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KEY POINTS

- The concept of a trust is unknown under Dutch property law.
- Alternative methods for protecting investors' ownership rights in financial instruments are afforded by the Securities Giro Administration and Transfer Act (*Wet giraal effectenverkeer*, "Wge") and the use of nominee companies.
- These alternative methods provide for adequate arrangements to safeguard the rights of investors against the intermediary's insolvency.

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Segregation of financial instruments in the Netherlands: why the Dutch do not need the trust

This article concerns the protection of investors' ownership rights in financial instruments held by an intermediary under Dutch law, especially in the event of such intermediary's insolvency.

INTRODUCTION

The concept of a trust is unknown under Dutch property law. That entails that it is not possible to construe an intermediary's holding of financial instruments in its own name for the benefit of its clients as bringing about a true separation of such financial instruments from the intermediary's own assets. However, under Dutch property law, alternative mechanisms have been developed with a view to protecting financial instruments belonging to clients against attaching creditors of the intermediary and against the intermediary's creditors on the intermediary's insolvency.

With respect to financial instruments qualifying as securities, these methods are:

- the holding of securities belonging to clients in accordance with the Securities Giro Administration and Transfer Act (*Wet giraal effectenverkeer*, "Wge"); or
- entrusting such securities to a separate legal entity, a risk remote depositary company, an SPV, which will hold the securities for the clients.

With respect to cleared derivatives, it is also the Wge that provides for client protection. However, where client securities held in accordance with the Wge form part of segregated estates belonging to the clients of the intermediary, cleared derivative positions are protected by the creation of a segregated estate belonging to the intermediary itself against which recourse can only be taken by clients of the intermediary with positions in

derivatives and not by other creditors of the intermediary.

In this article, these protective mechanisms will be described and analysed on the basis of their legal effects. The system of the Wge applicable to the holding of securities will be discussed first. Thereafter, the method of entrusting client securities to a risk remote SPV will be described in greater detail. Subsequently, a high-level overview of the regime of the Wge applicable to the holding of cleared derivatives will be given. Before getting to the merits of the article, I will say a few words on the regulatory basis of the various segregation regimes.

BACKGROUND

Although this article is not about regulatory law, it may be useful to observe that legal segregation of client assets is not just a matter of property law but is also heavily connected with regulatory law. Asset segregation is at the cutting edge between regulatory law and property law. By having devices in place that provide for proprietary segregation, EU member states intermediaries will also comply with safeguarding requirements imposed by regulatory law, such as MiFID II (Directive 2014/65/EU) and EMIR (Regulation EU/648/2012).

Under Art 16 (8) MiFID II, each EU member state is obliged to draw up rules requiring that investment firms – including banks which provide investment services – when holding financial instruments belonging to clients, shall have adequate arrangements

in place to safeguard the ownership rights of clients, especially in the event of the investment firm's insolvency, and to prevent the investment firm from using a client's financial instruments for its own account, except with the client's express consent. In addition, with respect to cleared derivatives, Art 39 and 48 EMIR, which are directly applicable in each EU member state, impose certain segregation and porting requirements on intermediaries – investment firms, banks or clearing houses – holding assets and positions for clients.

In the Netherlands, Art 16(8) MiFID II has been implemented in s 4:87 of the Act on Financial Supervision (*Wet op het financieel toezicht*, "Wft"). With respect to financial instruments qualifying as securities, s 4:87 Wft is elaborated in ss 7:15-7:20 of the Further Regulation on Conduct Supervision of Financial Undertakings (*Nadere regeling gedragstoezicht financiële ondernemingen*, "Nrgfo"). The Nrgfo prescribes for the various types of intermediaries how the safeguarding of clients' ownership rights in securities must be set up. For investment firms that are in the business of reception and transmission of orders, execution of orders or portfolio management and for banks it provides for two possible methods which may be regarded as providing adequate protection. These methods are the holding of securities belonging to clients in accordance with the Wge or entrusting such securities to a risk remote SPV.

Not accidentally these two methods are the only ways in which, under Dutch property law, the goal of protecting clients' property rights in fungible securities can be attained with certainty. According to the Nrgfo, the safeguarding requirement

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may also be satisfied by other arrangements which, in the opinion of the Authority for the Financial Markets (*Autoriteit Financiële Markten*, “AFM”), offer sufficient safeguards of clients’ ownership rights relating to their securities. However, such alternative arrangements require the AFM’s prior approval, whereas the two methods just mentioned do not.

