

# BUILDING COMPETITIVE FINANCIAL MARKETS FOR INNOVATION AND GROWTH

A WORK PROGRAMME FOR STRUCTURAL REFORMS  
TO SOUTH AFRICA'S FINANCIAL MARKETS



**national treasury**

Department:  
National Treasury  
REPUBLIC OF SOUTH AFRICA





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# **INTRODUCTION AND BACKGROUND**

South Africa's financial markets have served the country well. They are widely regarded as among the deepest, best developed, and most liquid in the world, particularly compared to peer emerging markets.

To remain in a competitive position, South Africa needs to continually review and improve its financial regulatory framework. Financial markets are constantly innovating and developing, new approaches to all aspects of the operation and regulation of financial markets are being developed globally. In particular, technology has brought new efficiencies, and new risks in trading, clearing, settlement and custody amongst others. The authorities themselves have driven many innovations, including blockchain settlement, and electronic trading of government bonds. The regulatory framework must therefore remain responsive to these developments.

The new Administration has also placed growth and development at the centre of its new policy agenda. In all aspects of the economy, the legislative framework must create an enabling environment for innovation and growth.

The Financial Markets Act 19 of 2012 was promulgated during a period of substantial change in global financial markets. It allowed for the licensing of new exchanges, created a legislative framework for unlisted securities, and strengthened the system of regulation to ensure it remained on par with the best in the world.

There have been some important developments since that Act was promulgated. Domestically, the introduction of a new 'Twin Peaks' architecture has been one of the most significant developments in the history of financial regulation. The South African Reserve Bank (Reserve Bank) has been given new responsibilities for financial stability, and new powers to resolve financial firms that pose systemic risk. A new regulator – the Prudential Authority – has been given a wide-ranging mandate to ensure financial safety and soundness. Finally, the previous Financial Services Board has been re-engineered as a dedicated market conduct regulator, the Financial Sector Conduct Authority. Internationally, South Africa has committed to a number of international regulatory obligations, flowing from being part of the Group of Twenty, the Financial Stability Board and the International Organisation of Securities Commissions (IOSCO). There has been a series of ongoing international reforms, particularly the introduction of the Markets in Financial Instruments Directive (MiFID) in the European Union. To ensure that its markets remain vibrant and integrated with world markets it is important to regularly update the legislative framework governing South Africa's financial markets to account for these international and domestic developments. These developments were among the key considerations behind establishing the Financial Markets Review Committee to conduct a review of the domestic wholesale financial markets. The Committee's recommendations are presented in the accompanying Financial Markets Review.

This Discussion Paper is intended to provide guidance to the process of updating financial market legislation to implement those recommendations and to inform market participants about how those recommendations align with recommendations that have been emerging from other concurrent reviews, including those contained in the Review of the National Payment System Act 78 of 1998.<sup>1</sup>

In addition, this Discussion Paper sets out the future of the regulatory framework for financial markets in the context of the Twin Peaks reforms, international developments (e.g. MiFID) and South Africa's Group of Twenty commitments.

<sup>1</sup>Review of the National Payment Systems Act 78 of 1998, (September 2018), available at [http://www.treasury.gov.za/publications/other/National Payments System%20Act%20Review%20Policy%20Paper%20-%20final%20version%20-%2013%20September%202018.pdf](http://www.treasury.gov.za/publications/other/National%20Payments%20System%20Act%20Review%20Policy%20Paper%20-%20final%20version%20-%2013%20September%202018.pdf)

The proposals in this Discussion Paper draw heavily on inputs from, and discussions with, the South African financial sector regulators, industry participants, developments in international regulatory frameworks, and research papers on the South African financial system, including discussion papers prepared by the regulators, the International Monetary Fund's Financial Sector Assessment Program reports<sup>2</sup>, and several reviews by Genesis Analytics commissioned by the National Treasury and Financial Sector Conduct Authority.<sup>3</sup> We also wish to acknowledge helpful comments made by the World Bank; in particular, by World Bank consultant Inigo de la Lastra.

The issues addressed in the following sections are divided into high-level issues (issues that could shape the style and coverage of the new financial markets legislation) and specific issues (issues raised by stakeholders concerning particular omissions or flaws in the current Financial Markets Act). A full list of the proposals is included in Attachment B.

Given that the issues are dealt with sequentially, it may be helpful to see the proposals in summary from the outset, in order to provide better context for the detailed discussion that follows. This summary is provided in Box 1 below.

## BOX 1: SUMMARY OF PROPOSALS

### 1. Weaknesses and limitations of the current financial markets legislation:

- The Financial Markets Act is a very narrow Act – it focuses primarily on regulation of financial market infrastructures and post-trade requirements.
- The Act leaves many South African financial markets unregulated. In recent years, derivatives markets have been brought into the Financial Markets Act, but other over-the-counter markets remain outside the regulatory perimeter.
- Market abuse provisions apply only to regulated markets.
- The general style of the Act is exclusive (with complex definitions) rather than inclusive.
- It places a heavy reliance on financial market infrastructures in regulating market activity.
- There are inconsistencies in the way regulations are applied.
- The Act provides no framework for regulating for financial stability, except for requirements related to central counterparties.

### 2. Proposed coverage of new financial markets legislation:

- It is proposed that the new financial markets legislation be included as a Part in the Financial Sector Regulation Act 9 of 2017, and that it aligns with the scheme contained in that Act. An advantage to this approach would be the reduction of the number of sectoral laws.
- The proposed new financial markets legislation will have a much broader coverage than at present of all financial markets (both organised and over-the-counter) – over-the-counter markets will be designated as “regulated” markets.
- It will place an equal focus on pre-trade and post-trade aspects.
- Market abuse provisions will apply to all financial markets.
- The general style of the new financial markets legislation will be inclusive rather than exclusive.
- The new legislation will accommodate financial innovation, ‘FinTech’, disruptive technologies (through flexible definitions, minimal limits on structures, and conditional licences).

<sup>2</sup>South Africa: Financial Sector Assessment Program - Detailed Assessment of Implementation on the IOSCO objectives and principles of securities regulation (March 2015); Financial System Stability Assessment (December 2014) available at <https://www.imf.org/external/pubs/ft/scr/2014/cr14340.pdf>.

<sup>3</sup>Note: Genesis Analytics Reports commissioned by National Treasury and Financial Sector Conduct Authority but not published include - A future contract for securities market regulations: Review of the Self-Regulation System in South Africa (March 2014); and Assessment of the Impact of Multiple Exchanges in South Africa (July 2018)



**3. Regulatory model for markets:**

- It is proposed that, for organised markets, regulators will receive all regulatory powers in the new Part of the Financial Sector Regulation Act, but may delegate some (non-core) powers and functions to financial market infrastructures. In line with international best practice, it is anticipated that some regulatory responsibilities for overseeing their particular markets will be delegated to financial market infrastructures.
- For over-the-counter markets, a regulator will be assigned for each “regulated” market. The regulator will authorise participants, and set rules for participation and operations. It is proposed that:
  - The Reserve Bank should continue to regulate the foreign exchange market (due to the existence of exchange controls); and
  - The Financial Sector Conduct Authority should regulate all other over-the-counter markets and should regulate jointly with the Prudential Authority where it is applicable.
- Licences (other than financial market infrastructure licences) to participate in financial market activities (e.g., as market makers) will be issued by the Financial Sector Conduct Authority (see Point 5 below) – these should be reasonably standardised.
- Participants will require authorisation in order to participate in particular markets. These authorisations will be issued by the market regulator (in the case of over-the-counter markets) and by the market operator (in the case of organised markets).
- The proposals include establishing a single, strictly advisory, Financial Markets Standards Group to advise the regulators on matters such as codes of conduct and operations of particular markets.

**4. Regulatory model for financial market infrastructures:**

- The proposed new financial markets legislation will strengthen the respective roles of the Financial Sector Conduct Authority, the Prudential Authority and the Reserve Bank.
- In the case of the Reserve Bank, the proposed new legislation will recognise the financial stability function currently contained in Chapter 2 of the Financial Sector Regulation Act. As is current practice, the implementation of this function will be through the Prudential Authority and, to a lesser extent, through the Financial Sector Conduct Authority.
- The definition of financial market infrastructures will be inclusive – including trading venues and payments systems.
- The new financial markets legislation will designate three groups of financial market infrastructures as systemically important: central counterparties, central securities depositories and payments systems.
- While payments systems will be defined as financial market infrastructures and designated in the legislation as systemic, their regulation and supervision will remain under terms set in the current National Payments System Act. That Act will in due course be updated in line with the National Payments System Review process.
- Financial market infrastructures (non-payment) will be supervised as follows:
  - Non-systemically important financial market infrastructures will be licensed, regulated and supervised solely by the Financial Sector Conduct Authority for market efficiency, integrity, and competitiveness.
  - Systemically important financial market infrastructures will face a dual-licensing regime. They will be licensed “for their functions” (e.g., to conduct business as a central counterparty or central securities depository) and regulated for financial stability purposes by the Reserve Bank although, consistent with the current approach under the Financial Sector Regulation Act, the mechanics of licensing and issuing standards relating to safety and soundness, and supervising systemically important financial market infrastructures for compliance with these standards, will be the responsibility of the Prudential Authority. Similarly, the mechanics of issuing and supervising standards relating to market efficiency and integrity will be delegated to the Financial Sector Conduct Authority.

**5. Mechanical aspects of the new financial markets legislation:**

- The new financial markets legislation will be a new Part of the Financial Sector Regulation Act:
  - This will ensure there is consistency within the Financial Sector Regulation Act and avoid duplication;
  - It also reflects the fact that the Reserve Bank, the Prudential Authority and the Financial Sector Conduct Authority each have clearly defined regulatory roles with respect to financial markets (for financial stability, safety and soundness, and market efficiency/integrity).
- The new legislation will introduce new regulatory subcategories and tools, including:
  - Conduct licence (markets) – with categories such as:
    - i. groups of market participants;
    - ii. members of financial market infrastructures;
  - Conduct standards (markets) issued by the Financial Sector Conduct Authority; and
  - Standards issued by the Prudential Authority (for prudential) and by the Financial Sector Conduct Authority (for market efficiency and integrity) for systemic stability requirements and joint standards for systemic stability requirements (issued jointly by the Prudential Authority and the Financial Sector Conduct Authority) – each issued under direction from the Reserve Bank).
- Financial institutions that operate in financial markets will still be required to hold multiple licences.<sup>4</sup> For example, a stockbroker would need a licence in terms of the new financial markets legislation to enable its participation in market activity (requiring compliance with conduct standards aimed at ensuring the efficiency, integrity, and competitiveness of markets) as well as a general conduct licence (under the Conduct of Financial Institutions Act, when it is promulgated) to enable it to interface with financial customers (requiring compliance with general conduct standards aimed at ensuring the fair treatment of financial customers). They would also be required to be authorised by the operators of any organised stock exchange on which they intend to trade.
- Existing licences will be grandfathered, in much the same way as when the Insurance Act was promulgated. For example, exchange licences will be converted.
- It will be important for the regulators to coordinate, so as to eliminate duplication and conflict in licensing conditions.

<sup>4</sup>While references are made here, and elsewhere, to “multiple” and “separate” licences, it is understood that the proposed licensing model for conduct in South Africa is for there to be a single conduct licence with multiple categories and possibly sub-categories. This approach makes good sense. Under this approach, the separate licences mentioned above would be categories within the single conduct licence.

# HIGH-LEVEL ISSUES

This first part of the Discussion Paper addresses critical issues that will shape the new financial markets legislation.

## 1. SCOPE OF THE NEW FINANCIAL MARKETS LEGISLATION

While the title of the current Financial Markets Act refers to “financial markets”, its coverage is, in practice, much narrower than the title suggests.

In designing regulatory architecture, it is common to distinguish between retail and wholesale market segments. The differences between the retail and wholesale levels of financial sector activity are often subtle and blurred. The most widely agreed distinction is that, at the retail level, providers of financial products and services deal directly with the end users of those products and services (e.g., an insurance company writing policies to its customers to cover certain risks) whereas, at the wholesale level, transactions tend to be between financial institutions acting on their own behalf or on behalf of their ultimate customers. It is normally assumed that the intensity of regulatory intervention at the retail level should be greater than at the wholesale level, given the asymmetry of information and power between the providers of financial products and services and their retail customers.

The difficulty with the division into wholesale and retail elements is that the distinction is not only blurred by the involvement of retail customers in some markets and some wholesale customers in the acquisition of some retail financial products and services, it is a division that can shift rapidly with technological innovation. An alternative, simpler, distinction is between:

- Markets – in which financial instruments are traded. That is, participants in these markets both buy and sell financial products and services by making two-way prices.
- Direct provision – in which the financial customer is only a buyer or a seller of a given financial product or service. In these cases, the financial institution makes a one-way price for the customer to respond to. For example, a bank customer can “sell” a deposit to a bank, but it cannot “buy” a deposit from the bank. (In this latter case the bank would deposit the money with the customer.) Using this distinction, a “place” in which deposits are both bought and sold (e.g., the interbank money market), would be defined as a market.<sup>5</sup>

This Discussion Paper focuses exclusively on markets – and the participants and infrastructures that support activities in these markets. Direct provision of financial products and services is the province of the Conduct of Financial Institutions Bill.

Market activity, in turn, can be separated into activities conducted–

- on organised markets, such as equities and derivatives exchanges,<sup>6</sup> and/or
- directly between professional market participants – usually referred to as over-the-counter markets.

Many countries have focused their financial markets laws on regulating organised markets, including the way in which participants in those markets behave, as well as the operation of the financial market infrastructures that facilitate and support the trading, clearing, settling, custody and recording of transactions in these markets. The current Financial Markets Act can best be described as a financial market infrastructures law, in that the bulk of the Chapters of the Act deal with licensing and regulating financial market infrastructures. This is a relatively narrow interpretation of financial markets and financial market activities.

<sup>5</sup>Organised markets are defined in the European Union Markets and Financial Instruments Directive II (MiFID II) of 2014 as multilateral systems operated and/or managed by a market operator, which bring together or facilitate the bringing together of multiple third-party buying and selling interests in financial instruments.

<sup>6</sup>Organised markets are defined in the European Union Markets and Financial Instruments Directive II (MiFID II) of 2014 as multilateral systems operated and/or managed by a market operator, which bring together or facilitate the bringing together of multiple third-party buying and selling interests in financial instruments.

In the South African context these markets are usually referred to as “listed markets”. Internationally, the term “listed” is, however, increasingly an anachronism, and it is proposed to move away from the differentiation between “listed” and “unlisted” markets and adopt the international terminology of “organised” markets.

One of the key observations of the accompanying Financial Markets Review is that over-the-counter markets for financial instruments in South Africa need to be regulated. While Financial Markets Act Regulations, issued in February 2018<sup>7</sup>, provide a regulatory framework for over-the-counter derivative providers, there are other over-the-counter financial markets in South Africa that are not currently captured within the ambit of the current Financial Markets Act. These include active markets such as the foreign exchange market, the securities financing market, and the money market, as well as inchoate markets such as the various markets for crypto assets, to name just a few. In some cases, these over-the-counter markets are covered by law outside the Financial Markets Act; in others there is no specific regulatory framework.

Inevitably, whether any particular over-the-counter market (e.g., a commodities market) should be classified as a “financial” market, is open to debate. However, if the new financial markets legislation is to be comprehensive, it should cover most, if not all, financial markets, whether organised or over-the-counter. Section 7.2 provides more detail on this issue for over-the-counter markets. In some cases, further assessment and a policy decision will be needed to determine whether a particular market should be regulated or exempted.

Any law that addresses financial markets should also include regulation of critical services that support the efficiency of these markets, such as credit-rating agencies, benchmark indexes and other market-related services such as research. There is a particular need to regulate how conflicts of interest are identified and managed in providing these services.

#### **PROPOSAL 1:**

That the coverage of the new financial markets legislation be expanded to include all financial markets in South Africa (subject to materiality), including both organised and over-the-counter financial markets, as well as critical market-related services such as credit-rating agencies, benchmark indexes and market research.

Extending the coverage of the new financial markets legislation to include all over-the-counter markets and critical market-related services will require either amending or repealing some other laws (such as the Credit Rating Services Act (2012)) or incorporating those laws into the new financial markets legislation. The latter approach would be more consistent with the objectives of the new financial markets legislation but would expand the scope of the redrafting exercise considerably. Which of these two approaches is a policy decision.

## **2. FLEXIBILITY OF THE NEW FINANCIAL MARKETS LEGISLATION**

While South Africa’s financial markets have arguably served the country well historically, there were many comments from stakeholders that pointed to flaws in the current Financial Markets Act that tended to create a restrictive, rather than an enabling environment for innovation and growth. This theme is also echoed throughout the Financial Markets Review.

<sup>7</sup>Financial Markets Act, 2012, Regulations (February 2018), available at [http://www.treasury.gov.za/otc/41433\\_9-2\\_NationalRegulation\\_DS.pdf](http://www.treasury.gov.za/otc/41433_9-2_NationalRegulation_DS.pdf).

## **BUILDING COMPETITIVE FINANCIAL MARKETS FOR INNOVATION AND GROWTH**

One particular weakness that was identified in the current Financial Markets Act was that the definition of “exchanges” (for trading on organised markets) was too narrow, thereby making it unclear whether new trading venues such as multilateral trading facilities were covered.<sup>8</sup> Other trading venues and types of trading that are of uncertain legality under the current Financial Markets Act include systematic internalisers, dark pools, and algorithmic and high-frequency trading. In this instance, expanding the scope of the financial markets legislation requires conducting additional assessments.

Similarly, the definition of “securities” in the current Financial Markets Act has been identified as too restrictive. In particular, securities financing transactions have been identified as problematic under the Financial Markets Act (see Issue 14 below). It is also unclear whether the definitions in the current Financial Markets Act are flexible enough to facilitate, for example, the issuance and trading of so-called “Green Bonds” that support the climate and sustainable development goals of the South African government.

Another weakness of the current Financial Markets Act is its approach to defining market participants. These are divided into authorised users (known more commonly as stockbrokers) of exchanges, members of other financial market infrastructures such as clearing and settling infrastructures and over-the-counter derivative providers. These definitions fail to capture many market participants, including participants in other over-the-counter markets. While adopting the exact terminology used by MiFID II would raise potential incompatibility issues in the South African context (see Issue 4 below), there are nevertheless advantages to adopting the general MiFID II approach, which groups all market participants together under some very general criteria.

Of particular importance, the growing role of technology in financial markets makes it difficult to predict what the most efficient trading platforms, depositories, clearing systems and so on might look like in five to ten years. Blockchain technology alone offers the prospect at some time in the future of a single, integrated platform capable of handling trading, clearing, settling and custody. In a potential further disruption, blockchain-based platforms offer the prospect of retail investors participating directly in these processes, without the need to use professional intermediaries. It will be critical that the new financial markets legislation is flexible enough to enable the South African financial system to benefit from technological innovations, especially if they are more efficient than existing technologies, and provided they can be implemented in a way that is safe for end users of the products and services they provide.

One immediate implication of seeking the flexibility to include new technologies is that the primary law should be less detailed, rather than more detailed, since prescription reduces flexibility. As noted earlier, the philosophy underlying the Financial Sector Regulation Act is to include the principles in primary law, and the implementation detail of the regulatory requirements through standards, which can then be adapted relatively easily as circumstances change.

### **PROPOSAL 2:**

- That a broad approach should be taken on the definitions of financial instruments, market participants (which should include their nominees), trading venues, and financial market activities. These should incorporate all currently known instruments, market participants, types of trading platforms, and activities, including multilateral trading facilities, systematic internalisers, dark pools, and high-frequency trading. There should also be flexibility for these definitions to be extended by regulation, along the lines currently used in the definitions of financial products and services in s2 and s3 respectively of the Financial Sector Regulation Act.
- More generally, it is proposed that the new financial markets legislation should adopt the same approach as the Financial Sector Regulation Act with detail, wherever practicable, being left to standards; the one area where detail is still likely to be needed in the new financial markets legislation is in the definition and licensing of financial market infrastructures. It is further proposed that:
  - (a) the regulatory framework should have sufficient flexibility to encompass technological innovation; and
  - (b) to the extent possible, separate licences should be issued for each financial market activity (e.g., trading, clearing, settling, custody), without requiring holders of any given licence to either hold, or not hold, any other particular licence.<sup>9</sup>

<sup>8</sup>Multilateral trading facilities are self-regulated, non-discretionary electronic trading venues that make markets in securities. Article 4 (15) of MiFID describes a multilateral trading facility as: a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract. The term ‘non-discretionary rules’ means that the firm operating the multilateral trading facility has no discretion as to how buyers and sellers may interact. Interests are brought together by forming a contract and the execution takes place under the system’s rules or by means of the system’s protocols or internal operating procedures.

<sup>9</sup> As noted earlier, the “separate” licences, may simply be categories within a single conduct licence.

### **3. OBJECTIVE OF THE NEW FINANCIAL MARKETS LEGISLATION**

Section 2 of the current Financial Markets Act states that this Act aims to:

- (a) ensure that the South African financial markets are fair, efficient and transparent;
- (b) increase confidence in the South African financial markets by-
  - I. requiring that securities services be provided in a fair, efficient and transparent manner; and
  - II. contributing to the maintenance of a stable financial market environment;
- (c) promote the protection of regulated persons, clients and investors;
- (d) reduce systemic risk; and
- (e) promote the international and domestic competitiveness of the South African financial markets and of securities services in the Republic.

It is important that the objective of the new financial markets legislation aligns with and uses terminology consistent with the Financial Sector Regulation Act. In that context, the following observations are offered about the objective of the current Financial Markets Act:

- While the first objective is a reasonable objective for financial market conduct, the Financial Markets Act uses “fair” and “transparent” in preference to “integrity”, as used in the Financial Sector Regulation Act. Around the globe, laws established to regulate financial markets typically express their objectives in terms of some combination of efficiency, fairness, transparency, and integrity. Since a market needs to be fair if it is to be said to have integrity, and transparent if it is to be efficient, the use of all four terms arguably involves some redundancy. Thus, the drafters of the Financial Sector Regulation Act distilled the objectives of market regulation down to efficiency and integrity.
- The first part of the second objective (... that securities services be provided in a fair, efficient and transparent manner) is somewhat duplicative of the first. Further, the narrowing of the focus from “markets” to “services” could be seen as straying into the direct provision space.
- The second part of the second objective is arguably duplicative of the fourth objective of reducing systemic risk.
- The third objective appears to be more relevant to conduct regulation of direct provision of financial products and services (rather than to conduct regulation of markets) – it is also curious that it refers to protection of “regulated persons” (which is not normally an objective of regulation).
- The fourth objective, of reducing systemic risk, is reasonable, given the role of financial market infrastructures in financial markets.
- The fifth is also reasonable as a point of balance, although the terminology requires refining if it is to avoid being misinterpreted as relating to the business of providing physical security to homes and businesses.

