



**national treasury**

Department:  
National Treasury  
REPUBLIC OF SOUTH AFRICA

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# **RESPONSE DOCUMENT**

## **ELECTRONIC SURVEY: “REDUCING THE RISKS OF OVER-THE-COUNTER DERIVATIVES IN SOUTH AFRICA”**

**JULY 2012**

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## **A. Background**

In the interests of consulting fully with relevant stakeholders, the National Treasury released the paper “*Reducing the Risks of Over-the Counter Derivatives in South Africa*” which aimed to encourage discussion on the regulatory and legislative reforms for the South African over-the-counter (OTC) derivatives market. Interested stakeholders were invited to respond to an electronic survey which covers all the questions contained in the document relating to the first phase of reform: a code of conduct, the registration of participants and the implementation of central reporting to a Trade Repository (TR) for South Africa.

17 responses were received in total representing local and foreign banks, trade associations and local and foreign institutions that supply post-trade services. This document summarises the responses to the electronic survey.

## **B. Code of conduct**

### ***1. Which participants in the OTC derivatives market should be subject to the code of conduct?***

All registered professional participants, as well as their employees and agents, should be subject to the code of conduct. Questions 4 and 5 below discuss who should qualify as a “professional” participant and who should be required to be registered.

Respondents distinguished between those who originate OTC contracts and those professional entities who participate in the secondary market (intermediary services) and advisory services, to which FAIS already applies. To the extent that the code of conduct should apply to all registered professional entities trading and providing professional services to retail clients in OTC contracts, duplication with existing codes of conduct should be avoided where possible. The code of conduct for Category I and V may have to be amended to specifically deal with OTC derivatives.

### ***2. Should foreign participants be subject to the code of conduct?***

Yes, foreign participants with a local presence should be bound by the code of conduct.

Foreign participants without a local presence conducting OTC business within South Africa (either as originators or as a counterparty) should be subject to the same code of conduct or an equivalent code (in their jurisdiction), especially if the activity of the foreign participant poses or contributes to systemic risk. Some additional comments:

- Foreign participants should get pre-approval from the Financial Service Board (FSB);
- The new regulation may introduce additional costs for local players which would be unfair and uncompetitive and South Africa may run the risk of losing liquidity to international players.

### **3. Which of these provisions should the code of conduct include?**

General views are that all the below provisions should be included in the code of conduct, with the exception of “commitment to help with valuation and accounting issues” and “...., including secondary market liquidity of structured products”.

The provisions of the code of conduct and the provisions in the FAIS Act and subordinate legislation should be aligned and harmonised with global standards. However in terms of the provisions, the regulator should also be wary of blanket statements such as “full disclosure of all material facts” as this may lead to unrealistic expectations on participants. This has the potential to increase systemic risk. It is suggested that “material facts” should be qualified.

<b>Provisions</b>	<b>Comments</b>
<i>Criteria for assessing the suitability of products for non-professional counterparties.</i>	Yes
<i>Full disclosure of all material risks in terms appropriate for non-professionals.</i>	Yes
<i>Appropriately worded health warnings, especially for retail users.</i>	Yes
<i>Commitment to help with valuation and accounting issues.</i>	<i>No, because providing accounting advice would be extending a role to a professional participant which is already in the market.</i>
<i>Early termination issues, including secondary market liquidity of structured products.</i>	<i>Perhaps, for disclosure purposes, but should be carefully considered. Basel III specifically penalises contracts with optionality and is encouraging longer commitments from end-users of bank products in an attempt to reduce systemic risk.</i>
<i>Key terms of legal agreements.</i>	<i>Yes, The Treasury might even consider introducing requirements both in relation to how transactions in OTC derivatives are valued internally and whether and how "marks" for positions in OTC derivatives are provided by dealers to their counterparties, just like other jurisdictions.</i>
<i>Valuation methodologies</i>	<i>Yes for disclosure purposes. The FSB/Treasury might consider introducing requirements both in</i>

	<p><i>relation to how transactions in OTC derivatives are valued internally and whether and how “marks” for positions in OTC derivatives are provided by dealers to their counterparties<sup>1</sup></i></p> <p><i>Other jurisdictions require the use of valuations by <b>Independent third-party providers</b> (ITPPs) whose valuations are based on objective and independent inputs and apply a consistent valuation methodology across all clients.</i></p>
<i>Collateralisation procedures.</i>	<i>Yes, but only for disclosure purposes and should not be narrow on the way that collateralisation is done.</i>
<i>Issues around market conduct, including confidentiality and practices such as front-running</i>	<i>Yes but this is already covered under FAIS</i>
<i>Advertising and soliciting business.</i>	<i>Yes</i>
<i>Dispute resolution procedures</i>	<p><i>Yes, for dispute resolution it is suggested that portfolio reconciliation be included which consists of four main components: (1) the exchange and normalization of position details; (2) the pairing (or reconciling) of the counterparties’ records; (3) the identification of discrepancies; and (4) the communication and resolution of those discrepancies.</i></p> <p><i>With portfolio reconciliation, so as to ease the operational burden FSB/Treasury could also: a) require reconciliation to occur less frequently for smaller portfolios and to only require reconciliation for material disputes; (b) permit parties to a transaction to use qualified third parties for the reconciliation process and (c) establish timeframes for the resolution of disputes that reflect, among other factors, the complexity of the trade and dispute.</i></p>
<i>Due diligence and know-your-customer procedures</i>	<i>Yes but is already covered under FAIS</i>

## **C. Registration of market participants**

### **4. Which participants should qualify as professional participants in the OTC derivatives market?**

All participants in the OTC derivatives market who originate derivatives products:

- Banks
- Authorised Dealers

<sup>1</sup>Business Conduct Standards for Swap Dealers and Major Swap Participants, 77Fed. Reg. 9734

- Category I&II, IIA FAIS entities
- Insurance companies
- Investment companies and funds
- Endowments.

All participants who consume or use those derivatives products, subject to a *de minimus* threshold: life companies; pension funds; non-financial institutions and corporates (although not all respondents agree on the need for corporates to register). A size threshold should also apply for non-financial market participants.

