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MERRILL LYNCH PROFESSIONAL CLEARING CORP. ARTICLE 38(6) CSDR DISCLOSURE:  
U.S. LAW

SECTION 1: SEGREGATION LEVELS

1. Introduction

The purpose of this document is to disclose the levels of protection associated with the different levels of segregation that Merrill Lynch Professional Clearing Corp. (*ML Pro* and *we/us*) provide in respect of securities that we may hold directly for clients (individually and collectively, *you/your*) with Central Securities Depositories within the EEA (and, if offered, Switzerland) (*European CSDs* and *CSDs*), including a description of the main legal implications of the respective levels of segregation offered and information on the U.S. insolvency law applicable. This disclosure is required under Article 38(6) of the Central Securities Depositories Regulation (*CSDR*) and, as applicable, Article 73 of the Swiss Financial Markets Infrastructure Act (*FMIA* or *FinfraG*).

Under CSDR, the CSDs of which we are a Direct Participant (see the glossary of technical terms at the end of this document (the *Glossary*)) have their own disclosure obligations.

This document is not intended to constitute legal, investment or other advice and should not be relied upon as such. Clients should seek their own legal or other appropriate professional advice if they require any guidance on the matters discussed in this document.

2. Background

ML Pro is a broker-dealer registered as such with the Securities and Exchange Commission (*SEC*). Accordingly, ML Pro custodies your cash and securities (and holds them as collateral for any financing you have received from any of these entities) in accounts established in accordance with SEC regulations governing such accounts. ML Pro does not hold customer securities on its premises. Non-U.S. securities are held in depositories or other control locations outside the United States that meet requirements promulgated by the SEC. These non-U.S. control locations are (i) major foreign bank custodians, (ii) in some cases, non-U.S. affiliates of ML Pro, or (iii) industry-standard CSDs.

In our own books and records, we record each client's individual entitlement to securities that we hold for that client in a separate client account. To custody cash and securities for clients, we currently maintain open accounts with European CSDs and other custodians and depositories (*Segregated Accounts*). We are operationally able to establish two types of Segregated Accounts with European CSDs to custody clients' securities: Individual Client Segregated Accounts (*ISAs*) and Omnibus Client Segregated Accounts (*OSAs*). Proprietary securities cannot be held in ISAs, OSAs, or other Segregated Accounts.

An OSA is used to hold the securities of a number of clients on a collective basis, whereas an ISA is used to hold the securities of a single client and therefore the client's securities in an ISA are held separately from the securities of other clients. Although each ISA may be named in a way that identifies the client for whom it is maintained, the client does not have any right or ability to give instructions to the European CSD with respect to any ISA maintained on its behalf or the securities maintained in that

account, and so holding assets in an ISA does not give a client any operational rights with respect to those assets. Moreover, the Uniform Commercial Code, which includes laws governing the rights and obligation of entities that maintain securities accounts for their customers, does not recognize any special property interest in the assets maintained for a client in an ISA as opposed to an OSA or other Segregated Account.

### **3. Main legal implications of levels of segregation**

To the extent your assets are being custodied and/or held as collateral with ML Pro in connection with a prime brokerage or customer account, the general protections described below, along with various financial reporting requirements, would help to protect your assets.

#### *The Customer Protection Rule*

ML Pro is subject to Rule 15c3-3 under the Securities Exchange Act of 1934, commonly known as the Customer Protection Rule. The Customer Protection Rule requires us to segregate customer cash and securities from our own assets and sets requirements for the Segregated Accounts in which we hold customer assets. The Customer Protection Rule is designed so that a U.S. broker-dealer will hold sufficient property in Segregated Accounts to satisfy its customers' claims for the return of their assets, even if the broker-dealer becomes insolvent. As described more fully below, applicable U.S. insolvency laws complement this framework by requiring assets held in Segregated Accounts to be distributed to customers, and by allowing such assets to be distributed to other (non-customer) creditors only if all customer claims have been satisfied.

The Customer Protection Rule requires a broker-dealer to obtain and maintain possession or control of customers' fully paid and excess margin securities. These securities may not be rehypothecated by the broker-dealer. Further, to protect customers' free credit balances (cash), the broker-dealer is also required to calculate, on an aggregate basis for all customers, the difference between the amount of money it owes to customers (customer credits) and the amount of money customers owe to it (customer debits). If the amount of the customer credits exceeds the amount of the customer debits, an amount equal to this difference (i.e., excess credit), plus a cushion, is required to be deposited in a special reserve bank account for the exclusive benefit of customers. Customers have priority over the broker-dealer's creditors as to this special reserve.

Subject to strict limitations imposed by the Customer Protection Rule, we may use customer securities to facilitate obtaining financing, including pledging such securities to secure credit extended to us. Our use of customer securities is subject to limits based on the amount of credit extended to the individual customer, as well as aggregate limits based on the total amount of credit extended to all customers. Any securities that are eligible to be rehypothecated or otherwise used are not required to be held in a Segregated Account.