Among stakeholder comments received on the current Financial Markets Act there was a preference to see the concepts of “efficiency” and “integrity” spelled out in more detail in the law. The proposal below is consistent with this suggestion. By way of reference, IOSCO defines:

- Market efficiency as the ability of market participants to transact business easily and at a price that reflects all available market information; and
- Market integrity as the extent to which a market operates in a manner that is, and is perceived to be, fair and orderly, and where effective rules are in place and enforced by regulators so that confidence and participation in their market is fostered.

#### **PROPOSAL 3:**

The following objective is proposed for the new financial markets legislation: to-

- (a) reduce systemic risk arising from financial markets and financial market infrastructures (particularly risk arising from a lack of prudential safety and soundness of financial market infrastructures);
- (b) enhance the efficiency and integrity of the South African financial markets; and
- (c) promote the international and domestic competitiveness of the South African financial markets.

The proposed objective suggests that the new financial markets legislation, unlike the current Financial Markets Act, involves shared regulatory responsibilities between the Reserve Bank (responsible for financial stability), the Prudential Authority (responsible for the prudential safety and soundness of financial market infrastructures – the failure of which is the most likely source of systemic instability) and the Financial Sector Conduct Authority (responsible for the efficiency, integrity and competitiveness of financial markets). Importantly, the ordering of the objectives suggests that financial stability (and its foundation stone of prudential soundness) has a higher priority than the objectives relating to efficiency, integrity, and competitiveness. This relative ranking of regulatory priorities is relevant to the question of who should license financial market infrastructures. This is taken up in Section 6 below.

It should be noted that the Financial Sector Regulation Act does not mention “competitiveness” as an explicit objective; however, the authorities as part of performing their functions must consider the aspects of sustainable competition. If the objectives in s7(1) of the Financial Sector Regulation Act are amended to include this concept, the objective will need to be clarified to ensure that the scope excludes macro competition aspects, such as market structure, which are the responsibility of the Competition Commission of South Africa. If this path is followed, it may be necessary to expand the Memorandums of Understanding with the Competition Commission provided for in the Financial Sector Regulation Act.

## **4. RELEVANCE OF MIFID II AND EUROPEAN FINANCIAL MARKET REGULATIONS FOR THE NEW FINANCIAL MARKETS LEGISLATION**

A common theme from consultations with market participants was enthusiasm for (or, at least, acceptance of) aligning the new financial markets legislation with MiFID II and key European supporting regulations (in particular, the European Central Securities Depositories Regulation and Market Abuse Regulation). The European market laws have a number of attractive features.

As proposed above for the new financial markets legislation, MiFID II takes a relatively high-level approach to the primary law, with a focus on providing maximum flexibility – for example, it uses broad, inclusive definitions for trading venues, market participants, investment activities and financial instruments. For example:

- it defines three types of trading venues: regulated markets (conventional exchanges), multilateral trading facilities and organised trading facilities (essentially any trading facility that is not a regulated market or multilateral trading facility);
- it defines all market participants as “investment firms”, and requires all such firms to be licensed;
- investment firms are defined as persons whose regular business is the provision of investment services to third parties and/or the performance of one or more investment activities;
- investment services and activities are defined by a list, although the list is very broad and includes activities such as execution of orders, dealing on own account, portfolio management, investment advice and operation of multilateral trading facilities or organised trading facilities, as well as ancillary services such as custody, research and extending credit to investors to carry out the investment transactions; and
- it defines financial instruments through a list, including transferable securities, money market instruments, units in undertakings for collective investments in transferable securities, structured deposits, depositary receipts, derivatives products, and emission allowances.

While MiFID II provides a useful guiding model in some respects, it has some limitations in others. In particular:

- The scope of MiFID II does not align exactly with that of either the current Financial Markets Act or the proposed new financial markets legislation:
  - unlike the current Financial Markets Act, MiFID II covers both markets and some direct provision, in that it includes investment advice to retail customers and financial product manufacturing considerations;
  - unlike the proposed new financial markets legislation, MiFID II does not cover all financial market infrastructures (see Issue 5 below); and



- MiFID II and the European regulations use some terminology that is special to the European Union (e.g., “investment firms” for market participants, whereas South Africa uses authorised users and members), some of which may be suitable for the new financial markets legislation, but others of which will not be.
- Noting the challenges observed with implementation of MiFID II requirements by the regulators and market participants, adopting some of the approaches in MiFID II will have to consider the new developments and revisions to that framework, and importantly South Africa’s domestic setup.

#### **PROPOSAL 4:**

That European market laws such as MiFID II and related regulations (and other international equivalents) be considered as a general model for guidance on a range of issues in drafting the new financial markets legislation, while recognising that there will be many areas in which deviations will be needed for both local and practical reasons.

## **5. FINANCIAL MARKET INFRASTRUCTURES IN THE REVISED FINANCIAL MARKETS LEGISLATION**

As noted above, the current Financial Markets Act does not regulate all financial market infrastructures in the South African financial system. The most notable exception from the set of financial market infrastructures covered by the Financial Markets Act is payments systems, which are regulated by the Reserve Bank under the National Payments System Act. The discussion below addresses whether or not payments systems should be included under the new financial markets legislation (if only for definitional completeness), as well as how financial market infrastructures should be regulated under the new financial markets legislation.

### **5.1 DEFINITION OF FINANCIAL MARKET INFRASTRUCTURES**

There are two separate issues involved with the definition of financial market infrastructures. The first is the relatively mechanical question of whether the language in the Financial Sector Regulation Act should be amended from “market infrastructures” to “financial market infrastructures”. While both terms are used internationally, the latter term is the more common in international regulatory discussions and documents. The former term, market infrastructures, was used in the Financial Sector Regulation Act in order to be consistent with the terminology used in the Financial Markets Act at the time. The fact that the Financial Markets Act will be replaced by the new financial markets legislation removes this constraint and offers the opportunity to align the South African terminology with that used elsewhere in global markets.

#### **PROPOSAL 5:**

That the new financial markets legislation adopt the widely used term “financial market infrastructures” and that the Financial Sector Regulation Act be amended to replace the term “market infrastructures” with “financial market infrastructures”.

The second issue is more substantive; namely, should financial market infrastructures be defined by their core functions, or by a list of institutional types? The question has two layers. One could argue that the current Financial Markets Act takes both approaches. At the aggregate level, the Financial Markets Act defines financial market infrastructures by an institutional list (each of which has a Chapter addressing how it is to operate and be regulated). The list includes:

- exchanges;
- central securities depositories;
- clearing houses;
- central counterparties; and
- trade repositories.

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The weakness of relying on a list approach is that it automatically excludes any financial market infrastructure that is not on the list. For example, given their primary function, payments systems are arguably financial market infrastructures, yet they are excluded from the definition of financial market infrastructures in the Financial Markets Act by omission from the list.

While the Financial Markets Act takes an institutional list approach at the aggregate level, each of the categories of financial market infrastructure is then defined by the functions it performs. The functions are quite detailed and specific. For example, according to s30(2) of the Financial Markets Act, a licensed central securities depository must meet an exhaustive list of requirements, including-

- (a) constituting, maintaining and providing an infrastructure for holding uncertificated securities which enables the making of entries in respect of uncertificated securities;
- (b) constituting, maintaining and providing an infrastructure, which infrastructure will include a securities settlement system;
- (c) performing custody and administration in respect of a central securities account;
- (d) issuing depository rules;
- (e) supervising compliance by participants with the depository rules and depository directives; and
- (f) other additional requirements.

While useful in parameterising what is expected of a licensed central securities depository, an exhaustive list of functions can also be restrictive in that it requires every licensed financial market infrastructure to perform all the functions listed for that category of financial market infrastructure. Importantly, an exhaustive list of functions provides no flexibility to address changes that may arise as a result of technological innovation (see Issue 2 above on the flexibility of the new financial markets legislation).

An alternative approach would be to use a very broad definition of financial market infrastructures based on their essential nature as shared industry platforms. Such a definition is provided by the Committee on Payments and Settlement Systems for the Bank for International Settlements (since renamed the Committee on Payments and Market Infrastructures (CPMI)) and the Technical Committee of IOSCO in their proposed Principles for Financial Market Infrastructures, which state that a financial market infrastructure is:

*A multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling or recording payments, securities, derivatives or other financial transactions.*

A broad definition (such as the one above) would capture any financial market infrastructure that met the minimum requirements of the definition. It would, for example, capture all but one of the categories listed in the Financial Markets Act, as well as payments systems and any other system used for clearing or settling financial market transactions.

The one category of financial market infrastructure in the Financial Markets Act list that would not be captured by the above definition is exchanges. The CPMI-IOSCO definition deliberately limits financial market infrastructures to systems that deal with post-trade activities. The Principles for Financial Market Infrastructures nonetheless note that:

*“... the principles in this report are not addressed to market infrastructures such as trading exchanges, trade execution facilities, or multilateral trade-compression systems; nonetheless, relevant authorities may decide to apply some or all of these principles to types of infrastructures not formally covered by this report.*

There should be no question that exchanges and other trading venues should be regulated under the new financial markets legislation. The only issue in this respect is whether the new financial markets legislation:

- (a) conforms with the CPMI-IOSCO definition of financial market infrastructures and then includes a separate category of “market infrastructures” to include trading venues; or
- (b) broadens the CPMI-IOSCO definition to include pre-trade infrastructures such as trading venues, as well as post-trade financial market infrastructures.

The division of infrastructures into market infrastructures (pre-trade) and financial market infrastructures (post-trade) is arguably unnecessarily pedantic (especially given that the use of the descriptor “financial” to distinguish post-trade infrastructures is unhelpful in

identifying the source of the distinction). It is also specific to securities markets; the distinction is less clear for other financial markets. There is a strong case for including trading venues in the definition of South African financial market infrastructures.

Similarly, at the financial market infrastructure category level, it would be more logical for the definitions to focus on “core functions” only, thereby leaving flexibility for the authorities to license new entrants that intend to specialise in subsets of infrastructure activities, where such specialisation makes good business sense and does not compromise market integrity or stability. The European legislation provides a guide to this style of definition. By way of illustration, in contrast to the long list of functions listed for a central securities depository under the current Financial Markets Act (see above), the European Union Regulation of 2014 defines a central securities depository as an entity which operates a securities settlement system (“settlement service”) and at least one of the following two core services:

- records newly issued securities in a book-entry system (“notary service”); and
- provides and maintains securities accounts at the top tier level (“central maintenance service”).

In practice, many central securities depositories provide not only all three of the services listed above, but also additional services such as services that are connected with the securities life cycle and as are usually supplied by banks as part of their custody business, including cash accounts, overnight credit, securities lending, cash management and guarantees.

The new financial markets legislation need not accept the definition of the core function of a central securities depository contained in the European Union’s Central Securities Depository Regulations. Indeed, there is a case that, in the South African context, settlement and securities administration services are equally important, and could even be identified as separate core functions. The point of the European approach is that, while a central securities depository is neither required to, nor prevented from, taking on additional functions beyond the core functions, the way in which it is regulated is responsive to the risks involved. If additional activities add material risk to the underlying core central securities depository functions, the weight of regulatory intervention should increase commensurately.

#### **PROPOSAL 6:**

That a financial market infrastructure be defined in the following general terms:

- A multilateral system among participating institutions, including the operator of the system, used for the purposes of trading, clearing, settling or recording payments, financial instruments, derivatives or other financial transactions.

And that particular categories of financial market infrastructures be defined by their core functions, rather than by an exhaustive list of functions, and that the risk-based regulatory framework take full account of the risks posed by additional activities to core functions.

## **5.2 PAYMENTS SYSTEMS AS FINANCIAL MARKET INFRASTRUCTURES**

There are currently seven payments systems in operation in South Africa:

- South African Multiple Option Settlement (SAMOS) system (RTGS) – operated by the Reserve Bank;
- Southern African Development Community Integrated Regional Electronic Settlement System (SIRESS) (which settles cross-border transactions) – operated by the Reserve Bank;
- The Continuous Linked Settlement (CLS) system (which settles designated foreign exchange transactions) – operated by CLS bank;
- Automated clearing house/Clearing system (which clears retail transactions) – operated by BankservAfrica;
- Clearing system (automated clearing house) (which clears the payment leg of equities, bonds and money-market transactions) – operated by Strate;

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- Clearing system (automated clearing house) (which clears retail card transactions) – operated by Visa; and
- Clearing system (automated clearing house) (which clears retail card transactions) – operated by Mastercard.

The Reserve Bank currently oversees each of these payment systems as well as operating SAMOS and SIRESS.<sup>10</sup> The Financial Markets Act excludes these systems (by not including them in the list of financial market infrastructures). At the time the Financial Sector Regulation Act was being drafted, the decision was taken to leave payments systems out of the reforms. Replacing the Financial Markets Act with the new financial markets legislation provides the opportunity to reconsider whether they should be included in the new framework.

The case for including payments systems in the category of financial market infrastructures for regulatory purposes rests primarily on the principle of consistency. There can be no dispute that payments systems meet the definition of financial market infrastructures suggested above. Indeed, even if taking a “list” approach to defining financial market infrastructures, any logical list would include all systems for trading, clearing, settling, custody and recording transactions. On the “duck” principle, payments systems, which facilitate settlement, are financial market infrastructures. Logically, they should fit into the Twin Peaks regulatory framework in the same way that other financial market infrastructures do.

Logically, they should fit into the Twin Peaks regulatory framework in the same way that other financial market infrastructures do.

The case for excluding them is that central banks around the globe have historically regulated payments systems, often informally. Given that payments systems have historically functioned very reliably, there is an argument that there is no need to change this.

The following observations are relevant:

- First, including payments systems within the definition of financial market infrastructures does not necessarily imply changes in either who regulates them or how they are regulated. They could, for example, be recognised as financial market infrastructures in the new financial markets legislation, but then carved out from the regulatory framework of the new legislation and left with the regulatory framework in the National Payment System Act, with oversight left to the Reserve Bank as empowered through the Reserve Bank Act, as is currently the case.
- Second, while inclusion of payments systems within the definition of financial market infrastructures does not necessarily lead to changes in the regulatory framework for payments, as noted in the National Payment System Act:
  - does not provide for licensing of payments system operators;
  - is insufficiently flexible for dealing with new technologies (e.g., M-Pesa and crypto assets);
  - lacks many of the supervisory and enforcement powers present in the Financial Sector Regulation Act, including:
    - the power to issue standards;
    - the powers to regulate and supervise conduct matters;
    - effective compliance and enforcement mechanisms;
    - effective administrative powers, such as financial penalties;
  - has complex governance arrangements;
  - has an outdated self-regulatory model;
  - lacks a proper appeals mechanism; and
  - is not fully consistent with international standards for payments system regulation.

While the comments in this Discussion Paper relating to payments systems are primarily focused on the regulatory architecture, the general thrust of the reforms proposed by the Review of the National Payment System Act are in close alignment with the proposals for the new financial markets legislation.

<sup>10</sup>While internally, the Reserve Bank delegates the regulatory role for payments systems to the National Payments System Department, for the purposes of this Discussion Paper, no distinction is drawn between Departments within the Reserve Bank. Hence all references in this paper to “the Reserve Bank” should be read as including reference to National Payments System Department.

It is worth noting that some of the recommended changes to the National Payment System Act made by the Review of the National Payment System Act would be addressed automatically by including payments systems under the definition of financial market infrastructures in the new financial markets legislation (e.g., licensing powers, powers to issue standards, supervisory powers, enforcement powers). However, many of the proposed reforms to the National Payment System Act would still need to be addressed separately. These could be implemented by revising the National Payment System Act as a separate Act or by integrating the revised National Payment System Act into the Financial Sector Regulation Act. Preferably, as the National Payment System Act is currently under review, there should be consideration made on some of the gaps identified in the review, such as the framework for licensing and the supervisory and enforcement powers vis a vie the Financial Sector Regulation Act.

Including payments systems in the group of financial market infrastructures (or, more accurately, not excluding them – since the definition suggested in sub-issue 5.1 above should lead to their automatic inclusion) does not pre-judge who will regulate them, or how they will be regulated. Those matters are the subject of a separate discussion (see sub-issues 5.6 and 6.1 below).

#### **PROPOSAL 7:**

That payments systems be included in the definition of financial market infrastructures in the new financial markets legislation.

### **5.3 SYSTEMICALLY IMPORTANT NON-FINANCIAL INSTITUTIONS**

The CPMI-IOSCO Principles for Financial Market Infrastructures recognise that the operational reliability of a financial market infrastructure may be dependent on the continuous functioning of services provided by non-financial service providers such as telcos, information providers and messaging providers. The Principles recognise that regulators may wish to establish expectations for a financial market infrastructure's critical service providers, in order to support the financial market infrastructure's overall safety and efficiency.

Establishing reasonable expectations of critical service providers does not require the providers to be regulated by the same regulator as financial market infrastructures. The expectations can be established through an outsourcing policy for financial market infrastructures or by cooperation between the regulator of financial market infrastructures and the regulator of the critical service providers (assuming there is such a regulator).

Perhaps the most obvious candidates for this type of inclusion are critical service providers to payments systems, for example, messaging services such as the Society for Worldwide Interbank Financial Telecommunication (SWIFT) that provide secure financial messaging services. Based on the model proposed in Section 1, services such as these could be included in the category of critical market-related services, which would automatically then bring them into the financial regulatory net.

The more difficult issue is how far out from core financial services should the regulatory net extend (e.g., other messaging services such as Bloomberg Chat)?

Since there is little common ground in regulating financial and non-financial entities, and there are other channels for establishing service expectations for critical service providers, it would be premature to extend the financial regulatory net by too much at this stage.

The easiest way to include these providers in the regulatory net, without creating yet another category of regulated institution, would be to include them within the definition of critical market-related services (credit rating services, etc.). As is the case with other category definitions in the Financial Sector Regulation Act, flexibility can be achieved by providing the Minister with the power to designate a particular service to be a critical market-related service. There is also a case for linking critical market-related services to the power of the Governor, under s29(1)(a), to designate a provider of critical market-related services to be systemically important, should the need arise.

#### PROPOSAL 8:

That certain non-financial institutions that provide critical market-related services be included within the category of regulated institutions. The initial list of services in this category will include credit-rating agencies, providers of financial benchmark indexes, financial market research and messaging services such as SWIFT. The law should take a flexible approach to the definition of critical market-related services so that the list may be extended over time if circumstances so warrant.

It is also proposed that critical financial market-related services be incorporated into the Governor's power under s29(1)(a) to declare the provider of a financial product or service to be systemically important, along with guidance as to what might constitute "systemic importance" in these cases.

## 5.4 OBJECTIVES OF REGULATING FINANCIAL MARKET INFRASTRUCTURES

The core objectives of financial market infrastructure regulation in most countries can be reduced to the following two:

- The traditional objective focuses on the efficiency and integrity of financial markets. Thus, for example, organised markets such as stock exchanges have traditionally been regulated by market conduct regulators with a view to ensuring transparency over bids, offers and transactions, minimising transactions costs and preventing various forms of market abuse. In some countries, competitiveness has been added to the objectives, as suggested in Proposal 3.
- The newer objective focuses on the potential for some financial market infrastructures to destabilise the financial system in the event that the infrastructure ceases to operate, due to either a technological flaw in the infrastructure, or the failure of the safety and soundness of the operator of the infrastructure. For example, the sheer size of derivatives settlements exposures in 2008, and the potential disruption that would have occurred in global financial markets had a major international central counterparty failed at that time, provided the catalyst for the subsequent rethinking of how over-the-counter derivatives transactions are cleared, and the way in which central counterparties are regulated.

An interesting question here is whether the second object of the Financial Sector Conduct Authority is relevant in the case of financial market infrastructures; namely, the need to protect financial customers by promoting fair treatment by financial institutions. As noted earlier, fair treatment of customers is largely focused on the direct provision of financial products and services, rather than on the trading of financial products in financial markets. While it will almost certainly be the case that market participants will need both a financial markets licence (to trade in a particular market) and a direct provision licence (to provide those same services to financial customers), the case is less obvious for financial market infrastructures. While instances cannot be ruled out in which the operator of a financial market infrastructure may deal directly with financial customers (e.g., the outer levels of the payments system, such as third-party payments providers), the normal case, at least at the moment, is that financial market infrastructures deal primarily with professional financial institutions that are authorised members of the financial market infrastructure. Of course, this status quo may change with technological innovation (e.g., trading in equities without the need to go through a stockbroker).

It will be important to retain flexibility to deal with changing circumstances and technology. Nevertheless, for the immediate future, the regulatory objective of competitiveness is regarded as providing sufficient flexibility for the authorities to take action to ensure that doing business through any financial market infrastructure does not lead to unfair treatment of end users, either through exclusion or through excessive cost.

The other implication of these twin objectives is that not all financial market infrastructures need to be regulated in the same way. From a financial market conduct perspective, all financial market infrastructures need to be regulated with a view to achieving market efficiency, integrity and competitiveness. From a financial stability perspective, however, only the subset of financial market infrastructures that are designated to be systemically important warrant regulation to support financial stability (primarily through prudential regulation). These systemically important financial market infrastructures need to be regulated for their safety and soundness as well as for any other aspects that could affect financial stability (see sub-issue 5.6 below for a fuller discussion about how financial market infrastructures should be regulated).

## **PROPOSAL 9:**

That financial market infrastructures be classified into two categories: systemically important financial market infrastructures and other financial market infrastructures.

- All financial market infrastructures should be subject to regulation for market efficiency, fairness, and competitiveness.
- systemically important financial market infrastructures should be subject to additional regulation (for safety and soundness) with a view to supporting financial stability.

## **5.5 DEFINING SYSTEMIC IMPORTANCE OF FINANCIAL MARKET INFRASTRUCTURES**

Since systemically important financial market infrastructures will be subject to additional regulatory oversight for financial stability purposes, inclusion in the group designated as systemically important is likely to have some adverse implications for their profitability.

Under s29(1)(a) of the Financial Sector Regulation Act, the Governor of the Reserve Bank may:

*By written notice to a financial institution, designate the institution as a systemically important financial institution.*

This section applies to all individual financial institutions, including financial market infrastructures (as currently defined under the Financial Sector Regulation Act). While s29 provides guidance to the Governor, and a process for the institution to make submissions on the matter, s29 essentially leaves the final judgment to the Governor as to whether or not a particular financial market infrastructure is systemically important.

