

**CENTRAL DEPOSITORY**  
**GUARANTEE FUND PROCEDURES**

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**REVISED 2019**

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## **1. PURPOSE OF THE GUARANTEE FUND**

CDSC has set up the Guarantee Fund in accordance with the provisions of Section 60B of the Central Depositories Act.

This is a mechanism that is designed to ensure financial integrity in the securities market by ensuring that transactions will be settled among CDAs.

The Guarantee Fund does not protect clients against losses they may suffer as a result of a Stockbroker failure, malpractice or non-payment. This type of protection would be provided by the Investor Compensation Fund established under the Capital Markets Act, Cap 485A.

## **2. DEFINITIONS**

In this Procedures, unless the content otherwise requires –

“beneficiary” means any person with a legitimate claim against the Guarantee Fund and includes CDAs who have made contributions to the Fund in accordance with these Procedures;

“CDA” means a Central Depository Agent;

“CDSC” means Central Depository and Settlement Corporation;

“CMA” means the Capital Markets Authority;

“Custodian” means a financial institution that holds clients' **securities** for safekeeping and ease of administration;

“NSE” means the Nairobi Securities Exchange

### **3 COMPOSITION OF THE GUARANTEE FUND**

#### **3.1 Contribution by CDAs**

- 3.1.1 The initial contribution per CDA shall be Kshs 5,000,000<sup>1</sup>. This must be a cash deposit in the CDSC Guarantee Fund Account.
- 3.1.2 The minimum contribution of a CDA to the fund may be revised from time to time. Such revisions shall become effective fourteen (14) business days after notification by CDSC to the CDA. The CDA shall be required to deposit the additional contribution within fourteen (14) business days of revision becoming effective.
- 3.1.3 CDSC may revise a CDA's minimum contribution based on the 12 months cumulative moving average liability of the CDA as illustrated in Annexure 1.

#### **3.2 Bank Guarantee**

- 3.2.1 In addition to its contributions to the Fund and upon request by CDSC, a CDA may deposit a bank guarantee issued by a Tier I bank (the "Bank Guarantee") for 10% (Annual Risk Factor) of the moving average of the Cumulative Liability (See Annexure I) over the past 12 months to cover any additional or potential exposure.
- 3.2.2 The bank guarantee shall not be issued by a bank or financial institution that has a direct relationship, either through shareholding, directorship or management, with the CDA

#### **3.3 Additional Letter of Credit**

- 3.3.1 CDAs may deposit additional bank guarantee (the "Additional Letter of Credit") to increase their Settlement Limit. The Settlement Limit will be increased by an amount equal to the amount covered in the Additional Letter of Credit divided by 20 %.
- 3.3.2 The Additional Letter of Credit in excess of the minimum contribution requirement of a particular CDA will be restricted to its funds settlement only and cannot be used in the case of default of another CDA.
- 3.3.3 Letters of guarantee shall only be accepted from tier 1 banks. Letters of guarantee provided by custodians shall not be from banks associated with the custodian or within the same group

#### **3.4 CDSC Guarantee fund resources**

This shall constitute;

##### **3.4.1 Transaction Levy**

- 3.4.1.1 This shall constitute the transaction levy contribution of 0.01% of the value of transactions.
- 3.4.1.2 This contribution is recorded separately and shall be used equally in the calculation of the loss sharing in the event of a default and shall not be used in the calculation of the Settlement Limit of the CDA.

- 3.4.1.3 CDSC may make cash contributions to the Guarantee Fund.

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<sup>1</sup> Initial contribution was set at Kshs 1,500,000 in 2004. This was revised to Kshs5,000,000 in 2010

### **3.4.2 Penalties**

Penalties charged to CDAs for non-compliance

### **3.4.3 Line of Credit**

CDSC may negotiate an uncommitted unsecured line of credit with commercial Banks for an amount to be agreed on from time to time to supplement the Guarantee Fund.

