REGULATING
OVER-THE-COUNTER
DERIVATIVE MARKETS
IN SOUTH AFRICA
SECOND DRAFT POLICY DOCUMENT ACCOMPANYING THE MINISTERIAL REGULATIONS
AND BOARD NOTICES ISSUED UNDER THE FINANCIAL MARKETS ACT, NO. 19 OF 2012
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PURPOSE AND CONSULTATION PROCESS

In 2012, National Treasury released a discussion paper, Reducing the risks of over-the-counter derivatives in South Africa. This paper sets out a process of consultation, with a view to proposing a new regulatory framework for over-the-counter ('OTC') derivatives.

In 2014, proposed Ministerial regulations for unlisted OTC derivatives were published for public comment. These proposed regulations aimed to ensure that South Africa can meet its G20 obligations in terms of the regulation of the OTC derivatives market.

Comments from stakeholders were subsequently received and a second draft of proposed regulations has been developed. This second draft of Ministerial regulations has been released for public comment, together with related Financial Services Board ('FSB-SA') Notices.

This policy document informs the proposed regulatory framework and is drafted in accordance with s107 (2) (iv) of the Financial Markets Act, No.19 of 2012. The regulatory framework discussed in this document covers Ministerial regulations and FSB-SA Notices relating to:

CATEGORISATION OF DERIVATIVES AND REGULATING DERIVATIVE MARKET PARTICIPANTS

- Requirements for the regulation of unlisted securities;
- The requirement to be authorised as an OTC derivative provider as a category of regulated person;
- The code of conduct binding on OTC derivative providers, their officers and employees, clients and counterparties;
- Reporting obligations of OTC derivative providers to trade repositories in terms of OTC derivative transactions;
- Margining requirements for non-centrally cleared OTC derivative transactions binding on OTC derivative providers, their clients and counterparties.

MARKET INFRASTRUCTURES

- Requirements applicable to the licensing of trade repositories and additional duties on trade repositories relating to their collection and publication of OTC derivative data;
- Asset and resource requirements applicable to market infrastructures;
- The requirements and functions of a clearing house that is a central clearing counterparty ('CCP');
- Functions and duties that may be exercised by an external market infrastructure;
- Requirements with which a central securities depository must comply in order to approve an external central securities depository as a participant; and,
- Securities services to be provided by an external central securities depository.

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 (Round 2). The deadline for submission is 6 July 2015.

Queries can be sent to Isabelle Kaira at: Isabelle.Kaira@treasury.gov.za
BACKGROUND AND REFORM OBJECTIVES

The global financial crisis of 2007 exposed major weaknesses in the financial system, and the effects of the crisis are still felt through low growth rates as the global economy slowly recovers.

The global financial crisis highlighted a number of weaknesses in the global framework for financial regulation. The lessons from the crisis fed into South Africa’s comprehensive financial services reform programme, which was summarised in the 2011 Policy Document A safer financial sector to serve South Africa better.

One component of the comprehensive response has been to deal with systemic risk. The financial crisis highlighted the risk that the failure of one financial institution often leads to the failure of other financial institutions because of the complex web of interrelationships in the system. Minimising these knock-on effects has been a key focus of the regulatory reforms following the crisis. In particular, the market for OTC derivatives was especially opaque. Such derivatives created substantial counterparty risk – the risk in a bilateral transaction that one party defaults on its obligations to the other.

South Africa has supported the G20’s efforts to reduce the risks posed by OTC derivatives, and has put in place a process to ensure that its regulatory framework is on par with other jurisdictions.

THE G-20 AGREEMENTS

In September 2009, as a step to prevent future crises arising from OTC derivatives markets, G20 Leaders agreed in Pittsburgh that:

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. On several occasions since then, including 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.

1. Available online at www.treasury.gov.za/twinpeaks
SOUTH AFRICAN OTC DERIVATIVE MARKETS

Although the South African financial market is small relative to global standards, OTC derivatives play an important role in the financial markets and economy. In a study commissioned by the National Treasury and conducted by Price Water House Coopers (‘PWC’), the outstanding notional amounts as at June 2012 for OTC derivatives was valued at R27.7 trillion. This amount includes interbank trades between domestic and foreign banks, between domestic banks, and other non-financial participants including corporates.

The most common type of derivative asset class, accounting for over 85% of transactions traded in the domestic market, are interest rate derivatives at an estimated outstanding notional amount of R24.3 trillion. Foreign exchange derivatives are the second largest at 12.1% of the total notional amount.

The results also indicate that derivatives products are particularly popular amongst banking institutions and corporates who use them primarily for risk hedging. The majority of the interest rate derivatives transactions involve significant exposure to global markets as these are dominated by inter-bank trades between local and foreign banks. This is consistent with trends in global OTC derivatives markets which are largely characterised by cross-border transactions.

Even though, the South African financial markets were not severely impacted directly by the financial crisis, the indirect impact of sluggish market performances due to slowing global economic activity, adversely affected job ratios in particular. It is therefore necessary to implement better and stronger measures to prevent domino financial impacts.

APPROACH TO REGULATORY REFORMS

The Financial Markets Act, which came into force on 3 June 2013, 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 Financial Markets Act, as enabling legislation, provides for the regulation and supervision of the OTC derivatives market and related market infrastructures, such as clearing houses and trade repositories that are necessary for the implementation of G20 requirements.

CONSULTATION PHASE

In April 2012, National Treasury released a document entitled Reducing the risks of over-the-counter derivatives in South Africa. This document expanded on the discussion on the regulatory and legislative reforms for the South African OTC derivatives markets and outlined the three phases of implementation of OTC derivatives reforms:

- **Phase 1** – Code of Conduct and Registration of market participants, and Central Clearing
- **Phase 2** – Standardisation, Central Clearing and Central Trading (where appropriate)
- **Phase 3** – Risk management – margin and capital requirements for non-centrally cleared derivatives (where appropriate).