An alternative approach is to define systemic importance of financial market infrastructures in law. The case for this alternative approach is that it provides greater transparency for financial institutions. The case for leaving it to the Governor under s29(1)(a) rests on two weaknesses of the alternative approach:

- First, any attempt to codify what is meant by “systemically important” is almost certain to be deficient, in that it will be unlikely to adequately anticipate changes in the economic environment over time that may increase or decrease the potential systemic impact of the failure of any given financial market infrastructure (or other type of financial institution).
- Second, codifying the concept in law is likely to encourage institutions designated to be systemically important to challenge that classification in the courts, thereby unnecessarily tying up legal and regulatory resources.

While codifying the parameters of systemic importance in law has the limitations noted above, leaving the judgement to the Governor under s29 is not the only alternative. A third alternative is to simply designate certain financial market infrastructure groups to be systemically important in the law. While the approach under s29 makes good sense for individual financial institutions, in the case of financial market infrastructures, systemic importance is less nuanced. There is therefore a case for treating the two groups differently.

The designation of a particular financial market infrastructure or group of financial market infrastructures as systemically important rests on a number of considerations. Arguably the most critical is whether, in the event of a business failure of the operator of the financial market infrastructure, the financial system could encounter significant disruption. There is universal agreement that payments systems are systemically important. Securities clearing and settlement facilities, including central counterparties and central securities depositories, are also widely agreed to be systemically important. If the financial system had to wait even a fraction of the time it could take to resolve a failed central counterparty or central securities depository through the court system, the systemic damage could be immense. Hence there is a strong case to designate them as systemically important and to impose on them very strong prudential requirements, including capital, liquidity back up and a recovery and resolution framework that gives the regulator the power to step in and either assume the clearing and settling responsibilities of the failed securities clearing and settlement facility or transfer them to another facility.

#### PROPOSAL 10:

That the following three groups of financial market infrastructures be designated as systemically important (systemically important financial market infrastructures): central counterparties; central securities depositories; and payments systems.

To avoid doubt, any member of a group of financial market infrastructures that is designated as systemically important will automatically be designated as a systemically important financial market infrastructure. The regulator (or regulators) should nevertheless be able to apply less onerous regulatory standards to a member of a systemically important financial market infrastructure group that is not by itself considered to be systemically important.

The definition of systemically important financial market infrastructures in Proposal 10 is not entirely consistent with the definition used by the CPMI and IOSCO in drafting the Principles for Financial Market Infrastructures, in that Proposal 10 does not include trade repositories. The exclusion of trade repositories is deliberate, in that they do not fit the above criteria of posing systemic disruption in the event of the failure of an operator of such a repository.

As noted earlier, including payments systems within the definition of systemically important financial market infrastructures does not preclude carving out their regulatory framework from the new financial markets legislation and addressing it in a separate revision of the National Payment System Act. Given that such a carve out is suggested in a later proposal, the discussion of regulating financial market infrastructures that follows in the remainder of this and the next section will be directed at non-payment financial market infrastructures.

## 5.6 REGULATING (NON-PAYMENT) FINANCIAL MARKET INFRASTRUCTURES

As noted above, the objective of regulating financial market infrastructures depends on the type of financial market infrastructure:

- All financial market infrastructures require regulation for the purposes of achieving the efficiency, integrity, and competitiveness of the financial system.
- Those financial market infrastructures that are designated to be systemically important also require prudential regulation and supervision for the purposes of supporting financial stability.

The way in which the Financial Sector Conduct Authority regulates financial markets for efficiency, integrity and competitiveness, and the extent to which the details of that regulatory approach are codified in primary law or left to conduct standards, is taken up in later issues. The key issue at this point is how systemically important financial market infrastructures should be regulated and whether additional regulatory tools need to be included in the new financial markets legislation.

The starting point for regulating systemically important financial market infrastructures is the CPMI-IOSCO Principles for Financial Market Infrastructures. While not all of the 24 Principles identified by CPMI-IOSCO apply to every systemically important financial market infrastructure, they are useful to list in general terms:

- Principle 1: There should be a strong legal basis for all aspects of the systemically important financial market infrastructure's activities.
- Principle 2: Systemically important financial market infrastructures should be appropriately governed.
- Principle 3: Systemically important financial market infrastructures should have a comprehensive framework for managing the risks to which they are exposed.
- Principle 4: Systemically important financial market infrastructures should have appropriate systems in place for measuring and managing credit risk.
- Principle 5: Systemically important financial market infrastructures should take a prudent approach to collateral management.
- Principle 6: Systemically important financial market infrastructures that are central counterparties should have an appropriate margining system.
- Principle 7: Systemically important financial market infrastructures should manage their liquidity risk.
- Principle 8: Systemically important financial market infrastructures should have, and adhere to, clear rules that define final settlement.



- Principle 9: Systemically important financial market infrastructures should settle in central bank funds or, where this is impractical, in funds with little or no credit or liquidity risk.
- Principle 10: Systemically important financial market infrastructures should have clear rules with respect to physical deliveries.
- Principle 11: Systemically important financial market infrastructures that are central securities depositories should have appropriate safeguards to protect issuers and holders.
- Principle 12: Systemically important financial market infrastructures that are exchange-of-value settlement systems should eliminate principal risk.
- Principle 13: Systemically important financial market infrastructures should have participant default rules and procedures.
- Principle 14: Systemically important financial market infrastructures that are central counterparties should have segregation and portability arrangements that protect customer positions and collateral.
- Principle 15: Systemically important financial market infrastructures should manage general business risk.
- Principle 16: Systemically important financial market infrastructures should manage their custody and investment risks.
- Principle 17: Systemically important financial market infrastructures should manage their operational risks.
- Principle 18: Systemically important financial market infrastructures should allow fair and open access and participation.
- Principle 19: Systemically important financial market infrastructures should be able to identify separately direct and indirect participation.
- Principle 20: Linked systemically important financial market infrastructures should understand and manage the risks involved.
- Principle 21: Systemically important financial market infrastructures should be efficient and effective in their operations and should be regularly reviewed for these.
- Principle 22: Systemically important financial market infrastructures should accommodate internationally accepted communication procedures.
- Principle 23: Systemically important financial market infrastructures should meet high disclosure standards.
- Principle 24: Systemically important financial market infrastructures that are trade repositories should provide accurate and timely data in line with regulatory and industry expectations.

Most countries that have started regulating systemically important financial market infrastructures for financial stability purposes have adopted these principles as a base regulatory framework. While extensions beyond the Principles for Financial Market Infrastructure have been few to date, most regulators have introduced at least a requirement for systemically important financial market infrastructures to have a recovery and resolution plan.

A key question is whether or not the new financial markets legislation needs to introduce new regulatory powers in order to implement the financial stability regulatory framework outlined in the CPMI-IOSCO Principles.

Consistent with the philosophy underlying the Financial Sector Regulation Act, implementation of these regulatory requirements should be primarily through standards, rather than through codification in the Financial Sector Regulation Act itself. There will, of course, be exceptions to this rule (such as the need for systemically important financial market infrastructures to have a strong legal basis), but the general intent should be to implement the CPMI-IOSCO Principles through standards. The question therefore is whether the Financial Sector Regulation Act provides sufficient flexibility for the regulators to meet the Principles through standards?

Section 106 of the Financial Sector Regulation Act enables the Financial Sector Conduct Authority to issue conduct standards on a wide range of matters. This range of conduct standards will be expanded in the new financial markets legislation (see Section 7.4 below) to include market conduct standards. The focus of these standards will nevertheless remain firmly grounded in efficiency, integrity, and competitiveness. While some of the CPMI-IOSCO Principles summarised above could be addressed through conduct standards (e.g., Principle 21 (efficiency) and Principle 23 (disclosures)), the majority of the Principles relate to matters that are more aptly described as prudential (to the extent that prudential soundness of systemically important financial market infrastructures underpins financial stability).

Section 30 of the Financial Sector Regulation Act empowers the Reserve Bank to direct the Prudential Authority to impose, either through prudential standards or directives, regulatory requirements on systemically important financial institutions. These requirements may be applied to one or more specific institutions, and may address the following matters:

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- (a) solvency measures and capital requirements, which may include requirements in relation to counter-cyclical capital buffers;
- (b) leverage ratios;
- (c) liquidity;
- (d) organisational structures;
- (e) risk management arrangements, including guarantee arrangements;
- (f) sectoral and geographical exposures;
- (g) required statistical returns;
- (h) recovery and resolution planning; and
- (i) any other matter in respect of which a prudential standard or regulator's directive may be made that is prescribed by Regulations made for this section on the recommendation of the Governor.

The matters identified in s30 are in some ways broader, and in others narrower, than the matters covered in the CPMI-IOSCO Principles. While issuing standards for the bulk of the Principles could be justified under s30(1)(e) (risk management arrangements), the Governance Principle (Principle 2) and Operational Principles (Principles 10,19,20 and 22) are less clear-cut. While it is unlikely that the Reserve Bank's authority would be challenged, and additional matters may be prescribed by regulation, there is a case for providing greater clarity than is currently provided by s30(1).

While terminology is arguably more form than substance, internationally, standards that address systemically important financial market infrastructures are usually referred to as "systemic stability" or "financial stability" standards. In contrast, the Financial Sector Regulation Act refers to them as "prudential" standards. In the interests both of clarity and international consistency there is a case for changing the terminology in the Financial Sector Regulation Act to align with international practice (with a preference for "systemic stability" rather than "financial stability", although this may require amendment to terminology used elsewhere in the Act). It is important that systemic stability standards are distinguished from other prudential standards, by their purpose - even though they may in many cases cover similar subject matters (e.g., capital, liquidity and governance).

Section 30(1), as originally drafted, was structured the way it was primarily to avoid having the Reserve Bank issue standards to systemically important financial institutions that duplicated or conflicted with prudential standards issued by the Prudential Authority. The Reserve Bank was nevertheless identified as the "owner" of those standards, even though they were issued and supervised by the Prudential Authority.

This structure was designed largely with banks in mind. At the time the Act was being drafted, the idea of financial market infrastructures as systemically important was relatively new, the Principles for Financial Market Infrastructures were largely untested, and the ideas of systemic stability standards and financial stability regulation were yet to emerge. The fact that standards for systemically important financial market infrastructures under the Financial Sector Regulation Act are still emerging makes concern about duplication less of an issue for financial market infrastructures than for systemically important banks. Nevertheless, at least with respect to prudentially oriented systemic stability standards, consistency suggests maintaining the existing arrangements in the Financial Sector Regulation Act whereby the Reserve Bank is given responsibility for designing systemic stability standards for systemically important financial market infrastructures, but the Prudential Authority is assigned responsibility for issuing and supervising industry compliance with the standards. A key principle underlying those arrangements at the time they were introduced was the notion that, while the Reserve Bank would have responsibility for financial stability, it would not be an active supervisor.

The case for maintaining this structure is threefold:

- First, while many of the Principles for Financial Market Infrastructures are motivated by financial stability considerations, they are primarily prudential in nature;
- Second, in view of the prudential underpinnings of financial stability regulation and supervision of individual institutions, it could be potentially destabilising to have the Reserve Bank and the Prudential Authority playing overlapping, and potentially conflicting roles; and

- Third, the Financial Sector Regulation Act is still a relatively new law. It makes sense to allow time for the existing arrangements to be fully implemented before changing them. If subsequent events require the Reserve Bank to take a more active role as a financial stability regulator and supervisor, these arrangements may need to be revisited. For the immediate future, however, preserving the existing arrangements is likely to be the least disruptive option.

As noted above, the Principles for Financial Market Infrastructures also address conduct issues. Thus, the new financial markets legislation should encompass not only systemic stability standards of a prudential nature, but also systemic stability standards of a conduct nature. In this regard the logical approach in the new financial markets legislation is a parallel arrangement to that above, whereby the Reserve Bank is assigned responsibility for designing systemic stability standards of a conduct nature for systemically important financial market infrastructures, but the Financial Sector Conduct Authority is assigned responsibility for issuing the standards (under direction from the Reserve Bank) and for supervising the industry's compliance with the standards.

#### **PROPOSAL 11:**

**That:**

- the definition of financial institutions in s1 of the Financial Sector Regulation Act be amended to remove financial market infrastructures and to establish financial market infrastructures as a separate category of institutions (with systemically important financial market infrastructures as a subcategory);
- Part 2 of Chapter 7 of the Financial Sector Regulation Act be amended to introduce a new category of "systemic stability standards", applicable to systemically important financial market infrastructures and other systemically important financial institutions, the substance of which should include, but not be limited to, the matters in the Principles for Financial Market Infrastructures (e.g., they will still need to cover the additional prudential aspects identified in s30(1) for systemically important financial institutions);
- It be made clear that, where systemic stability standards for systemically important financial institutions overlap with existing prudential standards that apply more broadly, the intention of the systemic stability standards should be additional to the existing requirements; and
- the Reserve Bank's power in s30 be broadened to enable the Reserve Bank to direct the Prudential Authority to issue systemic stability standards on prudential matters, the Financial Sector Conduct Authority to issue systemic stability standards on conduct matters and, where warranted, to direct the Prudential Authority and Financial Sector Conduct Authority to issue joint systemic stability standards. As with the existing s30, where systemic stability standards are issued under direction, they should be developed and issued in close consultation with the other regulators.

The current inclusion of financial market infrastructures within the category of financial institutions will result in a material number of provisions of the Financial Sector Regulation Act applying to them. Establishing them as a separate category of institutions for systemic purposes will automatically exclude them from these provisions unless they are explicitly re-included. The drafters will need to be careful to identify all the clauses that will need to be redrafted to extend their application to financial market infrastructures.

## **6. ALLOCATING REGULATORY RESPONSIBILITIES UNDER THE NEW FINANCIAL MARKETS LEGISLATION**

The allocation of regulatory responsibilities is fundamental to the implementation of Twin Peaks in South Africa. In the case of prudential responsibilities and direct provision conduct responsibilities, the allocation between the Prudential Authority and the Financial Sector Conduct Authority is relatively clear-cut. It is less clear-cut in the market conduct space, where prudential, conduct and financial stability responsibilities overlap. It is also the area in which other countries have struggled most to define the appropriate roles of the different regulators.

The issues have become more complex by the post-2008 recognition of the systemic significance of certain financial market infrastructures and the fact that these have historically been regulated exclusively by conduct regulators (with the exception of payments systems, which have traditionally been regulated by central banks).

The primary responsibilities for the Financial Sector Regulation Act's objectives are allocated as follows:

- Financial stability to the Reserve Bank;
- Safety and soundness of financial institutions to the Prudential Authority (including market infrastructures);
- Fair treatment and customer protection to the Financial Sector Conduct Authority; and
- Efficiency and integrity of the financial system to the Financial Sector Conduct Authority.

The allocation of two responsibilities to the Financial Sector Conduct Authority reflects the fact, noted earlier, that conduct regulation has both market and direct provision components.

With respect to most providers of financial products and services there is a role for at least two, and in some cases all three, of the regulatory agencies to be involved. For example, banks are regulated for prudence by the Prudential Authority and for direct provision conduct by the Financial Sector Conduct Authority. If a bank is designated to be a systemically important financial institution, the Reserve Bank also has a role to play in designing the financial stability requirements that such a bank must meet.

Financial markets are more complex, because of the role of specialised financial market infrastructures, the fact that some of these are systemically important and the fact that the need for regulation extends beyond the participants in any given market to include the operators of the markets or infrastructures.

## 6.1 REGULATORY RESPONSIBILITIES FOR FINANCIAL MARKET INFRASTRUCTURES

Leaving aside the question of the role for financial market infrastructures for the moment (see Issue 7 below), the key issues for financial market infrastructures are:

- Who should license them (i.e., to perform their core financial market infrastructure functions – e.g., to be a central counterparty or an exchange);
- Who should set the regulatory requirements with which they must comply; and
- Who should supervise them?

Before turning to the South African context, there are two Twin Peaks precedents worth considering: Australia and the United Kingdom.

### AUSTRALIA

Australia identifies four main categories of financial market infrastructures: market operators (such as securities exchanges); securities clearing and settlement facilities; derivative trade repositories; and payments systems. Securities clearing and settlement facilities are further divided into central counterparties and securities settlement facilities.

The separation of clearing and settling facilities into securities clearing and settlement facilities and payments systems is important in understanding how regulatory responsibilities are allocated in Australia. Section 768A(2)(h) of the Australian Corporations Act explicitly exempts payments system facilities (i.e., a facility for the exchange of non-cash payments) from the definition of a securities clearing and settlement facility.<sup>11</sup> Securities clearing and settlement facilities were established to clear and settle transactions from over-the-counter and exchange traded markets. In the cases of both central counterparties and securities settlement facilities, the clearing and settling entity stands between buyers and sellers and takes on the trade obligations of the two parties.

<sup>11</sup>Payments between financial institutions in Australia are settled through one of several systems, including the RITS system (Australia's high-value RTGS settlement system), which is operated by the Reserve Bank of Australia, AusPayNet (which manages clearing for cheques, direct entry payments, ATMs, debit cards and high-value payments), credit card payments clearing systems (Visa and Mastercard), ePal and BPAY. Most recently, a New Payments Platform, was introduced to enable individuals and small businesses to make real-time, small-value payments from domestic accounts (including through the mobile phone network).

While the Reserve Bank of Australia has full regulatory responsibilities for the payments system, the various components of the system (both high-value and low-value) are not formally licensed by the Reserve Bank of Australia or any other regulatory body. Importantly, the Reserve Bank of Australia regulates the payments system for both financial stability and conduct (efficiency, integrity and competition).<sup>12</sup>

The remaining groups of financial market infrastructures are regulated under the Corporations Act and must be licensed either directly by the Australian Securities and Investments Commission (in the case of trade repositories) or by the Minister on advice from the Australian Securities and Investments Commission (in the cases of market operators and securities clearing and settlement facilities). The Australian Securities and Investments Commission regulates all these groups for compliance with their conduct obligations under the Corporations Act. In the case of securities clearing and settlement facilities, licence obligations are administered by the Australian Securities and Investments Commission, while compliance is overseen jointly by the Australian Securities and Investments Commission and the Reserve Bank of Australia.

Australia has determined that, outside the payments system, the only systemically important financial market infrastructures are securities clearing and settlement facilities. At present there are seven securities clearing and settlement facilities licensed to operate in Australia:

- The four Australian Stock Exchange Group facilities – ASX Clear Pty Limited, ASX Clear (Futures) Pty Limited, ASX Settlement Pty Limited and Austraclear Limited – which are domiciled in Australia.
- IMB Limited, an Australian building society, which operates a market for trading in its own shares by its members, and an associated securities settlement facility to settle these trades.
- The United Kingdom-based LCH Limited.
- The United States-based Chicago Mercantile Exchange.

The Australian Securities and Investments Commission and the Reserve Bank of Australia work closely together in regulating securities clearing and settlement facilities and advising the Minister on applications for securities clearing and settlement facility licences and changes to operating rules, both of which are submitted to the Australian Securities and Investments Commission.

The division of regulatory responsibilities across Australian financial market infrastructures is shown in Table 1 below.

Table 1

Australia	Licensing Authority	Regulator
Organised markets	Minister	Australian Securities and Investments Commission
Clearing and settlement facilities	Minister	Australian Securities and Investments Commission and Reserve Bank of Australia
Trade repositories	Australian Securities and Investments Commission	Australian Securities and Investments Commission
Payments systems	NA	Reserve Bank of Australia

<sup>12</sup>Indeed, the Reserve Bank of Australia was one of the first payments system regulators to focus on conduct issues. A number of high-profile legal cases against payments system operators have changed the efficiency and effectiveness of the payments system in Australia.

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The way in which regulatory responsibilities are allocated for securities clearing and settlement facilities is particularly relevant. Under Part 7.3 of the Corporations Act, the Reserve Bank of Australia has a formal regulatory role to ensure that the infrastructure supporting the clearing and settlement of transactions in financial markets is operated in a way that promotes financial stability. The Reserve Bank of Australia’s powers include the power to determine Financial Stability Standards for licenced clearing and settling facilities.<sup>13</sup> These Standards may apply to all securities clearing and settlement facility licensees or to a specified class of facility.

Similarly, in its role as conduct regulator, the Australian Securities and Investments Commission may issue Market Integrity Rules (under Pt 7.2A s798(G) of the Corporations Act) dealing with activities and conduct in relation to domestic licensed financial markets, including the activities and conduct of market participants.

The way in which the Reserve Bank of Australia and the Australian Securities and Investments Commission issue their regulatory instruments is based on the way in which they have divided their responsibilities under the Principles for Financial Market Infrastructures. The division is shown in Table 2 below. Some Principles are relevant to both regulators and, accordingly, are jointly overseen.

Table 2

Financial Market Infrastructure Principle	Responsible Authority	
1. Legal basis	Joint Responsibility of the Australian Securities and Investments Commission and Reserve Bank of Australia	
2. Governance		
11. Central securities depositories		
13. Participant default rules and procedures		
14. Segregation and portability		
15. General business risk		
16. Custody and investment risks		
17. Operational risk		
18. Access and participation requirements		
19. Tiered participation arrangements		
20. Financial market infrastructure links		
23. Disclosure of rules, key procedures and market data		
3. Framework for the comprehensive management of risks		Reserve Bank of Australia
4. Credit risk		
5. Collateral		
6. Margin		
7. Liquidity risk		
8. Settlement finality		
9. Money settlements	Reserve Bank of Australia	
10. Physical deliveries		
12. Exchange-of-value settlement systems		

<sup>13</sup> Under s827D the Reserve Bank of Australia is responsible for issuing Financial Stability Standards “for the purposes of ensuring that clearing and settling facility licensees conduct their affairs in a way that causes or promotes overall stability in the Australian financial system”.

Financial Market Infrastructure Principle	Responsible Authority
21. Efficiency and effectiveness	Australian Securities and Investments Commission
22. Communication procedures and standards	
24. Trade repositories should provide accurate and timely data	

To date, the Reserve Bank of Australia has issued two Financial Stability Standards – one for central counterparties, and one for securities settlement facilities. The standards cover matters such as legal basis, governance, credit and liquidity management, settlement models, operational resilience and management of business and investment risks. The systemic stability standards also include specific requirements for financial resources held to cover any losses incurred by central counterparties in the event of a participant default and a requirement to develop a comprehensive and effective plan for recovery or orderly wind-down.

Both the Australian Securities and Investments Commission and the Reserve Bank of Australia are responsible for assessing how well securities clearing and settlement facility licensees have complied with the standards and rules. Within the Reserve Bank of Australia, responsibility for carrying out its regulatory and supervisory responsibilities for both the payments system and securities clearing and settlement facilities is delegated to the Reserve Bank of Australia’s Payments System Board.

