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# 2018 FINANCIAL MARKETS REVIEW





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## 2018 FINANCIAL MARKETS REVIEW

The 2018 Financial Markets Review is compiled with the latest available information from departmental sources, the South African Reserve Bank (SARB) and Financial Sector Conduct Authority (FSCA.)

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# 2018 FINANCIAL MARKETS REVIEW

EXECUTIVE  
SUMMARY



# Executive Summary

International cases of misconduct in wholesale financial markets have focused the attention of regulators and market participants on measures to (i) strengthen standards of market practice; and (ii) increase the accountability of financial institutions and individuals for the ethos and conduct of business. There is no indication of similar widespread misconduct in South African wholesale financial markets, but room for improvements in conduct and governance were identified by the 2012 review of the Johannesburg Interbank Agreed Rate (Jibar)-setting process and the 2015 Foreign Exchange Review (FX Review).

The international focus on strengthening codes and standards in light of misconduct scandals means that South Africa cannot afford to be complacent. Therefore, South Africa's financial sector authorities – National Treasury, the South African Reserve Bank (SARB) and the Financial Sector Conduct Authority (FSCA) established the Financial Markets Review Committee (FMRC) to develop recommendations to reinforce conduct standards in wholesale financial markets focusing on (i) specific tools to strengthen the implementation and governance of conduct standards by market participants; and (ii) areas where changes to financial markets legislation and associated subordinate legislation are required to support a new conduct framework for wholesale financial markets.

The work programme of the Financial Markets Review (FMR) project commenced in May 2017 under the auspices of the FMRC. The mandate of the FMRC as well as the chapter of the report that deals with the mandate is shown in the table below.

## ADDRESSING THE MANDATE OF THE FINANCIAL MARKETS REVIEW COMMITTEE

Mandate	Dealt with mainly in
Review standards and practices in South Africa's wholesale financial markets, both regulated and unregulated	Chapter 2 (Governance) Chapter 3 (Market conduct)
Review governance, accountability and incentives in wholesale financial markets and the associated regulatory framework, setting out the responsibilities of senior managers and the board of directors of financial institutions	Chapter 2 (Governance)
Develop overarching principles for conduct and integrity to provide a consistent framework for specific reforms in wholesale financial markets	Chapter 1 (section 1.6) Annexure D (Market integrity report)
Identify any gaps in the legislation, regulation and supervision of conduct in wholesale financial markets to be addressed through the market conduct policy framework under Twin Peaks	Chapter 6 (Regulatory framework)
Identify and incorporate the role of global standards and good practice in South Africa's regulatory approach to wholesale financial markets	Chapter 2 (Governance) Chapter 3 (Market conduct) Chapter 4 (Market structure)
Develop recommendations for regulators on a pre-emptive, outcomes-focused and risk-based approach to conduct and integrity in wholesale financial markets	Chapter 5 (Trading venues and technology) Chapter 6 (Regulatory framework)
Facilitate the establishment of a market-led Financial Markets Standards Group	Chapter 2 (Governance)

The detailed work of the FMRC is prepared by an FMR team, which in turn is supported by the Financial Markets Panel (FMP), the members of which are nominated by financial market associations. Based on responses to a questionnaire by market participants, discussion papers produced by the FMP and interviews by the project team, a draft report with recommendations was presented to the FMRC in July 2018. It is envisaged that the draft report will be released for comment to the public during September 2018 and the final report will be published early in 2019.

# Executive Summary

The recommendations of the FMRC are:

## GOVERNANCE

Issue to be addressed	Recommendation
Corporate and risk governance practices	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 National Treasury, SARB, PA and FSCA)
	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
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)
	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 <sup>1</sup> between firms
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)
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
Whistle-blowing	7. Regulators to consider implementing a programme that rewards whistle-blowers for providing information about substantial misconduct in financial markets that leads to a successful enforcement action with monetary sanctions
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

## MARKET CONDUCT

Issue to be addressed	Recommendation
Standards and codes of market practice	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 (FMSG) by senior market professionals and compliance officers. The FMSG's first task could be to consider the development of a general code of conduct for financial market participants
	10. Regulators to consider establishing equivalent standards of market practice across wholesale financial markets including over-the-counter (OTC) markets (consider the Financial Advisory and Intermediary Services (FAIS) Merchant Banking exemption)
	11. Regulators to consider setting up equivalent regimes to monitor and enforce standards and codes of market practice, whether statutory or voluntary

<sup>1</sup> Rolling bad apples are individuals with a history of misconduct who move between firms



# Executive Summary

Issue to be addressed	Recommendation
Market discipline	<p>12. Regulators to consider progressing the establishment of trade repositories in all OTC markets (not only OTC derivatives). This will provide regulators with data that is necessary to carry out monitoring and surveillance to stimulate market discipline</p> <p>13. Regulators to consider meeting with market participants to establish ways in which bilateral market discipline might be improved</p> <p>14. Regulators to consider obliging market participants to inform them if misconduct is detected or suspected</p>
Conflicts of interest	<p>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 OTC financial markets. Such regulations could specifically address third-party payments (also by market makers) when executing orders on behalf of clients</p>
Market abuse	<p>16. National Treasury to consider including a market abuse regulation catch-all clause in the Financial Markets Act 19 of 2012 (FMA)</p> <p>17. Regulators to consider requiring that short sales be flagged on exchanges and reported to the exchange and/or the regulator. (Note: FSCA 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)</p>
Monitoring and surveillance	<p>18. Regulators to consider implementing market surveillance and monitoring systems for OTC markets and fragmented exchange-traded markets. However, fully functional trade repositories will be a prerequisite (see 3.3.4)</p> <p>19. Regulators to consider providing standards for surveillance to firms</p>

## MARKET STRUCTURE

Issue to be addressed	Recommendation
Liquidity	<p>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)</p>
	<p>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</p>
Transparency	<p>22. Regulators to consider implementing the Global Financial Markets Association's (GFMA) Guiding Principles for Market Transparency Requirements to further support market integrity</p>
	<p>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</p>
Competition	<p>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</p>
	<p>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</p>

# Executive Summary

Issue to be addressed	Recommendation
Market makers / Primary dealers	26. National Treasury and regulators to encourage the implementation of measures to promote price transparency for most (if not all) OTC financial instruments
Securities financing transactions (SFTs)	27. Regulators to consider implementing trade repositories as an effective way to collect comprehensive market data for SFTs
	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 FSCA is drafting Conduct Standards for SFT participants, which will include reporting requirements)
	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)
Benchmarks	30. The South African Reserve Bank (SARB) to finalise the recommendations for interest rate benchmarks and implement the recommendations. (Note: Work is underway in the SARB Working Group on Rand Interest Rate Benchmarks)

## TRADING VENUES AND TECHNOLOGY

Issue to be addressed	Recommendation
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 FSCA is proposing amendments to the FMA)
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 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)
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 35. Regulators to consider encouraging more over-the-counter (OTC) derivatives contracts be cleared through central counterparties. This may require the standardisation of such OTC derivative products

# Executive Summary

## REGULATORY FRAMEWORK

Issue to be addressed	Recommendation
FMA within a Twin Peaks regulatory framework	<p>36. The FMA to be divided into two pieces of legislation – the first in relation to dealing with market infrastructures and alternative trading venues (proposed Market Infrastructure Act) and the second with the handling of the market conduct of financial markets (predominantly market abuse and conflicts of interest), either in the form of a distinct Act or as part of the Conduct of Financial Institutions Act (COFI Act) or as standards under the FSR Act</p> <p>37. National Treasury to consider reassessing whether a separate conduct Act (i.e. COFI Act) is required or whether regulations under the FSR Act are sufficient</p>
Role of self-regulatory organisations (SROs)	38. It is recommended that the SRO model be retained where appropriate. It is further recommended that SROs' delegation of regulatory authority be revisited to maximise the benefits of self-regulation and limit its disadvantages (mainly conflicts of interest). (Note: The FSCA made recommendations to review the FMA in this regard)
Insolvency Act	39. The conflict between the provisions of the Insolvency Act and the margining requirements for OTC derivatives to be resolved. (Note: The National Treasury is engaging the Department of Justice on the matter)
Buy-side	40. Equivalent standards of conduct to address market manipulation to be considered for both buy-side and sell-side

## FINALISATION OF THE 2015 FX REVIEW

Issue to be addressed	Recommendation
Treasury outsourcing companies (TOCs)	41. Regulators to investigate the regulatory framework for TOCs within the Twin Peaks regulatory framework for consistency (e.g. authorisation and governance) and proportional equivalency (e.g. conflicts of interest and regulation)
Interdealer brokers	42. Regulators to investigate the current regulatory framework for interdealer brokers and consider revising it within the Twin Peaks regulatory framework for consistency (e.g. authorisation, capital and governance) and proportional equivalency (e.g. regulation)
Exchange control 'nuisance' clauses	43. The SARB (Financial Surveillance Department) to dispense with the distinction between 6- and 12-month foreign exchange hedges and extend the Active Currency Management Regime accordingly



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# 2018 FINANCIAL MARKETS REVIEW

INTRODUCTION

# Introduction

## 1.1 BACKGROUND

International cases of misconduct in wholesale financial markets have focused the attention of regulators and market participants on measures to (i) strengthen standards of market practice; and (ii) increase the accountability of financial institutions and individuals for the ethos and conduct of business. The substantial fines imposed in the United States (US), United Kingdom (UK) and Europe for the manipulation of interest rate and foreign exchange benchmarks in recent years reflect the significant damage to public confidence in financial markets following the global financial crisis of 2007–08. Moreover, these cases have provided a signal to international financial institutions that decisive action is required to better align governance, incentives and behaviour with expected standards of conduct and market integrity. In South Africa, there is no indication of similar widespread misconduct in wholesale financial markets, but the following improvements in conduct and governance have been identified:

- A review of the Johannesburg Interbank Agreed Rate (Jibar)-setting process by the South African Reserve Bank (SARB) (2011–12) found no evidence of malpractice on the side of the contributing banks in the submission of underlying interest rates, from which Jibar was derived, to the calculation agent. However, a need was identified for improvements in governance, leading to a new code of conduct being implemented in 2013, which is now the subject of regular review and updates, including alignment with changing international standards, where appropriate.
- The Foreign Exchange Review Committee (FXRC) (formed in 2014–15), appointed by the SARB and the then Financial Services Board – now the Financial Sector Conduct Authority (FSCA) – found no evidence of malpractice or serious misconduct in the South African domestic foreign exchange market. However, the FXRC did identify a number of areas for improvement in overall market conduct. One outcome of the Foreign Exchange Review (FX Review) was a draft Code of Conduct for over-the-counter (OTC) Financial Markets, prepared by the SARB and FSCA in consultation with market participants through the Financial Markets Liaison Group. While the FXRC review was underway, the Competition Commission (CC) announced on 19 May 2015, that it had initiated an investigation against several international financial institutions who had allegedly been fixing prices of foreign exchange trades in mainly offshore financial centres. The investigation is still underway.

One of the key recommendations of the FXRC was that a benchmark review of financial markets, like the Fair and Effective Markets Review conducted in the UK, be undertaken. Furthermore, the FXRC recommended the formation of a Financial Markets Standards Group (FMSG) to provide a forum for senior market professionals to discuss compliance issues and to resolve conflicts and ambiguities in standards of market practice.

In response to the FXRC recommendations, South Africa's financial sector authorities – National Treasury, the SARB and the FSCA – established the Financial Markets Review Committee (FMRC) to develop recommendations to reinforce conduct standards in wholesale financial markets focusing on (i) specific tools to strengthen the implementation and governance of conduct standards by market participants; and (ii) areas where changes to financial markets legislation and associated subordinate legislation are required to support a new conduct framework for wholesale financial markets.

## 1.2 MANDATE OF THE FINANCIAL MARKETS REVIEW COMMITTEE

The mandate of the FMRC is to:

- review standards and practices in South Africa's wholesale financial markets, both regulated and unregulated;
- review governance, accountability and incentives in wholesale financial markets and the associated regulatory framework, setting out the responsibilities of senior managers and the board of directors (board) of financial institutions;
- develop overarching principles for conduct and integrity to provide a consistent framework for specific reforms in wholesale financial markets;

<sup>2</sup> As from 1 April 2018, the Financial Sector Conduct Authority (FSCA) replaced the Financial Services Board (see <https://www.fsc.co.za/Documents/FSCA%20stakeholder%20letter.pdf>). For consistency the Financial Sector Conduct Authority (FSCA) will be used throughout the document. Where the acronym FSB is used, it refers to Financial Stability Board ([www.fsb.org](http://www.fsb.org)).

# Introduction

- identify any gaps in the legislation, regulation and supervision of conduct in wholesale financial markets to be addressed through the market conduct policy framework under Twin Peaks;
- identify and incorporate the role of global standards and good practice in South Africa's regulatory approach to wholesale financial markets;
- develop recommendations for regulators on a pre-emptive, outcomes-focused and risk-based approach to conduct and integrity in wholesale financial markets; and
- facilitate the establishment of a market-led FMSG.

**Table 1.1: Addressing the mandate of the Financial Markets Review Committee**

Mandate	Dealt with mainly in
Review standards and practices in South Africa's wholesale financial markets, both regulated and unregulated.	Chapter 2 (Governance) Chapter 3 (Market conduct)
Review governance, accountability and incentives in wholesale financial markets and the associated regulatory framework, setting out the responsibilities of senior managers and the board of directors of financial institutions.	Chapter 2 (Governance)
Develop overarching principles for conduct and integrity to provide a consistent framework for specific reforms in wholesale financial markets.	Chapter 1 (section 1.6) Annexure D (Market integrity report)
Identify any gaps in the legislation, regulation and supervision of conduct in wholesale financial markets to be addressed through the market conduct policy framework under Twin Peaks.	Chapter 6 (Regulatory framework)
Identify and incorporate the role of global standards and good practice in South Africa's regulatory approach to wholesale financial markets.	Chapter 2 (Governance) Chapter 3 (Market conduct)
Develop recommendations for regulators on a pre-emptive, outcomes-focused and risk-based approach to conduct and integrity in wholesale financial markets.	Chapter 4 (Market structure) Chapter 5 (Trading venues and technology) Chapter 6 (Regulatory framework)
Facilitate the establishment of a market-led FMSG.	Chapter 2 (Governance)

## 1.3 SCOPE OF THE REVIEW

Similarly to the UK's Fair and Effective Markets Review, the Financial Markets Review (FMR) will focus on sell-side participants in OTC wholesale markets for money market and other debt instruments, foreign exchange, commodities and associated derivatives. Market infrastructures and other trading venues as well as technological developments affecting financial markets will also be included in the review.

### 1.3.1 WHOLESALE MARKETS

The International Organization of Securities Commissions (IOSCO) defines wholesale markets as 'markets that predominantly consist of professional counterparties where both counterparties are persons or firms that are considered more sophisticated than typical retail customers or participants'<sup>3</sup>.

<sup>3</sup> <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD563.pdf>



# Introduction

Figure 1.1 shows financial market activities included in the definition of wholesale. The shaded areas indicate the activities in scope for the review.

**Figure 1.1: Wholesale financial market activities**

Investment (and corporate) Banking		Fund management and other services	Market infrastructures
Arrangement of debt and equity issues including underwriting and private placements	Treasury management and transaction banking	Management of large-scale investment portfolios of pension funds, institutions, CISs	Primary markets
Mergers and acquisitions	On- and off-balance sheet financing of transactions	Securities financing transactions	Secondary (venue traded) and OTC markets
Market making (primary dealing)	Securities financing transactions	Custody and depository services	Clearing
Equity / FICC sales and trading	Risk solutions including bespoke hedging services	Operational and fund administration services	Settlement
Broking (as agent)	Authorised foreign exchange dealers		Custody
Research and market information services	Advice		Production and dissemination of data
			Benchmarking

In scope
  Follow up of FX review

## 1.3.2 EXISTING SOUTH AFRICAN INITIATIVES

Existing market conduct initiatives considered by the FMR include:

- the proposed Conduct of Financial Institutions (COFI) Bill;
- the Financial Markets Act 19 of 2012 (FMA) regulations for OTC derivatives markets;
- review of the Jibar-setting process and implementation of the Jibar Code of Conduct;
- report of the FXRC;
- draft Code of Conduct for OTC Derivatives Providers;
- draft conduct standards for participants entering into securities financing transactions; and
- projects under the Financial Markets Wholesale Conduct Coordinating Committee (previously the Listed Equities, Debt and Derivatives (LEDD) Coordinating Committee).

A further important initiative by National Treasury is the review of the FMA, which is primary legislation governing the regulation of financial markets, market infrastructures and securities services in South Africa. Questions were posed as to the necessity of two reviews. To address these questions, the differences between the mandates of the FMR and the review of the FMA are summarised in Figure 1.2 and discussed in more detail in Chapter 6.

# Introduction

**Figure 1.2: Financial Markets Review and review of the Financial Markets Act**

Policy decisions relating to Financial Markets Act	<b>FMA and market conduct</b>	<ol style="list-style-type: none"> <li>Both prudential and market conduct in a single FMA</li> <li>Split FMA: move conduct issues to another piece of law and create a new market infrastructures (MI) Act</li> </ol>
	<b>FMA and future prudential law</b>	Develop the MI Act as the pre-cursor of the future over-arching prudential law (licensing, prudential capital, governance and risk management requirements, recovery and resolution, supervision)
	<b>Self-regulatory organisations</b>	<ol style="list-style-type: none"> <li>More of the same i.e, no change from current</li> <li>Develop options for the delegation of regulatory authority (prudential and market conduct)</li> </ol>
Mandate of reviews	<b>FMA mandate (depending on policy decisions)</b>	<b>FMR mandate</b>
	<ul style="list-style-type: none"> <li>Mainly a prudential focus</li> <li>Develop MI policy and draft MI bill including                             <ul style="list-style-type: none"> <li>Trade repositories for cross-market monitoring and surveillance</li> </ul> </li> <li>Move FMA conduct matters (e.g, market abuse regime) to a separate piece of law, regulations under FSR Act, or COFI Act</li> <li>Develop delegation-of-regulatory-authority regime for SROs</li> </ul>	Develop recommendations to reinforce conduct standards in wholesale financial markets focusing on <ol style="list-style-type: none"> <li>specific tools to strengthen the implementation and governance of conduct standards by market participants; and</li> <li>areas where changes to financial markets legislation and associated subordinate legislation are required to support a new conduct framework for wholesale financial markets</li> </ol>

## 1.4 PROCESS OF THE REVIEW

The work programme for the FMR project officially commenced in May 2017 and the FMRC had its inaugural meeting in July 2017. The FMRC is co-chaired by National Treasury, the SARB and the FSCA.

The Project Team – Mr James Cross, a retired senior deputy governor of the SARB, Ms Margaret Olivier (SARB), Ms Lynne Thomas (an independent consultant to National Treasury until December 2017) and Ms Ingrid Goodspeed (an independent consultant from March 2018) – presented a proposed work programme, a draft questionnaire as well as draft terms of reference for the Financial Markets Panel (FMP).

The FMP is an independent panel of market participants that was set up by the FMRC to provide information and guidance on market structures, practices and governance. The members of the FMP were nominated by the relevant financial market associations: Association of Corporate Treasurers of Southern Africa (ACTSA), Association for Savings and Investment South Africa (ASISA), Banking Association South Africa (BASA), South African Institute of Chartered Accountants (SAICA), South African Institute of Stockbrokers (SAIS), International Bankers Association (IBA), Financial Markets Liaison Group (FMLG) and Association of Black Securities and Investment Professionals (ABSIP). The first meeting of the FMP was held on 18 August 2017.

**As per the terms of reference of the FMP, the following work streams were set up:**

- governance and accountability (including the Senior Managers Regime);
- foreign exchange market;
- fixed income and money markets;
- regulated markets; and
- review of the legal framework, including licensing.

# Introduction

Members of the FMP contributed to the FMR by encouraging their respective associations (and their members) to participate in the questionnaire. The purpose of the FMRC questionnaire was to seek the opinions of market participants on a range of themes identified from other international assessments of wholesale financial markets as well as issues specific to South African financial institutions and markets. The questionnaire provided an opportunity for market participants to provide input on current market practices and the management of conduct risk in South Africa. The Project Team received 38 responses in total – banks: 14; non-banks: 19; market infrastructure providers: 2; and industry associations: 3.

From May 2017 until May 2018 the Project Team continued to have targeted interviews with market participants, FMP members and official sector participants to clarify issues raised and gain an understanding of matters that have an impact on the fixed income, currency and commodities (FICC) markets. Approximately 160 interviews were conducted during this period.

The working groups of the FMP produced several discussion papers that provided input to the report.

Drafting of the report commenced in March 2018 and, after various consultations with the FMRC and official sector participants, the draft report was presented to the FMRC at the end of July 2018. It is envisaged that the draft report will be released for comment to the public at the during September 2018 for a period of four weeks. The FMRC will consider the input received and, if required, make changes to the recommendations and the final report. A final report will be presented to the Minister of Finance by the three Co-Chairs (National Treasury, the SARB and the FSCA) early in 2019 before its publication.

Where the report records the views of market participants (shaded in the report) these are largely unedited. Participants' views do not necessarily reflect the views of the FMRC, National Treasury, SARB or FSCA.

As the implementation of the Twin Peaks regulatory framework in financial markets and infrastructures is still in its infancy (see 1.5 below), many of the FMRC's recommendations are directed to 'the regulators' (i.e. the SARB, the Prudential Authority (PA) and the FSCA). The intention is that the regulators work together on their implementation.

## 1.5 WHY ARE MARKET CONDUCT ISSUES RELEVANT IN WHOLESALE MARKETS?

Although South Africa has been largely insulated from the international misconduct scandals, there are nevertheless two important motivations for conducting a benchmark FMR.

First, the Twin Peaks reforms to financial regulation and supervision have seen the introduction of a new market conduct policy framework with a dedicated conduct supervisor, the FSCA. A benchmark review of wholesale financial markets will aid the development of a consistent policy framework and inform the allocation of responsibilities at the FSCA and SARB in supporting the efficiency and integrity of the financial system. It will also clarify the role of the market in setting and implementing conduct standards under the new regulatory approach.

Second, the international focus on strengthening codes and standards in light of misconduct scandals means that South Africa cannot afford to be complacent. Maintaining South Africa's position as one of the leading emerging markets, and further developing its role as a financial centre for Africa, requires that its financial institutions and infrastructures keep pace with international good practice. A benchmark review will assist in demonstrating where good practice already exists and where further action is required to adapt and incorporate international standards into the local financial system. The review and its outcomes should support confidence in South African markets, among both local and international counterparties.

# Introduction

## 1.6 WHAT IS MARKET INTEGRITY AND MARKET EFFECTIVENESS?

The local and international frameworks for market conduct reveal several core characteristics of market integrity, broadly spanning market structures, practices, ethics and governance. Many of these features are confirmed by market participants in South Africa in discussing the concepts of fairness, effectiveness and market integrity, together with the strengths and risks associated with current market practices.

### 1.6.1 MARKET INTEGRITY AND EFFECTIVENESS DEFINED

**Market integrity is usually defined in terms of the key outcomes, behaviours and processes in wholesale financial markets (see the complete Market integrity report in Annexure D). The following overarching principles indicate where market integrity exists:**

1. Participants act fairly, honestly and in the interests of the broader South African financial markets in all aspects of business, with the skills and knowledge required for the specific markets in which they operate, and with due care and diligence with respect to expected standards of market practice.
2. Standards of market practice – both the general principles of high standards of conduct in wholesale financial markets and the specific practices required in particular markets – are widely understood and consistently applied by market participants. In particular, rigorous standards are applied by market participants in the management of conflicts of interest in their conduct of business, their handling of confidential information, and in their communications.
3. Markets have sufficient transparency and provide fair access to information about prices and issuers of financial securities to reinforce confidence that standards of market practice are upheld and to support a robust price-formation process.
4. Markets provide fair, open and non-discriminatory access to financial products and services, either directly or through intermediation, and are competitive in support of innovation and choice to meet the varied needs of market participants.
5. Markets have reliable price-formation processes and robust trading infrastructures to deliver fair outcomes for diverse market participants as well as appropriate pricing and allocation of capital and risk in the economy.
6. Financial institutions have in place clear structures for governance, accountability, internal controls and risk management, led at the most senior level, and review these on a regular basis to ensure consistency with international good practice.
7. Surveillance and enforcement mechanisms – at financial institutions and the regulatory authorities – effectively deter, detect and penalise market abuse, backed by a sound and robust legal framework.
8. Legislation and regulation is clear, consistent, proportionate and free of undue influence to underpin fair outcomes in financial markets, stability in the financial system, and an efficient allocation of capital in support of economic growth. Accordingly, the supervision by financial regulators is pre-emptive, risk-based and outcomes-focused, and sufficiently intensive and intrusive to achieve these goals.

**IOSCO distinguishes between market integrity and market efficiency as follows:**

- Market integrity is 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.
- Market efficiency is the ability of market participants to transact business easily and at a price that reflects all available market information.

Factors identified by IOSCO to determine if a market is efficient include liquidity, price discovery and transparency.



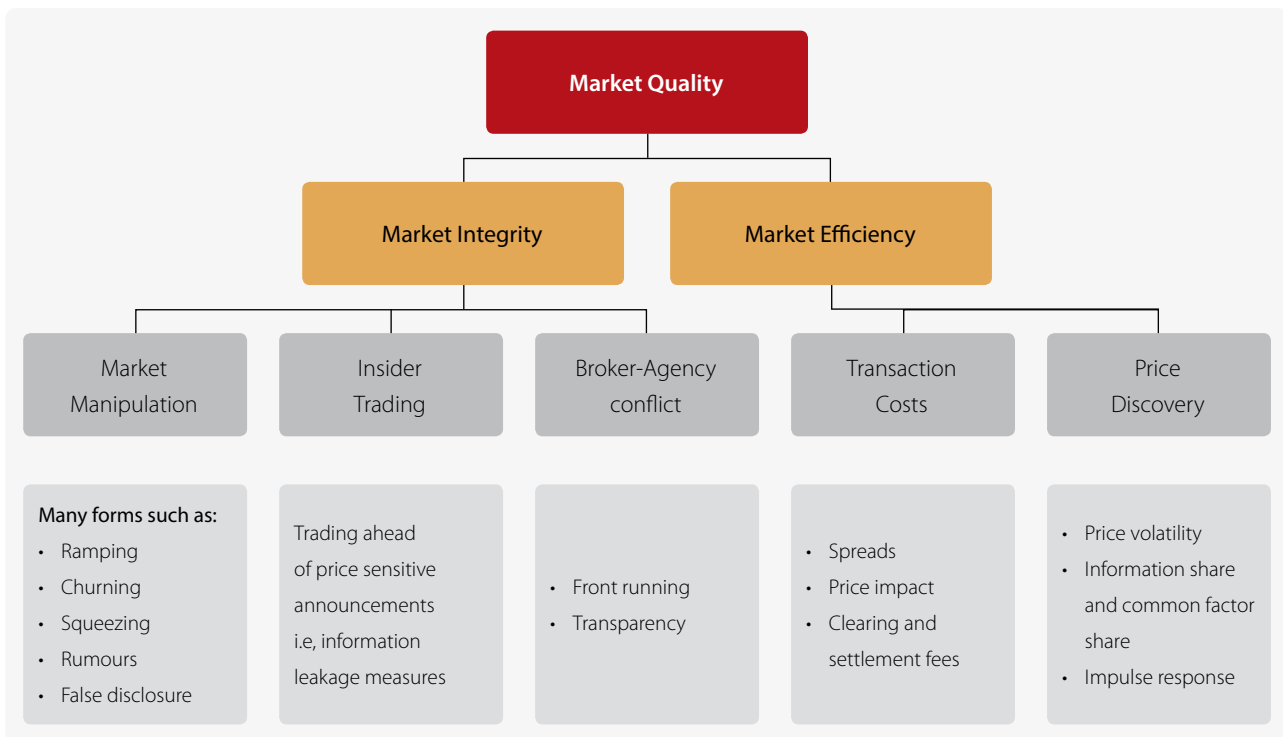
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IOSCO's fundamental principles to preserve the integrity of the market require market participants to:

- observe high standards of integrity and fair dealing;
- act with due care and diligence in the best interests of its clients and the integrity of the market;
- observe high standards of market conduct;
- not place its interests above those of its clients;
- give similarly situated treatment to similarly situated clients;
- comply with any law, code or standard relevant to securities regulation as it applies to the firm.

Aitken and Harris (2011)<sup>4</sup> introduce the concept of market quality as a blend of market integrity and market efficiency. They propose an outcomes-based framework for assessing financial market quality that includes measurement indicators for market integrity as well as market efficiency. These indicators may assist regulators to design evidence-based regulation and policy making for financial markets. This is illustrated in Figure 1.3.

**Figure 1.3: Market quality as a composite of market integrity and efficiency**



Source: Aitken and Harris (2011)

<sup>4</sup> <https://researchers.mq.edu.au/en/publications/evidence-based-policy-making-for-financial-markets-a-fairness-and>

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## 1.6.2 THE VIEW OF MARKET PARTICIPANTS ON MARKET INTEGRITY

### 1.6.2.1 Definition of 'effective', 'fair' and 'market integrity'

#### An 'effective' market:

- enables investment, funding and risk transfer, and provides competitive prices;
- has many participants who trade large volumes where the bid offer spread is small; and
- has deep liquid markets, predictable trading conditions and settlement mechanisms.

#### A 'fair' market:

- has clear standards of market practice;
- is appropriately transparent;
- allows open access;
- enables competition based on merit;
- operates with integrity, free from manipulation or inappropriate trading;
- is where participants trade on equal terms, with transparency of pricing and incentives;
- has a clear and consistent regulatory framework and approach, pre- and post-trade transparency, and open access to diverse regulated participants, with the presence of a level playing field;
- applies uniform rules across participants, including both buy-side and sell-side; and
- treats all participants, counterparties and clients equally and fairly, with no participant given advantage over another, and no actions that prejudice any client or participant.

**'Market integrity' means there is sufficient trust in markets to confidently and consistently transact with predictable outcomes.**

#### The main features of market integrity are:

- high standards of compliance and adherence to ethical standards, established best practices, codes of conduct and directives;
- conflict management;
- equal access to the market;
- best execution;
- transparency, including price transparency and fair pricing and promotion strategies;
- information on issuers available to the entire market at the same time;
- fit and proper intermediaries;
- the prevention and detection of market abuse;
- appropriate complaints management; and
- an open, honest and transparent relationship with regulators.

#### Issues in South Africa:

- Markets function effectively but there may be deficiencies in fairness because market standards are not adequately clear in their application. There have been almost no holistic binding standards or principles of market practice; instead the approach is fragmented across asset class and is generally non-binding. It is suggested that the FX Global Code could be a starting point for developing an overarching code of practice with practical guidelines.
- The market is effective in terms of liquidity, depth, sophistication and technological updates, but there is not a level playing field in terms of fairness and consistency of regulation across international participants bound by international rules and smaller participants involved only in the local market.



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- The market is fair, effective and with good integrity, but has challenges in terms of limited liquidity depth and limited price providers in certain products, as well as skills shortages in some places. Examples are foreign exchange optionality, index derivatives, structured products and equity volatility.
- The government bond market is functioning well. However, the corporate bond market is illiquid and with deficiencies in the price discovery process. The functioning of the structured note market is another area of concern.
- Challenges for fairness in pricing, for example the credit valuation adjustment (CVA) charge on derivative contracts, is an area of discrimination between large and small participants, with a lack of transparency on how CVA charges are levied.
- Information is to some extent available through various platforms, albeit the following business day.
- High-frequency traders that have co-located their computer servers with those of the exchanges is an issue of the trade-off between improvements in market efficiency and fairness as market information is received split seconds before it is available to other participants.
- There are limitations to integrity because the financial system caters largely for the middle class, with sub-minimum products and services for the marginalised. It is also suggested that the system does not enable black participants because vehicles that allow enterprises to expand are inaccessible to them.

It is recommended that an 'integrity forum' be established by the regulator or another body for all market participants to monitor and enforce integrated codes of conduct across the industry.

## 1.6.2.2 Strengths of standards and practices in establishing market integrity

The legal and regulatory framework plays a role in supporting market integrity, particularly its alignment with international best practices, including the Group of Twenty (G20) and Group of Thirty (G30) reforms and requirements, the Twin Peaks model and proposed OTC regulations.