Operators of trading platforms and other trade execution facilities for OTC derivatives should also be subject to the code of conduct.

Operators of post-trade clearing and settlement services for OTC derivatives should also be subject to the code of conduct.

The definition of what actually constitutes a “professional client” needs to be properly thought out due to potential conflicts arising out of what constitutes “professional clients” under FAIS. Examples include swap dealers i.e. entities that hold markers and make 2-way prices for counterparties. A professional client (as defined in the draft *Code of Conduct for authorised Financial Services Providers conducting financial services with professional clients*) may also qualify as a professional participant.

**5. Which participants in the OTC derivatives market should be subject to registration requirements?**

All professional participants.

Also, some respondents argue that non-professional participants above a certain threshold should be subject to registration.

**6. Should additional registration requirements be imposed on professional participants? If yes, which requirements?**

Generally, no. All professional participants are already regulated and the current proposed requirements are adequate in their scope. Alternatively, the FAIS FSP classification system and associated rules should be used if possible, or extended/amended as appropriate, as this would obviate the need for additional industry structures that add costs.

Asset-class registration, in addition to participant registration, could assist in determining the types of OTC contracts which are registered can be accommodated for in the TR.

**7. Should foreign participants be subject to registration requirements? If so, who?**

Yes, all foreign professional participants should be subject to registration requirements so as to level the playing field. Recognition of comparable regulation and registrations that occur outside of South Africa should be considered.

**8. How should the category of professional participants, however defined, be policed?**

Professional participants are already regulated by the FSB as “Financial Service Providers”. “Product writers” have an additional responsibility to comply with prudential requirements. The definition of “product writer” should be thought out.

## **D. Regulatory framework**

**9. What should be the minimum regulatory requirements to operate a repository? In this regard, are the license requirements appropriate and sufficient?**

Overall the commenters believe that the licensing requirements in the Financial Markets Bill are appropriate and sufficient.

- *Legal framework* - A TR should have a well-founded, transparent and an enforceable legal basis for each aspect of its activities in all relevant jurisdictions.
- *Market transparency and data availability, operational reliability*- Governance arrangements for a TR should be clear and transparent to fulfill public interest requirements and to support the objectives of owners and participants. In particular, they should recognize the TR’s unique role and responsibilities in the market it supports.
- *Access and participation, safeguarding of data* - A TR should implement appropriate policies and procedures, and devote sufficient resources, to ensure the confidentiality, continuity and integrity of information. Furthermore, a TR should have robust system controls and safeguards to protect the data from loss and information leakage, recorded trade information resulting from subsequent post-trade events.

A potential conflict is the liability issue arising out of the fact that a TR is not an SRO and the protection granted to other SRO’s under the FMB would not apply to the TR.

**10. Should regulation allow for a foreign TR, and if so, why? What should be the minimum regulatory requirements in this instance?**

Yes, but subject to the minimum requirements provided for in the FMB. If the TR is local, data collection should be in line with foreign TRs and this can be best achieved if international providers of Independent Verification Services (IVS) are tasked with reporting of transaction data when reporting is required in multiple jurisdictions.

It is further noted that the FMB allows for outsourcing which theoretically allows for a foreign services provider to partner with a local entity to provide the basis of a TR and thus the following options can be considered:

- A proprietary local solution;
- A hybrid between a local company and a Foreign Service Provider (FSP); or,
- A fully outsourced solution.

Some reasons for not allowing a foreign TR were raised as follows:

- The extent to which the South African regulator would be able to regulate the information available in a TR in a foreign jurisdiction may be restricted. Standards for international cooperative oversight arrangements regarding TRs are not yet well defined. Legal barriers may exist in certain jurisdictions, which would restrict the ability of a foreign repository to provide South African regulators with the information they might require.
- The South Africa OTC derivatives market is relatively small, representing approximately 0.2% of the overall OTC derivatives market in the world. Since greater focus tends to go to the larger markets, the smaller South African market carries the risk of being overlooked when pooled with bigger markets. During times of crisis, timely and detailed information about open positions is fundamental to avoid and minimize costs. Ease of access to data is vital to reduce risks and to close-out positions timeously.
- If South Africa is seen to be a possible financial hub for Africa, the argument for a local TR is strengthened.
- A foreign TR would subject South African participants to foreign regulatory reporting requirements which are unlikely to cater for the needs of local participants and regulators and might not be consistent with local OTC clearing methodologies.



- Economies of scale benefits could be offset by hard currency costs, making the economic benefit of an offshore provider negative or negligible.
- This will be contrary to the South African government's objective of job creation.
- South African participants reporting into foreign TRs operating in a different time zone could lead to potential timing issues, which would increase the burden of reporting requirements (to and from the foreign TR) and all ancillary services (e.g. valuation, collateral management).

## **E. Defining the role and responsibility of a TR**

### ***11. In terms of the reported data, what should the TR's responsibilities be?***

The purpose of the TR is to assist regulators in their oversight and market regulation responsibilities:

- The TR should be responsible for accepting all data, cleared or uncleared, with respect to transactions in an asset class for which it proposes to act as a TR.
- The TR should be the source of transaction data for all transactions within an asset class. Requiring all transactions, whether simple or complex, electronically confirmable or not, to be reported to a single repository per asset class will reduce the potential for data fragmentation and avoid more complex trades not being supported by any TR, and thereby ensure lower regulatory costs to aggregate data and promote the ability of regulators to understand and respond in a timely fashion to the build-up of concentrated exposures.
- The maintenance of accurate and secure records and the protection of confidentiality in accordance with regulatory requirements.
- The TR should prepare relevant reports for the regulators and could prepare aggregate data for publication.

For further detail on the roles and responsibilities, please refer to the joint publication by CPSS and technical committee of IOSCO "Considerations for TRs in OTC derivatives" <http://www.bis.org/publ/cpss8990/comments/dtctr.pdf>.