While the Reserve Bank of Australia has the power to set standards and assess licensees’ compliance, enforcement powers against securities clearing and settlement facilities rest with the Minister and the Australian Securities and Investments Commission. The Minister or the Australian Securities and Investments Commission may take enforcement action independently, or on the advice of the Reserve Bank of Australia.

## THE UNITED KINGDOM

Under the Bank of England Act (1998), the Bank has an objective to protect and enhance the stability of the United Kingdom’s financial system. The Financial Conduct Authority is the conduct regulator for the financial sector.

**Payments:** Prior to 2015 the Bank of England was the sole regulator of the United Kingdom’s payments system. In 2015, however, a new payments system regulator was established as a subsidiary of the Financial Conduct Authority. The Payments System Regulator is mandated to–

- ensure payment systems are operated and developed in a way that considers and promotes the interests of all the businesses and consumers that use them;
- promote effective competition in the markets for payment systems and services – between operators, payments service providers and infrastructure providers; and
- promote the development of and innovation in payment systems, in particular the infrastructure used to operate those systems.

Notwithstanding the establishment of the Payments System Regulator, the Bank of England retains a key regulatory role over payments systems. Under s181 of the Banking Act, the Bank of England oversees certain systems of payments between financial institutions. It does so through a financial stability lens.

**Exchanges:** As is the case in Australia, the Financial Conduct Authority is responsible for licensing and regulating organised financial markets, including Recognised Investment Exchanges and other trading platforms. It is also responsible for regulating the conduct of participants in financial markets (including over-the-counter financial markets).

**Derivative trade repositories:** The regulatory framework for trade repositories based in the United Kingdom is at the European Union level. European Union-based trade repositories must be registered by the European Securities and Markets Authority in accordance with the European Markets Infrastructure Regulation. All counterparties are required to report details of any derivative contract (over-the-counter or exchange traded) they have concluded, or which they have modified or terminated, to a registered (European Union)

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or recognised (non-European Union) trade repository under the European Markets Infrastructure Regulation reporting requirements. Once registered, the trade repository is supervised by the European Securities and Markets Authority.

**Securities clearing and settlement facilities:** The Bank of England has responsibility for supervising securities clearing and settlement facilities. The Bank has had formal statutory responsibility for supervising clearing and settlement systems since 2013. This responsibility was transferred from the Financial Services Authority to the Bank of England (as part of the Twin Peaks reforms). Institutions that provide both exchange services and central counterparty clearing services are regulated by the Bank with respect to their activities as Registered Clearing Houses and by the Financial Conduct Authority for their activities as Recognised Investment Exchanges.

The IMF's 2016 Financial Sector Assessment Program Report for the United Kingdom noted that the reforms made the Bank of England effectively the lead supervisor for all financial market infrastructures and observed that this enabled a consistent implementation of the Principles for Financial Market Infrastructures across all types of financial market infrastructures.

The Bank of England's approach to financial market infrastructure supervision is based on its broad financial stability objective.

Table 3

United Kingdom	Licensing Authority	Regulator
Organised markets	Financial Conduct Authority	Financial Conduct Authority
Clearing and settlement facilities	Bank of England	Bank of England
Trade repositories	European Securities and Markets Authority	European Securities and Markets Authority
Payments system	NA	Bank of England and Payments System Regulator

### CONSIDERATIONS FOR SOUTH AFRICA

While the models applied in Australia and the United Kingdom both appear to be effective, they are quite different in a number of respects. In particular, the establishment of the Payment System Regulator in the United Kingdom runs counter to the Twin Peaks philosophy (even if it is a subsidiary of the Financial Conduct Authority). The insertion of the European Securities and Markets Authority is also special to the United Kingdom and its position in Europe.

The more interesting aspect is that both Australia and the United Kingdom appear to have deviated from the Twin Peaks philosophy in certain cases by assigning both systemic and conduct responsibilities to the same agency (to the Reserve Bank of Australia for payments and to the Bank of England for securities clearing and settlement facilities). Curiously, the United Kingdom has highlighted the need to separate conduct and systemic regulation in the case of payments, but not in the case of securities clearing and settlement facilities, while Australia has done effectively the opposite.

While payments systems are a key feature of the regulatory architecture in both Australia and the United Kingdom, as noted earlier, this Discussion Paper is predicated on the assumption that, while payments systems will be defined as financial market infrastructures in the new financial markets legislation, their regulation and supervision will remain with the National Payment System Act. Thus, the analysis and proposals below are limited to non-payment financial market infrastructures.

The critical regulatory allocation decision for (non-payment) financial market infrastructures relates to the balance between financial stability regulation and conduct regulation. There can be little debate over the proposition that all such financial market infrastructures should be regulated and supervised for conduct (in particular, for efficiency and integrity).



Consistent with this argument it is proposed that those (non-payment) financial market infrastructure groups not designated as systemically important should be licensed “for their functions”, regulated and supervised by the Financial Sector Conduct Authority. While the focus of regulation for this group of financial market infrastructures will primarily be on conduct matters and operational requirements, licensing is likely to include a range of prudential considerations such as fitness and propriety, minimum capital and risk management systems. These are typically less onerous and less risk based than the equivalent requirements imposed on prudentially regulated financial institutions.

In the case of systemically important (non-payment) financial market infrastructures, there is a need for both financial stability regulation (including its prudential foundations) and conduct regulation. In the case of systemic importance there should be little debate over the proposition that regulation for financial stability is not only needed, it is of a higher level of importance than regulation for conduct. An efficient, competitive financial system is of little value if it is unstable.

Given the priority of financial stability over conduct, a reasonable starting point is for the Reserve Bank to be the primary licensing agency<sup>14</sup> for all systemically important (non-payment) financial market infrastructures although, consistent with existing arrangements in the Financial Sector Regulation Act, the licensing process would be conducted by the Prudential Authority and the licence issued by the Prudential Authority, but with the concurrence of the Reserve Bank. Licensing of these infrastructures should also require consultation with the Financial Sector Conduct Authority.

The only remaining question is whether the Reserve Bank should be the sole licensing and regulatory agency involved with certain systemically important financial market infrastructures, or whether the Financial Sector Conduct Authority should have responsibility for conduct regulation of all systemically important (non-payment) financial market infrastructures.

There is a strong case for the Financial Sector Conduct Authority to play a role as conduct regulator for all financial market infrastructures. This would involve the Financial Sector Conduct Authority issuing systemically important (non-payment) financial market infrastructures with a conduct licence. In effect, every systemically important (non-payment) financial market infrastructure would need at least two licences – one to operate as a particular type of financial market infrastructure, and a second to govern the way in which the infrastructure conducts its business with its particular market participants. Under this approach, in the case of a central counterparty, for example:

- the Prudential Authority would license the entity to be a central counterparty, while the Financial Sector Conduct Authority would license it to deal with its clearing members;
- the Prudential Authority would supervise and enforce compliance with standards of a prudential nature (with systemic stability requirements) applicable to central counterparties (designed by the Prudential Authority in consultation with the Reserve Bank and subject to its approval); and
- the Financial Sector Conduct Authority would supervise and enforce with standards of a conduct nature (with systemic stability requirements) applicable to central counterparties (also designed by the Financial Sector Conduct Authority in consultation with the Reserve Bank and subject to its approval).

This approach is consistent with the dual-licensing approach used under the Financial Sector Regulation Act. It is also consistent with the Twin Peaks philosophy of assigning a single regulatory function to each regulatory agency. The change from the existing Twin Peaks framework is that it formalises financial stability as a regulatory function. This is more evolution than revolution.

## **SUMMARY**

Under the structure described above:

- non-systemically important financial market infrastructures would be licensed, regulated and supervised solely by the Financial Sector Conduct Authority;

<sup>14</sup>As noted earlier, the term “primary” means that the Prudential Authority, as the Reserve Bank’s delegate, will issue the licence that gives an entity the right to operate as a financial market infrastructure (i.e., to perform its core infrastructure functions).

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- payments systems would be defined as systemically important financial market infrastructures in the new financial markets legislation, but would be “carved out” from the regulatory framework in the legislation;
- systemically important (non-payment) financial market infrastructures would be licensed “for their functions” (e.g., to conduct business as a central counterparty, a central securities depository) by the Prudential Authority (in consultation with the Reserve Bank and the Financial Sector Conduct Authority), and for their conduct by the Financial Sector Conduct Authority (in consultation with the Reserve Bank and Prudential Authority);
- systemically important (non-payment) financial market infrastructures would be regulated for financial stability by the Reserve Bank. The Reserve Bank would be consulted and has to approve the standards on systemic stability requirements to be issued by the Prudential Authority (if they relate to prudential matters), the Financial Sector Conduct Authority (if they relate to conduct matters), or jointly (for matters that relate to both prudence and conduct).

Under this approach, systemically important (non-payment) financial market infrastructures would be supervised by both the Prudential Authority (for prudence) and the Financial Sector Conduct Authority (for conduct).

Under this proposal, the allocation of regulatory responsibilities in South Africa would be as shown in Table 4 below.

Table 4

South Africa	Licensing Authority	Regulator	Supervisor
Organised markets (including exchanges)	Financial Sector Conduct Authority	Financial Sector Conduct Authority	Financial Sector Conduct Authority
Clearing and settlement facilities (central counterparties and central securities depositories)	Prudential Authority (under delegation from Reserve Bank) for its systemically important financial market infrastructure function / Financial Sector Conduct Authority for conduct	Prudential Authority (prudence) and Financial Sector Conduct Authority (conduct) – both under direction from the Reserve Bank	Prudential Authority (prudence) and Financial Sector Conduct Authority (conduct)
Trade repositories	Financial Sector Conduct Authority	Financial Sector Conduct Authority	Financial Sector Conduct Authority
Payments systems* * subject to any revisions to the National Payment System Act	NA	Reserve Bank	Reserve Bank

## PROPOSAL 12:

### That:

- the licensing, regulatory and supervisory responsibilities for payments systems be carved out from the new financial markets legislation, with resolution of these issues to be addressed by reforms to the National Payment System Act.

That, for all non-payment financial market infrastructures:

- the Financial Sector Conduct Authority be assigned as the licensing and sole regulatory authority for (non-payment) financial market infrastructures that are not designated systemically important financial market infrastructures;
- the Reserve Bank be assigned as the licensing authority for all (non-payment) financial market infrastructures designated as systemically important, but with the actual licensing function to be delegated to the Prudential Authority;
- the Financial Sector Conduct Authority be assigned as the conduct regulator (with the power to issue conduct licences) for all systemically important (non-payment) financial market infrastructures;
- for all systemically important (non-payment) financial market infrastructures the Prudential Authority be provided with the power to supervise and enforce standards (systemic stability) relating to safety and soundness, the Financial Sector Conduct Authority with the power to supervise and enforce standards (systemic stability) relating to market efficiency and integrity, and both agencies with the responsibility to supervise and enforce joint standards (systemic stability) ; and
- any supervisory or enforcement action by the Prudential Authority or Financial Sector Conduct Authority that could have a material impact on the continued operation of a systemically important financial market infrastructure regulated by them (e.g., delicensing, licence suspension or restrictive licence conditions) be subject to Reserve Bank concurrence before either agency takes the relevant action.

## PROPOSAL 13:

That the Reserve Bank and the Financial Sector Conduct Authority agree on an allocation of regulatory and supervisory responsibilities for systemically important (non-payment) financial market infrastructures as outlined in the Principles for Financial Market Infrastructures. Note that this does not need to be formalised in the new financial markets legislation.

Since this approach to regulating systemically important (non-payment) financial market infrastructures changes the current licensing regime for some existing infrastructures, suitable transition arrangements will be required to accommodate the changes without undue disruption.

As with both the Australian and United Kingdom models, the regulation and supervision of systemically important financial market infrastructures would need to be subject to legislated coordination and cooperation arrangements. While these are arguably already included in the Financial Sector Regulation Act, there is a case for strengthening them in the case of systemically important (non-payment) financial market infrastructures, given their importance in the financial system.

## 6.2 REGULATORY RESPONSIBILITIES FOR MARKETS IN FINANCIAL INSTRUMENTS

As noted above, financial instruments may be traded on organised markets (trading venues) or bilaterally in over-the-counter markets. The underlying principle guiding proposals for the new financial markets legislation is that all markets in financial instruments, regardless of how they are traded, should be regulated, unless specifically exempted by the relevant authority. As a general principle, regulating markets on which financial instruments are traded should involve:

- authorisation of market participants- first phase to consider only those in organised markets;
- setting of operational rules for different types of markets, including whether trades in any given market need to be cleared, settled and/or reported;

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- setting of access rules for various market participants for different types of markets;
- monitoring conduct and market performance for compliance with the market conduct standards and the law more generally; and
- where the Financial Sector Conduct Authority is not the lead market regulator, the framework should provide for the Financial Sector Conduct Authority to have some regulatory ambit and to take enforcement action against participants who breach provisions of the law.

In the case of organised markets there are well-defined market operators and participants. Licensing the market operator, for example the operator of an equities or a derivatives exchange, or multiple such operators, effectively licenses the market. In contrast, in many countries, over-the-counter markets have historically been largely unregulated or informally self-regulated. In some cases, participation in these markets can also be quite informal.

Concerns about the size and potential systemic importance of over-the-counter derivatives markets has led many countries, including South Africa, to introduce some regulation for these markets. In South Africa, regulation drew on a very general provision included in the Financial Markets Act. Under s5(1) of the current Financial Markets Act, the Minister may prescribe:

- (a) requirements for the regulation of unlisted securities;
- (b) a category of regulated person who provides securities services not otherwise regulated by the Act; and
- (c) the securities services that may be provided, and the functions and duties that may be exercised, by external participants and financial market infrastructures.

In the 2018 Financial Markets Act Regulations, **the Minister declared an authorised over-the-counter derivative provider to be a regulated person**. Under s2 of the regulations, no person may act as, or hold itself out to be, an over-the-counter derivative provider, unless it is authorised as such by the Financial Sector Conduct Authority. The Regulations also make provision for the Financial Sector Conduct Authority, with the concurrence of the Prudential Authority, to determine eligibility criteria for over-the-counter derivative transactions to be subject to mandatory clearing.

While the 2018 Financial Markets Act Regulations are specific to the over-the-counter derivatives market, they provide a template for how other over-the-counter markets might be regulated.

Consistent with the Twin Peaks model, regulatory responsibility for market efficiency, integrity and competitiveness for all over-the-counter markets (with a few exceptions noted below) should be assigned to the Financial Sector Conduct Authority.

The exception to this general rule should be the foreign exchange market. Consistent with current practice, and the foreign exchange controls that apply in South Africa, the Reserve Bank should regulate the foreign exchange market and authorise participants. In the event that exchange controls are removed at some future point in time, consideration should be given to transferring regulatory authority for the foreign exchange market to the Financial Sector Conduct Authority.

Notwithstanding this exception, under the proposals in this section, participants in the foreign exchange market would still be required to hold the appropriate financial market licence from the Financial Sector Conduct Authority and the Financial Sector Conduct Authority would still be responsible for monitoring and enforcing general conduct standards for participants in the foreign exchange market.

Regulation of over-the-counter derivative markets is also one area where the Prudential Authority has some responsibility. In practice, imposing prudential requirements such as margining, determination of eligible collateral or making clearing determination and authorisation of over-the-counter derivatives providers requires consultation and concurrence by the two authorities considering their respective roles. Therefore, the framework for over-the-counter markets should consider the role of the Prudential Authority and joint responsibilities of the Prudential Authority and Financial Sector Conduct Authority can be divided into conduct and prudential.

## PROPOSAL 14:

### That:

- regulation of existing over-the-counter markets in financial instruments (to be designated as regulated over-the-counter markets) be formalised for at least the following financial instruments:
  - derivatives in financial instruments;
  - money market instruments;
  - debt instruments;
  - foreign exchange;
  - tradable investments in collective investment schemes and asset-backed-securities; and
  - crypto assets;
- the new financial markets legislation include flexibility for the Minister to designate additional financial instruments for which over-the-counter trading needs to be conducted through a regulated over-the-counter market;
- the Financial Sector Conduct Authority be assigned as the regulator for all regulated over-the-counter markets (and consider the role of the Prudential Authority in the over-the-counter markets), with the exception of the over-the-counter foreign exchange market in South African Rand, for which the Reserve Bank should continue to be the regulator until such time as exchange controls are removed, at which point consideration should be given to transferring regulatory responsibility to the Financial Sector Conduct Authority; and
- the following minimum responsibilities be assigned to the regulator of each regulated over-the-counter market:
  - authorising market participants who are eligible to transact in the regulated over-the-counter market;
  - setting the rules for trading, clearing, settling and reporting trades in the regulated over-the-counter market;
  - monitoring the regulated over-the-counter market for evidence of breaches of the market conduct standards, plus any particular rules or standards that the regulator may have set for the specified markets;
  - taking enforcement actions against participants where needed; and
  - exempting specified financial instruments from the need to trade on a regulated over-the-counter market.

## 6.3 LICENSING

Under the proposals in this paper, the new financial markets legislation will involve a very different licensing regime to that which applies under the current Financial Markets Act. It is important to be clear on how this new licensing regime, if adopted, would interface with the general licensing regime in the Financial Sector Regulation Act.

The proposals above for the new financial markets legislation involve a set of specific market activities and licences not fully covered by the Financial Sector Regulation Act. Indeed, while there is some overlap into financial market products and services, the financial products and services set out in s2 and s3 of the Financial Sector Regulation Act generally refer to direct provision financial services and products.

Thus, consistent with the approach of embedding the new financial markets legislation in the Financial Sector Regulation Act, it would be helpful to introduce an additional licensing category for financial market activities (other than financial market infrastructures, for which there should be a separate licence category).<sup>15</sup> How this licence category is integrated with the more general licensing regime for the Financial Sector Conduct Authority is a matter for the Financial Sector Conduct Authority to determine. As noted earlier, it may elect to issue a single conduct licence, with categories and subcategories. Alternatively, it may issue several differentiated licences, each

<sup>15</sup>It should be noted that, in its comments on the Financial Markets Act, the Financial Sector Conduct Authority suggested that it should license authorised users, clearing members of clearing houses, and central securities depository participants under the Conduct of Financial Institutions Bill and supervise their compliance with the Conduct of Financial Institutions Act (when it becomes law) and the Financial Sector Regulation Act. Since authorised users, clearing members of clearing houses and central securities depository participants (all referred to in this Discussion Paper as part of the more general group of market participants) are an integral part of financial market activities, it may be more appropriate to license them under the new financial markets legislation.

with subcategories. However, the future conduct licensing model is currently being conceptualised. The following section refers to the category of Conduct Licences (Markets), without suggesting where these should fit within the broader conduct licensing regime..

The intention is that Conduct Licences (Markets) would be issued for very broad categories of financial market activities, whereas authorisations would be for participation in specific markets or to trade in specific trading venues. Conduct Licences (Markets) should provide common licensing requirements (governance, financial soundness, risk management systems, technology systems, etc.) for specific groups of participants in South Africa's financial markets. For market participants, Conduct Licences (Markets) would be akin to a "passport" into the financial markets. Participants who wish to trade in a particular market, such as the market for foreign exchange, would need a separate authorisation (akin to a "visa") from the regulator of that particular market (in the case of the foreign exchange market this would be the Reserve Bank). This authorisation, in turn, may impose additional requirements on the licence holder. Similarly, participants who wish to trade on a particular trading venue would require both a conduct licence (markets) (as a participant) and an authorisation from the particular trading venue or operator of the trading venue.

#### **PROPOSAL 15:**

That the new financial markets legislation include a new licensing subcategory of conduct licence (markets). This licence, to be issued by the Financial Sector Conduct Authority, should include at least the following subcategories:

- operating a trading venue;
- market participant;
- member of a financial market infrastructure; and
- provider of a critical support service (ratings, benchmark indexes, research, etc.).

While the details of licensing requirements will vary across different subcategories of licence, the requirements within any subgroup should be consistent

An issue that will require further consideration is whether there will be an additional licence group for retail-level participants who wish to trade in regulated markets (for example, if equity trading can be effected through a mobile phone app, should the retail-level participant require a licence of some sort)? If so, the licence conditions should be considerably less onerous than those for professional wholesale market participants.

## **6.4 APPROACH TO REGULATING MARKETS IN FINANCIAL INSTRUMENTS**

Another key observation of the 2018 Financial Markets Review is that, even within the set of financial markets currently regulated by the Financial Markets Act, there are material disparities and differences in the standards of conduct applied. Regardless of the status quo, there is a compelling case that the most effective approach to enhancing the efficiency and integrity of financial markets is by applying common standards of conduct wherever possible. Consistent with Proposal 15 to introduce a new licensing category for financial market participants, the new financial markets legislation should also introduce a new subcategory of conduct standards (markets) for regulating activities and conduct in South Africa's financial markets.

## PROPOSAL 16:

### That:

- a new subcategory of conduct standards (markets) be included in Chapter 7 of the Financial Sector Regulation Act (to better distinguish them from other conduct standards (i.e., general conduct standards regulating the way in which financial institutions deal with their financial customers));
- conduct standards (markets) have the flexibility to be applicable to particular markets, financial instruments, groups of market participants, financial market infrastructures, or to all regulated entities;
- while some variations in conduct standards (markets) are to be expected for particular markets or circumstances, the overriding principle should be that the same standards should apply to all groups providing essentially the same market services or participating in the same market activities, regardless of which particular market segment or type is involved; and
- matters on which conduct standards (markets) may be issued should include:
  - governance;
  - fitness and propriety;
  - disclosure and transparency (including of pre-trade and post-trade information and of fees);
  - accounting standards;
  - risk management systems;
  - financial soundness (including capital and liquidity);
  - qualifications;
  - minimum listing requirements;
  - minimum membership requirements for financial market infrastructure groups;
  - clearing, settlement and reporting requirements;
  - trading behaviour;
  - best execution;
  - operations (such as settlement cycles, circuit breakers, tick sizes, time synchronization, minimum transactions size, trade cancellation, trading disruptions, issuer transfer, suspension and removal of issuers, reference prices and portfolio compression);
  - technology (such as interoperability, security and protection of data);
  - management of conflicts of interest;
  - rules for setting fees;
  - recovery and resolution (for financial market infrastructures not designated as systemically important – and therefore not covered by the Reserve Bank's systemic stability standards for recovery and resolution); and
  - remuneration/incentives.

As noted in the recommendations of the Financial Markets Review, it is also critical for market efficiency and integrity that market abuse provisions apply equally to all markets for financial instruments, whether organised or over-the-counter, and that the regulator enforces those provisions uniformly across the financial system.

## PROPOSAL 17:

That all market abuse provisions, including those relating to insider trading and market manipulation, apply equally to all markets in financial instruments, regardless of how the markets are structured.