Under Dutch property law, the only way to achieve that clients’ ownership rights in fungible securities do not form part of the intermediary’s own assets and are therefore protected from any risk of the intermediary becoming insolvent and from recourse by the intermediary’s creditors, is by legally segregating such securities from those of the intermediary. This follows from the *Teixeira de Mattos* decision of the Dutch Supreme Court of 12 January 1968. Pursuant to this decision, bearer securities which an intermediary holds for the benefit of its clients will form part of the assets of that intermediary if the securities are not in any way identifiable as the client’s property. The same applies to registered securities if these securities are registered in the name of the intermediary.

The requisite segregation can be accomplished in two ways:

- by having the intermediary hold securities belonging to clients in accordance with the Wge; or
- by having securities belonging to clients entrusted to a separate legal entity.

So, property law and regulatory law run in parallel where the segregation of client securities is concerned.

Dutch regulatory law does not prescribe a specific structure by which the safeguarding of clients’ ownership rights in cleared derivatives must be accomplished. That is not surprising in light of the fact that EMIR already provides for segregation and porting requirements with respect to cleared derivatives and is directly applicable in each EU member state. However, the Wge provides for a segregation regime on the basis of Dutch property law that applies in addition to EMIR and is designed to create a good fit between EMIR and Dutch

property law and to facilitate segregation and porting of derivative positions in accordance with EMIR.

As a matter of statutory law, an intermediary holding client assets has a right of retention, a right to suspend performance and a right of set-off with respect to assets held by it on behalf of its clients, thus securing claims of the intermediary against the client. It is also customary for investment firms and banks that act as an intermediary to have the client vest a right of pledge in favour of the intermediary on the client assets held by it (or the SPV) for the purpose of securing obligations of the client vis-à-vis the intermediary. However, these rights do not as such affect clients’ ownership rights with respect to the assets.

SEGREGATION OF SECURITIES VIA THE WGE

Types of securities covered

The Wge is applicable to two types of securities:

- financial instruments as referred to under a, b or c of the definition of financial instrument in s 1:1 Wft, ie traditional securities (shares, bonds, warrants, convertibles), money market instruments and participations in investment institutions; and
- other financial instruments designated as eligible for safekeeping under the Wge by an institute qualifying as a central institute within the meaning of the Wge (ie a central securities depository as defined in the CSDR, in the Netherlands in practice always Euroclear Nederland).

The form in which these securities have been issued, the governing law and the corporate seat of the issuer are irrelevant: the securities may have been issued in bearer form or as registered or dematerialised securities, under foreign law and by a foreign issuer. However, for the Wge to be applicable, the securities must be administered in book-entry form in a securities account maintained by an intermediary or by the central institute in the Netherlands. According to the Wge, an intermediary may be a member institution of

a central institute and/or an investment firm and/or a bank that is authorised to provide its services in the Netherlands.

Collective deposits and giro deposits

Pursuant to the Wge, client securities which are deposited with an intermediary form part of a “collective deposit” (*verzameldepot*) of securities of the same kind, ie securities which are mutually interchangeable, deposited with that intermediary on behalf of clients. By virtue of the Wge, clients who have deposited their securities with an intermediary give up their individual ownership of the securities deposited, and become joint owners of the relevant collective deposit, *pro rata* to the quantity of securities deposited. Since a collective deposit does not form part of the assets of the intermediary, the securities are not available to the intermediary’s trustee in bankruptcy if the intermediary becomes insolvent and are therefore protected from such insolvency. Each joint owner of a collective deposit has a claim *in rem*, a proprietary entitlement, with respect to the securities concerned, entitling it to demand delivery from the jointly owned collective deposit of his interest in the pool.

In a similar way as the collective deposits are established with the intermediaries, “giro deposits” (*girodepots*) are established with the central institute. Just as a collective deposit is a pool consisting of securities of a particular kind deposited with an intermediary by its clients and administered by the intermediary, a giro deposit is a pool consisting of securities of a particular kind deposited by a member institution with the relevant central institute and administered by the central institute. The Wge ensures that securities that are included in a giro deposit do not form part of the assets of the member institutions or the central institute in the event of their bankruptcy. This is because, by virtue of the Wge, these securities are jointly owned, on a *pro rata* basis, by all clients of all member institutions who have deposited securities of the relevant kind with these member institutions. The fact that the identity of the clients of the member institutions is not known to the central institute and, in fact, no relationship exists

between those clients and the central institute does not alter this.

An intermediary which is a member institution of a central institute may arrange for the securities in a collective deposit to be included in a giro deposit held by the central institute. The intermediary may however also arrange for the securities to be held in sub-custody with another intermediary, in the Netherlands or abroad, in which case the entitlement vis-à-vis the latter intermediary in respect of the securities held in sub-custody forms part of the collective deposits.