In terms of s 107 of the Financial Markets Act, it is required that all regulations are consulted on with recognised industry bodies. As such a consultative approach was undertaken to develop and implement requirements in the phases set out above and OTC Derivative Working Groups, chaired by the National Treasury and the Financial Services Board (‘FSB-SA’), were constituted. These included representation from major bank and non-bank institutions, the Johannesburg Stock Exchange, STRATE, the South African Reserve Bank (‘SARB’) and industry associations such as the Banking Association of South Africa.
(‘BASA’), and the Association for Savings and Investment South Africa (‘ASISA’) to advise the Minister on the most appropriate regulatory framework for the OTC derivatives market. Each working group was responsible for a different aspect of the regulatory framework with the following mandates:

- **Registration and Code of Conduct**, to advise the Minister on the regulation of OTC derivatives providers and the code of conduct that governs the behaviour of OTC derivatives providers, their employees and clients.
- **Central Reporting**, to advise on the appropriate framework for the reporting of OTC transactions to trade repositories.
- **Central Clearing**, to advise on the appropriate framework towards mandating of central clearing.

### OBJECTIVES OF THE REGULATORY FRAMEWORK

The proposed regulatory framework is informed by the following objectives of the Financial Markets Act.

**Objective 1:** Contributing to the maintenance of a stable financial market environment and reducing systemic risk.

Included in the authorisation requirements for OTC derivatives providers are prudential, governance and sound risk management requirements. The licensing and supervision provisions for central counterparties and trade repositories will ensure risk management, prudential and governance requirements that are appropriate to the risks that each of these bring to financial markets.

Central reporting obligations for OTC derivatives providers will facilitate the monitoring of potential systemic risk by the relevant authorities. The enabling provisions for central clearing recognise the potential reduction in systemic risk from the compulsory clearing of certain asset classes or products. Additional requirements relating to timely confirmations, portfolio reconciliations and portfolio compression also contribute to the stability of the financial market environment.

Given the cross-border nature of the market, the regulatory framework takes into account the transfer of risks across jurisdictions. In this regard, the framework allows for a process of recognition of external market infrastructures and exemption from direct supervision by the FSB-SA where the registrar is satisfied that the legal and supervisory arrangements of the jurisdiction where the market infrastructure is supervised, are equivalent to that of the South African regulatory framework.

**Objective 2:** Promoting fair, efficient and transparent markets

The regulatory framework includes a code of conduct which will be binding on all OTC derivatives providers, their employees and clients. The recognition and equivalence framework for external market infrastructures will promote efficiency by allowing market participants the choice to access the functions or securities services of a broader range of market infrastructures while still ensuring the appropriate management of risks. The requirement on TRs to publish aggregated OTC derivatives data and provide authorities with transaction level data will improve market transparency.
Objective 3: Boosting investor confidence and investor protection

The code of conduct provides requirements aimed at protecting investors, such as enhanced disclosure requirements and appropriateness tests to ensure that retail investors understand the risks associated with the derivative transactions. OTC derivatives providers are also required to act in the best interests of the client or counterparty through the safeguarding of collateral and margin.

The prudent licensing and regulatory requirements for central counterparties and trade repositories will contribute to the attainment of this objective.

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. As an example, 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 global nature of international derivatives market means that any legislative or regulatory requirements imposed in one country are likely to impact OTC derivatives providers 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 supervisory framework must be assessed to be equivalent by the relevant authorities 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) No. 37 of 2002, 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 regulatory framework recognises the financial stability and prudential oversight roles that the SARB will play within the twin peaks framework, which will be implemented shortly and is described in more detail below.
**Principle 5: Minimising Market Disruption**

Despite the benefits of enhanced regulation for the OTC derivatives market being well recognised, these benefits cannot be achieved without some degree of market effect. In this regard, the working groups have been fundamental to improving the authorities' understanding of the possible impact of OTC derivatives market regulations and as a means of communicating anticipated regulatory changes to market participants in advance of implementation.

**GLOBAL IMPLEMENTATION PROGRESS**

As the G-20’s international coordination body, the FSB regularly assesses the progress of the FSB member jurisdictions’ implementation of the OTC derivatives reforms and as such the status of South Africa's implementation at legislative and regulatory levels is regularly reviewed.

In November 2014, the FSB published the "Eighth progress report on implementation of OTC derivatives reforms" covering progress in trade reporting, central clearing, capital requirements, margin requirements and exchange or platform trading. The majority of the FSB members (15 out of 19), including South Africa have adopted and implemented final legislation that establishes enforceable legislative provisions relating to reporting to trade repositories, central clearing, margining, capital and exchange/trading platforms. However, in terms of implementation, South Africa is lagging behind most other jurisdictions, which raises questions about the progress towards implementation of the framework for regulating OTC derivatives markets.

In the EU, regulations for central reporting and capital requirements for OTC derivatives exposures are already in force and in operation, while central clearing has been proposed. In contrast in South Africa central reporting requirements and capital requirements have been proposed but are not yet fully effective. As the UK represents South Africa’s most important trading partner with at least 20% of total trades, and Europe (excluding the UK) a further 14%, local participants exposed to counterparties in these jurisdictions may have some of the requirements from these jurisdictions imposed upon them, which may be difficult to meet.

Releasing the second draft of the Ministerial regulations and FSB-SA notices will therefore put South Africa a step closer to meeting its obligations and also address much of the uncertainty that market participants have thus far experienced with regards to the regulation of OTC derivatives markets. The regulatory framework will assist with creating a level playing field particularly for cross-border activities.