## **7. THE ROLE OF FINANCIAL MARKET INFRASTRUCTURES IN THE NEW FINANCIAL MARKETS LEGISLATION**

According to IOSCO, a financial market infrastructure (or other similar entity) should be classified as a self-regulatory organisation if it performs three main regulatory functions - rule making, supervision and enforcement. IOSCO recognises that financial market infrastructures can provide valuable assistance to achieving the objectives of securities regulation. It has identified the following potential benefits from the use of financial market infrastructures:

- Increased focus on ethical and conduct standards;
- financial market infrastructures' ability to compel the production of information;
- quicker response to changing market conditions, given the market expertise and experience of self-regulatory organisations; and
- self-regulatory organisation funding of technology infrastructure.

### **7.1 FINANCIAL MARKET INFRASTRUCTURES IN ORGANISED MARKETS**

South Africa currently employs a "strong" self-regulatory model in the market for listed securities. While the current Financial Markets Act removed the previous "Self-regulatory Organisation" terminology, financial market infrastructures retained some regulatory responsibilities, in conjunction with additional requirements and enhanced powers and oversight by the Financial Sector Conduct Authority in supervising financial markets and their participants. Under the current Financial Markets Act, the regulatory coverage of financial market infrastructures was extended to include licensing of central securities depositories, clearing houses and trade repositories (although the requirement to carry out self-regulatory tasks does not apply to associated clearing houses or trade repositories).

Under the current Financial Markets Act, a licensed financial market infrastructure with regulatory responsibilities must:

- Issue rules (exchange, depository or clearing house as applicable) and listing requirements;
- Regulate access and participation requirements;
- Monitor and supervise compliance with these rules, listing requirements, the Act, directives and other requirements;
- Enforce the rules, listing requirements and directives; and
- Report to the Financial Sector Conduct Authority and assist it in enforcing the Financial Markets Act.

Under the current Financial Markets Act, the Financial Sector Conduct Authority has powers to:

- Approve rules and listing requirements;
- Assume the regulatory and supervisory responsibilities of a financial market infrastructure in certain circumstances; and
- Require arrangements to manage conflicts of interest.

The Financial Sector Conduct Authority also has the power to assume any or all of the regulatory powers from a financial market infrastructure where it is necessary to meet the objectives of the Act.

While South Africa has generally been assessed positively with respect to its implementation of the IOSCO principles, including Principle 9 on the use of financial market infrastructures, there has long been dissatisfaction among stakeholders with the way in which financial market infrastructures operate in the South African financial markets, including inconsistencies in the way financial market infrastructures regulate their markets and members. Importantly, the recent licensing of four new exchanges has changed the context for financial market infrastructures.



Internationally there is no single “best practice” self-regulatory model, although the general trend has been a move away from the use of financial market infrastructures as regulators and towards a greater centralisation of regulatory responsibility within the official regulatory agency. For example:

- In Australia, the Australian Securities and Investments Commission has taken back responsibility for supervision of real-time trading on domestic licensed markets from the Australian Stock Exchange. While the Australian Securities and Investments Commission is now responsible for supervising trading activities by broker participants, the Australian Stock Exchange retained responsibility for supervising listed entities. The Australian Securities and Investments Commission develops Market Integrity Rules which, together with the Australian Stock Exchange’s Operating Rules, form the regulatory framework for the market supervision regime.
- In the United Kingdom, which had historically made extensive use of financial market infrastructures as regulators, the Financial Services and Markets Act (2000) removed the regulatory functions of financial market infrastructures and made the Financial Services Authority (and subsequently the Financial Conduct Authority) the sole regulator for the United Kingdom’s financial services industry. The Financial Conduct Authority is also the United Kingdom’s Listing Authority, responsible for monitoring market disclosures, reviewing and approving prospectuses, and operating the listing regime (including maintaining and monitoring compliance with the Listing Rules).
- In Continental Europe, the role of self-regulation was never extensive. The self-regulatory functions of exchanges were scaled back due to the need to harmonise the European Union’s financial market rules (e.g., European Union Directives required regulatory responsibilities of exchanges to be conducted by government regulators). The European Commission has stated that “It is no longer appropriate for exchanges to carry out regulatory roles since they are commercial entities.”
- Of the major economies, the United States makes arguably the most extensive use of financial market infrastructures as regulators. The United States is often described as a mixed model, with a number of exchanges having regulatory responsibilities. A notable feature of the United States self-regulatory model is that the regulatory function has evolved from individual financial market infrastructures focused on a single market to broader, industry-based financial market infrastructures. The Financial Industry Regulatory Authority, for example, was created in 2007 by a merger between the enforcement arms of the New York Stock Exchange and the National Association of Securities Dealers to provide a single regulator to centralise regulation of broker-dealers. All broker dealers in the United States must be members of a recognised financial market infrastructure (such as the Financial Industry Regulatory Authority). Similarly, the National Futures Association is an industry-wide, self-regulatory organisation for the United States derivatives industry (with mandatory membership).

While a move away from the strong, individual exchange-based self-regulatory model is almost inevitable in South Africa now that there is more than one exchange, it would be premature to move too far along the spectrum, for the following reasons:

- firstly, the Financial Sector Conduct Authority currently lacks the capacity to take on as broad a regulatory role as, say, the Financial Conduct Authority in the United Kingdom (e.g., taking on the role as national listing authority); and
- secondly, there are some functions that financial market infrastructures are better placed to execute (e.g., real-time market surveillance).

The current Financial Markets Act assigns regulatory responsibilities to financial market infrastructures and provides the Financial Sector Conduct Authority with the power to resume those responsibilities, subject to conditions. In view of the considerations outlined above, the time has come to reverse the direction of delegation of regulatory powers. Under such a reversal, all regulatory responsibilities would reside with the official regulators. The regulators, in turn, would have the power to delegate certain of these to financial market infrastructures in circumstances that would further the objects of the Act. This flow of powers from the regulators to financial market infrastructures is not only more consistent with international practice, it is consistent with the changing composition and structure of South Africa’s financial markets.

## **BUILDING COMPETITIVE FINANCIAL MARKETS FOR INNOVATION AND GROWTH**

For this change in delegatory structure to have integrity, it should not be possible for certain regulatory roles to be delegated to a financial market infrastructure. In particular, with multiple exchanges now operating in South Africa, it will be important for the Financial Sector Conduct Authority to take responsibility for cross-market surveillance. It would also further the efficiency of the financial markets if the Financial Sector Conduct Authority were to establish common standards for participants in various parts of the system.

Matters that the Financial Sector Conduct Authority should not be able to delegate might include:

- Approving financial market infrastructure rules (it would be helpful for the Financial Sector Conduct Authority to be more active in assessing rules for their effect on the efficiency, integrity and competitiveness of markets);
- Licensing and regulating market participants. – This will happen automatically under the proposed licensing regime for financial markets. While the Financial Sector Conduct Authority should set the standards for licensing and conduct by participants in organised markets, financial market infrastructures should still have a role in setting the entry standards to their particular financial market infrastructures (through membership rules), provided these are applied on a transparent and non-discriminatory basis;
- Setting minimum listing requirements;
- Monitoring and supervising cross-market activity; and
- Enforcement.

Matters that might be delegated to a financial market infrastructure could include:

- Membership rules and listing requirements (subject to these being additional to the minimum standards set by the Financial Sector Conduct Authority);
- Setting market-specific operating standards such as technology, security and protection of data for members;
- Monitoring and supervising member compliance with particular financial market infrastructure rules, listing requirements, the Act, directives and other requirements, including real-time monitoring of transaction in their markets.

While this allocation of responsibilities may be reasonable at this point in time, it will be important that the drafting of the new financial markets legislation provides sufficient flexibility for the roles to change over time if changing circumstances warrant it.

If this proposal is implemented, it will be important to include suitable transitional arrangements to allow for the disruption that could follow a relatively major shift in regulatory responsibilities, and also for the time it will take for the Financial Sector Conduct Authority to recruit staff and build its capability for what would be a much more active regulatory engagement with financial markets than is currently the case. It would be reasonable, for example, for most of the existing regulatory functions of financial market infrastructures to remain with them during a generous transition period, and for the transfer of responsibilities to the Financial Sector Conduct Authority to be sequential.

### **PROPOSAL 18:**

That, with respect to organised markets:

- the statutory assignment of regulatory powers to financial market infrastructures not be included in the new financial markets legislation; and
- responsibility for regulating and supervising all market conduct be assigned to the Financial Sector Conduct Authority, but with provision for the Financial Sector Conduct Authority to delegate certain of these functions to financial market infrastructures, subject to the following:
  - identifying the regulatory requirements for the Financial Sector Conduct Authority that may be delegated to a financial market infrastructure – such as membership rules, listing rules, market-specific operating standards and real-time monitoring of market activities in individual markets – provided the delegation will further achieve the objects of the Act; and
  - identifying the regulatory requirements for the Financial Sector Conduct Authority that may not be delegated to a financial market infrastructure – such as licensing and regulating market participants, and cross-market surveillance.
- Consider transitional arrangements, to avoid market disruption.

## 7.2 FINANCIAL MARKET INFRASTRUCTURES IN OVER-THE-COUNTER MARKETS

Over-the-counter markets for financial instruments in South Africa have generally been either unregulated or self-regulating. Thus, the role of financial market infrastructures in these markets has been either informal, or non-existent. In view of Proposal 18 to remove the statutory assignment of regulatory responsibilities to existing financial market infrastructures, there is no case for establishing new financial market infrastructures for markets in which they do not currently exist.

Bringing these markets into the regulatory net will nevertheless be a new experience for the Financial Sector Conduct Authority. From a practical perspective, it will make sense for the Financial Sector Conduct Authority to draw on existing market practice as a starting point and to use market associations (see sub-issue 7.4 below) in an advisory capacity to help develop an appropriate regulatory model for these markets.

### PROPOSAL 19:

That industry associations play an advisory role in supporting the market regulator to develop an appropriate regulatory model for over-the-counter markets for financial instruments.

## 7.3 CODES OF CONDUCT

One area in which industry associations can play a useful supporting role for the market regulators, in both organised and over-the-counter markets, is in helping to set-up, and monitor compliance with, industry codes of conduct.

As noted by the Financial Markets Review, financial sector regulators currently deal with a wide range of industry bodies, including committees, workgroups, and forums to debate financial market matters such as codes of conduct. In view of the objective stated earlier of standardising the approach to regulating financial markets to the greatest extent possible, the new financial markets legislation should adopt the recommendation of the Financial Markets Review to rationalise these bodies into a single Financial Markets Standards Group, with representation from senior market professionals and compliance officers.

## 7.4 OPERATING AND TECHNICAL STANDARDS

In addition to advising on codes of conduct, the Financial Markets Standards Group should play a strong role in advising the market regulators of over-the-counter markets on operational aspects of those markets. The most critical of these operational aspects relates to helping the market regulator to define appropriate technical standards for financial transactions. These include standards for encryption and authentication for messaging platforms, interoperability and terms for industry contracts (e.g., the local versions of International Swaps and Derivatives Association contracts).

While the discussion above suggests that there be a single, industry-level Financial Markets Standards Group, nothing should prevent this Group from calling on expertise from different market segments as needed.

## PROPOSAL 20:

**That:**

- the new financial markets legislation establish a Financial Markets Standards Group, with representation from senior market professionals and compliance officers, to be approved by the Financial Sector Conduct Authority. The Financial Markets Standards Group's role will be largely advisory on industry matters, including codes of conduct, and operating and technical standards.
- the Financial Sector Conduct Authority be assigned responsibility for setting (on advice from the Financial Markets Standards Group), monitoring and enforcing a common industry code of conduct applying to both organised and over-the-counter markets for financial instruments, but with the Financial Sector Conduct Authority having the power to delegate responsibility for monitoring industry performance against the code to the Financial Markets Standards Group.

## 8. SENIOR MANAGERS REGIME

Since the 2008 global financial crisis, many countries have been looking to strengthen individual accountability of senior individuals within the banking sector, and more broadly. The new accountability regimes go beyond the traditional fit and proper requirements that regulators have implemented for some time. Importantly, they are more prescriptive and some of the new regimes impose criminal penalties on individuals.

The United Kingdom was the first to implement such a regime. The new Senior Managers and Certification Regime came into operation on 7 March 2016 through a series of amendments to the Financial Services and Markets Act (2000). The new regime replaced the existing Approved Persons Regime for the banking sector, which was seen to be too broad and insufficiently focused on senior management. The Financial Conduct Authority and the Prudential Regulation Authority were also given enhanced powers to approve senior managers and to take enforcement action against them.

The United Kingdom regime has three main components.

- **Senior Managers Regime** – the Prudential Regulation Authority and Financial Conduct Authority have specified a range of functions as Senior Management Functions. The Prudential Regulation Authority and Financial Conduct Authority have issued a set of “Prescribed Responsibilities” which must be allocated to one or more senior managers. Individuals performing these functions (which include directors) need pre-approval by the Financial Conduct Authority and the Prudential Regulation Authority. Firms are also required to produce and maintain a single document setting out their overall framework for the allocation of responsibilities (“Responsibilities Map”). There is a statutory “Duty of Responsibility” on all senior managers to take reasonable steps to prevent regulatory breaches in their part of the business. An approved senior manager can therefore be held accountable in the event of a regulatory breach, with potential criminal liability for a decision that causes the institution to fail.
- **Certification Regime** – In addition to the regime applying to senior managers, firms are required to assess the fitness and propriety of certain other employees who could pose a risk of significant harm to the firm or any of its customers, although there is no prior regulatory approval required. The functions within scope are specified by the Financial Conduct Authority and Prudential Regulation Authority and include, for example, those responsible for benchmark submissions, material risk takers, and investment advisers.
- **Conduct Rules** – the Financial Conduct Authority and Prudential Regulation Authority have issued two sets of enforceable conduct rules to set expectations about standards of behaviour. The first tier applies to senior managers and those in the certification regime. The second tier applies only to senior managers. Firms must ensure that those subject to the conduct rules are aware of and understand the rules. Firms must also notify the regulators of certain breaches of the conduct rules or when certain formal disciplinary action is taken.

The initial regime applied from March 2016 to banks, Prudential Regulation Authority-designated investment firms, building societies, credit unions, and United Kingdom branches of overseas institutions. A similar regime was also applied by the Authority to insurers (Senior Insurance Managers Regime) to implement a number of the regime requirements to firms subject to the European Union Solvency II Directive.

The Senior Managers and Certification Regime is in the process of being extended to apply to all financial services firms regulated by the Financial Conduct Authority (including insurers, investment firms, asset managers, brokers and consumer credit firms). The extension of the regime to insurers was due to come into effect on 10 December 2018, with implementation for other firms likely to apply from mid to late 2019.

The Australian Government followed the United Kingdom lead by proposing a Banking Executive Accountability Regime. Legislation giving effect to the regime was passed on 7 February 2018. Unlike in the United Kingdom, the regime is initially limited just to banks. For large Authorised Deposit-taking Institutions, the regime came into force on 1 July 2018 and took effect for other Authorised Deposit-taking Institutions on 1 July 2019.

The Banking Executive Accountability Regime draws heavily on the United Kingdom's regime and is broadly in line with the heightened regulatory focus on individual accountability across the globe. The Australian Prudential Regulation Authority has responsibility for the regime, in addition to its oversight of culture, remuneration, governance, risk management and fit-and-proper requirements for Authorised Deposit-taking Institutions and other financial institutions.

A particular aspect of the Australian regime is its focus on remuneration. Responding to public concerns that senior managers of banks had not been appropriately penalised for conduct failures by their institutions, the Banking Executive Accountability Regime requires Authorised Deposit-taking Institutions to defer a minimum percentage of an Accountable Person's variable remuneration for a minimum of four years. The minimum amount to be deferred varies according to the size of the Authorised Deposit-taking Institution and the Accountable Person's position and responsibilities. For Chief Executives of large Authorised Deposit-taking Institutions, this minimum will be the lesser of 60% of variable remuneration or 40% of total remuneration for a year. Lower percentages apply (40% and 20%, respectively) to other Accountable Persons, with further concessions for small Authorised Deposit-taking Institutions. Authorised Deposit-taking Institutions will be obliged to reduce variable remuneration where an Accountable Person fails to meet his or her accountability obligations.

## **CONSIDERATIONS FOR SOUTH AFRICA**

The concept of a senior managers regime is attractive from a regulatory perspective in that it puts accountability directly on those who have the power to influence conduct within regulated financial institutions. While there is less evidence of egregious conduct behaviour in South African financial markets than elsewhere in global markets, South Africa is unlikely to have been completely immune from some of the practices exposed in those countries. Implementing a senior managers regime could thus be seen as a defensive measure to help ward off potential future poor behaviour.

While implementing a senior managers regime in South Africa makes good sense, it is not clear that it should be included within the scope of the new financial markets legislation. As noted above for the United Kingdom and Australia, accountability regimes typically start with banks. One of the reasons for this is that banks, and other prudentially regulated financial institutions, typically face a wide range of conduct issues. Importantly, many of these arise with respect to consumers of financial products and services. Put differently, accountability regimes are typically motivated more by direct provision conduct issues than by market conduct issues. Therefore, including a senior managers regime within the new financial markets legislation would have the effect of narrowing it unnecessarily and excluding some of the key drivers behind such a regime.

In summary, while the idea of introducing a senior managers accountability regime for South Africa is supported, it is not proposed to include such a regime within the scope of the new financial markets legislation.

## **SPECIFIC ISSUES**

The issues addressed below are a compilation of those issues raised by stakeholders during industry discussions and recommendations from research and discussion papers. To the extent possible these issues have been collected into groups with common themes. In many cases the issues raised have been addressed under the high-level issues in the first section of this paper. Each issue starts with a brief summary of the issues as expressed by stakeholders.

### **9. MANDATORY TRADING AND CLEARING OF OVER-THE-COUNTER DERIVATIVES TRANSACTIONS**

**Question:** Should the new financial markets legislation mandate trading and clearing of certain over-the-counter derivatives transactions, or other over-the-counter transactions?

As a member of the Group of Twenty, South Africa has committed to regulatory reforms for over-the-counter derivatives transactions under certain conditions in order to mitigate systemic risk and protect against market abuse. These commitments included:

- All standardised contracts should be cleared through central counterparties.
- All contracts should be reported to trade repositories.
- All standardised contracts should be traded on exchanges or electronic trading platforms, where appropriate.
- Non-centrally cleared (bilateral) contracts should be subject to higher capital requirements and margin requirements.

South Africa has partially implemented these reforms. While banking regulations have been amended to subject non-centrally cleared over-the-counter derivatives to higher capital requirements, implementation of the clearing requirements has been limited to establishing incentives to clear, rather than requiring mandatory clearing of particular over-the-counter derivatives transactions. The Financial Markets Act regulations include provisions for authorised over-the-counter derivative providers to centrally clear over-the-counter derivatives transactions, and provide criteria for the Authorities to impose central clearing requirements on participants.

At this stage, South Africa has not mandated exchange trading of any existing over-the-counter derivatives transactions. Whether or not to mandate exchange trading or central clearing of any particular financial instruments is a policy matter and requires additional market assessments.

Regardless of the decision on any particular group of financial instruments, there is a question of whether such decisions should be included in primary law, or implemented through the rules set by the regulator of that particular market. Consistent with the approach of the Financial Sector Regulation Act, it would be more helpful for the authorities to impose additional requirements, where needed, through standards.

While it is not proposed that specific requirements with respect to mandatory trading or clearing of transactions in over-the-counter financial instruments be included in the new financial markets legislation, consistent with the approach in the current Financial Markets Act, the drafting may need to include a specific power for the Minister to direct a market regulator to implement such a decision if it is made.

## **10. REPORTING OF OVER-THE-COUNTER TRANSACTIONS FOR TRANSPARENCY**

**Questions:**

- Should there be a requirement to report all short sales of financial instruments?
- Should mandatory reporting of trades to trade repositories be extended to cover all over-the-counter transactions in financial instruments (not just derivatives)?
- Should the information gathering powers in the Financial Sector Regulation Act be extended?

These questions all point to the same concerns – the lack of transparency in over-the-counter markets in South Africa and the need for the Financial Sector Conduct Authority to have greater visibility over market transactions if it is to conduct proper market surveillance and oversight of financial market conduct.

In addition to the commitments for trading and clearing over-the-counter derivatives transactions, South Africa has committed to the Group of Twenty proposal to report all over-the-counter derivatives contracts to a trade repository. The central question above is whether this commitment is sufficient and, if not, whether a reporting requirement should be extended to all over-the-counter market transactions in financial instruments.

There was widespread agreement among stakeholders that over-the-counter reporting requirements should be extended beyond transactions in derivative products. In the interests of market efficiency, however, there was an understandable concern that reporting costs be kept reasonable. For example, there was concern raised by a number of stakeholders about the high cost of complying with the Johannesburg Stock Exchange requirements as a result of their interpretation of s25 of the current Financial Markets Act.

Section 25 requires any transaction in a listed security that is conducted outside an exchange to be reported to the Financial Sector Conduct Authority. The Johannesburg Stock Exchange has, in turn, required all bond transactions to be cleared and settled through the Johannesburg Stock Exchange's systems. The impact of this requirement has been to make securities financing transactions (and bond transactions generally) very expensive (see Issue 14 below for further discussion of securities financing transactions). The form of reporting needs to be clarified in the new financial markets legislation.

If comprehensive reporting of financial market transactions is broadly agreed, the remaining question is whether this is sufficient for market transparency and surveillance. In terms of the first question, if all financial market transactions are reported, short positions should be visible to the regulators, provided they are reported to a trade repository in a form that can be readily aggregated. It is up to the regulators to ensure that the South African trade repository (or trade repositories) are required to report data in the form that they need in order to monitor financial markets for misconduct.

In addition to the general need for wider reporting and transparency, South Africa's markets are non-compliant with IOSCO principles for short selling. The IOSCO Technical Committee established the following four principles with respect to short selling, most of which are not currently in effect in South Africa:<sup>16</sup>

- (a) Short selling should be subject to appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of financial markets.
- (b) Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities.<sup>17</sup>
- (c) Short selling should be subject to an effective compliance and enforcement system.
- (d) Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.

<sup>16</sup>South Africa currently bans naked short selling, which technically complies with IOSCO's first Principle, although the effectiveness of this ban has been questioned.

<sup>17</sup>In practice, real-time tagging of short sales can be achieved by requiring market participants to specify the quantity of a sell order that is "short" at either the time the order is placed, or at the time the trade is reported.

In terms of the third question, it is worth noting that the information gathering powers of the regulators under Chapter 9 of the Financial Sector Regulation Act are already quite extensive. In particular, s131(1)(a) gives the responsible authority for any financial sector law the power to request any person, whether or not they are a regulated entity, to provide specified information or a specified document in the possession of, or under the control of, the person, provided the information or document is relevant to assisting the responsible authority to perform its functions in terms of the financial sector law. Powers with respect to regulated entities are considerably stronger and include the powers to conduct on-site inspections and investigations.