Legal consequences

The legal character of a Wge-entitlement in respect of securities is of a proprietary nature: the client has a co-ownership right in collective deposits of securities of the relevant kind. This means that in the event of the insolvency of the intermediary, securities held in custody by the intermediary are not available to the intermediary's trustee in bankruptcy and are therefore protected from such insolvency. It also means that there is no freeze in case of the insolvency of the intermediary: the client will still be able to give instructions with respect to the securities held by the intermediary. Pursuant to the Wge, an attachment against one intermediary may not be levied on the interest of another intermediary in a collective deposit. Similarly, it is not allowed for a creditor to levy an attachment against a central institute on the interest of a member institution of the central institute in a giro deposit.

In the event that a collective deposit or a giro deposit is insufficient to meet all claims for delivery of the underlying securities, the Wge provides for the apportionment of the deficiency among the joint owners of the collective deposit, *pro rata* to their interest. If the intermediary maintaining the collective deposit is itself a joint owner, it is only entitled to participate in the apportionment after the claims of the other joint owners have been fully satisfied, unless the intermediary proves that the shortage arose due to circumstances for which it cannot be held accountable.

SEGREGATION OF SECURITIES VIA INTERPOSITION OF AN SPV

Nominee company

Another method that is available under Dutch property law to legally segregate fungible client securities from the intermediary's own assets, is the set-up of a separate legal entity, a risk remote depositary company, an SPV, to which the securities are entrusted (*bewaarinstelling*). Although in practice this method of segregation has been largely superseded by application of the Wge, it remains important because it offers a solution for the safekeeping of securities which do not qualify as financial instruments to which the Wge is applicable or because it is uncertain whether segregation pursuant to the Wge will be recognised abroad.

Under this set-up, the client has a direct claim against the SPV with respect to the securities deposited. The obligations of the SPV with respect to such securities are solely towards the client. Consequently, the clients' rights with respect to these securities are legally segregated from the intermediary's own assets and are therefore protected from any risk of the intermediary becoming insolvent and from recourse by its creditors.

Although the securities held by the SPV are segregated from the assets of the intermediary, they are not segregated from the other assets of the SPV and become the property of the SPV. This means that they are reachable by the SPV's creditors, whether or not in the context of insolvency proceedings. It is therefore essential to reduce the risk of the SPV becoming subject to claims of creditors (other than the clients who have deposited their securities with the SPV) or going bankrupt to virtually nil, by limiting its activities to the safekeeping of securities and insulating it, insofar as possible, from all other obligations and/or liabilities.

Limitation of liabilities

This principle forms the background to a number of requirements set forth in ss 7:17 and 7:18 Nrgfo with respect to the use of an SPV that must be complied with for such a structure to qualify as a valid form of insulation. According to these

provisions, the SPV may not carry out any activities other than the safekeeping of client securities and may only act in the interest of the clients who have deposited their securities with it. Furthermore, the sum of the securities held by the SPV must at any time be equal to the liabilities of the SPV to its clients in respect of the securities deposited. Consequently, the SPV can, in principle, have no creditors other than clients who have entrusted securities to the SPV and the claims of those creditors can never exceed the total of the securities which such clients have entrusted to the SPV. Thus, the risk of the SPV going bankrupt is largely eliminated.

In view of the nature of the SPV as an extremely low-risk special purpose company, the SPV must not be placed in a position where its obligations vis-à-vis one client would result in the SPV being unable to fulfil its obligations towards other clients. Therefore, according to the Nrgfo, the SPV may only be liable to clients for culpable failures. In addition, its terms and conditions will always provide that in the event that, due to circumstances for which neither the SPV nor the intermediary can be held accountable, a deficiency occurs, this deficiency is apportioned by the SPV among all clients having rights vis-à-vis the SPV for the delivery of securities of the relative kind of securities, *pro rata* to the amount of their rights.

It is a requirement under the Nrgfo that the SPV is incorporated as a legal person under Dutch law. In practice, the SPV is mostly in the form of a public or private limited liability company. It depends on the investment firm or bank involved whether the SPV will be set up as a subsidiary of the investment firm or bank or as an orphan. In the latter case, the shares in the SPV will be held by a foundation (*stichting*) (a legal entity that does not issue shares and whose purpose is not the making of profit) which has issued non-convertible depositary receipts to the investment firm or bank concerned in consideration for the shares in the SPV.

