C.F.R. §§1.49, 30.7, 22.9.

- Pursuant to Regulation 1.49(e),[47] each Investment Firm that has either transferred Client Assets to, or held Client Assets from the Futures Omnibus Account in, another jurisdiction must, as of the close of each business day, have sufficient Client Assets, in specified locations, to meet all obligations to clients from the Futures Omnibus Account.

- Pursuant to Regulation 1.32,[48] each Investment Firm must perform a daily reconciliation of the amount of Client Assets in the Futures Omnibus Account, on a currency-by-currency basis.

b) *Foreign Futures Omnibus Account.* Pursuant to Regulation 30.7, where the FCM holds Client Assets of foreign futures customers with a third-party custodian, the FCM must:

- deposit Client Assets with a permitted third-party depository, whether located in the United States or another jurisdiction, in an account that clearly identifies such assets as "Client Assets" from the Foreign Futures Omnibus Account, which assets are set aside in accordance with Regulation 30.7;

- obtain a written acknowledgment from such third-party depository, whether located in the United States or another jurisdiction, stating that such depository was informed that such Client Assets (i) belong to clients of the FCM, (ii) are being held to support Foreign Futures, and (iii) are being held in accordance with Regulation 30.7; and

[47] 17 C.F.R. §1.49(e).

[48] 17 C.F.R. §1.32.

- perform a daily reconciliation of the amount of Client Assets in the Foreign Futures Omnibus Account.

c) *Cleared Swaps Customer Account.*

- Where an Investment Firm holds Client Assets of Cleared Swaps Customers, the Investment Firm must:
  - deposit Client Assets with a third-party depository, whether located in the United States or in another jurisdiction, in an account that clearly identifies such assets as "Cleared Swaps Customer Collateral", which assets are segregated in accordance with Section 4d(f) of the Act and Part 22 of the CFTC's Regulations; and
  - obtain a written acknowledgment from its third-party depository,[49] whether located in the United States or in another jurisdiction, confirming that such depository was informed that such Cleared Swaps Customer Collateral (i) belong to clients of the Investment Firm, (ii) are being held to support Cleared Swaps, and (iii) are being held in accordance with Section 4d(f) of the Act and the regulations thereunder.
- Pursuant to Regulation 1.49, as incorporated by Regulation 22.9, each FCM that holds Cleared Swaps Customer Collateral must, as of the close of each business day, have sufficient Client Assets, in specified locations, to meet all obligations to clients from the Cleared Swaps

[49] An acknowledgment letter need not be obtained from a DCO that has made effective, pursuant to the section 5c(c) of the Act and regulations promulgated thereunder, rules that provide for the segregation of Cleared Swaps Customer Collateral, in accordance with all relevant provisions of the Act and the regulations thereunder. *See* 17 C.F.R. §22.5(c).

Customer Account. The FCM must hold sufficient United States dollars, held in the United States, to meet all United States dollar obligations; sufficient funds in either United States dollars or in money center currencies held in either the United States or money center countries to meet obligations in money center currencies; and sufficient funds in either United States dollars, money center currencies, or the currency of the obligation to meet obligations in other currencies.

- Pursuant to Regulation 22.2(g),[50] each FCM must perform a daily reconciliation of the amount of Cleared Swaps Customer Collateral, on a currency-by-currency basis.

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions? If so, please provide details of those requirements.

**CFTC Response:**

Yes. Section 4d(a) of the Act and Regulation 1.20 would require the Investment Firm to place such Client Assets in the Futures Omnibus Account, to the extent that such Client Assets currently, or are intended to in the future, secure Futures. Similarly, Section 4d(f) of the Act and Part 22 of the Regulations would require that such Client Assets be placed in the Cleared Swaps Customer Collateral account. Regulation 30.7 would require the Investment Firm to place such Client Assets in the Foreign Futures Omnibus Account, to the extent that such Client Assets must be included in the Secured Amount or any additional amount, as described in Answer 3(b)(i). Neither the Act nor the Regulations require that the Investment Firm identify, within the relevant Omnibus Account, the jurisdiction from which such Client Assets originated (*e.g.*, the Investment Firm would not need to separately identify (i) USD originating from the United States and (ii) USD transferred from another jurisdiction).

[50] 17 C.F.R. §22.2(g).

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

**CFTC Response:**

Yes

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

**CFTC Response:**

Such Client Assets are entitled to the same protections as those Client Assets of U.S. customers held by Investment Firms in the United States.

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

**CFTC Response:**

None.

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

**CFTC Response:**

None. Such protections cannot be reduced.

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

**CFTC Response:**

a) *Futures Omnibus Account.*

- Pursuant to Regulation 1.49(d)[51]:
  - If an Investment Firm holds the Futures Omnibus Account with a third-party depository located in the United States, such depository must be: (i) a bank or trust company (each of which is subject to the oversight of applicable banking regulators); (ii) an FCM registered as such with the Commission; or (iii) a DCO.
  - If an FCM holds the Futures Omnibus Account with a third-party depository located outside of the United States, such depository must be: (i) a bank or trust company that has more than $1 billion of regulatory capital; (ii) an FCM registered as such with the Commission; or (iii) a DCO.
- The Investment Firm may hold the Futures Omnibus Account with an affiliate.

*b) Foreign Futures Omnibus Account.*

- Pursuant to Regulation 30.7, an Investment Firm may hold the Foreign Futures Omnibus Account in any of the following: i) a bank or trust company located outside of the United States; (ii) a member of any foreign board of trade; or (iii) the designated depository of such member or a DCO, as well as in the third-party depository in which it may hold the Futures Omnibus Account.
- The Investment Firm may hold the Foreign Futures Omnibus Account with an affiliate.

*c) Cleared Swaps:*

[51] 17 C.F.R. §1.49(d).

- Pursuant to Regulation 22.4,[52] if an Investment Firm holds Cleared Swaps Customer Collateral, with a third-party depository located in the United States, such depository must be: (i) a bank or trust company (each of which is subject to the oversight of applicable banking regulators); (ii) a collecting FCM[53] registered as an FCM with the Commission (but only with respect to a depositing FCM[54] providing Cleared Swaps Customer Collateral); or (iii) a DCO.
- Pursuant to Regulation 1.49(d), as incorporated by Regulation 22.9, if an Investment Firm holds Cleared Swaps Customer Collateral with a third-party depository located outside of the United States, such depository must be: (i) a bank or trust company that has more than $1 billion of regulatory capital; (ii) an FCM registered as such with the Commission; or (iii) a DCO.
- The Investment Firm may hold Cleared Swaps Customer Collateral with an affiliate.

b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

**CFTC Response:**

- *Futures Omnibus Accounts.* Regulation 1.20 states that "[u]nder no circumstances shall any portion of [Client Assets in Futures Omnibus Accounts] be obligated to a clearing organization, any member of a

[52] 17 C.F.R. §22.4.

[53] A collecting FCM is defined as an FCM that carries Cleared Swaps on behalf of another FCM and the Cleared Swaps Customers of the latter FCM, and as part of carrying such Cleared Swaps, collects Cleared Swaps Customer Collateral. 17 C.F.R. §22.1.

[54] A depositing FCM is an FCM that carries Cleared Swaps on behalf of its Cleared Swaps Customers through another FCM and, as part of carrying such Cleared Swaps, deposits Cleared Swaps Customer Collateral with such FCM. 17 C.F.R. §22.1.

contract market, a futures commission merchant, or any depository except to purchase, margin, guarantee, secure, transfer, adjust or settle trades, contracts or commodity option transactions of commodity or option customers."

- *Foreign Futures Omnibus Accounts*. Regulation 30.7 generally prohibits Client Assets in the Foreign Futures Omnibus Account from being "used to secure or guarantee the obligations of, or extend credit to, such futures commission merchant or any proprietary account of such futures commission merchant." Such prohibition would extend to custodians.
- *Cleared Swaps*. Regulation 22.2(d)(2) states that "[a] futures commission merchant may not impose or permit the imposition of a lien on Cleared Swaps Customer Collateral."[55]

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

**CFTC Response:**

Prior to opening a transactional account for a client, an Investment Firm is required to provide each client (except for certain "institutional customers" as defined in Regulation 1.3(g)[56]) specific disclosures pertaining to (i) the protection of Client Assets in the Futures Omnibus Account (pursuant to Regulation 1.55),[57] (ii) the protection of Client Assets in the Foreign Futures Omnibus Account (pursuant to Regulation 30.6),[58] and (iii) the governing provisions relating to the use of Cleared Swaps Customer Collateral (pursuant to Regulation 22.16).[59] Such disclosures emphasize that:

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55 17 C.F.R. §22.2(d)(2).

56 17 C.F.R. §1.3(g).

57 17 C.F.R. §1.55.

58 17 C.F.R. §30.6.

59 17 C.F.R. §22.16.

- Client Assets in the Foreign Futures Omnibus Account may not be provided the same level of protection as Client Assets in the Futures Omnibus Account;
- the client should consult with the Investment Firm concerning the nature of protections available to Client Assets, especially in the event of the Investment Firm experiencing insolvency;
- if the client gives the Investment Firm permission, either explicitly or implicitly, to deposit Client Assets in a jurisdiction outside of the United States, then in the event that the Investment Firm experiences insolvency, the laws of the relevant jurisdiction may apply, which may result in the client recovering less than all of the Client Assets that the client provides to the Investment Firm; and
- the CFTC cannot compel enforcement of the laws of the relevant jurisdiction.

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

**CFTC Response:**

The Act and the regulations promulgated thereunder do not permit clients to choose a lesser level of protection for Client Assets than the level that (i) Section 4d(a) and (b) of the Act and Regulations 1.20 to 1.30[60] afford to Client Assets in the Futures Omnibus Account, (ii) Regulation 30.7 affords to Client Assets in the Foreign Futures Omnibus Account, and (iii) Section 4d(f) of the Act and Regulations 22.1 *et. seq.* afford to Cleared Swaps Customer Collateral.

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

   a. Does the Investment Firm report where client assets are held?

   b. Does the Investment Firm or depository report the protections applicable to such client assets?

[60] 17 C.F.R. §§1.20-1.30.

c. Does the Investment Firm or depository report the amount of assets that are held?

In each case, are such reports provided on request or periodically? If periodically, with what frequency?

