

REVIEWING THE REGULATION OF FINANCIAL MARKETS IN SOUTH AFRICA

**Policy document explaining the Financial
Markets Bill, 2011**

August 2011

“The financial services sector is at the heart of the South African economy and touches the life of each and every citizen.”

- A Safer Financial Sector to Serve
South Africa Better, 23 February 2011

“I've been on Wall Street for many years, and I've never seen a weekend like this one. We are unwinding what has been years of silliness in the financial markets, and the silliness is being vaporized as we speak, unfortunately with the stock price of a number of companies involved in it.”

- Michael Holland, 64, chairman and founder of New York-based Holland & Co., in an interview with Bloomberg.com, 15 September 2008

TABLE OF CONTENTS

TABLE OF CONTENTS	3
1. BACKGROUND	4
2. THE SECURITIES SERVICES ACT: TAKING STOCK.....	6
3. OBJECTIVES OF SECURITIES REGULATION	7
3.1 Investor protection	9
3.2 Ensuring that the markets are fair, efficient and transparent	10
3.3 The reduction of systemic risk.....	11
4. THE REGULATORY ARCHITECTURE GOVERNING SOUTH AFRICA'S FINANCIAL MARKETS	11
4.1 The Regulators	12
4.2 Regulated entities and their activities	13
4.2.1 Market infrastructure and the provision of securities services	13
4.2.2 The Provision of Intermediary Services	16
4.3 Other Regulated Activities.....	17
4.3.1. Off-Market transactions in listed securities	17
4.3.2. Unlisted securities and the OTC market	17
4.4 Market Abuse.....	17
4.5 Supporting Legislation.....	18
5. PURPOSE OF THE POLICY REVIEW AND ITS METHODOLOGY	20
5.1 The 2008 FSAP and the IOSCO Objectives and Principles	21
5.2 UNIDROIT Convention on Intermediated Securities.....	26
5.3 The financial crisis and the G-20 outcomes.....	29
5.4 Other jurisdictions.....	33
5.5 Jurisprudence and Ombuds determinations	37
5.6 South African legislative developments	37
5.6.1 The Companies Act of 2008	37
5.6.2 The Competition Amendment Act of 2009	38
5.6.3 The Consumer Protection Act (CPA) of 2009	39
5.7 Regulatory effectiveness	41
5.7.1 The institutional framework for regulation.....	42
5.7.2 Accountability of the SROs and the Registrar	42
5.7.3 Proportionality and efficiency of the regulatory framework	43
5.7.4 Flexibility and simplicity of the regulatory framework.....	43
5.7.5 Timeliness and responsiveness of the regulatory framework	44
5.7.6 Compliance and enforcement mechanisms.....	44
5.7.7 Redress mechanisms	44
6. THE FINANCIAL MARKETS BILL	45
6.1 Structure of the FMB	45
6.2 Main Policy Issues	47
6.2.1 Strengthening the SRO regulatory model	47
6.2.2 Alignment to international best practice and Financial Sector Assessment Programme recommendations	48
6.2.3 Improved investor protection for cross-border transactions	48
6.2.4 Other matters.....	49
7. CONCLUSION.....	49

1. BACKGROUND

By channelling capital from those who can supply it to those who need it, financial markets play a critical role in mobilising savings towards investment in households, businesses and government, in order to support their sustained growth and development. In addition to raising capital, these individuals and entities use the financial markets to manage their risk and invest their savings to ensure future prosperity.

The domestic capital markets therefore play a pivotal role in allocating domestic and foreign savings towards South African investment requirements. This happens, whether directly through trading on the market or indirectly through another investment product like a collective investment scheme, through the listed and unlisted bond and equity markets (to include both the spot and derivatives markets). To illustrate the importance of a well functioning capital market towards achieving sustainable and inclusive economic growth, consider that South Africans invest about R5 trillion¹ of their R6.04 trillion aggregate savings – about 80 percent - into JSE listed equities and bonds and their derivative products. Moreover South Africa’s Central Securities Depository Strate holds these assets – representing 2.3 times South Africa’s annual GDP - under custody, and settles about 450000 trades each month valuing at over half a trillion Rand. Upholding the principles of investor protection, financial stability, liquidity, and price transparency and efficiency, must therefore be a regulatory priority.

The recent global financial crisis showed what can go wrong should regulatory failure allow exploitation by financial system “insiders” of investors, in order to enrich themselves at the expense of critically weakening the system as a whole. It also illuminated the linkages between the financial services sector and the real economy. The National Treasury

¹ The market capitalisation of the JSE is R6.6 trillion, with value traded per year at around R3 trillion. Foreigners currently hold about R2 trillion worth of these equities (or 30 percent). On the fixed income (bonds) side, the issued amount is R1.4 trillion, with value traded in nominal turnover at R20 trillion per year. Of this the nominal turnover by non-residents is around R5.1 trillion, or 26 percent of total turnover. R193 billion, or 26.9 percent of the R717 billion in outstanding South African government bonds are held by foreigners. Foreign holding of other debt is minimal. In terms of derivatives, turnover per year measured in notional values of the underlying is at around R109 trillion, while the value of unexpired contracts is R36.4 trillion. Derivative trading in South Africa is dominated by interest rate contracts.

document “A Safer Financial Sector to serve South Africa Better” reflects that South Africa’s robust macroeconomic fundamentals and financial regulatory framework unfortunately could not shield it from a disproportionately large impact of the crisis in terms of unemployment, as South Africa suffered job losses of close to 1 million. In recognition of the need for regulatory reform, President Jacob Zuma has committed South Africa to a global regulatory reform agenda, which includes a stronger regulatory framework, more effective supervision, improved crisis resolution, and enhanced accountability through international assessments and peer reviews. These commitments are translated into four policy priorities, being financial stability, consumer protection and sound market conduct, expanding access through financial inclusion, and combating financial crime.

South Africa’s financial markets have likewise been buffeted by the international turmoil, losing nearly half its market cap value over 2008. However, by January this year the JSE All Share Index had almost recovered to its pre-crisis end of day high of 33233 (reached on 22 May 2008) and has traded in a relatively narrow band for the past six months. Notably the regulatory framework, supported by the Financial Services Board (the FSB), the JSE and Strate (as Self Regulatory Organisations - SROs),² protected against market disruptions over a time when other countries were suffering settlement failures brought about by the bankruptcy of entities like the investment bank Lehman Brothers and the insurer AIG.

In 2010 the JSE was rated by the World Federation of Exchanges as the number one stock exchange in terms of regulation by the World Federation of Exchanges (WFE). We cannot however be complacent – the crisis has at the very least taught us the need for an ongoing and honest critical assessment of our regulatory requirements.

² An SRO is an entity that exercises regulatory authority over its industry. This structure serves as an extension of government regulation. Evidence suggests that the SRO model can be a more effective and efficient means to monitor and supervise the industry and its practices. This is because an SRO is positioned close to its industry and may know the industry much better than the government agencies – therefore if structured correctly it can provide more effective supervision than government counterparts.

2. THE SECURITIES SERVICES ACT: TAKING STOCK

The Securities Services Act No. 36 of 2004 (SSA) took effect on 1 February 2005. It governs the regulation of securities services in South Africa to include securities exchanges, central securities depositories (CSDs), clearing houses, and their respective members. It consolidated the South African regulatory framework for capital markets and aligned the regulation and supervision of South African financial markets with the prevailing international developments and regulatory standards. The SSA does not apply to collective investment schemes regulated by the Collective Investment Schemes Control Act No. 45 of 2002, or activities regulated by the Financial Advisory and Intermediary Services Act No. 37 of 2002.

Given the economic significance of a well-functioning financial market infrastructure and mindful of economic and regulatory developments both domestically and abroad, the National Treasury considers it timely to comprehensively review the SSA; this review should ensure that the SSA remains sufficiently robust to meet its objectives and the objectives of securities regulation in general. The National Treasury and the FSB have therefore interrogated the SSA, also taking into account the broader regulatory framework, like the now replaced Companies Act No. 61 of 1973³ and the Insolvency Act No. 24 of 1936. This report summarises the purpose, scope and outcomes of the review and recommends improvements to the relevant regulatory architecture, to be effected through new governing legislation, namely the Financial Markets Bill (FMB).

Notably, the review did not identify major new policy issues to be addressed; only that the extent to which existing policy is reflected in the SSA should be expanded.

In the interest of simplicity and legal certainty it is deemed appropriate to replace the SSA with the FMB rather than propose a complex amendment bill.

³ The Companies Act 61 of 1973 is being replaced by the Companies Act no 71 of 2008.

The report proceeds as follows. **Section 3** lays the platform for review by examining the objectives of securities regulation, followed by **Section 4** which outlines the existing regulatory architecture. **Section 5** explores the need for reform and details the methodology that was followed in this policy review. Lastly **Section 6** highlights policy refinements effected through the FMB, and **Section 7** concludes the report.