### Strength assessment includes the following:

- Transparency in markets mitigates market abuse.
- The surveillance and enforcement of the JSE Limited (JSE) is a strength, as is the enforcement of the FSCA.
- Technology supports market integrity (e.g. modern digital surveillance, trading, settlement and recording of transactions, and market infrastructure provided by the JSE and Strate Limited).
- Market participants foster an environment of compliance enhanced by adhering to global compliance and ethics principles (e.g. chartered financial analyst (CFA) standards and local standards contributed by industry groups such as the Banking Association South Africa (BASA), the Association for Savings and Investment South Africa (ASISA) and the South African Institute of Stockbrokers (SAIS).
- Audit standards are seen as a strength.

## 1.6.2.3 Risks to market integrity

### General risks to market integrity include:

- market manipulation and abuse;
- collusion and anti-competitive practices;
- a lack of enforcement against perpetrators;
- a lapse or lack of controls;
- inappropriate sharing or leaks of client confidential information;
- ineffective institutional Chinese walls;
- a breakdown or lack of appropriate management of conflicts of interest;

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- a lack of transparency;
- opaque fee structures and failure to be transparent with clients; and
- corruption.

**A further risk to market integrity is created by the following gaps in the application of standards of market practice:**

- Not all participants are governed by the same standards (e.g. banks versus non-bank institutions). Where market practices are not all captured in regulatory standards, the uncertainty creates risks of undesirable behaviour.
- Where formal standards do not exist, it is not always possible for firms to demonstrate good conduct and there are limitations on how they can be held accountable.
- The non-binding nature of industry guidelines and their not being sufficiently practical results in divergent practices.
- Standards often tend to be framed in terms of what is not allowed. Clear guidance should instead be provided on accepted levels of conduct.
- Market standards are incapable of keeping up with rapid local and international developments.

**The following gaps in the legislative and regulatory framework could be a risk to market integrity:**

- unregulated entities currently active in the wholesale markets;
- absence of a supervisor with legislated responsibility and enforcement powers to monitor and detect market manipulation and collusive practices in OTC wholesale markets;
- complexity of financial markets which constantly puts practices and regulations under pressure;
- perceived lack of enforcement;
- lack of visibility of regulators in terms of conduct monitoring and enforcement actions; and
- authorities that ignore whistle-blowing.

A suggested mitigant to the risk is that a longer-term FMP could provide a forum to take on responsibility in this area, with involvement from market participants to ensure that guidelines are sufficiently practical.



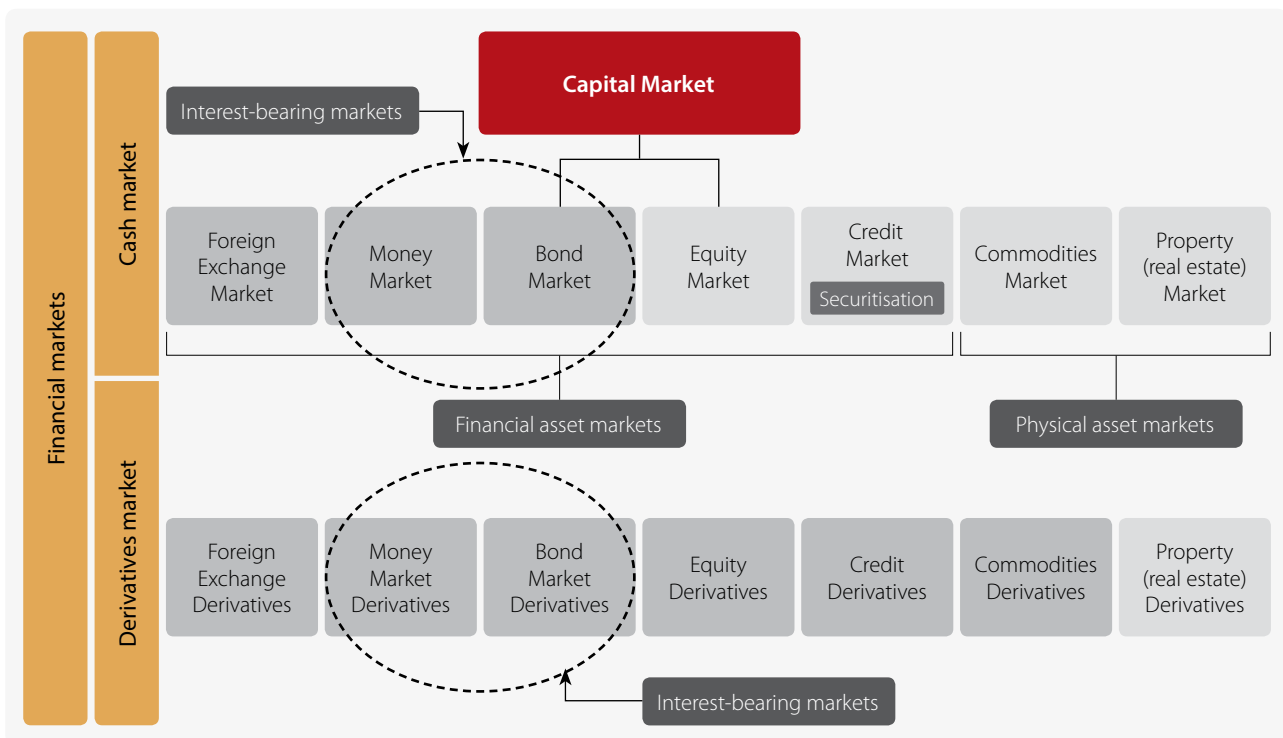


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## 1.7 A DESCRIPTION OF SOUTH AFRICAN FINANCIAL MARKETS

The financial markets are discussed with reference to Figure 1.4. The discussion will concentrate on those markets that are the focus of the review, namely interest-bearing, foreign exchange, commodities and derivatives markets. These are indicated by the shaded areas in Figure 1.4.

Figure 1.4: South African financial markets



Source: Goodspeed (2017)

## 1.7.1 THE FOREIGN EXCHANGE MARKET

<p>The market</p>	<p>The foreign exchange market is the financial market where currencies are bought and sold. The price at which they are traded is the exchange rate.</p> <p>The foreign exchange market plays a crucial role in facilitating cross-border trade, investment and financial transactions. In a world increasingly dominated by international trade – trade has grown by a factor of three over the past 20 years – the foreign exchange market is instrumental in facilitating such trade. The foreign exchange market is an important adjunct to the international capital market, allowing borrowers to meet their financing requirements in the currency that best meets their needs.</p> <p>The US dollar (USD) is the dominant currency in the foreign exchange market. The euro has the second-largest market share, followed by the Japanese yen and the British pound.</p>
<p>Turnover</p>	<p>The foreign exchange market is the largest financial market in the world. The average daily turnover in global foreign exchange markets in April 2016 was USD5.1 trillion. This is down from USD5.4 trillion in April 2013.</p> <p>The turnover in the South African foreign exchange market averaged USD19.1 billion per day for 2017. The foreign exchange swap market accounts for a much larger share of overall volume compared to the spot and forward market. The net average daily turnover against the South African rand (ZAR) in the spot, forward and swap market amounted to USD3.2 billion, USD1.0 billion and USD8.3 billion respectively for 2017.</p> <p>The ZAR trading activity outside South Africa is relatively large compared to activity in the domestic foreign exchange market. The ZAR trading activity offshore was approximately USD60 billion and USD49 billion in 2013 and 2016 respectively. For the same periods, turnover in the South African foreign exchange market was USD21.4 billion and USD20.6 billion respectively.</p>
<p>Benchmarks</p>	<p>WM/Reuters 4pm London fix</p>

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## 1.7.1 THE FOREIGN EXCHANGE MARKET

Instruments	Cash	OTC	Spot
	Derivatives	OTC JSE	Forwards FX swaps Currency swaps Currency options  Currency futures Currency options
Trading (OTC)	Bilateral		JSE turnover data showed a substantial growth of trading activity in the currency options market in the fourth quarter of 2017. Turnover in the currency options market increased from ZAR9.7 billion in January to ZAR72.1 billion in December 2017. For the same period, turnover in the currency futures market increased from ZAR15.5 billion to ZAR89.7 billion.
Trading venues (OTC)	Predominantly OTC Dealing systems (EBS, Reuters) for interbank market Web-based electronic platforms accessible by broader range of market participants		A substantial portion of the interbank foreign exchange transactions are executed via Reuters compared to other systems. In the domestic foreign exchange market, local banks have developed in-house trading platforms for streaming bid and offer prices to clients, and this also allows them to transact electronically. These developments are in line with global trend where there is high competition to increase market share and to improve efficiency.
Settlement	Continuous Linked Settlement (CLS) <sup>5</sup> (Payment-versus-Payment (PvP)) Traditional correspondent banking Bilateral		
Market intermediaries	Yes – treasury outsourcing companies (TOCs). The Financial Surveillance Department of the SARB clarified the role of TOCs in the foreign exchange market in Exchange Control Circular No. 13/2012. TOCs must obtain approval from the Financial Surveillance Department of the SARB, through an Authorised Dealer, prior to commencing any foreign exchange business.		The full extent of the role played by TOCs in the foreign exchange market is, however, not clear as no official figures are available. It is not clear how many authorised TOCs are actively involved in the foreign exchange business.
Surveillance	Dealing room recording (not universal or compulsory)		

<sup>5</sup> CLS Bank, based in New York, is a limited purpose bank for settling foreign exchange. It is owned by 69 financial institutions that are significant players in the foreign exchange market. It currently settles trades in 18 currencies, including the South African rand (ZAR).

### 1.7.1 THE FOREIGN EXCHANGE MARKET

<p>Codes of conduct</p>	<p><b>FX Global Code</b></p> <p>As a member of the Global Foreign Exchange Committee, South Africa endorsed the FX Global Code and committed itself to promoting and upholding the FX Global Code in the domestic foreign exchange market. The SARB, together with key market participants in the local foreign exchange market, have established the South African Foreign Exchange Committee. The purpose of this committee is to provide guidance in the foreign exchange market by endorsing and upholding the FX Global Code, and to facilitate market participants' adherence to the Code with the intention of promoting a fair and transparent market and complying with international best practises.</p>
<p>Legislation</p>	<p><b>Currency and Exchanges Act 9 of 1933 (exchange control)</b></p> <p>All major players in the local foreign exchange market, Authorised Dealers (ADs), Authorised Dealers with limited authority (ADLAs)<sup>6</sup> and TOCs are subject to regulations relating to banks under the Banks Act 94 of 1990 (Banks Act) and the Financial Intelligence Centre Act 38 of 2001 (FIC Act), in addition to the Exchange Control Regulations and the Orders and Rules under Exchange Control Regulations. This appointment gives these banks the right to buy and sell foreign exchange, subject to conditions and within the limits prescribed by the SARB's Financial Surveillance Department (FinSurv). ADs are not agents for FinSurv, but act on behalf of their clients.</p> <p>FinSurv is responsible for the day-to-day administration of exchange controls. The Minister of Finance has delegated to the Governor and/or a Deputy Governor as well as to the Head of FinSurv (and to other officials in the department) all the powers, functions and duties assigned to, and imposed on, National Treasury under the Exchange Control Regulations (with certain exceptions).</p> <p>The current legal framework in South Africa does not provide for the regulation and/or supervision of foreign exchange dealers directly or specifically. ADs, however, are subject to a host of requirements as prescribed by the Banks Act, the Regulations relating to Banks published under the Banks Act, the Exchange Control Regulations as well as the Orders and Rules published under the Exchange Control Regulations. Foreign currency participants that are either banks or non-banks, including institutional investors, insurance companies and managers of pension, money, mutual and hedge funds are also subject to certain requirements in terms of laws administered by FSCA, such as the FMA and FAIS Act.</p>

<sup>6</sup> ADLAs, including Bureaux de Change, are authorised by National Treasury to deal in foreign exchange for the sole purpose of facilitating travel-related transactions.

# Introduction

## 1.7.1 THE FOREIGN EXCHANGE MARKET

Market conduct issues	<p>In 2015 the foreign exchange market was rocked by revelations of the manipulation of foreign exchange rates by banks to increase their profits, sometimes through collusion. Six global banks (Bank of America, UBS, Royal Bank of Scotland, JPMorgan, Citigroup and Barclays) were fined more than USD 5.6 billion by the US Department of Justice to settle allegations in this regard.</p> <p>In October 2015 the SARB released the findings of its review into the trading practices among ADs in the South African foreign exchange market. While the review found no evidence of malpractice or serious misconduct, it held there is room for an improvement in overall market conduct.</p> <p>Also in 2015, the Competition Commission investigated several international financial institutions that had allegedly been fixing prices of foreign exchange trades in offshore financial centres. The investigation is still underway; a further supplementary affidavit was filed with the Competition Commission in December 2017.</p>
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## 1.7.2 THE MONEY MARKET

# Introduction

<p>The market</p>	<p>The money market is defined as that part of the financial market for the issuing, buying and selling of debt instruments with maturities ranging from one day to one year – the most common maturity being three months.</p> <p>Banks play a significant role in the money market as financial intermediaries and as the medium through which the SARB intervenes in the market for purposes of implementing monetary policy. Owing to their deposit-taking function, banks are large borrowers of funds, as can be seen by the dominant proportion of fixed and floating rate wholesale deposits and negotiable certificates of deposit (NCDs) in relation to other money market funding instruments. The interest rates determined in the markets for NCDs and other deposits, be it in the interbank market or wholesale money market, are used to formulate interest rate benchmark such as the Johannesburg Interbank Agreed Rate (Jibar), South African Benchmark Overnight Rate (Sabot) and the rand overnight deposit rate.</p> <p>Based on the market value of outstanding debt securities listed on the JSE as at 29 December 2017, about R391.6 billion worth of outstanding debt securities are linked to the Jibar as the reference interest rate. This represents almost all (≈ 99.98%) of the floating rate debt securities listed on the JSE. In particular, the three-month Jibar is used extensively. Furthermore, based on the results of the 2017 funding data collection exercise conducted by the Financial Markets Department of the SARB, the notional value of outstanding derivative and non-derivative contracts that reset against the three-month Jibar exceeded R38.0 trillion and R2.0 trillion respectively as at 31 August 2017.</p> <p>The SARB fulfils a crucial role in the money market by supplying accommodation to the banking system and, by so doing, influences money-market liquidity and interest rates. The SARB has embarked on a comprehensive review of the monetary policy implementation framework. However, the review of the interest rate benchmarks in the domestic market is a prerequisite for the finalisation of proposals to change the approach to monetary policy. These proposals will enhance the SARB's influence over interest rates in the market in line with its inflation-targeting monetary policy framework.</p> <p>An electronic dematerialised money market environment has been established in South Africa. The characteristics of the market include standardised and electronically issued money market securities, same-day settlement (T+0), electronic recording of trades in money market securities, and electronic clearing and settlement of money market trades.</p>
<p>Turnover</p>	<p>South Africa: average monthly settlement value of R331.06 billion</p>
<p>Benchmark</p>	<p>Jibar, Sabot, Short Term Fixed Interest Composite Index (Stefi)</p>

# Introduction

## 1.7.2 THE MONEY MARKET

Instruments	Cash	OTC	Bills Commercial paper/capital project bills Promissory notes Treasury bills Notes Bridging bonds Debentures NCDs Credit-linked notes Floating-rate notes Call bonds Zero-coupon bonds Repurchase agreements
	Derivatives	OTC JSE	FRAs Short-term interest rate futures Short-term interest rate options
Trading (OTC)	Bilateral		
Trading venues (OTC)	None – bilateral arrangements		
Settlement	Cash OTC: Strate Derivatives OTC: bilateral Derivatives JSE: JSE Clear		
Market intermediaries	Yes		
Surveillance	Dealing room recording (not universal or compulsory)		
Codes of conduct	SA Jibar Code of Conduct UK Money Markets Code		
Legislation	OTC cash market: none OTC derivatives: FMA Exchange-traded: FMA (JSE rules) Commercial paper: exemption notice in terms of the Banks Act (Government Notice No. 2172)		

## 1.7.2 THE MONEY MARKET

Market conduct issues	<p>Since 2009, details of the manipulation of financial benchmarks have emerged as regulators in jurisdictions, including the US, UK, Canada, Japan, Switzerland and European Union (EU) started investigating the fixing and false reporting of the London Interbank Offered Rate (Libor), Euro Interbank Offered Rate (Euribor) and Tokyo Interbank Offered Rate (Tibor). Employees in financial institutions around the world apparently attempted to fix such benchmarks to benefit themselves or their firms. In February 2013 the G20 asked the Financial Stability Board (FSB) to address the uncertainty surrounding the integrity of these reference rates by undertaking a fundamental review of them and implementing plans for reform to ensure that interest rate benchmarks are robust and appropriately used by market participants. In July 2015 the FSB issued recommendations to reform interest rate benchmarks. By July 2016 authorities in the EU, UK, Japan, Australia, Canada, Hong Kong, Mexico, Singapore and South Africa had taken steps to improve the interbank rates in their jurisdictions and ensure that such benchmark rates are robust and appropriately used by market participants. Apart from reforming existing interest rate benchmarks, steps are being taken to identify alternative risk-free rates for benchmarks as there are financial transactions, including many derivative transactions, that should ideally be using reference rates that are near to risk free (i.e. without bank credit risk). Therefore, when fully implemented, jurisdictions will have two groups of reference rates of interest: (i) a rate with bank credit risk; and (ii) a (near) risk-free rate.</p>
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## 1.7.3 THE BOND MARKET

The market	<p>Bond markets are markets in which institutions, corporations, companies and governments raise long-term debt to finance capital investments and expansion projects.</p> <p>The South African-listed bond market is estimated to be R2.71 trillion.<sup>7</sup> It is largely dominated by bonds issued by National Treasury, which account for 68.4% of the outstanding debt, followed by bonds issued by the financial sector (16.0%) and state-owned entities [parastatals] (11.2%).</p> <p>Long-term debt securities issued domestically are shown in figure 1.6.</p>	
Turnover	<p>South Africa: average monthly settlement value of R3 014.28 billion</p> <p>In terms of listed debt securities, the monthly average amount traded on the JSE is R2.3 trillion, which is comprised of repos (67.4%), standard bond trades (29.8%), option-exercised trades (0.02%), structured deals (1.09%) and free of value<sup>8</sup> transactions [measured in terms of the nominal bond value] (1.62%). In all the categories of trading, government bonds account for over 90% of the activity, with 98.8% of repo transactions using government bonds as the underlying asset (collateral). This, in turn, implies that trading in corporate bond markets is relatively thin, which adversely affects the price discovery process.</p>	
Benchmark	<p>Listed bond mark-to-market All Bond Index (ALBI) Government Bond Index (GOMI) The remainder of the ALBI bonds that are not in the GOMI (OTHI)</p>	
Instruments	Cash	<p>Vanilla spot bond Government Corporate State-owned entities Provincial and municipal Repurchase agreements Structured trades Securities lending and borrowing Money lending and borrowing</p>
	Derivatives	<p>OTC Interest rate swaps (various) Interest rate options (various)</p> <p>JSE Long-term interest rate futures Long-term interest rate options</p>

<sup>7</sup> According to JSE data as at 29 December 2017

<sup>8</sup> Free of value trades refer to those trades whereby the script is settled electronically through the central depository, whereas the cash is settled offshore.

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## 1.7.3 THE BOND MARKET

Trading (OTC)	<p>Bilateral: Currently, bonds are traded bilaterally. After reaching an agreement, the deals are reported to the JSE for matching and settlement.</p> <p>How bond trading has evolved is shown in figure 1.5.</p> <p>Primary dealers (PDs) are appointed by National Treasury to make the market in government bonds. There are currently nine primary dealers comprising five local banks and four international banks. The SARB conducts a weekly auction based on a Dutch auction framework. PDs are obliged to make quotes on fixed rate government bonds that have an outstanding amount of R10 billion and more; hence, by doing so, they improve liquidity in the secondary market. The SARB conducts a weekly government bond auction open to PDs only on behalf of National Treasury via an electronic auction system.</p>
Trading venues (OTC)	<p>Predominantly OTC</p> <p>Dealing systems (EBS, Reuters) for interbank market</p> <p>Web-based electronic platforms accessible by broader range of market participants</p> <p>An electronic trading platform (ETP) for PDs was implemented in July 2018. The ETP is an electronic order book that offers price transparency on selected government bonds to the public. National Treasury has entered into an agreement with the JSE, whereby the JSE as a licensed exchange will provide the ETP.</p> <p>According to the FMA, the exchange has the responsibility of issuing, monitoring the compliance and enforcing the rules for the markets which it operates. Hence, the JSE is the regulator for this market. The market will operate in parallel to the existing JSE reported market for government bonds where other market participants, including the PDs, will continue trading as they currently do.</p>
Settlement	<p>Cash OTC: Strate</p> <p>Derivatives OTC: bilateral</p> <p>Derivatives JSE: JSE Clear</p>
Market intermediaries	<p>Yes</p>
Surveillance	<p>Dealing room recording (not universal or compulsory)</p>
Codes of conduct	<p>SA Jibar Code of Conduct</p> <p>UK FICC Markets Standards Board has issued various standards</p>
Legislation	<p>OTC cash market: none</p> <p>OTC derivatives: FMA</p> <p>Exchange-traded: FMA (JSE rules)</p>
Market conduct issues	<p>Manipulation of financial benchmarks (see money markets)</p> <p>Trade in South African bonds has over the past decade increasingly moved offshore, impacting domestic liquidity and pricing efficiencies.</p>

# Introduction

Figure 1.5: How the bond market structure has evolved

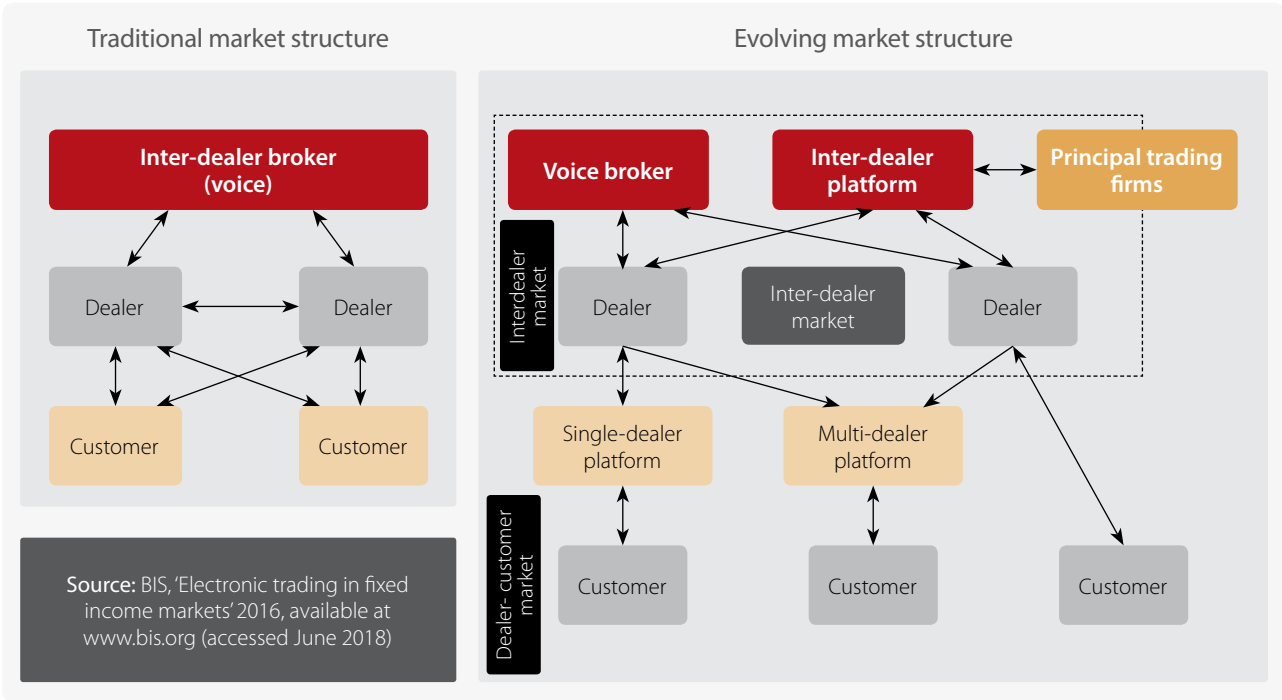
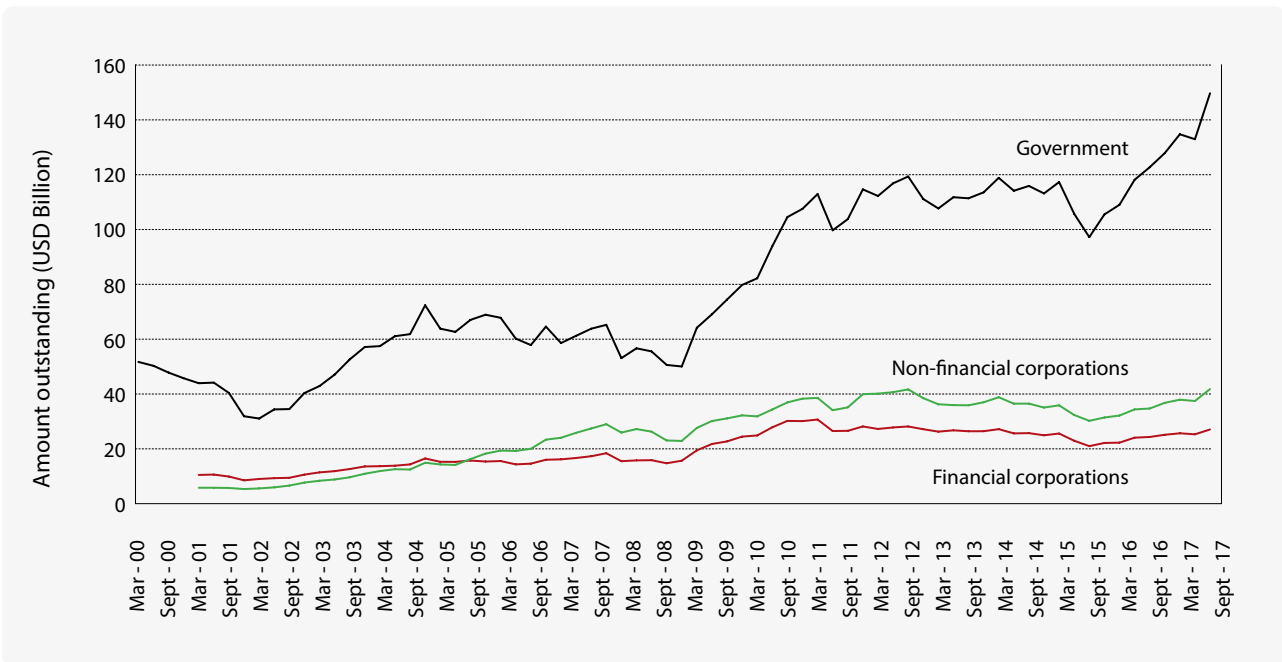


Figure 1.6: South African long-term domestic debt securities



Source: <http://stats.bis.org/statx/srs/table/c3?c=ZA>

## 1.7.4 CREDIT MARKET: SECURITISATION, STRUCTURED CREDIT PRODUCTS AND CREDIT DERIVATIVES

The market	<p>The credit market is the marketplace where the trading, structuring and investing in the credit/credit risk of governments, businesses and consumers take place either through instruments such as bonds and loans or through securitisation, structured credit products and credit derivatives.</p> <p>Securitisation is a structured process that pools and repackages the cash flows of interests in homogeneous illiquid financial assets (such as mortgages) and other future income streams (such as trade receivables and royalties) into marketable debt securities for sale to investors.</p>		
Turnover	South Africa: Securitisation activities in quarter 3 of 2016 were R58.5billion		
Instruments	Cash	OTC	Securitisation: Asset-backed securities (various) Covered bonds Residential mortgage-backed securities
	Derivatives	OTC	Credit default swaps Credit intermediation swaps Total rate of return swaps Credit spread options Credit-linked notes  Structured credit products: Credit-linked notes Collateral debt obligations
Benchmark	JSE calculates several benchmarks (in addition to Jibar) such as zero-coupon bond and swap curves		
Trading (OTC)	None – bilateral arrangements		
Trading venues (OTC)	None – bilateral arrangements		
Settlement	Bilateral		
Market intermediaries	No		
Surveillance	Dealing room recording (not universal or compulsory)		
Codes of conduct			

# Introduction

## 1.7.4 CREDIT MARKET: SECURITISATION, STRUCTURED CREDIT PRODUCTS AND CREDIT DERIVATIVES

Legislation	OTC cash market: The securitisation schemes regulations of 1 January 2008 published in Government Gazette No. 30628 dated 1 January 2008 (the Securitisation Regulations) OTC derivatives: FMA
Market conduct issues	2007/08 financial crisis

# Introduction

## 1.7.5 COMMODITIES MARKET

The market	The commodities markets trade in physical commodities, as grouped below, and in derivative financial instruments such as futures and options.							
Turnover	Varies per commodity							
Instruments	Cash	OTC	<b>Industrial metals</b> <ul style="list-style-type: none"> <li>Aluminium</li> <li>Copper</li> <li>Lead</li> <li>Nickel</li> <li>Palladium</li> <li>Zinc</li> </ul>	<b>Precious metals</b> <ul style="list-style-type: none"> <li>Gold</li> <li>Platinum</li> <li>Silver</li> </ul>	<b>Energy</b> <ul style="list-style-type: none"> <li>Crude oil</li> <li>Heating oil</li> <li>Natural gas</li> <li>Unleaded gas</li> </ul>	<b>Food &amp; fibre</b> <ul style="list-style-type: none"> <li>Cocoa</li> <li>Coffe</li> <li>Cotton</li> <li>Lumber</li> <li>Orange juice</li> <li>Sugar</li> <li>Rubber</li> </ul>	<b>Grains</b> <ul style="list-style-type: none"> <li>Corn</li> <li>Soybeans</li> <li>Wheat</li> <li>Oats</li> <li>Rice</li> <li>Maze</li> <li>Sunflower seed</li> </ul>	
	Derivatives		OTC	Commodity forwards Commodity swaps Commodity options				
		JSE		Commodity futures Commodity options Contracts for difference				

# Introduction

## 1.7.5 COMMODITIES MARKET

Trading (OTC)	Most of the world's commodities are sold by bilateral contracts between producers and consumers or importers and exporters. Such contracts specify the terms of execution, delivery and payment. Although there is both spot and derivatives trading of commodities on commodity exchanges, the majority of trading is in derivatives.
Benchmark	London Bullion Market (LBMA) gold, silver, platinum and palladium prices
Trading venues	OTC: none – bilateral arrangements Exchange-traded: dark pools
Settlement	Cash OTC: bilateral Derivatives OTC: bilateral Derivatives JSE: JSE Clear
Market intermediaries	Yes
Surveillance	Dealing room recording (not universal or compulsory)
Codes of conduct	Global precious metals code
Legislation	OTC cash market: none OTC derivatives: FMA Exchange-traded: FMA (JSE rules)
Market conduct issues	Manipulation of the century-old London gold fix was uncovered in 2014 but possibly dates back a decade.

# Introduction

## 1.8 RELATIVE SIZE OF SOUTH AFRICAN FINANCIAL MARKETS

### 1.8.1 FOREIGN EXCHANGE

According to the Bank for International Settlements Triennial Survey of foreign exchange and OTC derivatives trading (April 2016, updated May 2018), the relative size of South Africa's foreign exchange market is shown in table 1.2.

**Table 1.2: Relative size of the South African foreign exchange market**

Instruments	Measure	South Africa	World	SA % World
Spot transactions	Daily average turnover in USD billion	3	2 054	0.1%
Outright forwards		1	830	0.1%
Foreign exchange swaps		13	3 209	0.4%
Currency swaps		3	106	2.8%
Options		1	315	0.3%
<b>Total</b>			<b>21</b>	<b>6 514</b>

Source: BIS Triennial Survey. 2016, accessed at <https://stats.bis.org/statx/srs/table/d11.5?o=8:TO1,9:TO1>

### 1.8.2 THE BOND MARKET

According to the World Federation of Exchanges' Annual Statistics Guide (December 2017), the relative size of the South African bond market is shown in table 1.3.

**Table 1.3: Relative size of the South African bond market**

Indicator	Measure	South Africa	World	SA % World
Value of bonds listed	ZAR bn	2 562		
	USD bn	207	67 133	0.3%
Value of bonds traded	ZAR bn	27 041		
	USD bn	1 974	15 836	12.5%
Number of trades in bonds	('000)	453	32 500	1.4%

Source: WFE Annual statistics Guide 2017



# Introduction

## 1.8.3 EQUITY MARKET

According to the World Federation of Exchanges' Annual Statistics Guide (December 2017), the relative size of the South African equity market is shown in table 1.4.