### ***12. For what duties should the TR not be held responsible?***

TRs should not be responsible for:

- Confirmation or matching transactions reported. Such matching services should be provided by existing confirmation providers;
- Inaccurate data supplied to them or for interpreting the data;
- Registration of participants, nor for surveillance in respect of market abuse, nor for enforcement;
- Clearing and settlement;
- Collateral, risk and valuation management, including the calculation and management of margin, margin offset, default fund management-mostly performed by the clearing house;
- Trade compression;

Furthermore, the TR should have no delegated authority from the Registrar to act in his stead. The TR should not be permitted to bundle its trade reporting services with other services in a manner that requires purchase of such other services as a condition to utilizing the trade reporting service. This linkage would create an anti-competitive environment.

### ***13. How should the TR provide the regulator access to the reported data?***

Regulators, on request, should have direct electronic access to data via a secure internet connection or/ standardised reporting via file transfer protocol (FTP) for the regulator to perform its specific duties and without preferential access. The most cost effective solution should be encouraged to save costs.

### ***14. What should fair and open access and participation criteria look like for market participants?***

- Market participants should be able to access their own data through a web portal and should be required to report to a secure location.
- Respondents disagree as to whether data should be provided at an aggregated reporting level to market participants or the public.
- A non-discriminatory fee structure should be available for all users.

- There should be low barriers to obtain information to ensure that large to small participants have access to this information.
- The TR should not adopt policies or take any actions that constitute an unreasonable restraint on participation, impose material anti-competitive burdens on any market participant or unreasonably prohibit, condition or limit access to its services.
- Participation criteria should be equitable across all categories of participation, and the market should adopt publicly disclosed requirements for access and participation.
- Should participants want to be shareholders it should be encouraged.
- From the data price discovery should be promoted to increase liquidity in the fixed interest and equity markets by reporting limited information (no reporting of size or counterparties) at transaction level on a delayed basis.
- Public access should be considered.

**15. Should the trade information be captured in real-time?**

Generally, respondents were of the view that reporting does not have to be real-time because:

- This may result in incomplete and inaccurate information that will cause many cancellations and corrections after initial reporting has been done.
- Currently, there are participants with trade capture of bespoke trades which tend to be more manual and require more time thus making them poor candidates for real-time reporting.
- Real-time reporting will be of no practical value as systemic risk build-up is not an intra-day event. End of day reporting or T+1 is therefore more appropriate and most common.

**16. What services, other than data collection and storage, should the TR provide?**

The sole responsibility of the TR is to assist the registrar with formulating an opinion on systemic risk therefore collection and storage of data should be sufficient and will ensure that the TR remains a “not for profit” entity, much like Bankserv. Some are of the opinion that the following additional services should be provided by the TR (respondents disagree as to the additional services that should or should *not* be provided by the TR – refer Q12 above):

- Trade compression/ netting, valuation and collateral management components at Legal Entity Identifier (LEI);
- Clearing and settlement services;
- Payment calculations;
- Public and regulatory dissemination of aggregated data( and to the public at a fee so as to offset costs);
- Monitoring, analysis and screening should be performed centrally by the TR as it promotes efficiency in the system;
- Potential credit reduction facilities between banks;
- Data not matched through a recognised matching platform should be matched by the TR and confirmation sent to the counterparties to the trade and if there are anomalies identify them and provide the information to the two counterparties;
- Registration of OTC derivatives transactions;
- Agreed valuation methodologies can be applied to OTC positions and provided to the counterparties for auditing and administrative purposes;
- A TR could serve the purpose of avoiding “double reporting” of trading data that it may be required to report to other South African regulators e.g. South African Reserve Bank.

If regulators allow many repositories to compete against each other, this will definitely lead to other complementary services being provided by each TR e.g. settlement services, trade confirmation etc. A TR should not be restricted from providing other services as long as the general business risks are appropriately managed so that the TR itself is not a risk. Other additional services that could be offered by TRs should be offered as separate services and not bundled with trade reporting services. Third party service providers can also offer services thorough equal access.

***17. What information must the TR provide to reduce costs and risks associated with reporting to it?***

The TR should remain focused on its core function of collecting and storing data. The TR should allow for reporting entities and their counterparties to access their own transactional-

level data as well as the data which is made available to the public - open API specifications. The TR must also share data protection, information security and business continuity planning measures with participants to allow them to understand how TRs serve to reduce their data risk. A TR must provide its fee structure, supported data formats (using international standard message formats) and communication links to prospective customers.

To reduce transaction costs, increase transparency and liquidity and in turn improve confidence in the market, anonymous post-trade aggregate transaction level data could be made publicly available at a cost (although some respondents argue against the data being made public). Historical data of an aggregated nature may be sufficiently benign to the members of the TR and may be useful to analysts that are willing to pay for it. The registrar should remain fully informed of the type of data that is being sold as there may be some latent systemic risk concern.

***18. To what extent and how should interests of market participants be protected in levels of disclosure both in terms of financial technology used as well as confidential terms to a transaction?***

Market participants should be protected from a disclosure of financial technology as well as confidential transaction terms. As per the BIS paper this should be as follows:

*For safeguarding of data*

- A TR should implement appropriate policies and procedures, and devote sufficient resources, to ensure the confidentiality and integrity of information. Further, a TR should have robust system controls and safeguards to protect the data from loss and information leakage.
- A TR should have high-quality system safeguards and controls regarding the transmission, handling and protection of data to ensure the accuracy, integrity and confidentiality of the trade information recorded in the TR.
- A TR should protect data from loss and information leakages, unauthorised access and other processing risks, such as negligence, fraud, poor administration, inadequate record keeping and failure to protect customers' interests.
- The liability of a TR should be defined in a way that provides sufficient incentives for the TR to protect its users from potential negative impact caused in the use of the TR's services (e.g. loss of data). At the same time the TR's contractual arrangements

should afford indemnity to the TR such that its continued operations are not jeopardised. To that purpose, a TR should establish appropriate controls and protections such as using insurance schemes

***19. Should confidential information reported to the repository at transactional level, for instance, be shared with local or foreign regulatory bodies on request?***

Yes, the purpose of a TR is to provide the systemic risk regulator(s) with all information irrespective of confidentiality. However, sharing information with a foreign TR should only be undertaken under a Memorandum of Understanding between the local regulator and the foreign regulator responsible for the supervision of the foreign TR.