3. OBJECTIVES OF SECURITIES REGULATION

National Treasury's proposed reform of the financial sector regulatory system in South Africa is guided by fifteen governing principles, of which the following are most relevant for financial markets:⁴

Principle 1: Financial service providers must be appropriately licensed or regulated, meaning that entry into the market must be subject to an appropriate licensing or registration process, depending on the type of financial services provided. No provider of a financial service should be allowed to operate outside the regulatory perimeter.

Principle 2: There should be a transparent approach to regulation and supervision, meaning that where appropriate, regulation and supervision should be risk-based. It should also be proportional to the nature, scale and complexity of risks present in a regulated entity and the system as a whole.

Principle 3: The quality of supervision must be sufficiently intense, intrusive and effective. The ability to supervise requires appropriate resources, authority, organisation and constructive working relationships with other agencies and must be complemented by the will to act. The will to act requires supervisors to have a clear and unambiguous mandate, operational independence coupled with accountability, skilled staff, and a relationship with industry that avoids regulatory capture.

⁴ "A Safer Financial Sector to Serve South Africa Better," page 25.

Principle 4: Policy and legislation are set by government and the legislature, providing the operational framework for regulators. This means that the policy framework should be set transparently via the executive, and legislative proposals will be approved by Parliament. While regulators do not set policy, it is critical to clearly demarcate what constitutes policy, and empower regulators to set the supervisory framework.

Principle 5a: Regulators must operate objectively with integrity and be operationally independent, but must also be accountable for their actions and performance. Regulators must therefore be empowered to work without fear or favour and be operationally independent within an approved legislative and policy framework.

Principle 6: Regulations should be of universal applicability and comprehensive in scope in order to reduce regulatory arbitrage, so that individual institutions, or classes of institutions, should not arbitrarily be exempted from regulation and supervision.

Principle 7: The legislative framework should allow for a lead regulator for every financial institution that is regulated by a multiple set of financial regulators. All regulators involved must strive to coordinate their supervisory activities. As financial institutions are generally regulated or supervised by more than one regulator (often falling under different Ministries), regulators should be obliged to coordinate their activities, formalised through legislation or a Memoranda of Understanding. The lead regulator must ensure that effective consultation takes place between regulators, and should not inadvertently undermine other regulators.

Principle 11: Market conduct oversight must be sufficiently strong to complement prudential regulation.

Principle 15: The above principles are reflected in international standards like the International Organisation of Securities Commissions (IOSCO). To the extent that there are any contradictions or inconsistencies in the above principles, the international standards will apply.

In consolidating these principles, the effectiveness of the SSA can be measured by how well it delivers on the three core objectives of securities regulation, namely:-

- The protection of investors.
- Ensuring that markets are fair, efficient and transparent.
- The reduction of systemic risk.

These three objectives are closely related and in some respects overlap, as many of the requirements that help to ensure fair, efficient and transparent markets also provide investor protection and help to reduce systemic risk. Similarly, measures that reduce systemic risk protect investors. It is important to translate these broad objectives into tangible and meaningful protection for the financial markets. This examination follows.

3.1 INVESTOR PROTECTION

The National Treasury supports the view that relative to other consumer oriented sectors, the financial services sector should be held to higher standards with regard to market conduct and consumer protection.⁵ Effective market conduct regulation in financial services therefore requires a nuanced response to risks that arise for investors - broad consumer protection mechanisms afforded through other legislative instruments like the newly implemented Consumer Protection Act No. 68 of 2008 may not sufficiently deal with the complicated structures of the financial services sector and capital markets in particular.⁶ This means that financial services regulation must necessarily fill these gaps, and address investor protection head on (refer to sections 5 and 6 for more detail on how the SSA deals with and how the FMB will improve upon investor protection).

⁵ This is most effectively explained in the National Treasury's policy document: "A safer financial sector to serve South Africa better." Look to the treasury/FSB response under section 5.1 for a fuller review of these issues.

⁶ As a result of the regulatory provisions in the SSA that meet the standards set by the CPA, entities regulated in terms of the SSA have already been exempted from equivalent provisions in the CPA by the Minister of Trade and Industry, on recommendation by the Consumer Commissioner. The National Treasury will however continue to engage the DTI on how to further enhance investor protection in the regulated financial market space.

In this regard, securities regulation should protect investors from misleading, manipulative or fraudulent practices, including insider trading,⁷ front running⁸ and the misuse of client assets.⁹ It should compel an intermediary to get the necessary authorisation from the relevant SRO or FSB before it starts rendering services. These intermediaries should comply with standards set by the regulators with regards to governance, transparency and disclosure requirements as supported by comprehensive supervisory systems of inspection, surveillance and compliance programmes. Investors should have access to neutral mechanisms for redress and compensation for improper behaviour by the intermediaries. Investors in the securities markets are particularly vulnerable to misconduct by intermediaries and others, but the capacity of individual investors to take action may be limited. The complex character of securities transactions and of fraudulent schemes requires strong enforcement of securities law. Where a breach of law does occur, the supervisors should be empowered to quickly and effectively detect and respond to that breach.

3.2 ENSURING THAT THE MARKETS ARE FAIR, EFFICIENT AND TRANSPARENT

The regulator's licensing of exchanges, CSDs and clearing houses, and its approval of operating rules, helps to ensure fair markets. The fairness of the markets is closely linked to investor protection, and especially to the prevention of improper trading practices. Market structures should not unduly favour some market users over others. In particular, regulation should ensure the highest levels of transparency and efficiency, and should ensure that investors are given fair access to market facilities and market or price information.¹⁰ Regulation should also detect, deter and penalise market manipulation and other unfair trading practices.

⁷ Insider trading is the buying or selling of a security by someone who has access to material, non-public information about the security.

⁸ Front running is an unethical practice where a stock broker executes orders on a security for its own account while taking advantage of advance knowledge of pending orders from its customers.

⁹ The misuse of client assets could happen through an intermediary using client assets in way other than the one stipulated in the mandate.

¹⁰ Transparency may be defined as the degree to which information about trading (both for pre-trade and post-trade information) is made publicly available on a real-time basis. Pre-trade information concerns the posting of firm bids and offers as a means to enable investors to know, with some degree of certainty,

3.3 THE REDUCTION OF SYSTEMIC RISK

Financial market regulation should provide for mechanisms that reduce the risk of financial market failure. When failure occurs, the regulations should provide for the isolation of the failure to the failing institutions, thereby minimising contagion effects and the spreading of the failure to related financial entities and the system at large. The regulatory environment should therefore allow legitimate risk taking, but at the same time should promote comprehensive risk management, including complying with capital adequacy requirements and other prudential requirements.

An efficient and accurate clearing and settlement process that is properly supervised and utilises effective risk management tools is essential. There must be effective and legally secure arrangements for default handling, which refers to the case where a buyer or seller to a transaction cannot deliver his commitment of cash (in the case of the buyer) or securities (in the case of the seller), in the required time. This matter extends beyond securities law to the insolvency provisions of a jurisdiction. Instability may result from events in another jurisdiction or occur across several jurisdictions, so a regulator's response to market disruptions should seek to facilitate stability domestically and globally through cooperation and information sharing.

4. THE REGULATORY ARCHITECTURE GOVERNING SOUTH AFRICA'S FINANCIAL MARKETS

The objectives explained in Section 3 are given effect through effective securities supervision, which in turn depends on an appropriate legal framework. Surveillance and compliance programmes, effective enforcement and close cooperation with other regulators are all also necessary to give effect to government's regulatory objectives.

whether and at what prices they can transact. Post-trade information is related to the prices and the volume of all individual transactions actually concluded. Efficiency on the other hand requires that the dissemination of relevant information is timely and widespread and is reflected in the price formation process.

South Africa has adopted the SRO model for the regulation of securities services, as recognised by the International Organisation for Securities Commission (IOSCO).¹¹ Below follows a synopsis of the existing securities regulation, against which National Treasury's policy objectives, regulatory effectiveness and standards of international best practice are tested.

4.1 THE REGULATORS

The FSB is the primary regulator and delegates supervision to the Registrar, who in turn delegates certain aspects of this authority to the SROs. This function is supported by the Financial Markets Advisory Board (FMAB)¹² and the FSB Directorate of Market Abuse (DMA).¹³ The Registrar is accountable to the Minister of Finance for the effective and efficient implementation and enforcement of the SSA.

Currently in South Africa, exchanges and CSDs (and notably not clearing houses) are given the status of SROs through the SSA. These bodies are expected to perform regulatory functions on behalf of the Registrar, under his or her supervision. These functions include the licensing and supervision of market participants, including investigations into alleged regulatory breaches. Each member of the controlling body of a SRO owes a fiduciary duty as well as a duty of care and skill to the SRO. The SRO has significant reporting obligations to the Registrar, and due to its important national strategic

¹¹ IOSCO is an international association for regulators of the financial markets, and is recognised as the international standard setter for these markets. Its membership regulates more than 95 percent of the world securities markets and it is the primary international cooperatives forum for securities markets regulatory agencies. The FSB is a member. IOSCO principle number 9 references the SRO model, and states that such structures should be subjected to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising its powers and delegated responsibilities.