In the absence of specific examples of situations in which these powers may prove inadequate, Chapter 9, combined with comprehensive reporting of market transactions, would appear to provide the regulators with sufficient information to support the achievement of establishing the efficiency and integrity of South Africa's financial markets.

#### **PROPOSAL 21:**

**That:**

- comprehensive reporting requirements be extended to all transactions in financial instruments conducted in South Africa's financial markets – to avoid doubt, these transactions should include all short selling transactions;
- the assigned regulator for each of these markets be required to ensure that, in setting reporting requirements, it does so with a view to supporting market efficiency by ensuring that reporting obligations can be met at reasonable cost; and
- the new financial markets legislation be drafted so as to bring South Africa's regulatory regime in alignment with the IOSCO principles on short selling, and that these principles apply to trading in all regulated markets (both organised and over-the-counter).

## **11. POWERS, RESPONSIBILITIES AND APPROACH OF REGULATORS**

**Questions:**

- Should regulators set equivalent standards of market practice across organised and over-the-counter markets?
- Should regulators set common fit and proper requirements across financial market participants?
- Should regulators establish a register of fit and proper persons?
- Should the licensing authority for financial market infrastructures have the power to approve significant owners, members of controlling bodies and key persons?
- Should regulators take a common approach across all markets to regulating conflicts of interest?
- Should regulators establish equivalent regimes for enforcement – regardless of whether rules are statutory or voluntary?
- Should regulators monitor and conduct surveillance over all over-the-counter markets?
- Should regulators set standards for market surveillance?
- Should the new financial markets legislation include regulation of financial markets research?
- Should the new financial markets legislation include regulation of ratings agencies?
- Should the new financial markets legislation include regulation of benchmark indices?
- Should regulators have the power to set a standard on remuneration/compensation for authorised market participants?
- Should the new financial markets legislation require best execution?

As should be clear from the list of questions above, there was considerable interest in the powers, responsibilities and approach to regulation that might emerge under the new financial markets legislation.

The most common theme raised by industry was the need for an aligned approach to regulation. Disparities in the way regulations currently apply to different market segments, and even to different participants in the same market segment, is a constant source of stakeholder concern. Not only do material variations lead to distortions in market efficiency and integrity, they can be anti-competitive and costly.



Support for a common and equitable approach to regulating financial markets is reiterated consistently throughout the proposals relating to the high-level issues. It should be a fundamental principle of the new financial markets legislation that market conduct standards apply broadly and consistently to all markets and market participants.

The questions relating to the scope of regulation (e.g., which financial activities should be included, and for which aspects of conduct should the regulators have power to issue standards) are covered in the proposals on high-level issues and will not be repeated here.

A second theme running through these questions was concern about the effectiveness of the fitness and propriety regime in the current Financial Markets Act, in particular as it relates to financial market infrastructures. While the proposals in this Discussion Paper include the creation of a new category of institutions for financial market infrastructures (rather than including them under the general definition of financial institutions), most of the regulatory provisions in the Financial Sector Regulation Act that currently apply to financial institutions will continue to apply to financial market infrastructures. For example, the approval regime in Chapter 11 of the Act that applies to controllers of financial institutions will also apply to financial market infrastructures. The proposed powers for the authorities, along with the general powers under the Financial Sector Regulation Act (including the power in s108(2)(b) to impose through a standard the requirement for regulatory approval for specified matters), should be sufficient to address concerns about the governance of financial market infrastructures and other market participants.

One issue that is not adequately covered by the earlier proposals is the establishment by the regulator of a register of fit and proper persons. While the amount of work that could be involved with maintaining such a register is likely to be substantial, there would be considerable value in establishing it as an internal, rather than a public register. Publishing such a register could open the regulator up to legal action. In this respect it is worth noting that regulators often apply the fit and proper test informally, rather than formally. Where a person being nominated for a particular position is not considered fit and proper, regulators typically raise the matter with the regulated institution and encourage them to propose an alternative. Not only does this approach reduce the likelihood of expensive and damaging legal action, it helps protect the reputation of the nominated persons.

#### **PROPOSAL 22:**

That the Financial Sector Conduct Authority establish an internal register of information about the fitness and propriety of individuals. As echoed in earlier proposals, the new financial markets legislation should also establish a framework within which the regulators are required, to the greatest extent possible, to regulate, supervise and enforce on a common basis across the financial markets.

## **12. CLEARING HOUSES**

#### **Questions:**

- Should the new financial markets legislation eliminate associated clearing houses?
- Should the new financial markets legislation require clearing houses to be independent?
- Should exchanges appoint a clearing house, or should market participants be free to choose who clears their transactions?
- Should the new financial markets legislation include a limit on how many central counterparties are licensed?

There was no shortage of views on issues related to clearing houses in the South African financial markets. There was general acceptance of the proposition that the concept of an associated clearing house was no longer relevant to the South African financial system as it operates today. In particular, there was widespread agreement that no financial market infrastructure should be unregulated.

There was less agreement on whether or not a clearing house should be independent. Some market participants favoured the model, used in some overseas countries, in which clearing houses are owned by a group of market participants. While there is merit in the argument about independence, when markets are viewed as they exist today, the likelihood that technology will disrupt the status

quo in the near future, with platforms that perform most or all of the functions of financial market infrastructures, suggests that flexibility should be the guiding principle for any decision on the future of financial market infrastructures, including clearing houses. For example, the proposals under Issue 2 emphasise flexibility and issuing separate licenses for each financial market infrastructure function. Consistent with that guiding principle, the concept of an associated clearing house should be removed from the new financial markets legislation.

**PROPOSAL 23:**

That the concept of an associated clearing house be removed from the new financial markets legislation.

Section 10(2)(i)(ii) of the current Financial Markets Act states that an exchange may appoint a clearing house or central counterparty to clear and/or settle transactions on behalf of the exchange. While this provision does not mandate that a South African exchange must use a single clearing house for all its transactions, the de facto outcome has been effectively that.

The alternative of allowing participants to choose their clearing house, or any other post-trade infrastructure, is attractive from a competition perspective, although it requires certain controls to ensure that the clearing, settling and custody processes are effective and reliable. The key to ensuring that these processes are not disrupted is through interoperability.

**PROPOSAL 24:**

That post-trade processes be opened to competition, subject to ensuring that new entrants not only meet the licensing requirements involved, but that they also have in place the demonstrated necessary technology for interoperability. This may also require mandatory access to interoperability on the part of existing financial market infrastructures.

The question of whether there should be a limit on the number of central counterparties, or any group of financial market infrastructures, is a much vexed one in South Africa. There is no doubt that having the same security traded, cleared, settled or held in custody by more than one financial market infrastructure greatly increases the risk of fragmentation, duplication, dispute and manipulation. This argument, however, does not necessarily lead to the logical conclusion that only one of each type of financial market infrastructure should operate in South Africa. At most it leads to the conclusion that only one financial market infrastructure should operate for any given financial instrument, and even there the case is less than compelling.

To start with, the risk of duplication and conflict is not the same for all financial market infrastructures; while the risk is high for custody and clearing, it is less so for trading, where mandatory coordination works effectively in some markets. In fact, there is evidence that points to reduced trading costs and spreads in markets with multiple trading infrastructures. As noted above, interoperability is critical to avoiding conflicts.

The case for a single central counterparty is usually regarded as more compelling, given its systemic importance. Even though there is a powerful case for a single central counterparty for any given security, it is less compelling that all securities should use the same central counterparty; for example, one central counterparty could clear equity derivatives, while a different central counterparty could clear interest rate derivatives. That said, there are economies of scale and some risk-pooling benefits from fewer rather than more central counterparties in South Africa. Offsetting these benefits are the potential gains in efficiency and competition that could evolve from technological innovation in this space. Possibly the strongest case for a single financial market infrastructure is in the case of a trade repository and central securities depository.

In addition, a market with multiple central securities depositories providing settlement and custody services in the same financial instruments may not be efficient despite the requirements for interoperability as it can be costly for market participants to access multiple systems and the links between infrastructures may present additional risks that include credit and operational risks. Though a number of jurisdictions maintain single settlement and custody infrastructures, a single CSD market is dependent on a number of factors including the level of market development and scope of the market<sup>18</sup>.

Ultimately, the public utility nature of central counterparties, trade repositories and central securities depositories suggests that the decision on market structure should be policy, rather than regulatory. The following proposal is consistent with this view.

#### **PROPOSAL 25:**

That, subject to confirming the constitutionality of such a measure, the new financial markets legislation provide the Minister with the power to impose a limit on the number of financial market infrastructures in any particular financial market infrastructure category, and/or a moratorium on the issuance of further licences for any financial market infrastructure category for a period of five years, while a review is conducted of the impact of the limit on the efficiency, integrity and stability of the financial system. Following the review, the Minister may impose a new limit or moratorium for a period not exceeding a further five years.

## **13. REGULATION OF PROPRIETARY TRADING**

**Question:** Should the new financial markets legislation include limitations on proprietary trading by market participants, such as is imposed in the United States under the Volker Rule?

The 2008 global financial crisis was seen as caused in part by the conflicts that arose within major global banks between their responsibilities to the customers as market intermediaries and their responsibilities to their shareholders. In several countries, resolution of this conflict was implemented by a legislated separation between trading for customers and trading proprietary positions. In the United States, the separation is known as the Volker rule.

While a forced separation between these trading activities is one solution, another is to ensure that market transactions have sufficient transparency and market regulators have sufficient powers to identify misconduct and enforce standards designed to penalise poor behaviour. The proposals in this Discussion Paper are designed to provide a considerably stronger market conduct regime in both these respects. Even so, it is inevitable that some forms of misconduct will occur. For example, in the Australian financial markets, which were generally regarded (like South Africa's) to have avoided the excesses of the United States and European markets in the mid-2000s, recent investigations by the Australian Securities and Investments Commission have revealed a wide range of conflicts and misconduct in the foreign exchange and money markets.

The key question is whether the deterrents, including those proposed for the new financial markets legislation, are sufficient to keep the cost of isolated cases of misconduct lower than the cost of forced separation of proprietary trading from client trading. The bureaucratic cost of such a forced separation is demonstrated by the complexity that evolved over time with the Volker Rule. Paul Volker's original proposal was contained in a single paragraph. The revisions to the Rule in April 2018 ran to nearly 400 pages. While, under the revised Rule, United States banks are still to be banned from trading for their own profit, they are permitted to trade for the purposes of making a market and to hedge risk. The fine lines between these activities has increased the complexity of the Rule and

<sup>18</sup> An International Monetary Fund working paper further highlights that the decision for multiple or single central securities depositories should be balanced against efficiencies and safety (risk) considerations. Furthermore, the that multiple central securities depositories are more efficient in larger markets than smaller developing markets, even though links may be required, these may not be useful in smaller markets given the high fixed costs associated with IT systems for CSDs. The requirement for CSD links presents risks including operational and credit risks that must be managed. In the case of single CSDs frameworks, this may result in efficiencies from lower costs, and there is ease of linking transactions and settling a larger number of counterparties in a single CSD, however, concentration in one CSD is a concern as there is no potential substitute in case of major disruptions. (Organizing Central Securities Depositories in Developing Markets – Key Considerations, available at <https://www.imf.org/en/Publications/WP/Issues/2018/03/20/Organizing-Central-Securities-Depositories-in-Developing-Markets-7-Considerations-45687>)

greatly increased the difficulty of enforcing it. In addition, South Africa has increased the incentives to voluntarily separate proprietary trading from client trading by increasing the regulatory cost of proprietary trading.

The proposals in this Discussion Paper do not include imposing a “Volker Rule” type of prohibition on proprietary trading in South Africa’s financial markets at this time. The inherent conflict between proprietary and client-based trading, and the potential this conflict creates for market misconduct, should nevertheless place a high priority on the Financial Sector Conduct Authority setting a conduct standard addressing the need to manage the conflicts of interest inherent in proprietary trading and monitoring market behaviour for evidence of misconduct in this area.

## 14. SECURITIES FINANCING TRANSACTIONS

### Questions:

- Does s25 of the current Financial Markets Act mean that repurchase agreements (repos) need to be cleared through the Johannesburg Stock Exchange’s systems?
- Does the Insolvency Act effectively limit the commercial attractiveness of securities financing transactions by limiting the transferability of collateral?
- There is a need to clarify the requirements under s39 of the current Financial Markets Act for pledging securities.
- Repos can only be done as expensive sell-buy-back transactions. These should be able to be done under a Global Master Repurchase Agreement and should not have to be cleared through an exchange.

It was apparent from comments made by a number of stakeholders that securities financing transactions in South Africa are problematic at best. As noted earlier, the Johannesburg Stock Exchange’s interpretation of s25 of the current Financial Markets Act as requiring such transactions to be cleared through the Johannesburg Stock Exchange’s systems has added materially to the cost of such transactions, especially in situations where margining is required. Questions were also raised about the impact of the Insolvency Act (24 of 1936) on transferring collateral, other than in an outright sell-buy-back version of securities financing. There was also a question raised as to whether the settlement and transfer of ownership provisions in the Companies Act (71 of 2008) should be moved to the new financial markets legislation.

Finally, it was noted that the process set out in s39 of the current Financial Markets Act for pledging securities was unnecessarily complex and burdensome. While this issue may have broader application than just for securities financing transactions, there is a clear need for this provision to be reviewed in the context of the new financial markets legislation’s objective of supporting market efficiency.

Other countries have well-established and efficient markets in short-term collateralised funding. The availability of marketable securities is seen as critical to market liquidity and therefore financial stability in times of stress. Thus, there should be a priority on resolving these impediments in the new financial markets legislation.

### PROPOSAL 26:

#### That:

- the new financial markets legislation remove the ambiguity in the current s25 of the Financial Markets Act, with a view to enabling over-the-counter securities financing transactions to be executed under a Global Master Repurchase Agreement;
- the new financial markets legislation review and resolve the limitations on pledging securities contained in s39 of the current Financial Markets Act; and
- relevant provisions be identified in the Insolvency Act and Companies Act that may warrant amendment in order to better facilitate the transferability and protection of collateral in securities financing and other financial market transactions.

## 15. DEFINITIONS

**Comments:**

- Market integrity needs to be defined.
- Market efficiency needs to be defined.
- Securities need to be better defined.

As noted earlier in this Paper, the current Financial Markets Act has a number of restrictive definitions that limit its effectiveness in establishing a financial markets regulatory framework. As noted in the proposals under Issues 2, 4 and 5, the use of broader and more flexible definitions is a key characteristic of the proposed new financial markets legislation. In particular, inconsistencies in the definition of securities will be addressed and, wherever possible, the broader concept of financial instruments will be used.

**PROPOSAL 27:**

That very broad and flexible definitions of all key elements be adopted in the new financial markets legislation, including for trading venues, financial market infrastructures, financial instruments, financial market activities and objectives for the Act. These definitions should generally be inclusive, rather than exclusive.

## 16. THE LICENSING PROCESS

**Questions:**

- Should the regulators be empowered to issue conditional licences?
- Should licensing requirements be more explicit and transparent?

A number of stakeholders noted that the licensing process with the Financial Sector Conduct Authority was overly complex. The Financial Sector Conduct Authority also noted that the licensing process was made more difficult and costly for the applicant by the provision in the current Financial Markets Act that the Authority may only grant a licence with specific terms or conditions once it is satisfied that the applicant has complied with the relevant sections of the Act. This requirement is onerous in that it requires an applicant to mobilise human and financial resources, and implement systems ahead of any indication that its application will be successful. The requirement is particularly onerous in the case of financial market infrastructures.

The Financial Sector Conduct Authority has proposed providing it with the power to grant a conditional or provisional licence. During the term of the conditional/provisional licence the applicant should be afforded the opportunity to meet and demonstrate that it meets the requirements of the Act, before becoming fully operational. During the period of the conditional/provisional licence, the applicant should meet minimum requirements and have tight limitations on the business it may execute.

Some stakeholders expressed a preference to see the licensing requirements spelled out in detail in the new legislation, rather than in secondary legislative instruments such as regulations or standards. While there is a case for providing greater clarity, especially given the cost involved in applying for a licence, there is at least as strong a case for following the style of the Financial Sector Regulation Act and keeping the new financial markets legislation to framework law, with the details to be provided in standards, so as to preserve maximum flexibility for the regulators to adapt to changing market circumstances and international practice over time. As noted earlier, the one exception to this general rule is in respect of financial market infrastructures, where considerable detail is likely to remain in the new financial markets legislation. Other than for financial market infrastructures, the advantages of keeping licensing details in standards are that:

- technically, standards have the same legal standing as the Act;
- standards can be changed more easily than primary law to cope with changing market circumstances; and
- relegating detail to the standards avoids cluttering the primary legislation and making it longer than needed.

Notwithstanding the strength of the case for keeping the details of the licensing process in standards, there is a compelling case for potential licence applicants to see that detail and to see it as early as possible. Publishing standards on conduct licensing requirements should be a priority moving forward. Ideally, exposure drafts of standards addressing licensing and at least the core conduct standards should be circulated with the draft of the new financial markets legislation, to provide industry participants with a more complete picture of the new regulatory framework.

#### **PROPOSAL 28:**

**That:**

- the power for the relevant authority to issue an applicant with a provisional licence during a period of establishment be included in the new financial markets legislation. The minimum requirements of the provisional licence, which may vary according to the type of licence being applied for, should be specified in a licensing standard. The business that may be conducted under a provisional licence should be subject to restrictions imposed by the responsible authority.
- the regulators prioritise development of standards addressing licensing in the financial markets and core conduct issues, and that these be circulated for comment along with the draft of the new financial markets legislation.

## **17. BOND MARKET WEAKNESSES**

**Comments:**

- The South Africa bond market has numerous challenges.
- The listing rules for bonds on the Johannesburg Stock Exchange provide no protection for bond holders, especially for holders of state-owned enterprise debt.

**Question:** Is there a reason why hybrids cannot be issued in South Africa?

There was considerable discussion and negative comment by stakeholders about deficiencies in the South African bond market and, in particular, the lack of rights and protections for investors. While debt issued by private sector issuers was an issue with some, the overwhelming cause for concern was with debt issued by state-owned enterprises. This topic was considered to be sufficiently important that a separate set of meetings was held with industry and the Johannesburg Stock Exchange to determine whether the weaknesses needed to be addressed in the new financial markets legislation or whether they could be addressed more urgently through the Johannesburg Stock Exchange's debt listing requirements.

It is important to highlight from the outset that the problems with debt issued by state-owned enterprises are a combination of problems with the state-owned enterprises themselves and weaknesses in the debt market. In summary, the more urgent problems included:

- poor governance of state-owned enterprises, including a lack of transparency over how board members are appointed and dismissed;
- inadequate disclosures about the businesses of state-owned enterprises (including procurement processes, management of conflicts of interest, related party transactions, etc.) as well as about their financial soundness; and
- inadequate representation of debt holders in meetings with issuers and in their rights in calling and voting at meetings of debt holders;

A comprehensive reform of the governance and operation of state-owned enterprises is a matter for public policy and is beyond the scope of the new financial markets legislation. Notwithstanding the need for broader reforms of South Africa's state-owned enterprises, some of the current weaknesses in the market for debt can be addressed by reforms to the Johannesburg Stock Exchange's debt listing requirements.

The most obvious weakness of the Exchange's debt listing requirements was that they were much less detailed and offered investors in debt fewer protections than was the case for equity investors. At a minimum, the debt listing requirements needed to be aligned with the equivalent requirements for listing equities.

Coincidentally, the Johannesburg Stock Exchange was, at the time, reviewing its debt listing requirements, with a view to addressing many of the issues raised by investors. Following engagement with the Exchange it was apparent that their proposed reforms not only brought the debt listing requirements into reasonable parity with its equity listing requirements, but also that they went a long way towards meeting the needs of investors, although stopping short of meeting their full "wish list" of reforms.

The following is a summary of the main reforms proposed by the Johannesburg Stock Exchange:

- Including corporate governance requirements.
- Attestations by Directors as to compliance with governance requirements based on the King Code.
- Possible extension of this sign-off to include, where possible, disclosure of an independent governance rating.
- Disclosure about board appointment processes and of the reasons for changes in board members.
- Disclosure of the terms of reference of Board Committees.
- Disclosure of all loans to, and transactions (including procurement contracts) between, the issuer and management, related parties and prominent influential persons.
- Disclosure of all material procurement contracts.
- Mandatory appointment of a compliance officer to represent investors and collate investor comments, as well as monitoring compliance with terms and conditions of the securities documents.
- Provisions for Note holders to request the issuer to call a meeting.

These reforms are still under public consultation. If implemented, they will go a long way to addressing investor concerns. If, in the light of experience, further reforms are needed to ensure the efficiency and integrity of the South Africa debt markets, the powers proposed for the regulator under the new financial markets legislation, including the power proposed to set minimum listing requirements for all trading venues, should be sufficient for the Financial Sector Conduct Authority to take action to address them. These minimum listing requirements should also address requirements for issuing hybrid securities.

No further adjustments to the new financial markets legislation are proposed at this stage to address debt market weaknesses. The powers proposed earlier for the regulators to set minimum listing requirements for regulated markets should provide sufficient flexibility to implement reforms in the debt markets..

## 18. NOMINEES

**Comment:** The use of nominees and the consequences of their use need review.

**Question:** Should the authorities establish a securities ownership register?

Discussions with stakeholders included a range of views about the role and usefulness of nominees in the South African financial markets. Under Chapter 9 of the current Financial Markets Act, nominees of authorised users are approved by the exchanges on which they trade. Nominees of central securities depository participants are approved by the central securities depository. The Financial Sector Conduct Authority approves all other nominees. The Financial Sector Conduct Authority may also prescribe requirements for nominees and must keep a register of nominees.

As noted by the Financial Sector Conduct Authority, different authorisation standards are currently applied by the three different approving bodies. The Financial Sector Conduct Authority also notes that there are insufficient powers in the Financial Markets Act to supervise nominees. The Financial Sector Conduct Authority has suggested that the approval of nominees be removed from

the new financial markets legislation and regulated under the Conduct of Financial Institutions framework. Since nominees are a part of financial market activities it is questionable whether it would be appropriate to move this function to the retail conduct framework. Further, the proposed inclusion of nominees within the definition of market participants (see the proposals for Issue 2 above) should provide the regulators with the full suite of powers to authorise, regulate and supervise nominees under the new financial markets legislation.

The Financial Sector Conduct Authority has suggested that the regulators should have the power to establish a securities ownership register. Such a register would record beneficial ownership on a central registry and could be a viable alternative to nominee companies.