**CFTC Response to a-c:**

FCMs are required to maintain evidence of the existence and amount of Client Assets held, including the Client Assets at each depository. They are also required to maintain in their records "confirmation" letters from each depository acknowledging that the assets (i) belong to clients of the FCM, (ii) are being held to support Futures, Foreign Futures or Cleared Swaps, and (iii) are being held in accordance with Section 4d of the Act or in the case of Foreign Futures, Rule 30.7. Such records are reviewed during (approximate) annual examinations conducted by the DSRO.

Moreover, an FCM must prepare a segregation statement daily showing Client Assets and obligations. The statement must be completed by noon for balances at the close of the previous business day. Such statements are included in a report that is filed monthly with the CFTC which provides an FCM's net capital position, statement of segregated assets, and other financial information, as well as in an FCM's annual audited financial statements. An FCM must immediately report, pursuant to Regulation 1.12(h), the existence of a deficiency in any omnibus account to the CFTC. Currently, the CFTC is considering additional and more real-time reporting regarding the holding of Client Assets.

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

a. Where Client Assets are held?

b. The amount of Client Assets held at a depository?

c. The safeguards applicable to Client Assets held at a depository?

**CFTC Response to a-c:**

As discussed in Answer 9, DSROs conduct annual compliance examinations of FCMs, which include the

verification of Client Assets. Such verification includes a review of the "confirmation" letters maintained by the FCM.

Recently, NFA approved new rules, which would require futures brokerages to provide regulators with view-only Internet access to the segregated account information of customers. The newly approved requirements have been sent to the CFTC for approval.

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

    **CFTC Response:**

    A foreign regulator could obtain confirmation directly from the Investment Firm in the U.S. Moreover, where there is an applicable Memorandum of Understanding ("MOU"), the foreign regulator could obtain information through that MOU.

    b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

    **CFTC Response:**

    These Client Assets are entitled to the same protections as the Client Assets of U.S. customers as set forth in Section 766(h) of the Bankruptcy Code.

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

**CFTC Response:**

An Investment Firm has affirmative responsibilities under the Regulations to notify the CFTC upon the occurrence of one of a number of events, any of which may indicate financial distress. For example, pursuant to Regulation 1.12:

- an Investment Firm must provide the CFTC with notice within twenty-four (24) hours, if such Investment Firm knows or should know that its capital exceeds its minimum capital requirement, but is less than a certain percentage specified in Regulation 1.12;
- an Investment Firm must provide the CFTC with immediate notice, if such Investment Firm knows or should know that its capital is less than the amount specified in its minimum capital requirement;
- an Investment Firm must provide the CFTC with immediate notice, if such Investment Firm determines that it has a deficiency in Client Assets; and
- an Investment Firm must provide the CFTC with immediate notice, if such Investment Firm determines that any commodity interest account is undermargined by an amount that exceeds the adjusted net capital of such Investment Firm.

Additionally, the CFTC may receive information from a DSRO or a DCO that an Investment Firm is either currently not fulfilling its financial obligations, or has a risk profile indicating that it may shortly become unable to fulfill such obligations. Further, the CFTC Risk Surveillance Group may identify such an Investment Firm.

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*, capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

**CFTC Response:**

If the CFTC ascertains, whether from the notifications described in Answer 12 or otherwise, that the financial situation of an Investment Firm is deteriorating, then the CFTC will attempt to effect the transfer of Client Assets. For example, pursuant to Regulation 1.17(a)(4), if an Investment Firm holds less capital than the amount specified in its minimum capital requirement, then it generally must transfer all Client Assets and immediately cease conducting business as an Investment Firm, until such time as the Investment Firm is able to demonstrate compliance with its minimum capital requirement.[61] The Investment Firm itself or its DSRO would actually arrange the transfer of Client Assets, and the CFTC would facilitate such transfer as necessary.

[61] 17 C.F.R. §1.17(a)(4).

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

**CFTC Response:**

In general, an Investment Firm becomes subject to bankruptcy proceedings in the same manner as an entity that is not an Investment Firm – *i.e.*, either (i) the Investment Firm itself files a voluntary bankruptcy petition or (ii) the creditors of such Investment Firm file an involuntary bankruptcy petition. However, there are three key differences in the manner in which bankruptcy proceedings for an Investment Firm may be initiated, as contrasted with the manner in which bankruptcy proceedings for an entity that is not an Investment Firm may be initiated.

- First, if an Investment Firm has engaged, is engaging, or is about to engage in any act or practice constituting a violation of the Act, the Regulations, or any CFTC order, then pursuant to Section 6(c) of the Act, the CFTC may petition in federal court for the appointment of a receiver for the Investment Firm. If appropriate, the receiver would then file a voluntary bankruptcy petition on behalf of the Investment Firm.
- Similarly, if an Investment Firm is also a broker-dealer, and that broker-dealer is approaching financial difficulty, the Securities Investors Protection Corporation ("SIPC") may seek a protective decree from a federal court pursuant to Section 5 of the Securities Investors Protection Act, 15 U.S.C. §78eee.
- Finally, pursuant to Section 109(d) of the Bankruptcy Code, an Investment Firm is only eligible for liquidation under Subchapter IV of Chapter 7 of the Bankruptcy Code.[62] An Investment Firm is not eligible for reorganization under Chapter 11 of the Bankruptcy Code.

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

**CFTC Response:**

[62] 11 U.S.C. §109(d).

In general, the relevant United States Trustee, an officer of the executive branch, will appoint an Administrative Officer from a panel of private trustees. There are twenty-one United States Trustees, and they are organized on a regional basis. If the Investment Firm is also a broker-dealer, the Administrative Officer would be designated by SIPC. In practice, the CFTC coordinates with the relevant United States Trustee or SIPC to provide for the appointment of an Administrative Officer who is familiar with the commodity futures markets and the role of Investment Firms in such markets. In general, the Administrative Officer would also retain a law firm with knowledge of the Regime governing the Investment Firm, particularly with respect to bankruptcy.

16. What are the duties of the Administrative Officer?

a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

**CFTC Response:**

Section 704 of the Bankruptcy Code sets forth the general duties of the Administrative Officer. Such duties include the following: (i) investigating the financial affairs of the Investment Firm; (ii) reducing the estate of the Investment Firm to money and closing such estate as expeditiously as possible; (iii) accounting for property in such estate; (iv) examining and objecting to claims from creditors; (v) providing information on the administration of such estate; and (v) making a final report and filing a final account of the administration of such estate with the United States Trustee or the relevant bankruptcy court.[63]

Subchapter IV of Chapter 7 of the Bankruptcy Code[64] and Regulation Part 190 set forth certain duties of the Administrative Officer specific to the bankruptcy of an Investment Firm, and provide guidance to the Administrative Officer on satisfying such duties. Such duties include, and such guidance pertains, to the following: (i) the expeditious transfer, as described further below, of Client Assets from the Investment Firm to a solvent Investment Firm; (ii) the expeditious liquidation and distribution of Client Assets, as described further below, if a transfer of Client Assets is not

[63] 11 U.S.C. §704.

[64] 11 U.S.C. §§761-767.

feasible (because of, *e.g.*, the existence of a shortfall); and (iii) the requisite consultation with clients of the Investment Firm prior to the liquidation of Client Assets.

b. Under what standard (*e.g.*, strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

**CFTC Response:**

The standard under which the Administrative Officer would be subject to personal liability for failure to properly perform his or its duties is not articulated in the Bankruptcy Code, the Act, or the Regulations. Rather, such standard has been developed through case law. The leading case on this question, *Mosser v. Dunn*, 341 U.S. 267 (1951), articulated principles that have been interpreted to permit the Administrative Officer to be held personally liable for gross negligence or for willful disregard of his or its fiduciary duties.

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

a. Does the regulator continue to supervise the Investment Firm?

**CFTC Response:**

Yes, the Investment Firm remains an FCM and is still subject to the Act and the Regulations.

b. How, if at all, is the regulator involved in the process of returning Client Assets?

**CFTC Response:**

The CFTC would be involved in discussions with the Administrative Officer, the DSRO of the Investment Firm, and the DCO of the Investment Firm to facilitate efficient and orderly returns of Client Assets. The CFTC also has the right to appear and be heard in the bankruptcy proceedings for the Investment Firm. The CFTC, however, does not directly participate in disbursements of Client Assets. Rather,

the Administrative Officer is responsible for such disbursements.

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

**CFTC Response:**

During the insolvency of an Investment Firm, a Trustee segregates Client Assets as part of the process of returning assets on a pro rata basis, proportional to allowed claims, to clients of the Investment Firm through transfer or distribution.

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm which has become bankrupt or insolvent to a solvent Investment Firm?

**CFTC Response:**

Yes, if an Investment Firm becomes subject to bankruptcy proceedings before it transfers Client Assets as described in Answer 13, the Administrative Officer must immediately use best efforts, pursuant to Regulation 190.02(e),[65] to transfer eligible Client Assets, as determined in accordance with Regulation 190.06(e) and (f).[66]

a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

**CFTC Response:**

The Administrative Officer must use best efforts, pursuant to Regulation 190.02(e), to transfer eligible Client Assets no later than the close of business on the seventh calendar day after the petition for bankruptcy has been filed with respect to the Investment Firm. Such transfers are generally accomplished if there is no shortfall in Client Assets. Indeed, in such cases (*e.g.*, the bankruptcy cases of Refco, LLC and Lehman Brothers, Inc.), transferees may pay for the client business of the Investment Firm. In such cases, a transferee may be identified before the Investment Firm formally becomes subject to bankruptcy proceedings,

[65] *See* 17 C.F.R. §190.02(e).

[66] *See* 17 C.F.R. §§190.06(e)-(f).

the transfer may be approved by the Court within hours of the filing of such proceedings, and the transfer accomplished over a weekend.

b. What factors, if any, affect the time period required to accomplish such a transfer?

**CFTC Response:**

The key factor is the presence or absence of a shortfall in Client Assets. If such a shortfall exists, transfer becomes more challenging, though not necessarily impossible. For example, in the MF Global Bankruptcy, transfers of futures accounts were accomplished with only approximately 60 percent of Client Assets available for transfer. As Answer 25 discusses further below, the presence or absence of a shortfall is computed separately for each "account class."