¹² The FMAB may either on its own initiative or responding to a request from the Minister of Finance, investigate and advise on various matters concerning securities market participants or behaviour. The role and functioning of the advisory boards and committees as provided for under various FSB legislation is under review by the treasury; these are anticipated to be rationalised and absorbed into the proposed Council of Regulators structures referred to in section 5.1 (also discussed in the treasury's "red book" released in February this year).

¹³ The Directorate of Market Abuse supervises insider trading, market or price manipulation and the making of false, misleading or deceptive statements, promises and forecasts in respect of listed securities and public companies.

role in terms of the markets effectiveness and efficient functioning, is subject to control and ownership restrictions. It stands to reason that the SRO cannot supervise its own activities as that would inevitably give rise to conflicts of interest. The exchange is required to prove to the Registrar that it has implemented adequate procedures and internal controls to ensure that no real or potential conflicts of interest arise with respect to an exchange being listed on itself. This is one of the licence conditions.

As part of its responsibilities, an SRO is expected to, amongst other functions, issue directives, perform market surveillance, submit annual reports and audited financial statements to the Registrar, and conduct an annual self-assessment review. Should an SRO fail to properly perform its regulatory functions, the Registrar may assume these responsibilities.

4.2 REGULATED ENTITIES AND THEIR ACTIVITIES

Capital markets comprise the market infrastructure and related securities services (including that of trading, clearing and settlement), the provision of intermediary services (like brokering or standing as nominee for an investor) and market users (namely investors, be it on their own account or the account of others). In considering these three categories of market participation, the last category of investors should be protected through the appropriate regulation of the first two categories of market infrastructure and the provision of securities services, including securities intermediation. Investors should also be protected in their dealings with each other.

4.2.1 Market infrastructure and the provision of securities services

Exchange: An exchange brings together buyers and sellers of securities and then matches “like” orders across the market.¹⁴ To perform this function it requires a licence to

¹⁴ A matched order for securities constitutes a contract of purchase and sale of securities. The system uses order schedules and associated evaluation procedures to evaluate and update order characteristics such as price and quantity based on user-specified criteria.

conduct the business of an exchange, which is approved by the Registrar and renewed annually. The operational rules and the listing requirements of the exchange are required to be approved by the FSB when first introduced, but not on an on going basis should these rules be amended (provisions to require that changes to listing requirements are subject to FSB approval are considered in the FMB). In terms of the licence the exchange must:-

- Provide exchange rules that govern trading behaviour of users of the exchange, as well as listing requirements for issuers of securities on the exchange. These rules and requirements are subject to minimum criteria specified in the SSA.
- Satisfy the Registrar that it has sufficient financial and human resources to effectively conduct the business of an exchange.
- Have sufficient IT systems to identify and manage the risks emanating from the buying and selling of securities.

As an SRO, an exchange is also required to enforce its rules and requirements. The activities of the JSE, as listed on itself, are subject to the FSB supervision. In addition to this the Registrar can prescribe conditions with which an exchange must comply when it includes securities issued by it in its own list. These conditions require, among others, that:-

- That an exchange's primary function is to supervise compliance by the issuers of the listed securities with the listing requirements and other exchange rules or act. However, the exchange cannot supervise its own activities, as those will be subject to the FSB supervision.
- The exchange is to supervise securities transactions that go through it (the exchange). Securities issued by the exchange itself are, however, excluded as are subject to FSB supervision.

CSDs: A CSD is an organisation holding securities either in certificated or uncertificated (dematerialised) form, to enable the legal (book entry) transfer of securities between owners and entities acting on behalf of owners. The basic function of CSD is:-

- To maintain the register of securities.
- Issuance of international securities identification number (ISIN) for all issues of securities.
- Clearance and settlement of securities on the principle “delivery versus payment.”
- Provision of additional services to issuers of securities.

CSDs are approved by the Registrar and their licenses are renewed annually. As it is the case with exchanges, the CSD needs to provide member rules that meet minimum requirements and satisfy certain objectives specified in the SSA. In addition it must prove to the Registrar sufficient financial, IT and human capital resources to effectively conduct the business of a CSD. CSD rules are approved by the Registrar; Registrar approval is also needed for changes in the rules that happen over time. A CSD has SRO status under the SSA (which status continues in the FMB).

Clearing houses: A clearing house is a financial institution that provides clearing¹⁵ and settlement¹⁶ services for securities transactions. These transactions may be executed on an exchange in the market, as well as off-exchange in the over-the-counter (OTC)¹⁷ market.

The purpose of a clearing house is to reduce settlement risk by:-

- Netting offsetting transactions between multiple counterparties.
- Requiring collateral deposits (a.k.a. margin deposits).
- Providing independent valuation of trades and collateral.

¹⁵ Clearing denotes all activities from the time a commitment is made for a transaction until it is settled, and includes reporting and monitoring, risk margining, netting of trades to single positions, tax handling, and the handling of failures.

¹⁶ Settlement of securities is a business process whereby securities or interests in securities are delivered, usually against (in simultaneous exchange for) payment of money, to fulfill contractual obligations, such as those arising under securities trades.

¹⁷ OTC refers to the unlisted instruments or securities that are not listed on a licensed exchange.

- Monitoring the credit worthiness of the clearing firms.
- In many cases, by providing a guarantee fund that can be used to cover losses that exceed a defaulting clearing firm's collateral on deposit.

Clearing houses are approved by the Registrar and their licenses are renewed annually. The regulation of the clearing house and the conditions prescribed by the Registrar, under which the clearing house operates, are similar to that of a CSD. This includes that the clearing house's license is approved by the Registrar and renewed annually. Conditions regarding IT infrastructure, financial resources and human capital resources, are also applicable to clearing houses. Clearing houses are not provided for as an SRO under the SSA. However the FMB contemplates this change – see section 5.7.1 for more detail in this regard).

4.2.2 The Provision of Intermediary Services

Nominees: Nominees are individuals or firms, nominated by their customers to hold securities on their (the customers) behalf. The SSA says that nominees of a customer who is an authorised user of an exchange must be approved by that exchange. Likewise, a nominee of a CSD participant or any other nominee who has an account with a participant must be approved by the CSD in terms of the CSD's rules. In certain circumstances, the nominee can be approved by the FSB (the Registrar), in which case that nominee will have to comply with requirements that the Registrar prescribes for the nominees.

Brokers: Brokers are persons that are members of the South African Institute of Stockbrokers. They provide intermediary services including giving advice to clients on buying and selling of the JSE listed securities. There are three types of stock broking service, namely:-

- Execution-only, which means that the broker will only carry out the client's instructions to buy or sell.

- Advisory dealing, where the broker advises the client on which shares to buy and sell, but leaves the final decision to the investor.
- Discretionary dealing, where the stockbroker ascertains the client's investment objectives and then makes all dealing decisions on the client's behalf.

The exchange prescribes that a broker must be of good character and high integrity, and in addition must comply with the standards of training, experience and other qualifications as laid out in the exchange rules.

4.3 OTHER REGULATED ACTIVITIES

4.3.1. Off-Market transactions in listed securities¹⁸

Off-market transactions in listed securities resulting in a change in beneficial ownership are allowed between financial institutions as defined in the SSA on condition that both the financial institutions are transacting as principals and subject to a reporting requirement to the Registrar and the exchange on which the securities are listed.

4.3.2. Unlisted securities and the OTC market

The Registrar may prevent a person from carrying on the business of buying and selling unlisted securities if the business is carried on in a way that defeats an object of the SSA. The Registrar may also impose or prescribe conditions in respect of the OTC market. This is a key area expanded on in terms of the FMB, as considered in sections 5.1, 5.3 and 5.4.

4.4 MARKET ABUSE

¹⁸Off-market transactions are transactions that relate to transactions which occur outside a formal market, for example transactions in unlisted securities or transactions involving listed shares which are not executed on a securities exchange. These transactions are conducted through negotiations rather than an auction system.

Under the SSA market abuse comprises insider trading, the disclosure of inside information, engaging in a prohibited trading practice, and making false or misleading statements or promises.¹⁹ Examples of prohibited trading practices include:-

- Trading a security that involves no change in the beneficial ownership of that security.
- Buying a listed security at successively higher prices or selling a listed security at successively lower prices, for the purpose of improperly influencing the market price of that security.

Contravention of market abuse provisions may invoke significant fines (of up to R50 million) and imprisonment (of up to 10 years).

4.5 SUPPORTING LEGISLATION

The regulatory framework governing securities and securities services is further strengthened and enhanced by the broader regulatory framework, which can be explained as follows.

The Companies Act No 71 of 2008, the Insolvency Act No 24 of 1936 and the Cross-border Insolvency Act No 42 of 2000 provide for general legislation regulating matters related to the SSA.