**Table 1.4: Relative size of the South African equity market**

Indicator	Measure	South Africa	World	SA % World
Market capitalisation	ZAR bn	15 209		
	USD bn	1 231	82 512	1.5%
Value of share trading – electronic order book (EOB)	ZAR bn	5 062		
	USD bn	381	80 204	0.5%
Value of share trading – negotiated deals	ZAR bn	417		
	USD bn	31	25 757	0.1%
EOB % total trading		93.7%	77.0%	

Source: WFE Annual statistics Guide 2017

## 1.8.4 DERIVATIVES MARKET

According to the Bank for International Settlements Triennial Survey of foreign exchange and OTC derivatives trading (April 2016, updated May 2018), the relative size of South Africa's OTC interest-rate derivatives market is shown in table 1.5.

**Table 1.5: Relative size of South Africa's OTC derivatives market**

Instrument	Measure	South Africa	World	SA % World
Forward rate agreements	Daily average turnover in USD million	7	721	0.3%
Swaps		1	2 112	0.0%
Options		1	203	0.5%
Other		Less than 1	3	0.0%
Total interest rate derivatives		9	3039	0.3%

Source: BIS Triennial Survey, 2016, accessed at <https://stats.bis.org/statx/srs/table/d12.5?o=8:TO1>

According to the World Federation of Exchanges' Annual Statistics Guide (December 2017), the relative size of the South African exchange-traded derivatives market is shown in table 1.6. Only derivatives contracts with annual volumes greater than 1 million have been included.

# Introduction

**Table 1.6: Relative size of South Africa’s exchange-traded derivatives market**

Contracts	Measure	South Africa	World	SA % World
Stock options	Volume in millions	9	3 346	0.3%
Single stock futures		139	1 131	12.3%
Stock index options		4	3 354	0.1%
Stock index futures		20	2 370	0.8%
Short-term interest rate futures		10	1 564	0.6%
Currency options		21	814	2.6%
Currency futures		48	1 935	2.5%
Commodity futures		3	5 422	0.1%
Other options*		4	197	2.0%
Other futures*		133	235	56.6%
*Index volatility options and futures and dividend options and futures				
Source: WFE Annual statistics Guide 2017				

## 1.9 SOUTH AFRICAN MARKET INFRASTRUCTURES AND TRADING VENUES

### 1.9.1 FINANCIAL MARKET INFRASTRUCTURES

Financial market infrastructures<sup>9</sup> (FMIs) include systemically important payment systems, central securities depositories (CSDs), securities settlement systems, central counterparties, exchanges and trade repositories. Figure 1.7 shows the regulation of FMIs under the Twin Peaks regulatory framework. As indicated, the Financial Sector Regulation Act 9 of 2017 (FSR Act) distinguishes between market infrastructures and payment systems. This distinction is developed further in Chapter 6 (see Box 6.1).

<sup>9</sup> Similarly to the FSR Act’s definition of Market Infrastructures (MIs), exchanges are included in the definition of FMIs. This is in line with international regulators such as the Swiss Financial Market Supervisory Authority (FINMA), Federal Reserve Bank of New York. Furthermore exchanges are generally indistinguishable from the systems and networks that provide their trading and other services.

# Introduction

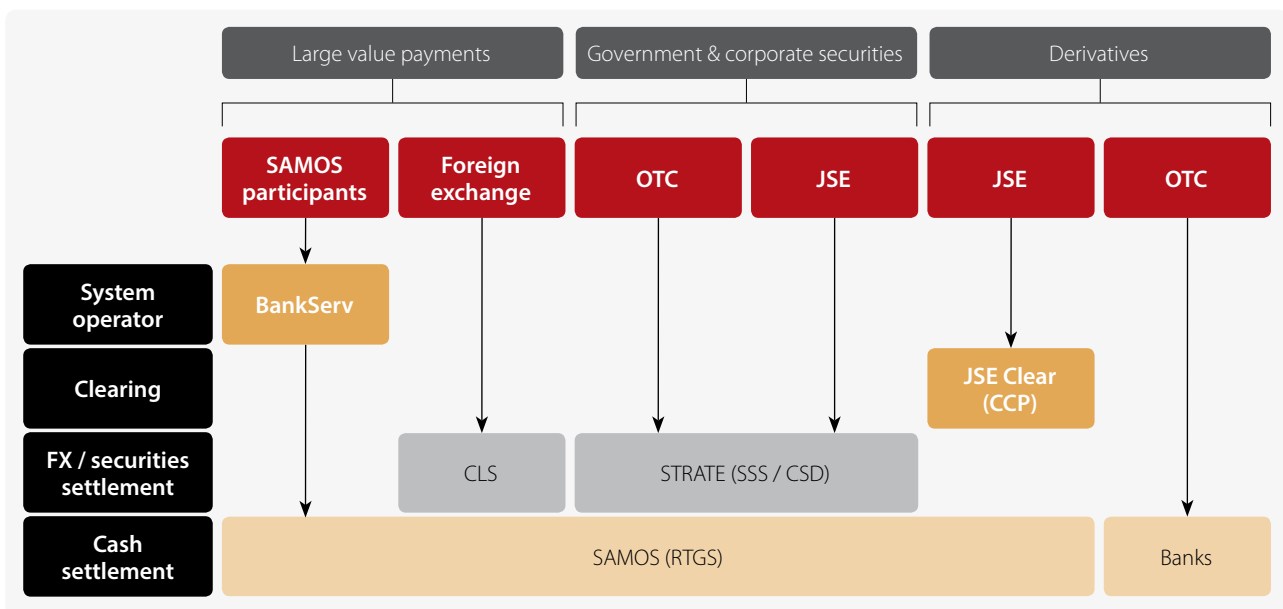
**Figure 1.7: Regulation of FMIs under Twin Peaks**

FMI Functions	Market infrastructures					Payment systems
	Exchange	Central securities depository	Clearing house	Central clearing counterparty	Trade repositories	
Sectorial law	Financial Markets Act					NPS Act
Licensing authority	Primarily FSCA, also PA for licensing					SARB
Supervision	Primarily FSCA also PA					SARB
Setting and supervising standards	PA and FSCA for respective standards					SARB and FSCA
Enforcement	Primarily FSCA also PA					SARB

Source: National Treasury

The transaction flows of South African FMIs, excluding retail payment systems, are outlined in Figure 1.8.

**Figure 1.8: South African financial market infrastructure transaction flows**



# Introduction

## 1.9.2 MARKET INFRASTRUCTURES

South Africa has the following market infrastructures:

- **CSDs:** Strate Limited is South Africa's largest CSD and is a licensed clearing house for bonds. Strate clears and settles equities, bonds and money market transactions. Strate's securities settlement system, the South African Financial Instruments Real-time Electronic Settlement (SAFIRES) operates on a delivery-versus-payment basis with the real-time gross settlement system, the South African Multiple Option Settlement (SAMOS) system, in facilitating the movement of cash between clearing banks. Strate is no longer the only CSD in South Africa. In May 2017 another CSD – Granite CSD (Pty) Limited – was licensed to be a CSD for bonds and money market securities.
- **Exchanges:** JSE Limited is the largest licensed securities exchange in South Africa and although not licensed as a central counterparty (CCP), performs a comparable function by acting as guarantor of all trading on the equity market. The JSE, like most international exchanges, offers trading, clearing and settlement not only in equities but also in bonds and derivatives (commodity, interest rate, currency and equity). Until 2016, the JSE was the only securities exchange in South Africa. Since then, four additional exchanges have been licensed – ZARX (2016), 4AX (2016), A2X (2017) and Equity Express Securities Exchange (2017).
- **JSE Clear**, a wholly owned subsidiary of the JSE, is a licensed clearinghouse for derivatives listed on the JSE. JSE Clear was formerly known as SAFCOM.

There are no trade repositories<sup>10</sup> in South Africa. One of the benefits of trade repositories is improved market transparency in financial markets, particularly OTC derivatives. Trade repositories maintain a centralised database of open OTC derivatives transactions and allow access to this information by the public and central banks, securities and market regulators, and prudential supervisors of market participants.

Since the establishment of UNEXcor in 1991, bonds have traded OTC and not on an exchange, either on the Bond Exchange of South Africa (BESA) or subsequently the JSE when it took over BESA in 2009. Trades in listed debt securities are now reported to the JSE. In 2017 Strate's Debt Instrument Solution (DIS) replaced Strate's legacy UNEXCor system with a new BaNCS platform for the South African bond market. It went live on 26 September 2017.

Further details of the trading, clearing and settlement roles of market infrastructures are shown in Table 1.7 below. While there are four other licensed exchanges and another CSD in South Africa, the table focuses on the JSE and Strate.

<sup>10</sup> The CPSS IOSCO Principles for Financial Market Infrastructures imply that a trade repository is an entity that, among other things, will provide information to central banks, financial market regulators and other relevant authorities. However it is possible that such authorities may maintain their own transaction databases to promote financial stability and detect (and prevent) market abuse. It is assumed that authorities' TRs will also comply with the principles and possibly even certain jurisdictional regulatory requirements.



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**Table 1.7: South African market infrastructures**

Market	Asset class	Trading platform	Clearing	Settlement	
				Securities	Cash
Equities	Equities	JSE (Millennium Exchange)	Strate (SAFIRES)	Strate SFIDvP (SAFIRES)	SARB (SAMOS)
Bonds	Government bonds	JSE (ETP)	Strate (TCS BaNCS)	Strate (SFIDvP) (TCS BaNCS)	SARB (SAMOS)
	Corporate and other bonds	OTC (Matched on JSE (Nutron))	Strate (TCS BaNCS)	Strate (SFIDvP) (TCS BaNCS)	SARB (SAMOS)
	Cash bonds	OTC (Matched on JSE (Nutron))	Strate (TCS BaNCS)	Strate (SFIDvP) (TCS BaNCS)	SARB (SAMOS)
Money market	Government and corporate short-term debt	OTC (ETME)	Strate (ETME and TCS BaNCS)	Strate (SFIDvP) MMSS	SARB (SAMOS)
Derivatives	Exchange- traded	JSE (Nutron)	JSE (JSE Clear – previously SAFCOM)	JSE (JSE Clear – previously SAFCOM)	JSE (JSE Clear – previously SAFCOM)

SAFIRES = South African Financial Instruments Real-time Electronic Settlement system  
 SFIDvP = Simultaneous, final and irrevocable delivery versus payment  
 SAMOS = South African Multiple Option Settlement system (South Africa’s real-time gross settlement system)  
 ETP = Electronic trading platform  
 DIS = Debt Instruments Solution  
 ETME = Electronic Trade Matching Engine  
 MMSS = Money Market Settlement System

## Box 1.1: Market infrastructures were one of the few heroes of the 2007–08 financial crisis

By late October 2008, central counterparties (CCPs) in leading financial markets had managed down the biggest default in financial history – the failure of Lehman Brothers – at no cost to their members. When Lehman Brothers sought Chapter 11 bankruptcy protection from its creditors in the United States on 15 September 2008, trillions worth of transactions conducted across the world by and through the investment bank and its subsidiaries were in jeopardy, and assets worth billions were out of the immediate reach of creditors and would remain so for many years. However, the trades conducted on securities exchanges escaped the worst of the Lehman disaster because they were cleared by CCPs.

CCPs step in as buyer to every seller and seller to every buyer in the markets that they clear. Within days of the Lehman bankruptcy, most outstanding open positions relating to Lehman trades were hedged to prevent further losses to creditors, and by late October 2008 CCPs in leading financial markets reported that they had managed down the biggest default in financial history at no cost to their members. Chris Tupker, Group Chairperson of LCH.Clearnet recalled, “At the moment Lehman sought Chapter 11 protection, every exchange in London was clearing through us. No other CCP had the variety and size of positions on its books that we did. I shudder to think what might have happened to the marketplace if we had failed.”<sup>11</sup>

<sup>11</sup> Norman, P.2011. The Risk Controllers. John Wiley & Sons. pp 4

# Introduction

## Box 1.1: Market infrastructures were one of the few heroes of the 2007–08 financial crisis - continued

Furthermore, throughout the crisis, the world's regulated stock and other exchanges continued to provide transparency, price discovery, certainty of execution and, in certain cases, central clearing. Central securities depositories (CSDs) also played a stabilising role during the crisis, facilitating the movement of collateral between counterparties at a time of severe liquidity stress. Despite record volumes in foreign exchange markets, CLS Bank<sup>12</sup> continued to effectively manage foreign exchange settlement risk of large-value payments during the financial crisis.

The story was very different for huge volumes of specialised transactions negotiated bilaterally between financial institutions on over-the-counter (OTC) markets. The stresses of the crisis uncovered the complex and interconnected network of exposures created by these OTC transactions, and the deficiencies in OTC markets that led to a build-up of systemic risk. These deficiencies included inadequate transparency with respect to counterparty risk; shortcomings in collateral management procedures; cumbersome operational processes; and uncoordinated default management. A case in point is the OTC market for repurchase agreements, which was not its usual reliable source of funding liquidity during the crisis. Doubts about the creditworthiness of counterparties as well as the ability to liquidate collateral in the event of counterparty default caused many participants to withdraw from the market, which led to a decline in the absolute volume of repurchase agreements.

## 1.9.3 OVER-THE-COUNTER MARKETS

In OTC markets, financial transactions are concluded off formal exchanges through private negotiation between buyers and sellers. An OTC market generally involves a group of dealers who provide two-way trading facilities in financial instruments and stand ready to buy at the bid price and sell at the ask price, hoping to profit from the difference between the two prices.

In South Africa and internationally, money and foreign exchange markets are OTC markets.

Internationally, apart from corporate bond trading on the New York Stock Exchange, bond markets are usually OTC markets. However, this should change as more jurisdictions, including South Africa, move to fully exchange-traded bond markets. In South Africa the JSE's Debt Market (formerly the Bond Exchange of South Africa, which became a wholly owned subsidiary of the JSE in June 2009) regulates trading in bonds.

As shown in Table 1.7, an electronic trading platform for government bonds was implemented for primary dealers in July 2018. The JSE is the regulator for the market. The market operates in parallel to the existing JSE reported market for government bonds where other market participants, including the primary dealers, will continue trading as they currently do.

OTC derivatives are typically negotiated bilaterally between counterparties. As discussed in Box 1.1, the stresses of the financial crisis revealed that large volumes of outstanding bilateral OTC derivatives transactions created a complex and interconnected network of exposures that contributed to a build-up of systemic risk.

<sup>12</sup> CLS Bank was founded in 1997 by leading foreign exchange trading banks with the support of central banks and the Bank for International Settlements to safely settle foreign exchange transactions. CLS (or Continuous Linked Settlement) is designed to remove the settlement risk of default by one party in a foreign exchange deal. The two parties to a trade simultaneously pay out and receive the currencies they have traded. CLS settles payment instructions relating to underlying foreign exchange transactions in 18 currencies, including the South African rand.



# Introduction

In 2009 the G20 agreed to the following comprehensive reforms for OTC derivatives markets to improve transparency, mitigate systemic risk, and protect against market abuse:

- All OTC derivatives contracts should be reported to trade repositories.
- All standardised contracts should be cleared through CCPs.
- 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 minimum margining requirements.

South Africa is still implementing the G20 reforms for OTC derivatives markets. According to the FSB<sup>13</sup> South Africa has experienced challenges in implementing OTC derivatives reforms within agreed phase-in dates of end 2012 for OTC derivatives trade reporting, central clearing and platform trading. South Africa has put into effect regulations in terms of the Banks Act to subject non-centrally cleared OTC derivatives to higher capital requirements and Conduct Standard 1 of 2018: Criteria for Authorisation of Over-the-Counter Derivative Providers.

A preliminary assessment of the implementation of the reforms indicate that derivatives markets are safer, with central clearing of over 61% of OTC interest rate derivatives at the end of 2016 compared to 24% at the end of 2008, and with central clearing covering more than 90% of OTC derivatives trades in 14 major jurisdictions.

## 1.9.4 DEALING SYSTEMS (EBS, REUTERS) FOR THE INTERBANK MARKET

Until the late 1980s, foreign exchange transactions were mostly telephone-based. A dealer needing to enter into a foreign exchange transaction would call a counterparty to get both the bid and offer rates for a specific transaction size. The size of the deal would typically influence the prices received. This 'two-sided' price quoting was standard practice in foreign exchange markets as it limited market makers' ability to adjust quoted prices to take advantage of information about the counterparty's intentions to buy or sell foreign exchange. At the same time, these telephone calls were the only way to get direct bank prices, so frequent calls were required to keep up to date on the latest price developments ('price discovery').

Although most transactions took place directly between banks, indirect dealing also occurred through brokers. Dealers would phone a voice broker, who would search for matching interest among their clients to complete a transaction. Voice brokers were beneficial in terms of both saving time on price discovery and the convenience of only needing to show a bid or an offer rate.

Given advances in technology and the relatively simple structure of some foreign exchange deals, it was only a matter of time before electronic technologies were implemented in foreign exchange markets. In 1989 Reuters began offering participants in the interbank market a so-called 'electronic broking service', whereby trading was carried out through a network of computer terminals linked among participating users, and new orders were matched with outstanding orders already in the system. In the early 1990s a consortium of banks launched Electronic Broking Systems (EBS) to provide a similar service (EBS was subsequently bought by ICAP to complement its other broking services). EBS allow banks to make a 'one-way' price quote and, in addition to the best bid and offer prices, display information about the closest bids and offers in the system. The resulting transparency of prices obviates the need to spend resources on price discovery activities, as interbank price quotes are now available at all times to participating interbank dealers. Another important feature of these systems is that a large order can be matched with several small ones, which allows banks to make a one-way price quote for smaller amounts. Access to these systems therefore enabled smaller institutions to deal at more favourable spreads than had previously been available only to large institutions. Reuters Matching and EBS continue to

<sup>13</sup> <http://www.fsb.org/wp-content/uploads/P030717-3.pdf>

# Introduction

dominate in the interdealer market, although they cover somewhat different currencies. While Reuters Matching specialises in major Commonwealth currencies, EBS trades more in the US dollar, euro, Japanese yen and Swiss franc.

**Table 1.8: OTC foreign exchange turnover by execution method in April 2016, net-net basis<sup>1</sup>**

Daily averages, in millions of US dollars								
	Voice		Electronic					Undis-tributed
	Direct	Indirect	Direct		Indirect			
			Single bank proprietary trading system	Other	Reuters Matching/EBS	Other electronic communication networks	Other	
Spot	517 563	187 665	282 011	481 411	313 118	167 662	62 081	34 648
Outright forwards	214 864	91 434	87 558	126 515	33 276	73 341	31 717	21 289
Foreign exchange swaps	578 190	435 357	271 109	256 406	360 396	189 316	79 013	57 841
Currency swaps	17 555	8 607	3 664	9 882	2 768	4 024	3 709	3 813
FX options	146 712	62 070	21 383	49 911	15 475	31 671	1 922	7 601
<b>All instruments</b>	<b>1 474 884</b>	<b>785 134</b>	<b>665 725</b>	<b>924 124</b>	<b>725 032</b>	<b>466 014</b>	<b>178 442</b>	<b>125 192</b>

<sup>1</sup> Data may differ slightly from national survey data owing to difference in aggregation procedures and rounding. Adjusted for local and cross-border inter-dealer double-counting (i.e. 'net-net' basis). Due to incomplete allocation by execution method, components do not sum to the aggregates published in the other tables

Source: BIS, Triennial Survey, 2017

## 1.9.5 MULTILATERAL TRADING FACILITY

A multilateral trading facility (MTF) is defined by the Market in Financial Instruments Directive MiFID as a multilateral system that brings together multiple third-party buying and selling interests in financial instruments. The system is operated by an investment firm or a market operator. MTFs are not allowed to execute client orders against proprietary capital or to engage in matched principal trading.

MTFs have been accused of reducing the size available at the inside quote, increasing order cancellations, and generally reducing the 'quality of liquidity' in the marketplace.

MTFs are not provided for in the FMA.



# Introduction

## 1.9.6 ORGANISED TRADING FACILITY

An organised trading facility (OTF) is defined by MiFID as a multilateral system that multiple third parties use to buy and sell interests in bonds, structured finance products and derivatives. Unlike MTFs, operators of OTFs have discretion regarding how to execute orders subject to pre-trade transparency and best-execution obligations. OTFs may deal on own account other than the matched principal trading of illiquid sovereign debt instruments.

OTFs are not provided for in the FMA.

## 1.9.7 DARK POOLS

A dark pool refers to orders and quotes that are not pre-trade transparent – that is, they cannot be seen by other market participants until the trade is complete. Many exchanges, including the JSE, provide dark-pool trading mechanisms that allow participants to execute trades without exposing their trading interest to the market. Dark liquidity is useful for traders who want to deal in large volumes of shares or other assets without revealing themselves to the rest of the market. Securities regulators are concerned about the impact of dark liquidity on market transparency and price discovery, among other things.

Dark pools allegedly favour high-frequency algorithmic trading by proprietary trading desks at the expense of institutional traders who would like to execute blocks of trades. To avoid being exposed to front-running, institutions find they must use increasingly sophisticated slice-and-dice mechanisms to execute small-size block trades but with a related increase in transaction costs.

## 1.9.8 SYSTEMATIC INTERNALISERS

Systematic internalisers (also known as ping pools) are alternative trading venues run by investment firms that deal on own account. Where dark pools bring orders together from many different investors, ping pools handle the transactions as principals, using their own capital to buy what investors want to sell, and selling what investors want to buy.

Systemic internalisers are not provided for in the FMA.

### Box 1.2: Markets in Financial Instruments Directive

The financial crisis led to many new or updated European Union conduct rules to ensure the orderly functioning of markets and market operators. Central to this regulatory framework is the Market in Financial Instruments Directive and Regulation (MiFID II and MiFIR), a substantial upgrade of its 2004 predecessor.

MiFID II organises securities markets and sets the rules governing market participants. The main differences, compared to the 2004 version, are the addition of organised trading facilities rules on algorithmic trading, the licensing of data publication arrangements, and the regulation of trading in bond and commodity markets. In addition, MiFID II, in combination with the European Market Infrastructure Regulation, sets the framework for the trading of standardised over-the-counter derivatives.



# Introduction

## 1.10 STRUCTURE OF THE REPORT

The report is divided into seven chapters. The six chapters after this introductory descriptive chapter address the various themes of the review, namely governance, market conduct, market structure, trading venues and technology, regulatory framework, and the finalisation of the 2015 FX Review.

This introductory chapter describes the reason for the review, the mandate of the FMRC, and the process it followed to finalise the review report. The chapter describes and quantifies the activities of the South African financial markets and outlines the market infrastructures operating in South Africa.

The governance chapter (Chapter 2) discusses how corporate governance supports market confidence and integrity. It describes governance as the rules and practices that govern the relationships between a firm's boards, management and stakeholders and which provides the structure through which the objectives and strategy of a company are set and their implementation monitored.

**The chapter covers the following topics:**

- corporate and risk governance practices;
- fit and proper vetting;
- accountability of senior managers;
- compensation structures (incentives and remuneration);
- whistle-blowing; and
- ongoing training and development.

**The market conduct chapter (Chapter 3) focuses on how financial sector firms conduct themselves in relation to clients, customers and each other, with a focus on market integrity. The chapter covers the following topics:**

- standards and codes of market practice;
- market discipline;
- conflicts of interest;
- market abuse; and
- market monitoring and surveillance.

The market structure chapter (Chapter 4) deals with the impact of liquidity, transparency, competition and market-making on the efficiency of the price-formation process. The chapter also considers the securities financing transactions and ZAR interest rate benchmarks.

The trading venues and technology chapter (Chapter 5) deals with market conduct issues related to trading venues, other market infrastructures and technology innovations such as algorithmic trading, high-frequency trading and other artificial intelligence applications.

The regulatory framework chapter (Chapter 6) briefly describes the international regulatory architecture and South Africa's regulatory framework. It then deals with policy questions relating to the Financial Markets Act within the Twin Peaks regulatory framework, the role of self-regulatory organisations, conflicts relating to the Insolvency Act, and buy-side issues.

Chapter 7 offers recommendations for finalising the FX Review concluded in 2015. Topics are treasury outsourcing companies; the authorisation and regulation of interdealer brokers; exchange control nuisance clauses; and the equivalent FX exercise in 2018.





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# 2018 FINANCIAL MARKETS REVIEW

GOVERNANCE

# Governance

## 2.1 SUMMARY OF RECOMMENDATIONS

Issue to be addressed	Recommendation
Corporate and risk governance practices	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)
	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
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)
	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
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)
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
Whistle-blowing	7. Regulators to consider implementing a programme that rewards whistle-blowers for providing information about substantial misconduct in financial markets that leads to a successful enforcement action with monetary sanctions
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

## 2.2 GOVERNANCE AND RISK CULTURE

Following the global financial crisis of 2007–08, it was observed that senior executives and senior managers in many financial institutions had a laissez-faire attitude towards corporate governance principles and risk culture within their institutions. For as long as short-term profits continued and enhanced the profitability of the firm, the management of the institution was willing to condone ‘ill-advised’ risk-taking. This behaviour led to substantial losses and, in some cases, the failing of a number of institutions.

Internationally, the increase in the number of cases of professional misconduct, lapses in ethics and as well as the compliance failures at financial institutions has highlighted the breakdown in corporate governance principles, risk management and internal controls within institutions.

South African financial institutions, in general, support good governance practices and in most instances subscribe to the King IV Report on Corporate Governance for South Africa, 2016 (King IV), published on 1 November 2016.

Although culture is not specifically included in the mandate of the Financial Markets Review Committee (FMRC), the FMRC recognises the impact it has on the market conduct of financial market participants and has therefore decided to include this section to briefly give context to the FMRC’s mandate in terms of culture and risk culture.

# Governance

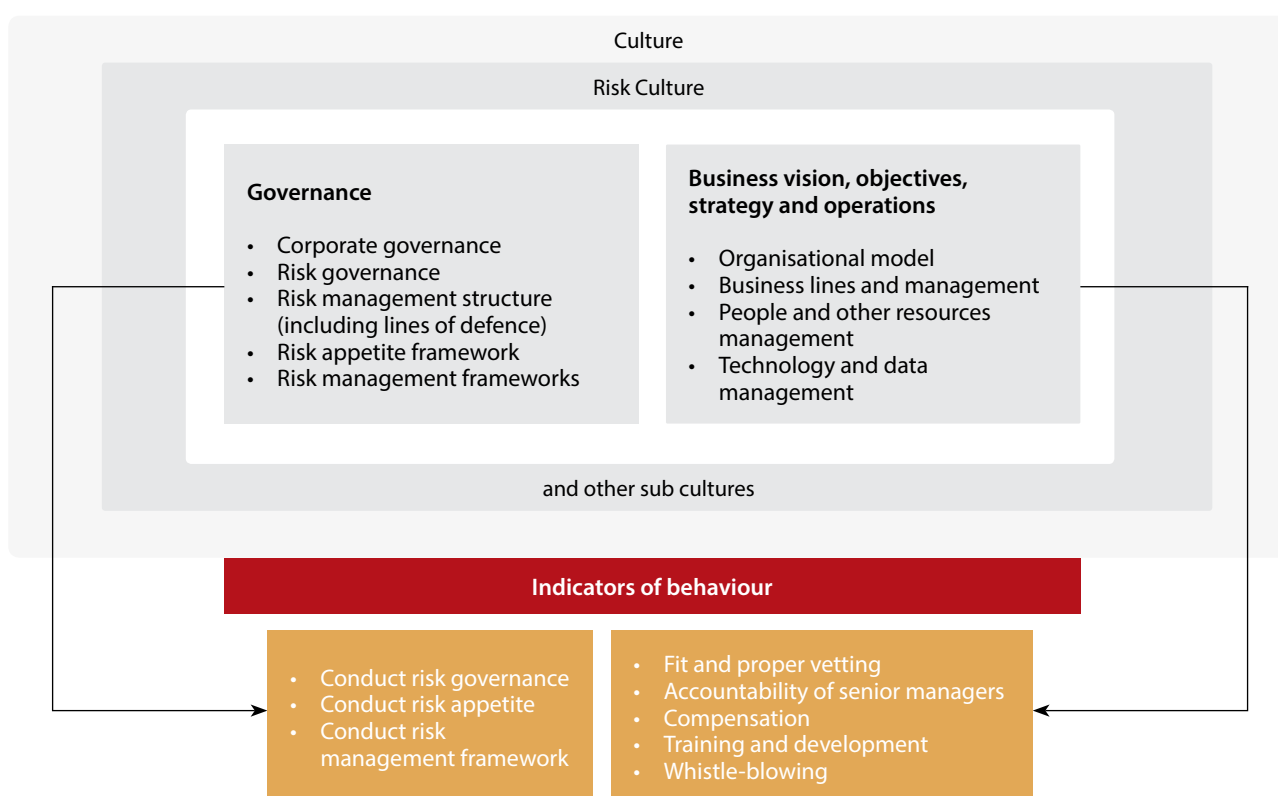
An article published in the Harvard Business Review<sup>14</sup> on corporate culture observed: “Ethical problems in organizations originate not with ‘a few bad apples’ but with the ‘barrel makers.’” It can therefore be surmised that the culture of institutions is shaped by the leaders of an institution.

Colloquially, culture is defined as ‘the way things are done here’. More formally, it is a firm’s values, beliefs and unofficial ground rules that manifest in the consistent, evident patterns of practices and behaviour of the firm. As such, culture is the glue that holds a firm together – business objectives, strategy, operations and governance – and influence its delivery of a set of outcomes. Unfortunately, such outcomes have not always benefited a firm’s stakeholders: shareholders, employees, local community, financial markets and society (see Box 2.1).

Culture has several sub-cultures, which could be the culture of individual business functions such as finance and trading. Risk culture is a subset of culture. The Financial Stability Board (FSB) defines risk culture as ‘a firm’s norms, attitudes and behaviours related to risk awareness, risk-taking and risk management.’<sup>15</sup>

Figure 2.1 summarises this schematically with specific focus on the FMRC’s mandate - (mis)conduct risk. It shows risk culture as a subset of culture and how, together, they play a role in propelling a business to deliver on its objectives with due regard for its corporate and risk governance artefacts.

**Figure 2.1: Culture manifests in behaviour**



<sup>14</sup> J O'Toole and W Bennis, 'What's needed next: a culture of candour', Harvard Business Review, June 2009.

<sup>15</sup> Financial Stability Board. Guidance on Supervisory Interaction with Financial Institutions on Risk Culture. A Framework for Assessing Risk Culture. 7 April 2014. available at: <http://www.fsb.org/wp-content/uploads/140407.pdf>.

# Governance

## Box 2.1: Financial sector misconduct undermines trust in financial institutions and markets

It is more than 10 years since the start of the 2007–08 global financial crisis that revealed the misconduct and market abuses of global banks that severely damaged trust and confidence in financial institutions and markets. The market abuse was not limited to the mis-selling of financial products to retail customers. Mis-selling of financial products to professional clients was prevalent, for example the United States (US) sub-prime mortgage-backed securities sold by US banks to international asset managers.

In 2013 the manipulation of the London Interbank Offered Rate and foreign exchange benchmarks both negatively impacted the reliability of financial markets and further damaged the reputation of several banks and the banking sector.

In Australia the 2017 Royal Commission of Inquiry into Misconduct in the Banking, Superannuation and Financial Services Industry heard a litany of ugly practices within some of the nation's biggest financial institutions. These practices include charging dead people for financial advice, charging people for advice they never received and then lying about it to regulators, acting on falsified documents, providing misleading financial advice, lending inappropriately, and delaying the processing of insurance claims.

## 2.3 CORPORATE AND RISK GOVERNANCE PRACTICES

### 2.3.1 INTRODUCTION

Good corporate governance supports market confidence and integrity. It is defined as the rules and practices that govern the relationships between a firm's board of directors (board), management and stakeholders, namely shareholders, bondholders, other creditors, customers, employees, pensioners and local communities.

The Basel Committee on Banking Supervision defines corporate governance as:<sup>16</sup>

**'[a] set of relationships between a company's management, its board, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance. It helps define the way authority and responsibility are allocated and how corporate decisions are made.'**

Corporate governance deals with matters such as board composition, characteristics, oversight, accountability and responsibility; remuneration and incentive structures; and risk management and internal controls. Corporate governance also provides the structure through which the objectives and strategy of a company are set in the interests of the company and stakeholders, and their achievement monitored.

Boards are increasingly focusing on conduct issues, consistent with their fiduciary responsibility. A combination of strong governance processes, robust risk and control environments independent of influence by business units, and consideration of conduct-related performance when deciding upon remuneration and incentives are considered important drivers of a firm's culture and intolerance for certain behaviour.