**EXPANDING THE SCOPE OF REGULATION**

**TWIN PEAKS AND FINANCIAL MARKETS ACT CONSEQUENTIAL AMENDMENTS**

On 11 December 2014, National Treasury published a revised draft of the Financial Sector Regulation (FSR) Bill including consequential amendments to the Financial Markets Act for public comment.

The FSR Bill gives effect to the government decision in 2011 to shift to a Twin Peaks model of financial sector regulation for South Africa. Twin Peaks is a comprehensive and complete system for regulating the financial sector. It represents a decisive shift away from a fragmented regulatory approach to reduce the possibility of regulatory arbitrage or forum shopping and close gaps in the regulatory system.

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Two authorities will be established – a Prudential Authority within the South African Reserve Bank and a new Financial Sector Conduct Authority (FSCA). The Prudential Authority will supervise the safety and soundness of banks, insurance companies and other financial institutions while the FSCA will supervise how financial services firms conduct their business and treat customers.

The revised Bill gives additional powers to the new authorities, in keeping with their respective objectives. These powers will be in addition to those provided in existing industry-specific financial sector laws (i.e. an “overlay”), and are intended to ensure that the authorities have the required tools to perform effectively in this first phase of their establishment, without being limited by gaps in the existing law.

The authorities will also be empowered to exercise their powers over all licensed financial institutions (to include financial product providers (e.g. OTC derivatives providers), financial service providers, market infrastructures including the payment system operator, and any institution required to be licensed under a financial sector law), regardless of which authority is the licensing authority (see below). This will ensure completeness of regulatory coverage.

Therefore, the Twin Peaks architecture, in terms of the derivatives market, will ensure that both authorities will have regulatory oversight over all market infrastructures (for example trade repositories and central counterparties) and market participants, such as OTC derivatives providers. This regulatory oversight will include issuing regulatory requirements, supervising regulated entities and taking enforcement action (including remedial and punitive action) against those who breach the requirements or break the law.

Licensing will remain under the current Financial Markets Act and all current licenses and licensing provisions will remain in place. In Phase 1 of Twin Peaks, FSCA will be the designated licensing authority for specific existing licenses and for overseeing compliance with the Financial Markets Act. The overall proposal is presented in the table below:

<table>
<thead>
<tr>
<th>Sectoral law</th>
<th>Exchange</th>
<th>CSD</th>
<th>Clearing house</th>
<th>CCP</th>
<th>TR</th>
<th>Regulated persons e.g. ODPs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lisencing authority</td>
<td>FSCA</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Supervision of sectoral law</td>
<td>Primarily FSCA, also PA for licensing</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Setting and supervision of standards</td>
<td>PA and FSCA, for respective standards</td>
<td></td>
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</tr>
<tr>
<td>Enforcement of sectoral law</td>
<td>Primarily FSCA, also PA for licensing</td>
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In Phase 2 of Twin Peaks, industry-specific licensing provisions will be repealed and replaced. Institutions will be required to get a license from the PA and a separate license from the FSCA. The intention is to eventually phase out the broad range of existing subordinate legislation (Ministerial regulations, Board Notices etc.) and replace these with standards issued by both authorities. This will standardize and streamline the current regulatory environment, where subordinate legislation currently refers to a wide range of instruments.

The proposed approach to regulating OTC derivatives markets discussed in this document has taken the move to Twin Peaks into consideration in terms of developing the regulatory framework. In particular, the regulatory framework has been developed jointly by National Treasury, the FSB-SA and the SARB. SARB has played a particularly important role in terms of developing the prudential requirements for market infrastructures and OTC derivatives providers.
CENTRAL COUNTERPARTIES AND EXTERNAL CENTRAL COUNTERPARTIES (CCPS)

The regulatory framework is consistent with the vision for Twin Peaks which should limit implementation challenges going forward. However, comments received on the first draft of Ministerial regulations highlighted the challenge regarding the regulation of central counterparties as a category of clearing house, but without central counterparties being explicitly defined in the Financial Markets Act as a category of market infrastructures. Therefore, the draft FSR Bill proposes amendments to the Financial Markets Act to explicitly include central counterparties as a category of “market infrastructures” and “regulated person” and in addition proposes new definitions for licensed and recognised external central counterparties.

In the current Financial Markets Act framework, clearing houses are differentiated between “associated” and “independent” clearing houses. An “associated clearing house” clears transactions in securities on behalf of one or more exchanges in accordance with the rules of the relevant exchange and does not approve or regulate clearing members; an “independent clearing house” clears transactions in securities on behalf of any person, and authorises and supervises its clearing members in accordance with its clearing house rules.

The definition of central counterparty will only refer to “independent” clearing houses, by removing the reference to “associated” from the central counterparty definition, it will require that only an independent clearing house can be licensed as a central counterparty, which will help to create a level playing field for those clearing houses that perform central counterparty functions which must be regulated extensively given their systemic importance.

In addition to the above amendments, defining licensed central counterparties and recognised or external central counterparties as categories of market infrastructures and regulated persons allows the scope of regulation to be extended to these market infrastructures and as such central counterparties will have to meet the requirements in the Financial Markets Act as well as the requirements in the Ministerial regulations.

ASSETS AND RESOURCES AND FIT AND PROPER REQUIREMENTS

The determination of assets and resources requirements that will be applicable to market infrastructures will be made through joint standards by the authorities as contemplated in the FSR Bill and not by the Minister as the current framework. The joint standards will be made in terms of the FSR Act. Currently, the assets and resources requirements are included in the Ministerial regulations and therefore market infrastructures will have to meet those requirements provisioned but only until the changes in FSR Bill become effective.