The Financial Services Board Act No 97 of 1990, the Financial Institutions (Protection of Funds) Act No 28 of 2001 and the Inspection of Financial Institutions Act No 80 of 1998 strengthen the Registrar's regulatory and supervisory powers in respect of inspections, curatorship and other enforcement measures. The Financial Services Board Act also provides regulated persons with an appeal against any decision of the regulator, while the Financial Services Ombuds Schemes Act allows for alternative dispute resolution mechanisms for users of the SROs and their clients.

¹⁹ An insider refers to any individual or entity that has access to market sensitive information before the rest of the market.

Besides these, common law of contracts assists.

5. PURPOSE OF THE POLICY REVIEW AND ITS METHODOLOGY

The purpose of the review has been to assess if the SSA:-

- Continues to meet its objectives and the objectives of financial regulation in general.
- Is aligned with local and international developments and standards.
- Has been effective in mitigating the impact of the financial crisis.

The review also identified gaps in the supervisory net and technical amendments necessary to maintain the integrity of the legislative framework.

Comparative analysis and consultation underpinned the review. By way of comparative analysis, the SSA was assessed against:-

- The IOSCO objectives and principles of securities regulation;
- The findings and recommendations of the 2008 Financial Sector Assessment Programme (the 2008 FSAP);
- The 2008 UNIDROIT Convention that South Africa intends to adopt;
- The outcomes and recommendations of the G-20 flowing from the financial market crisis; and
- Developments in comparable jurisdictions.

In addition, the implications of the following in the context of the SSA were considered:-

- Jurisprudence and other relevant determinations by administrative bodies; and
- South African legislative developments regarding the general regulatory architecture, specifically the Consumer Protection Act of 2008, the Companies Act of 2008 and the Competition Amendment Act of 2009.

Lastly, the regulatory effectiveness of the SSA was considered. In this regard, the extent to which the broader regulatory framework supports the objectives of the SSA was taken into account. Likewise, the impact of the SSA as envisaged to function within a broader macroprudential supervisory framework has become increasingly relevant.

By way of consultation, the FSB obtained written proposals from the SROs (namely the JSE and Strate) on improvements these entities considered necessary to improve the integrity of the SSA. The participants of Strate were also given an opportunity to comment on Strate's submission to the FSB. A working group consisting of representatives of the FSB, the National Treasury and the SROs was set up to collectively assess the SSA and discuss proposed changes thereto. To date stakeholder engagement has been contained to the SROs as an extension of the regulatory arm of the FSB. To ensure legal certainty, regulatory alignment and supervisory empowerment, the treasury continues to engage the dti on its overlapping areas of jurisdiction, especially with regards to the new Companies and Consumer Protection Acts, as well as the Competition Amendment Act. Broader stakeholder engagement will follow ahead of submission of the Bill to parliament.

5.1 THE 2008 FSAP AND THE IOSCO OBJECTIVES AND PRINCIPLES

The FSAP conducted by a joint World Bank and International Monetary Fund team, from time to time evaluates South Africa's financial system infrastructure by investigating its adherence to international standards, including those set by IOSCO. IOSCO's Objectives and Principles of Securities Regulation are internationally regarded as containing the minimum standards to be provided for through regulating securities services.

A joint IMF-World Bank FSAP mission visited South Africa in 2008 to conduct an FSAP update. The findings of this mission were favourable and found that the country's securities services regulatory framework to be modern and generally effective. The 2008 assessment however identified a need to strengthen supervision of conglomerates with a focus on risks that span more than one sector, and to further promote cooperation, consistency, and effectiveness among regulators. It also acknowledged that the framework for securities regulation has been enhanced, but can strengthen certain areas like the surveillance of OTC markets and improve effective oversight in areas like the monitoring of listed company disclosure.

In its assessment of South Africa's securities regulation against IOSCO principles, the 2008 FSAP recommended the following action plan for improvement:-

- The FSB should have the authority to adopt and publish its regulations without the approval of the Minister of Finance.
- The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers. In particular, the FSB lacks regulatory authority over disclosure requirements for public listed companies.
- The FSB should obtain legal authority to formally review and approve JSE listing requirements.
- The FSB should carefully examine whether it should assume greater responsibility in the OTC market, and in particular needs to assess its ability to effectively oversee and regulate the OTC market in equity-linked derivatives within the current structure, paying attention to reporting obligations.
- The FSB or the JSE should pro-actively monitor ongoing periodic company disclosure reports. Public disclosure of holdings by company officers and large investors require improvement.
- Regulations providing an opportunity for third parties to solicit voting proxies should be a priority.
- A priority goal should be conversion to a T+3 equity settlement cycle and legal action to establish a central counterparty system. Improvements in the trading infrastructure should also include expansion of IT telecommunications capacity for all trading.

Further to these recommendations, the FSAP proposed the:-

- Facilitation of further development of the stock and bond markets.
- Increase of the size of fines that can be imposed by the JSE to a level that provides a meaningful deterrent commensurate with the significance of the misconduct. The FSB's policy of "name and shame" should be adopted by the JSE²⁰.

²⁰ Note that this recommendation was superfluous. At the time the recommendation was made the JSE's Rules already stipulated that the findings of a disciplinary tribunal or committee may be published by the JSE Gazette. The JSE has in the past published such findings also in the national media. The "name and shame" policy is therefore already of full force and effect.

- Enhancement of day-to-day collaboration amongst the staff of the different sectoral regulators, in respect of individual institutions and emerging risk issues.
- Increase of focus on qualitative standards, including corporate governance, risk management, and internal controls.
- Development of the skills of supervisors to meet the growing complexity of the regulatory requirements and the demands of taking a less compliance-based approach to supervision.
- Further, develop risk assessment models, taking a more consistent approach across sectors, and the creation of increased central capacity at the main regulators to identify risk and allocate resources flexibly to issues as they arise.
- Consideration of a mechanism for resolving policy disagreements among different regulators and departments, and assessing trade-offs among differing policy objectives. The Policy Board for Financial Services and Regulation was created to ensure better coordination, but it plays a purely advisory role to the NT.

The treasury/FSB response to the 2008 FSAP, and implications of the FSAP for the FMB

The FMB cements the FSB's regulatory independence and powers for example by allowing for its adopting of subordinate operationally focussed regulation without Minister approval, and approving all regulatory rules and requirements issued by the SROs (like the JSE's listing requirements for its issuers).

The *treasury is working with the FSB and industry towards market improvements*, including a move to T+3 guaranteed settlement in the equities markets (a higher standard than the global norm of rolling of settlement) and a central securities ownership register. Given their complications related to suitable models for South Africa as well as technological and system changes that would need to happen, these are medium- to long-term projects, supported by enabling provisions in the FMB.

On a continual basis the National Treasury *supports the diversification of the South African exchange products and service offering*, for example by opening markets to foreign issuers, ongoing exchange control reform (that impact domestically domiciled firms, foreign direct investment as well as both local and foreign investors), and facilitating new markets like Satrix, Itrix, currency futures and the JSE/FTSE Shariah Index (giving diversification benefits to both investors and the JSE). The FMB is sufficiently enabling to support product innovation, while at the same time making sure that strong supervision of products protects against systemic risk (that may be introduced by poorly monitored risky product offerings). Currently the bond market is under review, as trade in South African bonds has over the past decade increasingly moved offshore, impacting domestic liquidity and pricing efficiencies. Bond listing requirements are being strengthened to enhance transparency of listed debt instruments and better ensure compliance with listing requirements. Again this lies beyond the FMB provisions, although it should be noted that listings requirements will here forward require FSB approval, and should further strengthen SRO governance.

Although falling outside the scope of the FMB as applies to all financial services (and not just financial markets), a Council of Financial Regulators has been set up to *improve coordination between financial sector regulators* on issues such as enforcement, market conduct and general regulation. The Financial Stability Oversight Committee will coordinate on managing risks to financial stability and will be jointly chaired by the Governor of the Reserve Bank and the Minister of Finance.

To further ensure policy alignment across financial/non-financial regulators, the FMB itself requires coordination between any non-financial services regulator acting on activities regulated by the FSB (as primary regulator), and the FSB. The National Treasury supports the need for better coordination between government departments on areas of overlapping jurisdiction. Conflicting laws and policy objectives erodes legal certainty, can undermine regulatory effectiveness and lead to inefficiencies, severe market disruption and investor harm. An example of crucial coordination between two departments is between the dti and treasury, in guiding coordination between the Companies and Consumer Protection Acts with existing financial services regulation (see section 5.6 in this regard).

The JSE has introduced a process to proactively review disclosure, but such is dealt with in the in the listings requirements and therefore FMB provisions are not necessary in this regard. The National Treasury believes that the current system, in which the JSE has authority to set disclosure standards for listed companies, and proactively reviews initial listing application disclosures and refers complaints concerning periodic disclosure reports to an industry review panel, is appropriate.