<sup>16</sup> Basel Committee on Banking Supervision, Corporate Governance Principles for Banks, available at <http://www.bis.org/bcb/publ/d328.pdf>



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## 2.3.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

The governance portion of the questionnaire deals predominantly with the governance of conduct, namely (i) the accountability for standards of conduct at firms and how such accountability is allocated between the board, senior management, line managers or desk heads, and individual staff; (ii) the management of conduct risk; and (iii) the monitoring of conduct standards.

### 2.3.2.1 Accountability for standards of conduct

There is variation in how participants answered the questions dealing with the accountability for standards of conduct at firms and how such accountability is allocated between the board, senior management, line managers or desk heads, and individual staff. In four cases (two banks and two non-banks), participants gave detailed descriptions of their governance structures, the risk management frameworks and the approaches to conduct standards. One of these detailed responses provides a summary of the enterprise risk management framework, which covers culture and values; risk governance; specific roles and responsibilities for risk management; processes for risk identification, assessment and reporting; and the control environment. A description of the management structure and associated allocation of roles across the Group is also provided. Another detailed response sets out how the institution's standards of conduct are defined and implemented through the organisation, including the definition of culture and conduct risk; governance processes for conduct risk; and the responsibilities of management committees, lines of business and individual staff. A further response highlights the roles of the Board, Audit and Risk Committee, and Ethics Committee. The fourth detailed response outlines the internal control environment, including the separation of functions and roles of compliance, risk management and internal audit teams.

One of the common themes across the responses is the role of internal policies and codes of conduct that hold all employees (and the board and senior management) accountable for their standards of conduct. In some responses, there is emphasis on the institution's overall values (or culture) and business principles in providing the foundation for policies and codes for standards of conduct, placing value on the institution's reputation for integrity. Some responses also note that internal policies and codes are informed by legislative and regulatory requirements. One response suggests that international requirements and best practices are also a factor.

Tools to support adherence to policies and codes of conduct for individual staff are noted in five responses, including regular conduct training and attestation, and the inclusion of standards of conduct in performance agreements. In two responses, the use of conduct metrics in monitoring adherence is noted, although no further detail is given on these measures.

Another common theme concerns the institutional structure and the associated division of responsibilities for conduct and risk management more generally. Various responses highlight the role of the board and its various subcommittees at the most senior level in terms of setting the tone from the top and determining the framework for risk identification and management within the institution (both for risks in general across the institution and for conduct risk in particular). Responsibilities for institutional culture and standards of conduct across different tiers of the institution are also reflected in the responses, including senior management, line management, desk heads and individual staff.

The allocation of specific roles and functions in terms of risk management are also a common feature in the responses. Three responses refer to the three lines of defence model in the allocation of responsibilities and accountabilities in the risk management environment. The first line is management control of risks within the business function; the second line is oversight and control by independent functions such as compliance and legal that maintain an effective risk management framework; and the third line is independent assurance of the effectiveness of risk management through audit functions. Relatedly, several responses note the role of the compliance team in monitoring policies and the risk management framework. Other responses further highlight the specific

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segregation of functions and duties in the institution as part of the framework for managing conduct risk, such as the separation of front and back office duties, together with compliance and risk management.

## 2.3.2.2 Management of conduct risk

Three responses provide specific definitions of conduct risk, reflecting the broad notion of inappropriate behaviour that harms the institution, its clients or financial markets. Four responses (all banks) describe the approach to conduct risk within the institution in some detail, including where it is currently evolving.

One response highlights the definition of conduct risk as a starting point and outlines the objectives of a proposed conduct risk framework for the institution, including a collective view of conduct risks; setting out responsibilities for identifying, managing and overseeing conduct risks (first and second lines of defence); a periodic review of material conduct risks and the effectiveness of controls; enhanced reporting to governance structures on conduct risks; and promoting and reinforcing good conduct and culture.

Another detailed response notes the focus on conduct as consistent with the institution's values and business principles, and emphasises the need for a holistic, forward-looking, evidenced-focused approach embedded within the risk management framework. The proposed global approach to conduct risk management for the institution is described, including a definition of conduct risk; key areas where conduct risks may crystallise within the business; and outcomes to be delivered within the institution to ensure the effective conduct of risk management. The implementation plan is also outlined, including the development of approaches specific to markets and customers, aligned with the global approach of the institution; a gap analysis comparing the status of conduct risk management in each market and the improvements required; and ongoing evolution in response to regulatory, customer and market feedback.

A further detailed response notes that conduct risk is one of the 17 risks in the Group's Enterprise Risk Management Framework. The institution is currently formalising the process of identifying conduct risk across the Group, which entails conducting risk identification and control assessments; setting conduct risk tolerance levels and thresholds; maintaining a conduct risk universe; and conducting risk stress testing. The approach to conduct is based on a broad definition of what constitutes market conduct, and the identification of conduct risk includes measures such as employee fit and proper checks, confirmation of qualifications, market abuse surveillance, conflicts of interest clearance, policy and training attestations, and risk management plans and assessments. The structure of enterprise risk management is described utilising the three lines of defence model as adapted in the institution, and the reporting of risks on conduct matters through to governance committees is also noted.

The fourth detailed response outlines the institution's approach to enhancing and embedding culture and ethics and managing conduct under its conduct risk framework. This approach links, among other things, the Group's strategy and business models, governance arrangements, product development, people management practices, risk control framework, data analytics and management information. At the heart of the conduct risk framework is the Group's values and code of ethics which provide the foundation for measurable 'conduct pillars' to drive good conduct and fair client outcomes. Governance structures are in place with responsibility and oversight for market conduct activities to promote fair and effective customer outcomes. In addition, the specific roles of the Social and Ethics Committee, Group Management Committee and Business Conduct Committee are described.

Several responses highlight the institutions' risk management framework, of which conduct risk forms a part and is embedded in the control processes. In one case, a detailed description of the risk management function is provided. Other responses focus on market conduct policies and codes of conduct as part of the conduct risk framework.

In many cases, the board and senior management play a prominent role in developing and implementing risk management





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and conduct policies. In addition, some responses also highlight the roles of business heads, line managers and desk heads, and compliance and risk teams in the overall approach, which is generally consistent with three lines of defence model. For example, one response outlines several elements of the approach to identifying conduct risk, including through the governance process; desk heads responsible for ensuring appropriate conduct by the desk; board and senior management leading by example and enforcement; and independent and effective second and third lines of defence to monitor and detect non-compliance. Internal committees and forums for discussion of conduct matters are also noted in several responses.

Monitoring, surveillance and reporting processes are another common theme in the responses. For example, one response outlines the monitoring of infringements such as missed trades, failed trades and risk limit breaches which are escalated to a conduct forum; and the conducting of monthly tests on traders' telephone recordings, chats, broker recordings and trade surveillance.

Three responses highlight the adoption of a treating customers fairly approach, and one notes that the institution has a culture of putting client interests first and has client fair dealing features in most of its staff key performance indicators. Staff training in respect of conduct risk is noted in two responses.

## 2.3.2.3 Monitoring conduct

One of the main themes across the responses is that conduct is monitored at multiple levels of the institution. Some responses indicate that all staff and business units are responsible, including, for example, the responsibility of all employees to report potential conduct concerns. Several others broadly describe monitoring in terms of a three lines of defence model including: roles for desk heads, line managers, and lines of business generally; compliance, risk management and legal divisions; and audit functions. The most common reference is to the role of the compliance and risk management units in monitoring and surveillance of conduct. In some instances, the roles of the Board, senior management and relevant committees and forums for addressing conduct risk within the institution are also noted.

Some responses outline the approach to identifying and monitoring conduct risk. For example, one response highlights the development of business conduct risk assessments as part of the operational risk and control process. Another detailed response provides an overview of the process for monitoring conduct risk, including: the identification of conduct risk by business divisions and infrastructure functions on a regular basis; the establishment of conduct risk appetite and metrics to monitor activities and practices; annual review of conduct risks by business divisions and infrastructure functions; annual reporting to management and quarterly reporting of significant conduct events or risk developments to the relevant risk forum for the division; requirements for employees to escalate significant conduct-related issues and events; and structures for oversight of conduct risk.

Other responses outline the monitoring of conduct risk through specific policies, for example including review and clearances for personal account dealing, control of insider trading, and clearance of conflicts of interest. One response (non-bank investor) outlines the role of the compliance department in monitoring both portfolio or mandate compliance and also regulatory compliance in relation to personal account dealing, conflicts of interest, anti-bribery and corruption, best execution in the listed environment, gifts and benefits, moonlighting, and processes and procedures to ensure compliance with FAIS, FICA, and other relevant financial sector legislation. Another response (non-bank investor) lists the broad areas where the compliance department has a monitoring role across fit and proper requirements, products, transactions, mandates, credit and counterparty exposures, fair valuations, fund liquidity and third-party suppliers.

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## Other processes that are seen to support the monitoring and enforcement of conduct standards are:

- Staff training and conduct policy attestations; annual staff declarations in relation to personal account dealing statements, gifts and entertainment, outside interests, and conduct and compliance; and staff performance and reward assessments that include conduct-related features.
- One response (bank) notes the role of regulators in monitoring conduct, including through the regular submissions to SARB Bank Supervision and daily conduct monitoring through Strate supervision.
- One response (a non-bank investor) notes the use of “four eyes” principles for all transactions to avoid fraud and irresponsible transactions, audited at least on an annual basis, with new investment proposals ratified by three separate committees.

Several responses outline the specific monitoring and surveillance tools and metrics used, including specific software. Monitoring may take the form of real-time data gathering and analysis as well as retrospective audit-style monitoring. The use of sample testing is also noted in some responses. For example, one response outlines tools for conflict clearance, monitoring market abuse activity, monitoring communications and recorded telephone conversations in the front office. Monitoring of leave, password sharing, and trade amendments are also noted. Another response provides a detailed description of the systems for monitoring conduct risk at the institution. The compliance surveillance teams monitor designated employees’ electronic communications such as e-mails and instant messaging platforms and undertakes information barrier surveillance and transaction surveillance for market manipulation risks. Monitoring of intra-day risk levels against predefined thresholds is used for certain markets to identify potentially inappropriate trading behaviour. In this institution, a front office supervisory tool has been developed to provide supervisors with greater transparency of employee’s conduct based on conduct and trading metrics, and supervisors are required to review and affirm each employee’s conduct or investigate and escalate any issues monthly. A supervisory manual documents roles, responsibilities and accountabilities of front office sales and trading managers and provides context and guidance to assist supervisors in managing operational and conduct risks.

Several responses indicate that contraventions of conduct policies are viewed as a serious matter in the institution. Disciplinary actions are linked to severity of breaches and the responses highlight various actions, including impacts on performance rating and compensation, job change, and for more serious cases, from verbal or written warnings, suspensions up to dismissal and debarment. One response also notes that certain breaches may result in civil or criminal proceedings. Another response notes that, depending on the contravention, penalties are as prescribed by the relevant regulations, citing FMA, JSE Rules, and FAIS. One response notes that the institution has recently finalised formal disciplinary proceedings for various misconduct incidents, which are reported on a quarterly basis to conduct and management committees. Some examples of misconduct incidents and penalties are given, including: dismissal for divulging confidential customer information and dishonesty in accepting gifts; and dismissal for gross negligence in failing to follow specified procedures for an account opening and for a specific transaction. Another case notes a recent case of dismissal of an employee accused of fraud.



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## 2.3.3 INTERNATIONAL STANDARDS AND GUIDANCE

Governance and governance practices have received much attention and have been well documented by various international standard-setters and authorities. Some of these include:

G20/OECD Principles of Corporate Governance	The revised principles were released and endorsed by the G20 in 2015. The principles are <ul style="list-style-type: none"> <li>• designated as one of the FSB's key standards for sound financial systems</li> <li>• used by the World Bank Group in its country Reviews on the Observance of Standards and Codes (ROSCs)</li> <li>• the basis for the                 <ul style="list-style-type: none"> <li>- corporate governance principles for banks issued by the Basel Committee on Banking Supervision (2015)</li> <li>- guidelines for Pension Fund Governance issued by the OECD (2009) and</li> <li>- issues paper on the corporate governance of insurers issued jointly by the OECD and International Association of Insurance Supervisors (2009).</li> </ul> </li> </ul>
Financial Stability Board (FSB)	Strengthening governance frameworks to mitigate misconduct risk: a toolkit for firms and supervisors (2018)
FSB	Thematic peer review on corporate governance (2017)

A more detailed description of these practices is shown in Annexure E. In general, the practices recommend<sup>17</sup> the following:

- The board has overall responsibility for the firm, including:
  - approving and overseeing management's implementation of the firm's strategic objectives and governance framework;
  - reinforcing norms for responsible and ethical behaviour; and
  - defining appropriate governance structures, including audit, risk and compensation committees.
- Under the direction and oversight of the board, senior management should carry out and manage the bank's activities in a manner consistent with the business strategy, risk appetite, remuneration and other policies approved by the board.
- Firms should have an effective and independent risk management function (second line of defence) under the direction of a chief risk officer, with sufficient stature, independence, resources and access to the board.
- Firms should have a risk governance framework that includes its risk appetite, risk strategies, risk policies and appropriate controls to identify, assess, mitigate and monitor the firm's material risks. It will include risk communication within the firm and risk reporting to the board and senior management.
- Firms should use stress tests and scenario analyses to better understand their potential risk exposures.
- The board should establish a compliance function (second line of defence) to assist the firm to operate with integrity and in compliance with applicable laws, regulations and internal policies.
- The internal audit function (third line of defence) should provide independent assurance to the board.
- Firm's remuneration structures should support sound corporate governance, promote good performance, convey acceptable risk-taking behaviour, and reinforce firms' corporate and risk culture.
- The governance of the firm should be transparent to its shareholders, other stakeholders and market participants.
- Regulators and supervisors should provide guidance for and supervise firms' corporate and risk governance.

<sup>17</sup> <https://www.bis.org/bcbs/publ/d328.htm>

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## 2.3.4 RECOMMENDATIONS

South Africa has several well-established governance frameworks for firms set out in various regulatory arrangements, including:

- primary legislation such as the Companies Act 71 of 2008 (South Africa's overarching legal framework for all firms that contains some basic corporate governance requirements), Banks Act 94 of 1990 (Banks Act), Insurance Act 18 of 2017 (Insurance Act) and the Financial Advisory and Intermediary Services Act 37 of 2002 (FAIS Act);
- secondary legislation such as regulations issued in terms of the Banks Act (see Chapter III of the Banks Act regulations issued December 2012) and the Insurance Act;
- stock exchange rules issued in terms of the Financial Markets Act 19 of 2012 (FMA); and
- governance codes such as *King IV*, provisions of which are incorporated into the exchanges' listing requirements.

The responsibility for monitoring and enforcing governance requirements is allocated to different regulatory agencies: the prudential regulator uses its prudential powers to ensure that banks and insurance companies adhere to appropriate corporate governance standards, and the JSE uses its delegated regulatory powers to ensure compliance with its rules. Governance codes such as *King IV*, where not incorporated into regulation, are enforced, in essence, through moral suasion having become accepted by shareholders, investors and other stakeholders as de facto best governance practice.<sup>18</sup>

Having corporate governance requirements embedded in various regulatory sources has the potential to increase compliance costs for market participants – particularly if listed. The regulators should consider exploring legislative governance requirements to establish equivalent but proportional<sup>19</sup> regulatory regimes for all market participants and to remove gaps or inconsistencies.<sup>20</sup> In addition, regulators could consider developing a central source of information (as envisaged in section 256 of the Financial Sector Regulation Act 9 of 2017 (FSR Act) relating to corporate governance standards applicable to financial institutions, both listed and unlisted.

An Interagency Governance Subcommittee has been constituted under the auspices of the Financial Market Wholesale Conduct Coordinating Committee and the Conduct of Financial Institutions (COFI) Bill Working Group. It has been tasked with establishing equivalent governance requirements across the financial sector.

## 2.4 FIT AND PROPER VETTING

### 2.4.1 INTRODUCTION

A fit and proper financial market participant (firm or individual) is financially sound, competent, reputable and reliable. The initial assessment and ongoing maintenance of appropriate fit and proper standards helps ensure that financial market activities are conducted with high standards of market practice and integrity.

<sup>18</sup> South Africa's 2008 Financial Sector Assessment Programme recognised that the King Commission reports have contributed to an improved system of corporate governance and accountability.

<sup>19</sup> Consideration could be given to proportionality factors other than size, such as ownership structure, geographical presence, stage of development, complexity and risk profile.

<sup>20</sup> Not all such governance provisions are in sync. For example, the Companies Act requires the audit committee to be appointed by shareholders, not the board, which is out of line with section 64 of the Banks Act (section 64), JSE listing requirements and *King IV*.



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## 2.4.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

Where relevant for the institution, market participants indicated that specific fit and proper vetting mechanisms are in place. The regulatory requirements for key individuals and representatives (e.g. under the FAIS Act<sup>21</sup>) were noted as one of the reasons for the fit and proper vetting. Internal codes of conduct and/or ethics policies (e.g. covering honesty, integrity and competence) were contained in the fit and proper vetting process.

The role of external associations was highlighted, with professional bodies such as the CFA Institute that can increase the level of ethical behaviour and professional conduct.

## 2.4.3 INTERNATIONAL STANDARDS AND GUIDANCE

Most of the international standard-setting bodies have issued guidance papers to address the matters raised above.

### 2.4.3.1 Financial Stability Board governance toolkit to mitigate misconduct risk

The FSB governance toolkit to mitigate misconduct risk addresses the regulatory tools to address the 'rolling bad apple'<sup>22</sup> phenomenon, including fit and proper assessments.

Since the scope of fit and proper assessment regimes tends to be firms' board members, senior executives, head of internal control functions and individuals in predetermined risk-taking or customer-facing roles, their scope will not typically reach all potential rolling bad apples. However, fit and proper assessments can help clarify the roles, responsibilities and accountability of key decision makers and certain employees, such as those who are material risk takers, deal with customers, administer benchmark submissions, and are algorithmic and proprietary traders.

### 2.4.3.2 IOSCO fit and proper assessments

In 2009 the International Organization of Securities Commissions (IOSCO) published a final report on best practices for fit and proper assessments. The aspects to be considered to assess fitness and propriety are (i) competence and capability; (ii) honesty, integrity, fairness and ethical behaviour; and (iii) financial soundness.

Assessing competence and capability means the person has (i) satisfactory past performance or expertise in the business being conducted; (ii) an appropriate range of skills and experience to understand, operate and manage the regulated activities; and (iii) the technical knowledge and ability to perform the regulated activities, especially recognised professional qualifications and membership of relevant professional institutions.

<sup>21</sup> FAIS provides a framework for honesty and integrity, competence (including experience, qualification and examination requirements), and continuous professional development.

<sup>22</sup> Rolling bad apples refer to employees who have left (or have been fired from) one institution because of conduct-related matters and move to the next employer in the same industry and in the same (or similar) position.

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In assessing the honesty, integrity, fairness and ethical behaviour of the applicant/key person, consideration should be given to whether the person has been convicted of dishonesty, fraud, money laundering, theft or financial crime within the past 10 years. Each person should be dealt with on a case-by-case basis, taking into account the seriousness of the offence, the circumstances surrounding the offence, the explanation offered by the person, the relevance of the offence to the proposed role, the time since the offence, and evidence of the person's rehabilitation.

Financial soundness is an important element in determining fitness and probity. Not only should current financial soundness be assessed but also whether the person can maintain solvency, financial controls and control over financial risks into the future.

## 2.4.3.3 IOSCO tracking bad apples

IOSCO's 2017 Task Force Report on Wholesale Market Conduct indicates that to track individuals with histories of misconduct or to identify bad apples, some jurisdictions require specific information to be shared when certain types of staff move between firms.

**The regulators in some jurisdictions keep registers accessible to the public, which ensures transparency by enabling clients to find out about persons they plan to do business with. Some examples are:**

- In Germany, BaFin operates an internal employee and complaints register to track certain individuals' misbehaviour.
- In Japan, the Japan Securities Dealers Association has rules under which its members must inform the association about inappropriate acts that employees have committed.
- In Switzerland, the Swiss Financial Market Supervisory Authority (FINMA) maintains a non-public database of individuals with questionable business conduct or with a track record of not meeting relevant legal requirements. In addition, FINMA sends a business conduct letter to those entered on the watch list in certain circumstances, informing the individuals that FINMA reserves the right to review compliance with business conduct requirements if the individuals intend to assume a specific position.
- In the United Kingdom, regulatory references need to be prepared by the firm and certain information must be shared about employees moving between firms.
- In the United States, the Financial Industry Regulatory Authority (FINRA) maintains a publicly available database of brokers called BrokerCheck, which contains background information for every registered firm and person.

## 2.4.3.4 European Central Bank

**The European Central Bank's (ECB) fitness and propriety of members of the management body is assessed against five criteria:**

- Experience:** Members of the management body must have sufficient knowledge, skills and experience to fulfil their functions. The term experience covers both practical/professional experience gained in previous occupations and theoretical experience (knowledge and skills) gained through education and training.
- Reputation:** Members of the management body must always be of sufficiently good repute to ensure the sound and prudent management of the firm. Since a person can either have a good or a bad reputation, the principle of proportionality cannot apply to the reputation requirement or to the assessment of the reputation requirement.
- Conflicts of interest and independence of mind:** Members of management bodies should be able to make sound, objective and independent decisions (i.e. act with independence of mind). Independence of mind can be affected by conflicts of interest. The institution should have governance policies in place for identifying, disclosing, mitigating, managing and preventing conflicts of interest, whether actual, potential (i.e. reasonably foreseeable) or perceived (i.e. by the public). There is a conflict of interest if the attainment of the interests of a member may adversely affect the interests of the institution. Having a conflict of interest does not necessarily mean that an appointee is unsuitable. This will only be the case if the conflict of interest poses a material risk and if it is not possible to prevent, adequately mitigate or manage the conflict of interest.



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- iv. **Time commitment:** All members of the management body must be able to commit sufficient time to performing their functions in the firm.
- v. **Collective suitability:** The firm has the primary responsibility of identifying gaps in the collective suitability of its members through the self-assessment of its management body. How appointees will fit into the collective suitability is one of the criteria that need to be assessed at the time of the initial fit and proper assessment.

The ECB has the power to remove at any time members from the management body of a significant supervised entity who do not fulfil the requirements.

## 2.4.4 RECOMMENDATIONS

**In South Africa, several fit and proper regimes exist:**

- The FAIS-revised fit and proper requirements are (i) honesty, integrity and good standing; (ii) competence, which includes experience, qualifications and regulatory examinations; (iii) operational ability; and (iv) financial soundness.
- Over-the-counter (OTC) derivatives providers under the FMA have similar fit and proper standards requirements to FAIS, namely honesty and integrity; competency; operational ability; and financial soundness of the firm's directors and senior managers.
- Regulation 42 issued under the Banks Act requires banks to submit form BA 020 for each person it wishes to appoint as a director or executive officer prior to the appointment. These applications are vetted, and consent is required from the Prudential Authority (PA). The terms of section 60(6) allow the PA to object to the appointment or continued employment of a chief executive officer, director or executive officer of a bank if the Chief Executive Officer (CEO) of the PA reasonably believes that the person concerned is no longer fit and proper to hold that office or if the holding of such office by the person concerned is not in the interest of the public.
- Foreign exchange dealers: The current legal framework in South Africa does not provide for the regulation and/or supervision of foreign exchange dealers in their individual capacity. The PA has the power to apply fit and proper principles at executive level, but that power does not extend to foreign exchange dealers. The PA does not have the power to sanction these individuals in the event of serious market conduct malpractices. Therefore, the regulators do not necessarily have the power to prosecute a foreign exchange dealer for insider trading, front-running of client transactions, collusion or the manipulation of benchmarks other than through criminal prosecutions for fraud and contraventions in terms of the Financial Intelligence Centre Act and Income Tax Act.
- Section 145 of the FSR Act allows for the removal of a person from a specified position or function in a financial institution if the person no longer complies with applicable fit and proper person requirements. A consultation process must be followed before such removal (section 146).
- Sections 8(1)(c), 28(1)(c) and 48(1)(c) of the FMA deal with fit and proper requirements for applicants for an exchange licence, central securities depository licence and clearing house licence, respectively. Sections 17(2)(a), 35(2)(b) and 53(2)(b) deal with fit and proper requirements for authorised users, central securities depository participants and clearing members, respectively. According to section 66(1) of the FMA, no person may be appointed as a member of the controlling body of a market infrastructure if that person does not meet the fit and proper requirements prescribed by the registrar.

It is recommended that the regulators (the Interagency Governance Subcommittee) consider exploring existing fit and proper requirements to establish an equivalent regulatory regime for all market participants, and to address any gaps or inconsistencies.

It is further recommended that the regulators 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.

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## 2.5 ACCOUNTABILITY OF SENIOR MANAGERS

### 2.5.1 INTRODUCTION

Financial investigations after the financial crises that started in 2007–08 revealed the lack of specific accountability for material failures by many bankers, especially at the most senior levels, which resulted in significant harm to firms, their customers, and ultimately taxpayers and the economy. Senior bankers avoided accountability for these failings by claiming ignorance or sheltering behind collective decision-making and faced little realistic prospect of financial penalties or other sanctions proportionate with the severity of the failures with which they were associated.

### 2.5.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

The report shows the views of market participants with respect to the accountability for standards of conduct at firms and how such accountability is allocated between the board, senior management, line managers or desk heads, and individual staff.

In response to questions relating to the main risks to market integrity that arise from current market practices, some market participants highlighted the risk of a lack of accountability and lack of enforcement of meaningful sanctions.

### 2.5.3 INTERNATIONAL STANDARDS AND GUIDANCE

#### 2.5.3.1 FSB governance toolkit to mitigate misconduct risk

The FSB governance toolkit to mitigate misconduct risk addresses the regulatory tools to strengthen individual responsibility and accountability. The tools are: (i) identify key responsibilities and assign them; (ii) hold individuals accountable through legislative/regulative and supervisory provisions and a firm's internal processes; (iii) assess the suitability (integrity and competence) of individuals assigned key responsibilities; (iv) develop and monitor a responsibility and accountability framework; (v) and coordinate tools with other authorities in the same jurisdiction.

#### 2.5.3.2 United Kingdom Senior Manager Regime

Introduced in 2016, the United Kingdom's (UK) Senior Managers Regime (SMR) covers banks regulated in the UK and aims to strengthen individual accountability. The Senior Insurance Managers Regime (SIMR) is a similar initiative for UK-regulated insurers. By late 2018, the SMR is likely to be extended to all firms authorised under the Financial Services and Markets Act 19 of 2012.

The SMR was an outcome of the UK's Parliamentary Committee on Banking Standards criticism that the existing regulatory framework, namely the Approved Persons Regime, was unable to hold individuals fully accountable for decisions and standards of the bank in their areas of responsibility. As a result, the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) developed the SMR which requires a clear allocation of responsibilities to senior individuals in firms and establishes a set of binding conduct rules to help regulators hold individuals who are in breach of them accountable and undertake enforcement actions.

The SMR requires a clear allocation of responsibilities to the most senior individuals in firms, key members of the board, the top layer of senior management, and the heads of key control functions – internal audit, compliance and risk management. The SMR covers





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group-entity senior managers, who are managers based in a group or parent company who exercise direct and significant influence over the way in which a firm carries out its regulated activities.

Although the regime is jointly proposed by the FCA and PRA, both the regulators have different objectives and interests that they seek to address through this regime. The PRA is focused on those who have a large potential impact on the financial safety and soundness of a firm, while the FCA looks more widely at those who can have an impact on the firm's customers. Individuals who perform a senior management function specified by the PRA will require pre-approval by the PRA with the FCA's consent, whereas individuals who perform a senior management function specified by the FCA will only require pre-approval by the FCA.

## The regime has three major elements:

- i. The **Senior Managers Regime** defines a senior manager as an individual who performs a senior management function, as specified by the regulator, on behalf of a relevant firm, whether physically based in the UK or overseas. It introduces specific prescribed responsibilities which must be allocated among senior management functions.
- ii. The **Statements of Responsibilities** describe the responsibilities that the senior manager is to perform as part of his/her function and how he/she fits in with the firm's overall Management Responsibilities Map. The Statement of Responsibilities needs to be sent to the regulator who also needs to receive a notification of any updates.
- iii. The **Management Responsibilities Map** defines the responsibilities and reporting structures within the firm, and highlights where there are shared or unclear reporting structures and no allocation of responsibility. The firm's board is required to provide annual confirmation that there are no gaps in the allocation of responsibilities within the firm.

The regime also requires firms to ensure that incoming managers are properly briefed, especially about conduct risk. An outgoing manager should provide a handover certificate confirming and detailing the regulatory risks that the business is exposed to as well as actions undertaken or an explanation of why no steps were taken to mitigate the risks.

The SMR conduct rules are high-level requirements that apply to persons within the scope of the SMR. The FCA conduct rules apply to most employees of firms based in the UK or who deal with customers in the UK. Tier 1 conduct rules apply to all employees except ancillary staff, while Tier 2 is applicable to individuals in senior management functions. The rules are as follows:

Tier 1 (individual conduct rules)	Tier 2 (senior manager conduct rules)
<ul style="list-style-type: none"> <li>• Act with integrity</li> <li>• Act with due skill, care and diligence</li> <li>• Transparent and cooperative with the FCA, the PRA and other regulators</li> <li>• Pay due regard to the interests of customers and treat them fairly</li> <li>• Observe proper standards of market conduct</li> </ul>	<ul style="list-style-type: none"> <li>• Take reasonable steps to ensure that the business of the firm for which senior managers are responsible is controlled effectively and complies with relevant requirements and standards of the regulatory system</li> <li>• Take reasonable steps to ensure that any delegation of responsibilities is to an appropriate person and provide oversight to ensure that the delegated responsibilities are managed effectively</li> </ul>

The SMR is complemented by a certification regime that applies to employees who could pose the risk of significant harm to the firm or any of its customers or whose actions could have a material impact on the risk profile of the firm. Such individuals are not pre-approved by the regulators. Certified persons generally comprise the next management rung down from senior management plus certain technical and customer-facing functions. Firms need to certify that these individuals are fit and proper for their roles both at the outset and on a continuing basis. The regime also requires firms to include facts that relate to breaches of conduct rules, and a description and outcome of disciplinary action taken in relation to any breach of conduct rules. Since most employees fall within the ambit of both the FCA and PRA regimes, firms are expected to put in place a single process for certifying each individual.

## 2.5.3.3 Australia Banking Executive Accountability Regime

Australia's Banking Executive Accountability Regime (BEAR) draws its inspiration from SMR in the UK. However, it is narrower in coverage in that it applies only to authorised deposit-taking institutions (ADI), and deals mainly with matters related to the prudential standing and reputation of ADIs, which is why it is administered by The Australian Prudential Regulation Authority (APRA). APRA and the Australian Securities and Investments Commission (ASIC) have complementary interests and work together to ensure they are aligned and coordinated in their activities, but view governance, culture and accountability from different perspectives. ASIC, on the one hand, takes an interest in the shortcomings that lead to damaging outcomes for consumers and markets. APRA, on the other hand, has an interest in failings that indicate a lax attitude to risk-taking, which might ultimately have an impact on the soundness of the financial institution itself (and thereby jeopardise the interests of depositors, policyholders, and pension fund members and beneficiaries).

BEAR has five main elements, namely registration, obligations, accountabilities, remuneration and sanctions.

- i. **Registration:** BEAR prescribes directors and senior executives responsible for ADIs' health and well-being as accountable persons. Accountable persons must register with APRA before they may perform their duties. Unlike the UK SMR, APRA does not vet appointments. However, the pre-appointment registration provides APRA with an opportunity, should it become aware of information that might make an appointee unsuitable, to discuss any concerns with the individual or the employing ADI. Therefore, accountability for senior appointments is with the boards and senior executive teams that make the appointments.
- ii. **Obligations:** Accountable persons and ADIs are required to (i) act with honesty and integrity; (ii) behave with due skill, care and diligence; and (iii) deal with APRA in an open, constructive and cooperative way. They must also take reasonable steps to prevent matters arising which would undermine the ADI's prudential standing and prudential reputation.
- iii. **Accountabilities:** BEAR requires the crafting of accountability maps and statements, which clarify the allocation of accountability across the executive team within an ADI. Accountable persons need to have accountability statements that set out the aspects of the ADIs' operations for which they are accountable. Each ADI must have an accountability map, showing how the statements come together to cover the totality of an ADI's business and risks. This clarity of accountability is the foundation of BEAR. In many ADIs, there is often collective responsibility for various aspects of their business. Collective responsibility may result in no individual accountability.
- iv. **Remuneration:** BEAR requires ADIs to defer a minimum proportion of an accountable person's variable remuneration – generally 40% for executives or 60% for the CEO of a large bank – for a minimum of four years. It also requires ADIs to have remuneration policies that provide for the reduction in variable remuneration should an accountable person fail to comply with his/her obligations. APRA requires ADIs to explain how adverse prudential outcomes have been factored into remuneration outcomes. BEAR does not grant APRA any power to determine what amount of remuneration an individual should receive.
- v. **Sanctions:** BEAR applies sanctions at two levels: the ADI and the individual. For ADIs, BEAR provides a penalty regime in instances where the ADI has failed to meet its obligations under the legislation (i.e. by failing to operate with integrity, skill, care and diligence, or preventing the prudential standing or reputation of the ADI from being materially undermined). APRA cannot impose the fines unilaterally. It must make a successful case before the Courts, which means APRA must believe it has reasonable grounds for success and that the offence is material. For individuals, APRA's sanction is the power to remove accountable persons from their role and, in the most extreme cases, prevent them for taking on any similar role in the industry in the future. Financial sanctions for any failure to fulfil their obligations will be addressed via the ADIs' remuneration policies.

