UNCERTIFICATED SECURITIES AS COLLATERAL IN SOUTH AFRICAN SECURITIES LENDING TRANSACTIONS

The question how uncertificated securities can be provided as effective collateral in South African securities lending transactions has been such a hotly debated topic that, for many years, the majority of participants in the South African securities lending market only accepted cash as collateral for loaned securities. Therefore, the South African securities lending market called for an effective method to provide uncertificated securities as collateral in securities lending transactions.

Under South African law, a share in a company consists of a bundle of personal (incorporeal) rights entitling the holder of the share to an interest in the company, its assets and dividends. Similarly, debt securities consist of a bundle of personal rights against the issuer of such debt securities. Securities may have true (beneficial) owners and registered owners. The true owner of a security is the person to whom the security belongs, but it is only if the true owner has its name entered into the register of the company or the issuer that it is a registered owner of the security.

Securities are transferred by way of a cession. A cession is a bilateral act by which a personal right is transferred from a cedent to a cessionary. There are two types of securities cession namely:

- an out-and-out cession in terms of which the rights are transferred completely by the cedent to the cessionary; and

- a cession *in securitatem debiti* in terms of which the cedent retains a reversionary interest in the ceded right.

True ownership in securities is transferred by an out-and-out cession. In the certificated environment, an out-and-out cession was evidenced by the delivery of the share certificates together with a signed share transfer form or the delivery of the debt certificate together with the appropriate transfer form. In the uncertificated environment, such a transfer is effected by the parties agreeing to cede the securities fully on an out-and-out basis which is accompanied by the transfer of registered ownership in the uncertificated securities through the debiting and crediting of the respective securities accounts in accordance with section 91A(4) of the Companies Act, 1973 ("Companies Act").

The current state of the South African law is that a cession *in securitatem debiti* of an incorporeal right is akin to a pledge of a corporeal thing. This point was clearly made by the Supreme Court of Appeal in *Millman N.O. v Twiggs and Another,* 1995 (3) SA 674 (A). In *Millman*, a company called Continental Foods (Proprietary) Limited (of which Millman was the liquidator) ceded to Twiggs an amount of R500 000 *in securitatem debiti* for debts owed by Continental Foods to Twiggs. The nature of this cession to Twiggs was questioned by Millman. When dealing with the nature of a cession *in securitatem debiti*, the court stated that:

> "*When a right is ceded with the avowed object of securing a debt, the cession is regarded as a pledge of the right in question; dominium of the right remains with the cedent and*

vests upon his insolvency in his trustee, who is under the common law entitled to administer it 'in the interests of all the creditors, and with due regard to the special position of the pledgee'."

Recently in *Grobler v Oosthuizen* [2009] ZA SCA 51 the Supreme Court of Appeal had to consider whether or not the proceeds of certain ceded policies paid to Oosthuizen without the knowledge that the ceded claims had reverted back to Grobler were valid. The Supreme Court of Appeal in Grobler confirmed the position that a cession *in securitatem debiti* of an incorporeal right is equivalent to the pledge of a corporeal right.

The demands of commerce recognise and require that securities should be capable of being offered as security for a debt owed by the true owner of the securities to its creditor. This was given recognition by the legislature in section 43 of the Securities Services Act, 2004. Section 43 specifies that a cession of uncertificated securities to secure a debt "*must be effected*" by entering the details of the cession in the cedent's securities account to ensure that there can be no transfer of these uncertificated securities from the cedent's securities account without the knowledge and permission of the cessionary. This process is referred to as "*statutory flagging*".

Section 43 of the Securities Services Act therefore recognises and applies the common law in respect of a cession *in securitatem debiti* because the uncertificated securities are not transferred out of the cedent's securities account and thus "*dominium*" (ownership in the form of a reversionary right) of the uncertificated securities remains with the cedent. Indeed, section 43 presupposes that no transfer of registered ownership of the dominium occurs. Such transfer of registered ownership in uncertificated securities is dealt with in section 91A(4) of the Companies Act and the mirrored provisions in section 42 of the Securities Services Act.

There is, however, a problem with ceding uncertificated securities *in securitatem debiti* by way of statutory flagging. In the South African market, securities lending is largely conducted under the Global Master Securities Lending Agreement (GMSLA) published by the International Securities Lending Association with such securities lending facilitated by banks playing the role of intermediaries. In this capacity, a bank, on request from a client, will borrow securities from another market participant in order to lend those securities to its client. The bank will receive collateral from its client in connection with that loan, and the bank's own borrowing from the market participant will be accompanied by a collateral obligation. If uncertificated securities are provided to the bank as collateral by its client by way of statutory flagging, the bank will be unable to use such uncertificated securities as collateral and will rather have to use its own assets to collateralise its borrowing from the market participant. Consequently, statutory flagging introduces unnecessary costs and compromises liquidity. Furthermore, the point has been correctly made by market participants that the provision for netting in the GMSLA following a default of a party will not operate effectively unless title to the collateral given has passed to the counterparty.

Because of the problems with statutory flagging, and due to the demands of the South African securities lending market to allow for the provision of uncertificated securities as collateral in securities lending transactions, the South African Securities Lending Association (SASLA) has published an amended South African schedule to the GMSLA. Surprisingly the schedule allows

for the cession *in securitatem debiti* of uncertificated securities without statutory flagging. This is achieved by:

- a cession *in securitatem debiti* of the true ownership in the uncertificated securities; and
- a transfer in the registered ownership of these uncertificated securities from the cedent to the cessionary in terms of section 91A(4) of the Companies Act.