### **3.5 Interests (Profits)**

3.5.1 Sums of money as accrued from interest and profits from investing any of the Fund's assets

## **4 MANAGEMENT OF THE FUND**

4.1 The fund will be managed in accordance with the CDSC Investment Policy approved by the Board of CDSC.

4.2 The assets of the Fund must be invested in safe, cash and cash equivalents investments (such as T-Bills, term deposits, etc.)

## **5 APPLICATION OF THE GUARANTEE FUND**

5.1 CDSC shall cover the losses resulting from a default by applying the Guarantee fund financial resources as follows, in the listed order

- a) The defaulting CDA's resources
- b) CDSC Guarantee fund's own resources
- c) Non-defaulting CDAs' guarantee fund contributions.

5.2 When a pro rata charge is made against a CDA's contribution to the Guarantee Fund, CDSC shall promptly notify the CDA of the amount of the charge and the reasons thereof.

5.3 The amount of any deficiency, obligation, expense or loss will be determined by CDSC without reference to the possibility of any subsequent recovery in respect thereof, but the net amount of any such recovery will be applied in accordance with Clause 7.4.6

5.4 A defaulting CDA shall be required to regularize their position as well as replenish all the losses suffered to the Guarantee Fund and non-defaulting participants contributions back to the positions before the drawn down within 14 days of the draw down

## **6 WITHDRAWAL FROM THE GUARANTEE FUND**

If a CDA ceases to be a CDA its contribution to the Guarantee Fund shall be refunded inclusive of any profits accrued from investment pro rata to its contribution, less any loss attributable to the CDA and any expenses incurred in relation to the management of the Fund and taxes

## **7 MANAGEMENT OF SETTLEMENT RISK**

To guarantee settlement, CDSC has put in place a series of lines of defence and financial safeguards that allow it to manage settlement risk.

### **7.1 Types of settlement risks**

7.1.1 Risk of securities settlement failure - the financial risk is equal to the difference between the price of the trade and the price at which replacement securities can ultimately be bought.

7.1.2 Risk of funds settlement failure - the financial risk is equal to the net settlement obligation of the CDA. However, the amount could be recovered by selling out the unpaid securities that are seized by the Guarantee Fund. The potential loss would then depend on the percentage decrease in the price of the securities.

## 7.2 *Prevention of funds settlement failure*

7.2.1 Funds settlement failure may occur where a CDA is unable to meet its net settlement obligation

7.2.2 To mitigate against the potential loss or financial risk associated with a funds settlement failure, CDSC will set a net Settlement Limit for each CDA, which will be determined by the following formula:

$$SL = \frac{(RLC + GFC)}{[x]\%}$$

“X” being the risk factor currently set at 20%

Where, for each CDA

SL	:	Settlement Limit		
RLC	:	Required Letter of Credit	(See 3.4	- Required Letter of Credit)
GFC	:	Guarantee Fund Contribution	(See 3.2	- The Guarantee Fund)

7.2.3 Any additional cash contribution to the Guarantee Fund by a CDA will increase the Settlement Limit of that CDA which will be recalculated as per the formula above (clause 7.2.2).

7.2.4 Increase in settlement limit arising from the interest accrued on the CDA’s contribution to the Fund will be computed using the above formula and revised on an annual basis.

7.2.5 A CDA who has exceeded their settlement limit will be required to regularize their position by T+1 12noon for stockbrokers and investment banks and by T+2 12noon for custodians.

7.2.6 A CDA who has exceeded their settlement limit will be required to regularize their position either through:

- i. Trading; where the CDA stops exceeding their limit by additional trading activity. The timelines in 7.2.5 above shall apply; or
- ii. early settlement of trades (trade acceleration); where the CDA accelerates the trades to settle on T+1; or
- iii. by making additional cash contributions to the Guarantee Fund sub account commensurate to 20% of the exceeded position; or
- iv. by providing to CDSC a bank guarantee that covers the exceeded position.

7.2.7 A CDA that has exceeded its Settlement Limit and has not regularized its position (as per clause 7.2.6) shall be liable to pay a daily penalty of 1% of the outstanding required additional cash contribution to the Guarantee Fund until the CDA regularizes its position.