BEAR became effective on 1 July 2018 for large banks and will be effective one year later for other ADIs. Other transitional arrangements include ADIs that are allowed three months to register accountable persons and, until the end of 2019, to incorporate remuneration requirements in pre-existing executive employment contracts.



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## 2.5.4 RECOMMENDATIONS

In South Africa, regulation 4 (BA 099) of the Banks Act requires senior managers (CEO, chief financial officer and other officials) to attest to compliance with section 50 of the Banks Act (Investments and loans and advances by controlling companies) and the Financial Intelligence Centre Act 38 of 2001 as well as to the correctness of statutory returns submitted. In addition, officials responsible for specific risks (balance sheet, income statement, solvency, liquidity counterparty, interest rate, market (position), credit, technological, operational and any other risk regarded as material) certify to the bank's disclosure and management of the risk. Managers attest to this monthly.

After a consultation process (section 146), section 145 of FSR Act allows for the removal of a person from a specified position or function in or in relation to the financial institution if the person (i) has contravened a financial sector law; (ii) has been involved in financial crime; (iii) has not prevented a contravention of a financial sector law by the financial institution or the financial institution being involved in financial crime; or (iv) no longer complies with applicable fit and proper person requirements.

Other than these, no regulatory regime for the accountability of senior managers for market participants exists. It is recommended that regulators consider the implementation of an accountability regime that is equivalent and proportional for all market participants without prescribing individual roles and responsibilities within firms.

## 2.6 COMPENSATION (INCENTIVES AND REMUNERATION)

### 2.6.1 INTRODUCTION

The structure of performance pay may magnify an excessive risk-taking culture when it rewards high short-term profits with generous remuneration and bonus payments without adequate regard to the longer-term risks that seeking such profits imposes on the firm. While the rewards for fleeting short-term success have been lavish, the penalties for failures, which often manifest much later, have been small, even negligible. Such perverse incentives encourage excessive risk-taking at all levels of the firm, from traders and underwriters right up to the firm's CEO. Furthermore, the lack of attention to risk also contributes to large, even excessive, absolute levels of compensation.

### 2.6.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

With respect to incentives and remuneration, market participants were asked (i) whether their incentives and remuneration were aligned with agreed standards of market practice; and (ii) if changes in incentive structures in wholesale financial markets had an impact on market practices.

#### 2.6.2.1 Alignment with agreed standards of market practice

Most responses by market participants provided a general overview of their institution's remuneration policy and approach linked to performance (with varying degrees of detail). A common theme noted in the responses is that remuneration is linked to the long-term performance of the firm, and the structure of the variable component of remuneration is also linked to the long-term performance or sustained value for the firm. Vesting periods for long-term incentives to align with compliance and sustainability were noted in some cases. The use of deferred compensation to align with sustainable business practices as well as remuneration

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policies for periods ranging from three to five years are also common practice. These provisions are seen as aligning incentives with sound risk management, including the management of conduct risks.

Participants also noted that international and domestic market practices and regulatory requirements had an impact on the institution's remuneration policy. Regular benchmarking exercises are undertaken to ensure remuneration is in line with the market.

## 2.6.2.2 Impact of changes in incentive structures

Several other responses tend to support the view that changes in incentive structures have had a positive impact on market practices. For example, one response (bank) suggests that there has been a shift towards balanced performance scorecards that capture both financial and non-financial metrics and promote fair outcomes for stakeholders. Another response (bank) cites longer vesting periods for share awards, the viable threat of clawback, and a reduction in the portion of compensation paid in cash. However, it was also suggested that the few cases of market abuse recorded by the FSCA has weakened the impact. A further response (non-bank institution) notes an increase in the ratio of long-term relative to short-term incentives, with long-term incentives being aligned with the interests of clients and shareholders. Another response (non-bank institution) indicates that the FSCA-driven conflict of interest and treating customers fairly processes have had an impact on market practice.

It is noted that following the global financial crisis, most excesses have been removed from incentives; however, it is also suggested that skills shortages in specialised areas may result in the over-compensation of certain specialists.

## 2.6.3 INTERNATIONAL STANDARDS AND GUIDANCE

### 2.6.3.1 FSB Principles and Standards for Sound Compensation Practices

The FSB Principles and Standards for Sound Compensation Practices published in 2009 were augmented by supplementary guidance in 2018.

The principles are:

1. The board oversees and senior management implements a compensation system to promote ethical behaviour and compliance with laws, regulations and conduct standards.
2. Compensation design and decision-making involves sound governance, robust risk management frameworks and participation by control functions, including human resources, to ensure compensation incentives address misconduct risk.
3. The board is responsible for ensuring accountability for misconduct. Boards (i) oversee compensation systems that promote prudent risk-taking behaviour and business practice; and (ii) hold senior management accountable for implementing compensation systems that address misconduct risk.
4. Senior management holds business line management accountable for communicating, implementing and meeting expectations regarding ethical behaviour and business practices in compliance with laws, regulations and conduct standards. The potential consequences of misconduct on compensation should be clearly communicated to all employees.
5. Compensation should be adjusted for all types of risk, including those difficult to measure. These include risks associated with misconduct that can result in harm to firms, customers and other stakeholders. The processes for managing misconduct risk through compensation systems should include, at a minimum, ex ante processes that embed non-financial assessment criteria such as the quality of risk management, degree of compliance with laws and regulations, and the broader conduct objectives of the firm, including the fair treatment of customers, into individual performance management and compensation



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plans at all levels of the organisation and as part of the broader governance and risk management framework. Such processes should be supported by ongoing formal training courses that reinforce appropriate standards of behaviour.

6. To accommodate the longer-term nature of misconduct risk, compensation systems should provide for mechanisms to adjust variable compensation, such as in-year adjustments and malus or clawback arrangements, which can reduce variable compensation after it is awarded or paid.
7. To ensure consistency, fairness and transparency in the application of compensation adjustments, it is important that effective compensation policies and procedures are in place. These should clearly specify, ex ante, misconduct triggers or other mechanisms that may result in reductions to variable compensation.
8. Supervisors monitor and assess the effectiveness of firms' compensation policies and procedures. National regulations and/or guidance should set out clear expectations on the use of compensation tools in addressing misconduct risk and related misconduct outcomes, and the criteria for their application.

## The standards include:

- The Board, through the Remuneration Committee, works closely with the firm's Risk Committee in the evaluation of the incentives created by the compensation system.
- For significant financial institutions, the size of the variable compensation pool and its allocation within the firm considers the full range of current and potential risks, in particular the cost and quantity of capital required to support the risks taken, the cost and quantity of the liquidity risk assumed in the conduct of business, and consistency with the timing and likelihood of potential future revenues incorporated into current earnings.
- Subdued or negative financial performance of the firm generally lead to a contraction of the firm's total variable compensation, taking into account both current compensation and reductions in pay-outs of amounts previously earned, including through malus or clawback arrangements.
- For senior executives as well as other employees whose actions have a material impact on the risk exposure of the firm, the following is applicable:
  - A substantial proportion of compensation should be variable and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance.
  - A substantial portion of variable compensation, such as 40–60%, should be payable under deferral arrangements over a period of years, and these proportions should increase significantly along with the level of seniority and/or responsibility. For the most senior management and the most highly paid employees, the percentage of variable compensation that is deferred should be substantially higher, for instance above 60%.
  - The deferral period should not be less than three years, provided that the period is correctly aligned with the nature of the business, its risks and the activities of the employee in question. Compensation payable under deferral arrangements should generally vest no faster than on a pro rata basis.
  - A substantial proportion, such as more than 50% of variable compensation, should be awarded in shares or share-linked instruments (or, where appropriate, other non-cash instruments) as long as these instruments create incentives aligned with long-term value creation and the time horizons of risk. Awards in shares or share-linked instruments should be subject to an appropriate share retention policy.
  - The remaining portion of the deferred compensation can be paid as cash compensation vesting gradually. In the event of negative contributions of the firm and/or the relevant line of business in any year during the vesting period, any unvested portions are to be clawed back, subject to the realised performance of the firm and the business line.

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## 2.6.3.2 UK FCA's Remuneration Code

The Capital Requirements Directive (CRD IV) contains remuneration requirements which aim to ensure that remuneration policies are consistent with and promote sound and effective management, do not provide excessive risk-taking, and are aligned with the long-term interests of institutions across the European Union (EU). The European Banking Authority (EBA) published guidelines in December 2015 that set out how the CRD IV rules should be applied. The EBA guidelines came into effect on 1 January 2017.

The FCA published a policy statement titled 'Remuneration in CRD IV firms: final guidance and changes to Handbook'. The guidance applies to all firms that fall within the scope of CRD IV, namely banks, building societies, investment firms and overseas firms that are required to comply with the FCA's Remuneration Code. The guidance came into effect on 3 May 2017 and gives guidance on how the EBA guidelines apply to firms as well as clarification on the FCA's Remuneration Code.

Firms are required to identify employees whose professional activities have a material impact on the firm's risk profile, including prudential, operational, conduct and reputational risk.

The proportionality rule (which is highly detailed) is then applied to determine the extent to which the FCA Remuneration Code requirements apply on an individual or firm-wide basis.

Any firms that are significant in terms of their size, internal organisation and the nature, scope and complexity of their activities must establish a Remuneration Committee. Significance must be assessed on a stand-alone entity basis.

Firms must have a clear and verifiable mechanism for measuring performance. Firms are then required to apply risk adjustments to bonus pools in a clear and transparent manner.

**To ensure that variable remuneration links to the long-term strategy of the institution and reflects overall performance, regulators have imposed the following rules on how variable remuneration is to be paid out:**

- At least 40% of the amount of variable remuneration in any event should be deferred.
- The deferral period cannot be shorter than between three and five years.
- For the remaining 60% of the variable remuneration, only 50% of the given amount is to be paid in cash, whereas the remaining 50% must be paid in shares, which are subject to a six-month retention period.

## 2.6.3.3 Australia (APRA)

The minimum amount of variable remuneration to be deferred is dependent on the size of the ADI. There are higher deferrals for larger ADIs and also different bands applied to CEOs. A minimum of the lesser of 40% of an executive's variable remuneration or 20% of an executive's total remuneration is to be deferred for a minimum period of four years if the entity is a large ADI. APRA will also be given stronger powers to require ADIs to review and adjust their remuneration policies when APRA believes such policies are not appropriate. ADIs must notify the APRA if the variable remuneration of an accountable person has been reduced or will be reduced as a result of that accountable person failing or being likely to have failed his/her accountable person obligations.



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## 2.6.4 RECOMMENDATIONS

National Treasury's 2011 policy document 'A safer financial sector to serve South Africa better' confirms South Africa's support for the FSB's Principles and Standards on Sound Compensation Practices. However, no regulatory remuneration guidance has been issued.

*King IV* recommends that remuneration policy be designed to (i) attract, motivate, reward and retain human capital; (ii) promote the achievement of strategic objectives within the firm's risk appetite; (iii) promote positive outcomes across the economic, social and environmental context in which the firm operates; and (iv) promote an ethical culture and responsible corporate citizenship. The remuneration policy and its implementation report should be tabled annually for a non-binding advisory vote by shareholders at the annual general meeting (AGM). If voted against by 25% or more of the votes at the AGM, an engagement process should follow to ascertain the reason for dissenting votes and address legitimate and reasonable concerns. This may include changing the remuneration policy.

It is recommended that regulators 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.

## 2.7 WHISTLE-BLOWING

### 2.7.1 INTRODUCTION

Whistle-blowing is an important mechanism to prevent and detect improper conduct, fraud and corruption.

### 2.7.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

The responses received from market participants indicate that whistle-blowing arrangements are in place. How it is implemented varies from participant to participant.

### 2.7.3 INTERNATIONAL STANDARDS AND GUIDANCE

In more opaque markets, whistle-blowers who inform regulators of suspected instances of misconduct can be a vital source of information to support regulation against misconduct. Market regulators can incentivise market participants to provide such information by ensuring that necessary protections are in place so that no retaliation is taken against a whistle-blower for disclosure of information and, in certain circumstances, monetary rewards are provided.

In the UK, banks, building societies, large investment firms and insurers are required to establish and maintain an independent whistle-blowing channel through which staff may make disclosures. These firms are also required to appoint a senior individual as a whistle-blowers' champion to ensure the effectiveness of the whistle-blowing arrangements.

In the US, the Securities and Exchanges Commission (SEC) has established a whistle-blower programme in terms of which the SEC is authorised to pay an award of between 10% and 30% of amounts collected if an eligible whistle-blower voluntarily provides original information that leads to a successful enforcement action with monetary sanctions exceeding USD 1 million. In terms of whistle-blower protection, under the Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), no employer may

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discharge, demote, suspend, threaten or harass, directly or indirectly, or in any other manner discriminate against, a whistle-blower in the terms and conditions of employment because of any lawful act done by the whistle-blower. An individual may bring a private right of action in federal court against his/her employer for such retaliation. In addition, the SEC may bring an enforcement action against a company for violation of these anti-retaliation provisions. The largest award made in terms of the program is more than USD30 million in September 2014. <https://www.sec.gov/whistleblower>.

The US Commodity Futures Trading Commission (CFTC) too has a whistle-blower program created by the Dodd-Frank Act. In July 2018 the CFTC announced an award of about USD30 million to a whistle-blower. This is the largest award made in terms of the program. <https://www.whistleblower.gov/orders/>.

## 2.7.4 RECOMMENDATIONS

In South Africa whistle-blowers are protected by legislation. The Protected Disclosures Act 26 of 2000 makes provision for employees to report unlawful or irregular conduct by employers and fellow employees while providing protection for employees who blow the whistle. The Act provides such protection for any disclosure made in good faith by an employee who reasonably believes that the information disclosed, and any allegation contained in it, is substantially true, and who does not make the disclosure for purposes of personal gain, excluding any reward payable in terms of any law.

It is recommended that the regulators consider implementing a programme that rewards whistle-blowers for providing information about substantial misconduct in financial markets that leads to a successful enforcement action with monetary sanctions.

## 2.8 ONGOING TRAINING AND DEVELOPMENT

### 2.8.1 INTRODUCTION

Market participants are expected to have the appropriate skills and knowledge to provide the services that they offer. Ongoing training may be required to ensure their knowledge and expertise is maintained and updated. Such training often covers ethics, conduct and conflicts of interest.

### 2.8.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

Many of the responses describe regular training and development processes in their institutions, utilising some combination of internal training (web-based and/or face to face) and external provision. Often these processes are managed and tracked by compliance departments, although the human resources departments also play a role in sourcing appropriate training to meet identified needs. Managers and desk heads may also have some responsibility for the technical training of their staff.

Membership of professional bodies and participation in industry associations and related working groups, seminars and conferences as mechanisms for keeping informed about regulatory and market developments and associated training were highlighted as important mechanisms to keep current with market standards and practices.

Market participants believe that a lack of education and skills of retirement fund trustees creates opportunities for consultants and advisers to retirement funds to abuse the system and suggest that the weaknesses in the education and skills of retirement fund trustees be addressed.





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## 2.8.3 INTERNATIONAL STANDARDS AND GUIDANCE

IOSCO identifies five categories of conduct expectations, one of which is competence. Obligations on individuals based on this expectation seek to ensure that individuals can perform the functions that they have been assigned. They are generally imposed through specific statutory or other regulatory obligations, which may include minimum qualification requirements, licensing or entry requirements, and ongoing training requirements.

In wholesale markets, the individual-level authorisation requirements are closely tied to the firm-level authorisation process. Firms may be required to report the names of their officers and employees at the point of authorisation or registration. Individual registration requirements may be made public and include an ongoing obligation to maintain and meet standards to remain registered.

### Box 2.1: Retirement fund trustees – a special case

The UK's Competition and Markets Authority (CMA) is working on competition in the market for investment consultancy and fiduciary management services. Investment consultants provide advice to retirement funds and other institutional investors on investment strategy, asset allocation and asset manager product selection. Fiduciary managers may provide investment advice but also assume the legal delegation of some or all investment decisions based on the strategy agreed by the trustees. The level of delegation may vary, with some mandates being for the full assets of a fund.

In July 2018 CMA issued a provisional decision report. It found that pension schemes trustees have limited ability to drive competition between investment consultants and fiduciary managers and that material customer detriment may be expected as a result. Provisional remedies include:

- The introduction of mandatory tendering for fiduciary management services
- A requirement on investment consultancy and fiduciary management firms to report investment performance using a set of common standards.
- A requirement on fiduciary management firms to disaggregate and provide greater clarity on fees costs
- A requirement on pension trustees to set objectives when they hire an investment consultant, to judge quality of the service.

CMA also recommends that the UK's Pension Regulator develop guidance to support pension trustees in asking for and using the enhanced information they will now be able to access

## 2.8.4 RECOMMENDATIONS

FSCA has proposed continuous professional development (CPD) for advisers to retail customers (including pension funds) under the FAIS Act. The financial services providers will be required to establish and maintain policies on how to maintain, update and develop new knowledge and skills, training plans to ensure CPD is relevant and appropriate as well as record-keeping of CPD hours and evidence of activities. Different CPD standards will apply depending on the complexity of the products advised on.

Professional bodies such as the South African Institute of Financial Markets (SAIFM)<sup>23</sup> and the South African Institute of Stockbrokers (SAIS)<sup>24</sup> seek to professionalise individuals operating in financial markets. Both have CPD programmes.

<sup>23</sup> SAIFM is a professional body for financial market practitioners and promotes professionalism and integrity in the financial markets. Its professional designations registered on the National Qualifications Framework are Member of the Institute of Financial Markets (MIFM) and Fellow of the Institute of Financial Markets (FIFM).

<sup>24</sup> SAIS is a professional body for the South African financial markets. Its qualification – Financial Markets Practitioner – is registered on the Occupational Qualifications Sub framework of the National Qualifications Framework.

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With respect to retirement fund trustees, it is recommended that regulators consider measures to educate retirement fund trustees and provide them with minimum tools to assess the advice and other services provided to their funds as well as fees and costs.

## 2.9 CORPORATE AND RISK GOVERNANCE PRACTICES IN SOUTH AFRICA

Further investigative work is being undertaken by the FMRC on corporate and risk governance practices relating to wholesale market conduct at banks. The results of the work are expected towards the end of September 2018 and will be documented here.





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National Treasury  
REPUBLIC OF SOUTH AFRICA



South African Reserve Bank



**FSCA**  
Financial Sector  
Conduct Authority



# 2018 FINANCIAL MARKETS REVIEW

MARKET  
CONDUCT

# Market Conduct

## 3.1 SUMMARY OF RECOMMENDATIONS

Issue to be addressed	Recommendation
Standards and codes of market practice	<p>9. Financial sector authorities to consider assessing the mandates of the committees, workgroups and forums attended by both the regulatory authorities and market participants to debate and discuss financial market matters with a view to rationalising such committees, workgroups and forums. Thereafter regulators to consider encouraging the formation of a Financial Markets Standards Group (FMSG) by senior market professionals and compliance officers. The FMSG's first task could be to consider the development of a general code of conduct for financial market participants</p> <p>10. Regulators to consider establishing equivalent standards of market practice across wholesale financial markets including over-the-counter (OTC) markets (consider the Financial Advisory and Intermediary Services (FAIS) Merchant Banking exemption)</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>
Market discipline	<p>12. Regulators to consider progressing the establishment of trade repositories in all OTC markets (not only OTC derivatives). This will provide regulators with data that is necessary to carry out monitoring and surveillance to stimulate market discipline</p> <p>13. Regulators to consider meeting with market participants to establish ways in which bilateral market discipline might be improved</p> <p>14. Regulators to consider obliging market participants to inform them if misconduct is detected or suspected</p>
Conflicts of interest	<p>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 OTC financial markets. Such regulations could specifically address third-party payments (also by market makers) when executing orders on behalf of clients</p>
Market abuse	<p>16. National Treasury to consider including a market abuse regulation catch-all clause in the Financial Markets Act 19 of 2012 (FMA)</p> <p>17. Regulators to consider requiring that short sales be flagged on exchanges and reported to the exchange and/or the regulator. (Note: FSCA 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)</p>
Monitoring and surveillance	<p>18. Regulators to consider implementing market surveillance and monitoring systems for OTC markets and fragmented exchange-traded markets. However, fully functional trade repositories will be a prerequisite (see 3.3.4)</p> <p>19. Regulators to consider providing standards for surveillance to firms</p>

## 3.2 STANDARDS AND CODES OF MARKET PRACTICE

### 3.2.1 INTRODUCTION

There are currently multiple local and international standards and codes<sup>25</sup> that set out market practice in wholesale financial markets. In South Africa, standards are made by regulators in terms of the Financial Sector Regulation Act 9 of 2017 (FSR Act), and statutory codes of conduct are issued under laws such as the FMA and FAIS. There are no voluntary South African codes for financial market participants.

<sup>25</sup> Standards and codes will be discussed more fully in Chapter 6 (Regulatory framework).

# Market Conduct

Statutory codes made under the FMA are the 2016 Code of Conduct for Authorised Over-the-counter Derivative Providers; and the 2017 Draft Code of Conduct for Parties to Securities Financing Transactions in Securities Markets. While each code has provisions related to the specific activities carried on by the market participants the code addresses, in general the codes require market participants to act with integrity and high standards of market conduct including to:

- render services honestly, fairly, and with due skill, care and diligence;
- treat clients fairly and/or render services in the interests of clients;
- exercise independent professional judgement;
- conduct themselves in such a manner and implement such actions to preserve the integrity of the industry and further the objectives of the applicable Act (e.g. the FMA)
- be open and cooperative with regulatory authorities (including tax authorities);
- comply with all applicable laws, rules and regulations governing their activities;
- maintain appropriate records, governance and risk management frameworks;
- manage conflicts of interest;
- not be party to an activity that intends to create a false or misleading impression, or distort or disrupt a market;
- report any market abuse practice such as insider trading, market manipulation or false and misleading statements that they become aware of to FSCA.

Under FAIS, Board Notice 103 of 2004 (extended to 30 June 2019 by Notice 17 of 2018), known as the Merchant Banking exemption, exempts banks from FAIS in respect of clients deemed by the Registrar of Financial Services Providers not to require statutory protection. Such clients are large corporates and clients that have sufficient know-how and expertise to deal on an equal footing with banks. The exemption is limited to advice and execution services and does not extend to discretionary services. A bank rendering discretionary financial services is subject to all the conduct requirements under the FAIS Act.

Voluntary international codes acknowledged in South Africa include the 2017 Global Code of Conduct for the Foreign Exchange Market (FX Global Code)<sup>26</sup> and 2018 Global Code of Conduct for Precious Metals<sup>27</sup>. While these codes are not legally binding, they are gaining increasing significance in the eyes of authorities and regulators that use moral suasion to encourage their implementation. For example, in March 2018 the SARB announced its commitment to adhere to the FX Global Code and its expectation that as of 1 September 2018 firms doing business with it also adhere to the code. The codes describe principles requiring that market participants:

- behave in an ethical and professional manner to uphold the fairness and integrity of financial markets;
- have a sound and effective governance framework as well as a robust control and compliance environment to effectively identify, manage and report on the risks;
- be clear and accurate in their communications, protect confidential information, and promote effective communication that is fair, open and appropriately transparent;
- exercise care when negotiating and executing transactions to support fair, open and transparent financial markets; and
- put in place robust, efficient, transparent and risk mitigating post-trade processes to ensure the predictable, smooth and timely settlement of trades in financial markets.

<sup>26</sup> Developed under the auspices of the Basel Committee for Bank Supervision's central bank Foreign Exchange Working Group (FXWG) <https://www.bis.org/about/factmktc/fxwg.htm>

<sup>27</sup> Developed under the auspices of the London Bullion Market Association <http://www.lbma.org.uk/global-precious-metals-code>



# Market Conduct

## 3.2.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

### Market participants have the following views:

- A multiple of codes can cause inconsistencies and a lack of clarity and understanding among market participants, and potentially limit fairness and effectiveness. For institutions with global businesses, international as well as local standards are relevant. A consistent set of standards, possibly consolidating various codes, for wholesale and professional market participants across markets would be useful.
- Grey areas can arise when the pace of development of these codes is not able to keep up to date with the evolving global markets environment. It is suggested that robust and proactive engagement between industry associations (The Association for Savings and Investment South Africa (ASISA), The Banking Association South Africa (BASA), The Association of Corporate Treasurers of Southern Africa (ACTSA), The South African Institute of Stockbrokers (SAIS), Debt Issuers Association (DIA) and The Institute of Retirement Funds (IRF), and also the International Swaps and Derivatives Association ISDA) and regulators is needed to ensure that codes keep pace with market developments. Ongoing consultative sessions held by industry bodies should allow market participants to explore and reach consensus, with representatives then responsible for consolidating the market conduct policy for their respective institutions. However, to ensure standards are applied consistently in practice across market participants, regulators should play a more active role in communicating expectations around market practice and in the development of codes. Memorandums of understanding with the competition authorities will be required to avoid market participants being fearful or reluctant to work together in industry forums to find common standards and practices.
- While market participants may clearly understand the standards, the lack of monitoring and enforcement, including in the case of voluntary codes, means that the effectiveness of standards cannot easily be established.

## 3.2.3 INTERNATIONAL STANDARDS AND GUIDANCE

The International Organization of Securities Commissions (IOSCO) has identified five categories of conduct expectations that are relevant to wholesale market participants, namely honesty, upholding market integrity, conflict management, competence, and communication and confidentiality.

- Honesty** allows participants to rely on the representations and undertakings of others. Obligations based on this expectation are usually prohibitions against statements and conduct that is misleading or deceptive. These obligations are generally imposed on all market participants, and not exclusively on participants in wholesale markets.
- Upholding market integrity** gives market participants (and their clients) confidence that they are all subject to the same rules and that markets reflect genuine forces of supply and demand. This expectation is most often expressed in prohibitions on causing or attempts at causing artificial pricing in the market; creating a false or misleading appearance of trading; disseminating false or misleading information with respect to a financial instrument and/or its issuer; creating or attempts at creating an abusive controlling position in a financial market; and misuse of information or insider trading.
- Conflict management**, together with other regulatory requirements, helps to enable firms' clients to have confidence that firms will not use their position to privilege themselves or others (including other clients) at the expense of their clients. Market participants are generally required, at both the individual and firm level, to avoid or manage potential and existing material conflicts of interest.
- Competence** gives clients confidence that market participants are capable – with appropriate human, technical and financial resources – of meeting their commitments, including understanding the technical and regulatory expectations placed upon them. Obligations on individuals are generally imposed through specific statutory or other regulatory obligations which may include minimum qualification requirements, licensing or entry requirements, and ongoing training requirements. Individual registration requirements may also be made public and include an ongoing obligation to maintain and meet standards to remain registered. In wholesale markets the individual-level authorisation requirements are closely tied to the



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firm-level authorisation process. Firms may also be required to report the names of their officers and employees at the point of authorisation or registration.

- v. **Communication and confidentiality** expectations help address the frequent information asymmetry between parties in wholesale markets. Obligations include communicating relevant information clearly and in a timely way and securing and maintaining the confidentiality of sensitive information and not misusing it.

In addition to these five categories, regulators impose organisational, control and governance standards and requirements on firms and their employees.

- Organisational, control and governance requirements aim to prevent and reduce misconduct risk through identifying, punishing and deterring individual conduct at firms that do not meet the expectations of conduct. They are generally imposed through general principles, specific rules and statutory obligations. Regulators require authorised or regulated firms to govern, organise and control their businesses responsibly and effectively, and to manage risk adequately. This generally includes requirements for risk management, internal audit and compliance functions. There is also a more general expectation that regulated market participants will assist regulators as they enforce obligations on individuals and firms through surveillance and investigation.
- Firms and their senior managers may be held accountable for the failure of their employees to meet individual-level obligations or to comply with the organisational and control requirements. Regulators may seek to increase accountability by ensuring senior managers are held responsible for the development of a firm's culture that would, in turn, strengthen compliance with individual- and firm-level expectations of conduct. In addition to enhancing responsibility, regulators may require firms to comply with their own codes of conduct as part of their regulatory regimes.

These core conduct expectations are consistent with existing IOSCO principles and standards, and generally reflect IOSCO members<sup>28</sup> approaches to conduct regulation.

Some market regulators such as the Monetary Authority of Singapore ([www.mas.gov.sg](http://www.mas.gov.sg)) and the United Kingdom's (UK) Financial Conduct Authority (FCA) ([www.fca.org.uk](http://www.fca.org.uk)) support guidelines issued by industry-established and practitioner-led bodies such as the Singapore Foreign Exchange Market Committee (SFEMC) ([www.sfemc.org](http://www.sfemc.org)) and the Fixed Income, Currency and Commodities (FICC) Markets Standards Board (FMSB) respectively ([www.fmsb.com](http://www.fmsb.com)). The guidelines issued by these bodies are technical and granular and add detail to high-level principles and regulation to explain and illustrate them more fully.

**Voluntary standards and codes such as the FX Global Code and those developed by SFEMS and FMSB can be effective if they:**

- reflect the market's collective view of best practice, clarifying worked practical examples;
- are grounded in, and reinforced by, regulatory frameworks and requirements;
- are kept current; and
- are given impact by incentives that encourage adoption and adherence.

<sup>28</sup> IOSCO's membership regulates more than 95% of the world's securities markets in more than 115 jurisdictions and includes all major emerging markets.



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## Box 3.1: Practitioner-led standards bodies

The Fixed Income, Currency and Commodities (FICC) Markets Standards Board (FMSB) was established in 2015 as a private sector response to the market conduct issues in global FICC wholesale financial markets. Its objective is to improve standards of behaviour in FICC markets by developing clear standards and guidelines on conduct, and thereby making the markets more transparent, fair and effective. Membership of the FMSB attempts to be representative of all participants in the wholesale FICC markets and includes banks, asset managers, corporations, brokers, trading platforms, exchanges and infrastructure providers. Standards include the New Issue Process Standard for the Fixed Income Markets (2017), Binary Options for the Commodities Markets (2016) and the Reference Price Transactions for the Fixed Income Markets (2016). Standards of good practice include Monitoring of Written Electronic Communications (2017), Front Office Supervision (2017), Conduct Training (2016), and Surveillance in Foreign Exchange Markets (2016).

The Singapore Foreign Exchange Market Committee (SFEMC) aims to promote growth of the Singapore financial market as a leading international centre for transactions in foreign exchange, money market, fixed income and derivatives instruments by, among other things, enhancing the stature and reputation of the Singapore markets by promoting high standards of professional conduct and competencies, discussing technical issues, and recommending appropriate standards and codes for use in the market. SFEMC is responsible for the Singapore Guide to Conduct and Market Practices for The Wholesale Financial Markets (Blue Book).

The Federal Reserve Bank of New York sponsors the Treasury Market Practices Group (TMPG). This is a group of market professionals from a variety of institutions, including securities dealers, banks, buy-side firms and market utilities committed to supporting the integrity and efficiency of the United States (US) Treasury, agency debt, and agency mortgage-backed securities (MBS) markets. Practice recommendations include US Treasury Market Best Practices (2017), Best Practices for Agency Debt Securities and Agency MBS (2010), Automated Trading Practice Guidance (2015), and Clearing and Settlement (2017, ongoing).

## 3.2.4 RECOMMENDATIONS

The 2015 Report of the Foreign Exchange Review Committee (FXRC) on the operations of Authorised Dealers (ADs) in the South African foreign exchange market recommended that the Regulators encourage the formation of an FMSG by a group of senior market professionals and compliance officers.<sup>29</sup> The FMSG, akin to the UK's FMSB and Singapore's SFEMC, would be an industry-established and practitioner-led body. However the FMRC is aware of a number of committees, workgroups and forums attended by both financial sector authorities and market participants to debate and discuss financial market matters. It is recommended that financial sector authorities consider rationalising these. Thereafter consideration can be given to the formation of a FMSG. It is suggested that the FMSG's first task be to consider the development of a general code of conduct for financial market participants.