**PROPOSAL 29:**

That the Financial Sector Conduct Authority be given the power to establish a securities ownership register as a central record of beneficial ownership of financial instruments.

## **19. RECOGNITION OF FOREIGN JURISDICTIONS AND EXTERNAL PARTICIPANTS**

**Questions:**

- Should foreign financial market infrastructures and market participants have to comply with all local regulatory requirements, as a local financial market infrastructure would, or should there be some form of equivalence with certain jurisdictions?
- Should the South African regulatory authorities authorise external financial market infrastructures, or their market participants as well?

**Comments:**

- There needs to be greater clarity as to what is involved in recognising a foreign jurisdiction as “equivalent” to South Africa.
- Need to clarify the definition of “link” in s6 and s7 of current Financial Markets Act regulations.
- Need to clarify that external central counterparties (as well as other external financial market infrastructures) also need to be authorised by the South African regulatory authorities.
- There needs to be greater clarity about reciprocity so that South African financial market infrastructures and market participants can provide services to other markets (e.g., elsewhere in Africa).
- Care needs to be taken to ensure that external participants do not have an unfair regulatory advantage and do not disintermediate local market activity.

The current Financial Markets Act defines the following potential external participants in South Africa’s financial markets:

- external central securities depository;
- external clearing house;
- external central counterparty;
- external exchange;
- external trade repository;
- external authorised user (stockbroker);
- external clearing member (member of a clearing house); and
- external participant.

Collectively these will be referred to as external participants. Under s5(1)(c) of the Financial Markets Act the Minister may prescribe the services that may be provided by external participants and the functions and duties that may be performed.



Under section 6 of the Financial Markets Act the Authority, with the concurrence of the South African Reserve Bank, and the Prudential Authority may exempt or recognise an external market infrastructure (external central counterparty, external central securities depository and external trade repository), in relation to the securities services that may be provided and to exercise the functions and duties set out in the Act, as the case may be, provided that:

- (a) the applicant for exemption or recognition is based in an equivalent jurisdiction in accordance with requirements in section 6A of the Act;
- (b) the Authority must have in place supervisory and cooperation arrangements with the foreign supervisory authority from the equivalent jurisdiction taking into account the minimum requirements in section 6c for these arrangements;
- (c) is already authorised by the relevant supervisory authority in that foreign country and is subject to supervision and enforcement on an ongoing basis;
- (d) complies with the criteria joint standards for licensing, authorisation, exemption or recognition; and
- (e) the applicant must also undertake to co-operate and share information with the authorities.

While the regime suggested by the recent regulations provides a framework for the idea of “recognition” of external participants, there is a case for further clarity. However, the Financial Sector Conduct Authority have published drafts for consultation on the equivalence framework for licensing external central counterparties and trade repositories and this should help to provide some clarity on the framework.

#### **PROPOSAL 30:**

That the recognition framework for external participants (including market participants and financial market infrastructures) be clarified to address the following:

- whether equivalence will be assessed in terms of either or both of the rules applying to a financial market infrastructure or by the financial market infrastructure to its members;
- whether external participants will be subject to regulation of their activities with respect to South African financial instruments by the responsible authority in South Africa as well as their home regulator;
- what disclosures will be required by external participants;
- how reciprocity will be assessed and implemented; and
- the need for memorandums of understanding between South African and relevant foreign regulators, addressing the issues above, information sharing, reciprocity and other such considerations.

## **20. RANGE OF MARKET OFFENCES**

#### **Questions:**

- What additional offences should be included in the new financial markets legislation?
- Should the new financial markets legislation include a market abuse “catch-all” clause as is used in United Kingdom legislation?
- Should there be compulsory disclosure of misconduct if a financial institution detects or suspects a breach of the Act?

#### **Comment:**

Market offences should be extended to over-the-counter markets.

The fact that market abuse provisions in the current Financial Markets Act do not apply to over-the-counter markets was a regular theme of discussions with stakeholders. Chapter 10 of the current Financial Markets Act addresses offences under the headings of insider trading, the prohibited practices of manipulative, improper, false or deceptive trading and the making of false, misleading or deceptive statements, promises and forecasts. While these powers are quite robust, they are limited in application to exchange traded markets. The earlier proposals to extend the coverage of the new financial markets legislation to all financial markets and market participants should address this concern.

The question about offences generally is nevertheless very relevant in the context of the new financial markets legislation. The Financial Sector Regulation Act provides a number of offences that will apply automatically to financial market activity. These include s273 (provision of false and misleading information to a regulator) and breaches of conduct standards (e.g., with respect to disclosure). While these provisions are helpful, they do not address specific market abuses such as insider trading or market manipulation. Thus, at a minimum, the powers in the current Financial Markets Act will need to be retained and expanded.

The United Kingdom approach is arguably more general than the approach in the current Financial Markets Act, in that it collects all offences under the single heading of market abuse (s118 of the Financial Services and Markets Act (2000)), but defines market abuse in a way that allows for flexible interpretation. Given that the extension of the offences in Chapter 10 of the current Financial Markets Act to all financial markets and activities should be sufficient to establish a comprehensive regime for pursuing market abuse, it is not clear that the United Kingdom approach would necessarily be any more effective. The drafters may wish to further consider both alternatives.

The question about mandatory reporting of breaches or suspected breaches of the Act (or other financial sector laws) is already covered in s117 of the Financial Sector Regulation Act (reporting obligations of licensees). Under s252(1) auditors are also subject to a mandatory reporting regime for identified or suspected breaches of the Act.

While this Discussion Paper does not include a specific proposal on market abuse provisions, prior to commencing drafting, a review will need to be conducted of the United Kingdom approach to defining market abuse, and whether it adds anything beyond what would be added by a simple extension of the market abuse framework in Chapter 10 of the current Financial Markets Act to all markets in financial instruments.

## 21. WHISTLEBLOWING INCENTIVES

**Question:**

Should the new financial markets legislation include a whistleblower rewards scheme?

The Financial Markets Review recommended introducing a whistleblower reward scheme. The general framework for whistleblower protection in South Africa is provided under the Protected Disclosures Act (26 of 2000).<sup>18</sup> This Act does not include provision for financial incentives for whistleblowers.

While the Financial Sector Regulation Act does not purport to provide a comprehensive whistleblower framework, s253 and s254 allow persons to report suspected breaches to the regulator and to do so with certain protections. As with the Protected Disclosures Act, these protections do not contemplate providing financial rewards for whistleblowers.

The best-known whistleblower reward scheme internationally is that in the United States, although it is understood that Nigeria also employs such a scheme. In 2011, the Dodd-Frank Act established new incentives and protections for individuals to report possible violations of the federal securities laws, including:

- monetary awards for providing original information to the Securities and Exchange Commission that leads to a successful enforcement action;
- heightened confidentiality assurances; and
- enhanced protection from retaliation for employees (these apply to employees who first report internally to the company and employees who report directly to the Securities and Exchange Commission and those who assist with the investigation. Relief can include reinstatement of position, payment of back pay (at double rate) and compensation for costs.

<sup>18</sup>Protected Disclosures Act (26 of 2000) available at <http://www.justice.gov.za/legislation/acts/2000-026.pdf>

The Securities and Exchange Commission is authorised to provide monetary awards to eligible individuals who come forward with high-quality original information that leads to an enforcement action resulting in over USD 1 million in sanctions. Information may be submitted anonymously (via legal representation). The range for awards is between 10% and 30% of the money collected. The Securities and Exchange Commission created the Office of the Whistleblower in 2011 to encourage whistleblowers to assist in the discovery and prosecution of securities laws violations. The Commission has paid more than USD 85million to 32 whistleblowers since August 2011. A similar program exists at the Commodity Futures Trading Commission.

- The effectiveness of the United States whistleblower incentive scheme has been questioned: A Discussion Paper published by the Australian Senate Economics References Committee, observed that introducing an incentive scheme might increase the number of unreliable disclosures, undermine internal reporting mechanisms and be inconsistent with the Australian culture.
- In the United Kingdom, in response to the Parliamentary Commission on Banking Standards, the Financial Conduct Authority and Prudential Regulation Authority conducted research into the impact of financial incentives on encouraging whistleblowing in the United States. They concluded that introducing financial incentives to whistleblowers would not encourage whistleblowing or significantly increase the integrity and transparency in financial markets. It was noted that there is “no empirical evidence to suggest that the United States system raises either the number or the quality of whistleblowing disclosures within financial services”, nor do the incentives in the United States model “appear to improve the protection available to whistleblowers”.

Regardless of the merits or otherwise of a whistleblower incentive scheme, there is a question as to whether the new financial markets legislation is the appropriate place to introduce such a programme. If there were public support for such a scheme, it would be more appropriate to include it in amendments to the Protected Disclosures Act.

This Discussion Paper does not propose amending the provisions of s253 and s254 of the Financial Sector Regulation Act to include a whistleblower incentive scheme.

## **22. PROTECTION OF MARGIN AND COLLATERAL UNDER THE INSOLVENCY ACT**

**Question:**

Does the Insolvency Act need to be amended to remove a conflict with margining of derivatives and collateral usage in other financial market transactions?

The role of the Insolvency Act in bringing into question the security of margin payments on derivatives transactions and of collateral more generally was raised in a number of discussions. In the absence of a clear legal opinion this matter needs to be investigated in the course of drafting the new financial markets legislation. However, certain sections of the Insolvency Act have been amended to accommodate the margining framework for over-the-counter derivative transactions with reference to section 35B to allow for immediate accessibility of margins posted on those transactions. Other amendments are under consideration for transactions relating to market infrastructures.

While outside the scope of the new financial markets legislation, it would be helpful if the Insolvency Act could be reviewed during drafting of the new financial markets legislation to assess whether amendments are necessary to protect margins paid on derivatives positions and to protect collateral more generally

In addition to the issues raised above, stakeholders also submitted numerous detailed editorial suggestions on particular clauses in the current Financial Markets Act. To the extent that these are not covered in other issues above, and to the extent that the particular clauses remain in the new financial markets legislation, the drafters will need to consider these suggestions as part of the revision process.

## 23. REGULATING THE SETTLEMENT PROCESS

**Question:**

Should the new financial markets legislation include regulation of the settlement process, including a definition of final settlement?

The importance of certainty around the settlement process cannot be overstated. This certainty is particularly important in the event that one or the other party to a transaction is placed in liquidation during a transaction. Uncertainty about settlement has the potential to increase settlement risk not only for the transaction involved, but also for other transactions where the settlement procedures followed by central securities depositories link the settlement of transactions.

The new financial markets legislation needs to address settlement requirements, particularly in the areas of oversight, enforcement and supervision. These should take account of international principles and practices. Importantly, they should place greater settlement responsibility for linked transactions on central securities depositories and their participants.

The need for clarity around final settlement is highlighted in the CPMI-IOSCO Principles for Financial Market Infrastructures. Principle 8 stipulates that the legal framework for financial market infrastructures should at least have the following key considerations:

- Key consideration 1 - as a minimum define the point at which the settlement of a payment is final and irrevocable;
- Key consideration 2 - that the settlement process should be completed no later than the end of the value date (preferably intraday or in real time) and consider real-time gross settlements or multiple batch settlement processes; and
- Key consideration 3 - the point at which unsettled payments, transfer instructions or other obligations may not be revoked by a participant should also be specified.

These considerations are not adequately addressed in the current National Payment System Act. Recommendation 16 of the Review of the National Payment System Act suggests that the National Payment System Act or settlement standards should explicitly state that settlement is final and irrevocable, and the point at which settlement is final and irrevocable cannot be unwound. It also recommends that settlement should be in line with Principle 8 of the CPMI-IOSCO Principles.

These settlement standards should be in alignment with exchange rules and the National Payment System Act. Section 17 of the National Payment System Act requires the same alignment for exchange rules. Finality is thus left to what the relevant parties define as the point of “contractual commitment”, and exceptions can be made to these rules. Further, the timing of the exact contractual commitment point depends on the various settlement cycles of the different securities and markets.

With respect to listed securities, while there is certainty provided by s38, s39, s41 and s46 of the current Financial Markets Act, this is limited to the rights in the final settlement of securities transactions. There is less certainty about the finality of settlement instructions. Section 35 of the current Financial Markets Act requires central securities depositories to issue rules in this regard. The new financial markets legislation and central securities depository rules should clearly define the point at which settlement is final in reference to Principle 8 of the CPMI-IOSCO Principles. In addition, there is a need for reduced settlement risks in the process. This requires consideration of the timing of various settlement cycles adopted by the central securities depository.

As central securities depositories currently perform linked settlements for various transactions, provisions must be in place for the linking and delinking processes and preference should be for “automated processes”, rather than manual processes, where applicable. To that end, the central securities depository rules should be clear on the procedures to link and delink transactions. This includes the extent to which these are applied and that trades must be ready for settlement before entering a linking process. The responsibility for this process should be on both the central securities depository and central securities depository participants to manage settlement risks (from possible failure of a linked transaction) and to enhance settlement processes.

It is also critical to enhance settlement discipline in order to reduce the number of cancelled transactions and “rolled settlement transactions” (in which transactions are allowed to settle on a date other than the intended settlement date). In this respect, it is also important to distinguish the rolling of settlements from failed trades and this should align with international standards.

Increased oversight over settlement processes by the regulators is also required to detect unwanted market practices or behaviours and identify potential threats to the settlement system. This responsibility, including the responsibility to have in place capabilities to detect and resolve any issues and to inform the authorities of such occurrences, is one that might reasonably be delegated to central securities depositories.

While flexibility is needed to address different market situations, it would be helpful to have the basic definitions in the new financial markets legislation, with some of the details left to standards.

#### **PROPOSAL 31:**

**That:**

- a definition of final settlement be included in the new financial markets legislation;
- settlement provisions in the new financial markets legislation be aligned with international settlement principles; and
- central securities depositories be required to distinguish failed settlements from rolled settlements.

## **24. DEMATERIALISATION AND REMATERIALISATION**

**Question:**

Should the new financial markets legislation support the move to digitisation by preventing rematerialisation of securities?

Section 33(1) of the current Financial Markets Act facilitates the dematerialisation of certificated securities, despite any contrary provision in any other law. According to the Financial Markets Act, when an issuer issues new listed securities, such securities must be issued in uncertificated form. This clause has helped accelerate the digitisation of securities traded in the South African financial markets and reduced the time taken to clear and settle transactions in securities. However, there might be a need to align the Companies Act with the new financial markets legislation in several respects:

- Section 49 of the Companies Act does not expressly provide the manner in which dematerialisation may be effected. Regulation 33 provides expressly for an instruction to dematerialise from the holder of the certificated securities whose name is entered in the company's securities register. Neither s49, nor Regulation 33, appears to permit an issuer to dematerialise securities in the absence of shareholder instructions. At a minimum this appears to rule out bulk dematerialisation by the issuer.
- Unlike s33(1) of the current Financial Markets Act, s49 of the Companies Act does not require newly listed companies to issue in dematerialised form.
- Chapter 2, Part E of the Companies Act enables dematerialised securities to be rematerialised, thereby enabling the digitisation process to be unwound.

These features of the Companies Act run counter to the modernisation of markets and moves to increase liquidity and shorten settlement windows, thereby reducing risk to those who trade in organised markets.

However, impacts of dematerialisation on the market participants should be considered including the costs associated with the dematerialisation processes such as the additional fees associated with maintaining an electronic record specifically at a central securities depository. Furthermore, alternative processes for dematerialisation should be explored to accommodate a broad range of diverse market participants who may be adversely affected by these requirements. Creating those alternatives may require reviewing the provisions in the current Financial Markets Act.

**PROPOSAL 32:**

That the Companies Act be amended to:

- clarify that issuers may dematerialise securities on issue without the need to seek instructions from each shareholder;
- clarify that newly listed securities should be issued in dematerialised form; and
- remove the ability of dematerialised securities to be rematerialised.

# **ATTACHMENT A:**

## **ALIGNMENT OF THE FINANCIAL MARKETS REVIEW RECOMMENDATIONS AND PROPOSALS FOR THE NEW FINANCIAL MARKETS LEGISLATION**

<b>Issues</b>	<b>Financial Markets Review Recommendations</b>	<b>Financial Markets Legislation Proposals</b>
<b>GOVERNANCE</b>		
Corporate and risk governance practices	<p>1. Regulators to consider exploring legislative governance requirements to establish equivalent but proportional regulatory regimes for all market participants and to remove gaps or inconsistencies. (Note: Work is underway in the Interagency Governance Subcommittee. The Interagency Governance Subcommittee consists of members of the National Treasury, Reserve Bank, Prudential Authority and Financial Sector Conduct Authority.)</p>	<p>See– Proposal 18 – Financial Sector Conduct Authority to replace financial market infrastructures in setting regulatory standards. Proposal 15 – new category of conduct licence (markets) to be issued by the Financial Sector Conduct Authority. Proposal 16 – new category of conduct standards (markets) – to be common across market participants. Proposal 22 – regulators required, to the greatest extent possible, to regulate, supervise and enforce on a common basis across financial markets.</p>
	<p>2. Regulators to consider developing a central source of information (as envisaged in section 256 of the FSR Act) relating to corporate governance standards applicable to financial institutions, both listed and unlisted.</p>	<p>See– Proposal 22 – Financial Sector Conduct Authority to establish an internal register of information about the fitness and propriety of individuals.</p>

**BUILDING COMPETITIVE FINANCIAL MARKETS  
FOR INNOVATION AND GROWTH**

Issues	Financial Markets Review Recommendations	Financial Markets Legislation Proposals
Fit and proper requirements for market participants	3. Regulators to consider exploring existing fit and proper requirements to establish an equivalent regulatory regime for all market participants and to address any gaps or inconsistencies. (Note: Work is underway in the Interagency Governance Subcommittee.)	See– Proposal 18 – Financial Sector Conduct Authority to replace financial market infrastructures in setting regulatory standards. Proposal 16 – Financial Sector Conduct Authority to have power to issue conduct standards (markets) with extensive governance coverage.
	4. Regulators to consider (i) establishing registers of fit and proper persons; and (ii) allowing specific information on non-registered individuals to be shared between employers to stop bad apples rolling between firms.	See– Proposal 22 – Financial Sector Conduct Authority to establish an internal register of information about the fitness and propriety of individuals.
Responsibilities of senior managers/ executives	5. Regulators to consider the implementation of an accountability regime that is equivalent and proportional for all market participants without prescribing individual roles and responsibilities within firms. (Note: Work is underway in the Interagency Governance Subcommittee.)	Agree with the recommendation – but suggest this needs to start with banks, rather than in new financial markets legislation. See discussion under Issue 8.
Compensation (incentives and remuneration)	6. Regulators to consider how to reduce incentives that promote excessive risk-taking that may arise from the structure of compensation schemes, without prescribing compensation design or levels.	See– Proposal 16 – Financial Sector Conduct Authority to have power to issue conduct standards (markets) including with respect to incentives.
Whistleblowing	7. Regulators to consider implementing a programme that rewards whistleblowers for providing information about substantial misconduct in financial markets that leads to a successful enforcement action with monetary sanctions	On balance there was a preference not to legislate rewards. See comments under Issue 21.
Ongoing training and development	8. Regulators to consider measures to ensure the education of retirement fund trustees and to provide them with minimum tools to assess the advice and other services provided to their funds.	Agree with the recommendation but noted that this can be done in a standard, rather than coded into primary law.



Issues	Financial Markets Review Recommendations	Financial Markets Legislation Proposals
<b>MARKET CONDUCT</b>		
Standards and codes of market practice	<p>9. Financial sector authorities to consider rationalising the many committees, workgroups and forums attended by both the regulatory authorities and market participants to debate and discuss financial market matters. Thereafter regulators to consider encouraging the formation of a Financial Markets Standards Group by senior market professionals and compliance officers. The Financial Markets Standards Group's first task could be to consider the development of a general code of conduct for financial market participants.</p>	<p>See– Proposal 20 – to establish a Financial Markets Standards Group, with representation from senior market professionals and compliance officers, to be approved by the Financial Sector Conduct Authority. The Financial Markets Standards Group will be largely advisory.</p>
	<p>10. Regulators to consider establishing equivalent standards of market practice across wholesale financial markets including over-the-counter markets (consider the Financial Advisory and Intermediary Services (FAIS) Merchant Banking exemption).</p>	<p>See– Proposal 1 – to expand coverage of the new financial markets legislation to include all over-the-counter financial markets. Proposal 18 – Financial Sector Conduct Authority to replace financial market infrastructures in setting regulatory standards. Proposal 22 – regulators required, to the greatest extent possible, to regulate, supervise and enforce on a common basis.</p>
	<p>11. Regulators to consider setting up equivalent regimes to monitor and enforce standards and codes of market practice, whether statutory or voluntary.</p>	<p>See– Proposal 17 – all market abuse provisions, including those relating to insider trading and market manipulation, will apply equally to all markets in financial instruments, regardless of how the markets are structured.</p>

Issues	Financial Markets Review Recommendations	Financial Markets Legislation Proposals
Market discipline	12. Regulators to consider progressing the establishment of trade repositories in all over-the-counter markets (not only over-the-counter derivatives). This will provide regulators with data that is necessary to carry out monitoring and surveillance to stimulate market discipline.	See– Proposal 21 – extends comprehensive reporting requirements to all transactions in financial instruments conducted in South Africa’s financial markets.
	13. Regulators to consider meeting with market participants to establish ways in which bilateral market discipline might be improved.	Agree with the recommendation, although no formal proposal is made, other than through: Proposal 20 – to establish a Financial Markets Standards Group with representation from senior market professionals and compliance officers, to be approved by the Financial Sector Conduct Authority. The Financial Markets Standards Group will be largely advisory.
	14. Regulators to consider obliging market participants to inform them if misconduct is detected or conflicts of interest suspected.	See– s117 of Financial Sector Regulation Act, which will be picked up automatically given that the new financial markets legislation will be embedded in the Financial Sector Regulation Act.
	15. Regulators to consider investigating the various conflict of interest requirements for wholesale markets and establishing consistent, equivalent and comprehensive regulations for type 1 and 2 conflicts across exchange-traded and over-the-counter financial markets. Such regulations could specifically address third-party payments (also by market makers) when executing orders on behalf of clients.	See– Proposal 16 – Financial Sector Conduct Authority to have power to issue conduct standards (markets) including with respect to conflicts of interest.
Market abuse	16. National Treasury to consider including a market abuse regulation catch-all clause in the Financial Markets Act 19 of 2012 (Financial Markets Act)	See– Proposal 17 – all market abuse provisions, including those relating to insider trading and market manipulation, will apply equally to all markets in financial instruments, regardless of how the markets are structured.
	17. Regulators to consider requiring that short sales be flagged on exchanges and reported to the exchange and/or the regulator. (Note: Financial Sector Conduct Authority has completed a report on international practices on short sale reporting and disclosure and is crafting a consultation paper on short sale reporting for South Africa.)	See– Proposal 21 – bring South Africa’s regulatory regime into alignment with the IOSCO principles on short selling, and that these principles apply to trading in all regulated markets (both organised and over-the-counter).