Securities held in Segregated Accounts as required by the Customer Protection Rule may be pledged to a European CSD or certain other permitted custodians to secure our obligation to pay custodial and administrative fees related to Segregated Accounts, but otherwise cannot be subjected to any lien or other encumbrance that would prevent a trustee or receiver from recovering such securities for distribution to customers in the event of our insolvency.

### *The Net Capital Rule*

The SEC's Net Capital Rule (Rule 15c3-1) ensures that a broker-dealer maintains at all times sufficient liquid assets to promptly satisfy its aggregate indebtedness (i.e., liabilities to customers, creditors and other broker-dealers) and to provide a cushion of liquid assets in excess of such indebtedness to cover potential market, credit, and other risks. Failure to maintain sufficient liquidity would result in the broker-dealer being required to cease operations immediately. Notice of sudden, substantial decreases in net worth must be given to the broker-dealer's regulators. Further, the broker-dealer cannot pay substantial dividends or release assets to its affiliates without regulatory approval.

### *Insolvency Proceedings under SIPA and the Dodd-Frank OLA*

When a broker-dealer becomes insolvent or near-insolvent, U.S. regulators generally seek to transfer customer accounts to a financially sound broker-dealer. A broker-dealer that is in compliance with the Customer Protection Rule should have the assets necessary to move all customer accounts to the new broker-dealer. If there are customer accounts remaining at the time of the commencement of an insolvency proceeding, then the remaining customers would be subject to the provisions of U.S. insolvency law described below.

Were we to become insolvent, our insolvency proceedings would take place in the United States and be governed by U.S. law. Specifically, if we held customer assets at the time of our insolvency, then our insolvency proceedings would be governed by the Securities Investor Protection Act of 1970 (**SIPA**) or the Dodd-Frank Orderly Liquidation Authority (**Dodd-Frank OLA**).

A SIPA proceeding creates a framework allowing regulators to provide for the transfer of an insolvent broker-dealer's customer accounts to other broker-dealers. Were we to become insolvent, the Securities Investor Protection Corporation (**SIPC**) would step into a bankruptcy proceeding and administer a bankruptcy under SIPA, by appointing a trustee to liquidate our assets and distribute them to customers and creditors under court supervision.

In a proceeding under the Dodd-Frank OLA, the Federal Deposit Insurance Corporation (**FDIC**) would liquidate our assets and distribute them to customers and creditors with limited court oversight. The Dodd-Frank OLA gives little guidance as to which assets and liabilities of a firm would be part of the SIPA estate and which would be administered under the Dodd-Frank OLA. The FDIC will exercise its discretion with respect to this issue. If appointed receiver of a broker-dealer covered under the Dodd-Frank OLA, the FDIC shall appoint SIPC as receiver, but SIPA shall apply only to those claims and assets that the FDIC does not transfer to a bridge financial company.

Under both SIPA and the Dodd-Frank OLA, clients that are "customers" are entitled and required to file customer claims for securities that we hold on their behalf. Securities that we hold in Segregated Accounts for customers (including securities held at a European CSD) form part of our estate and are distributed to customers in satisfaction of their customer claims, regardless of whether such property is held in an OSA, an ISA or another Segregated Account. There is no legal benefit under U.S. insolvency law to a customer's securities being held in ISAs, as opposed to OSAs.

Property held in Segregated Accounts is not available for distribution to creditors unless all customer claims have been satisfied. Securities held for customers can also be sold by the trustee or receiver to generate cash for distribution to customers. (If a Segregated Account is subject to a lien that is permitted

under the Customer Protection Rule, such as the lien that European CSDs are permitted to impose for custodial and administrative fees arising in connection with Segregated Accounts, then the secured creditor is permitted to satisfy such lien before turning the remaining assets over to the trustee or liquidator for distribution to customers.)

### *Shortfalls*

As described above, the Customer Protection Rule is designed to ensure that in the event of our insolvency there would be enough cash and securities in Segregated Accounts to make our customers whole. SIPA and the Dodd-Frank OLA provide for such assets to be distributed to customers and not to be subject to creditor claims until customer claims are satisfied in full. SIPC would calculate each customer's "net equity" (i.e., each customer's claims to cash and securities net of any amounts owed to the broker-dealer) and distribute the Segregated Assets to the customers, on a pro rata basis, up to the amount of their respective net equity.

SIPC advances are also available to reduce or eliminate any shortfall. SIPC advances are presently limited to \$500,000 per customer (up to \$250,000 of which can be used to satisfy a claim for cash). However, advances are not available for broker-dealers, banks, individuals who are officers or directors of, or who otherwise can exert control over, the broker-dealer, and individuals or entities who have an ownership interest in the broker-dealer or who have subordinated their claims against the broker-dealer. If you are uncertain whether you would qualify as a "customer" for purposes of the Customer Protection Rule, SIPA, or the Dodd-Frank OLA (see Glossary), you should obtain legal advice.<sup>1</sup>

If, notwithstanding the Customer Protection Rule, there were a shortfall between the amount of cash and securities that we are obliged to deliver to clients and the amount of cash and securities that we hold on their behalf in Segregated Accounts (including Segregated Accounts that are not maintained by European CSDs), plus any applicable SIPC advances, this could result in fewer securities than clients are entitled to being returned to them on our insolvency.