Since multiple standards for market practice can cause inconsistencies and a lack of clarity and understanding among market participants, and potentially limit fairness and effectiveness, it is recommended that regulators consider establishing equivalent standards of market practice across wholesale financial markets including OTC markets (consider the FAIS Merchant Banking exemption).

<sup>29</sup> Memorandums of understanding or similar arrangements will be required to encourage market participants to work together to develop common standards and practices.





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Standards and codes are effective if grounded in and reinforced by regulatory frameworks, and by incentives that encourage adoption and adherence and deterrents for non-adherence. It is recommended that regulators consider setting up equivalent regimes to monitor and enforce standards and codes of market practice, whether statutory or voluntary.

## 3.3 MARKET DISCIPLINE

### 3.3.1 INTRODUCTION

In the context of financial market regulation, the term 'market discipline'<sup>30</sup> refers to the prevention or remediation of excessive risk-taking (including conduct risk) and reckless behaviour (including misconduct) by market participants themselves or by regulators. Market discipline can be enhanced, although not exclusively, through initiatives such as transparency and effective disclosure (including disclosing bad apples), and fair market competition.

A lack of transparency and disclosure may increase conduct risk by creating opportunities for dishonest market participants to repeatedly engage in abusive practices, particularly in OTC financial markets.

The 2007–08 financial crisis highlighted how the lack of transparency, particularly in respect of OTC derivatives, misled regulators and market participants about the risks and risk concentrations. Two cases in point were Lehman Brothers and AIG. According to the 2009 Deutsche Börse Group Report<sup>31</sup>, the firms had open derivatives positions with almost 22 000 and 1 500 counterparties respectively at the time of their bankruptcies. Lehman Brothers held roughly 134 000 active OTC derivatives contracts and AIG around 50 000, and many counterparties were impacted in a chain reaction of negative spillover effects. Since the OTC derivatives market has no reporting requirements and hence no post-trade transparency, it was nearly impossible to gain a realistic view on risk positions.

Effective competition enhances market discipline (and vice versa) when buy-side firms and end users withdraw or curtail their business from counterparties they suspect are harming their interests or abusing the market. On the one hand, knowledge of this potential reaction helps discourage market misconduct. On the other hand, competition gives market participants the ability to choose between alternative counterparties and solutions, which enables them to exercise their preferences and enforce market discipline.

### 3.3.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

Market participants believe that surveillance and enforcement – at both entity and market levels – are required to ensure market discipline. However, their view is that market discipline is not visibly enforced in South Africa, especially in comparison to foreign regulators. A central debarment register could be used to cut across the listed and unlisted markets to enhance the integrity of the financial markets.

<sup>30</sup> Financial markets discipline most firms in one way or another – for example, when firms apply for finance. Such discipline ensures scarce resources flow to the most efficient firms. In theory, financial market discipline (see Basel II's Pillar 3) preserves bank safety and soundness by penalising undue risk-taking or by helping supervisors do so.

<sup>31</sup> [http://deutsche-boerse.com/blob/2532344/ebd7dc9b7aeac3efdf0c273309093130/data/the-global-derivatives-market-0909\\_en.pdf](http://deutsche-boerse.com/blob/2532344/ebd7dc9b7aeac3efdf0c273309093130/data/the-global-derivatives-market-0909_en.pdf)



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Fragmentation in markets may introduce complexities and challenges in maintaining discipline, for example it may be difficult for the JSE Limited (JSE) to apply surveillance to A2X as they are competitors.<sup>32</sup>

Market discipline works well in regulated areas where a small group of professionals representing large organisations influence and implement discipline and enforce sound practices, as does the culture of larger and more transparent businesses. Challenges include weaknesses in communicating to wider market participants, extending discipline to smaller institutions and foreign firms that fall between regulatory cracks, and the possibility that large and incumbent firms push back against innovation and greater transparency.

Reputational risk is a driver of market discipline as reputations are fragile and firms will act fast if under threat.

## 3.3.3 INTERNATIONAL STANDARDS AND GUIDANCE

### 3.3.3.1 Reporting to trade repositories

In September 2009, the Group of Twenty (G20) Leaders made several commitments regarding the operation of OTC derivatives markets, including that all OTC derivatives contracts should be reported to trade repositories to improve transparency, mitigate systemic risk and protect against market abuse in the OTC derivatives markets. Current international attention is focused on implementing these commitments, including the reporting of OTC derivatives transactions to trade repositories.

At the behest of the Financial Stability Board (FSB), a working group led by representatives of the Committee on Payment and Settlement Systems (CPSS), the International Organization of Securities Commissions (IOSCO) and the European Commission was convened to make recommendations on the implementation of the G20 objectives. The report of this OTC Derivatives Working Group recommends the public dissemination of trade repositories' data to improve the transparency of OTC derivatives markets and thereby facilitate the exercise of market discipline and investor protection. Public dissemination of trade repositories' data could be done in an aggregated form to preserve the confidentiality of reporting firms and counterparties.

### 3.3.3.2 Rolling bad apples

**In April 2018 the Financial Stability Board introduced a toolkit to strengthen governance frameworks to mitigate misconduct risk. Tools were proposed to address rolling bad apples. Firms should:**

- advise potential employees of its conduct expectations during recruitment and hiring;
- broaden interviewing techniques to consider the interviewee's behavioural competency and conduct history;
- use multiple sources of information to establish potential employees' conduct history;
- regularly monitor the conduct of employees, especially if they are in positions that could cause significant harm to the firm or its customers; and
- do exit reviews to keep appropriate records on former employees for the firm's benefit and that of prospective employers.

<sup>32</sup> Cross-market surveillance will out of necessity need to be the ambit of regulators (see 3.6 – Monitoring and surveillance).



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Regulatory authorities should assess firms' methods for screening prospective employees and monitoring current ones and provide ways for firms to exchange meaningful information on employees such as a central database of financial services professionals.

### 3.3.3.3 Bilateral market discipline

The UK's Fair and Effective Markets Review (FEMR) found that bilateral market discipline did not help maintain conduct standards in the pre-crisis period. It did not believe this would change in future. Although larger buy-side firms can switch counterparties if conduct irregularities are noticed or report misconduct to a sell-side firm's compliance department they did not do so. Instead they focus on a narrow range of mainly pricing metrics to monitor the performance of their counterparties.

There are several reasons for this including:

- the limited choice of alternative counterparties, which indicates increased concentration and reduced balance sheet capacity on the sell-side;
- the need to maintain relationships with a range of counterparties to ensure best execution;
- the fear of retaliatory action;
- difficulties in detecting misconduct due to limited post-trade transparency in some FICC markets; and
- limited incentives for buy-side firms to monitor misconduct given the limited share of transaction costs in their overall cost base, the linking of fund management fees to performance against industry-wide benchmarks and limited pressure from end-investors to investigate such practices.

Interventions proposed by FEMR to improve bilateral market discipline as a curb on market misconduct include:

- giving greater effect to voluntary codes or introducing statutory codes;
- greater coordination by the buy-side, for example through relevant committees of buy-side trade associations;
- increased activism by end-investors, for example by asking fund managers to sign up to their own codes of conduct; and
- obliging firms to report suspected misconduct to regulatory authorities.

FEMR suggests holding a workshop of market participants and regulators to discuss ways to improve market discipline.

### 3.3.4 RECOMMENDATIONS

Regulation 3 of the FMA Regulations (enacted into law on 9 February 2018) requires authorised OTC derivative provider (ODPs) to report OTC derivative transactions to a licensed trade repository. Regulation 11 of the (draft) joint standards of April 2018 (Requirements and Duties of Trade Repositories) stipulates that a trade repository must make its transaction data available to regulatory authorities. Since there is no licensed trade repository in South Africa, ODPs will only start reporting once a licensed trade repository has been established, and only then will reporting to regulatory authorities begin. It is recommended that regulators<sup>33</sup> consider encouraging the establishment of trade repositories in all OTC markets (not only OTC derivatives) for the benefits this will generate, such as improved market transparency and access by regulatory authorities to information in line with their needs, which includes information for monitoring and cross-market surveillance (also see item 3.5) and to motivate market discipline.

<sup>33</sup> The CPSS IOSCO Principles for Financial Market Infrastructures imply that a trade repository is an entity that, among other things, will provide information to central banks, financial market regulators and other relevant authorities. However it is possible that such authorities may maintain their own transaction databases to promote financial stability and detect (and prevent) market abuse. It is assumed that authorities' TRs will also comply with the principles and possibly even certain jurisdictional regulatory requirements.



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As recommended previously (see 2.4.4) regulatory authorities should consider providing a way for firms to exchange meaningful information on employees to weed out rolling bad apples, such as by means of a centralised database of information on the conduct of financial market professionals.

The global financial crisis has shown that the assumption that market discipline facilitated by transparency is self-sustaining should be questioned. Post-crisis, the FEMR indicates that market discipline is weak as market participants do not use influence and information effectively on a bilateral basis e.g., buy-side firms switching counterparties if irregularities are detected. It is recommended that regulators consider meeting with market participants to establish ways in which bilateral market discipline might be improved. It is further recommended that regulators consider obliging market participants to inform them if they detect or suspect misconduct.

## 3.4 CONFLICTS OF INTEREST

### 3.4.1 INTRODUCTION

Potential conflicts of interest are a fact of life in wholesale financial markets, and the more concentrated and horizontally integrated financial market participants are, the greater the potential is. Asymmetric information<sup>34</sup> that is necessary to exploit conflicts of interest as well as fiduciary obligations is of lesser importance in wholesale financial markets compared to activities involving retail clients. Efforts to address the issue in wholesale financial markets are generally focused around improved transparency and market discipline and are essential to deal with a problem that has and will continue to shake public confidence in financial markets.

#### Box: 3.1 Learning from history: Merrill Lynch and Enron

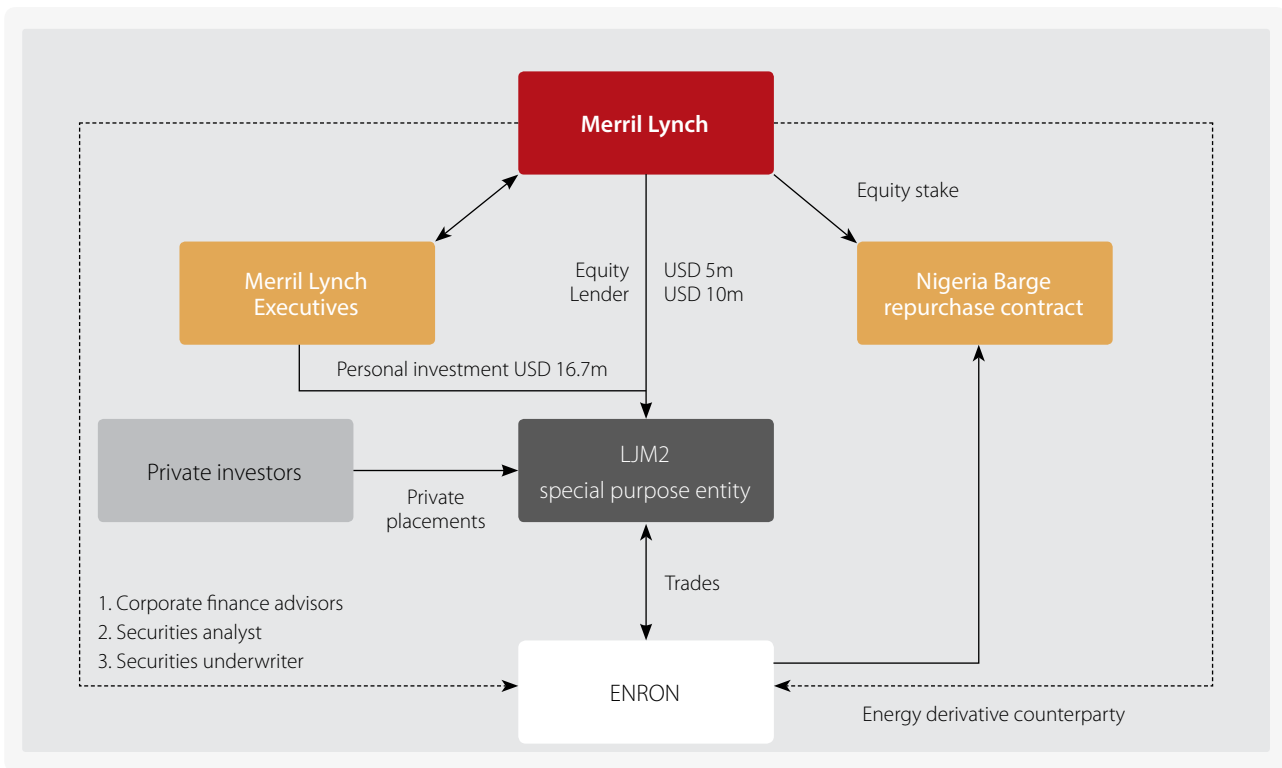
Significant conflicts of interest existed in the business relationships between Merrill Lynch and Enron. Merrill Lynch structured and financed the off-balance-sheet special purpose entity LJM2 (see structure on the next page). Other investors in LJM2 were senior Merrill Lynch executives as well as unaffiliated investors advised by Merrill Lynch. LJM2 was established to conduct energy trades with Enron. LJM2's Chief Executive Officer (CEO) was the Chief Financial Officer (CFO) of Enron. In addition, Merrill Lynch structured a repurchase transaction for Enron of several barges in Nigeria.

At the same time, Merrill Lynch's services for Enron included advisory and underwriting services and being counterparty in its energy derivatives trading. Furthermore, Merrill Lynch provided equity analyst coverage of Enron and its subsidiaries and structures. From 1999 to 2001, the firm earned underwriting fees of USD20 million and advisory fees of USD18 million. It was involved in fund raising for LJM2 in the amount of USD265 million of a total of USD387 million.

<sup>34</sup> Informational advantage does not exist to the same extent because wholesale market participants have greater market know-how and expertise as well as direct access to market information.



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Source: Walter I., 2003.

There are two broad types of conflicts of interest:

- Type 1 conflicts are between a firm's economic interests and the interests of its clients. For example, reaching sales targets in a profit-driven environment often supersedes all other objectives and results in conflicts of interest.
- Type 2 conflicts are between a firm's clients or types of clients, which results in the firm favouring one over the other. For example, the proprietary information of a client obtained by a bank may be used by its investment banking division in advising another client in a contested acquisition.

## 3.4.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

The views of market participants varied, from respondents not being aware of problems in this area to respondents highlighting that conflicts of interest are inherent in wholesale financial markets and the shareholding of financial market infrastructures (FMIs). Specific responses were that both buy- and sell-side require attention.

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## Market participants had a number of suggestions to mitigate conflicts of interest:

- The sell-side institutional level requires strict policies, procedures and codes of conduct; strong internal controls; disclosure and transparency; physical and electronic Chinese walls to prevent inappropriate sharing of information; the management of watch or restricted lists of insiders and wall crossing; conflict checks and clearances on deals; staff conflicts-of-interest training and surveillance; confidentiality requirements and information management (physical and electronic); management of research and communications; control of personal account dealing; measures to control the involvement of employees in activities where conflicts may arise, including in relation to remuneration; and compliance with financial crime requirements, and policies on gifts and on the outside business interests of staff.
- The buy-side institutional level requires trading embargos when employees receive potentially price-sensitive non-public information; disclosure of conflicts of interest to clients; policies on personal account trading, insider trading, best execution and fair pricing; and disclosure of transaction costs and gifts and entertainment.
- At market level, codes such as the FX Global Code are required.

The Financial Advisory and Intermediary Services Act 37 of 2002 (FAIS Act) (at retail client level), together with Financial Intelligence Centre Act 38 of 2001 (FIC Act) and FMA<sup>35</sup>, has improved market conduct. However, there is a need to synchronise the requirements of conflict of interest policies required under the FAIS Act as well as other regulatory requirements such as Treating Customers Fairly, (Protection of Personal Information Act (POPI) and the monitoring of counterparty exposure under Solvency Assessment and Management (SAM).

## 3.4.3 INTERNATIONAL STANDARDS AND GUIDANCE

### 3.4.3.1 IOSCO

IOSCO's Task Force Report on Wholesale Market Conduct sets out how regulators in various jurisdictions expect firms to manage conflicts of interest in wholesale financial markets, mainly in respect of third-party payments when executing orders on behalf of clients. Essentially, brokers should be acting on behalf of their clients to find the best result for their transactions.

IOSCO highlights that the large role often played by market makers in wholesale markets may create significant misconduct risks. First, the market maker may have an interest in market price movements that conflict with clients' interests. Second, the market maker may gain information about market conditions by trading with customers and counterparties, necessitating the need to manage confidential information. As such, in many jurisdictions, market regulators impose specific expectations about how firms should manage such conflicts of interest, particularly when brokers are acting on behalf of clients.

In the European Union (EU), the Market in Financial Instruments Directive (MiFID II) requires investment firms – including their managers, employees and tied agents, or any person linked to them by control – to identify and prevent or manage type 1 and type 2 conflicts of interest, whether caused by inducements from third parties or by the firm's remuneration and other incentive structures. Where the firm's management of conflicts of interest may, despite its efforts, damage its clients' interests, this must be disclosed to clients before doing business with the client, together with the nature and/or sources of conflicts of interest and the steps taken to mitigate them. MiFID II requires firms to act honestly, fairly and professionally, and to communicate in a way that is fair,

<sup>35</sup> Board Notice 1 of 2015 requires market infrastructures to manage conflicts of interest between their regulatory functions and commercial services and disclose the nature and extent of these in their annual reports. The Code of Conduct for Authorised Users requires firms to manage inducements that are likely to conflict with duties owed to clients and to disclose actual or potential conflicts of interest to clients. The Code of Conduct for authorised Over-the-counter Derivative Providers requires authorised OTC derivative providers to manage conflicts of interest between itself and its clients and counterparties.



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clear and not misleading and which places explicit emphasis on the obligation of firms to avoid or prevent conflicts from arising in the first place by reinforcing the restrictions on third-party payments when executing orders on behalf of clients.

In the UK, the FCA and its predecessor, the Financial Services Authority (FSA), finalised guidance on dealing with conflicts of interest inherent in Payment for Order Flow (PFOF), which is an arrangement in terms of which a broker receives payment from market makers in exchange for directing order flow to them. The FCA is of the view that brokers demanding PFOF are in breach of MiFID II standards, as PFOF is incompatible with conflicts of interest rules and may pose risks to price formation and market integrity.

## 3.4.4 RECOMMENDATIONS

The FMA has been used in numerous ways to stipulate conflict of interest requirements to firms in wholesale financial markets. Board Notice 1 of 2015 requires market infrastructures to manage conflicts of interest between their regulatory functions and commercial services, and to disclose the nature and extent of these in their annual reports. The Code of Conduct for Authorised Over-the-counter Derivative Providers requires and authorised OTC derivative provider to manage conflicts of interest between itself and its clients and counterparties. Gaps appear to relate to OTC markets other than derivatives, type 2 conflicts and third-party payments when executing orders on behalf of clients – a case in point being market intermediaries (also called treasury outsourcing companies (TOCs)) that receive payments from both buy- and sell-side as pointed out in the FX Report.<sup>36</sup>

Apart from the FMA there are other conflict of interest regimes such as Financial Advisory and Intermediary Services FAIS, the Insurance Act 18 of 2017 and the Collective Investment Schemes Control Act 45 of 2002 (CISCA).

It is recommended that the regulators investigate the various conflict of interest stipulations for wholesale markets and establish consistent, equivalent and comprehensive regulations for type 1 and type 2 conflicts across exchange-traded and OTC financial markets. Such regulations should specifically address third-party payments (also by market makers) when executing orders on behalf of clients.

## 3.5 MARKET ABUSE

### 3.5.1 INTRODUCTION

Market abuse damages the integrity of financial markets by distorting prices, impairing the ability of markets to be used for hedging and creating a false appearance of market activity. Ideally, regulatory authorities around the world should have suitable data and systems in place to detect, investigate and prosecute market manipulation.

### 3.5.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

Market participants believe that market abuse, together with conflicts of interest, are the greatest threat to the integrity of financial markets, both on-exchange and OTC.

<sup>36</sup> See Chapter 7 – Finalisation of the 2015 FX Review – for a more detailed discussion on treasury outsourcing companies.



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Markets with small volumes, relatively few participants and sophisticated products such as bond options and credit-linked notes are highlighted as being at risk of abuse. Manipulation is more difficult in transparent markets. Corporate bond markets are also seen as susceptible to manipulation.

## Market participants highlighted several ways to reduce market abuse:

- Institutional-level mitigants include good risk governance practices: strong internal controls (such as flagging insiders with material price-sensitive information, and restrictions on personal account dealing), segregation of functions, independent research functions, transaction and communication surveillance, Chinese walls, and adherence to internal and market codes.
- Market-level mitigants include codes of market practice, market surveillance, and disclosure of client names in government bond markets, which could reduce the risk of 'painting the tape'.<sup>37</sup>

Other areas of market abuse raised by market participants are non-disclosure of fees and commissions charged by intermediaries, higher margins charged in single-bank relationships, an over-charge on credit valuation adjustments (CVAs)<sup>38</sup> by banks, the use of algorithmic trading by the buy-side, and trading in dark pools (see Chapter 5 for a detailed discussion of dark pools).

## 3.5.3 INTERNATIONAL STANDARDS AND GUIDANCE

### 3.5.3.1 IOSCO

In 2013, IOSCO updated its 2000 report 'Investigating and prosecuting market manipulation' by recognising that because of developments in technology, new market structures and ways of trading in capital markets (e.g. high-frequency and algorithmic trading, market fragmentation and dark liquidity, direct electronic access, colocation) have emerged, as have new methods of market manipulation such as spoofing, manipulation of benchmark prices such as the London Interbank Offered Rate (Libor), and manipulation via unauthorised buying and selling on hijacked accounts. Methods of manipulation identified in 2000 remain in play, namely painting-the-tape, wash sales, improper matched orders, advancing the bid, marking the close or banging the close, pumping and dumping, creating an abusive corner or squeeze, and disseminating false or misleading market information.

The tools for preventing market manipulation focus on maintaining the integrity of the market price of financial instruments and include short-selling rules, rules limiting participation by interested parties during offerings, different methods for calculating an index as well as requirements relating to the timing of the calculation and announcement of the level (oversight now actively regulated per the 2013 addendum), and contract design and the position limits of derivatives.

Tools for detecting market manipulation include market surveillance and the surveillance of information provided to the public (e.g. media and the Internet).

The 2000 IOSCO report deals in detail with investigating and taking enforcement action against manipulation. It also deals with the cooperation required between exchanges, between exchanges and regulators, between regulators and other authorities and international cooperation.

<sup>37</sup> Market participants attempt to influence the price of a security by buying and selling it among themselves to give the impression of extensive trading activity.

<sup>38</sup> In the context of Basel III, the fair value of a derivative instrument should reflect the variations of the credit quality of the counterparty over time. To reflect these changes, an adjustment, known as the credit valuation adjustment (CVA) is made to the risk-neutral price to account for the specific risk of the counterparty.





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The 2013 addendum to the 2000 report acknowledged the new risks for investors and challenges for regulation as a result of the evolution and growth of OTC markets. The report stresses that unlike exchanges, direct legally enforceable relationships rarely exist between OTC markets and the issuers quoted on them, as OTC markets are largely unregulated or operate under minimal regulation and generally do not have listing standards. OTC markets are now quoted online and real-time quotes are accessible by market participants and investors. This may create risks to investors if (i) fraudsters obtain access to potential victims in real time; and (ii) OTC markets are used to develop and refine manipulative practices due to the low level of supervision.

## 3.5.3.2 EU Market Abuse Regulation

The EU Market Abuse Regulation (MAR)<sup>39</sup> defines market abuse as unlawful behaviour in the financial markets, consisting of insider dealing, unlawful disclosure of inside information and market manipulation. Such behaviour prevents full and proper market transparency. The scope of the regulation includes any financial instrument traded on a regulated market, a multilateral trading facility (MTF) or an organised trading facility (OTF), and any other conduct or action that can have an impact on such a financial instrument, irrespective of whether it takes place on a trading venue, which should improve investor protection, protect the integrity of markets and clearly prohibit the market abuse of such instruments.

The MAR also covers the manipulation of benchmark calculations and orders to trade in one product to affect the price of a related instrument. It includes surveillance requirements across securities that are not necessarily explicitly related, such as the monitoring of trading across instruments that have an economic relationship with each other (and not just securities/assets and their derivatives).

**The European Securities and Markets Authority's (ESMA) technical standards requires compliance in four stages, namely identification, mapping, monitoring and reporting. These stages are described below:**

- **Identification** refers to identifying market abuses applicable to a firm. ESMA has included a comprehensive list of market abuse behaviours, including collusion, ping orders, phishing, concealing ownership, quote stuffing, no intention of executing orders, momentum ignition, and smoking.
- **Mapping** refers to linking abusive behaviour to red flags and indicators so that the behaviour can be monitored.
- **Monitoring** refers to observing the behaviour identified by the alerts on an ongoing basis. Appropriate documentation is required to demonstrate due diligence. The monitoring stage should also provide feedback on how accurate the red flags and indicators are.
- **Reporting** refers to documenting the behaviour that triggers alerts. Audit trails can be used to demonstrate compliance and for risk management purposes.

## 3.5.4 RECOMMENDATIONS

The FMA has anti-market abuse provisions that prohibit insider trading, market manipulation and the disclosure of false or misleading information. Market abuse is subject to both administrative and criminal sanctions. The potential for market abuse is monitored by the exchanges, which refer suspicious activity to the regulator (now the FSCA). Decisions on investigations and on administrative enforcement actions were taken by the Directorate of Market Abuse and by the Enforcement Committee respectively<sup>40</sup>. Although administrative sanctions have been imposed, there has been only one criminal conviction for market abuse.

<sup>39</sup> <https://www.esma.europa.eu/regulation/trading/market-abuse>

<sup>40</sup> Under the consequential amendments of the FMA by the FSR Act, the role of the Directorate of Market Abuse will change to a body making recommendations on investigations. The FSCA is to determine its functions and duties. The FSCA will make decisions previously made by the Enforcement Committee.



# Market Conduct

The FMA's market abuse provisions do not apply to all markets and transactions (e.g. unlisted derivatives that have listed securities or derivatives as underlying instruments). It is recommended that National Treasury consider including a market abuse regulation (MAR) catch-all clause in the FMA such as that in the EU and UK. Market abuse provisions apply to:

- a. financial instruments admitted to trading on a regulated market or for which a request for admission to trading on a regulated market has been made;
- b. financial instruments not covered by point (a), the price or value of which depends on or has an effect on the price or value of a financial instrument referred to in those points, including, but not limited to, credit default swaps and contracts for the difference.

## Box 3.2: A specific case: the transparency of short selling

Research analysts study companies and industries, analyse different raw data, and often make forecasts and recommendations about whether to buy, sell or hold securities. Investors often view analysts as experts on, and important sources of, information about the securities they cover and therefore rely on their advice. In January/February 2018, Viceroy short sold Capitec shares and then issued a negative report on the firm. The report disclosed that Viceroy had short sold the share. This disclosure was made with the report, not when the short sale occurred. To avoid being accused of spreading a rumour to affect a market price, analysts need to demonstrate that they have based their investment views on verifiable facts and reasonable assumptions.

Should rumour spreading to impact a market price be considered market abuse in South Africa?

IOSCO recognises that while short selling can be beneficial to market liquidity, regulation is required to help prevent manipulative practices associated with significant short-selling<sup>41</sup>. One such regulatory requirement is that short sales be disclosed and at a minimum be reported to the regulator. South Africa is not compliant with this IOSCO principle as it does not have reporting requirements for short selling. It is recommended that regulators consider requiring that short sales be flagged on exchanges and reported to the exchange and/or the regulator. FSCA 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.

## 3.6 MONITORING AND SURVEILLANCE

### 3.6.1 INTRODUCTION

Surveillance is generally understood to be a process for creating visibility by collection and analysing copious amounts of data, through possibly using expert systems and other artificial intelligence, to identify matters of relevance to firms and regulatory authorities. Firms use it to identify internal infringements, and regulators and exchanges use it to detect abusive, manipulative and illegal trading practices that could disrupt markets as well as other issues of systemic importance, which has becoming increasingly important with increased financial market fragmentation and globalisation.

<sup>41</sup> <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf>



# Market Conduct

## 3.6.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

Market participants indicated that their monitoring, surveillance and reporting processes include examining infringements such as missed trades, failed trades and risk limit breaches that are escalated; conducting tests performed on traders' telephone recordings, chats and broker recordings; conducting trade surveillance; ensuring the review of and clearances for personal account dealing; controlling insider trading; and ensuring the clearance of conflicts of interest.

The JSE believes its surveillance capability is exceptional and that incidences of market abuse are unlikely to go undetected.

## 3.6.3 INTERNATIONAL STANDARDS AND GUIDANCE

### 3.6.3.1 Surveillance at market and cross-market level

The IOSCO 'Methodology for Assessing Implementation of the Objectives and Principles of Securities Regulation' states the following:

- Principle 10: The regulator should have comprehensive inspection, investigation and surveillance powers.
- Principle 12: The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance programme.
- Principle 36: Regulation should be designed to detect and deter manipulation and other unfair trading practices.
- Principle 37: Market authorities should have an effective compliance and enforcement system that includes the surveillance of short-selling activities.

According to IOSCO, the role of the regulators in obtaining relevant data for purposes of market surveillance and monitoring is important. It is also challenging as wholesale financial markets are often fragmented with multiple platforms and infrastructures and are generally opaque. IOSCO's work has established that minimum expectations about market surveillance and audit trail capabilities of market authorities are to:

- conduct market surveillance on a timely basis;
- conduct post-trade analytics;
- reconstruct trade events (entire market view);
- ensure data quality;
- access information about trades/positions or any other information needed for effective market surveillance, including being able to obtain information to have a view of larger traders; and
- obtain certain minimum information fields, including audit trail data for orders, and trades of equities and derivatives.

Market surveillance involves the ongoing scrutiny of activities in financial markets to give regulators broad insight into potential market misconduct or other problems and can give regulators information that is critical to their ability to bring enforcement actions addressing misconduct. It also may include an analysis of reports that consolidate a variety of data sources, including raw market data and trade reports submitted by firms and individuals. Market regulators can aggregate and analyse transaction data from multiple markets to obtain a clearer picture of market dynamics, supervise overall market conditions, and identify any anomalies. For example, regulators may conduct surveillance to detect potential insider trading and market manipulation, discern patterns and trends in individual trading misconduct, obtain a cross-market perspective on a given set of activities, detect evidence of cyber breaches related to the markets, and monitor systems outages that could impact the financial system. To achieve this, market regulators will need sufficiently skilled staff, adequate surveillance and audit trail capability, and the ability to adapt to technological changes, including to keep up with the volume of message traffic.

# Market Conduct

Market surveillance is often more than the collection and cursory analysis of market data. It often encompasses detailed analysis of market data from a variety of sources to gain market insight on misconduct. A centralised system for external sources – including whistle-blowers and other regulators – to submit complaints and referrals on a confidential basis may enhance a regulator’s risk-monitoring processes, in addition to serving as an integral component of an enforcement framework. Regulators can also incorporate observations from firms’ or regulators’ own risk monitoring into their broader supervisory efforts, leveraging risk analyses to set supervisory priorities going forward.

## 3.6.3.2 Surveillance at firm level

Firms have their own monitoring and surveillance tools and metrics, including real-time data gathering and analysis; retrospective audit-style monitoring; the use of sample testing; the monitoring of communications and recorded telephone conversations in the front office; the monitoring of leave, password sharing and trade amendments; information barrier surveillance and transaction surveillance for market manipulation risks; the monitoring of intra-day risk levels against predefined thresholds to identify potentially inappropriate trading behaviour; and the surveillance of high-volume trades or unusual trading activities.

Ideally, a firm’s surveillance framework should include automated post-trade surveillance with broad product coverage, automated communication surveillance for all written communication channels such as email, internal and external chats as well as manual or automated voice surveillance targeted by risk.

Firms that have robust surveillance and monitoring tools may contribute to regulators’ market surveillance once trade repository reporting with consistent reporting requirements for OTC markets commences.

## 3.6.4 RECOMMENDATIONS

South African licensed exchanges operate systems designed to detect unusual trading volumes and price movements that could indicate insider trading or market manipulation. When activity generates an alert that indicates possible market manipulation, an initial investigation is undertaken and the results will be brought to the attention of the FSCA (previously the Directorate of Market Abuse). Cross market surveillance is not in place in South Africa.

