

Custody and Loss of Securities

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In the last few decades, Turkish capital markets have achieved significant growth and become one of the main and most reliable attractions for local and foreign investors. State authorities take the necessary measures to encourage the development of capital markets and ensure investor protection appropriate for the rapid development of the capital markets and the state of the Turkish economy.

In parallel with and as an inevitable outcome of the developments in the Turkish capital markets, the system and principles of securities custody services have become crucial, especially for foreign investors. These have been created in a fragmented regulatory system with the regulation of certain public authorities by the Capital Markets Board (*Sermaye Piyasası Kurulu*) and the Banking Regulation and Supervision Agency (*Bankacılık Düzenleme ve Denetleme Kurumu*).

The terms and conditions of securities custody services are regulated mainly under the Capital Markets Law (*Sermaye Piyasası Kanunu*), the Banking Law (*Bankacılık Kanunu*), the Regulation on Incorporation, Operation and Supervision of the Central Registry Agency and other various regulations and communiqués on the capital markets in Turkey (“Capital Market Regulations”).

In this article, several different concepts will be analyzed and explained in detail to explain the most significant aspects of securities custody services, namely the access to the books and records of custodians, legal and financial effects of bankruptcy by custodian banks, and recovery of assets.

Authorized Institutions for Custody of Securities

The system of securities custody services is operated by three different institutions, namely; (i) banks and brokerage companies as eligible custodians, (ii) Takasbank and (iii) the Central Registry Agency.

Under the Capital Market Regulations, eligible custodians are defined as banks and brokerage companies that carry out specific functions listed in the regulations and that are members of the system operated by the Central Securities Depository of Turkey (“Takasbank”). Takasbank, started as a department within the Istanbul Stock Exchange (“ISE”) (*İstanbul Menkul Kıymetler Borsası*) in 1988, was originally responsible for the provision of settlement services

for securities traded by the members of the ISE. In January 1992, the operations of that department were transferred to an independent company, the ISE Settlement and Custody Co. Inc., which was set up with the ISE and its members as shareholders. This company was then transformed into a bank and renamed Takasbank in 1996.

Takasbank is incorporated as a non-deposit taking bank and authorized by the Capital Markets Board of Turkey to function as the clearing and settlement institution for the ISE markets, the clearing house for the Turkish derivatives exchange, the national numbering agency of Turkey and the custodian for the mutual funds and pension funds incorporated in Turkey.

The Central Registry Agency (*Merkezi Kayıt Kuruluşu*), which is a private law company established in accordance with the provisions of the Capital Markets Law, monitors and maintains the data which is in the custody of Takasbank and the custodian banks. The Central Registry Agency is the authorized central securities depository for dematerialized financial instruments in Turkey and provides custody and post-trading services for a number of securities including equities, corporate debt securities, warrants, exchange-traded funds and mutual funds.

The Central Dematerialized System, the main system run by the Central Registry Agency, provides services to participants (financial institutions and issuers), the ISE, Takasbank and investors. The Central

Registry Agency plays a significant role in the securities market both as a post-trading institution and as the primary source of ownership information for the issuers. Currently, certificates of securities are registered and kept electronically in the data system of the Central Registry Agency.

Access to Books and Records

Eligible custodians are required to set up a sub-account under their main account with Takasbank for each of their clients. Each investor is identified by Takasbank by name and assigned a unique Takasbank number. Clients are able to check their equity holdings and block their assets via the proprietary interactive voice response system of Takasbank or web-based monitoring service. However, Takasbank does not deal directly with investors. It provides each member of the ISE with access to its system via leased lines through which they can monitor and execute transfers between their custodial accounts and their customers' sub-accounts from their office terminals. As mentioned above, under this system, each member has one main custody account in its own name and sub-accounts for each of their customers with Takasbank.

There is no specific restriction on accessing the books and records of Takasbank. However, since Takasbank is organized within the ISE and supervised by the Capital Markets Board, officials of Takasbank, in practice, do not provide access to the books and records of Takasbank to persons other than the Capital Markets Board.

Eligible custodian banks are not prohibited from providing access to the books and records of its clients' accounts. Therefore, accessing the books and records of custodian banks by the clients' independent public accountants may be provided for in a custodian agreement executed between the custodian bank and its client.

Furthermore, eligible custodians are required to inform clients in the shortest time possible about circumstances that may influence their rights to financial assets and require a quick decision, as well as movements of significant cash and assets on the clients' accounts. Additionally, eligible custodian banks are required to send an account summary showing changes and the current status at least once every six (6) months.

In addition, the Central Registry Agency provides an innovative service as of May 10, 2009 through

a newly developed electronic customer alert system which aims to inform subscribed investors about possible errors and abuses of stocks in their accounts immediately and decrease or eliminate possible individual or systemic risks.