In considering the need for *greater regulatory surveillance of the over the counter (OTC) market* in South Africa, National Treasury recognises the need to bring the OTC derivatives within the regulatory fold. The focus, at this stage, is possible incentives for the standardisation of OTC derivatives to be cleared through a central counterparty. Discussions are also underway in identifying those OTC products that have the potential of introducing risk in the South African capital markets for purposes of regulation and whether such trades in respect of such products should be reported, and if so, what should be reported or disclosed and to whom. These discussions will give policy guidance to the manner in which these products will be accommodated within the financial markets regulatory framework. In any event the FMB better provides for the regulation of OTC derivative products. Whereas the SSA talks of prohibiting the buying and selling of unlisted products if such contravenes the objectives of the SSA, the FMB will regulate the buying and selling of unlisted products, and includes also the regulation of other services that can be offered on those unlisted product including services such as clearing and settlement.

Regarding the lack of minimum customer margin requirements and concentration limits that, combined with the lack of surveillance of OTC derivatives activities, may creates a counterparty risk exposure for JSE member firms that has systemic risk implications, the JSE in response has subsequently amended the margining methodology in the equity derivatives market to take into account the volatility, liquidity and concentration risk of the underlying instrument. As mentioned above, discussions are also underway on the possibility of clearing OTC trades in an effort to reducing counterparty risk.

In terms of third parties being able to solicit voting proxies, the FSB and the National Treasury agree this to be a priority. The treasury will therefore engage with the dti in this regard and as such lies outside the scope of the SSA (and proposed FMB).

Besides these matters, the FMB should also:-

- Give the FSB the authority to adopt and publish subordinate regulation (rules) without the approval of the Minister of Finance and formally review and approve JSE listing requirements.
- Require that the JSE: issues rules providing for conversion to a T+3 equity settlement cycle and legal action to establish a central counterparty system; pro-actively monitors company disclosure reports, and disclosure of holdings by company officers and large investors; and increases fines to ensure a meaningful deterrent commensurate with the significance of the misconduct in terms of the exchange rules.
- Strengthen procedures for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and to contain systemic risk (such as the participant's failure manual).
- Strengthen protective and other measures where an insolvency occurs (including providing for the FMB to take precedence over insolvency law).

5.2 UNIDROIT CONVENTION ON INTERMEDIATED SECURITIES

UNIDROIT operates within the UN structures studying the needs and methods for modernising, harmonising and coordinating private and, in particular, commercial law between countries and regions. South Africa is one of its 59 member countries.

The volume of securities held through intermediaries systems all over the world has sharply increased and the globalised economy needs a reliable and efficient legal framework with regard to cross-border holding and transfer of those securities. The structural and technological innovations that have made the modern securities holding

systems possible have not been universally matched by corresponding levels of legislative modernisation.

The purpose of the UNIDROIT Convention is, therefore, to promote uniformity and predictability of laws across Member Countries to ensure legal certainty of book entries in securities accounts. The UNIDROIT Convention is not drafted as a comprehensive code covering all substantive rules relevant to the subject. It is a set of key provisions to be incorporated by contracting Member States into their existing laws, with whatever modifications of their existing laws are appropriate. In a nutshell, the principles embodied in this convention enhance protection to the markets participants and the financial markets systems as well as improve efficiency by:-

- Providing certainty as to the law applicable to clearance, settlement and secured credit transactions that cross national borders.
- Improving transactional efficiencies in global securities markets.
- Reducing systemic risk in cross-border transactions and intermediary holdings.
- Facilitating cross-border capital flows.

The treasury/FSB response to UNIDROIT recommendations and implications for the FMB

To build investor protection and minimise systemic risk, National Treasury strongly supports enhanced transparency and legal certainty in the intermediation of securities both locally and cross-border. The National Treasury supports the Convention principles and considers its provisions to be aligned with South Africa's policy objectives, especially in so far as the level of flexibility with which it accommodates South Africa's securities' infrastructure and ownership-transfer processes.

The National Treasury recognises the need for securities regulation to incorporate the principles of the UNIDROIT Convention. This will help mitigate financial sector stability risk in periods of economic volatility by addressing the potential disruption of the chain of subsequent settlement obligations should a large counterparty fail to settle as committed.

The FMB takes into account the following UNIDROIT principles:-

- The *rights of the clients*, including in particular dividends and another distributions and voting rights, must be protected.
- There should be *clear and simple rules for buying and selling of shares*, including rules relating to using those securities as collateral.
- *Netting of obligations or off-sets of obligations must be legally enforceable* between or among participants in the netting arrangement which reduces the number and value of payments or deliveries needed to settle a set of transactions.
- *Upper-tier attachment against the issuer or any intermediary other than the “relevant” intermediary²¹ is prohibited.* The effect of attempting to freeze securities at the upper tier would have unwarranted consequences for the entire account and even for the system as a whole. Note that this issue is not present in a transparent system featuring a central securities register. In such markets, the attachment is made directly against the specific securities account at the upper-tier (e.g. the CSD) and there is no effect on other investors at lower tiers. This practice is also acknowledged in the UNIDROIT Convention provision.
- There are *clear rules on priority in case of competing interests*. UNIDROIT requires the member States to make rules in its domestic laws regarding the ranking of competing interests against the same uncertificated securities. As it is possible for an investor to grant more than one interest against the same securities (e.g. pledge, cession to secure a debt, usufruct, etc), any interest holder may decide to realise his interest to the prejudice of other creditors. Priority rules will bring certainty regarding the ranking of competing interests registered against the same securities. The ranking should be based on date of entry and not the on the date on which the debt or agreement giving rise to the interest occurred.

²¹ When an attachment order to freeze an account is issued by the court, it must be given effect to by making an entry of the attachment in the correct account of that account holder. Where an account holder's account is part of a chain of holdings, the attachment must be made at the level closest to the account holder, in other words, at its direct relevant nominee with whom it has a direct relationship. The attachment order should not be made at the level of a higher tier intermediary in the holding chain where it will be in an omnibus account where the interests of particular clients at a lower level intermediary are not distinguished. This is because the upper-tier intermediary cannot be expected to have information regarding the securities that a particular investor has.

- *“Good faith” acquisition or “acquisition by an innocent person” must be protected.* Due to the nature of transactions performed on an exchange, both the buyer and seller do not know who they are dealing with. In terms of our common law, a transaction is invalidated when entered into as a result of fraud (or other illegality). Therefore, legislation should include a rule protecting an innocent acquirer by prohibiting the reversal of the transaction. The uncertainty resulting from the threat of a constant reversal of settlement transactions is not healthy to the integrity of the uncertificated securities register and market. Of course, the dispossessed owner may still institute other legal proceedings (such as claim for damages) against the fraudulent party or any other responsible person.
- *During insolvency proceedings, the rights and interests of clients must be protected at all times.* That being said, a transaction that is valid between the two parties must also be valid (effective) to third parties, including the curator. In other words, a curator cannot come in and unwind finalised transactions in the “anonymous” market- that would create crises in the market.

5.3 THE FINANCIAL CRISIS AND THE G-20²² OUTCOMES

In the January 2009 Special report on Regulatory Reform, the USA Congressional Oversight Panel identified the following three major failures of the present regulatory system, in the context of the financial crises:-

- Failure to effectively manage risk.
- Failure to require sufficient transparency.
- Failure to ensure fair dealings.

The report notes that financial markets are inherently volatile and prone to extremes and that government therefore has a critical role to play in helping to manage both public and

²² The G-20 is a Group of Finance Ministers and Central bank Governors from twenty major economies in the world. South Africa is a member of this group and is a representative for Africa.

private risk. It goes on to state that markets have become opaque in a number of ways, with some markets, such as hedge funds and credit default swaps, providing virtually no information. Disclosure alone, however, does not always provide transparency. Market participants must have useful, relevant information delivered in an appropriate, timely manner. Recent market occurrences involving off-balance-sheet entities and complex financial instruments reveal the lack of transparency resulting from the wrong information disclosed at the wrong time and in the wrong manner.

Further, fair dealings (to minimise deception, fraud and parties that are unfairly matched) must be provided for in the regulatory system. Unfairness, or even the perception of unfairness, causes a loss of confidence in the marketplace. It is therefore critical for regulators to ensure fairness through meaningful disclosure, consumer protection measures, stronger enforcement, and other measures.

An appropriate regulatory response (that strikes a reasonable balance between the costs of regulation and its benefits) should:-

- Provide consumers and investors with adequate information for making sound financial decisions and thus protect them from being misled or defrauded, especially in complex financial transactions;
- Reduce conflicts of interest and help manage moral hazard, and
- Reduce systemic threats to the broader financial system and the economy as a whole by limiting risk taking in key parts of the financial sector.

Since 1990 certain large markets and market intermediary institutions have developed outside the jurisdiction of financial market regulators. Collectively, these markets and market actors have become known as the shadow financial system. The key components of the shadow financial system are unregulated financial instruments such as OTC derivatives, off-balance-sheet entities such as conduits and special investment vehicles (SIVs), and non-bank institutions such as hedge, private equity and money market funds. In the context of financial markets, specifically, the transparency of OTC derivative markets could be enhanced by the clearing of OTC derivatives contracts through regulated clearing

houses or regulated exchanges (with the exchanges making use of clearing houses to minimise counterparty risk).

