

REGULATING OVER-THE-COUNTER (OTC) DERIVATIVES MARKETS IN SOUTH AFRICA

Policy document regarding the regulations issued
under the Financial Markets Act, No. 19 of 2012

4 July 2014



national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA



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CONTENTS

Purpose and Consultation Process - **1** | List of Abbreviations - **2**

Papers by International Standard Setters - **3** | Background and Reform Objectives - **4**

Consultation Phase - **4** | Objectives of the Regulatory Framework - **5** | Guiding Principles - **5**

The Regulatory Framework - **6** | Conclusion - **8**



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PURPOSE AND CONSULTATION PROCESS

This policy document informs the proposed regulatory framework relating to the over-the-counter (“OTC”) derivatives market in South Africa and is drafted in accordance with s107(2)(iv) of the Financial Markets Act, No.19 of 2012 (FMA), effective 3 June 2013. The regulatory framework discussed in this document covers Ministerial regulations relating to:

- Requirements for the regulation of unlisted securities, including the categorisation of OTC derivatives;
- The requirement to be authorised as an over-the-counter derivative provider (“ODP”) as a category of regulated person¹;
- Securities services to be provided by an external central securities depository (“CSD”) and external clearing members;
- Functions and duties that may be exercised by an external clearing house, central counterparty (“CCP”) or external trade repository (TR);
- Assets and resources requirements applicable to market infrastructures (“MIs”);
- Regulations applicable to the licensing of trade repositories;
- Assets and resources requirements and functions applicable to a clearing house that is a central counterparty;
- Requirements with which a CSD must comply for approval of an external CSD as a participant.

This policy document must be read in conjunction with the draft regulations which can be found on the National Treasury (“NT”) website at www.treasury.gov.za and with the earlier policy paper *Reducing the risks of over-the-counter derivatives in South Africa* at <http://www.treasury.gov.za/legislation/bills/2012/FMB/>.

Comments on any aspect of the regulatory framework are to be submitted via email to financial.policy@treasury.gov.za with the subject title FMA: Ministerial Regulations. The deadline for submission is 3 September 2014.

Queries can be sent to Isabelle Kaira at: Isabelle.Kaira@treasury.gov.za

¹ Financial Services Board (“FSB-SA”) notices prescribing additional requirements relating to criteria for the authorisation of ODPs, a code of conduct for ODPs and reporting obligations on ODPs will be released later this year.

LIST OF ABBREVIATIONS

ASISA	Association for Savings and Investment South Africa
BASA	Banking Association of South Africa
BCBS	Basel Committee on Banking Supervision
CCP	Central Counterparty
CPSS	Committee on Payment and Settlement Systems
CSD	Central Securities Depository
EU	European Union
FAIS Act	Financial Advisory and Intermediary Services Act No. 37 of 2002
FMA	Financial Markets Act No. 19 of 2012
FSB	Financial Stability Board
FSB-SA	Financial Services Board (South Africa)
G20	Group of 20 Finance Ministers and Central Bank Governors
IOSCO	International Organisation of Securities Commissions
JSE	Johannesburg Stock Exchange
MI	Market infrastructure
NT	National Treasury
ODP	Over-the-Counter Derivative Provider
OTC	Over-the-Counter
SARB	South African Reserve Bank
SSA	Securities Services Act No. 36 of 2004
Strate	Strate Limited
TR	Trade Repository
UK	United Kingdom
US	United States of America
WG	Working Group

PAPERS BY INTERNATIONAL STANDARD SETTERS

BCBS and IOSCO (2013), Second Consultative Document - Margin Requirements for Non-Centrally Cleared Derivatives, available at:
<http://www.bis.org/publ/bcbs242.pdf>

CPSS –IOSCO (2012), Report on OTC Derivatives Data Reporting and Aggregation Requirements, Final Report, available at:
<http://www.bis.org/publ/cpss100.pdf>

CPSS-IOSCO (2012), Principles for Financial Market Infrastructures (FMIs), available at:
<http://www.bis.org/publ/cpss101a.pdf>

CPSS-IOSCO (2012), Principles for Financial Market Infrastructures: Disclosure Framework and Assessment Methodology, available at:
<http://www.bis.org/publ/cpss106.pdf>

FSB (September 2013), OTC Derivatives Market Reforms - Sixth Progress Report on Implementation, available at:
http://www.financialstabilityboard.org/publications/r_130902b.pdf

CPSS-IOSCO (2013), Authorities' Access to Trade Repository data report, available at:
<http://www.bis.org/press/p130812a.htm>

IOSCO (2010), OTC Markets and Derivatives Trading in Emerging Markets - Final Report, available at:
<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD330.pdf>