It is understood that the voluntary sharing of information between local regulators would be limited to the Financial Service Board and the South African Reserve Bank. Requests from agencies such as the credit regulator, consumer protection, tax authorities etc. would not be entertained as this falls out of the purpose for which the TR was established, namely systemic risk management.

It goes without saying that the registrar has a duty of care in these matters and may not unilaterally disclose information in the interests of the market or on behalf of the market.

These are some of the examples from the OTC Derivatives Regulators' Forum (ODRF) on data access guidelines: a market regulator and prudential supervisor will have the ability to view trade level details for the firms under their jurisdiction, while central banks will have aggregate report views by currency and concentration. Additionally, the data inventory includes those trades over the entities supervised, as well as data for underlying reference entities of material interest – even if traded by foreign counterparties. Additionally, Treasury should consider the CPSS IOSCO initiatives on data access sharing.

***20. Should data reported by market participants be regarded as market participants' data or be owned by the repository? If the former, should reporting entities and counterparties be charged a fee for accessing their own data?***

The general opinion is that market participants should own the data and no fee should be charged because participants should not be charged for accessing their own data. And if you don't own your own data you also can't move your data to a more cost effective repository provider. It is important to clarify who owns data and the process to follow if market participants switch repositories. Data should not be commercialized and fees should not be charged for access to the data as the TR should be a not "not-for-profit" entity.

**21. To ensure accuracy of data, should repositories be required to confirm trades to a counterparty or counterparties who have reported the trades?**

No, as this may be expensive, time consuming, overly bureaucratic and if a number of TRs are established this would involve double work and effort and would be complicated to administer. It should also be considered that there is already a framework established based on the Markitwire framework where confirmed trades are already reported to the TR.

However, a TR should be allowed to use various methods to ensure accuracy of data to ensure that a singular, bilaterally agreed upon record with a common trade identifier is submitted to the TR. In fact these services are good sources of trade data for the trade counterparties and upon receipt of the two trade records with a common trade identifier by a TR, the TR should in fact report back to the reporting parties any key differences between the records.

## **F. Structure and financing of the TR**

**22. Should South Africa licence only one TR or should multiple repositories be allowed to operate?**

From a risk monitoring perspective, it would not make sense for there to be multiple repositories covering the same market segment. It will prove particularly difficult for regulators in times of crisis to aggregate such data across multiple repositories, as this requires bilateral information sharing agreements, additional costs will be incurred by regulators to develop technology tools to both aggregate the data and they will rely on receipt of data in an inconsistent format across all repositories, with duplication and potential omission.

For greater efficiency and more accurate data, a single global repository could be considered as it will provide aggregated, netted, validated and reconciled data to a regulator across all asset classes. If many global firms report once and meet multiple reporting obligations by centralising such reporting through a global TR, reporting entities will be able to adopt internationally recognised identifiers in describing the transaction identifier, product and legal entity name to ensure consistency of use and quality of inventory. When firms leverage a global TR to disseminate data to appropriate regulators, it reduces the risks of duplication or omission in public reporting, limits the possibility of erroneous consolidation by the public of available data and reduces the burden on market participants to connect and reconcile to multiple TRs.

Multiple repositories could be allowed to encourage competition.

**23. Should a South African TR be licenced as a state utility, as a utility-owned by market participants and operating on a non-profit basis or should the licenced repository be allowed to operate as a for-profit entity?**

All respondents agreed that the TR should not be allowed to operate as a for-profit entity.

**24. How should the TR be financed and what should be its source of revenue (membership and transaction fees)?**

If the TR is a state-owned entity, it should be financed by the state and if the TR is owned by market participants it should be financed by those market participants. Both structures may recoup some costs by charging participants reasonable transaction reporting fees, membership fees and may charge fees for the sale of public data or the sale of data, limited to the specific data of a counterparty, to a counterparty that is not a reporting participant and the costs should be market driven. A tiered fee structure should be permissible to allow a TR to apply an appropriate threshold, where reporting entities falling under the threshold would not be required to pay. Additionally, regulator access to data should be freely available as such costs should be recovered through the fee methodology applied against the reporting entities.

Fees should be minimal so as to not inflate trading costs for the end-user.

**25. If the TR is funded via membership and transaction fees, should smaller participants who report to the TR be exempt from paying fees?**

It should be noted that smaller participants should not be totally exempt from contributing to the funding of the TR and the paying of fees thereof. A tiered fee structure should be permissible to allow a TR to apply an appropriate threshold where reporting entities falling under the threshold would not be required to pay.

Since the TR model is likely to evolve over some time, the TR should evolve its business model and should be required to satisfy the regulator as to the appropriateness of that model as it evolves. The fees should be the same for the same types of activities but the model could allow for differentiated fees for different types of transactions or volume discounts for large users. Regardless, the fee should relate to the work the repository has to perform in recording the transaction-essentially a user-pays model.



## **G. Monitoring of systemic risk**

### ***26. What information should be reported to the TR to assist the regulator in its monitoring of systemic risk and to determine current exposures?***

Systemic risk can be adequately monitored by getting data on individual firm-position data (including valuation and collateral held) while transactional data gives information that may assist in determining market abuse. At a minimum, transactional data (type of derivative, notional, currency, rate(s) or price(s), tenor, salient and reset dates, counterparty etc.) should be reported to the TR. However to enable the prudential regulator to accurately assess and monitor systemic risk the following data should also be reported:

- Fair market valuation of the transaction and changes thereto;
- Collateral provided, the valuation thereof and the changes thereof;
- Hedge transaction, the valuation thereof and the changes thereof;
- On-market transactional and valuation data from exchanges and clearing houses.

A certain amount of entity-level data may also be required to identify netting sets and guarantee relationships. Currently, South Africa has some information provided by the banks to the SARB in their BA returns and it will be worthwhile to examine what additional information is required from that data. The data that is reported to the TR should be informed by the OTC clearing solution selected to avoid wasted effort.