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

**CFTC Response:**

In general, clients are protected from being required to return Client Assets distributed in accordance with the Act and the Regulations, whether such distributions occurred before or after a petition for bankruptcy has been filed with respect to the Investment Firm. Specifically:

- Pursuant to Section 764(b) of the Bankruptcy Code, in conjunction with Regulations 190.06(g)(1) and (3),[67] the Administrative Officer cannot avoid the following pre-petition actions:
  - a transfer of Client Assets by the Investment Firm as described in Answer 13, provided that the CFTC does not disapprove of such transfer; or
  - a transfer or withdrawal of Client Assets by the relevant client, provided that (i) the client is not affiliated with the Investment Firm, (ii) the client is not colluding with the Investment Firm or its

[67] *See* 11 U.S.C. §764(b), 17 C.F.R. §190.06(g)(1), 17 C.F.R. §190.06(g)(3).

principals, and (iii) the CFTC does not disapprove of the transfer or withdrawal.

- Pursuant to Section 764(b) of the Bankruptcy Code, in conjunction with Regulation 190.06(g)(2),[68] the Administrative Officer cannot avoid the following post-petition actions:
  - a transfer of Client Assets by the Administrative Officer as described in Answer 19, or a transfer of Client Assets by the DSRO or the DCO of the Investment Firm, provided that (i) the relevant transfer occurs no later than the close of business on the seventh business day after the filing of the petition for bankruptcy with respect to the Investment Firm, and (ii) the CFTC receives notification of such transfer, pursuant to Regulation 190.02(a)(2), and does not disapprove of such transfer; and
  - a transfer of Client Assets at the direction of the CFTC upon such terms and conditions that the CFTC may deem appropriate and in the public interest, provided that such transfer occurs no later than the seventh calendar day after the filing of the petition for bankruptcy with respect to the Investment Firm.

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

**CFTC Response:**

Neither the Bankruptcy Code nor the Act establishes a fund, separate from Client Assets, which would compensate clients in the event that the Investment Firm becomes subject to bankruptcy proceedings.

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

**CFTC Response:**

No. The Act and the regulations promulgated thereunder do not permit clients to choose a lesser level of protection for Client Assets than the level that (i) Section 4d(a) and (b) of the Act and Regulations 1.20 to 1.30 afford to Client

[68] *See* 11 U.S.C. §764(b), 17 C.F.R. §190.06(g)(2).

Assets in the Futures Omnibus Account, (ii) Regulation 30.7 affords to Client Assets in the Foreign Futures Omnibus Account, and (iii) Section 4d(f) of the Act and Regulations 22.1 *et. seq.* afford to Cleared Swaps Customer Collateral.

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

**CFTC Response:**

If clients permit, either explicitly or implicitly, an Investment Firm to hold Client Assets in another jurisdiction, then such clients may suffer "sovereign loss" in the event that such Investment Firm becomes subject to bankruptcy proceedings. In general, "sovereign loss" refers to any loss generated by the application of the law of the relevant jurisdiction to Client Assets, in a manner that is different than the manner applicable under United States law.

- *Futures or Cleared Swaps.* Pursuant to Framework 2 of Appendix B to Regulation Part 190, if there is "sovereign loss" in one jurisdiction, then such loss would be allocated as follows:
    - those clients that permitted the Investment Firm to hold their Futures collateral or Cleared Swaps Customer Collateral only in the United States will be fully insulated from such loss;
    - those clients that permitted, explicitly or implicitly, the Investment Firm to hold their portions of the Futures collateral or Cleared Swaps Customer Collateral, respectively, in the jurisdiction with "sovereign loss" would have such portions exposed to such loss; and
    - if "sovereign loss" exceeds those portions of the Futures collateral or Cleared Swaps Customer Collateral referenced immediately above, then those clients that permitted, explicitly or implicitly, the Investment Firm to hold their portions of the Futures collateral or Cleared Swaps Customer Collateral, respectively, outside the United States, but in a jurisdiction without "sovereign loss," would have their portions exposed to such excess loss.
- *Foreign Futures Omnibus Account.* If "sovereign loss" causes a shortfall in the Foreign Futures Omnibus Account, then such loss would be allocated among all clients with Client Assets in the Foreign Futures Omnibus Account, in the manner that Answer 25 describes, regardless of which clients permitted, either explicitly or implicitly, the Investment Firm to hold portions of the Foreign Futures Omnibus Account outside of the United States.

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

**CFTC Response:**

All clients would share *pro rata* in the event of losses resulting from such failure.

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

**CFTC Response:**

If a shortfall exists, then the Administrative Officer would separate the claims of clients into "account classes" based on the segregation or set-aside requirements applicable to the contracts underlying such claims and the Client Assets securing such contracts. For example, the Administrative Officer would place claims pertaining to Futures in one "account class" (*i.e.*, the Futures account class) claims pertaining to Foreign Futures in another "account class" (*i.e.*, the Foreign Futures account class), and claims pertaining to Cleared Swaps in a third account class.

Within each "account class," the claims of each client would be satisfied on a *pro rata* basis from the aggregate Client Assets relevant to such "account class," subject to the adjustment for "sovereign loss" (as further described in Answer 23), and to the priority accorded to clients that are not affiliated with the Investment Firm (as further described in Answer 26). As a practical matter, if the Investment Firm becomes subject to bankruptcy proceedings due to a shortfall in one "account class," other clients with claims in that "account class" are exposed to losses, while clients with claims in another "account class" without a shortfall may benefit from a prompt transfer.

Pursuant to Section 766(j)(2) of the Bankruptcy Code, if the Administrative Officer cannot satisfy the claims of a client from applicable Client Assets, then the client will have a claim as an unsecured creditor against the general estate of the Investment Company.[69]

[69] *See* 11 U.S.C. §766(j)(2).

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

**CFTC Response:**

Client Assets in FCM bankruptcies can be, and have been, distributed in advance of other claims.[70]

The Bankruptcy Code, the Act, and the Regulations do not differentiate between foreign and domestic clients. Pursuant to Section 766(h) of the Bankruptcy Code, clients are entitled to have their claims satisfied from "customer property" (*i.e.*, Client Assets) in priority to all other claims, other than certain administrative expenses of the estate. Where the transfer of Client Assets and associated positions is not practicable (e.g., where there is a shortfall in Client Assets due to a client default that exceeds the resources of the Investment Firm), Client Assets in each "account class" are distributed pro rata among the client claims for that "account class," with each client claim receiving the same percentage economic distribution, regardless of the form of Client Assets deposited. However, such claims are subject to the priority accorded to clients that are not affiliated with the Investment Firm. Pursuant to Section 766(h) of the Bankruptcy Code and Regulation 190.08(b),[71] clients that are not affiliated with the Investment Firm are entitled to have their claims satisfied from "customer property" (*i.e.*, Client Assets) in priority to clients that are affiliated with the Investment Firm.

## III. Pertinent references

Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?

**Statutes:**

The Commodity Exchange Act, 7 U.S.C. §1 *et seq.* available at http://www4.law.cornell.edu/uscode/html/uscode07/usc_sup_01_7_10_1.html

The Bankruptcy Code, 11 U.S.C. §101 *et. seq.*, and in particular Subchapter IV of Chapter 7, 11 U.S.C. §§ 761-767, available at http://www.gpo.gov/fdsys/pkg/USCODE-2011-title11/pdf/USCODE-2011-title11.pdf

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[70] *See, e.g.*, Refco, LLC, Lehman Brothers, Inc., MF Global.

[71] *See* 11 U.S.C. §766(h); 17 C.F.R. §190.08(b).

**Regulations (all references are found in 17 C.F.R.), and are available at:** http://ecfr.gpoaccess.gov

CFTC Regulation 1.12 (Maintenance of Minimum Financial Requirements by Futures Commission Merchants and Introducing Brokers)

CFTC Regulation 1.17 (Minimum Financial Requirements for Futures Commission Merchants and Introducing Brokers)

CFTC Regulations 1.20 to 1.30 (Customers' Money, Securities, and Property)

CFTC Regulation 1.32 (Segregation Account; Daily Computation and Record)

CFTC Regulation 1.49 (Denomination of Customer Funds and Location of Depositories)

CFTC Regulation 1.55 (Distribution of "Risk Disclosure Statement" by Futures Commission Merchants and Introducing Brokers)

CFTC Regulations 22.1 to 22.16 (Cleared Swaps)

CFTC Regulation 30.6 (Disclosure)

CFTC Regulation 30.7 (Treatment of Foreign Futures or Foreign Options Secured Amount)

CFTC Regulation Part 190 (Bankruptcy Rules)

# United States – SEC
# 2013 Survey of Regimes
# For the Protection, Distribution
# and/or Transfer of Client Assets

## I. Background

This questionnaire seeks information to aid in understanding the responding jurisdictions' techniques for protecting Client Assets both in advance of and in the event of the insolvency and/or winding up of an Investment Firm, and for promptly transferring such assets to a solvent Investment Firm or distributing them to the client. It is not intended to require information concerning the general legal framework for insolvency, except to the limited extent necessary to understand how rules for the protection of Client Assets fit within that framework.

### Definitions.

(1) **"Administrative Officer"** refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) **"Client Assets"** means Client Assets (or an analogous term) as defined in the responding jurisdiction, including, to the extent appropriate, Positions, Securities, and Client Money:

- "**Positions"** are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- "**Securities"** are defined to incorporate both securities and derivatives, as those terms are defined or understood in the responding jurisdiction; and

- "**Client Money"** refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) **"Investment Firm"** means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) **"Omnibus Account"** means an Investment Firm's account with a third party in which Client Assets are maintained separate from the firm's assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) **"Regime"** refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.

## II. Survey Questions *Where appropriate, please provide citations to statutes, regulations, or other authorities supporting your answers below.*

### Context

1. Please provide a brief overview setting forth the defining characteristics of your jurisdiction's approach to protecting Client Assets.