Bankruptcy of Subcustodian Banks

If a custodian bank becomes bankrupt, it is crucial for customers to recover securities or cash assets that are held directly by the bank. In this section, the terms and conditions of recovery of assets held directly by banks and recovery of securities and cash held by the securities depository will be analyzed.

Recovery of Assets Held Directly by a Custodian Bank

Custodian banks may not take the assets of clients into their own charge or place such assets in their own account held at another institution. Additionally, custodian banks are required to maintain assets in a form that allows such assets and their owners to be easily determined. Therefore, in the case of bankruptcy of the custodian bank, securities would not be held by the custodian bank in its own name and therefore should not be included in the bankrupt bank's estate. A custodian bank is liable for its activities relating to its role as an intermediary and should therefore be liable to the owner of the securities if, as a result of its actions, securities are lost or otherwise not recoverable.

Recovery of Securities Held by the Securities Depository

As explained above, custodian banks are not authorized to safekeep certificated securities. Takasbank is the only institution which is permitted to safekeep certificated securities in Turkey. Therefore, proof of ownership by the customer should be provable with depository receipts or records with Takasbank.

In addition, the Investor Protection Fund (Yatırımcıları Koruma Fonu) ("Fund") was established to cover the cash payment and securities delivery obligations arising from capital market operations and transactions in which intermediary institutions and banks operating under the Capital Markets Law are engaged in the event of bankruptcy or gradual liquidation. The Fund's coverage of cash payments and securities delivery is capped at TL 63,701 (approximately USD 40,000) for 2011 if the custodian bank has insufficient assets when subject to bankruptcy or gradual liquidation.

All intermediary institutions are required to participate in the Fund. The Fund covers securities which are delivered to intermediary institutions, including custodian banks, for sale, safe custody, management or transfer.

Pursuant to the Capital Markets Law, it is mandatory for the depositors to insure all securities which are in the custody of Takasbank, as well as depository receipts issued by Takasbank. The ISE currently applies an umbrella insurance (*şemsiye sigorta*) policy, which is a single coverage for the overall account. This policy needs to be renewed each year.

In cases where the Capital Markets Board determines that the financial structure of a custodian bank has been weakened significantly, it may order the gradual liquidation of this custodian bank. A decision for gradual liquidation will be communicated to the affected custodian bank, the ISE, the Central Registry Agency, Takasbank, the Turkish Bankers' Association and the Fund. During the gradual liquidation proceedings, the assets of the custodian bank may not be transferred, pledged, shown as collateral, used for securitization or be subject to attachment, unless pursuant to the action of the Fund and the Capital Markets Board as a part of the gradual liquidation proceedings.

In the event of liquidation, the Fund will prepare and issue a schedule of creditors showing the names of creditors and the amounts of their receivables within six (6) months of the date of a gradual liquidation decision. The Fund starts to distribute the securities which were kept in custody on behalf of customers on the thirtieth day following the announcement date of the schedule of creditors. To this end, the securities under custody will be compared and reconciled separately in individual accounts, and as a result, will be delivered to the rightful owners or, alternatively, be transferred to their bank accounts upon their request. The Fund may send a notice via registered mail to any owner who fails to apply to the Fund within thirty (30) days following the start of distribution. However, securities belonging to an owner who owes debts to the custodian bank may not be delivered until the outstanding balance is fully paid.

The period of commencement of distribution may be extended upon the proposal of the Fund and ap-

proval of the Capital Markets Board.

Recovery of Cash Held by the Securities Depository

Deposits in the form of cash are considered ordinary deposits and create a debtor-creditor relationship between the bank and the depositor, since the legal title to the cash actually passes to the bank. If the bank becomes insolvent, the depositor becomes an unsecured creditor in the bankruptcy proceeding and may not be able to fully recover its cash, depending on the ratio of outstanding assets and debts. However, the Fund's coverage, as explained above, may apply if cash (a) stems from securities transactions and (b) is deposited in the custodian account.

In the event a custodian bank is unable to repay its debts due to insolvency, if cash is not maintained in owner accounts, the customer may not be able to recover the cash but would have a claim against the insolvent custodian bank.

Where the custodian bank has insufficient assets for the repayment of losses, the Fund will cover such losses up to a cap of TL 63,701 (approximately USD 40,000) for 2011.

Loss of Assets

Under the Capital Markets Regulations, eligible custodians are liable for all trading in line with its business and the losses and damages to clients caused by it. Any provision to the contrary may not be added to the custody agreement.

On the other hand, the Central Registry Agency and Takasbank are only liable for losses caused to owners if the losses arise from mistakes in keeping records of securities. If there is a deficiency in a security certificate, the last person or legal entity who submitted the certificate to Takasbank is liable. On the other hand, if losses arise due to the action of members of the ISE, the loss may be compensated from the security deposit paid by each member of the ISE at the time of registration.

Losses due to damage to the electronic database of the Central Registry Agency should be covered by the mandatory umbrella insurance from the ISE mentioned above.