Operational aspects

While the securities are held by the SPV, the intermediary remains charged with, and responsible for, most of the acts implementing

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Biog box

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the custody of the securities. Accordingly, the intermediary is entrusted with the administration of the securities for its respective clients, including the collection of coupons and dividends, realising subscription rights, effecting conversions, lodging securities for the purpose of meetings, as well as executing orders for the sale and purchase of securities and effecting cash payments. With a view to avoiding conflicts of interest, the Nrgfo prescribes that employees of the intermediary that work for the SPV may not engage in activities for the business unit of the intermediary responsible for the providing of investment services.

In its day-to-day dealings with the investment firm or the bank, the client is hardly aware of the existence of the SPV. It could be said that under this structure, the two components of the custodial function, safekeeping on the one hand and the provision of custodial services on the other, have formally been segregated, but that in daily practice, the intermediary and the SPV operate as one entity, or, to put it differently, the intermediary operates as a custodian using the SPV as a “vault” or a bare nominee.

SEGREGATION OF CLEARED DERIVATIVES VIA THE WGE

With respect to cleared derivatives, the Wge provides for the creation, by operation of law, of a segregated estate of the intermediary against which estate recourse can only be taken by clients with positions in derivatives and not by other creditors of the intermediary. This segregation regime applies in addition to and in support of the segregation and porting rules laid down in Art 39 and 48 EMIR. For the regime to be applicable, the intermediary must act as a middleman (*tussenpersoon*) and must be established in the Netherlands.

In respect of cleared derivatives the client will generally hold contractual claims vis-à-vis the intermediary corresponding to its derivatives positions and collateral posted in connection with these positions. By virtue of the Wge, derivative positions which an intermediary providing clearing services –

a clearing member in case of a direct clearing structure – has entered into vis-à-vis a third party – a CCP in case of a direct clearing structure – for the account and risk of a client and which correspond with the derivative positions of that client vis-à-vis that intermediary, as well as all the rights and obligations in respect of the provision of collateral pursuant to the corresponding positions, form a segregated derivatives estate (*derivatenvermogen*).

Although title to this derivatives estate is with the intermediary, the derivatives estate is legally segregated from the other assets of the intermediary. In deviation from the general principle of Dutch property law that all creditors may recover their claims from all assets of the debtor, the segregated derivatives estate may only be used to satisfy the claims of clients of the intermediary arising from client positions in derivatives connected with the corresponding position.

An attachment against an intermediary on the derivatives estate is not allowed. An attachment against a CCP on client positions that are held for an intermediary is also prohibited. The same applies for an attachment against an intermediary on client positions that are held for another intermediary to the extent that such client positions are connected with positions that form part of the derivatives estate of the latter intermediary.

The Wge further provides that in the event of the bankruptcy of the intermediary, its trustee in bankruptcy must cooperate with the transfer of the derivative assets held by the intermediary for the account of its clients to another intermediary in accordance with Art 48 EMIR. The same applies for the transfer of the client positions and collateral provided by the client to the intermediary for the purpose of securing these client positions.

The Wge segregation regime for cleared derivatives also applies in case of an indirect clearing structure. Under such a structure, the client of a clearing member offers clearing services to an indirect client and the Wge rules will apply as if the client were the clearing member, and the indirect client were the client.

CONCLUSION

Due to the absence of the concept of a trust in the Netherlands, it is not possible under Dutch property law to construe an intermediary's holding of financial instruments in its own name for the benefit of its clients as bringing about a true separation of such financial instruments from the intermediary's own assets. However, under Dutch property law, alternative mechanisms, trust-like arrangements, have been developed with a view to protecting financial instruments belonging to clients against attaching creditors of the intermediary and against the intermediary's creditors on the intermediary's insolvency. These alternative methods are afforded by the Wge for fungible securities and cleared derivatives and by the creation of risk-remote custody vehicles for fungible securities. These alternative methods have never been successfully challenged and it is generally held that they provide for adequate safeguarding of the rights of investors against the intermediary's insolvency. ■

Further Reading:

- Don't trust the trust: the Romanian chapter (2021) 10 JIBFL 719.
- Custodianship: why do EU civil code states not trust the trust? (2021) 9 JIBFL 609.
- LexisPSL: Banking & Finance: Use of custody clients' securities as collateral under Dutch law.
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- Schim, 'Custody of Securities and Book-Entry Transfer of Rights regarding Securities', in: *Financial law in the Netherlands*, Kluwer Law International 2010, p 135-169.
- Haentjens and Rank, 'Legal and operational segregation of securities, derivatives and cash', in: *Research Handbook on Crisis Management in the Banking Sector*, Edward Elgar 2015, p 366-378.