*Under authority granted in the Securities and Exchange Act of 1934 (Exchange Act), the SEC adopted Rule 15c3-3 to protect customer securities and cash held at a broker dealer.*[72] *As explained in more detail below, the Rule requires that customer securities be held free of lien in a good control location, customer cash be accounted for once a week, and forbids the use of "free credit balances" to finance a broker-dealer's inventory or expenses. The Rule further requires the "locking away" of customer net credits held at a broker-dealer in a Reserve Account so that if a broker-dealer is liquidated, those customer securities and funds would be available to be returned to customers. Rule 15c3-3 requires broker-dealers to account for customer securities and cash on a daily basis and take steps to ensure that customer fully-paid and excess margin securities are held in the control of the broker-dealer free of lien. On a weekly basis, broker-dealers are required to perform a calculation of the amount of customer cash they hold and compare that amount with the amount of cash they have extended to or on behalf of customers for margin loans and short sales. The excess of the amount of money held for customers (if any) must be on deposit in a special reserve bank account for the exclusive benefit of customers in the form of cash or US government securities.*

*These requirements – along with the broker-dealer net capital rule – are designed to allow a broker-dealer to self-liquidate in an orderly wind-down where customer cash and securities are quickly returned to customers or transferred to a solvent broker-dealer. A trustee in a court-supervised proceeding under the Securities Investor Protection Act ("SIPA") liquidates broker-dealers that cannot self-liquidate. These provisions are designed to restore customer funds and securities quickly and to insulate the securities markets from disruption following the failure of broker-dealers. Under SIPA, customers' cash and securities held by the brokerage firm are returned to customers on a pro rata basis. If sufficient funds and securities are not available to satisfy customer net equity claims, the reserve funds of the Securities Investor Protection Corporation ("SIPC") are used to supplement the distribution, up to a ceiling of $500,000 per customer, including a maximum of $250,000 for cash claims.*[73]

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[72] *For purposes of this survey, the term "broker dealer" generally refers only to "clearing" broker-dealers that hold customer assets. Non-clearing firms do not hold customer assets.*

[73] *The Dodd-Frank Act amended certain sections of the Security Investor Protection Act of 1970 ("SIPA"), to, among other things, increase the amount of SIPC protection available for claims for cash from $100,000 to $250,000. See http://www.sipc.org/Portals/0/PDF/Dodd%20Frank%20Amend%20%207-29-10.pdf.*

*A broker-dealer is also subject to important reporting requirements (to the SEC) that are relevant to the protection of customer assets, as described in response to question 9, below.*

*Finally, in 2012, the SEC approved a rule of the Financial Industry Regulatory Authority (FINRA) to require each member firm to file certain additional financial or operational schedules or reports to supplement existing filing requirements.*[74] *While this FINRA Rule would not directly improve customer protection, FINRA has expressed its belief that the new rule will improve income and expense data, which would in turn improve the oversight of broker-dealers.*

*In addition to the above, the following rulemaking proposals are pending, which will impact the characteristics of the U.S. approach to protecting client assets:*

- *In June 2011, the SEC proposed amendments to Rule 17a-5,* [75] *which, among other things: (1) strengthen oversight of broker-dealer custody practices, including proposed amendments that would require a broker-dealer to file a report on a quarterly basis that contains information about whether and, if so how, it maintains custody of its customers' securities and cash; and (2) clarify and strengthen the rules governing audits of broker-dealers, including an auditor's examination of broker-dealer controls relating to the custody of customer assets.*

- *SEC's rulemaking to implement specified provisions of the Dodd-Frank Act is ongoing, including:*

  - *Proposals regarding the segregation of security-based swaps.*

  - *Rules applicable to systemically important broker-dealers. Specifically, under Title II of the Dodd-Frank Act, the FDIC may be appointed as receiver over a broker or dealer for which a determination has been made, under Section 203 of the Dodd Frank Act, that the broker-dealer is systemically important. Section 205 of the Dodd-Frank Act, 12 U.S.C. S. 5385, prescribes, among other things, the manner in which customer property is to be treated in the resolution of a covered broker or dealer. Pursuant to Section 205(h) of the Dodd-Frank Act, 12 U.S.C. S. 5385(h), the FDIC and the SEC, in consultation with SIPC, are jointly to issue regulations implementing Section 205.*

a. How does your jurisdiction define the term "client assets?" If the jurisdiction uses an analogous term, please provide that term and its definition.

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[74] *See SEC approval of FINRA Rule 4524, available at: http://www.sec.gov/rules/sro/finra/2012/34-66364.pdf (Feb. 9, 2012). See also description at: http://www.grantthornton.com/staticfiles/GTCom/Financial%20services/Financial%20Bulletin/Financial_Bulletin_Jun12_2012.pdf.*

[75] *Available at: http://www.sec.gov/rules/proposed/2011/34-64676.pdf. The report would establish a custody profile for the broker-dealer that examiners could use as a starting point to focus their custody examinations. SEC staff has evaluated comments received in response to this proposal and is working to finalize a recommendation.*

*Client Assets" would generally refer to customer funds or securities[76] held on behalf of customers by a broker-dealer. The responses below generally refer to the customer protection rules as they relate to customers of broker-dealers registered with the SEC, unless otherwise noted (such as references to implementing provisions of the Dodd-Frank Act with respect to security-based swaps and security-based swap dealers).*

b. What is the nature of a client's ownership rights with respect to its client assets placed with the investment firm?

*Exchange Act Rule 15c3-3 ("customer protection rule") general governs the nature of a client's ownership rights. For example, paragraph (a)(8) of Rule 15c3-3 generally defines the term "free credit balance" to mean liabilities of a broker-dealer to customers that are subject to immediate cash payment to customers on demand, whether resulting from sales of securities, dividends, interest, deposits or otherwise, excluding, however, funds in commodity accounts which are segregated in accordance with the Commodity Exchange Act or in a similar manner. In addition, paragraph (l) of Rule 15c3-3 states, with regard to the delivery of securities, that nothing stated in Rule 15c3-3 shall be construed as affecting the absolute right of a customer of a broker-dealer to receive in the course of normal business operations following demand made on the broker-dealer, the physical delivery of certificates for:*

*(1) Fully-paid securities to which he is entitled, and*

*(2) Margin securities upon full payment by such customer to the broker-dealer of his indebtedness to the broker-dealer; and, subject to the right of the broker-dealer under §220.7(b) of Regulation T [12 CFR 220.7(b)] to retain collateral for his own protection beyond the requirements of Regulation T, excess margin securities not reasonably required to collateralize such customer's indebtedness to the broker-dealer.*

c. How does your jurisdiction define the term "client"? If the jurisdiction uses an analogous term, please provide that term and its definition.

*In accordance with Exchange Act Rule 15c3-3(a)(1), the term "client" refers to a "customer," which is generally any person from whom or on whose behalf a broker-dealer has received or acquired or holds funds or securities for the account of that person. The "customer" also includes any other person to the extent that person has a claim for property or funds, which by contract agreement or understanding, or by operation of law, is part of the capital of the broker-dealer or is subordinated to the claims of creditors of the broker-dealer.*

[76] *The term "security" is defined term under Exchange Act section 3(a)(10).*

d. Please describe any notable exclusions from the terms "client" or "client assets."

*The term "customer" generally does not include a broker-dealer, a municipal securities dealer, or a government securities broker or government securities dealer.*

*In answering the remaining questions:*

*(1) Please provide details, as appropriate, where the Regime in your jurisdiction applies different treatment or results based on differences in:*

*a. Categories of Client Assets;*

*b. Models of trading (e.g., exchange-traded versus over-the-counter).*

*c. Categories of clients (*e.g.*, retail versus sophisticated)*

*(2) You are requested to provide details of the Regime in your jurisdiction. You are additionally invited to provide information explaining how that Regime is applied in practice, through,* e.g.*, informal arrangements between governmental entities.*

## Pre-Insolvency

2. Does the regime in your jurisdiction require an Investment Firm to hold special authorization (*i.e.*, a specific form of license or registration) to be permitted to hold Client Assets?

a. If special authorization is required, what requirements (both initial and ongoing) is an Investment Firm required to comply with to hold such authorization?

b. If special authorization is not required, how, if at all, is this activity supervised by a regulator?

*Each firm that engages in the business of effecting transactions in securities for others must be registered with the SEC as a broker-dealer. Each broker-dealer is subject to a minimum net capital requirement, which increases if a broker-dealer holds customer accounts. The net capital requirement for broker-dealers is the greater of a fixed-dollar amount or an amount determined using a financial ratio based on either the firm's level of aggregate indebtedness of or the amount of the firm's customer debits (e.g., margin loans and money extended on behalf of customers to effect short sales). Broker-dealers that do not receive, directly or indirectly, or hold funds or securities for customers or owe funds or securities to customers must maintain a fixed dollar amount of $5,000.00 in net capital. A broker-dealer that receives, but does not hold, customer securities must maintain a fixed-dollar amount of $50,000.00 in net capital. A broker-dealer that carries customer or broker-dealer accounts and receives or holds funds or securities for those persons must maintain a fixed-dollar amount of $250,000.00 in net capital. However, customers that receive and hold customer funds and securities typically have customer debits*

*that make their financial ratio amount of required net capital much larger than the $250,000 fixed-dollar amount. Thus, the financial ratio amount becomes the minimum requirement. New firms are subject to more stringent capital requirements than firms that have been in the business for more than one year.*

*The capital levels of a broker-dealer and its compliance at all times with minimum capital requirements and customer segregation requirements is monitored by both review of periodic and annual reports (filed by the broker-dealer), along with on-site inspections.[77] A broker-dealer's designated examining authority [78] monitors regularly compliance with capital levels. For example FINRA, through initial examinations, ensures that new broker-dealers have enough capital to survive for a certain period of time without generating revenue. FINRA will also conduct special inquiries of firms that hold customer assets. The SEC may also review a firm's filings or conduct a site inspection. The broker dealer must also provide an audited annual report to the SEC.*

3. Does the Regime in your jurisdiction require that Client Assets be maintained separately from the assets of an Investment Firm? If so, please provide a description of the process by which segregation is accomplished, and of the applicable requirements. Specifically:

    a. Must the Client Assets of one client be maintained separately from those of other clients?

        i. Are Investment Firms allowed to hold Omnibus Accounts?

        ii. What measures are used to protect the Client Assets of each client from losses due to the activities of other clients?