It is recommended that regulators consider implementing market surveillance and monitoring systems for OTC markets and fragmented exchange-traded markets. However, fully functional trade repositories will be a prerequisite to accept and analyse the data submitted. There are currently no operational trade repositories in the OTC markets, except possibly for the database of SARB’s Financial Surveillance Department, which holds only settlement trades and not intermediate trades or cancelled trades.

It is recommended that the regulators consider providing standards for surveillance to firms. Although institutions appear to have surveillance and monitoring systems and processes in place, practices may be inconsistent across markets.





**national treasury**  
Department of  
National Treasury  
REPUBLIC OF SOUTH AFRICA



South African Reserve Bank



**FSCA**  
Financial Sector  
Conduct Authority



# 2018 FINANCIAL MARKETS REVIEW

## MARKET STRUCTURE

# Market structure

## 4.1 SUMMARY OF RECOMMENDATIONS

Issue to be addressed	Recommendation
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)
	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
Transparency	22. Regulators to consider implementing the Global Financial Markets Association's (GFMA) Guiding Principles for Market Transparency Requirements to further support market integrity
	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
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
	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
Market makers / Primary dealers	26. National Treasury and regulators to encourage the implementation of measures to promote price transparency for most (if not all) OTC financial instruments
Securities financing transactions (SFTs)	27. Regulators to consider implementing trade repositories as an effective way to collect comprehensive market data for SFTs
	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 FSCA is drafting Conduct Standards for SFT participants, which will include reporting requirements)
	29. Regulators to investigate the necessity and ways to expand the repurchase (repo) market. (Note: Work is underway in the Working group of Financial Market Steering Committee)
Benchmarks	30. The South African Reserve Bank (SARB) to finalise the recommendations for interest rate benchmarks and implement the recommendations. (Note: work is underway in the SARB Working Group on Rand Interest Rate Benchmarks)

# Market Structure

## 4.2 LIQUIDITY

### 4.2.1 INTRODUCTION

Market liquidity – the ability to rapidly execute large financial transactions with a limited price impact – is a key feature of financial market efficiency and functioning. As witnessed during the financial market crisis of 2007–08, market liquidity in financial markets can evaporate quickly. For sovereign and, to an even greater degree, corporate bond markets, liquidity hinges mainly on the capacity and willingness of market makers and, to some extent, proprietary traders to absorb temporary demand–supply imbalances by taking on inventory risk.

### 4.2.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

It is the view of certain market participants that the wholesale markets appear increasingly prone to volatility because of illiquidity. This is of particular concern in periods of market stress when the ability to execute transactions and mitigate risk is curtailed. Several contributing factors could include more stringent capital requirements, a reduction in natural risk-takers such as bank proprietary desks and hedge funds as well as the more recent trend of market participants focusing on key target markets and exiting non-core activities.

South African markets are described as intermediately liquid and transparent when there are several major market participants on both the buy and sell-side. The relative size of the local market compared to the major industrialised nations and regions is commensurate with a relatively less liquid market. It is possible that forthcoming regulatory changes, such as the Basel Committee on Banking Supervision's (BCBS) Fundamental Review of the Trading Book, will penalise South Africa's relative illiquidity.

**Interest rate derivatives:** These are still largely traded over the counter (OTC) but significant screen pricing is observed providing price discovery and liquidity. The introduction of central clearing requirements, locally and internationally, on standardised OTC derivative products should increase observability. Post-trade transparency does not currently exist. However, this is expected to change as local trade repository reporting requirements are implemented.

**Bonds:** In general, there is pre-trade transparency, with further transparency and price discovery expected with the introduction of the electronic trading platform between primary dealers. There is less post-trade transparency, with less general market visibility, and limited regulatory reporting.

**Money market:** Liquidity varies by product type and market demand. There is significant transparency for generalised products quoted with on-screen rates (e.g. negotiable certificates of deposit (NCDs)), but less transparency for products quoted off-screen (e.g. deposits).

**Foreign exchange:** The rand is regarded as one of the more liquid emerging market currencies and is viewed as highly liquid with significant price transparency and discovery.

In general, market participants believe the market is fair, effective and with good integrity, but with challenges in terms of limited liquidity depth and limited price providers in certain products, and skills shortages in some places. Examples are foreign exchange optionality, index derivatives, structured products and equity volatility.



# Market Structure

While the government bond market is functioning well, the corporate bond market is illiquid and with deficiencies in the price discovery process. The functioning of the structured note market is another area of concern.

## 4.2.3 INTERNATIONAL STANDARDS AND GUIDANCE

### 4.2.3.1 United Kingdom Fair and Effective Markets Review

The United Kingdom's (UK) Fair and Effective Markets Review (FEMR) states that their fixed income, currency and commodities (FICC) markets have historically demonstrated important strengths, namely tight pricing and deep liquidity for more actively traded instruments such as government bonds, standardised derivatives and major foreign currencies, and facilitation of trading in a wide range of less standardised assets, tailored to users' needs. The commitment of capital by market makers, trading as principals, has helped sustain liquidity in a number of secondary FICC markets, particularly for more bespoke assets, larger trade sizes, and during periods of market-wide stress.

Liquidity in some FICC markets is lower than it was before the financial crisis and it is argued that regulations such as capital requirements have contributed to that.

In several jurisdictions, the systems of primary dealers and of interdealer brokers help enhance market liquidity.

### 4.2.3.2 IOSCO's study on the liquidity of the secondary corporate bond markets

In 2017, International Organization of Securities Commissions (IOSCO) issued its final report on the liquidity of the secondary corporate bond markets<sup>42</sup>. South Africa participated in the study, which is relevant as South African market participants have raised corporate bond illiquidity as a hindrance to the price discovery process (see 4.2.2) – a perception that exists in many jurisdictions. It appears that South Africa's corporate bond market activity, except turnover<sup>43</sup>, is substantially lower than that of other emerging economies (see figures 4.1, 4.2 and 4.3).

<sup>42</sup> <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD558.pdf>

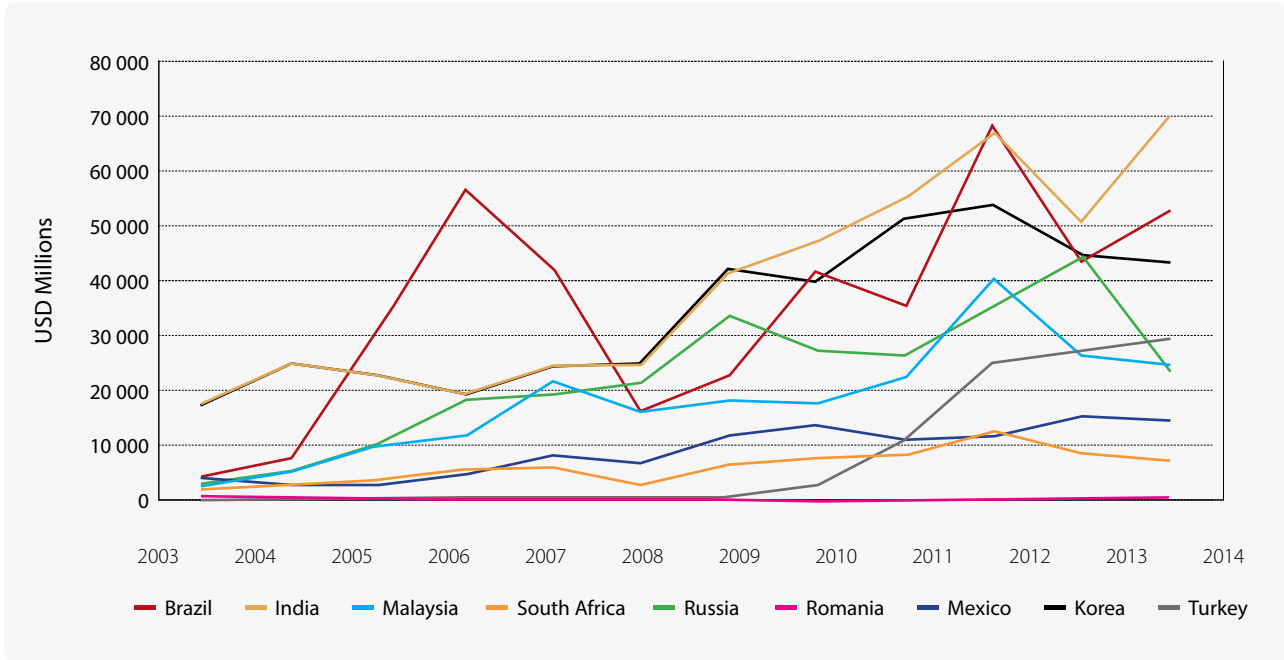
<sup>43</sup> Turnover is typically calculated as total trading volume per year divided by total debt outstanding





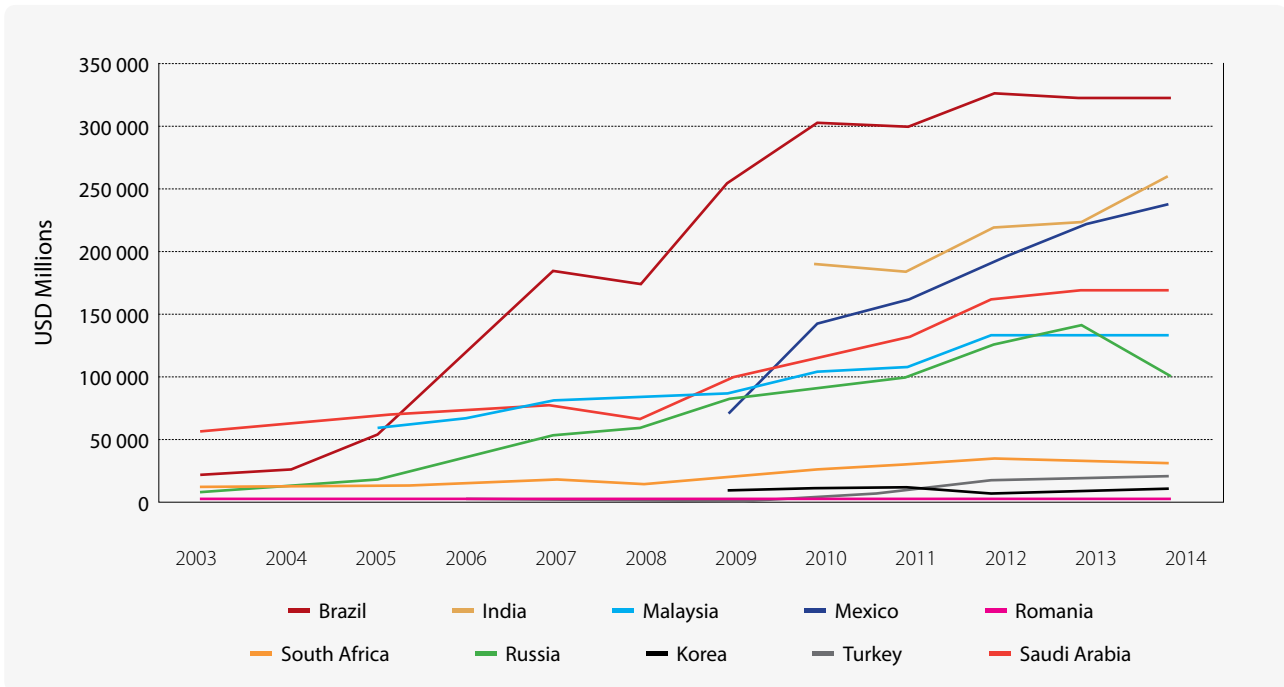
# Market Structure

Figure 4.1: Emerging economies' annual corporate bond issuance



Source :IOSCO

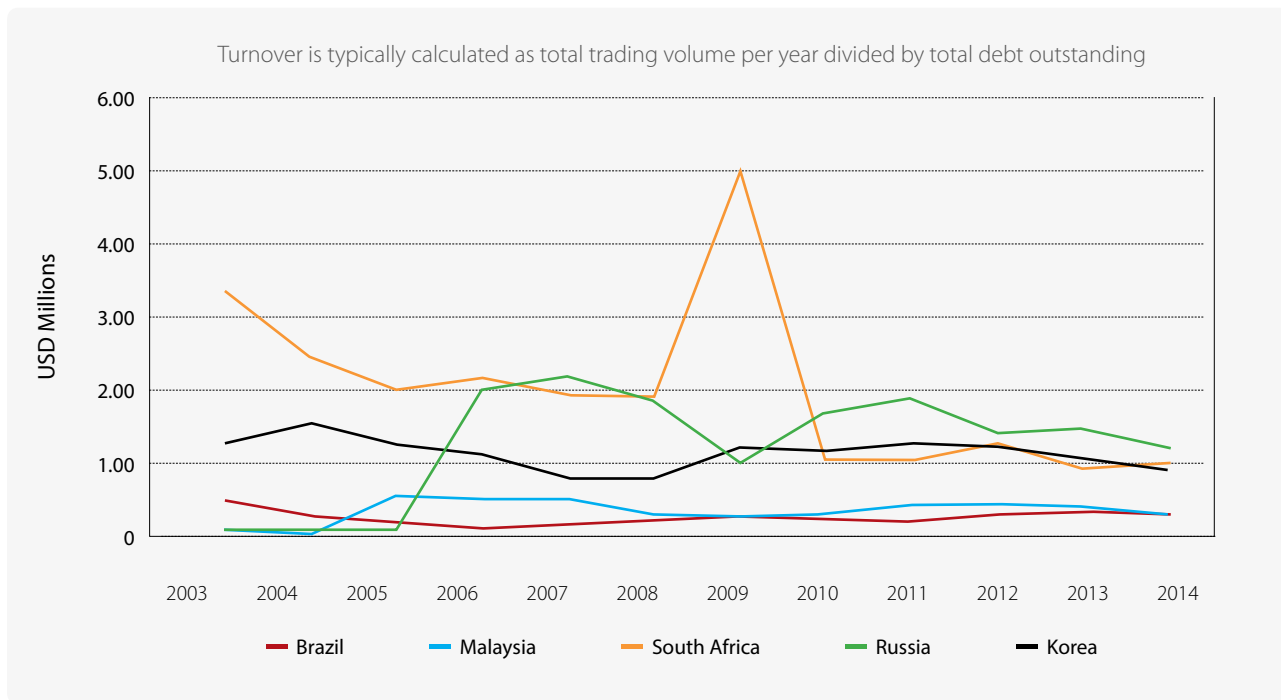
Figure 4.2: Emerging economies' corporate bond debt outstanding



Source :IOSCO

# Market Structure

**Figure 4.3: Emerging economies' corporate bond turnover (%)**



Source: IOSCO

IOSCO's study revealed significant changes to the characteristics and structure of the secondary corporate bond markets, including changing dealer inventory levels, increased use of technology and electronic trading venues, and changes in the role of participants and execution models (i.e. dealers shifting from a principal model to an agency model). Through using many different metrics to measure corporate bond market liquidity, IOSCO found potential signs of lower liquidity in metrics such as turnover ratio, dealer inventories, and block trade size; mixed evidence of changes in liquidity in metrics such as divergence of trading (e.g. less liquid assets being traded relatively less), average trade size, and average number of counterparties or market makers; and evidence of improving liquidity in indicators such as trading volume, bid-ask spreads, and price-impact measures. Based on the totality of information collected and analysed, IOSCO did not find substantial evidence showing that liquidity in the secondary corporate bond markets has deteriorated markedly from historic norms for non-crisis periods.

## 4.2.4 RECOMMENDATIONS

It is recommended that regulators consider investigating deficiencies in price discovery in certain instruments (e.g. foreign exchange optionality, index derivatives, structured products, equity volatility derivatives, corporate bonds and structured notes).

It is further recommended that regulators consider investigating the characteristics and structure of South Africa's primary and secondary corporate 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.

# Market Structure

## 4.3 TRANSPARENCY

### 4.3.1 INTRODUCTION

According to the Global Financial Markets Association (GFMA), “Market transparency requirements should support specific policy objectives, consider the fundamental structural differences between markets and among asset classes, and provide meaningful and useful information to market participants while doing no harm to market integrity, liquidity, efficiency and resilience. If designed appropriately, transparency – whether through regulatory reporting to support market surveillance duties or public dissemination – can achieve these objectives.”<sup>44</sup>

### 4.3.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

Market participants are of the view that transparency alone is not sufficient to deliver effective markets – market depth and liquidity, and open access and robust competition are also required. There are risks of unintended consequences of greater transparency, namely transparency in comparatively illiquid markets – liquidity may be further reduced if participants are unable or unwilling to undertake large trades if post-trade reporting hinders risk management.

The corporate bond market is not transparent, as it is driven by a lack of liquidity with the implication that price discovery is difficult. Respondents explain further that the market is small and predominantly buy-and-hold with a mismatch between strong demand and limited supply from a select number of issuers.

The Electronic Trading Platform for government bonds will enhance pre-trade transparency in this major part of the debt market.

There is insufficient transparency in OTC markets, particularly interest rate derivatives.

With respect to trade data and trade repository, there is no trade repository in South Africa. Trade repository reporting requirements should assist post-trade transparency in the OTC space. Available data on bonds reflects activity on the JSE and misses activity going through Euroclear.

Moving OTC trade onto electronic platforms would only be feasible and desirable in the case of liquid markets. An examination of liquidity is first needed before considering the desirability of greater transparency through moving to electronic platforms. It would also be necessary to consider the benefits and costs for participants in terms of the incentives to move from OTC structures to electronic platforms.

A central trade repository would help curb instances of market abuse in less transparent markets.

Certain market participants expressed concern that advisors and consultants to retirement funds play a role in directing the flow of capital, but there are no requirements to disclose their recommendations.

<sup>44</sup> Global Financial Markets Association. Guiding Principles for Market Transparency. April 2018. available at: <http://www.gfma.org/correspondence/item.aspx?id=993>

# Market Structure

## 4.3.3 INTERNATIONAL STANDARDS AND GUIDANCE

### 4.3.3.1 Global Financial Markets Association

In April 2018, the GFMA<sup>45</sup>, which represents the common interests of the world's leading financial and capital market participants, released 'Guiding Principles for Market Transparency Requirements'. The GFMA encourages policymakers and regulators to design market transparency frameworks in line with the following principles:

- Transparency to regulators should be timely, consistent and appropriate to fulfil market surveillance duties and to support market integrity.
- Public market transparency requirements should support the provision of liquidity for price formation and risk management, while doing no harm to market integrity, liquidity, efficiency and resilience.
- The level of transparency and timing for reporting should be appropriately calibrated based on regulatory intent, market structure and liquidity profiles of specific assets.
- An effective transparency framework is based on consultation with all market participants and a cost-benefit analysis.
- The market's ability to implement requirements, including on a cross-border basis, if appropriate, is critical.

### 4.3.3.2 UK FEMR

Several regulatory changes are likely to improve transparency in FICC markets over time. A progressive transfer of derivatives business onto exchanges or electronic venues is expected because of reforms agreed to by the Group of Twenty (G20) in 2009 and implemented in Europe through The European Market Infrastructure Regulation (EMIR) and Market in Financial Instruments Directive (MiFID II), and in the United States (US) through the Dodd–Frank Act. In 2017 the MiFID rules relating to pre- and post-trade transparency will be extended to a wider range of FICC assets. The European Union (EU) Regulation on Energy Market Integrity and Transparency (REMIT) for wholesale energy markets came into force in December 2011. REMIT requires energy market participants to provide records of transactions to a registered reporting mechanism such as a trade repository and to publicly disclose inside information timeously.

**Initiatives to increase transparency in securitisation markets include:**

- The introduction of loan-level information requirements the Bank of England and the European Central Bank (ECB) as part of their collateral eligibility criteria.
- Ongoing work by the European Securities and Markets Authority (ESMA) to seek further improvements in the disclosure of transaction documentation and performance information.

MiFID II will extend pre- and post-trade transparency requirements to FICC markets. These obligations will apply to all multilateral trading venues (regulated markets, multilateral trading facilities (MTFs) and organised trading facility (OTFs)) and to organised forms of bilateral trading conducted by 'systematic internalisers' (including, for example, large OTC market makers).

<sup>45</sup> Members of the GFMA are The Association for Financial Markets in Europe (AFME), Asia Securities Industry & Financial Markets Association (ASIFMA) and Securities Industry and Financial Markets Association (SIFMA).



# Market Structure

The MiFID II Transparency Regime should enhance the fairness and effectiveness of FICC markets, as was noted by many respondents to the FEMR's consultation. However, implementation requires care. For example, applying transparency requirements to large transactions or transactions in illiquid instruments can make it difficult for market makers to trade such instruments without suffering an adverse price movement and may require them to widen spreads to price in this risk, which will reduce market effectiveness for end users. The MiFID II framework seeks to address this issue for illiquid assets and large-scale transactions by introducing waivers from pre-trade transparency requirements and deferrals for post-trade reporting.

Since MiFID II introduces a more ambitious system of transparency than has ever been previously implemented it is important that the regime is reviewed regularly.

### 4.3.3.3 IOSCO's survey result on corporate and government bond markets

IOSCO found that in most jurisdictions in the Asia Pacific region for bonds traded OTC, post-trade information (e.g. executed prices and trading volume) is generally more accessible than pre-trade information (e.g. bid/offer prices) for which access is mainly open to alternative trading system (ATS) members or other information vendor subscribers such as dealers or market makers. Unlike in case of corporate bond trading, the information of government bond trading is more accessible in most jurisdictions because of its higher liquidity and more facility providers.

### 4.3.3.4 IOSCO Regulatory Reporting and Public Transparency in the Secondary Corporate Bond Markets<sup>46</sup>

With respect to secondary corporate bond markets, IOSCO recommends the following:

- Regulatory authorities should be able to obtain the information necessary to develop a comprehensive understanding of the corporate bond market in their jurisdiction. This understanding should include the characteristics of the market and the types of bonds traded.
- To facilitate cross-border understanding among regulators of corporate bond markets, regulatory authorities should make a clear framework and underlying methodology of regulatory reporting and transparency available.
- Regulatory authorities should have access, either directly or upon request, to pre-trade information, where it is available, relating to corporate bonds. This might include information other than firm bids and offers, such as indications of interest.
- Regulatory authorities should consider steps to enhance the public availability of appropriate pre-trade information relating to corporate bonds, considering the potential impact that pre-trade transparency may have on market liquidity.
- Regulatory authorities should implement post-trade transparency requirements for secondary market trading in corporate bonds. Taking into consideration the specifics of the market, these requirements should be calibrated in a way that a high level of post-trade transparency is achieved. They should also consider the potential impact that post-trade transparency may have on market liquidity. Post-trade transparency requirements should include, at a minimum, the disclosure of information about the identification of the bond, the price, the volume, the buy/sell indicator and the timing of execution.
- Where there is transparency of post-trade data relating to corporate bonds, regulatory authorities should take steps to facilitate the consolidation of that data.

<sup>46</sup> <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD597.pdf>



# Market Structure

## 4.3.4 RECOMMENDATIONS

The European Commission Expert Group on Corporate Bond Market Liquidity concluded that, “A well-calibrated trade transparency regime can provide numerous benefits: (i) improve data quality; (ii) reduce information asymmetries; (iii) enhance price discovery; and (iv) increase market efficiency.”<sup>47</sup> Consequently Regulators consider implementation of the GFMA’s Guiding Principles for Market Transparency Requirements to further support market integrity.

In addition, consistent with IOSCO principles that promote transparency of trading information, it is recommended that regulatory authorities should consider steps to enhance pre-trade transparency in corporate bond markets and implement post-trade transparency by way of, for example, trade repositories.

## 4.4 COMPETITION

### 4.4.1 INTRODUCTION

As in most sectors of the economy, the benefits of full, effective competition in financial markets financial sector are enhanced efficiency, the provision of better products to final consumers, greater innovation, lower prices and improved international competitiveness.

### 4.4.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

**Around one-third of market participants responses suggested that there are no substantial restrictions or undue barriers to entry. The restrictions to competition in South Africa’s wholesale markets that were identified include:**

- The capital required to participate in markets; regulatory barriers to entry and the cost of regulatory compliance; the skills required and the strict requirements for affiliation with market structures. While these features may create barriers to entry this should be weighed against their importance for the safety and soundness of financial markets. Requirements for participation should be proportionate but are not necessarily anti-competitive in nature.
- Differences in local and international regulatory requirements are also noted as a potential barrier to greater foreign participation, for example through potential inconsistencies between local and international rules in the OTC derivative space, with the implication that reforms in South Africa should be cognisant of the international environment.
- Exchange control was noted as a barrier to competition in the foreign exchange market. This is viewed as a limiting factor both for foreign participation and South African resident participation in the market. The cost and compliance requirements for ADs – and associated advantage for larger institutions – are also noted.
- With respect to concentration in specific markets: the historical dominance of the JSE is noted, as well as barriers to alternative trading platforms and infrastructures. The limited number of institutions active in the debt market is highlighted. It is also suggested that large firms with diverse distribution networks and appetite for warehousing risk for periods of time have a competitive advantage. Tight pricing in markets (for instance, in fixed income) is further identified as a hurdle for smaller entrants and, related to low profit margins, large institutions fulfilling a wide range of roles for their clients are argued to have an advantage over smaller and independent market participants.

<sup>47</sup> [https://ec.europa.eu/info/files/171120-corporate-bonds-report\\_en](https://ec.europa.eu/info/files/171120-corporate-bonds-report_en)



# Market Structure

## 4.4.3 INTERNATIONAL STANDARDS AND GUIDANCE

### 4.4.3.1 UK FEMR

MiFID II will extend non-discriminatory access requirements to FICC trading venues. Many FICC markets have a two-tier structure of separate dealer-to-dealer and dealer-to-client markets. Dealer-to-dealer markets allow market makers to lay off risk among themselves in a way that maximises their market-making ability. Access to these markets should be appropriate and only exclude participants to ensure the effective functioning of the market. Furthermore, access should be free from artificial barriers and not introduce or maintain access criteria that serve to exclude market participants unnecessarily.

## 4.4.4 RECOMMENDATIONS

Regulators consider addressing the identified restrictions to competition: capital required to participate in markets; regulatory barriers to entry; the cost of regulatory compliance; the strict requirements for affiliation with market structures.

Since this work may support the regulatory ambit of the Competition Commission it is recommended that regulatory authorities 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.

## 4.5 MARKET MAKERS/PRIMARY DEALERS

### 4.5.1 INTRODUCTION

Market makers serve a crucial role in financial markets by providing liquidity to facilitate market efficiency and functioning. In the equity market, issuers generally have one instrument which is subject to a single initial public offering – with the possibility of rights issues later. As a share has no redemption date, an investor must sell it in the secondary market (usually an exchange) to realise its value. By contrast, bonds trade over the counter; both electronically and via voice brokers. Whereas equities only have a single issue, government bond issuers have many outstanding issues of varying maturity; currency and type (e.g. inflation-linked). Furthermore, a good part of the market is buy-and-hold, because bonds are held to redemption. Therefore, government bonds are inherently less liquid than equities, which has resulted in a different type of market. This market is characterised by a primary dealer system.

Primary dealers are financial institutions that are appointed by sovereign issuers to buy, promote and distribute government bonds. Once a bond is issued, issuers rely on their primary dealers to make a market and support the liquidity in the product. Market participants profit from this liquidity. Quoting in the interdealer market can also take the form of a quoting obligation. Under this obligation, which forms part of most primary dealer contracts, banks are obliged to quote two-way prices to each other within a certain spread and for a number of hours per day. Prices that are formed in this way serve as an important benchmark throughout the market. As this can create a cost to the primary dealer, the issuers can in turn provide them with certain incentives, such as access to auctions, consideration for syndications and access to a non-competitive bidding facility after an auction, or the possibility to compete for derivatives contracts.

# Market Structure

## 4.5.2 IN SOUTH AFRICA

### 4.5.2.1 Primary dealers

A panel of primary dealers was appointed by National Treasury to market government's domestic capital market debt instruments as from 1 April 1998, subject to these institutions being able to fully conform to a set of qualifying criteria. The qualifying criteria include the following:

- Primary dealers must be local banking institutions or foreign banks with branch offices in South Africa.
- Market-making operations by primary dealers should not impose prudential and systemic risk to the financial markets.
- Primary dealers are required to continuously quote firm bid and offer yields in selected benchmark government bonds and to participate meaningfully in regular auctions in government bonds.

Primary dealers operate under the Primary Dealers Code of Conduct.

### 4.5.2.2 The view of market participants

Market participants emphasised that only primary dealers can submit bids in the weekly government bond auctions, which suggests that there is unfair access to information and the market.

One participant highlighted the approach to end-of-day mark to market on government through polling primary dealers for rates on benchmark bonds. It is suggested that a central order book would create the transparency and ability for more participants to be involved in setting the closing levels, such as end-of-day auction on equities.

## 4.5.3 INTERNATIONAL STANDARDS AND GUIDANCE

In many jurisdictions, access to the primary central government debt market is restricted to primary (or 'authorised') dealers. Primary dealers are appointed by the sovereign issuer or its agent to buy, promote and distribute sovereign debt securities. In addition (typically) to preferential access to sovereign debt auctions, they often benefit from other privileges such as (i) eligibility to participate in non-competitive auctions; (ii) access to the fiscal agent's or central bank's securities lending facilities; or (iii) being considered by the agent as a privileged counterparty for debt management operations (e.g. syndicated issuance, buybacks and swaps).

In turn, primary dealers in many countries are obliged to meet specific requirements in the primary market, often including quantitative thresholds for auction participation as well as market-making obligations in secondary markets. These obligations differ across jurisdictions, with some requiring primary dealers to continuously quote firm two-way prices, including limits on bid-ask spreads and minimum amounts of quoted volumes, whereas others provide more leeway to primary dealers in adjusting their quotes.

Large banking groups tend to have many primary dealer mandates, reinforcing the close ties between primary and secondary sovereign bond markets. Yet, interviews with market participants suggest that many dealers have been concentrating their efforts on a reduced number of core market segments, even though the incentives offered to primary dealers tend to be more generous for smaller, less liquid sovereign bond markets. This could affect secondary market liquidity in those markets where the remaining primary dealers lack the capacity to take up the market share.





# Market Structure

## 4.5.4 RECOMMENDATIONS

Transparency and price discovery in government bonds is expected to improve with the introduction of the electronic trading platform in July 2018. However, this will be between primary dealers. It is recommended that National Treasury and regulators encourage the implementation of measures to promote price transparency for most, if not all, OTC financial instruments.

## 4.6 SECURITIES FINANCING TRANSACTIONS

### 4.6.1 INTRODUCTION

Securities financing transactions (SFTs) are defined as any transactions where securities are used to borrow cash, or vice versa, including repurchase (repo) transactions, securities lending and margin trading transactions.

### 4.6.2 IN SOUTH AFRICA

The FSCA has proposed a new code of conduct which participants in the securities financing market will need to adhere to in future. The Code of Conduct for Parties to SFTs in the South African Securities Markets has been released in draft form.

The FSCA is finalising Conduct Standards in place of the Code of Conduct.

**The code of conduct will be binding on all parties involved in SFTs (including officers, employees and clients) and requires, among other things:**

- prudent practices and standards of market conduct;
- disclosure of whether parties to an SFT are acting as principal or agent;
- parties understand and are mindful of the tax regulations applicable to SFTs under the Income Tax Act 58 of 1962;
- accounting treatment of SFTs is in accordance with prescribed financial accounting standards;
- that all SFTs be arranged through or concluded with authorised financial institutions (which are subject to regulatory oversight);
- the principles of Treating Customers Fairly to be adhered to;
- that any outsourcing of key functions remains subject to the ultimate responsibility of the SFT of the participant; and
- open and cooperative engagement between parties in the SFT market and the Financial Sector Conduct Authority (FSCA), particularly with regard to any non-compliance with the code of conduct or material operational failure relating to any party.

### 4.6.3 INTERNATIONAL STANDARDS AND GUIDANCE

The Financial Stability Board (FSB) recognises that SFTs play an important role in supporting price discovery and secondary market liquidity for a variety of securities. They are central to financial intermediaries' market-making activities as well as to their investment and risk management strategies. Such transactions can also be used by market participants to take on leverage as well as engage in liquidity and maturity transformation.

Investment funds are often involved in securities lending as the beneficial owners of securities being lent, and the actual lending of securities is often facilitated by agent lenders (e.g. custodian banks) upon instruction from asset managers. In addition, some funds (e.g. hedge funds) are also involved in securities lending as borrowers of securities, typically to cover short positions.



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Agent lenders may offer insurance-like commitments, known as borrower or counterparty indemnifications, to their clients to insure against potential losses when a counterparty defaults or does not return borrowed securities, and the pledged collateral is not sufficient to cover the replacement cost of the loaned securities.

