



Deutsche Securities (Proprietary) Limited
A non-bank member of the Deutsche Bank Group

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Mr T Mufamadi, MP
Standing Committee on Finance
Parliament of RSA
P O Box 15
Cape Town
8000

Attention: Mr A Wicomb

e-mail:awicomb@parliament.gov.za

Dear Sirs,

Financial Markets Bill, 2012: Submission to Parliament

We would like to provide comment on section 38 of the Financial Markets Bill, 2012 ("FMB").

Background

Deutsche Securities (Proprietary) Limited (the "Prime Broker") conducts a prime brokerage business *inter alia* providing and or procuring settlement and financing services to its prime brokerage clients (principally hedge funds). As collateral for client obligations in respect of the services the Prime Broker creates a security interest over the assets of the client through a security cession or a pledge in terms of section 43 of the Securities Services Act, 2004 ("SSA") or such other method as agreed between the parties.

Part of the Prime Broker's role is to protect the securities lenders from hedge fund credit risk by standing as principal on securities lending transactions between these parties. It is estimated that hedge fund lending accounts for R10 – R20 billion exposure of the R100 billion securities lending market at any given time. The operational risk of implementing a pledge under section 43 of the SSA can lead to systemic credit risk in the market.

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A non-bank member of the Deutsche Bank Group
Licensed Financial Services Provider – FSP No. 16700
Member of the JSE Limited and the Financial Derivatives Division of the JSE

Directors: HL Bosman, MN Fick, MK Koep (Managing Director), AB Thornton-Dibb, M Ismail,
IA Tayob, R. Visser, E Owen

Section 43 of the SSA

In terms of section 43 of the SSA, a pledge or cession to secure a debt in respect of an interest in uncertificated securities must be effected by entry in the central securities account of the pledgor/cedent in favour of the pledgee/cessionary specifying the name of the pledgee/cessionary, the interest in the securities pledged/ceded and the date. The securities are therefore flagged to create a valid security interest.

While this method of taking security interest works in general, it creates a substantial administrative burden on prime brokers. The flagging process is not automated and therefore all details required in terms of Section 43 have to be recorded manually. A manual process introduces an element of operational risk into the process of creating a valid security interest. The flagging process requires the Prime Broker to provide daily reports to its participant indicating which securities should be flagged and blocked for settlement. This includes all transactions effected through the Prime Broker and all other third party brokers who may effect transaction in securities on behalf of the client. Securities need to be released from the pledge in order for settlement to take place. Should securities not be released in a timely manner the ability of participants to commit to particular trades is negatively affected.

Further, where the Prime Broker conducts a loan (as principal) with a prime brokerage client, and receives security collateral, in order for such collateral to constitute a valid security interest (pledge) under South African law, such assets must remain part of the estate of the party providing the security and the assets must remain under the control/possession of the secured party (the Prime Broker). If the secured party loses possession of the pledged securities the security interest is lost. Accordingly, if the Prime Broker receives securities from a prime brokerage client by way of a pledge and then purports to transfer those pledged assets to another third party counterparty as security for a securities lending transaction with that party, there is real risk that: (a) the Prime Broker has transferred assets that do not belong to the Prime Broker (pledged assets remain part of the estate of the prime brokerage client); and (b) the Prime Broker would no longer be secured if the prime brokerage client was to default or go insolvent. This may lead to systemic credit risk.

Section 38 of the FMB

Section 38 of the FMB amends and replaces section 43 of the SSA. According to the FMB Explanatory Memorandum dated April 2012 section 43 has been amended to clarify that the required entries in respect of pledges and cessions should be effected at the level of holding and to make the entry effective to third parties. This is to align the FMB with the Companies Act, 2008 and to give effect to UNIDROIT.

Section 38 provides that:

“(1)(a) A pledge, or cession, to secure a debt, as constituted by an agreement, in respect of uncertificated securities or an interest in uncertificated securities held by a central securities depository, participant, authorised user, or nominee, as the case may be, must be effected by entry in the central securities account or the securities account, as the case may be, of—

- (i) the pledgor in favour of the pledgee specifying the name of the pledgee, the class, number and nominal value of the uncertificated securities, the interest in the uncertificated securities pledged and the*

date of entry; or

- (ii) the cedent in favour of the cessionary specifying the name of the cessionary, the class, number and nominal value of the uncertificated securities, the interest in the uncertificated securities ceded and the date of entry, as the case may be.*
- (b) Uncertificated securities or an interest in uncertificated securities referred to in paragraph (a) may not be transferred or otherwise dealt with, and no instruction by the pledgor or cedent may be given effect to, without the written consent of the pledgee or cessionary.*
- (c) The pledgee or cessionary of uncertificated securities or an interest in uncertificated securities referred to in paragraph (a) is entitled to all the rights of a pledgee of movable property or cessionary of a right in movable property pledged or ceded to secure a debt.*
- (d) A pledge or cession to secure a debt effected in accordance with paragraph (a) is effective against third parties.*
- (e) Nothing in this section prejudices any power of a participant or central securities depositor, as the case may be, to effect a pledge or cession to secure a debt to a person to whom the right to any uncertificated securities or a interest in uncertificated securities referred to in paragraph (a) has been transmitted by operation of law.*
- (2) This section does not apply to an out and out cession in respect of securities or an interest in securities and such cession must be effected in accordance with section 37."*

Whereas section 38 works when dealing with a pledge between two parties who intend to pledge the asset over a long term, we believe that the implementation of this section is not practical for prime brokers. Prime brokers often deal with a number of clients with a large pool of assets in an actively traded portfolio.

The current Strate Rules and Practise Notes provide for only one pledge to be registered over any share at any one time. Once pledged the shares are blocked for settlement. While this works very well for single and long term pledges it presents a number of practical problems for an actively traded portfolio such as the prime brokerage portfolios. Recording the pledge over client assets becomes very labour intensive, manual and introduces an unacceptable level of operational risk. We believe therefore that there is a commercial need to consider another method of creating a pledge to secure a debt under section 38(1)(a).

Proposal

We would propose that the committee consider including a provision to allow prime brokers and broker dealers to create a pledge over a viscous pool of assets similar to creating a floating charge in the UK, where the pledgor would create a pledge in the securities account in favour of the pledgee specifying the name of the pledgee, the interest in the uncertificated securities pledged and the date of entry as follows:

Example:

XYZ Ltd Account Pledged to ABC Ltd 27 May 2012

Anglo	200
Amplats	300
SAB	500

The Prime Broker may then move the pledged assets in this account with the consent of the client in accordance with section 38(1)(b).

One of the formalities of establishing a security interest under South African law is the publicity principle. The pledge will be recorded at holding level in STRATE, therefore meeting the publicity requirement as third parties would be able to see that the securities in the pledged account have been encumbered in favour of the prime broker.

Yours faithfully

A handwritten signature in black ink, appearing to be a stylized 'S' or similar character, positioned above the company name.

Deutsche Securities (Pty) Limited