*Broker-dealers are subject to strict financial responsibility requirements under the Exchange Act that are designed to protect and account for customer assets. These requirements include:*

- *The Customer Protection Rule (Exchange Act Rule 15c3-3).[79] Under this rule, broker-dealers are required to segregate customer securities and cash from the firm's proprietary business activities and in particular to obtain and maintain possession or control of customer fully paid and excess margin securities, so that if a broker-dealer*

[77] *See 17 CFR 240.17a-5(a).*
[78] *Upon becoming registered as a broker-dealer with the SEC, each broker-dealer is assigned an SRO to be its designated examining authority, or DEA. The DEA is responsible for regular examinations of the broker-dealer as well as oversight of the broker-dealers' activities.*
[79] *17 CFR 240.15c3-3.*

*fails financially, those customer securities and funds would be available to be returned to customers in an orderly wind-down or liquidation administered by a SIPA trustee. This means the broker-dealer cannot lend or hypothecate[80] these securities and must hold them itself or, as is more common, in a satisfactory control location. Exchange Act Rule 15c3-3 also requires a broker-dealer to maintain a reserve account that contains (at least) the net dollar amount of cash the broker-dealer owes to its customers (in accordance with a prescribed formula). Customer securities and funds are not available to satisfy claims of general creditors of the broker-dealer.*

- *The SEC's Rules 8c-1 and 15c2-1,[81] commonly called the "Hypothecation Rules," prohibit a broker-dealer from comingling customer securities with its own proprietary securities. They further require broker-dealers to obtain a customer's written consent in order to hypothecate securities under circumstances that would permit the commingling of customers' securities and to give written notice to a pledgee that, among other things, a security pledged is carried for the account of a customer.*

- *The Quarterly Security Count Rule (Exchange Act Rule 17a-13). This SEC rule requires a broker-dealer on a quarterly basis to count, examine, and verify the securities it actually holds for customers and for itself — and compare that with the amounts of such securities it should be holding as indicated by its records. This process includes verifying the actual amount of securities located at sub-custodians such as the Depository Trust and Clearing Corporation (DTCC). If there are differences between the actual amounts held and the amounts that should be held, the broker-dealer must take capital charges until the differences are resolved.*

*These requirements – along with the broker-dealer net capital rule – are designed to allow a broker-dealer to self-liquidate in an orderly wind-down where customer cash and securities are quickly returned to customers or transferred to a solvent broker-dealer. These requirements are also designed to restore customer funds and securities quickly and to insulate the securities markets from disruption following the failure of broker-dealers.*

*Finally, the SEC staff is in the process of developing proposed segregation requirements for cleared and non-cleared security-based swaps pursuant to Section 763 of the Dodd-Frank Act (Section 3E of the Exchange Act) for security-based swap dealers and major security-based swap participants, to recommend for proposal. These requirements would affect broker-dealers only to the extent that they were required to also register with the SEC as security-based swap dealers*

*In response to question 3(a)(i) & (ii):*

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[80] *But see Exchange Act Rules 8c-1 and 15c2-1, as described in the subsequent bullet.*
[81] *17 CFR 240.8c-1 and 15c2-1.*

- *A broker-dealer generally holds and segregates client assets in an omnibus basis. Most securities held at a central securities depository, such as DTCC, or a custodian bank, are held in an omnibus basis in the name of the broker-dealer. The bank must agree, however, that the account is held for the benefit of the broker-dealer's customers and not place any lien on the account. Broker-dealers are required to make and keep current (as of the end of each business day) ledger accounts itemizing separately each cash and margin account of every customer of the broker-dealer under Rule 17a-3.*
- *In addition, all securities accounts are protected under the SEC's customer protection rules, margin rules, and under SIPA. For example, anytime a customer opens a margin account, the margin must be done individually. In addition, all customer obligations to a broker-dealer must be over collateralized. Thus, even if a customer defaults on a margin call, the account has been over collateralized and losses will not flow to other customers. In addition, the provisions of SIPA are intended to protect investors from the loss of securities or cash left with a failed broker-dealer.*

b. Please describe any requirement that an Investment Firm must reconcile the Client Asset account. For example:

i. How do you calculate the amount of Client Assets that a firm is required to hold in one or more accounts segregated for the benefit of clients?

A) Are required Client Assets fungible between or within asset classes, or is the Investment Firm required to hold, *e.g.*, the specific assets deposited by the client?

B) How is the reconciliation conducted (*e.g.*, on an aggregate basis, or a client-by-client basis)?

C) If a client has a debit balance (*i.e.*, the client owes the Investment Firm), is such balance deducted in determining the amount the Investment Firm is required to hold? Would one client's net debit balances reduce the firm's obligations with respect to the total required funds on deposit for net credit balances of other clients?

ii Timing issues:

A) How often is reconciliation required (*e.g.*, daily, weekly, monthly).

B) When is such reconciliation required (e.g., noon of the following business day, the tenth business day of the following month).

C) Is the Investment Firm required to make good any deficiency from their own funds? If so, in what period? Is any payment by the Investment Firm thereby deemed to be Client Money?

iii. Is an Investment Firm permitted or encouraged to maintain any of their own assets in a Client Asset account (*e.g.*, as a "buffer")? If so, are any such assets so transferred then deemed to be Client Assets? Is there a requirement to remove any excess assets?

*Broker-dealers are required to make and keep current (as of the end of each business day) ledger accounts itemizing separately each cash and margin account of every customer of the broker-dealer.*[82] *The ledger should include all purchases, sales, receipts and deliveries of securities and commodities for the account and all debits and credits to such account. Broker-dealers must also make and keep current ledgers reflecting all assets and liabilities, income and expense, and capital accounts.*[83]

*Broker-dealers must reconcile the Client Asset account with a Reserve Computation. The Reserve Computation is calculated pursuant to a formula set forth in Exhibit A to Exchange Act Rule 15c3-3.*[84] *Under the formula, a broker-dealer adds up various credit and debit line items. The credit items include cash balances in customer accounts and funds obtained through the use of customer securities. The debit items include monies owed by customers (e.g., from margin lending), securities borrowed by the broker-dealer to effectuate customer short sales, and required margin posted to certain clearing agencies as a consequence of customer securities transactions. If, under the formula, customer credit items exceed customer debit items, the broker-dealer must maintain cash or qualified securities in that net amount in a "Special Reserve Bank Account for the Exclusive Benefit of Customers." This account must be segregated from any other bank account of the broker-dealer. Broker-dealers calculate the Reserve Computation on an aggregate basis, so one client's debit balance would reduce a broker-dealer's obligations with respect to the total required funds on deposit with respect to net credit balances of other clients. Although the Reserve Computation is done on an aggregate basis, the Investment Firm must make and keep current ledger accounts itemizing separately each cash and margin account of every customer of the broker-dealer, as well as a stock record that reflects the positions of each client.*[85]

*Generally, a broker-dealer with a deposit requirement of $1 million or more must compute its reserve requirement on a weekly basis. The weekly computation determines the required*

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[82] *17 C.F.R. 240.17a-3(a)(3).*
[83] *17 C.F.R. 240.17a-3(a)(2).*
[84] *17 C.F.R. 240.15c3-3a.*
[85] *17 C.F.R. 240.17a-3(a).*

*minimum balance the broker-dealer must maintain in the reserve account and is made as of the close of the last business day of the week. The required amount to be on deposit in the special reserve bank account is due one hour after the opening of business on the second following business day, normally Tuesday at 10 am. Broker-dealers with deposits less than $1 million make their computations on a monthly basis if certain requirements are met. Broker-dealers are encouraged to maintain a buffer in the Reserve account and most do so.*

c. Can the Investment Firm use Client Assets of one client for meeting obligations of another client? If so, how?

*Customer credit balances can be used only to make margin loans to other customers. Customer margin loans must be over collateralized with cash or highly liquid securities and, therefore, if a customer defaults on an obligation, the broker-dealer should hold collateral well in excess of the amount of the customer's obligation to the broker-dealer. This means that a customer default on an obligation to the broker-dealer financed by the use of customer cash should not cause the broker-dealer to suffer any loss. Furthermore, the fact that customer margin loans are over collateralized means that if the broker-dealer fails, the margin loans can be transferred to a solvent broker-dealer for cash or liquidated to an equity and, therefore, any customer cash used to finance the margin loans will be available to be returned to the customers.*

d. Are there any restrictions on the ability of the Investment Firm (or other party holding Client Assets) to invest, encumber, rehypothecate, stock-lend, or otherwise use, the Client Assets? If so, please describe.

i. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets with such client's consent?

ii. How is a client's consent to permit an Investment Firm to use or re-hypothecate Client Assets demonstrated? In other words, what evidence of a client's consent must an Investment Firm have in order to use or re-hypothecate Client Assets?

iii. How are the ownership rights of a client over its client assets changed or affected when the Investment Firm uses or re-hypothecates such assets without such client's consent? Where such use or re-hypothecation is a violation of the relevant statute, rule or regulation, what is the impact on the client's right to its client assets (if any) and what remedies (if any) are available to the client? What is the basis for that conclusion (*i.e.*, established by statute or

regulation, established by prior judicial decision, based on interpretation of the regulator)?

*Under Exchange Act Rule 15c3-3, broker-dealers are required to promptly obtain and maintain physical possession and control of all "fully paid" securities and "excess margin securities" carried by the broker-dealer for customers. Fully paid securities are securities held for customers in cash accounts as defined in the Federal Reserve's Regulation T. The term also applies to margin accounts in which the customer is not running a debit balance. Margin securities are those securities carried for a customer in a margin account, with market value equal to (or less than) 140% of the account's debit balance. Such securities are left available to the broker-dealer for purposes of financing the debit balance and may be used as collateral for bank loans or stock loans or repurchase agreements.*[86] *Excess margin securities are those securities that have a market value in excess of 140% of the aggregate debit balance in that customer's account. Excess margin securities and fully paid securities may not be used by the broker-dealer and must be segregated in a lien-free environment.*

*In addition, under Exchange Act Rule 15c3-3, a credit balance in a customer's account is considered a "free credit balance." Generally, free credit balances are defined under Rule 15c3-3 as liabilities of a broker-dealer to customers, which are subject to immediate cash payment to customers on demand.*[87] *Rule 15c3-3 permits broker-dealers to use customer free credit balances only to finance customer-related debits (e.g., customers' margin loans). Customers' free credit balances not used to finance customer-related debits must be deposited in the broker-dealer's customer reserve account to the extent the broker-dealer owes its customers more than the customers owe the firm, as described in Question 3 above.*

*Finally, paragraph (l) of Rule 15c3-3 states, with regard to the delivery of securities, that nothing stated in Rule 15c3-3 shall be construed as affecting the absolute right of a customer of a broker-dealer to receive in the course of normal business operations following demand made on the broker-dealer, the physical delivery of certificates for:*

> *(1) Fully-paid securities to which he is entitled, and*
>
> *(2) Margin securities upon full payment by such customer to the broker-dealer of his indebtedness to the broker-dealer; and, subject to the right of the broker-dealer under §220.7(b) of Regulation T [12 CFR 220.7(b)] to retain collateral for his own protection beyond the requirements of Regulation T, excess margin securities not reasonably required to collateralize such customer's indebtedness to the broker-dealer.*

*If a broker-dealer is in violation of Rule 15c3-3 or the hypothecation rules, it would not impact the customer's right to demand the customer's cash or securities from the broker-dealer.*

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[86] *A Broker-dealer may decide which margin securities in a client's margin account it wishes to pledge, loan, or sell under a repurchase agreement to finance customer debit balances.*

[87] *See definitions in paragraph (a) of Rule 15c3-3.*

*Exchange Act Rules 8c-1 and 15c2-1, commonly called the "hypothecation rules," prohibit a broker-dealer from comingling customer securities with its own proprietary securities. Under Rules 8c-1 and 15c2-1 of the Exchange Act, broker-dealers are required to obtain a customer's written consent in order to hypothecate securities under circumstances that would permit the commingling of customers' securities and to give written notice to a pledgee that, among other things, a security pledged is carried for the account of a customer.*

*Under Exchange Act Rule 17a-3,[88] broker-dealers are required to make and keep current records identifying accounts for which the broker-dealer has extended credit. In the case of a margin account, broker-dealers are required to obtain and preserve customer signatures. Written consent, for the purposes of Rules 8c-1, 15c2-1 and 17a-3, is generally obtained by broker-dealers when a customer executes a margin agreement. Broker-dealers are not required to obtain additional client consents after receiving a signed margin agreement containing authorization to hypothecate securities under certain circumstances.[89]*

e. What are the requirements, if any, for clearinghouses or other central counterparties to maintain the separate identification of collateral posted by the Investment Firm for its Client Positions?

