

CENTRAL DEPOSITORY
GUARANTEE FUND PROCEDURES

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1. DEFINITIONS

In these Procedures, unless the context otherwise requires:

“CDA” means a Central Depository Agent; An institution appointed as an agent of a central depository to carry out one or more of the services provided by that central depository.

“CDSC” means the Central Depository and Settlement Corporation Ltd.

“CMA” means the Capital Markets Authority.

“Custodian Bank” means a bank licensed under the Banking Act, approved by the Authority as an authorized depository and appointed a CDA by CDSC.

“Delivery Versus Payment-DVP” means a mechanism used in securities transfers which ensures that the final transfer of the securities (the delivery) can be considered completed if and only if, the final and irrevocable payment for the transaction has been made.

“Securities Exchange” means a marketplace where securities and other financial instruments are traded.

“Fund” means the Guarantee Fund.

“Settlement Bank” means a commercial Bank appointed by CDSC to provide funds settlement services to CDAs in respect of executed trades.

“T” means the day on which a trade took place on the Securities Exchange.

“Trading Participant” means a member company of the Securities Exchange.

2. 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 and Rule 15 of the Central Depositories (Regulation of the Central Depositories) Rules, 2004.

The Guarantee Fund has been set up to guarantee the settlement of transactions arising out of default by any of the CDAs in discharging their obligation. The Fund shall be maintained by CDSC, who will also be responsible for its administration.

The Fund 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 resulting from a CDA's operational or financial failure, malpractice (such as misappropriation of client funds or unauthorized trading), or non-payment of proceeds due to clients. Such risks fall under the scope of the Investor Compensation Fund, which is established under the Capital Markets Act, Cap 485A.

3. COMPOSITION OF THE GUARANTEE FUND

3.1 Contribution by CDAs

3.1.1 Initial Contribution by CDAs

- 3.1.1.1 The initial contribution per CDA shall be Kes 5,000,000. This must be a cash deposit in the CDSC Guarantee Fund Account.

3.1.2 Additional Contribution by CDAs

- 3.1.2.1 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 notification.
- 3.1.2.2 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.

3.1.3 Bank Guarantee

- 3.1.3.1 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 arising from its settlement obligation.
- 3.1.3.2 The bank guarantee shall not be issued by a bank that has a direct relationship, either through shareholding, directorship, or management, with the CDA.

3.1.4 Additional Letter of Credit

- 3.1.4.1 CDAs may deposit an 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 %.
- 3.1.4.2 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.

3.1.4.3 Letters of guarantee shall only be accepted from Tier 1 banks and shall not be from banks associated with the CDA.

3.2 Guarantee Fund Resources

This shall constitute:

3.2.1 Transaction Levy

3.2.1.1 This shall constitute the transaction levy contribution of 0.01% of the value of transactions.

3.2.1.2 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.

3.2.2 Penalties and Fines

3.2.2.1 All Penalties and fines charged to CDAs for non-compliance.

3.3 Investment Income

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

3.4 CDSC Contribution to the Fund

CDSC may make cash contributions to the Guarantee Fund from its revenue as the Board may determine from time to time.

3.5 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.

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 (Fund Trustee).

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

5. APPLICATION OF THE GUARANTEE FUND

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

- a) The defaulting CDA's resources.
- b) 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 9.4.6

5.4 A defaulting CDA shall be required to regularize their position as well as replenish all the losses suffered by the Guarantee Fund and non-defaulting CDAs' within 14 days of the draw down.

6. WITHDRAWAL FROM THE GUARANTEE FUND

- 6.1 A CDA that ceases its operations as a CDA, may apply to CDSC for approval to withdraw its contribution to the Guarantee Fund.
- 6.2 Where approval has been granted by CDSC, the CDAs 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.
- 6.3 For the avoidance of doubt, no refund will be made to a CDA on monies remitted as transaction levies, penalties and fines.