IOSCO (2012), International Standards for Derivatives Market Intermediary Regulation - Final Report, available at:
<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD381.pdf>

National Treasury (2011), A Safer Financial Sector to Serve South Africa Better, available at:
<http://www.treasury.gov.za/documents/national%20budget/2011/A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf>

National Treasury (2012), Explanatory Memorandum: Annexure B - Reducing the Risks of Over-the-Counter Derivatives in South Africa, available at:
<http://www.treasury.gov.za/legislation/bills/2012/FMB/Annexure%20B%20Reducing%20the%20Risks%20of%20OTC%20Derivatives.pdf>

BACKGROUND AND REFORM OBJECTIVES

In September 2009, G20 Leaders agreed in Pittsburgh that:²

All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.

In November 2011, G20 Leaders in Cannes further agreed:

We call on the Basel Committee on Banking Supervision (BCBS), the International Organization for Securities Commissions (IOSCO) together with other relevant organizations to develop for consultation standards on margining for non-centrally cleared OTC derivatives by June 2012.

In its October 2010 report on [Implementing OTC Derivatives Market Reforms](#), the Financial Stability Board (FSB) made 21 recommendations addressing practical issues that authorities may encounter in implementing the G20 Leaders' commitments. In the April 2013 G20 Finance Ministers and Central Bank Governors meeting, the G20 has reaffirmed its commitment to achieving these goals.

As a member of the G20, South Africa is committed to G20 and FSB agreements for OTC derivatives market reforms.

On 3 June 2013, the FMA, which repealed the Securities Services Act No. 36 of 2004 (SSA), came into force. The FMA has as its objectives the reduction of systemic risk, the protection of regulated persons, clients and investors and the promotion of fair, efficient and transparent financial markets. The FMA as enabling legislation provides for the regulation and supervision of the OTC derivatives market and related MIs, such as clearing houses and TRs, necessary for the implementation of G20 requirements.

CONSULTATION PHASE

In terms of s107 of the FMA, it is required that all regulations are consulted on with recognised industry bodies. OTC Derivative Working Groups ("WGs") have been constituted under the Chairmanship of the NT and the FSB-SA and includes representation from major bank and non-bank institutions, the Johannesburg Stock Exchange (JSE), Strate Limited (Strate), industry associations such as the Banking Association of South Africa (BASA), the Association for Savings and Investment South Africa (ASISA) and the South African Reserve Bank (SARB). The WGs were established with the mandate to advise the Minister on the most appropriate regulatory framework for the OTC derivatives market. Each WG was responsible for a different aspect of the regulatory framework:

- *OTC Registration and Code of Conduct WG* (Chair, FSB-SA): tasked to advise the Minister on the regulation of ODPs and the code of conduct that governs the behaviour of ODPs, their employees and clients.
- *OTC Central Reporting WG* (Chair, NT): tasked to advise on the appropriate framework for the reporting of OTC transactions to TRs.
- *OTC Central Clearing WG* (Chair, NT): tasked to advise on the appropriate framework towards mandating of central clearing.

The WGs will continue to meet as required, as outstanding elements of the regulatory framework are finalised.

² G20, Pittsburgh summit declaration (www.g20.utoronto.ca/2009/2009communique0925.html)

OBJECTIVES OF THE REGULATORY FRAMEWORK

The proposed regulatory framework is informed by the objectives of the FMA.

GUIDING PRINCIPLES

The development of the regulatory framework was guided by the following five principles:

Principle 1: Adoption of Appropriate International Standards

It is important that the South African regulatory framework reflects, where appropriate, international best standards and practice. The regulatory framework draws judiciously, as a minimum, on the standards set by international standard setting bodies such as IOSCO.

Principle 2: Developing Harmonised and Equivalent Regulatory Frameworks

The international nature of the global derivatives market means that any legislative or regulatory requirements imposed in one country are likely to impact ODPs or counterparties in other jurisdictions. In order to ensure that South African market players can continue to trade across borders, a necessity for the continued efficiency and risk management associated with the local OTC market, South Africa's regulatory and supervision framework must be assessed as equivalent by regulators in other jurisdictions. Regulations of equivalent jurisdictions ensure level playing fields, minimise duplication and uncertainty and reduce the opportunity for regulatory arbitrage.

Principle 3: Alignment with Existing Legislation

Alignment with relevant existing legislation such as the Financial Advisory and Intermediary Services Act (FAIS Act) and the Banks Act No. 94 of 1990 further assists in levelling playing fields between domestic participants, avoiding duplication and minimising regulatory arbitrage domestically.