The argument put forward by SASLA's advisers in relation to the validity of a cession *in securitatem debiti* of uncertificated securities without statutory flagging is that statutory flagging is not practically possible where a transfer of registered ownership in uncertificated securities is effected because these uncertificated securities will, following such transfer, be reflected in the securities account of the transferee (ie the cessionary) and will thus not be in the transferor's (cedent's) securities account to flag. This process of transferring registered ownership in the uncertificated securities and ceding *in securitatem debiti* the true ownership of the uncertificated securities is thus seen by SASLA as an effective alternative to statutory flagging which will avoid the liquidity and costing problems related to statutory flagging discussed above.

However, if a lender in a securities lending transaction in South Africa were to accept uncertificated securities as collateral without statutory flagging in terms of the schedule, that lender will be exposed to certain risks:

- Firstly, section 43 of the Securities Services Act states that statutory flagging "*must be effected*" when ceding uncertificated securities to secure a debt. There is a risk, therefore, that the words "*must be effected*" will be interpreted by a court to mean that statutory flagging is the only method for parties to effectively provide uncertificated securities as security for a debt. In such circumstances, a court will likely regard the provision of uncertificated securities as collateral without statutory flagging as ineffective security. Such a finding could potentially have disastrous consequences for a borrower. For example, in the case of the insolvency of the lender, the ceded securities would fall into the insolvent estate of the lender and the borrower (because it has not provided these securities as collateral in terms of section 43) may be found by a court to only have a concurrent claim against the estate of the lender for the return of these uncertificated securities.

- Secondly, uncertificated securities are fungible and according to the common law ownership in fungibles passes when such fungibles are transferred to a transferee and are co-mingled with fungibles of the same type held by the transferee. Accordingly, if the borrower transfers registered ownership of the uncertificated securities to be provided as collateral to the lender who holds similar uncertificated securities in its securities account, there is a risk that a court may recharacterise this transfer of registered ownership as an outright transfer which will result in the consequences of an outright transfer having to be performed. Such consequences include:

    - the payment of securities transfer tax;
    - the payment of capital gains tax in certain circumstances;

- in relation to banks registered in South Africa, holding the required capital in relation to the banks consequent contingent liabilities; and

- making the appropriate book entries to reflect the outright transfer of the uncertificated securities.

This recharacterisation risk will be even greater if the parties to the schedule have agreed that the uncertificated securities may be transferred in title to a third party, as the nature of a cession *in securitatem debiti* is that the cessionary is not permitted to use the ceded rights for his or her own purposes.

Section 43 of the Securities Services Act has, however, not altered the common law position with regard to an out- and-out cession of incorporeal rights. Indeed, the court in *Grobler* did not reject the notion that parties to a cession to secure a debt can draft the cession as an out-and-out cession on an outright transfer basis on which is superimposed an undertaking that the cessionary will recede the security to the cedent on satisfaction of the secured debt.

As the courts in South Africa have a common law power to recharacterise a transaction where the transaction does not accord with the intention of the parties, in order for parties to a securities lending transaction in South Africa to cede out-and-out uncertificated securities on an outright transfer basis only as security for a debt, this intention would have to be clearly expressed and performed by the parties. An expressly intended out-and-out cession transferring full ownership of the uncertificated securities outright as collateral will have to be supported by the parties accepting the consequences of this outright transfer (as described above) and performing all obligations in respect of those consequences.

One of the most undesirable consequences of an outright transfer of uncertificated securities as collateral is the payment of securities transfer tax. Currently, the Securities Transfer Tax Act, 2007 provides for the payment of securities transfer tax in respect of every securities transfer unless the transfer is conducted by way of recognised exemptions. Under the Securities Transfer Tax Act, parties to a securities lending transaction are exempt from paying securities transfer tax in respect of loaned securities if the transaction falls within the definition of a "*lending arrangement*". However, the wording of this exemption makes it clear that this exemption does not extend to the provision of uncertificated securities as collateral on an outright transfer basis. The National Treasury has been approached in an effort to amend the Securities Transfer Tax Act to include under the securities lending exemption the provision of uncertificated securities as collateral where these uncertificated securities are transferred outright. However, as at September 2010 no such amendment appears forthcoming.

Therefore, parties to a securities lending transaction in South Africa are currently faced with a difficult decision in respect of the provision of uncertificated securities as collateral, namely whether or not to:

- cede uncertificated securities *in securitatem debiti* as collateral by way of statutory flagging with its attendant consequences in relation to costing and liquidity;

- cede *in securitatem debiti* true ownership in uncertificated securities coupled with a transfer of registered ownership in the uncertificated securities to the cessionary with its attendant risks as to effectiveness and to recharacterisation; or

- cede uncertificated securities as collateral on an out-and-out basis transferring full ownership of the uncertificated securities outright with its attendant consequences including the payment of securities transfer tax.

None of the above methods of providing uncertificated securities as collateral is without negative or at least potentially negative consequences. Any party wishing to provide uncertificated securities as collateral under any one of the abovementioned methods must therefore accept the consequences or potential consequences which may flow from the selected method. Parties wishing to avoid such consequences or potential consequences should therefore rather elect for cash as the appropriate form of collateral in a securities lending transaction.

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