7. MANAGEMENT OF SETTLEMENT RISK

To guarantee settlement, CDSC has put in place a series of lines of defense 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 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 fund 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 (SL) for each CDA, which will be determined by the following formula:

$$SL = \frac{(ALC + GFC)}{[X]\%}$$

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

Where, for each CDA

- SL : Settlement Limit
 - ALC : Additional Letter of Credit (Clause 3.1.4 - Additional Letter of Credit)
 - GFC : Guarantee Fund Contribution (Clause 3.1.1 - The Guarantee Fund Contribution)
- 7.2.3 Any additional cash contribution or Additional Letter of Credit issued as per Procedure 5.1.4 above 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 into the designated 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 7.2.5) 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.
- 7.2.8 A CDA that has regularized its exceeded limit position in accordance with procedure 7.2.6 (iii) may apply to CDSC for the refund of the deposited funds.

7.3 Additional Criteria for Higher Settlement Limit

These are the criteria or guidelines to be followed whenever a Custodian Bank CDA requests to be allowed a higher settlement limit based on its net asset value:

- 7.3.1 The Custodian Bank must have a contribution of not less than Kes.10 million in 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, volatility or portfolio of securities or the volume of transactions of the Custodian Bank. The Custodian Bank shall be required to deposit the additional contribution within three (3) business days.
- 7.3.3 The Custodian Bank must maintain minimum share capital as stipulated by its primary Regulator.
- 7.3.4 The Custodian Bank that meets the requirements stipulated in Procedures 7.3.2 to 7.3.4 may be allowed a settlement limit of a maximum of 10% of the net asset value.
- 7.3.5 The Custodian Bank must maintain Positive Net Asset Value at all times (Calculated as All Assets less All liabilities);
- 7.3.6 The Custodian Bank 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 Custodian Bank 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 two months 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 Custodian Bank'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 Custodian Bank shows a decrease in its net asset value, CDSC shall immediately revise downwards the settlement limit of that Custodian Bank 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 Securities exchange and the CMA immediately.
- 7.4.2 To meet a defaulting CDA's obligation, the defaulting CDA's Settlement Bank shall 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 fund's 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 CDA's 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 12:00 noon on the next business day (T+4).
 - e) In the event that the CDA does not reimburse the Settlement bank as stated in (d) above, the Settlement bank shall notify CDSC by 2.00 pm on the same day (i.e. 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's position within one business day of being notified by the Settlement Bank (i.e. 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 (i.e. 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 replenish contributions of non-defaulting CDAs utilized in accordance with procedure 5.1 c) above;
 - c) To the guarantee fund resources;
 - d) To the CDSC reserve; and
 - e) To the defaulting CDA's contribution.
- 7.4.7 Following a draw down, the defaulting CDA shall be required to replenish their contribution to the Fund to the minimum level as set out in Section 5.4. Failure to do so shall be treated as a default and shall lead to the suspension or revocation of the appointment as a CDA.

8 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

		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	(30,000,000.00)	(500,000.00)	(10,000,000.00)
	Day 3	3,000,000.00	600,000.00	700,000.00
	Day 4	400,000.00	(4,000,000.00)	(8,000,000.00)
	Day 5	(50,000,000.00)	300,000.00	(2,000,000.00)
	Day 6	(105,000,000.00)	(5,000,000.00)	(18,000,000.00)
	Day 7	7,000,000.00	(4,000,000.00)	6,000,000.00
	Day 8	(86,000,000.00)	500,000.00	(20,000,000.00)
	Day 9	(156,000,000.00)	(30,000,000.00)	800,000.00
	Day 10	2,000,000.00	700,000.00	(46,000,000.00)
(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)	Moving average of CL	(136,875,000.00)	(12,500,000.00)	(26,250,000.00)

(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)	Settlement Limit <u>D+E</u> 20%	93,437,500.00	31,250,000.00	38,125,000.00
(G)	Minimum Contribution to the Guarantee Fund (C) x 20%	27,375,000.00	2,500,000.00	5,250,000.00

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

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