The 2 April 2009 G-20 declaration reiterated the following principles for strengthening the regulation and supervision of the financial sector:-

- Strengthening transparency and accountability.
- Enhancing sound regulation.
- Promoting integrity in financial markets.
- Reinforcing international cooperation.

The 2 April 2009 G-20 declaration included a progress report against each of the 47 actions set out in the Washington Action Plan. In particular, it agreed the following major reforms relevant to securities regulation (note only those principles that directly affect financial markets are referred to):-

- All systemically important financial institutions, markets, and instruments should be subject to an appropriate degree of regulation and oversight.
- Large and complex financial institutions require particularly careful oversight given their systemic importance. The regulators need be empowered to gather relevant information on all material financial institutions, markets, and instruments in order to assess the potential for their failure or severe stress to contribute to systemic risk.
- Financial institutions need to adhere to rules consistent with international best practises, when it comes to reporting risk and losses. Regulators should work to ensure that a financial institution's financial statements include a complete, accurate, and timely picture of the firm's activities (including off-balance sheet activities) and are reported on a consistent and regular basis.
- The securities regulatory framework need be reviewed and adapted regularly to keep pace with developments in the financial system and promote good practices and consistent approaches at the international level. National and regional authorities should review resolution regimes and bankruptcy laws in light of recent experience to

ensure that they permit an orderly wind-down of large complex cross-border financial institutions.

- Promote the standardisation and resilience of credit derivatives markets, in particular through the establishment of central clearing counterparties subject to effective regulation and supervision. Financial institutions should continue to work to strengthen the infrastructure supporting OTC derivatives markets. For credit derivatives, this should include standardising contracts to facilitate central counterparty clearing for eligible contracts. Central counterparties should be subject to transparent and effective oversight by prudential supervisors and other relevant authorities, including central banks, and meet high standards in terms of risk management, operational arrangements, default procedures, fair access and transparency. Infrastructure for central clearing and settlements for credit derivatives must meet high prudential standards.
- National and regional authorities should work together to enhance regulatory cooperation between jurisdictions on a regional and international level. National and regional authorities should work to promote information sharing about domestic and cross-border threats to market stability and ensure that national (or regional, where applicable) legal provisions are adequate to address these threats.
- National and regional authorities should also review business conduct rules to protect markets and investors, especially against market manipulation and fraud and strengthen their cross-border cooperation to protect the international financial system from illicit actors. In case of misconduct, there should be an appropriate sanctions regime. Regulators should take all steps necessary to strengthen cross-border crisis management arrangements, including on cooperation and communication with each other and with appropriate authorities, and develop comprehensive contact lists and conduct simulation exercises, as appropriate.

The international agencies, that include Basel Committee, Financial Stability Board, etc, are working to flash-out these high level recommendations.

The treasury/FSB response to G-20 recommendations and the global financial market crisis, and implications for the FMB

In so far as the following items as relating to the G-20 recommendations (and in part already discussed in earlier sections), the FMB:-

- Improves investor protection through enhanced transparency and disclosure.
- Supports better cooperation and information sharing with domestic and foreign regulators.
- Enhances risk management.
- Extends and enhances the scope of regulation of OTC markets.

The treasury and FSB have initiated separate projects to investigate the most appropriate regulatory options for hedge funds, credit ratings agencies and the OTC market; only the last of these is relevant for the FMB.

The National Treasury strongly recognises the need for a closer monitoring of potentially systemic entities across South Africa's financial sector. While South Africa's financial markets regulation currently deals with all of these issues, we see scope for improvements. The FMB has therefore strengthened existing provisions contained in the SSA to ensure supervision that better protects investors and the system, as supported by changes to the broader system brought about through the Council of Regulators.

5.4 OTHER JURISDICTIONS

A brief assessment of securities regulation in other jurisdictions (whose capital markets are comparable to that of South Africa) was undertaken to ascertain how the South African regulatory framework compares.

The international agenda for strengthening financial services regulation can be summarised as follows:-

Australia: In Australia, the Australian Securities and Investment Commission is responsible for regulating and supervising the participants or listed entities compliance with the law while the Australian Securities Exchange (ASX) is responsible only for the supervision of its market, ensuring compliance with its rules and referring suspected breaches of the law to relevant authorities. This is similar to the SRO model adopted by South Africa whereby exchanges and CSDs are responsible for ensuring compliance with their rules by their members. Not so long ago, in Australia, the ASX did not regulate conduct by brokers, financial advisers in relation to OTC activities including margin lending, securities lending/borrowing etc and did not regulate or supervise the activities of non-ASX participants in any way. It also did not monitor trading on any market or OTC activity, nor did it monitor or supervise bilateral OTC contracts between market participants.

However, internationally, we have seen a move by securities regulators towards enhancing their regulatory framework in response to the global financial crisis and under guidance from IOSCO and the G-20. Similarly, the ASX has launched exchange traded CFDs to create a regulated market for trading of CFDs to enhance transparency with having an exchange and clearing mechanism.

The United States (US): The Securities and Exchange Commission (SEC) is an independent agency of the US government that holds primary responsibility of regulating the securities industry and enforcing the federal securities laws. The SEC has the power to register, regulate and oversee brokerage firms, transfer agents, and clearing agencies as well as the SROs, e.g. New York Stock Exchange and American Stock Exchange. Although it is the primary overseer and regulator of the US securities markets, the SEC works closely with, inter alia, the SROs. The SROs are required to have rules and have the ultimate responsibility of enforcing these rules.

The US has moved swiftly in exploring and adopting ways of regulating the OTC market. The SEC allowed LCH Clearnet Ltd to operate as a central counterparty for credit default swaps in order to add transparency. In addition, the SEC recently adopted new legislation

relating to the oversight of NRSROs²³ in response to the requirements of the CRA Reform Act to improve the quality of ratings for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating agency industry. The new legislation, called the Investor Protection Act of 2009, provides additional improvements to financial regulation in the areas of public disclosure, internal processes, management of conflict of interest, compliance officers, annual reports, transparency, (including transparency of credit rating methodologies and information), etc.

UK: The Financial Services Authority (FSA) is the regulator of the financial services in the UK since December 2001. The FSA endorses the European Regulation on Credit Rating Agencies approved by the European Parliament. This Regulation puts in place a regime for registering and regulating CRAs and subjecting them to effective supervision. The FSA, as part of the OTC Derivatives Supervisory Group, work with G14²⁴ dealers to increase standardisation across products and also encourage them to expand clearing. FSA is also working closely with clearing houses on G-20 proposals to expand the range of products that they clear, such expansion would be subject to regulatory approval and oversight. Similarly the European Commission has published a legislative proposal which will make clearing of certain OTC derivatives a mandatory obligation, and reporting of OTC derivatives to trade repositories mandatory.

Brazil: The Securities Commission of Brazil (CVM) is currently working on different projects that respond to the G-20 recommendations. The said initiatives include projects aimed at enhancing transparency, risk management related to OTC derivatives trading. Currently, the registration of all OTC derivatives trades, with the trade Repository, is mandatory in Brazil. These repositories are SROs.

²³ A Nationally Recognized Statistical Rating Organization (NRSRO) is a credit rating agency (CRA) which issues credit ratings that the U.S. Securities and Exchange Commission (SEC) permits other financial firms to use for certain regulatory purposes.

²⁴ G14 refers to the group of 14 major financial derivative traders in the world.

A treasury/FSB view towards international developments and implications thereof for the FMB

Internationally the SRO regulatory model applied in South Africa is a well recognised model for regulatory oversight. While conflicts of interests can arise between the SRO as market participant and the SRO as part-regulator, these can be regulated through an appropriate requirements imposed and monitored by the FSB. In addition, benefits in so far as the SRO having a better first hand knowledge of the regulatory issues means that stronger rules and supervision results, that could be weakened where strong asymmetry in information exist between the regulated and the regulator. The SRO model is still considered in South Africa an efficient and effective model for supervision in the financial markets and is therefore retained. This model allows for a better use of limited resources within the FSB (see also section 5.7.1).

Looking at the scope of regulation, the National Treasury and the FSB recognise that the changes that are taking place in other jurisdictions are informed by the same G-20 recommendations that have in part informed the FMB. In addition, most countries subscribe to the same IOSCO principles that the SSA was recently evaluated against by the FSAP. The National Treasury therefore notes the similarities between South Africa and the countries reviewed above with respect to regulatory architecture and their responses to the crisis, especially with respect to transparency, monitoring of regulated entities and their activities, accountability of systemic institutions and market infrastructures, greater cooperation between regulators both domestically and internationally, and extending the scope of regulation to cover the shadow financial systems (by for example regulating Credit Rating Agencies and improving the visibility of OTC derivatives). The issues of the Credit Rating Agencies lies beyond the scope of this bill, but is responded to in newly proposed legislation called the Credit Rating Services Bill.

5.5 JURISPRUDENCE AND OMBUDS DETERMINATIONS

The SSA or its provisions have not been the subject of any major litigation since its enactment in 2005. Similarly, no significant number of ombuds or other dispute resolution determinations has been made on the substance of the SSA since its enactment. This reflects well on the strength of the SSA's protection provisions.