*There is no requirement that a clearinghouse or other central counterparty maintain the separate identification of collateral posted by a broker-dealer for its client positions, although the clearinghouse or counterparty must segregate the assets owed to the broker-dealer in bulk. However, the broker-dealer is required to segregate customer securities from general firm securities. The broker-dealer must notify the clearinghouse regarding what securities relate to customer positions as opposed to firm positions.*

4. Are Investment Firms in your jurisdiction permitted to transfer to, or hold Client Assets belonging to clients in your jurisdiction in, another jurisdiction? If so, does the Regime in your jurisdiction require Investment Firms to preserve the separate identification of:

a. Client Assets transferred to or located in other jurisdictions?

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[88] *17 CFR 240.17a-3.*

[89] *Certain disclosures (required by Exchange Act Rule 10b-16) are also normally included within the margin agreement, which is designed to ensure that the customer, before the account is opened, understands the terms and conditions under which credit charges will be made.*

b. Client Assets that have been transferred to the Investment Firm from other jurisdictions and that have been identified as Client Assets in those jurisdictions? If so, please provide details of those requirements.

*A broker-dealer is deemed to have control over securities if they are in the custody of a foreign depository, foreign clearing agency or foreign custodian bank, which the Commission must deem a "satisfactory control location" for securities.[90] The foreign entity must agree to hold the securities for the benefit of the broker-dealer's customers and free of all charges, liens, or claims. Cash cannot, however, be held at a foreign location.*

5. Are Investment Firms in your jurisdiction permitted, under the Regime in your jurisdiction, to hold Client Assets (belonging to foreign clients) deposited by Investment Firms regulated/supervised by other jurisdictions ("Foreign Investment Firms") in an Omnibus Account (that includes Client Assets from domestic clients)? If so,

a. What protections are applicable to the Foreign Investment Firm's Client Assets?

b. What steps, if any, must the Foreign Investment Firm take to secure such protections for its Client Assets?

c. What steps may the Foreign Investment Firm take that will reduce such protections (i.e. waiver of rights)? What is the impact if the Foreign Investment Firm takes such steps?

*See answer to 3 and 4, above, and 6 below. Exchange Act Rule 15c3-3(a)(1), defines the term "customer," to generally include any person from whom or on whose behalf a broker-dealer has received or acquired or holds funds or securities for the account of that person. The rule generally does not distinguish between foreign and domestic customers.*

*Non-proprietary accounts of a foreign broker-dealer or a foreign bank would generally be considered "customers" under Rule 15c3-3.[91] The proprietary account of a foreign broker-dealer would be treated as a non-customer under Rule 15c3-3.*

*A Foreign Investment Firm depositing Client Assets belonging to its foreign clients in an Omnibus Account at U.S. broker-dealer should ensure that it maintains books and records for its individual foreign clients to ensure these clients receive maximum protection under SIPA in the event of a liquidation of the U.S. broker-dealer.*

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[90] See 17 CFR 240.15c3-3(c)(4) and (c)(7) and Exchange Act Release No. 10428 (Oct. 10, 1973).
[91] See Interpretation 15c3-3(a)(1)/01 available at http://www.finra.org/web/groups/industry/@ip/@reg/@rules/documents/interpretationsfor/p037772.pdf

1. *The requirements of Rule 15c3-3 are mandatory for the broker-dealer. Consequently, customers, including foreign customers, generally may not "opt out" of the protection requirements.*

6. If the Regime in your jurisdiction permits or requires Client Assets to be held by third party custodians:

   a. Please describe the requirements, if any, concerning the qualifications of such custodians e.g., licensing, creditworthiness. May the Client Assets be kept with an affiliate of the Investment Firm?

   b. Please describe any requirements concerning the custody agreement between intermediary and custodian. In particular, may the custodian be permitted to place a lien, charge or other encumbrance on Client Assets? If so, please explain.

*Securities are considered under control of a broker-dealer if they are held in a location that the SEC has deemed to be a good control location. Securities must be held free of all charges, liens, or claims. Good control locations include the following:*

- *Securities under the custody and control of a clearing corporation or other subsidiary of either a national securities exchange or a registered national securities association or a custodian bank and in compliance with the Hypothecation Rules. In addition, the delivery of the certificates to the broker-dealer cannot require the payment of money or value and the books and records of the broker-dealer must identify the customers entitled to receive specified quantities or units of the securities that are held for the customers collectively.*

- *Securities that are carried for the account of any customer by a broker or dealer and are carried in a special omnibus account in the name of such broker or dealer. Such securities are deemed to be under the control of the broker-dealer to the extent that he has instructed such carrying broker-dealer to maintain physical possession or control of the securities free of any charge, lien, or claim of any kind in favor of the carrying broker-dealer or any person claiming through the carrying broker-dealer.*

- *Securities that are in the custody of a foreign depository, foreign clearing agency, or foreign custodian bank, which the SEC has designated as a satisfactory control location.*

- *Securities that are in the custody or control of a bank, as defined in the Securities and Exchange Act. The delivery of these securities may not require the payment of money or value and the bank must acknowledge in writing that the securities are not subject to any right, charge, security interest, lien or claim of any kind in favor of the bank or any person claiming through the bank.*

- *Securities held at any location, which the SEC has designated as adequate for the protection of customer securities.*

7. Under what circumstances, if any, is an Investment Firm required to disclose to clients information related to the protection of the client's assets? What is the nature of such required disclosures? How do any such required disclosures apply to Client Assets held in another jurisdiction?

*A broker-dealer must send customers quarterly account statements showing their security positions, as required by applicable SRO rules of which the broker-dealer is member. The account statements must include a description of any securities positions, money balances and account activity since the firm issued the prior account statement. In addition, each account statement is required to include a statement that advises the customer to report promptly any inaccuracy or discrepancy in that person's account to his or her brokerage firm. Such statement also must advise the customer that any oral communications should be re-confirmed in writing to further protect the customer's rights, including rights under SIPA.*[92]

*The industry practice is to send monthly account statements to customers with activity in their accounts during that month. In addition, broker-dealers are required to send a customer a confirmation of each transaction under Rule 10b-10.*[93]

*In addition, SRO rules also require that broker-dealers provide non-institutional customers with a margin disclosure statement describing the risks of trading in a margin account, as well as advise new customers when they open a new account about how to obtain information about SIPC. Broker-dealers whose customers trade in security futures are also required to provide a customer with disclosure regarding the protections afforded by a securities account or a futures account where the security futures may be held.*[94]

*In addition, customers are allowed to enter into certain transactions that are not protected under SIPA. Prior to entering into such a transaction, customers must be given notice that the transaction is not protected under SIPA.*

8. Under what conditions, if any, may clients choose to waive or otherwise reduce or vary any of the Client Asset protection requirements applicable in your jurisdiction? If so, how is this done and, based on your knowledge, is this routine in your jurisdiction?

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[92] *For example, see FINRA Rule 2340. FINRA rules are available at www.finra.org.*
[93] *17 CFR 240.10b-10.*
[94] *17 CFR 240.15c3-3(o).*

*The segregation requirements discussed above are mandatory for the broker-dealer. Consequently, customers generally may not "opt out" of the protection requirements. Further, customers are not treated differently based on permissions they have granted pre-bankruptcy. However, as stated above, a customer may enter into a transaction that is not protected under SIPA, if given appropriate notice.*

***Security-based swap dealers and major security-based swap participants – non-cleared security-based swaps***

*The Dodd-Frank Act establishes segregation requirements for cleared and non-cleared security-based swaps and provides the SEC with authority to adopt rules with respect to segregation for security-based swap dealers and major security-based swap participants. In particular, section 763 of the Dodd-Frank Act amends the Exchange Act to add new section 3E.[95] Section 3E sets forth requirements applicable to security-based swap dealers and major security-based swap participants with respect to the segregation of cleared and non-cleared security-based swaps collateral and provides the SEC with rulemaking authority in this area.[96]*

*In particular, Exchange Act Section 3E(f)(1)(B) provides that, if requested by the counterparty, a security-based swap dealer or major security-based swap participant shall segregate the funds or other property for the benefit of the counterparty and, in accordance with such rules and regulations as the SEC may promulgate, maintain the funds or other property in a segregated account separate from the assets and other interests of the security-based swap dealer or major security-based swap participant.[97] Section 3E(f)(3) provides that the segregated account shall be carried by an independent third-party custodian and be designated as a segregated account for and on behalf of the counterparty ("individual segregation").[98] In the case of non-cleared security-based swaps, therefore, each counterparty has the right to require its collateral to be isolated in an account at an independent custodian that identifies the counterparty by name, rather than commingled with collateral of other counterparties. The objective of individual segregation is for the funds and other property of the counterparty to be carried in a manner that will keep these assets separate from the bankruptcy estate of the security-based swap dealer or major security-based swap participant if it fails financially and becomes subject to a liquidation proceeding.*

9. Are Investment Firms in your jurisdiction required to report to regulators or Self-Regulatory Organizations concerning Client Assets? Specifically:

   a. Does the Investment Firm report where client assets are held?

   b. Does the Investment Firm or depository report the protections applicable to such client assets?