Furthermore, detailed trade terms reporting will ensure trading is fully understood from a pricing and liquidity perspective - aggregate reporting of information can be misleading as it ignores characteristics that impact liquidity and pricing.

### ***27. What information should be reported to the TR to assess the size, interconnectedness and substitutability of financial markets, instruments and market participants?***

The TR will need to collect detailed data relating to the initial terms of each OTC derivatives transaction (including subsequent corrections of errors or omissions), as well as on-going data to determine the market value of the transaction over time in order to assist regulators to determine the current exposure. For monitoring risk, regulators must have access to aggregate and transaction-level data (including the LEI and counterparty details) for all South African professional participants participating in derivatives transactions and South

African referenced derivatives. The use of LEI is an important level of information for the effectiveness of a TR.

**28. Should the TR disclose information to the public to enhance the public's understanding of the OTC derivatives market? If yes, what information should the TR disclose to the public?**

Yes, although not all respondents agree. Broad and statistical information should be made public and it should include aggregate data on positions, transaction volumes and average prices but individual trade-level data should not be provided. In determining the appropriate level of public aggregation, factors that should be considered include ensuring the full anonymity of parties to the trade and providing that such aggregate data shall be for the benefit of market size overview. The public aggregate reporting should generally provide information about the overall market size of asset class, product concentrations, geographic/currency concentrations that can be applied across all asset classes. Further, asset class specific information may vary and such effort should be coordinated and authorised with the industry prior to such disclosure.

**29. Should TRs be responsible for disseminating information to market participants? If so, to which market participants and at what level of disclosure?**

Yes, although not all respondents agreed. A TR should provide market participants reports of the trades submitted by them or which they are a counterparty to the trade to enable reconciliation. This disclosure should be limited to trades in which the market participants is a party to the trade and data which is made available to the public should be made available to all market participants.

**30. What other functions should a TR fulfil, if any, in support of mitigating systemic risk?**

A TR should provide exposure reports that assist regulators in analysing the data captured by reporting predictive assessments on concentration and interconnectedness and comparative studies on trends in the OTC derivatives market in South Africa and compare it to other countries or regions.

**31. Assuming all OTC derivatives are required to be reported, to what extent will market participants be able to circumvent regulation by embedding OTC derivatives in vanilla (standard), non-OTC products, transacting out of other jurisdictions, or transacting through non-regulated entities? How can such risks be mitigated?**

To mitigate these risks, the regulatory framework applicable to the OTC derivatives market must:

- Be appropriate for the South African context and provide for robust monitoring and enforcement. That is, one would need to rely on alternative reporting undertaken by SARB in terms of their IMA/DI's to determine these embedded products and full definition of the OTC derivatives should be established;
- Require audits of reporting entities and certification from such auditors;
- Be harmonised with the regulatory frameworks of other jurisdictions and be clear and unambiguous in its requirements of participant. It should be a requirement for local participants to report all foreign transacted OTC derivatives to the local TR as well as interoperability between the local TR and foreign TRs. All transactions (local, international, vanilla, exotic) must be registered on the local TR;
- Implement a "look-through" principle in the regulations in a similar manner to that implemented in Reg. 28 for pension funds where an embedded derivative with an instrument is required to be reported as if it were a stand-alone instrument;
- Be pragmatic and cost effective; as excessive burden or cost in local markets will move market to foreign borders, resulting in dual markets that will significantly impact local liquidity. High compliance costs incentivise profit maximising behaviour and alternative market infrastructure will be investigated therefore moving to execution venues that offer better value should be encouraged, especially in well regulated jurisdictions.

## **H. Increased market surveillance of the OTC derivatives markets**

### ***32. What level of detail should be reported to the TR for purposes of assessing the integrity, fairness and transparency of the OTC derivatives market?***

Some respondents argued that the basic purpose of the TR is to monitor systemic risk and not market conduct. In keeping with the move to Twin Peaks, prudential and market conduct regulatory functions should be separated out of the TR.

To enable the fairness, integrity and transparency of the OTC derivatives market, the regulator must prescribe -

- Clear and unambiguous rules regarding registration of market participants and reporting requirements;
- A code of conduct with which all market participants should comply;
- The requirement for an annual compliance report to be submitted by market participants;
- Clear and unambiguous rules regarding the types of conduct, practices or transactions which are considered abusive market practices or conduct; and
- Penalties for non-compliance of the above requirements.

The regulator must conduct an in depth monitoring programme which could include the surveillance of data reported to a TR, on-site visits to or inspections of participants, reviewing annual compliance reports and monitoring of complaints. The regulator must enforce the prescribed requirements provided for in the rules and regulations.

***33. What level of detail should be reported to enable the Financial Services Board to monitor potential market abuses in the OTC derivatives market?***

It is recommended that the TR should provide data that is relevant for detecting insider trading or market abuse by reporting the primary economic terms in electronic format plus reporting of full confirmations in the appropriate format to the TR. The FSB/Treasury should avoid using different datasets for different regulatory purposes because determining which data fields have to be reported to the TR is complex and challenging. Therefore to be time and cost-effective the FSB/Treasury should follow a two-pronged approach in defining what data sets have to be reported to the TR to adhere to all the regulatory objectives (this approach is similar to other jurisdictions)<sup>12</sup>:

- A basic data set that contains key economic terms in normalized data fields should be reported to a TR for every derivative transaction. Such data set could be applicable across asset classes and products, and the number of additional fields that are asset class specific would be very limited. The FSB/Treasury should take the views of TRs into account when making any determination about the appropriate data fields.

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<sup>2</sup> Swap Data Recording keeping and Reporting, 77Fed. Reg. 2136(Jan. 13, 2012)

- All relevant elements of the transaction need to be captured in TRs so they can be made available to regulatory authorities if required. The FSB/Treasury should therefore require counterparties to also report the full set of transaction confirmation data (either in normalized data fields or as a copy/electronic image of the paper confirmation where appropriate) to the TR for each OTC derivatives transaction.