Besides this, jurisprudence and ombud (and other dispute resolution) determinations do not assist in the review of the SSA and have no implications for the FMB.

5.6 SOUTH AFRICAN LEGISLATIVE DEVELOPMENTS

5.6.1 The Companies Act of 2008

The Companies Act is an integral part of the regulatory framework relating to the regulation of capital markets. With the enactment of the new Companies Act in 2008, the FSB undertook a detailed assessment of the implications of that Act for the legislation administered by the FSB, including the SSA. With regard to the SSA, these relate to technical adjustments (like correcting legislative references and conflicts), and conflicting regulatory requirements that could potentially undermine the enforcement activities by the Registrar (like the business rescue proceedings).

Implications of the Companies Act for the FMB

The NT and the FSB believe that the new Companies Act will assist in significantly enhancing corporate governance and accountability of companies. In so doing, the FMB aligns to the Companies Act, taking into account the following:-

- References to the 2008 Companies Act.

- General alignment between the FMB and the 2008 Companies Act, including alignment of terminology, elimination of overlaps, alignment of dates for the submission of financial statements and the like.
- Clarification of the financial reporting standards that apply to SROs.
- Provision for business rescue instead of judicial management.
- Clarification of business rescue *versus* curatorship.

5.6.2 The Competition Amendment Act of 2009

With the enactment of the Competition Amendment Act, the FSB undertook a detailed assessment of the implications of the 2008 Amendment Act for the legislation administered by the FSB, including the SSA.

Of greatest significance is the weakening of the regulatory authority of the Registrar, This is because the Competition Act, amongst other things, affords the Competition Commission the authority to investigate and prosecute any entity or any market without necessarily engaging the relevant regulatory authority responsible for that market.

The treasury agrees that the operational independence of the Competition Commission is sacrosanct. But investigations should be fully informed by all factors relevant to market behaviour, including regulation, as well as the impact of such an investigation or determinations on other policy objectives, like systemic stability. An uninformed competition assessment can in fact have the unintended consequence of undermining market efficiency and investor protection, for example with respect to finding fault with product standards that for complicated financial instruments make such easier to understand and compare.

With regards to merger transactions between entities in financial markets, there are often many other policy grounds for considering such a merger other than competition; like whether the merger may be necessary for stability reasons, or should be prevented for

reasons of strategic national interest. This should be considered in the governing securities regulation.

The treasury/FSB regulatory response to the Competition Act, and its implications for the FMB

For heavily regulated and systemic business like that in financial markets, alignment and coordination between the Competition Commissioner and the Registrar is an imperative (as has already in part been discussed in considering the FSAP 2008 recommendations, as well as the G-20 recommendations responding to the financial crisis - sections 5.1 and 5.3).

The FMB therefore compels regulators with jurisdiction overlapping with the Registrar to engage him or her before making or initiating investigations or market inquiries or releasing a report thereon.

The Competition Act is also being amended to allow for the exclusion of the jurisdiction by the Minister of Finance of the Competition Commission in respect of certain mergers and amalgamations, similarly to the prevailing situation in that Act in relation to bank mergers and amalgamations.

5.6.3 The Consumer Protection Act (CPA) of 2009

Effective 1 April 2011, jurisdiction of the CPA overlapped with the SSA, and reflected many provisions that contradicted regulatory requirements under the SSA. One example the need to address a contradiction is that in the financial sector the right for a consumer to select a supplier in section 13 of the CPA should be limited to selecting a supplier that has satisfied stringent regulatory requirements; in the provision of securities settlement services in South Africa there is only one qualifying supplier, although the legislation promotes competition and transparency by setting a common standard for potential suppliers to comply with. Another example has to do with provisions on cooling-off periods

(s 16) and returning of goods (s 20) which cannot be applied to the trading of securities as the principle of “final and irrevocable settlement” is essential to the integrity of the market, mitigating systemic risk. These created significant legal uncertainty as of 1 April 2011, and by implication a threat to investor protection and systemic risk.

Paramount to identifying a set of activities that should be exempt from the CPA is the distinction between business activity that is already subject to stringent and financial sector specific regulatory requirements under the SSA, and business activity that is not. The latter must without exception be subject to the CPA. The financial markets are already strictly regulated by the SSA for fairness, systemic stability, market efficiency, market conduct and consumer protection. As such it should optimally be subject to the authority of a single regulator to ensure against regulatory arbitrage and inconsistency in the areas of regulatory design and enforcement. To not do so could have the perverse consequence of weakening investor protection. It is also important to take into account that Strate and the JSE are self-regulatory organisations, meaning that they have regulatory authority over their users (consumers) as delegated by the FSB.

The NT/FSB regulatory response to Consumer Protection Act

The treasury strongly supports the objective of consumer protection, and believes that the financial services sector should be held to even higher standards with regard to market conduct and consumer protection. This is because of inherent market failures which characterise the financial sector. Firstly, financial transactions are often incomplete, and in some cases (like pensions or insurance) may take decades to complete. Secondly, given the presence of strong information asymmetries between buyers and sellers of financial products and services, consumers remain vulnerable to abuse that not only threatens their own personal circumstances, but can force many of them into poverty. But the nature of financial services often requires a nuance response to abuses that may not be best captured in general requirements. This makes alignment across the legislation imperative to ensure that we better deliver on consumer (investor) protection.

The National Treasury is engaging the dti to ensure harmonisation between the CPA and the SSA/FMB. As an interim arrangement business regulated in terms of the SSA has been exempt by the Minister of Trade and Industry from the CPA. As a longer term solution, the FMB proposes a consequential amendment to the CPA to exclude the regulated business of the FMB from the CPA. Importantly business that is not regulated in terms of the FMB will remain subject to the CPA.

5.7 REGULATORY EFFECTIVENESS²⁵

Regulatory effectiveness may be ascertained by assessing the extent to which the objectives of the SSA were met in the implementation and application of the SSA, with specific reference to :—

- The institutional framework for regulation.
- Accountability of the SROs and Registrar.
- Proportionality and efficiency of the regulatory framework.
- Flexibility of the regulatory framework.
- Timeliness and responsiveness of the regulatory framework.
- Compliance and enforcement mechanisms.
- Redress mechanisms.

The objects of the SSA are to:-

- Increase confidence in the South African financial markets by requiring that securities services be provided in a fair, efficient and transparent manner and contributing to the maintenance of a stable financial market environment.
- Promote the protection of regulated persons (exchanges, CSDs or any other persons who provide securities services) and clients.
- Reduce systemic risk.
- Promote the international competitiveness of securities services in the Republic.

²⁵ The assessment of the regulatory effectiveness of the SSA is a retrospective assessment. It focuses on the SSA as is and does not take into account future developments that may need to be accommodated in the SSA because of the other parts of this assessment and the outcomes thereof.

5.7.1 The institutional framework for regulation

The institutional framework, including the SRO model, established by the SSA has assisted in meeting the objectives of the SSA. The SRO model fosters integrity in the marketplace and among participants. Moreover, it is an effective method of regulation because SROs are familiar with the increasingly complex nature of the industry as well as the products developed and marketed by members and member organisations. SROs as a result have the specific knowledge and ability to effectively implement and conduct efficient and cost effective regulatory programs.

However, the SRO model is not without its shortcomings. Issues of conflict of interest, enforcement of the SSA and rules, adequacy of resources, costs, unfair access to securities services have emerged and impacted on the effectiveness of our SRO model. These issues are currently being addressed by the FSB in consultation with the relevant parties. Others will be incorporated through the FMB.

Since the coming into operation of the SSA there has only been one failed trade in the JSE's equities market and failure of two derivatives members. In all instances, the implementation of appropriate risk management practices resulted in the absorption of risk by the relevant clearing members, settlement authority or Strate.

South Africa received a favourable report from the FSAP, except for the recommendations noted that have likewise informed this review (section 5.1). Also, the recent financial crisis has emphasised the robustness of our institutional framework, although providing some scope for improvement (section 5.3). In this regard, the FMB provides for an independent clearing house within the SRO model, and introduces the concept of a trade repository.

5.7.2 Accountability of the SROs and the Registrar

The Registrar is accountable to the executive and legislature for the effective administration of the SSA. The Registrar, as an integral part of the FSB (a public entity), is

subject to the Financial Services Board Act and the Public Finance Management Act No. 1 of 1999 that imposes planning and reporting responsibilities on the FSB. SROs are accountable to the Registrar for the effective performance of their functions as set out in the SSA. The SSA empowers the Registrar to take regulatory action against the SROs should they fail to or fail to effectively perform their functions.

While few difficulties have been experienced to date, note is made of the scope to improve the nature and timeliness of communication especially with respect to matters that may impact systemic stability. Such should be enabled through the FMB.

5.7.3 Proportionality and efficiency of the regulatory framework

The regulatory framework appears to be proportional to the scope and magnitude of the market failure it addresses as well as other broader economic or social needs. The SSA, in combination with the supporting legislation referred to in section 4.2, is efficient in that it is able to achieve objectives at the lowest cost. The National Treasury is of the view that the SRO model is a cost efficient model that utilises available regulatory resources optimally.