SETTING THE RECOGNITION FRAMEWORK

Financial Markets Act amendments will include provisions that empower the FSCA and the Prudential Authority to develop joint standards for the “recognition” of external market infrastructures in relation to the securities services that they may provide or the functions and duties that they may exercise as prescribed by the Minister in 5(1)(c). These provisions include a requirement on the authorities to enter into supervisory cooperative arrangements with the relevant supervisory authorities of an external market infrastructure and to assess external market infrastructures against those joint standards. In addition, an overseas regulatory regime must be recognised as equivalent in terms of the FSR Act in order for the external market infrastructure to be granted recognition.

A recognition framework has been included in the Ministerial regulations.
INSOLVENCY PROVISIONS

Presently, the insolvency provisions in s 35(a) of the Insolvency Act (Act No. 24 of 1936), limit the insolvency protection to only domestically established market infrastructures that include an exchange, central securities depository and a clearing house. There has been wide concern as this provision excludes recognised external central counterparties from the insolvency protection offered against default or insolvency of their clearing members or counterparties. In light of this, proposals have been made to amend s 35(a) in the Insolvency Act by including a licensed central counterparty or recognised external central counterparty that is recognised in terms of the equivalence framework and that has legal recognition as a category of market infrastructures that are subject to the provisions of this section. To have the legal recognition, an external central counterparty, in addition to being recognised under the Financial Markets Act, will have to meet the requirements in s 23 of the Companies Act (Act No.71 of 2008) and register as an external company.

The proposed amendments have created numerous timing and implementation challenges. Under the current framework, the Ministerial regulations may become effective before the amendments, and market participants would then be required to meet standards developed in the Ministerial regulations as opposed to meeting Financial Markets Act requirements specifically.

However, certain sections contained in the draft Ministerial regulations referring to the definitions and requirements in the current framework will be repealed or re-issued as standards when the FSR Bill and consequential amendments become effective. Comments, if any, on this particular implementation challenge are encouraged.

SCOPE FOR OTC DERIVATIVES PRODUCTS

The definition of derivative in the Financial Markets Act is deliberately broad; therefore in order to bring OTC derivative products under the scope of regulation, they have been defined as a “regulated product”. OTC derivatives have been defined to mean an unlisted derivative instrument as prescribed by the registrar of Securities Services (“registrar”), excluding:

(i) Foreign exchange spot contracts; and
(ii) Physically settled or physically deliverable commodity contracts

The above products are excluded from the definition based on the product characteristics; FX spots have fixed payment obligations and have short term maturity and are considered to be subject to less counterparty credit risk due to their short-term maturity. Although exempt from the definition of derivatives and certain requirements they are not exempted from trade reporting requirements.

Furthermore, aligning the definition with other jurisdictions will remove cross-border inconsistencies and thereby ensure that there is a measure of regulatory equivalence.

AUTHORISATION OF OTC DERIVATIVES PROVIDERS

The Ministerial regulations for the OTC derivatives markets prescribe an OTC derivatives provider as a category of “regulated person” in terms of s 5(1) (b) of the Financial Markets Act. The amendment of the OTC derivatives provider definition now includes “sells” OTC derivatives. An OTC derivatives provider is therefore defined as a person who as a regular feature of its business and transacting as principal:

(i) Originates, issues or sells OTC derivatives; or
(ii) Makes a market in OTC derivatives
OTC derivatives providers are therefore required to meet the criteria for authorisation that has been determined by the registrar and to be authorised by the registrar.

The categorisation of OTC derivatives providers as regulated persons is necessary in terms of the scope of coverage of the regulatory framework for the OTC derivative market in SA. All OTC derivative providers will be required to meet all of the requirements included in the regulatory framework however counterparties or clients (see next section on categorisation of counterparties) will only be required to meet some of the requirements.

The authorisation requirements also aim to ensure the sufficiency of financial and operational (staff and systems) 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. This is achieved by i.e. requiring that OTC derivatives providers prove their financial soundness as part of fit and proper requirements prescribed by the registrar.

DIFFERENTIATING COUNTERPARTIES AND CLIENTS

The regulations are different for counterparties and clients; therefore the scope of coverage takes this differentiation into account.

(i) “Counterparty” - another authorised OTC derivatives providers; an authorised user; a bank; a long-term or short-term insurer; a financial services provider; a person outside the Republic rendering a service similar to an OTC derivatives provider, or services performed by an authorised user, or that is registered, licensed, recognised, approved or authorised to conduct the business of bank to render services of a business of long or short term insurance, financial services and collective investment schemes; a central bank or other national monetary authority; a private equity fund; collective investment schemes; and any other person who elects in writing to be categorised as a counterparty.

(ii) “Client” – in relation to an OTC derivatives provider means any person, other than a counterparty.

This differentiation is important where certain counterparties or clients may not have the operational capability to comply with the requirements or where product characteristics (e.g. liquidity, standardisation) limit the benefits associated with the regulatory requirements.

A CODE OF CONDUCT FOR OTC DERIVATIVE PROVIDERS, THEIR EMPLOYEES AND COUNTERPARTIES

A code of conduct has been introduced in terms of s 6 (8) (b) and s 74 of the Financial Markets Act. This code of conduct will be binding on all OTC derivatives providers, their directors, officers and employees, clients and counterparties. The code of conduct is aligned to similar requirements in other jurisdictions and includes risk mitigation requirements identified by IOSCO as necessary, especially for non-centrally cleared derivatives. According to IOSCO (2014), risk mitigation techniques for non-centrally cleared OTC derivatives have three main benefits:

• Promoting legal certainty and facilitating timely dispute resolution by ensuring that there is an accurate and definitive written record of the terms of a transaction which form the basis of the contractual relationship between the counterparties. In the event of a dispute, such legal certainty, together with a pre-agreed dispute resolution mechanism, could prevent the dispute from escalating and facilitate its resolution.