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[95] *See Pub. L. 111-203 § 763 and 15 U.S.C. 78c-5.*
[96] *See 15 U.S.C. 78c-5.*
[97] *See 15 U.S.C. 78c-5(f)(1)(B).*
[98] *See 15 U.S.C. 78c-5(f)(3).*

c. Does the Investment Firm or depository report the amount of assets that are held?

In each case, are such reports provided on request or periodically? If periodically, with what frequency?

*A broker-dealer is also subject to important reporting requirements (to the SEC) that are relevant to the protection of customer assets. In particular:*

- *To assist the SEC in monitoring broker-dealer compliance with the SEC's financial responsibility rules, the SEC requires broker-dealers to file monthly, quarterly, and annual financial reports (commonly referred to as "FOCUS reports"). The FOCUS report contains, among other things, a statement of financial condition, a statement of income, a statement of changes in ownership equity, a net capital computation and a reserve computation under Exchange act Rule 15c3-3. Broker-dealers that carry customer accounts generally file FOCUS reports monthly.*

- *A broker-dealer also must file an annual audit with the SEC and its designated examining authority under Exchange Act Rule 17a-5(d). If during the course of the audit, the independent public accountant finds material inadequacies that exist in the accounting system, internal accounting control, or procedures for safeguarding securities, the independent public accountant must inform the chief financial officer who must notify the SEC and the designated examining authority within 24 hours. If such chief financial officer fails to notify the SEC and the designated examining authority within 24 hours or the independent public accountant disagrees with statements contained in the notice, the independent public accountant must inform the SEC and the designated examining authority of the material inadequacy within 24 hours thereafter.*

- *Pursuant to Exchange Act Rule 15c3-3, a broker-dealer must immediately notify the SEC and its designated examining authority if the broker-dealer fails to make a required deposit in its reserve bank account (see discussion of reserve accounts in response to question 3(a)). The broker-dealer must promptly thereafter confirm such notification to the SEC in writing.[99] In addition, pursuant to Exchange Act Rule 17a-11 (commonly called the "early warning rule"), a broker-dealer must promptly notify the SEC and its designated examining authority if its net capital level falls below certain specified levels.[100] The equity capital of a broker-dealer may not be withdrawn if it falls below the early warning levels.*

10. What steps do regulators or Self-Regulatory Organizations take, whether through examinations, inspections, audits, or otherwise, to verify

    a. Where Client Assets are held?

    b. The amount of Client Assets held at a depository?

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[99] *17 CFR 240.15c3-3(i).*
[100] *17 CFR 240.17a-11.*

c. The safeguards applicable to Client Assets held at a depository?

*Exchange Act Section 17(b) currently subjects broker-dealers to routine inspections and examinations by staff of the SEC and the relevant SRO. In addition, Section 17 of the Exchange Act, together with Exchange Act Rule 17a-5, require a broker-dealer to, among other things, file an annual report with the SEC and the broker-dealer's designated examining authority. The report must contain audited financial statements and certain supporting schedules and supplemental reports, as applicable. An independent public accountant registered with the Public Company Accounting Oversight Board (PCAOB) must conduct the audit.*

*In June 2011,[101] the SEC proposed amendments would enhance these broker-dealer examinations in two ways. First, the proposed amendments would require a broker-dealer that maintains custody of customer securities and cash or clears transactions to allow Commission and SRO examiners to:*

- *Access the work papers of the registered public accounting firm that audits the broker-dealer; and*
- *Discuss any findings with the personnel of the registered public accounting firm.*

*The examiners could use this information to better focus their examinations.*

*Second, the proposed amendments would require a broker-dealer to file a report on a quarterly basis that contains information about whether and, if so how, it maintains custody of its customers' securities and cash. The report would establish a custody profile for the broker-dealer that examiners could use as a starting point to focus their custody examinations.*

*A number of FINRA rules are also relevant to this question. For example, under FINRA Rule 4110, FINRA may impose greater capital requirements on clearing or carrying broker-dealers for the protection of investors or when in the public interest. In addition, FINRA Rule 4311 sets forth a number of requirements for the establishment of a relationship between an introducing firm and carrying firm, including the allocation of responsibilities related to such things as receipt and delivery of funds and securities, maintenance of books and records and monitoring of accounts. Furthermore, FINRA Rule 4160 (verification of assets) states that a FINRA member firm, when notified by FINRA, may not continue to custody or retain record ownership of assets, whether such assets are proprietary or customer assets, at a financial institution that is not a member of FINRA, which, upon FINRA staff's request, fails promptly to provide FINRA with written verification of assets maintained by the member at such financial institution.*

*Rule 4160 does not apply to:*

> *(1) Proprietary assets of members that are treated as non-allowable assets under SEC Rule 15c3-1; or*
>
> *(2) Instances where FINRA determines that there is no independent custody or record ownership of the assets.*

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[101] *See http://www.sec.gov/rules/proposed/2011/34-64676.pdf.*

*Finally, FINRA has made arrangements with the DTCC that provides FINRA with routine and direct access to position reports and similar information that DTCC (and its subsidiaries and affiliates) provides to its participants.*

11. Where an Investment Firm based in a foreign jurisdiction (a "Foreign Investment Firm") deposits Client Assets (*i.e.*, of the clients of the Foreign Investment Firm) in an Omnibus Account at an Investment Firm or depository in your jurisdiction, what steps may a foreign regulator with jurisdiction over that Foreign Investment Firm take to verify

    a. The amount and/or value of such Client Assets?

*A foreign regulator could obtain confirmation directly from the U.S. investment firm. Moreover, where there is an applicable MOU, the foreign regulator could obtain information through the MOU.*

    b. The protections actually applicable to such Client Assets, in light of the steps taken by the Foreign Investment Firm to secure or to reduce such protections?

*Such client assets are generally entitled to the same protections as the client assets of U.S. customers as set forth under SIPA.*

12. Under what circumstances, if any, is an Investment Firm required to notify the regulators, or the market generally, of material changes in their financial position or ability to continue to carry on business? What is the nature of such required disclosures?

*As noted above in response to question 9, pursuant to Exchange Act Rule 17a-11 (commonly called the "early warning rule"), a broker-dealer must promptly notify the SEC and its designated examining authority if its net capital level falls below certain specified levels.[102] The equity capital of a broker-dealer may not be withdrawn if it falls below the early warning levels.*

13. For an Investment Firm whose financial situation is seen to have deteriorated *(e.g.*, capital has fallen below certain thresholds), what actions, if any, may the firm's regulators take to protect Client Assets?

*The Exchange Act and the regulations promulgated thereunder prohibit a broker-dealer from continuing to do a securities business if the firm does not have sufficient net capital.[103] Further, a broker-dealer is restricted from withdrawing capital if certain parameters have been broken.[104] The Self Regulatory Organizations ("SROs"), i.e. FINRA, also have rules that*

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[102] *17 CFR 240.17a-11.*
[103] *15 U.S.C. 78o(c)(3) and 17 CFR 240.15c3-1.*
[104] *17 CFR 240.15c3-1(e)(2).*

*restrict the activities of a broker-dealer in financial difficulty.[105] The SROs have rules that allow the SRO to direct the intermediary to take specific corrective or prophylactic actions, such as reducing their business.[106] The SEC may also petition the court to place a freeze on the broker-dealer's assets. To the extent that it becomes apparent that a broker-dealer is in or is approaching financial difficulty, SEC staff must contact SIPC to inform it of the status of the situation so that it can assess whether it should initiate a liquidation proceeding.[107] If the firm holds customer cash and securities, the goal is to have these accounts transferred to a solvent broker-dealer in an orderly self-liquidation or prior to liquidation under SIPA.*

## Post-Insolvency

14. Please describe the process by which an Investment Firm enters the status of "insolvent" or "bankrupt" or the equivalent. For example, is a petition filed by the firm's regulator or some other administrative agency, by creditors of the firm, or otherwise? Is a decree entered by a court? Is this process different from the process applicable to entities that are not Investment Firms?

*Although each broker-dealer failure is unique and presents different issues, generally SEC staff will collect as much information as possible before taking any action. Usually, SEC staff and the firm's designated examining authority know that the firm is approaching financial difficulty because the firm has filed telegraphic notice pursuant to Exchange Act Rule 17a-11. SEC staff may collect reports that have been filed by the relevant broker-dealer, contact the broker-dealer's designated examining authority, and, if the firm is an introducing firm, contact the firm's clearing firm. Further, SEC staff may attempt to have an on-site inspection initiated, either by SEC staff or by the staff of the firm's designated examining authority. These examinations may be conducted at any time. To the extent that it becomes apparent that a broker-dealer is in or is approaching financial difficulty, SEC staff must contact SIPC to inform it of the status of the situation so that it can assess whether it should initiate a liquidation proceeding.[108]*

*Generally, when a broker-dealer goes out of business, it self-liquidates by transferring customer accounts to a new firm. The goal is to have these accounts transferred to a solvent broker-dealer in an orderly self-liquidation, i.e., prior to any liquidation under SIPA.*

*When a self-liquidation is not possible, a court supervised proceeding is conducted under the provisions of SIPA. Specifically, SIPC may, upon notice to a failing member, file an application for a protective decree with any court of competent jurisdiction[109] if SIPC determines that the member has failed or is in danger of failing to meet its obligations to customers, <u>and</u> is (1) insolvent or is unable to meet its obligations as they mature; or (2) the subject of a proceeding in which a receiver, trustee, or liquidator for such debtor has been appointed; or (3) not in*

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[105] *See e.g., FINRA Rule 4120.*
[106] *Id.*
[107] *15 U.S.C. 78eee(a)(1).*
[108] *15 U.S.C. 78eee(a)(1).*
[109] *15 U.S.C. 78eee(a)(3).*

*compliance with applicable requirements under the Exchange Act or rules of the SEC or any SRO with respect to financial responsibility or hypothecation of customers' securities; or (4) unable to make such computation as may be necessary to establish compliance with such financial responsibility or hypothecation rules.*

*If the court issues a protective decree, the court must appoint, as trustee for the liquidation of the business of the debtor and as attorney for the trustee, such persons as SIPC, in its sole discretion, specifies.*[110] *SIPC thus acts either as trustee or works with an independent court-appointed trustee in a brokerage insolvency case to recover funds.*

*The trustee in a liquidation under SIPA is responsible for distributing customer property and liquidating the failed broker-dealer; all securities (such as stocks and bonds) are returned to the customers of the failed brokerage firm, where those securities are registered in their names or are in the process of being registered (i.e., securities certificates in the name of the customer held by the broker-dealer). Whenever feasible, customer accounts are quickly transferred to another operating broker-dealer to facilitate customers' orderly receipt of cash and securities and continuing access to brokerage services. In general, if the books and records of the broker-dealer are in order*[111] *and customer accounts are properly margined, the trustee likely can transfer the accounts to another broker-dealer in a process known as a bulk transfer. After the transfer, customers may choose to maintain their accounts at the new firm or transfer them to a firm of their choice. (Client consent is not required to do a bulk transfer).*

*If a bulk transfer is not possible, the trustee returns customer securities and cash directly to customers through a claims process. The firm's remaining customer assets are distributed on a pro rata basis with securities and cash shared in proportion to the size of claims. If sufficient assets are not available in the firm's customer accounts to satisfy claims within these limits, the reserve funds of SIPC are used to supplement the distribution, up to a ceiling of $500,000 per customer, including a maximum of $250,000 for cash claims.*

*Clients are not required to have secondary or "back-up accounts" with other broker-dealers. It is not common practice for them to do so. Large institutional clients, however, may have customer relationships with more than one broker-dealer.*

15. Please describe the process by which the Administrative Officer (as defined above), if any, is selected. What qualifications, if any, must an Administrative Officer have? Who selects the Administrative Officer?