Compliance and implementation costs are also reasonable. Fees and levies charged by the FSB are calculated on the time spent and no industry participants have to date refused to pay fees and levies or argued that fees and levies are too costly or not commensurate with the regulatory functions of the FSB.

Therefore, there are no changes made through the FMB in this regard.

5.7.4 Flexibility and simplicity of the regulatory framework

The SSA is crafted as enabling legislation. The subordinate legislative authority afforded to the Registrar and rule-making authority afforded to the SROs is sufficiently flexible and

simple to accommodate changes in the financial system while still achieving objectives. Having said that, the National Treasury recognises a role for further policy guidance that may be required extending from the act itself, for example with respect to remote membership or OTC derivatives regulation. Such should be enabled through the FMB.

5.7.5 Timeliness and responsiveness of the regulatory framework

As stated above, the SSA is crafted as enabling legislation. The subordinate legislative authority afforded to the Registrar and rule-making authority afforded to the SROs allows for a timely and responsive reaction to the rapid pace and complexity of innovation in the financial sector.

The FMB continues to support this regulatory architecture.

5.7.6 Compliance and enforcement mechanisms

The SSA read with the Financial Services Board Act, the Financial Institutions (Protection of Funds) Act and the Inspection of Financial Institutions Act, allows the Registrar and the SROs effective compliance and enforcement mechanisms. These mechanisms include, amongst others, the right to issue directives, withdraw licenses, refer matters for criminal prosecution, impose administrative penalties (through the enforcement committee), undertake inspections, apply for curatorship, apply for other court orders and prescribe matters. Read together, the SSA empowers the Registrar to effectively take action against transgressors of the law. However, improvements have been recently made relating to the setting up of the enforcement committee, further changes are made through the FMB.

5.7.7 Redress mechanisms

Decisions of the Registrar and SROs are subject to the Promotion of Administrative Justice Act No. 3 of 2000. The decisions of the Registrar and SROs are also, or in addition,

subject to an appeal to the appeal board established under the Financial Services Board Act. Administrative penalties imposed by the enforcement committee also established under the latter Act are appealable to the high court. These mechanisms sufficiently guard against arbitrary rules and unequal treatment.

Implications of the assessment of the regulatory effectiveness of the SSA for the FMB

It appears that the SSA has constituted an effective and efficient regulatory framework for meeting its objectives. The FMB therefore does not represent a new and distinct policy direction and should be seen as a strengthening of the existing regulatory framework. However, examples of tightening legislation including the following:-

- Clarification of the communication lines between the SRO and the Registrar and the Registrar and the Minister.
- Amending the SSA to reflect on FSAP and G-20 recommendations including supervision of systematically important financial institutions, creating an environment that allows for the settlement of OTC derivatives through Central Counterparties, etc
- Strengthening the supervisory responsibilities of the SROs.

6. THE FINANCIAL MARKETS BILL

As highlighted in the preceding discussion, the FMB is a product of various processes including – consultation with SROs, legislative developments in the country, global financial markets crises and the G-20 recommendations.

6.1 STRUCTURE OF THE FMB

The FMB has 12 chapters, summarised as follows:-

- Chapter I contains the relevant definitions and sets out the objects of the Bill. It also indicates how and to whom the Bill and rules made there under applies, and prohibits certain activities.
- Chapter II provides for the powers and functions of the Registrar and Deputy Registrar of Securities Services.
- Chapter III deals with the licensing, functions, funding and rules of an exchange, and related to this, exchange listing requirements, removal of listings and disclosures by issuers of listed securities, the specific obligations of authorised users and the use of the term “stockbroker”. It also deals with the buying and selling of listed securities and the reporting of off-market transactions in listed securities.
- Chapter IV deals with the custody and administration of securities. In doing so it also deals with the licensing, functions and rules of a central securities depository and its participants.
- Chapter V deals with the licensing, functions and rules of an independent clearing house, and matters relating to the amalgamation, merger, transfer or disposal of an associated clearing house.
- Chapter VI provides for the establishment of a trade repository, to which all trades in unlisted instruments will be reported. In doing so, it lays out the licensing and operational requirements of the trade repository, as well as its function.
- Chapter VII deals with SROs. The Bill confers the status of an SRO on exchanges, central securities depositories and independent clearing houses. This Chapter also deals with various matters relating to licensing, reporting, institutional form and mergers and amalgamations.
- Chapter VIII provides that the Registrar may prescribe a code of conduct for authorised users, participants or clearing members of independent clearing houses.
- Chapter IX deals with general provisions relating to listed and unlisted securities. It authorises the Registrar to regulate trading in unlisted transactions and prohibit undesirable advertising or canvassing relating to securities.
- Chapter X prohibits market abuse and deals with the functions of the Directorate of Market Abuse in dealing with market abuse related offences.

- Chapter XI obliges regulated persons to have audited financial statements, deals with the role and functions of the auditor, the powers of the registrar and the Courts in ensuring compliance with the legislation.
- Chapter XII provides for general provisions which include offences and penalties and matters relating to fair administrative action, right to appeal, the certification of documents, regulations, savings and the like.

6.2 MAIN POLICY ISSUES

The FMB strengthens the SRO regulatory model (which has proven efficient and effective in delivering on the objectives of securities regulation), aligns financial markets regulation with international best practice, and gives effect to recommendations made by the 2008 World Bank and International Monetary Fund Financial Sector Assessment Programme, as well as South Africa's commitment to the UNIDROIT Convention to improve investor protection in cross-border transactions.

6.2.1 Strengthening the SRO regulatory model

To further empower the FSB, the bill strengthens its regulatory independence and enables it to publish the detail, status and outcome of inspections and onsite visits. It also enables the FSB to prescribe fees for the SRO and approve listings requirements, and liquidation orders. It provides the rules with which SROs must comply, as well as the parameters of regulatory requirements that inform how an SRO must license and supervise its users. It extends reporting requirements by the SROs to the registrar on matters of systemic relevance, and similarly extends the reporting requirements of the registrar to the Minister on these matters. The bill also strengthens governance requirements for SROs.

The bill reduces regulatory burden by facilitating partial membership. This means that an entity subject to equivalent regulatory requirements under this Bill and another Act, can apply for a limited licence under this Bill that exempts that entity from those duplicated requirements (and supervision).

6.2.2 Alignment to international best practice and Financial Sector Assessment Programme recommendations

The FMB improves investor protection and reduces systemic risk by increasing the scope of regulation for unlisted securities (to include over-the-counter derivatives), and enhances transparency in these instruments by providing for the establishment of a trade repository to which all trades in these instruments will be reported and monitored. The initial focus of the trade repository will be on OTC derivatives, in line with the G-20 recommendations. The aim is to have all transactions in OTC derivatives reported to the trade repository and disclosed to the registrar and other relevant supervisory bodies to enhance transparency in this market, as well as for risk identification/assessment and market surveillance purposes.

The FMB provides and allows for the establishment of an independent clearing house as a stand-alone SRO, consistent with what is allowed for exchanges and securities depositories. This provision should promote the central clearing of over-the-counter derivatives, also one of the main topics on the G-20 agenda.

6.2.3 Improved investor protection for cross-border transactions

To increase competition and better regulate cross-border transactions, the bill provides for foreign entities to be members of the South African financial markets infrastructure. It creates a platform for the signing of Memoranda of Understanding with regulators in other countries, which is helpful in a situation whereby the FSB wants to investigate, inspect or conduct on-site visits for foreign regulators.

By facilitating settlement transactions between international and domestic depositories, the Bill improves investor protection for intermediated security services and helps investors participate in foreign markets without the need to involve a foreign participant or a global custodian.

6.2.4 Other matters

The FMB aligns financial markets regulation to the new Companies Act.

To safeguard financial sector stability, the bill ensures that regulators with jurisdiction over industry participants covered by this Bill may only make decisions on such participants in coordination with the FSB as lead regulator.

Lastly, given that the financial services sector is generally held to higher standards than most sectors with regard to market conduct and consumer protection, the Bill proposes more stringent regulation to apply to securities markets, and the regulated activity is therefore excluded from more general legislation like the Consumer Protection Act (CPA) of 2008.

From a technical perspective, the Bill corrects references to legislation repealed or replaced subsequent to the enactment of the Securities Services Act in 2004.

7. CONCLUSION

The FMB is the product of a solid review and engagement process, and will significantly strengthen the prudential and market conduct regulation in South Africa as it pertains to financial markets. Stable, investor friendly and fair markets feeds though to a more efficient and effective allocation of limited resources supporting business growth, economic growth and employment.

Compared to the existing SSA, it remains flexible but strengthens certain provisions. In addition, the scope of regulation is broadened to cover the shadow financial system and improve the monitoring and communication of systemic risk between the SRO, the FSB and the Minister of Finance; namely that the right steps can be taken at the right time, minimising long lasting market disruptions.