• Facilitating the management of counterparty credit and other risks. Many non-centrally cleared OTC derivatives agreements contain clauses related to the management of counterparty credit risk, such as valuation of the non-centrally cleared OTC derivatives transaction,
exchange of collateral and close-out netting in the event of default. Ensuring that these provisions are properly documented will promote legal enforceability and facilitate the effective functioning of such counterparty credit risk management arrangements.

In addition, by terminating and replacing substantially similar transactions with a smaller number of transactions of decreased notional value, portfolio compression could potentially reduce the operational risks of maintaining unnecessary transactions, as well as counterparty credit risk exposure. Finally, portfolio reconciliation helps to mitigate operational risks by ensuring that portfolios accurately reflect the on-going trading relationship between counterparties.

- Increasing overall financial stability.

**Requirement to categorise clients and counterparties:** In terms of the code of conduct, OTC derivatives providers will be required to categorise persons they dealing with either as a “client” or as “counterparty” prior to executing any OTC derivatives transactions with that person for the first time. “Client” is the classification that offers the most protection and imposes additional requirements on OTC derivatives providers in terms of appropriateness (assessing the skill and knowledge of the client as suitable to deal in OTC derivatives) and disclosure (inter alia on the nature of the product and the risks inherent in it).

**ADDITIONAL RISK MITIGATION STANDARDS FOR NON-CENTRALLY CLEARED OTC DERIVATIVES TRANSACTIONS:**

In line with IOSCO’s risk mitigation proposals, the code of conduct proposes six additional risk management requirements covering:

- trading relationship documentation, which must include all terms governing the trading relationship;
- trade confirmation;
- portfolio reconciliation;
- portfolio compression;
- dispute resolution; and,
- safeguarding collateral.

An OTC derivatives provider will be required to perform portfolio reconciliation of all non-centrally cleared transactions to identify any discrepancies in material terms, including valuation. The frequency of reconciliation depends on the size of each portfolio and whether the transactions have been concluded with a counterparty or client. The larger the number of open OTC derivatives transaction for a portfolio the more often a portfolio reconciliation procedure would have to be conducted.

OTC derivatives providers will also have to analyse the possibility of (unilateral (where a central counterparty is involved))/bilateral or multilateral portfolio compression at least twice annually, where appropriate and technologically possible, with respect to open OTC derivatives trades with other OTC derivatives providers that are not centrally cleared. Portfolio compression is a key risk management tool as it reduces non-markets risks by reducing the size of OTC derivatives notional exposures and the number of line items in a particular portfolio by netting un-cleared open OTC derivatives transactions with its counterparties and clients. The OTC derivatives providers must provide the Registrar with a valid and reasonable explanation for concluding that a portfolio compression is not appropriate. The Ministerial regulations do not contain prescriptive requirements for portfolio compression; the registrar will however specify further requirements for OTC derivatives providers to meet this requirement.
IMPLEMENTING G20 REQUIREMENTS

LICENSING OF TRADE REPOSITORIES

To further facilitate central reporting to meet G20 recommendations, the registrar will issue notices that make provision for further requirements in terms of licensing and the on-going supervision of trade repositories and how trade repositories will provide access to their data, and submit reported data to relevant authorities including requirements for the safeguarding of data.

As part of the requirements trade repositories must provide direct access to transaction data to the relevant authorities, in this case the FSB-SA. Other supervisory authorities with supervisory cooperation agreements in place with the FSB-SA will also be given access to the reported transactions based on their mandate and responsibilities. There is consideration to provide the SARB supervision department with direct access to the trade repository transaction data once the FSR Bill comes into effect.

REPORTING REQUIREMENTS FOR OTC DERIVATIVES PROVIDERS

An authorised OTC derivatives provider will be required to report all executed OTC derivative transactions, whether confirmed or not, to a trade repository, including any modifications from the previous reporting to the trade repository. The objective of any central reporting mandate is to monitor concentration build-ups that pose a systemic risk and therefore mark-to-market or mark-to-model valuations of contracts reported to a trade repository shall also be done on a daily basis. As marging requirements will be implemented to ensure proper risk mitigation in the case of default of one of the counterparties, relevant details pertaining to collateral arrangements must also be reported.

Where trades are cleared through a central counterparty the reporting obligation falls on that central counterparty. The OTC derivatives providers or central counterparties can choose which trade repository it would prefer to report to, but the trade repositories must be domestically licensed or be a recognised external trade repository (refer to the section below on equivalence).

Given the limited number of market participants in South Africa compared to other larger jurisdictions, and to minimise reporting obligations for smaller counterparties that trade less frequently, the single-reporting model, where OTC derivatives providers report on behalf of their non-OTC derivatives provider counterparties, is preferable to the dual-reporting model where both counterparties are required to report.

Trade detail reporting requirements align closely with those of other jurisdictions. South African OTC derivatives providers may already be subject to reporting requirements in other jurisdictions and so to minimise costs from duplication, it is important that reporting fields are harmonised where practical.

Mandating the use of globally standardised identifiers, such as the legal entity identifiers (LEI), unique product identifiers (UPI) and unique trade identifiers (UTI) is central to authorities’ ability to monitor activity and concentration risks, the use of standardised identifiers will also help facilitate the processes for data aggregation.

The SARB requires appropriate data to facilitate resolution activities. Carrying out resolution involves ascertaining the obligations of the defaulting entity towards different counterparties and thereafter settling the claims of those counterparties with disposable
collateral using a transparent and non-discriminatory set of rules. To that end, authorities need to identify all the trades of the defaulting entity, identify all the counterparties to the above-mentioned trades with the help of counterparty information, and have information on bilateral netting agreements and transaction economics to determine counterparty exposure.