**34. What level of detail should be reported to the repository to measure investor confidence in the OTC derivatives market?**

Transactional level data including counterparty, value on agreed basis, net trade compression, collateral against transaction, net open position, LEI, underlier, operational and event data should be reported to the TR to measure investor confidence.

However, the concept of requiring additional information from participants will increase cost so it is recommended that the FSB should analyse the information that the TR will provide and conduct traditional methods like surveys so as to monitor investor confidence in the market (look at broader information in the market). Investor confidence in the OTC derivatives market is not a practicable measurement objective, especially using transactional level data. Derivatives are “derived” from underlying markets and therefore this is not a homogenous market that can measure such a benchmark therefore conducting a survey will prove to be useful.

## **I. Market supervision**

**35. Should supervision requirements be imposed on the OTC derivatives markets that are equivalent to those currently applied in the regulated market?**

Yes, supervision, monitoring and policing should be imposed to ensure compliance. Current regulation covers derivatives as an asset class and banks are subject to intensive supervision by the SARB’s Supervision Department. There are some professional participants that are not within supervision as yet, such as certain retail derivative products providers, hedge funds or investment firms. This should be addressed in order to avoid regulatory arbitrage.

**36. Which market participants should be subjected to supervision?**

All market participants - all professional participants and foreign participants with a local presence. Regulations made under the Financial Markets Act or the FAIS Act should also be considered.

**37. What should be the extent of market supervision?**

- TRs should be required to possess a clearly defined legal framework and their rules, procedures and contractual arrangements should be supported by the laws and regulations applicable to them.
- The rights of all participants, owners and regulators that use the information of a TR should be clearly stated and its governing rules and procedures made public. Those rules and procedures and related contractual requirements should provide certainty on service levels, rights to access, protection of confidential information and intellectual property rights and operational reliability.
- The status of the records in the repository, and whether they are the legal contracts of record, should also be clearly established.
- The TR could be required to appoint a chief compliance officer with responsibilities including reviewing compliance with applicable legislation or rules, identifying and resolving conflicts of interest and completing and certifying an annual compliance report.
- Please note answers in question 35 and 36 also.

**38. What information should be reported to the TR to achieve the market supervision objectives?**

*Transactional level reporting:* including counterparty, value on agreed basis, collateral against transaction, net open position, LEI, underlier, operational and event data. In order to satisfy these broad objectives, a TR will need to collect detailed data relating to the initial terms of each OTC derivatives transaction (including any subsequent corrections of errors or omissions), as well as on-going data to determine the market value of transactions over time.

**J. Nature and type of information to be reported**

**39. Should all OTC derivative transactions be reported to a TR? If not, which OTC derivative transactions should be exempted from being reported and why?**

From a systemic risk oversight perspective, it is imperative that all OTC derivative transactions be reported to a TR and that the trade information is accurately and promptly made available for regulators. To ease the burden of reporting on, for example,

small end-user clients, TRs can be required to provide a variety of access methods that would be efficient to be used by varying types of users. Additionally, third parties such as execution or clearing brokers or middleware service providers should be allowed to act as reporting agents for trading parties.

From a South African perspective, a phased approach should be taken with respect to bespoke transactions as significant challenges are expected. The approach that regulators in other G20 jurisdictions take should be monitored. This will include agreeing on the definition of what an OTC derivatives instrument is and then, what would be the appropriate level of information to meet the requirement for systemic risk management. This is a complex task that will result in a series of standardized templates for agreed products and a generic reporting template for the remainder. The ability for the registrar to exempt a derivative instrument from the TR reporting requirement is necessary given the uncertainty around what should be reported. Should the registrar, in consultation with the professional participants approve an off-shore TR, or an off-shore TR for a certain class of derivative instrument is mandated by the G20, as an example FX currency derivatives within the global initiative of CLS Bank, then the registrar must be able to exempt.

***40. Should non-financial institutions that hold derivatives positions be required to report those transactions to the repository?***

There are contradictory responses to this question; some believe that non-financial institutions should report their derivatives positions to the repository as a third party while others believe that financial intermediaries should report on their behalf or the product provider should be the reporting party as the professional participant. The non-financial institutions could be considered reporting entities when they exceed an appropriate usage “threshold”, which can be defined qualitatively or quantitatively.

***41. Should foreign counterparties be required to report their OTC derivative transactions to the South African TR?***

No, if the global TR is adopted then this will be sufficient in terms of meeting the reporting requirement mentioned above. The regulator should bear in mind that the majority of foreign participants are already regulated in their own jurisdictions, with reporting requirements that are applicable to them.

However, if it's a South African TR foreign counterparties should be required to report OTC derivatives entered into with South African firms, professional participant and

residents and the foreign participant should qualify as a professional participant in the South African market and with a local presence. This is to ensure that the regulator has a complete picture of the South African market. If the foreign participant is without local presence the TR should have the ability to validate the trade and the TR should have the ability to receive information from other TRs in different jurisdictions to confirm transactions if required.

#### **42. What level of transactional data should be reported to the repository?**

Transactional data will differ slightly per product type; however at a minimum the following transaction specific data should be captured:

*Unique transaction identifier, Unique Product Identifier, Contract Type, Unique counterparty identifier, counterparty origin, parent counterparty, parent originator, effective data, maturity/termination/end data, settlement method, delivery type, notional amount, notional currency, payment frequency, timestamp information(execution, order, clearing(if cleared), reporting to TR), collateral information(i.e. initial margin requirement, variance, etc.) and any option related information (i.e. long/short values).*

The full confirmation level data set as well as life cycle events should be reported to the repository to provide the regulator with a full picture of trading undertaken by the organisation it supervises as well as the market on an on-going basis.

For the purpose of monitoring potential systemic risk, the principle economic terms of the transaction must be provided in order to identify the risks inherent in the transaction. Counterparty data would also enable a better understanding of concentration risk in the sector.

#### **43. What level of valuation data should be reported to the repository?**

The level of valuation data that should be reported to the repository should include enough detail to determine a fair market value of the position for each type of derivative. An alternative way of determining the fair market value could also be achieved through a monthly mark to market valuation.