As noted above, under SIPA and the Dodd-Frank OLA, securities held in ISAs would be treated in the same fashion as securities held in OSAs. In the case of any shortfall of customer property, the shortfall would be shared among all clients equally, in an amount that is proportionate to their customer claims. Therefore, a client may be exposed to a shortfall even where the securities that are the subject of the shortfall are completely unrelated to that client.

Even if a particular customer could "trace" or otherwise identify securities corresponding to its customer claim, this would not entitle such a customer to receive those securities—the customer would be subject to the same losses as all other customers, and the customer's claim could be satisfied with cash instead of securities. This logic applies with equal force to ISAs—the fact that securities are held in an ISA that is identifiable to a particular customer does not give that customer any special claim to receive those securities under SIPA or the Dodd-Frank OLA.

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<sup>1</sup> In addition, beyond the SIPC limit, ML Pro carries excess insurance coverage that would be available, subject to the terms of the insurance policy, if SIPC's coverage does not satisfy the shortfall in customers' accounts. Details of such coverage are available from ML Pro upon request.

The same result would apply to losses caused by a permitted lien asserted by a European CSD or other custodian. As described above, we are permitted to pledge the assets in Segregated Accounts to secure custodial and administrative fees owed to the European CSD in respect of Segregated Accounts. Because such a lien would have to be satisfied before customer property could be distributed to customers, it could theoretically result in a shortfall in customer property. Since a shortfall would be borne by all customers proportionately to their customer claims, a lien might affect all customers collectively, but a given customer would be indifferent to whether its particular securities were subject to the lien. In other words, the possibility that such a security interest will be asserted against customer property has no bearing on the choice between an OSA or an ISA.

If we were to become insolvent during a time when there is a shortfall of assets held in Segregated Accounts, clients could be treated as general unsecured creditors for any amounts that remain unsatisfied after the distribution of all customer property from Segregated Accounts and the disbursement of all SIPC, and excess-SIPC, advances. Clients would therefore be exposed to the risks of our insolvency, including the risk that they may not be able to recover all or part of any amounts claimed.

## SECTION 2: PRICING DISCLOSURE

Article 38(6) of CSDR also requires us to disclose the costs associated with the different levels of segregation described in section 1 of this document.

As noted in section 1, Merrill Lynch Professional Clearing Corp. (*ML Pro* and *we/us*) offers the choice between Individual Client Segregated Accounts (*ISAs*) and Omnibus Client Segregated Accounts (*OSAs*) at each CSD with which it holds assets directly for its clients.

ISAs and OSAs are fundamentally different from each other and as a result, the costs associated with each option will vary. Typically, an ISA will be more expensive than an OSA. The principal reason for this is that ISAs are operationally more expensive for ML Pro to open and maintain at a CSD. ISAs do not benefit from the operational efficiency afforded by an OSA—employing an ISA structure will require ML Pro to open and maintain multiple ISAs, which is likely to attract higher charges at the CSD (and other third parties) than would be incurred if ML Pro were simply able to use one account for a number of different clients.

Please note that it is not possible to provide detailed information about costs in this document. The particular pricing structures which apply to ISAs and OSAs will depend on various factors and will be calculated for clients on a case-by-case basis. A representative from ML Pro would be pleased to assist in this regard.

## SECTION 3: GLOSSARY

**Central Securities Depository** or **CSD** is an entity which records legal entitlements to dematerialised securities and operates a system for the settlement of transactions in those securities.

**Central Securities Depositories Regulation** or **CSDR** refers to EU Regulation 909/2014, which sets out rules applicable to CSDs in the EEA and their participants.

**Direct Participant** means an entity that holds securities in an account with a CSD and is responsible for settling transactions in securities that take place within a CSD. A Direct Participant should be distinguished from an indirect participant, which is an entity, such as a global custodian, which appoints a Direct Participant to hold securities for it with a CSD.

**Dodd-Frank Orderly Liquidation Authority** or **Dodd-Frank OLA** refers to Title II of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act.

**EEA** means the European Economic Area.

**FDIC** means the U.S. Federal Deposit Insurance Corporation.

**FinfraG** (Finanzmarktinfrastrukturgesetz) or **FMIA** is the Swiss Financial Markets Infrastructure Act which sets out rules applicable to Swiss CSDs and their participants.

**SEC** is the Securities and Exchange Commission.

**Segregated Accounts** are accounts opened and maintained with European CSDs and other custodians and depositaries to custody cash and securities for clients.

**Segregated Assets** are assets maintained in Segregated Accounts.

**SIPA** refers to the U.S. Securities Investor Protection Act of 1970.

**SIPC** refers to the U.S. Securities Investor Protection Corporation.

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