In order to ensure that reporting obligations do not conflict with privacy requirements included in other legislation, agreements between an OTC derivatives provider and its client or counterparty will be required to include consent provisions. The client or counterparty needs to only provide their consent once, when dealing with a particular OTC derivatives provider for the first time.

**CAPITAL REQUIREMENTS AND MARGINS ON NON-CENTRALLY CLEARED OTC DERIVATIVES**

It is necessary to have in place prudential and risk mitigation standards to counter the risks associated with non-centrally cleared derivatives. Requirements such as capital and margins are distinct risk mitigation functions as they offer different levels of protection, but are still complementary and necessary to address risks arising from non-centrally cleared derivatives transactions.

**Margin requirements**

The proposed collateralisation is consistent with international standards as presented in the final 2013 BCBS – IOSCO paper; this will ensure the control of international arbitrage by creating a level playing field for all providers in the OTC market.

The following entities are excluded from the exchange of margins:

- a central bank or other national monetary authority of any country, state or territory;
- a sovereign;
- a multilateral development bank; and
- the Bank for International Settlements.

The margin requirements apply to all OTC derivatives providers that are banks and non-bank OTC derivatives providers, counterparties and clients as defined in the regulations that are trading OTC derivatives in excess of the proposed thresholds. The following thresholds apply to a consolidated group:

- R10 billion threshold applies to providers that are banks;
- R350 million applies to providers that are non-bank financial institutions such as insurers; and
- R50 million threshold applies to providers that are non-bank and non-financial institutions.

Non-South African entities that trade with South African-established entities (who are subject to the margin requirements) are required to put collateralisation procedures in place, in order to allow their South African-established counterparties to comply with the proposed framework.

**Initial and variation margin requirements**

Covered entities will be required to collect initial margin by no later than the business day following the execution of a non-cleared OTC derivatives contract. The parties must agree in writing on which method to apply, either the Standardised Method or the initial margin model (IMM) method that will be used to calculate initial margin. An IMM can be developed by the counterparties or by a third-party, provided that it complies with the specified regulatory standards and it must be approved by the registrar before it can be used.
Variation margin must be exchanged or collected on a daily basis from the business day that follows the date that a non-cleared OTC derivative contract is executed. The amount of variation margin that is required to be posted shall be a function of each contract’s mark-to-market valuation, which is also required to be determined by the counterparties on a daily basis.

In alignment with international standards, initial margin and variation margin would have to be exchanged on a bilateral basis on all non-centrally cleared derivatives transactions with the exception of only physically settled foreign exchange (FX) forwards and swaps that are excluded from the exchange of initial margin but not from the exchange of variation margin.

**Safeguarding collateral**

All collateral that is collected in the form of initial margin is required to be segregated from proprietary assets on the books and records of the custodian (or third-party) that is holding it. The collecting counterparty must, however, offer the posting counterparty the right to segregate the collateral also from the assets of other posting counterparties (individual segregation).

Counterparties that collect initial margin are prohibited from rehypothecating, re-pledging or otherwise re-using the collateral which could potentially dilute the effectiveness of its role in reducing overall systemic risk, since the counterparty runs the risk of its margin being trapped by that third-party, in the event of the re-hypothecator’s default. This is a slightly more restrictive approach than provided for in the BSCS-IOSCO Standards, where re-hypothecation would be allowed, subject to a stringent set of conditions.

The phase-in time lines are aligned to the proposed BCBS-IOSCO timelines, to ensure that South Africa does not prejudice those OTC derivatives providers with exposures to counterparties in other jurisdictions that must comply with the relevant margin requirements. Therefore OTC derivatives providers, clients or counterparties that fall within the prescribed thresholds are required to comply with the exchange of initial and variation margin requirements from December 2015. Comments and suggestions on the proposed will be appreciated.

**Capital Requirements**

Capital requirements are a necessary tool to encourage settlement of OTC derivative transactions through central counterparties in order to reduce counterparty credit risks (CCR). Locally, capital requirements for non-centrally cleared derivatives are partially effective; higher capital requirements in terms of Basel III have been adopted for banks that are already prudentially supervised by the SARB. This excludes non-bank OTC derivatives providers that are not prudentially supervised. In particular, prudentially supervised banks must apply the credit valuation adjustment (CVA) for exposures relating to bilateral counterparties and central counterparties. As an example, higher weights will apply on exposures to bilateral arrangements and lower weights will apply to centrally cleared transactions with central counterparties.

The authorities have decided to exclude prudential capital requirements for non-bank OTC derivatives providers from the framework until the scope for those non-bank OTC derivatives providers that might be captured in this requirement are determined. The authorities have also agreed to issue the detailed capital requirements once they are finalised, by phasing-in the requirements over a specified time and by type of participant to provide sufficient time for compliance. The final determination will be made by end 2015.
However, bank OTC derivatives providers will have to comply with both higher capital requirements and margins for non-centrally cleared derivatives in the initial phase of the implementation, while non-bank OTC derivatives providers will be required to meet only the margin requirements when the requirements are in force.

**CENTRAL CLEARING REQUIREMENTS**

The South African authorities have decided *not to mandate* central clearing of OTC derivatives at this stage of the reform programme. This decision is also based on the market assessment and the size of standardised clearable market and also the lack of domestic market infrastructures to provide the central clearing services.

Furthermore, the authorities are of the view that international clearing requirements, particularly in the EU and US, combined with Basel III CVA capital charges and margin requirements for non-cleared trades, provide a sufficient incentive to South African market participants to centrally clear where it is appropriate to do so. South African authorities will continue to monitor the effectiveness of the incentives approach and will re-assess the need for a mandatory clearing requirement at a later stage.

**LICENSING OF CENTRAL COUNTERPARTIES**

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

Prudential regulatory standards for central counterparties 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.