Additionally, since the price of the underlier or collateral for a transaction can change it is best to record the following: initial margin requirements, maintenance margin requirement, variation margin, option values, exchange rates, strike price, lockout period, fixed rates/floating rates, market values of open positions, netting arrangements and valuation of collateral.



**44. What level of aggregate data should be reported to the repository?**

None - data should be reported at a transactional level to the TR. It should be the purpose of the TR to aggregate the information once the detail is received. The only aggregate data that might be reported would be related to collateral as firms generally do not collateralise transactions on a trade-by-trade basis.

**45. What data should be reported to the repository for purposes of disclosure to the regulators to achieve the regulatory objectives mentioned above?**

This is the following data that should be reported: transaction level data (i.e. time stamped price and volume for example), counterparty information, underlier information, operational data and event data. Position level and aggregate data are illustrated by the following sample data sets:

- Aggregate notional data for all contracts traded or settled in South African rands, including a breakdown by reference entity and/or sector;
- A list of the top counterparties trading South African rand-denominated contracts with each counterparty's aggregate notional position and aggregate position by contract type;
- A list of the top counterparty positions for each of the largest financial groups in South Africa;
- Aggregate notional data for contracts written on South African-domiciled corporations (reference entities), including a list of the top aggregate notional counterparty positions for contracts written on each firm;
- A list of the top counterparties' aggregate notional positions where the contract references the debt of the government of South Africa;
- A list of top counterparties' aggregate notional positions where the contract references a specific commodity;
- A list of the top counterparties' aggregate notional positions where contracts reference the debt of one of the ten largest South African financial groups;
- Data on the overall level of activity of each of the South African banks in each asset class;

- Each of the South African bank's overall positions in specific products within an asset class.

**46. What data should be reported to the TR for purposes of assisting the public in understanding the OTC derivatives market?**

The TR should be able to leverage the existing transaction data reported to provide public aggregated reporting on a weekly basis. However, some believe that data should not be released to the public because this would expose the market to potential systemic risk, especially during a stress event when information is overanalysed.

***47. What data should be disclosed to market participants, taking into account those who are parties to a transaction and those who are not?***

Aggregated data should be reported to market participants so that market concentration/activity can be viewed. A professional participant should have access to data that involves that participant as the reporting entity or counterparty. Price discovery, which may encourage liquidity in the fixed interest and equity markets can be improved by reporting limited information (no reporting of size, counterparties) on transactional level on a delayed basis.

***48. Should OTC derivatives prices be made available to both the regulators and the public?***

Yes, although not all respondents agree. The disclosure of pricing data is more closely linked to the execution model than the TR requirement and considering the TRs primary function is to address systemic risk, price reporting can be handled in a way that genuinely increases liquidity and therefore decreases risks. The public could receive aggregated data regarding nominal prices reported to the TR or prices should be made available in a range, subject to a delay-this is to promote transparency.

However, some respondents believe that OTC derivative prices should only be made available to regulators and market participants.

***49. Should the reporting obligation be based on broad functional categories, for example, operational data, product information, economics of a transaction, valuation data, counterparty information, the underlying information and event data, or should unique data fields be developed for different OTC derivatives?***

There may be both common and unique data fields for any combination of OTC derivative instrument and given the difficulty in defining a derivative instrument it would be necessary for the TR, under the guidance of the registrar, to engage with the professional participants to determine appropriate data. Where common reporting standards are agreed, these data sets would be submitted.

It is important to note that there is an incentive to standardise products and these will naturally gravitate towards central clearing. It is therefore highly probable that the TR will be left with nothing more than highly complex bespoke transactions that are not suitable for aggregation. The bespoke nature of the OTC derivatives will push the TR into developing unique data fields. The current protocols in the market should be used, like FIX and FpML to facilitate standardisation.

It is also possible that these transactions are collectively not systemically important, when compared to the standardised derivative products, resulting in the TR becoming largely irrelevant.

In addition, it should be noted that the TR should function only as a registry and if these broad functional categories are taken into account then additional information will add costs.

## **K. Reporting party**

***50. Should both counterparties assume the reporting obligations of OTC derivative transactions to the TR? If not, which counterparty should be obliged to report to the repository?***

These are suggested alternatives that could be taken:

- One of the counterparties should assume responsibility to report the trade and the other counterparty should have the obligation to validate or both counterparties should verify the transaction. The latter reflects current market practice and is in line with regulation proposed in other jurisdictions.<sup>3</sup> If one of the counterparties to the trade is a foreign counterparty without local presence then the local counterparty should take up the obligation to report the trade and the foreign counterparty should have the ability (no obligation) to validate the trade.

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<sup>3</sup> Swap Data Recordkeeping and Reporting Requirement 77 Fed. Reg. 2136(Jan.13, 2012)

- Both parties to the transaction should be assuming reporting responsibilities. For trades transacted on a platform, confirmation by matching service or clearing by a central counterparty, the single record created by those service providers should be reported. Alternatively, the TR should take up the responsibility of matching and reconciling the reported data to avoid duplication.
- If both counterparties are professional participants there should be an agreement drawn up between the parties on who should report to the TR and confirmation should be sent to both counterparties.
- It would be most effective if both counterparties are not obliged to report and the task is given to a third party that is specialised in this task. Allowing the counterparties to use third-parties for the reporting to TRs will enable a cost-effective and timely implementation of the reporting requirements therefore the choice of how best to satisfy the counterparty reporting obligations should rest on the counterparty which can include the use of the third party.

***51. Where a transaction is concluded between a financial counterparty and a non-financial counterparty or corporate, which counterparty should be instructed to report to the TR?***

- The financial counterparty or registered professional counterparty alone should be instructed to report to the TR and the non-financial counterparty should have the ability (no obligation) to validate the trade. If one of the counterparties to the trade is foreign without local presence, the local counterparty should have the obligation to report the trade and the foreign counterparty should have the ability (not obligated) to validate the trade.
- Both parties to transaction should be assuming reporting responsibilities. For trades transacted on a platform, confirmation by matching service or clearing by a central counterparty, the single record created by those service providers should be reported.