Issues	Financial Markets Review Recommendations	Financial Markets Legislation Proposals
Monitoring and surveillance	18. Regulators to consider implementing market surveillance and monitoring systems for over-the-counter markets and fragmented exchange-traded markets. However, fully functional trade repositories will be a prerequisite (see 3.3.4).	See– Proposal 14 – formalises the regulation of existing over-the-counter markets in financial instruments (to be designated as regulated over-the-counter markets). Proposal 21 – extends comprehensive reporting requirements to all transactions in financial instruments conducted in South Africa’s financial markets.
	19. Regulators to consider providing standards for surveillance to firms.	Financial Sector Conduct Authority will be able to do this through standards.
<b>MARKET STRUCTURE</b>		
Liquidity	20. Regulators to consider investigating deficiencies in price discovery in certain instruments (e.g., foreign exchange options, index derivatives, structured products, equity volatility derivatives, corporate bonds and structured notes).	Financial Sector Conduct Authority will have powers to do this.
	21. Regulators to investigate the characteristics and structure of the South African corporate primary and secondary bond markets, including listing requirements, liquidity, transparency, participants and use of trading technology and venues. Consideration could be given to implementing an electronic trading platform for corporate bonds to enhance liquidity and price discovery.	Some changes are under way via Johannesburg Stock Exchange debt listing requirements. Comment: No further adjustment to the new financial markets legislation is proposed at this stage to address debt market weaknesses. In the event that further reforms are needed to debt listing requirements, the powers proposed earlier for the regulators to set minimum listing requirements for regulated markets should provide sufficient flexibility to implement those reforms.
Transparency	22. Regulators to consider implementing the Global Financial Markets Association’s Guiding Principles for Market Transparency Requirements to further support market integrity.	Financial Sector Conduct Authority will be able to do this through standards.
	23. Regulators to consider steps to enhance pre-trade transparency of trading information, particularly in corporate bond markets, and implement post-trade transparency by way of, for example, trade repositories.	Financial Sector Conduct Authority will be able to do this through standards.

**BUILDING COMPETITIVE FINANCIAL MARKETS  
FOR INNOVATION AND GROWTH**

Issues	Financial Markets Review Recommendations	Financial Markets Legislation Proposals
Competition	24. Regulators to consider addressing the identified restrictions to competition, namely capital required to participate in markets, regulatory barriers to entry, the cost of regulatory compliance, and the strict requirements for affiliation with market structures.	See– Proposal 28 – introduces a conditional licence concept, which should help start-ups.
	25. Regulatory authorities to sign a memorandum of understanding with the Competition Commission to enable the consistent and effective promotion of competition to prevent anti-competitive behaviour in financial markets.	This can be added to the memorandums of understanding in the Financial Sector Regulation Act during drafting.
Market makers / Primary dealers	26. National Treasury and regulators to encourage the implementation of measures to promote price transparency for most (if not all) over-the-counter financial instruments.	Now that all over-the-counter markets will be regulated, it will be possible to have this done through a standard.
Securities financing transactions (SFTs)	27. Regulators to consider implementing trade repositories as an effective way to collect comprehensive market data for SFTs.	See– Proposal 21 – extends comprehensive reporting requirements to all transactions in financial instruments conducted in South Africa’s financial markets.
	28. Regulators to consider requiring fund managers to disclose appropriate information on SFTs to investors to allow investors to clearly understand the implications of SFTs and select investments that meet their risk profiles. (Note: The Financial Sector Conduct Authority is drafting conduct standards for SFT participants, which will include reporting requirements.)	Financial Sector Conduct Authority will be able to do this through a standard.
	29. Regulators to investigate the necessity and ways to expand the repurchase (repo) market. (Note: Work is underway in the working group of the Financial Markets Steering Committee.)	See– Proposal 26 – new financial markets legislation to remove the ambiguity in s25 of the current Financial Markets Act with a view to enabling over-the-counter securities financing transactions to be executed under a Global Market Repurchase Agreement.
Benchmarks	30. The South African Reserve Bank (Reserve Bank) to finalise the recommendations for interest rate benchmarks and implement the recommendations. (Note: Work is underway in the Reserve Bank Working Group on Rand Interest Rate Benchmarks.)	See– Proposal 1 – will bring benchmarks and other market-related services under the new financial markets legislation.

Issues	Financial Markets Review Recommendations	Financial Markets Legislation Proposals
<b>TRADING VENUES AND TECHNOLOGY</b>		
Alternative trading venues	31. Regulators to consider developing a regulatory regime for alternative trading venues to ensure level playing fields, market surveillance (including cross-market surveillance) and trading controls. (Note: The Financial Sector Conduct Authority is proposing amendments to the Financial Markets Act.)	See– Proposal 2 – established broad definitions that capture alternative trading venues.
Algorithmic and high-frequency trading	32. Regulators to consider the development of standards in respect of firms' algorithmic trading activities in governance, risk management (including conduct risk), model approval testing and deployment.	See– Proposal 2 – establishes broad definitions that enable all types of market activity to be regulated if warranted.
	33. Regulators to consider condoning the establishment of a management body of the exchanges to determine cross-market controls such as circuit breakers and actions if an exchange suspends or removes a financial instrument from trading. (Note: An Exchange Forum has been established to discuss market fragmentation conduct standards for exchanges.)	See– Proposal 20 – establishes Financial Markets Standards Group with an advisory function. Proposal 14 – establishes a regulator for each market, with responsibility, among other things, to set operational standards for the market.
Innovation and financial technology	34. Regulators to consider assessing the competitive landscape of market infrastructures, particularly exchanges and central securities depositories, to encourage technological innovation that improves outcomes across financial markets.	See– Proposal 3 – includes competitiveness as an explicit regulatory objective. Proposal 2 – involves taking an inclusive approach to definitions so as to encourage technological innovation.
	35. Regulators to consider encouraging more over-the-counter derivatives contracts be cleared through central counterparties. This may require the standardisation of such over-the-counter derivative products.	This is a Policy decision.

## **ATTACHMENT B:**

# **PROPOSALS FOR THE NEW FINANCIAL MARKETS LEGISLATION**

### PROPOSAL 1:

That the coverage of the new financial markets legislation be expanded to include all financial markets in South Africa (subject to materiality), including both organised and over-the-counter financial markets, as well as critical market-related services such as credit rating agencies, benchmark indexes, and market research.

### PROPOSAL 2:

- That a broad approach should be taken on the definitions of financial instruments, market participants (which should include their nominees), trading venues, and financial market activities. These should incorporate all currently known instruments, market participants, types of trading platforms, and activities, including multilateral trading facilities, systematic internalisers, dark pools and high-frequency trading. There should also be flexibility for these definitions to be extended by regulation, along the lines currently used in the definitions of financial products and services in s2 and s3 respectively of the Financial Sector Regulation Act.
- More generally, it is proposed that the new financial markets legislation should adopt the same approach as the Financial Sector Regulation Act with detail, wherever practicable, being left to standards; the one area where detail is still likely to be needed in the new financial markets legislation is in the definition and licensing of financial market infrastructures. It is further proposed that:
  - (a) the regulatory framework should have the flexibility to encompass technological innovation; and
  - (b) to the extent possible, separate licences should be issued for each financial market activity (e.g., trading, clearing, settling, custody), without requiring holders of any given licence to either hold, or not hold, any other particular licence.

### PROPOSAL 3:

The following objective is proposed for the new financial markets legislation to—

- (a) reduce systemic risk arising from financial markets and financial market infrastructures (particularly risk arising from a lack of prudential safety and soundness of financial market infrastructures);
- (b) enhance the efficiency and integrity of the South African financial markets; and
- (c) promote the international and domestic competitiveness of the South African financial markets.

### PROPOSAL 4:

That European market laws such as MiFID II and related regulations (and other international equivalents) be considered as a general model for guidance on a range of issues in drafting the new financial markets legislation, while recognising that there will be many areas in which deviations will be needed for both local and practical reasons.

#### **PROPOSAL 5:**

That the new financial markets legislation adopt the widely used term “financial market infrastructures” and that the Financial Sector Regulation Act be amended to replace the term “market infrastructures” with “financial market infrastructures”.

#### **PROPOSAL 6:**

That financial market infrastructures as a group be defined in the following general terms:

- A multilateral system among participating institutions, including the operator of the system, used for the purposes of trading, clearing, settling or recording payments, financial instruments, derivatives or other financial transactions.

And that particular categories of financial market infrastructures be defined by their core functions, rather than by an exhaustive list of functions, and that the risk-based regulatory framework take full account of the risks posed by additional activities to core functions.

#### **PROPOSAL 7:**

That payments systems be included in the definition of financial market infrastructures in the new financial markets legislation.

#### **PROPOSAL 8:**

That certain non-financial institutions that provide critical market-related services be included within the category of regulated institutions. The initial list of services in this category will include credit rating agencies, providers of financial benchmark indexes, financial market research, and messaging services such as SWIFT. The law should take a flexible approach to the definition of critical market-related services so that the list may be extended over time if circumstances so warrant.

It is also proposed that critical financial market-related services be incorporated into the Governor’s power under s29(1)(a) to declare the provider of a financial product or service to be systemically important, along with guidance as to what might constitute “systemic importance” in these cases.

#### **PROPOSAL 9:**

That financial market infrastructures be classified into two categories: systemically important financial market infrastructures and other financial market infrastructures.

- All financial market infrastructures should be subject to regulation for market efficiency, fairness and competitiveness.
- Systemically important financial market infrastructures should be subject to additional regulation (for safety and soundness) with a view to supporting financial stability.

#### **PROPOSAL 10:**

That the following three groups of financial market infrastructures be designated as systemically important (systemically important financial market infrastructures): central counterparties, central securities depositories and payments systems.

To avoid doubt, any member of a group of financial market infrastructures that is designated as systemically important will automatically be designated as a systemically important financial market infrastructure. The regulator (or regulators) should nevertheless be able to apply less onerous regulatory standards to a member of a systemically important financial market infrastructure group that is not by itself considered to be systemically important.

### PROPOSAL 11:

**That:**

- the definition of financial institutions in s1 of the Financial Sector Regulation Act be amended to remove financial market infrastructures and to establish financial market infrastructures as a separate category of institutions (with systemically important financial market infrastructures as a subcategory);
- Part 2 of Chapter 7 of the Financial Sector Regulation Act be amended to introduce a new category of “systemic stability standards”, applicable to systemically important financial market infrastructures and other systemically important financial institutions, the substance of which should include, but not be limited to, the matters in the Principles for Financial Market Infrastructures (e.g., they will still need to cover the additional prudential aspects identified in s30(1) for systemically important financial institutions);
- it be made clear that, where systemic stability standards for systemically important financial institutions overlap with existing prudential standards that apply more broadly, the intention of the systemic stability standards should be additional to the existing requirements; and
- the Reserve Bank’s power in s30 be broadened to enable the Reserve Bank to direct the Prudential Authority to issue systemic stability standards on prudential matters, the Financial Sector Conduct Authority to issue systemic stability standards on conduct matters and, where warranted, to direct the Prudential Authority and Financial Sector Conduct Authority to issue joint systemic stability standards. As with the existing s30, where systemic stability standards are issued under direction, they should be developed and issued in close consultation with the other regulators.

### PROPOSAL 12:

**That:**

- the licensing, regulatory and supervisory responsibilities for payments systems be carved out from the new financial markets legislation, with resolution of these issues to be addressed by reforms to the National Payment System Act.

That, for all non-payment financial market infrastructures:

- the Financial Sector Conduct Authority be assigned as the licensing and sole regulatory authority for (non-payment) financial market infrastructures that are not designated systemically important financial market infrastructures;
- the Reserve Bank should be assigned as the licensing authority for all (non-payment) financial market infrastructures designated as systemically important, but with the actual licensing process to be delegated to the Prudential Authority;
- the Financial Sector Conduct Authority be assigned as the conduct regulator (with the power to issue conduct licences) for all systemically important (non-payment) financial market infrastructures;
- for all systemically important (non-payment) financial market infrastructures the Prudential Authority be provided with the power to supervise and enforce standards (systemic stability) relating to safety and soundness, the Financial Sector Conduct Authority with the power to supervise and enforce standards (systemic stability) relating to market efficiency and integrity, and both agencies with responsibility to supervise and enforce joint systemic stability standards; and
- any supervisory or enforcement action by the Prudential Authority or Financial Sector Conduct Authority that could have a material impact on the continued operation of a systemically important financial market infrastructure regulated by them (e.g., delicensing, licence suspension, or restrictive licence conditions) be subject to Reserve Bank concurrence before either agency takes the relevant action.



### PROPOSAL 13:

That the Reserve Bank and the Financial Sector Conduct Authority agree on an allocation of regulatory and supervisory responsibilities for systemically important (non-payment) financial market infrastructures as outlined in the Principles for Financial Market Infrastructures - Note that this does not need to be formalised in the new financial markets legislation.

### PROPOSAL 14:

**That:**

- regulation of existing over-the-counter markets in financial instruments (to be designated as regulated over-the-counter markets) be formalised for at least the following financial instruments:
  - derivatives in financial instruments;
  - money market instruments;
  - debt instruments;
  - foreign exchange;
  - tradable investments in collective investment schemes and asset-backed-securities; and
  - crypto assets;
- the new financial markets legislation include flexibility for the Minister to designate additional financial instruments for which over-the-counter trading needs to be conducted through a regulated over-the-counter market;
- the Financial Sector Conduct Authority be assigned as the regulator for all regulated over-the-counter markets (consider the role of the Prudential Authority in over-the-counter markets), with the exception of the over-the-counter foreign exchange market in South African Rand, for which the Reserve Bank should continue to be the regulator until such time as exchange controls are removed, at which point consideration should be given to transferring regulatory responsibility to the Financial Sector Conduct Authority; and
- the following minimum responsibilities be assigned to the regulator of each regulated over-the-counter market:
  - authorising market participants who are eligible to transact in the regulated over-the-counter market;
  - setting the rules for trading, clearing, settling and reporting trades in the regulated over-the-counter market;
  - monitoring the regulated over-the-counter market for evidence of breaches of the market conduct standards, plus any particular rules or standards that the regulator may have set for the specified markets;
  - taking enforcement actions against participants where needed; and
  - exempting specified financial instruments from the need to trade on a regulated over-the-counter market.

### PROPOSAL 15:

That the new financial markets legislation include a new licensing subcategory of conduct licence (markets). This licence, to be issued by the Financial Sector Conduct Authority, should include at least the following subcategories:

- operating a trading venue;
- market participant;
- member of a financial market infrastructure; and
- provider of a critical support service (ratings, benchmark indexes, research, etc.).

While the details of licensing requirements will vary across different subcategories of licence, the requirements within any subgroup should be consistent.

#### PROPOSAL 16:

**That:**

- a new subcategory of conduct standards (markets) be included in Chapter 7 of the Financial Sector Regulation Act (to better distinguish them from other conduct standards (i.e., general conduct standards regulating the way in which financial institutions deal with their financial customers));
- conduct standards (markets) have the flexibility to be applicable to particular markets, financial instruments, groups of market participants, financial market infrastructures or to all regulated entities;
- while some variations in conduct standards (markets) are to be expected for particular markets or circumstances, the overriding principle should be that the same standards should apply to all groups providing essentially the same market services or participating in the same market activities, regardless of which particular market segment or type is involved; and
- matters on which conduct standards (markets) may be issued should include:
  - governance;
  - fitness and propriety;
  - disclosure and transparency (including of pre-trade and post-trade information and of fees);
  - accounting standards;
  - risk management systems;
  - financial soundness (including capital and liquidity);
  - qualifications;
  - minimum listing requirements;
  - minimum membership requirements for financial market infrastructure groups;
  - clearing, settlement and reporting requirements;
  - trading behaviour;
  - best execution;
  - operations (such as settlement cycles, circuit breakers, tick sizes, time synchronisation, minimum transactions size, trade cancellation, trading disruptions, issuer transfer, suspension and removal of issuers, reference prices, portfolio compression);
  - technology (such as interoperability, security and protection of data);
  - management of conflicts of interest;
  - rules for setting fees;
  - recovery and resolution (for financial market infrastructures not designated as systemically important – and therefore not covered by the Reserve Bank's systemic stability standards for recovery and resolution); and
  - remuneration/incentives.

#### PROPOSAL 17:

That, all market abuse provisions, including those relating to insider trading and market manipulation, apply equally to all markets in financial instruments, regardless of how the markets are structured.

#### **PROPOSAL 18:**

With respect to organised markets, that:

- the statutory assignment of regulatory powers to financial market infrastructures be removed from the new financial markets legislation; and
- responsibility for regulating and supervising all market conduct be assigned to the Financial Sector Conduct Authority, but with provision for the Financial Sector Conduct Authority to delegate certain of these to financial market infrastructures, subject to the following:
  - identifying the regulatory requirements for the Financial Sector Conduct Authority that may be delegated to a financial market infrastructure – such as membership rules, listing rules, market-specific operating standards and real-time monitoring of market activities in individual markets – provided the delegation will further achieve the objects of the Act; and
  - identifying the regulatory requirements for the Financial Sector Conduct Authority that may not be delegated to a financial market infrastructure – such as licensing and regulating market participants and cross-market surveillance.
- Careful thought be given to transition arrangements, so as to avoid market disruption.

#### **PROPOSAL 19:**

That industry associations play an advisory role in supporting the market regulator to develop an appropriate regulatory model for over-the-counter markets for financial instruments.

#### **PROPOSAL 20:**

That:

- the new financial markets legislation establish a Financial Markets Standards Group, with representation from senior market professionals and compliance officers, to be approved by the Financial Sector Conduct Authority. The Financial Markets Standards Group's role will be largely advisory on industry matters, including codes of conduct, and operating and technical standards.
- the Financial Sector Conduct Authority be assigned responsibility for setting (on advice from the Financial Markets Standards Group), monitoring and enforcing a common industry code of conduct applying to both organised and over-the-counter markets for financial instruments, but with the Financial Sector Conduct Authority having the power to delegate responsibility for monitoring industry performance against the code to the Financial Markets Standards Group.

#### **PROPOSAL 21:**

That:

- comprehensive reporting requirements be extended to all transactions in financial instruments conducted in South Africa's financial markets – to avoid doubt, these transactions should include all short selling transactions;
- the assigned regulator for each of these markets be required to ensure that, in setting reporting requirements, it does so with a view to supporting market efficiency by ensuring that reporting obligations can be met at reasonable cost; and
- the new financial markets legislation be drafted so as to bring South Africa's regulatory regime in alignment with the IOSCO principles on short selling, and that these principles apply to trading in all regulated markets (both organised and over-the-counter).

**PROPOSAL 22:**

That the Financial Sector Conduct Authority establish an internal register of information about the fitness and propriety of individuals.

As echoed in earlier proposals, the new financial markets legislation should also establish a framework within which the regulators are required, to the greatest extent possible, to regulate, supervise and enforce on a common basis across the financial markets.

**PROPOSAL 23:**

That the concept of an associated clearing house be removed from the new financial markets legislation.

**PROPOSAL 24:**

That post-trade processes be opened to competition, subject to ensuring that new entrants not only meet the licensing requirements involved, but that they have in place the demonstrated necessary technology for interoperability. This may also require mandatory access to interoperability on the part of existing financial market infrastructures.

**PROPOSAL 25:**

That, subject to confirming the Constitutionality of such a measure, the new financial markets legislation provide the Minister with the power to impose a limit on the number of financial market infrastructures in any particular financial market infrastructure category, and/or a moratorium on the issuance of further licences for any financial market infrastructure category for a period of five years, while a review is conducted of the impact of the limit on the efficiency, integrity and stability of the financial system. Following the review, the Minister may impose a new limit or moratorium for a period not exceeding a further five years.

**PROPOSAL 26:**

That:

- the new financial markets legislation remove the ambiguity in the current s25 of the Financial Markets Act, with a view to enabling over-the-counter securities financing transactions to be executed under a Global Master Repurchase Agreement;
- the new financial markets legislation review and resolve the limitations on pledging securities contained in s39 of the current Financial Markets Act ; and
- relevant provisions be identified in the Insolvency Act and Companies Act that may warrant amendment in order to better facilitate the transferability and protection of collateral in securities financing and other financial market transactions.

**PROPOSAL 27:**

That very broad and flexible definitions of all key elements be adopted in the new financial markets legislation, including for trading venues, financial market infrastructures, financial instruments, financial market activities and objectives for the Act. These definitions should generally be inclusive, rather than exclusive.

#### **PROPOSAL 28:**

That:

- the power for the relevant authority to issue an applicant with a provisional licence during a period of establishment be included in the new financial markets legislation. The minimum requirements of the provisional licence, which may vary according to the type of licence being applied for, should be specified in a licensing standard. The business that may be conducted under a provisional licence should be subject to restrictions imposed by the responsible authority.
- the regulators prioritise development of standards addressing licensing in the financial markets and core conduct issues, and that these be circulated for comment along with the draft of the new financial markets legislation.

#### **PROPOSAL 29:**

That the Financial Sector Conduct Authority be given the power to establish a securities ownership register as a central record of beneficial ownership of financial instruments.

#### **PROPOSAL 30:**

That the recognition framework for external participants (including market participants and financial market infrastructures) be clarified to address the following:

- whether equivalence will be assessed in terms of either or both of the rules applying to a financial market infrastructure or by the financial market infrastructure to its members;
- whether external participants will be subject to regulation of their activities with respect to South African financial instruments by the responsible authority in South Africa as well as their home regulator;
- what disclosures will be required by external participants;
- how reciprocity will be assessed and implemented; and
- the need for memorandums of understanding between the South African and relevant foreign regulators, addressing the issues above, information sharing, reciprocity and other such considerations.

#### **PROPOSAL 31:**

That:

- a definition of final settlement be included in the new financial markets legislation;
- settlement provisions in the new financial markets legislation be aligned with international settlement principles; and
- central securities depositories be required to distinguish failed settlements from rolled settlements.

#### **PROPOSAL 32:**

That the Companies Act be amended to:

- clarify that issuers may dematerialise securities on issue without the need to seek instructions from each shareholder;
- clarify that newly listed securities should be issued in dematerialised form; and
- remove the ability of dematerialised securities to be rematerialised.





# BUILDING COMPETITIVE FINANCIAL MARKETS FOR INNOVATION AND GROWTH

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