**CENTRAL COUNTERPARTY CLEARING SOLUTIONS**

A number of options have been considered for central clearing taking into account the current market structure and the regulatory oversight that can provided by each option. However, the approach is to provide a regulatory framework that allows any solution for central clearing and no particular solution has been mandated. Market participants can therefore consider the following options:

**Option 1** - International Central Counterparty solution with no local presence

Given that there are no domestic central counterparties established for OTC derivative transactions, domestic counterparties trading with foreign counterparties might be forced to clear OTC derivative transactions through international central counterparties that have no local establishment and are fully supervised by foreign authorities.
FIGURE 1: OFF-SHORE CENTRAL COUNTERPARTY CLEARING ARRANGEMENT

There are advantages to this arrangement as international central counterparties are well established and have a large base of clearing members and larger default funds to absorb losses of a defaulting clearing member with little impact on other clearing members and associated clients; considering this aspect there would be more available liquidity provision and better netting efficiencies realised, and there is potential for reduced costs and fees for clearing services.

The downside is that there are currently no domestic banks that are direct clearing members in the international central counterparties, therefore domestic participants would have to clear through a foreign clearing member as clients, as a result additional costs would be incurred through this clearing process. In addition, international central counterparties do not currently provide clearing for ZAR transactions, clearing ZAR based transactions would require back-to-back transactions, which can become a costly exercise (see figure 1).

In default situations without domestic participants that are clearing-members, ZAR based transactions might not be prioritised. The international central counterparty will be licensed and supervised by foreign authorities; this makes it difficult for domestic authorities to have sufficient oversight over foreign central counterparties, as no local regulation would apply. There is also greater exposure to global risks if clearing is conducted with international central counterparties.

**Option 2 - International Central Counterparty with a local branch established**

This option is more than just a "man and telephone option", as it requires an international central counterparty to have a branch that is locally established, licensed and fully supervised by local authorities. This would require the central counterparty to meet the license requirements provided for in the Financial Markets Act i.e. it must be licensed as a central counterparty and meet the requirements under the Ministerial regulations, which include that it must be fully capitalised as a separate entity from the holding entity and the collateral must be held locally.
Local providers could become clearing members of the central counterparty branch and provide services to other clients. All local laws would apply to the branch of the central counterparty (e.g. insolvency laws). However, it would take time for an international central counterparty to establish a local branch.

**Option 3 - Domestic Central Counterparty solution**
A completely domestic central counterparty could be established, where local authorities will have greater oversight and domestic participants will be better protected even in case of default. Domestic participants could be afforded the chance to participate as clearing members, specifically major domestic bank OTC derivatives providers that could extend client-clearing services to non-members. Clients will therefore have more options for clearing in the domestic market.

Similar netting benefits could be experienced as for international clearing and there would be no limitation on clearing ZAR denominated transactions and less restriction on the type of collateral accepted. Local currency is accepted as collateral and there is a possibility of other assets (e.g. government securities) which can be used as collateral as opposed to clearing through international central counterparties which will only accept limited types of collateral.

However, netting efficiencies could be reduced due to a split in collateral, as local-to-local interbank transactions would be cleared locally and interbank trades with international counterparties might still be preferably cleared with an offshore central counterparty as international counterparties would want to avoid disruption to their netting sets. In addition, a domestic central counterparty might have a limited number of participants and it would be difficult to attract international clearing members. More time will also be required to establish a fully domestic central counterparty as it will be a completely new market infrastructure for OTC derivatives transactions.

**Option 4 - Partnership /hybrid model**
Locally established entities e.g. a domestic exchange could partner with an international central counterparty to provide central clearing services to local market participants. This solution could also provide netting efficiencies given that the arrangements between the local entities and the international central counterparty could allow the domestic participants to use either alternative. In any case, application of local laws would probably apply to the local entity rather than to the international partner. However a local and international central counterparty partnership is complicated to achieve practically and it might still be costly to implement.

**Option 5 - International central counterparty with only a local representative office (limited requirements and equivalence framework applied).**
An international central counterparty supervised by foreign supervisors could establish a local representative office, it would only be required to meet limited requirements, so long as it is authorised or recognised and if it is subject to a regulatory framework determined to be equivalent to the requirements under the Financial Markets Act and Ministerial regulations. This is the preferred option as this will be easier to establish under the regulatory framework given the current constraints.

An international central counterparty willing to set up a registered office could do so in terms of s 23 of the Companies Act provisions for external companies and registered offices. In terms of this section an external company must be regarded as actively conducting business to be considered. Registration of an external company or representative office would be done to achieve the legal presence requirements. This process is not particularly onerous as there are fewer administrative
burdens imposed on external companies. The representative officer will be responsible for the recognised external central counterparty’s compliance requirements and the maintenance of the client relationship with domestic participants, but clearing arrangements will be conducted through the international central counterparty.

By registering a local representative office, the external central counterparty would be provided with legal recognition in the South African regulatory framework even though the international central counterparty’s place of effective management would be in the foreign jurisdiction.

The consequential amendments contained in the FSR Bill will also include changes to s 35 of the Insolvency Act, providing for the recognition of an external central counterparty that has legal presence; in the case of default or insolvency of a domestic participant, the recognised external central counterparty will receive similar protection as the domestically established entities covered in the insolvency framework.

EXCHANGE OR ELECTRONIC TRADING REQUIREMENTS

The G20 recommendations also include trading of standardised contracts on exchange or electronic trading platforms. However, given the extensive nature of the OTC derivative reform programme, the authorities have decided to postpone taking a decision on the trading of OTC derivatives on exchanges or trading platforms until a proper review is conducted by 2017.