*As stated above, upon the failure of a broker-dealer, SIPC may, upon notice to such broker-dealer, file an application for a protective decree with any court of competent jurisdiction. If the*

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[110] *15 U.S.C. 78eee(b)(3).*

[111] *When the records of the brokerage firm are accurate, deliveries of some securities and cash to customers may begin shortly after the trustee receives the completed claim forms from customers, or even earlier if the trustee can transfer customer accounts to another broker-dealer. Delays of several months usually arise when the failed brokerage firm's records are not accurate. It also is not uncommon for delays to take place when the troubled brokerage firm or its principals were involved in fraud.*

*court issues a protective decree, the court must appoint, as trustee for the liquidation of the business of the debtor and as attorney for the trustee, such persons as SIPC, in its sole discretion, specifies. The only qualification for the trustee under SIPA is that he or she must be disinterested, as that term is defined in SIPA.*[112] *In certain small liquidations, SIPC itself may be appointed as the trustee.*

16. What are the duties of the Administrative Officer?

*A trustee appointed under SIPA must (1) promptly deliver customer name securities to customers and distribute customer property; (2) sell or transfer offices and other productive units of the business of the debtor; (3) enforce rights of subrogation under SIPA; and (4) liquidate the debtor. The bankruptcy laws of the United States are applicable to the proceeding to the extent they are consistent with SIPA.*[113]

a. What guidance (whether pursuant to the Regime in your jurisdiction or otherwise), if any, is provided to the Administrative Officer?

*The Trustee must be guided by his/hers duties as set forth in SIPA.*

b. Under what standard (e.g., strict liability, negligence), if any, is the Administrative Officer, pursuant to the Regime in your jurisdiction, subject to personal liability for failure to properly perform his or its duties?

*Under general bankruptcy law, which is applicable to SIPA proceedings, a trustee may be held personally liable for willful or deliberate violations of his or her duties. A trustee may also be held liable, in his or her official capacity, for acts of negligence, but will not be held liable for mistakes of judgment where discretion is allowed.*

17. What is the regulator's role, if any, in insolvency proceedings in respect of an Investment Firm?

a. Does the regulator continue to supervise the Investment Firm?

b. How, if at all, is the regulator involved in the process of returning Client Assets?

*The SEC oversees SIPC and may, on its own motion, file notice of its appearance in any proceeding brought under SIPA and thereafter participate as a party.*[114] *In addition, the SEC may apply to any Federal District Court of the United States for an order requiring SIPC to initiate a proceeding and commit its funds to protect customers.*[115]

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[112] *15 U.S.C. 78eee(b)(3).*
[113] *15 U.S.C. 78fff(a).*
[114] *15 U.S.C. 78eee(c).*
[115] *15 U.S.C. 78ggg(b).*

18. What are the requirements, if any, governing the segregation and treatment of Client Assets *during* the insolvency of an Investment Firm?

*The Trustee is required to treat all Client Assets in accordance with the provisions as set forth under SIPA. SIPA defines the terms "customer," "customer property," "net equity" and other terms. These definitions provide important guidance for implementation of the requirements of SIPA and, in particular, how client assets are to be treated during the liquidation process.*

19. Does the Regime in your jurisdiction facilitate or encourage the transfer of Client Assets from an Investment Firm, which has become bankrupt or insolvent to a solvent Investment Firm?

    a. What steps, if any, are prerequisite to accomplishing such a transfer? In general, how long does it take to accomplish those steps?

    b. What factors, if any, affect the time period required to accomplish such a transfer?

*As explained in response to question 14, whenever feasible, customer accounts are quickly transferred to another operating broker-dealer to facilitate customers' orderly receipt of cash and securities and continuing access to brokerage services. In general, if the books and records of the broker-dealer are in order and customer accounts are properly margined, the trustee likely can transfer the accounts to another broker-dealer in about a week in a process known as a bulk transfer. The transfer could take longer depending on the books and records of the broker-dealer and whether the operating systems of the two broker-dealers are compatible. After the transfer, customers may choose to maintain their accounts at the new firm or transfer them to a firm of their choice. If a bulk transfer is not possible, the trustee returns customer securities and cash directly to customers through a claims process.*

20. To what extent are clients at risk of, or protected from, having to return Client Assets (or the value thereof) that were distributed to the client prior to the insolvency proceeding?

*Under SIPA, if customer property is not sufficient to pay all customers in full, the trustee may recover any property transferred by the debtor, which would have been customer property if such a transfer is void or voidable under the Bankruptcy Code. In general, a trustee can recover "preference" actions, which are principal payments made to customers within 90 days of the liquidation. A trustee can also recover for fraudulent transfer actions, which are payments made within two years (or further back, depending on applicable state law) of the bankruptcy filing, including payments for earnings and also payments for principal (unless the recipient can establish an affirmative defense that he/she received the principal payments without knowledge of the broker-dealer's difficulties).*

21. To what extent, if at all, does the Regime in your jurisdiction provide compensation to clients from other sources (for example, an investor protection or similar fund) for

loss of Client Assets? Please discuss the scope of protections, conditions on such protection, and the limits of compensation (*e.g.*, maximum compensation per client).

*Where sufficient assets are not available in the firm's customer accounts to satisfy claims in full, the reserve funds of SIPC are used to supplement the distribution of customer property, up to a ceiling of $500,000 per customer, including a maximum of $250,000 for cash claims.*

22. Are there circumstances in which clients are treated differently based on permissions they have granted pre-bankruptcy. *E.g.*, if any re-hypothecation has been entered into (or a 'right-to-use' exercised), please explain the client's position under the Insolvency Regime in such event.

*The segregation requirements discussed above are mandatory for the broker-dealer. Consequently, customers generally may not "opt out" of the protection requirements. Further, customers are not treated differently based on permissions they have granted pre-bankruptcy (re-hypothecation is irrelevant). However, as stated above, a customer may enter into a transaction that is not protected under SIPA, if given appropriate notice.*

23. Under what circumstances, if any, are clients affected by their permission previously given to allow their Client Assets to be held in another jurisdiction?

*Clients do not make this decision. Customer assets can only be held at a "control" location approved by the SEC. See answer to question 6(b) above, for an explanation of what might constitute a "good control location." In short, however, a broker-dealer is deemed to have control over securities if they are in the custody of a foreign depository, foreign clearing agency or foreign custodian bank, which the Commission has deemed a "satisfactory control location" for securities. However, cash cannot be held in a foreign location.*

24. What happens if the Investment Firm fails to comply with Client Asset protection requirements? Are specific clients treated differently?

*They would be prosecuted to the full extent of the law. Under the current regime, all customers, as defined under Rule 15c3-3, generally are treated the same way.*

25. If there is a shortfall, *i.e.*, if claims by clients exceed resources dedicated to paying such claims (whether from Client Assets, investor protection fund, or otherwise), how are Client Assets distributed? *E.g.*, is there a pro rata distribution of Client Assets, are there priorities between classes of clients, is there a priority distribution ahead of the distribution of the general estate/distribution to unsecured creditors?

*Under SIPA, customers' cash and securities held by the brokerage firm are returned to customers on a pro rata basis. If sufficient funds and securities are not available to satisfy customer net equity claims, the SIPC reserve funds are used to supplement the distribution, up to a ceiling of $500,000 per customer, including a maximum of $250,000 for cash claims.*

26. Please explain how claims of clients are ranked in the insolvency process relative to those of other creditors. Does your insolvency regime rank domestic creditors above foreign creditors?

*Claims of customers are ahead of other creditors. The U.S. Bankruptcy Code and the regulations promulgated thereunder do not differentiate between foreign and domestic customers. See CFTC answer for further details.*

## III. Pertinent references

**Please provide, for any statutes, regulations, or other authorities or texts that are referred to in your response, electronic copies (in English translation, if available), or URL links to available copies. How might a person outside your jurisdiction most readily get access to such items? Are there treatises that would be useful for obtaining a general understanding of client asset protection in your jurisdiction?**

*The following are links to the laws discussed in our responses. However, the list is not complete. Links to other rules and statutory provisions can be provided upon request.*

*Rule 15c3-1: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=4e84cfe5e594d0d270a353ed425ef653&rgn=div8&view=text&node=17:3.0.1.1.1.2.84.287&idno=17*

*Rule 15c3-3: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=4e84cfe5e594d0d270a353ed425ef653&rgn=div8&view=text&node=17:3.0.1.1.1.2.84.296&idno=17*

*Rule 15c3-3a: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=4e84cfe5e594d0d270a353ed425ef653&rgn=div8&view=text&node=17:3.0.1.1.1.2.84.297&idno=17*

*Rule 17a-3: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=4e84cfe5e594d0d270a353ed425ef653&rgn=div8&view=text&node=17:3.0.1.1.1.2.94.373&idno=17*

*Rule 17a-5: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=4e84cfe5e594d0d270a353ed425ef653&rgn=div8&view=text&node=17:3.0.1.1.1.2.94.375&idno=17*

*Rule 8c-1: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=4e84cfe5e594d0d270a353ed425ef653&rgn=div8&view=text&node=17:3.0.1.1.1.1.56.64&idno=17*

*Rule 15c2-1: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=4e84cfe5e594d0d270a353ed425ef653&rgn=div8&view=text&node=17:3.0.1.1.1.2.84.278&idno=17*