## 7.3 *Additional Criteria for Higher Settlement Limit*

This is the criteria or guidelines to be followed whenever a CDA requests to be allowed a higher

settlement limit based on its net asset value:

- 7.3.1 The CDA must have a contribution of not less than Kshs.10M to the Guarantee Fund. This contribution level will be subject to revision by the Business Conduct Committee;
- 7.3.2 Additional Guarantee Fund contributions may be required by CDSC in exceptional circumstances based on the value, the volatility or portfolio of securities or the volume of transactions of the CDA. The CDA shall be required to deposit the additional contribution within three (3) business days.
- 7.3.3 The CDA must maintain minimum share capital as stipulated by its primary Regulator;
- 7.3.4 The CDA who meets the requirements stipulated in Procedures 7.3.1 to 7.3.3 may be allowed a settlement limit of a maximum of 10% of the net asset value.
- 7.3.5 The CDA must maintain Positive Net Asset Value at all times ( Calculated as All Assets less All liabilities);
- 7.3.6 The CDA must maintain a Liquidity Ratio of 1 and above (Calculated as current assets over current liabilities);
- 7.3.7 For purposes of monitoring the above position, the CDA must submit to CDSC the following:
  - a) Quarterly unaudited Income statement and a statement of financial position for each quarter, which must be submitted within fifteen days of the end of the calendar quarter; and
  - b) Audited annual accounts, which must be submitted within 90 days of financial year-end.
- 7.3.8 Settlement limit that is based on a CDA's net asset value may be revised annually upon review of the supporting audited annual accounts of the CDA;
- 7.3.9 If the quarterly unaudited statement of financial position of a CDA shows a decrease in its net asset value, CDSC shall immediately revise downwards the settlement limit of that CDA in accordance with the reduced net asset value.

#### **7.4 Funds settlement failure**

- 7.4.1 If a CDA fails to satisfy their funds settlement obligations, CDSC will notify the NSE and the CMA immediately;
- 7.4.2 To meet a defaulting CDA's obligation, the defaulting CDA's Settlement Bank will provide for the shortfall in accordance with the terms of the CDSC – CDA- Settlement Bank Tripartite Agreement as follows:
  - a) The Settlement Bank shall inform CDSC of any shortfall in the funds settlement by 8.30 am on T+3 and provide for the shortfall;
  - b) CDSC shall immediately seize the defaulting CDA's clients' shares and allocate them to the Guarantee Fund;
  - c) The securities that shall be seized in 7.4.2 b above shall be the most liquid securities that form the CDAs obligation.

- d) The defaulting CDA shall be required to reimburse its Settlement bank of the amount paid on its behalf including any interest charges by 12.00noon on the next business day;
- e) In the event that the CDA does not reimburse the Settlement bank as stated in (c) above, the Settlement bank shall notify CDSC by 2.00pm on the same day (T+4);
- f) CDSC shall draw down the amount required (initial amount paid plus any accrued interest) from the Guarantee Fund and replenish the affected Settlement bank position within one business day of being notified by the Settlement bank(T+5) ;
- g) CDSC shall give notice to the defaulting CDA to replenish the Guarantee Fund within one business day after its Settlement bank has been reimbursed by CDSC by drawing down the Guarantee Fund (T+6);
- h) If the defaulting CDA fails to reimburse the Guarantee Fund as stated in (g) above, CDSC shall sell the seized shares and replenish the Guarantee Fund;
- i) Any loss arising from the sale of the seized shares shall be recovered from the defaulting CDA's guarantee fund contributions;
- j) CDSC shall levy penalties to the defaulting CDA in accordance with Procedure 17 of the CDS Operational Procedures

7.4.3 CDSC may use the line of credit to reimburse the settlement bank. The funds claimed above shall be used to repay the line of credit.

7.4.4 CDSC may use its own resources as a last resort to reimburse the settlement bank;

7.4.5 All amounts drawn from the guarantee fund contributions of non-defaulting CDAs are owed to the fund by the defaulting CDA.