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 Financial Markets Act) without significantly undermining their stability. In light of this, an equivalence framework has developed to provide for the recognition of external central counterparties, external trade repositories and external central securities depositories (‘CSD’) and to allow external participants to provide services and perform functions and duties prescribed in the Act.

CRITERIA FOR RECOGNITION

A recognition/equivalence framework has been included in the Ministerial regulations that provide for the recognition of external central counterparties, external trade repositories and external CSDs. The recognition is dependent on a number of elements including:

- Cooperation agreements have been established between the home and foreign authorities;
- Requirements those external participants should be subject to legal binding requirements that are similar to the requirements in the Act;
- There is effective supervision and enforcement in the relevant jurisdiction;
- The legal framework of the foreign country provides for an effective equivalent system for the recognition of such external participants that are under third country legal regimes;
- The external participants must be authorised and have full compliance with business continuity and prudential requirements that are applicable in that foreign country; and
- There are equivalent systems for anti-money laundering and combating of the financing of terrorism in the relevant jurisdiction.
In terms of the assessment of equivalence, the registrar will take into account the requirements in the Financial Markets Act for external participants relative to those requirements imposed in the foreign jurisdiction and determine whether they are sufficient. On application for recognition, the registrar will also take into account the above requirements, and will be empowered to impose additional conditions on the recognised external participant (as an example, the registrar may require that the recognised participant provides reports to the registrar and information on its compliance in the foreign country where it is authorised).

In line with the above framework, the Ministerial regulations also address:
- Requirements with which a CSD must comply for approval of an external CSD as a participant.
- The securities services to be provided by an external CSD.
- Functions and duties that may be exercised by an external central counterparty or external trade repository.

s5 (1) (c) of the Financial Markets Act 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 Financial Markets Act and that is regulated and supervised by a supervisory authority that is a member of IOSCO.

APPLICATION OF THE SOUTH AFRICAN REGULATORY FRAMEWORK TO OTC DERIVATIVES PROVIDERS IN A FOREIGN JURISDICTION

The relevant provisions of the Financial Markets Act and this regulatory framework will apply to any derivative transactions that take place between:
- Any two OTC derivatives providers that are located in the Republic, whether those OTC derivatives providers are locally incorporated or are a branch or subsidiary of a parent undertaking in a foreign jurisdiction.
- An OTC derivatives provider 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 Financial Markets Act, 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 withExisting 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 OTC Derivatives Framework. The deadline for submission is 6 July 2015.

Queries can be sent to Isabelle Kaira at: Isabelle.Kaira@treasury.gov.za
RELATED MATERIAL AND READING

This policy document must be read in conjunction with:

- The Financial Markets Act No. 19 of 2012;
- The second draft of the Ministerial regulations which can be found on the NT website at www.treasury.gov.za;
- The draft FSB-SA Notices which can be found on the NT website at www.treasury.gov.za and on the FSB-SA website at www.fsb.co.za;
- The first draft of the Ministerial regulations (which can be found on the NT website at http://www.treasury.gov.za/public%20comments/OTC/) and the response document (published with this policy document) summarising the comments received on the first draft of the Ministerial regulations and changes made in the second draft of the regulations;
- Documents for public comments on Twin Peaks which can be found on the National Treasury website at http://www.treasury.gov.za/public%20comments/FSR2014/;

PAPERS BY INTERNATIONAL STANDARD SETTERS


# LIST OF ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Name</th>
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<tbody>
<tr>
<td>ASISA</td>
<td>Association for Savings and Investment South Africa</td>
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<td>BASA</td>
<td>Banking Association of South Africa</td>
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<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
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<td>CCP</td>
<td>Central Counterparty</td>
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<tr>
<td>CM</td>
<td>Clearing Member</td>
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<tr>
<td>CPSS</td>
<td>Committee on Payment and Settlement Systems</td>
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<tr>
<td>CPMI</td>
<td>Committee on Payment and Market Infrastructures</td>
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<td>CSD</td>
<td>Central Securities Depository</td>
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<td>EU</td>
<td>European Union</td>
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<td>FAIS Act</td>
<td>Financial Advisory and Intermediary Services Act No 37 of 2002</td>
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<td>FSB</td>
<td>Financial Stability Board</td>
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<td>FSB-SA</td>
<td>Financial Services Board (South Africa)</td>
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<td>FSCA</td>
<td>Financial Sector Conduct Authority</td>
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<td>FSR Bill</td>
<td>Financial Sector Regulation Bill</td>
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<td>G20</td>
<td>Group of 20 Finance Ministers and Central Bank Governors</td>
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<tr>
<td>IOSCO</td>
<td>International Organisation of Securities Commissions</td>
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<td>JSE</td>
<td>Johannesburg Stock Exchange</td>
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<tr>
<td>LEI</td>
<td>Legal Entity Identifier</td>
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<td>MI</td>
<td>Market infrastructure</td>
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<td>NT</td>
<td>National Treasury</td>
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<td>ODP</td>
<td>Over-the-Counter Derivative Provider</td>
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<td>Over-the-Counter</td>
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<td>SARB</td>
<td>South African Reserve Bank</td>
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<td>Securities Services Act No. 36 of 2004</td>
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<td>Strate</td>
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<td>STRIPS</td>
<td>Separate Trading of Registered Interest and Principal of Securities</td>
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<td>TR</td>
<td>Trade Repository</td>
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<td>UK</td>
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<td>UPI</td>
<td>Unique Product Identifier</td>
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<td>Unique Transaction Identifier</td>
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REGULATING
OVER-THE-COUNTER
DERIVATIVE MARKETS
IN SOUTH AFRICA
SECOND DRAFT POLICY DOCUMENT ACCOMPANYING THE MINISTERIAL REGULATIONS AND BOARD NOTICES ISSUED UNDER THE FINANCIAL MARKETS ACT, NO. 19 OF 2012