Principle 4: Implementing the Twin Peaks Model of Financial Regulation

The twin peaks regulatory framework will establish the following two regulatory authorities:

- A new *Prudential Authority* within the Reserve Bank. This Authority will be responsible for the oversight of the safety and soundness of banks, insurers and financial conglomerates.
- A new *Market Conduct Authority* to protect customers of financial services firms and to improve the way financial service providers conduct their business. This Authority will also be responsible for ensuring the integrity and efficiency of financial markets and for promoting effective financial consumer education.

The regulatory framework recognises the financial stability and prudential oversight roles that the SARB will play within the twin peaks framework.

Principle 5: Minimizing Market Disruptions

While the benefits of enhanced regulation for the OTC derivatives market are recognised, these benefits cannot be achieved without some market disruption. In this regard, the WGs have been fundamental to improving the authorities' understanding of the possible impact of OTC derivatives market regulations and also as a means of communicating anticipated regulatory changes to market participants in advance of implementation.

THE REGULATORY FRAMEWORK

AUTHORISATION OF ODPS

The regulations for the OTC derivatives markets prescribes an ODP as a category of regulated person in terms of s5(1)(b) of the FMA. ODPS are required to be authorised by the Registrar of Securities Services (“registrar”).

LICENSING OF CCPS

In order to facilitate the G20 central clearing obligation, the FMA introduced a new chapter on independent clearing houses. The regulations (in terms of s48(1) and s107 of the FMA) define a CCP as a clearing house or external clearing house that *interposes itself between counterparties to contracts traded in one or more financial markets, becoming a buyer to every seller and a seller to every buyer and thereby ensuring the performance of open contracts. A CCP becomes counterparty to a trade through novation, an open offer system or through a legally binding agreement.*

The regulations introduce a rigorous framework for the regulation of CCPs, recognising the cross-border systemic risk that these institutions pose and containing stringent prudential, governance and conduct requirements.

Prudential regulatory standards for CCPs aim to ensure the sufficiency of financial resources of these institutions to minimise potential losses to their stakeholders and other financial markets participants ensuing from the execution of their OTC derivative-related operations. Prudential supervision furthermore aims to assess the adequacy of staff, systems, risk management, controls and other qualitative mitigants to failure.

LICENSING OF TRADE REPOSITORIES

To facilitate central reporting requirements, the regulations make provision for the licensing of trade repositories in terms of section 54 of the FMA.

PROVISION FOR EXTERNAL MARKET PARTICIPANTS

The cross-border nature of securities markets requires an appropriate regulatory framework that promotes the efficiency and competitiveness of the South African financial markets (as objects of the FMA) without significantly undermining their stability. The regulations therefore also address:

- Requirements with which a central securities depository (“CSD”) must comply for approval of an external CSD as a participant.
- The securities services to be provided by an external CSD and external clearing members.
- Functions and duties that may be exercised by an external clearing house, CCP or external trade repository (TR).

s5(1)(c) of the FMA and the regulations allow a licensed CSD to authorise an external CSD as a participant to perform custody and administration of securities; and settlement services. The regulations also provide for the requirements with which a CSD must comply for approval of an external CSD as a participant. Allowing for such CSD-to-CSD links will result in enhanced efficiencies in custody and settlement services while encouraging further foreign investor participation in South African financial markets.

When establishing a link with an external CSD, a CSD must ensure that it only establishes links with an external CSD that is subject to a regulatory framework equivalent to that established under the FMA and that is regulated and supervised by a supervisory authority that is a member of IOSCO.

APPLICATION OF THE SOUTH AFRICAN REGULATORY FRAMEWORK TO ODPS IN A FOREIGN JURISDICTION

The relevant provisions of the FMA and this regulatory framework will apply to any derivative transactions that take place between:

- any two ODPs that are located in the Republic, whether those ODPs are locally incorporated or are a branch or subsidiary of a parent undertaking in a foreign jurisdiction.
- an ODP and a counterparty/client, whether that counterparty/client is locally incorporated, a branch or a subsidiary of a parent undertaking in a foreign jurisdiction or located in a foreign jurisdiction (cross-border trade).

CONCLUSION

The proposed regulatory framework presented in this paper is informed by the objectives of the FMA, while its development was guided by the following five principles:

- **Principle 1:** Adoption of Appropriate International Standards
- **Principle 2:** Developing Harmonised and Equivalent Regulatory Frameworks
- **Principle 3:** Alignment with Existing Legislation
- **Principle 4:** Implementing the Twin Peaks Model of Financial Regulation
- **Principle 5:** Minimizing Market Disruptions

The regulatory framework will allow South Africa to meet its G20 obligations in terms of OTC derivatives.

Comments on any aspect of the regulatory framework are to be submitted via email to financial.policy@treasury.gov.za with the subject title FMA: Ministerial Regulations. The deadline for submission is 3 September 2014.

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