7.4.6 All amounts recovered from the defaulting CDA are applied as follows, in the listed order:

- a) To repay any outstanding amount on the line of credit;
- b) To contributions of non-defaulting CDAs;
- c) To the CDSC guarantee fund resources;
- d) To the CDSC reserve; and
- e) To the defaulting CDA's contribution.

7.4.7 Following a draw down, CDAs are required to replenish their contribution to the Fund to the minimum level as set out in Section 5.4 Failure to do so is treated as a default and shall lead to the suspension or termination of the appointment as a CDA.



## ANNEXURE I

### Initial Required Letter of Credit Fund will be computed as follows

To simplify the illustration of the computation of the minimum contribution, this example is based upon the moving average of the Cumulative Liability over a period of 10 days only.

In practice, computation of the amount of contribution will be based over past 12 months' dealings for each Participant (See 4.2.4 above)

		CDA X	CDA Y	CDA Z
(A)	Net Daily Settlement (NDS)			
	Day 1	10,000,000.00	300,000.00	400,000.00
	Day 2	<b>(30,000,000.00)</b>	<b>(500,000.00)</b>	<b>(10,000,000.00)</b>
	Day 3	3,000,000.00	600,000.00	700,000.00
	Day 4	400,000.00	<b>(4,000,000.00)</b>	<b>(8,000,000.00)</b>
	Day 5	<b>(50,000,000.00)</b>	300,000.00	<b>(2,000,000.00)</b>
	Day 6	<b>(105,000,000.00)</b>	<b>(5,000,000.00)</b>	<b>(18,000,000.00)</b>
	Day 7	7,000,000.00	<b>(4,000,000.00)</b>	6,000,000.00
	Day 8	<b>(86,000,000.00)</b>	500,000.00	<b>(20,000,000.00)</b>
	Day 9	<b>(156,000,000.00)</b>	<b>(30,000,000.00)</b>	800,000.00
	Day 10	2,000,000.00	700,000.00	<b>(46,000,000.00)</b>
(B)	CL			
	Day 1 to 3	(30,000,000.00)	(500,000.00)	(10,000,000.00)
	Day 2 to 4	(30,000,000.00)	(4,500,000.00)	(18,000,000.00)
	Day 3 to 5	(50,000,000.00)	(4,000,000.00)	(10,000,000.00)
	Day 4 to 6	(155,000,000.00)	(9,000,000.00)	(28,000,000.00)
	Day 5 to 7	(155,000,000.00)	(9,000,000.00)	(20,000,000.00)
	Day 6 to 8	(191,000,000.00)	(9,000,000.00)	(38,000,000.00)
	Day 7 to 9	(242,000,000.00)	(34,000,000.00)	(20,000,000.00)
	Day 8 to 10	(242,000,000.00)	(30,000,000.00)	(66,000,000.00)
(C)	<b>Moving average of CL</b>	<b>(136,875,000.00)</b>	<b>(12,500,000.00)</b>	<b>(26,250,000.00)</b>

(D)	Required Letter of Credit or Bank Guarantee to be deposited (C) x ARF %	13,687,500.00	1,250,000.00	2,625,000.00
(E)	Initial Cash Contribution to Guarantee Fund	5,000,000.00	5,000,000.00	5,000,000.00
(F)	<b>Settlement Limit</b> <b><u>D+E</u></b> <b>20%</b>	<b>93,437,500.00</b>	<b>31,250,000.00</b>	<b>38,125,000.00</b>
(G)	<b>Minimum Contribution to the Guarantee Fund</b> <b>(C) x 20%</b>	<b>27,375,000.00</b>	<b>2,500,000.00</b>	<b>5,250,000.00</b>

**Contribution of a CDA following a draw down will be computed as follows:**

(CV)	Current Value of Fund (CV) (excluding letters of credit)	<b>30,000,000</b>
(IV)	Initial Value of Fund (excluding letters of credit)	<b>27,000,000</b>
(X)	Required cash contribution of Participant (5000000 x CV/IV)	<b>5,555,556.00</b>