***52. Should a dual reporting responsibility be imposed on banks and JSE members? That is, reporting to both the repository as well as to the JSE and Reserve Bank?***

The JSE and the SARB have an objective to ensure that JSE members and banks respectively comply with prudential requirements. The JSE and SARB could act as the third party and provide their member trades and positions to the TR- electronically.

However, it would be ideal to ultimately move to single reporting where OTC derivative trades are directly and only reported to the well-structured TR for the ultimate use by the regulators (including the JSE and SARB). This will avoid duplication.

***53. Should foreign counterparties be required to report transactions with local parties or should the reporting obligation be imposed solely on the local counterparty?***

If one of the counterparties to the trade is a foreign participant without a local presence, the local professional counterparty should have the obligation to report the trade and the foreign counterparty should have the ability (not obligation) to validate the trade. The TR should have the ability to interoperate with a foreign TR for any reconciliation if required. However, if the local party is a non-professional client then the foreign counterparty, if it is deemed a professional participant in the South African market (registered, licenced and subject to South African law) should be required to report. This approach is considered cost-effective and is not burdensome to foreign participants who already have their own respective reporting requirements in their respective jurisdictions.

If both parties are professional participants then there should be an agreement between the contracting parties as to who will report.

***54. What are the potential risks associated with reporting by the foreign counterparties?***

Foreign counterparties, deemed as professional participants by South African law, may not be able to comply with the **extra territorial legislation** imposed by the South African regulator. Challenges with **privacy policy** or **confidentiality** may preclude them from submitting data, **different terminology** or **reporting formats** may impede their ability to comply, **different time zones** may require the South African TR to remain open 24 hours a day to process queries and accept data feeds and a reporting requirement in their home jurisdiction duplicates efforts and cost.

The potential risk is that foreign counterparties withdraw their services to the South African markets removing an important tool for risk mitigation or risk transfer out of the

South African market. It is also possible that branches of internationally headquartered banks in South Africa may be required to report to their home regulators TR and therefore transactions between two domestic counterparties may have to be reported off-shore.

## **L. Timing of reporting**

### **55. Should a 10-minute reporting time be imposed for all OTC derivatives transactions, or should a longer period be given, perhaps in the form of two or three windows per day during which reporting must take place?**

The 10 minute or real reporting time is not at all realistic-this will not add significant information to determine the build-up of systemic risk: The JSE timeline requirements are as follows:

- The JSE Equities Rules require that reported transactions must be reported “*without delay*” (rule 6.30.4);
- The JSE Interest Rate and Currency Rules provide for a 30 minute reporting requirement in respect of reported transactions concluded between two trading members (rule 7.120.3) and, in respect of a reported transaction concluded between a member and a client, rule 7.120.5 requires that the transaction is reported “*without delay*”; and
- The JSE Derivatives Rules are silent regarding the time in which a reported transaction must be reported.

Serious consideration should be given to the purpose of reporting before a reporting interval and reporting period is determined. These are the factors that should be taken into account: the type of derivative, level of standardisation and whether the transactions are matched or confirmed (i.e. all terms and conditions of the trade have been agreed).

Currently, the most feasible reporting time would be an end of day period (T+1), for example in the interest rates and credit derivatives markets, confirmations are highly automated and electronic; therefore a shorter period of time from execution to reporting should be required in this instance but for other bespoke trades this would not be feasible.

**56. Should any market participants or OTC derivative transactions be exempt from real-time reporting? If so, which market participants or transactions? What should be the timeline for delayed reporting of exempted transactions and market participants?**

To accommodate all participants, financial and non-financial, there should be a maximum reporting period of two/three to five business days after trade (T+5) imposed. For financial participants it may be within a shorter period. There could probably be exclusion for non-professional entities below a certain threshold.

Based on responses in question 55, all market participants or OTC derivative transactions should be exempt from “real-time” reporting. It is also necessary for provision to be made for a delay in reporting transactions where the participant has not fully unwound the risk and/or the trade is price sensitive. In which case, the reporting of the transaction must be delayed until the participant has fully unwound the risk and/or the information regarding the trade is no longer price sensitive. This delay could be a number of days or even weeks.

Therefore, real-time reporting is not feasible and this will not be useful to the regulators objective reducing systemic risk.

**57. Should changes in valuation for all OTC derivative transactions be reported on a daily basis? If not, how often should valuation changes be reported?**

Daily mark-to-market of positions in OTC derivatives has established itself as best practice for active users of these products globally<sup>4</sup> and this includes both cleared and uncleared OTC derivatives transactions.<sup>5</sup> End-users can be exempt from having to report on a daily basis as this may be burdensome; however periodic valuation reporting would be required nonetheless.

Some respondents argue that daily valuation would be unnecessary and complex and are recommending that the TR have built-in models that value the OTC derivatives.

**58. What should be the timeline for reporting of transactions for systemic risk monitoring?**

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<sup>4</sup> Business Conduct Standards for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 9724 (Feb.17, 2012); Swap Data Recordkeeping and Reporting, 77 Fed. Reg. 2136(Jan.13, 2012); European Market Infrastructure Regulation (EMIR).

<sup>5</sup> Real Time Public Reporting of Swap Transaction Data, 77 Fed. Reg. 1182 (Jan.9,2012)

End of day or T+1 should be the timeline for reporting of transactions for systemic risk monitoring, subject to an exemption in respect of trades where the participant has not fully unwound the risk and/or the trade is price sensitive

**59. What should be the timeline for reporting of transactions for purposes of OTC derivatives market surveillance and supervision?**

End of day or T+1 should be the timeline for reporting of transactions

**60. Should different timelines apply to different contracts, and data reported, for example transaction data, valuation data and confirmation data?**

The timeline for reporting data should be dependent upon the nature of the data. Preliminary transaction data can be reported shortly after the execution of a trade. Confirmation data by its nature can only be reported upon the completion of the confirmation process which can be delayed by the complexity of the transaction. Valuation data should be reported at the end of the trading day when trading firms value their portfolios.

**61. What sanction, if any, should be imposed for non-compliance?**

Administrative penalties only should be applied.