Securities lending activities by market participants, including investment funds, can cause financial stability risks including maturity or liquidity transformation, leverage associated with cash collateral reinvestment, procyclicality, risk of a fire sale of collateral securities, and inadequate collateral valuation practices. Another potential vulnerability that may have systemic implications is the risk associated with agent lender indemnifications, especially if done on a large scale.

The FSB has 11 policy recommendations to address shadow banking financial stability risks associated with securities financing transactions, such as repos and securities lending. These aim to dampen risks and procyclical incentives associated with SFTs that may exacerbate funding strains in times of market stress. If implemented appropriately, they should eventually introduce consistency in addressing financial stability risks across jurisdictions.

- **Recommendation 1:** Authorities should collect more granular data on securities lending and repo exposures among large international financial institutions with high urgency. Such efforts should, to the maximum possible extent, leverage existing international initiatives such as the FSB Data Gaps Initiative, considering the enhancements suggested in this document.
- **Recommendation 2:** Trade-level (flow) data and regular snapshots of outstanding balances (position/stock data) for repo markets should be collected. Regular snapshots of outstanding balances should also be collected for securities lending markets. Trade repositories are likely to be an effective way to collect comprehensive repo and securities lending market data.
- **Recommendation 3:** The FSB will provide global trends of securities financing markets (e.g. market size, collateral composition, haircuts and tenors). The FSB will set standards and processes for data collection and aggregation at the global level to ensure consistent data collection by national/regional authorities and to minimise double-counting at the global level.
- **Recommendation 4:** The Enhanced Disclosure Task Force should work to improve public disclosure for financial institutions' securities lending, repo and wider collateral management activities.
- **Recommendation 5:** Authorities should review reporting requirements, from fund managers to end-investors, against the FSB's proposal and consider whether any gaps need to be addressed.
- **Recommendation 6:** Regulatory authorities for non-bank entities that engage in securities lending (including securities lenders and their agents) should implement regulatory regimes that meet the minimum standards for cash collateral reinvestment in their jurisdictions to limit liquidity risks arising from such activities.
- **Recommendation 7:** Authorities should ensure that regulations governing the rehypothecation of client assets address the following principles:
  - Financial intermediaries should provide sufficient disclosure to clients in relation to rehypothecation of assets so that clients can understand their exposures in the event of a failure of the intermediary.
  - In jurisdictions where client assets may be re-hypothecated for the purpose of financing clients' long positions and covering short positions, they should not be rehypothecated for the purpose of financing the own-account activities of the intermediary.
  - Only entities subject to adequate regulation of liquidity risk should be allowed to engage in the rehypothecation of client assets.
- **Recommendation 8:** An appropriate expert group on client asset protection should examine the possible harmonisation of client asset rules with respect to rehypothecation, taking account of the systemic risk implications of the legal, operational and economic character of rehypothecation.
- **Recommendation 9:** Authorities should adopt minimum regulatory standards for collateral valuation and management for all securities lending and repo market participants.



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- **Recommendation 10:** Authorities should evaluate, with a view to mitigating systemic risks, the costs and benefits of proposals to introduce central counterparties (CCPs) in their interdealer repo markets where CCPs do not exist. Where CCPs exist, authorities should consider the pros and cons of broadening participation, in particular of important funding providers in the repo market.
- **Recommendation 11:** Changes to bankruptcy law treatment and development of repo resolution authorities (RRAs) may be viable theoretical options but should not be prioritised for further work at this stage due to significant difficulties in implementation.

In addition to regulatory measures, a wide range of internal risk management tools include stringent counterparty selection processes, collateral standards and haircuts, daily mark-to-market valuation, concentration limits, limits on the fraction of the portfolio lent at any one time, and periodic counterparty credit evaluations.

## Risks that are not fully addressed by regulatory measures include the following:

- Potential losses associated with indemnification-related exposures: Agent lender banks (and bank-affiliated asset managers subject to consolidated prudential oversight) are subject to the Basel capital requirements for potential losses resulting from indemnification-related exposures. By contrast, asset managers and other entities that are not affiliated with banks do not face capital requirements related to their indemnification exposures in any jurisdictions.
- Opacity risk related to indemnifications: To address opacity risk related to indemnifications, some jurisdictions require publicly offered investment funds to disclose any indemnities provided by securities lending agents. For bank-affiliated asset managers, the FSB recommended that the Enhanced Disclosure Task Force should work to improve public disclosure for financial institutions (i.e. banks) on any indemnifications provided as agents to securities lending clients, including a maturity profile of those contingent liabilities, where appropriate.

Agent lenders also reported mitigating indemnification-related risks by managing their operational risks, knowing their clients, hedging, stress testing, internal risk management, portfolio diversification, and by maintaining a diverse set of counterparties. Other ways that an agent lender may mitigate risks associated with indemnification include obtaining insurance coverage to back the indemnification commitments from one or more unaffiliated insurance companies and holding liquidity reserves against the exposure to assist in withstanding adverse liquidity shocks.

The FSB has issued recommendations on minimum haircuts for non-centrally cleared securities financing transactions.

## 4.6.4 RECOMMENDATIONS

### 4.6.4.1 Implement trade repositories

Regulators should consider implementing trade repositories as an effective way to collect comprehensive repo and securities lending market data.

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## 4.6.4.2 Advise beneficial owners (investors) of the risk of securities lending and repos

SFTs are used extensively by investment funds for efficient portfolio management to fulfil investment objectives or for enhancing returns. Since SFTs allow investment funds to access leverage on their clients' portfolios, appropriate information on such activities needs to be disclosed by fund managers to investors to allow investors to clearly understand the implications of SFTs and to select investments that meet their risk profiles. The FSB recommends that the following information be reported by fund managers to end-investors:

- the amount of securities on loan as a proportion of the total lendable assets and of the fund's assets under management, and the absolute amounts of the repo book and the reverse repo book;
- the top 10 collateral securities received by issuer, the top 10 counterparties of repos and securities lending (sources of borrowed cash, if applicable), and the top 10 counterparties of reverse repos (sources of borrowed securities);
- repos and securities lending data broken down by collateral type, currency, maturity, geography (counterparty), cash versus non-cash collateral, maturity of non-cash collateral, and settlement/clearing (tri-party, CCP, bilateral);
- reverse repo data broken down by collateral type, currency, maturity, geography (counterparty) and maturity of collateral;
- share of collateral received that is reused or rehypothecated, including information on any restrictions on the type of securities;
- split between the return from repos and securities lending and the return from cash collateral reinvestment;
- number of custodians and the amount of assets held by each; and
- The way securities received by the counterparty are held (i.e. in segregated accounts or pooled accounts).

The FSCA is drafting Conduct Standards for SFTs, which will address this recommendation.

## 4.6.4.3 Investigate necessity and ways to expand the repo market

Certain market participants suggested that there is an absence of a well-functioning repo market that allows for the trading of, or investing in, secured short-term money by any qualifying participant. It is recommended that the regulators investigate the necessity and means to expand the repo market, including expanding the investment options of money market funds to repurchase /reverse-repurchase agreements using government paper as collateral.

## 4.7 INTEREST RATE BENCHMARKS

### 4.7.1 INTRODUCTION

Credible interest rate benchmarks and reference interest rates are essential for the smooth and effective functioning and monitoring of the financial system, for financial market participants, and for central banks and regulators.

### 4.7.2 IN SOUTH AFRICA

The current design of key interest rate benchmarks in South Africa is not necessarily in line with global standards and practice. One of the most important reference rates in South Africa is the Jibar, with the three-month Jibar used by commercial banks to price a sizeable portion of assets and liabilities on and off their balance sheets. It is estimated that the total value of derivative and non-derivative contracts that reset against the three-month Jibar exceed R40 trillion. As part of normal good governance, and in line with the global drive to enhance the credibility of reference rates, the SARB reviews on a regular basis all aspects of the structure of the Jibar.



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In 2011, the SARB conducted a review of the Jibar, which focused on both the methodological and governance aspects of the Jibar determination process. The review culminated in the release of the Jibar Code of Conduct, Governance Process and Operating Rules (Jibar Code), first published on 1 March 2013. Since then, as part of the ongoing reassessment process, further changes have become necessary, based on experience of working with the Jibar Code.

In 2015, the SARB embarked on a data collection exercise aimed at establishing the extent to which the Jibar remained an appropriate and representative sample of banks' money market funding. The exercise further sought to determine the size of the underlying market relative to derivative contracts that reference the interest rate benchmark. The outcome of the exercise revealed that banks predominantly funded themselves by issuing wholesale deposit liabilities. It was also found that NCD issuance during the period under review was concentrated in the medium- to longer-term space (i.e. 6 to 12 months).

The findings of the SARB analysis raised questions about the robustness, representativeness and sustainability of the Jibar. The SARB also concluded that there were insufficient transactions in the NCD market for it to meet the IOSCO requirements on data sufficiency and benchmark design. Not only was there insufficient transaction data to view the NCD market as 'active', but the inflexibility of the three-month Jibar relative to moves in the three-month Treasury bill yield also indicated that the key three-month Jibar rate was not reflective of market conditions. The SARB also worked with the Reference Rate Working Group (RRWG) to reform the current money market overnight interest rate benchmark – the South African Benchmark Overnight Rate (Sabor).

After the 2015 Jibar review, the SARB requested banks to submit proposals on how to revise and improve the Jibar and Sabor. Proposals in this regard were tabled at the Financial Markets Liaison Group meetings in 2016. A resolution was taken that the SARB would draft a consultation paper on interest rate benchmark reforms in the domestic market. The SARB Working Group on Rand Interest Rate Benchmarks (Working Group) was established for this purpose, with representation from various departments within the SARB. In the research process, consultations were held with the largest domestic banks, asset managers, hedge funds, relevant industry bodies, the FSCA, the JSE Limited, and central securities depositories (CSDs). Following these consultations, transaction data was collected from the five largest domestic banks.<sup>48</sup> In the analyses of these data, various approaches to calculate and publish additional benchmark rates, overnight rates and RFRs were considered and form the basis of the consultation paper 'Consultation paper on selected interest rate benchmarks in South Africa'. <https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/8734/Consultation%20Paper%2030%20August%202018.pdf>.

The consultation paper is the result of such investigations and consultations with market participants on plans to reform (with the intention to strengthen) the interest rate benchmarks and, where reform is not a viable solution, to propose possible alternatives. The key objectives are to propose reforms to address the deficiencies in the existing domestic interest rate benchmarks, while ensuring they are still appropriate for the domestic market and in line with global standards and best practice. Having considered various alternatives aimed at maintaining some key aspects of the Jibar, the consultation paper proposes an unsecured term deposit curve as an alternative to the Jibar. Furthermore, the paper proposes refinements to Sabor, that is, a new Sabor money market rate, a Sabor RFR and the South African Rand Interbank Overnight Rate (ZARibor). This will add to a suite of new and potential RFRs such as general collateral repurchase (repo) rates and Treasury bill yields.

<sup>48</sup> Standard Bank, Nedbank, FirstRand Bank, Absa Bank and Investec Bank.

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The consultation paper proposes the reform of, and alternatives to, interest rate benchmarks in South Africa. The motivation behind these reform proposals is multifaceted. On the one hand, there is a need to enhance existing interest rate benchmarks by underpinning them with transaction data. On the other hand, the reform agenda seeks to promote the development and adoption of additional Ibor Plus and Ibor risk-free interest rate benchmarks to enable market participants to have choices that are 'fit for purpose'. The new and reformed Ibor Plus and Ibor RFRs will serve different purposes. Typically, for credit products, a credit-based interest rate benchmark is regarded as appropriate as it provides a hedge against adverse changes in the credit risk embedded in the underlying instrument. However, for other purposes, especially derivative contracts, an alternative benchmark reference rate that is closer to risk-free may be more appropriate. In the Ibor jurisdictions as well as the in the non-Ibor OSSG participating countries, progress towards Ibor Plus were constrained by low transaction volumes (or even a lack of transactions). With regard to the shift towards RFRs for the derivative markets, the five Ibor countries have announced their preferences for overnight RFRs as replacements for the Ibors; however, all of them encountered severe challenges to calculate term RFRs.

Furthermore, a review is also being carried out in support of the SARB's strategic initiatives which, among other things, seeks to maximise the effectiveness of monetary policy and to enhance frameworks for systemic risk identification and monitoring. These strategic initiatives are in support of the SARB's mandate of maintaining price and financial stability. A consultation paper titled 'New approach to monetary policy implementation by the South African Reserve Bank' is to be published by the SARB. A link to the paper will be provided once it has been published.

## 4.7.3 INTERNATIONAL STANDARDS AND GUIDANCE

Global interest rate benchmarks such as the London Interbank Offered Rate (Libor) and other major 'Ibors' play a fundamental role in the global financial system. After the events related to the actual and attempted manipulation of Libor in 2012, there has been a coordinated response from international regulators and central banks<sup>49</sup> to improve the robustness, reliability and transparency of interest rate benchmarks, particularly those that have been identified as systemically important. To give effect to this response, the FSB established a high-level Official Sector Steering Group (OSSG) of regulators and central banks. In July 2014, the OSSG of the FSB published a report which proposed recommendations for enhancing existing benchmarks for key interbank unsecured lending markets underpinned by transactions data (Ibor Plus). The OSSG also recommended the development and adoption of risk-free interest rate benchmarks (Ibor RF), given that there are certain financial transactions, including many derivatives transactions, that are better suited to reference rates that are closer to risk-free.

Since July 2014, the administrators of the most widely used Ibors have taken steps to strengthen their respective Ibors to meet the objectives set for Ibor Plus. These steps include reviews of respective benchmark methodologies and definitions, data collection exercises, feasibility studies, consideration of transitional and legal issues, and broad consultations with submitting banks, users and other stakeholders.

The OSSG members have also made progress in identifying potential risk-free rates (RFRs), and in some cases strategies have been identified to create liquidity in the underlying markets for the newly developed RFRs.

<sup>49</sup> These include the Wheatley Review of LIBOR, a report by the Bank for International Settlements (2013), the development of the Board of IOSCO 'Principles for Financial Benchmarks' as well as the Financial Stability Board's initiatives on benchmark reforms.



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In the US, the Federal Reserve Bank of New York has announced changes to the Effective Federal Funds Rate (EFFR) and introduced an Overnight Bank Funding Rate (OBFR) that reflects a broadened basis of unsecured borrowing by banks. Furthermore, the Alternative Reference Rates Committee (ARRC) in the US has selected the Secured Overnight Financing Rate (SOFR) as the recommended alternative benchmark rate for the USD Libor. In the UK, the Working Group on Sterling Risk-Free Reference Rates announced the Sterling Overnight Index Average (Sonia) as its preferred RFR as an alternative for the Libor, for use in sterling derivatives and relevant financial contracts. The next step will be the planning for the widespread adoption of Sonia.

As work on developing RFRs proceeds, several authorities are considering how to facilitate the availability of RFRs at terms longer than overnight.

## 4.7.3.1 IOSCO Principles for Financial Benchmarks

The following principles are intended to promote the reliability of benchmark determinations, and address benchmark governance, quality and accountability mechanisms:

- **Overall responsibility of the administrator:** The administrator is responsible for all aspects of the benchmark determination process, such as the development and determination of a benchmark, and establishing credible and transparent governance, oversight and accountability procedures.
- **Oversight of third parties:** Any outsourcing of functions should be subject to oversight by the administrator.
- **Conflicts of interest for administrators:** To address the incentives for benchmark manipulation, the policies and procedures for determining a benchmark should mitigate existing or potential conflicts of interest created by the ownership or control structure, or conflicts of interest due to other interests arising from the administrators' staff or wider group in relation to benchmark determinations.
- **Control framework for administrators:** An appropriate control framework should be in place at the administrator for the process of determining and distributing the benchmark. It should address conflicts of interest and facilitate whistle-blowing.
- **Internal oversight:** An oversight function should be in place to review and provide challenges on all aspects of the benchmark determination process.
- **Benchmark design:** The design of a benchmark should take into account factors intended to represent the economic realities of the interest the benchmark seeks to measure and to eliminate factors that might distort the value of the benchmark.
- **Data sufficiency:** The data used to construct a benchmark should be based on prices, rates, indices or values that have been formed by the competitive forces of supply and demand (i.e. in an active market) and be anchored by observable transactions entered into at arm's length between buyers and sellers in the market.
- **Hierarchy of data inputs:** Clear guidelines should be established regarding the hierarchy of data inputs and the exercise of expert judgement used for the determination of benchmarks. This principle intends to make transparent to users the way in which data and expert judgement may be used for the construction of a benchmark.
- **Transparency of benchmark determinations:** An explanation should be publicised to allow a subscriber or market authority to understand how the benchmark was determined and the extent to which judgement, if any, was used by the administrator in establishing a benchmark.
- **Periodic review:** The administrator should periodically review the conditions in the underlying interest that the benchmark measures to determine whether the interest has undergone structural changes that might require changes to the design of the benchmark methodology.
- **Content of the methodology:** The documentation and publication of the methodology should be detailed enough to allow stakeholders to understand how the benchmark is derived and to assess its representativeness.
- **Changes to the methodology:** The rationale of any proposed material change in methodology as well as procedures for making such changes should be published.

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- **Transition:** Clearly written policies and procedures should be established to address any cessation of a benchmark and to encourage subscribers and stakeholders to have fall-back provisions in contracts or financial instruments that reference a benchmark.
- **Submitter Code of Conduct:** Guidelines for submitters (Submitter Code of Conduct) should be available to any relevant regulatory authority and be made available to stakeholders.
- **Internal controls over data collection:** Appropriate internal controls should be in place over the administrator's data collection and transmission.
- **Complaints procedures:** A written complaints policy should be published in terms of which stakeholders may submit complaints concerning whether a specific benchmark determination is representative of the underlying interest it seeks to measure, application of the methodology to a specific benchmark determination as well as other administrator decisions in relation to a benchmark determination.
- **Audits:** An independent internal or external auditor should be appointed to periodically review and report on the administrator's adherence to its stated criteria and the requirements of the principles.
- **Audit trail:** Written records by the administrator should be retained for five years to safeguard necessary documents for audits.
- **Cooperation with regulatory authorities:** Relevant documents, audit trails and other documents should be available to regulatory authorities to enable them to determine the reliability of a given benchmark determination or to access information that might be needed to investigate misconduct.

## 4.7.3.2 European Commission

The European Commission's proposal for a regulation on indices used as benchmarks in financial instruments and financial contracts followed a public consultation in the wake of concerns about the integrity and accuracy of benchmarks. The 'Regulation on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds' (EU Benchmarks Regulation) became effective on 30 June 2016, with most of the provisions applying from 1 January 2018.

The EU Benchmarks Regulation is a response to the Libor and Euribor scandals and is intended to (i) improve governance and controls over the benchmark process, particularly in relation to conflicts of interest; (ii) improve the quality of input data and methodologies and ensure that data contributions are free of conflicts; and (iii) protect consumers and investors through greater transparency, rights of redress and a suitability assessment in certain cases.

The regulations introduced a common framework and consistent approach to benchmark regulation across the EU. It aims to ensure benchmarks are robust and reliable, and to minimise conflicts of interest in benchmark-setting processes. The regulations are also intended to prohibit the use in the EU of unauthorised benchmarks, including benchmarks prepared by unregistered non-EU administrators from non-equivalent jurisdictions, and to enhance the single market by creating a common framework across member states. By limiting the ability of national administrators to set benchmarks rates using their own discretion, it is hoped that conflicts of interests will be reduced and confidence will be restored in the accuracy and integrity of benchmarks.

Administrators of benchmarks must (i) apply for and obtain authorisation and/or registration from their competent authority; and (ii) adhere to various requirements, including in relation to internal governance and benchmark methodology.

*Contributors* to benchmarks must comply with the applicable code of conduct and contribute data for critical benchmarks where required, among other things.

*Users* of benchmarks may only use benchmarks provided by registered administrators.





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Benchmarks of non-EU administrators may only be used in the EU where (i) the administrator is authorised or registered under an equivalent third-country regime; (ii) the administrator is recognised by Member State authorities pending an equivalence decision; or (iii) the benchmark is endorsed by an EU administrator.

The requirements of the EU Benchmarks Regulation vary according to (i) the nature of the benchmark's underlying asset(s) (i.e. interest rate and commodity benchmarks); (ii) the significance of the benchmark in relation to financial markets (i.e. critical, significant and non-significant benchmarks); and (iii) the source of benchmark data inputs (i.e. regulated data benchmarks).

The Regulation has generally applied since 1 January 2018. However, certain transitional provisions are provided. An index provider providing a benchmark on 30 June 2016 has a transitional period until 1 January 2020 to apply for authorisation or registration as an administrator. An index provider may continue to provide an existing benchmark until 1 January 2020.

## 4.7.4 RECOMMENDATIONS

It is recommended that the process for the finalisation of the SARB recommendations be completed and the finalised recommendations be implemented. It is also recommended that in this process the SARB, as the administrator and regulatory authority, consider how it will implement the IOSCO principles for financial benchmarks.



**national treasury**  
Department of  
National Treasury  
REPUBLIC OF SOUTH AFRICA



South African Reserve Bank



**FSCA**  
Financial Sector  
Conduct Authority



# 2018 FINANCIAL MARKETS REVIEW

TRADING VENUES AND  
TECHNOLOGY

# Trading venues and technology

## 5.1 SUMMARY OF RECOMMENDATIONS

Issue to be addressed	Recommendation
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 FSCA has proposed amendments to the FMA)
Algorithmic and high-frequency trading	32. Regulators to consider the development of such standards in respect of firms' algorithmic trading activities in governance, risk management (including conduct risk), model approval testing and deployment 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
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 35. Regulators to consider encouraging more over-the-counter (OTC) derivatives contracts be cleared through central counterparties. This may require the standardisation of such OTC derivative products

## 5.2 TRADING VENUES

### 5.2.1 INTRODUCTION

Markets – exchanges and other trading facilities such as alternative trading systems (ATSs) and multilateral trading facilities (MTFs) – are today overwhelmingly electronic, which has facilitated their operations globally and through various forms of communication. Table 5.1 summarises OTC trading by asset class.

**Table 5.1 OTC trading by asset class**

	Foreign exchange	Government bonds	Corporate bonds	Interest rate swaps	Credit derivatives
Dealer to customer	<ul style="list-style-type: none"> <li>• Dealer platforms</li> <li>• Dealer to customer platforms</li> <li>• Multilateral platforms</li> </ul>	<ul style="list-style-type: none"> <li>• Voice</li> <li>• Dealer to customer platforms</li> </ul>	<ul style="list-style-type: none"> <li>• Voice</li> <li>• Dealer to customer platforms</li> </ul>	<ul style="list-style-type: none"> <li>• Voice</li> <li>• Dealer to customer platforms</li> </ul>	<ul style="list-style-type: none"> <li>• Voice</li> <li>• Dealer to customer platforms</li> </ul>
Dealer to dealer	<ul style="list-style-type: none"> <li>• Multilateral platforms</li> <li>• Interdealer-broker platforms</li> <li>• Single-dealer platform</li> </ul>	<ul style="list-style-type: none"> <li>• Multilateral platform for primary dealers (from July 2018)</li> <li>• Interdealer-broker platforms</li> <li>• Single-dealer platform</li> </ul>	<ul style="list-style-type: none"> <li>• Interdealer-broker platforms</li> <li>• Single-dealer platform</li> </ul>	<ul style="list-style-type: none"> <li>• Interdealer-broker platforms</li> <li>• Single-dealer platform</li> </ul>	<ul style="list-style-type: none"> <li>• Interdealer-broker platforms</li> <li>• Single-dealer platform</li> </ul>

# Trading venues and technology

	Foreign exchange	Government bonds	Corporate bonds	Interest rate swaps	Credit derivatives
Role of dealer	Principal	Principal	Principal	Principal	Principal
Volume that is traded electronic	High	Medium	Low	Low	Low
Multilateral platform: A trading venue where multiple buying and selling interests come together to agree transactions Single-dealer platform: A trading venue owned by a bank or dealer-broker that acts as the only market maker on the venue					

## Box 5.1: Trading OTC derivatives

In September 2009 the Group of Twenty (G20) specified that all over-the-counter (OTC) derivatives be traded on exchange or other electronic trading platforms by 2012 to improve transparency, mitigate systemic risk and address market abuse in derivatives markets. As at December 2009, approximately 89% of derivatives contracts were transacted OTC (i.e. directly between two contracting parties without the interposing of an exchange or other intermediary).

According to December 2017 Bank for International Settlements (BIS) statistics, central clearing continued to make inroads in OTC derivatives markets. In the credit default swaps market, the cleared segment rose from USD 4.9 trillion to USD 5.1 trillion. Consequently, the share of outstanding credit default swaps cleared through central counterparties (CCPs) was 55% at the end of December 2017. Bilateral contracts between reporting dealers (i.e. dealers that provide data to their central banks) declined further. These shifts are consistent with the novation to CCPs for contracts between dealers.

With respect to OTC interest rate derivatives markets, reporting dealers' positions booked against CCPs totalled USD320 trillion at the end of 2017, accounting for about 75% of notional amounts outstanding. The share of cleared positions was the highest for OTC interest rate derivatives denominated in Canadian dollars, at 88%, and the lowest for those in euros, at 72%.

In OTC foreign exchange derivatives markets, only 2% of notional amounts were centrally cleared at the end of 2017. While the BIS does not collect a decomposition of foreign exchange (FX) derivatives into FX swaps and forwards, the cleared amounts were probably concentrated in non-deliverable forwards because they are one of the few FX instruments that CCPs offer for clearing.

Where the OTC portion of the market continues to dominate, this dominance is mainly attributed to the customised nature of contracts, which allows them to meet the specific needs of the counterparties.

*Source: BIS, Statistical release: OTC derivatives statistics at end December 2017, May 2018, available at [https://www.bis.org/publ/otc\\_hy1805.pdf](https://www.bis.org/publ/otc_hy1805.pdf)*

# Trading venues and technology

## 5.2.2 IN SOUTH AFRICA: THE VIEW OF MARKET PARTICIPANTS

Market participants are of the view that technological developments have had benefits for market integrity through improving the transparency of markets as well as supporting efficiency and cost effectiveness, supporting the availability and reliability of information and the transparency of markets, improving the price discovery process, enhancing the recording and reporting of transactions, and improving risk monitoring and trade surveillance systems through an increasing amount of electronic data.

Market participants' responses also highlight the role of technological developments in improving the efficiency of execution and settlement and in driving down costs. Increased competition can also come from participants seeking to leverage new technologies to exploit market opportunities.

**Risks or costs associated with technological developments include:**

- the need for careful implementation of technology changes (e.g. disruption from debt instrument solution (DIS) implementation in the listed debt market with numerous failed trades and delayed settlement);
- risks to market integrity associated with enabling high-frequency trading and latency by colocation;
- abuse of markets through unfair or unlawful access to information; and
- the exclusion of the marginalised from the benefits of technological change.

## 5.2.3 INTERNATIONAL STANDARDS AND GUIDANCE

### 5.2.3.1 IOSCO

The fundamental principles for the regulation of secondary markets are expressed in the International Organisation of Securities Commissions' (IOSCO) Objectives and Principles of Securities Regulation. While the principles recommended by IOSCO are applicable to exchanges, they can be applied to OTC markets. The principles for secondary markets require regulators to ensure the integrity of trading by:

- requiring that the establishment of exchanges and trading systems is subject to authorisation and oversight;
- maintaining fair and equitable rules;
- promoting transparency of trading;
- detecting and deterring market manipulation and other unfair trading practices;
- seeking to ensure the proper management of large exposures, default risk and market disruption; and
- reducing systemic risks.

**In October 2011, IOSCO made further recommendations on regulatory issues raised by the impact of technological changes on market integrity and efficiency. These include the following:**

1. Regulators should require that trading venue operators provide fair, transparent and non-discriminatory access to their markets and to associated products and services.
2. Regulators should seek to ensure that trading venues have in place suitable trading control mechanisms (such as trading halts, volatility interruptions and limit-up, limit-down controls) to deal with volatile market conditions. Trading systems and algorithms should be robust and flexible so that they can deal with, and adjusting to, evolving market conditions. In the case of trading systems, this should include the ability to adjust to changes (including sudden increases) in message traffic.
3. All order flow of trading participants, irrespective of whether they are direct venue members or otherwise, must be subject to appropriate controls, including automated pre-trade controls. These controls should be subject to the regulatory requirements of a suitable market authority or authorities. In addition, regulators should identify any risks arising from currently unregulated

# Trading venues and technology

direct members/participants of trading venues and, where any are identified, take concrete steps to address them.

4. Regulators should continue to assess the impact on market integrity and efficiency of technological developments and market structure changes, including algorithmic and high-frequency trading. Based on this, regulators should seek to ensure that suitable measures are taken to mitigate any related risks to market integrity and efficiency, including any risks to price formation or to the resiliency and stability of markets, to which such developments give rise.
5. Market authorities should monitor the markets for novel forms or variations of market abuse that may arise because of technological developments and act as necessary. They should also review their arrangements (including cross-border information sharing arrangements) and capabilities for the continuous monitoring of trading (including transactions, orders entered or orders cancelled) to help ensure that they remain effective.

## 5.2.3.2 MiFID II and MiFIR

The Markets in Financial Instruments Directive (MiFID) was amended as a new directive (MiFID II) and a new regulation (MiFIR). MiFID II and MiFIR aim to improve financial markets by making them more efficient, resilient and transparent. MiFID, MiFID II and MiFIR defined several categories of trading venues, namely organised trading facilities (OTFs), regulated markets and multilateral trading facilities (MTFs).

### With respect to trading venues, MiFID II and MiFIR:

- level the playing fields by ensuring that functionally similar activities are subject to like regulatory requirements. RMs, MTFs and OTFs must have (i) transparent rules and procedures for fair and orderly trading; (ii) objective criteria for the efficient execution of orders; (iii) transparent rules for determining which instruments can be traded; (iv) transparent, non-discriminatory and objective membership criteria; and (v) transparent, fair and non-discriminatory fee structures that do not create incentives that contribute to disorderly trading or market abuse;
- subject all types of trading venues to improved and equal surveillance requirements to identify breaches, disorderly trading and market abuse. If a trading venue suspends or removes a financial instrument from trading due to suspected market abuse or on the request of the regulatory authority, other trading venues must do the same unless this will cause substantial damage to investors' interests or the orderly functioning of the market;
- require all trading venues to have in place effective systems, procedures and arrangements to ensure their systems are resilient and have sufficient capacity to ensure orderly trading under severe stress, and have effective business continuity arrangements;
- have numerous functionality requirements such as the ability to reject orders that exceed thresholds or are erroneous; halt or constrain orders; cancel, vary and correct transactions; specify tick sizes for certain instruments; and synchronise business clocks;
- introduce greater regulation in relation to algorithmic trading, market-making and direct electronic access;
- establish transparency and transaction reporting obligations to all trading venues. These are calibrated for different types of instrument and different types of trading; and
- mandate that derivatives must be traded on at least one trading venue and be sufficiently liquid, considering the average frequency and size of trades over a range of market conditions, the number and type of active market participants, and the average size of spreads.

MiFID II states that if trading venues outside the European territory are not deemed equivalent, counters will not be allowed to trade in those non-equivalent venues.



# Trading venues and technology

## 5.2.4 RECOMMENDATIONS

Apart from certain regulatory requirements relating to dark pools, there is no regulatory framework for alternative trading venues in South Africa. The FMRC recommends that regulators consider developing such a regulatory regime to ensure level playing fields, market surveillance (including cross-market surveillance), trading controls and market stability.

## 5.3 ALGORITHMIC AND HIGH-FREQUENCY TRADING

### 5.3.1 INTRODUCTION

Automated (or algorithmic or programme) trading is trading using algorithms (i.e. sets of rules or instructions) at some stage in the trading process. Computers and advanced mathematical models are used to make decisions about the timing, price and quantity of an order. Automated trading ranges from simple algorithmic execution to complex algorithmic trade decision-making.

Algorithmic execution involves the use of an electronic trading programme to execute a trade after the decision to trade has been made by a human trader. For example, automated trading may comprise a basic algorithm to feed portions of an order into the market at pre-set intervals to minimise market impact cost. Alternatively, the programme may use smart-order routing, which helps traders seek out where prices are best across a range of competing exchanges, platforms and dark pools, and route their orders accordingly.

Algorithmic trade decision-making involves the use of algorithms to initiate trades based on key input parameters such as order-book imbalance, momentum, correlations within or across markets, mean reversion and response to economic data or news headlines. Algorithms may also be designed to predict the presence and actions of other algorithms, thereby attempting to stay one step ahead of them. Once the algorithm has made the decision to trade, it also executes the trade. Therefore, trades can be made without human intervention using information received electronically.

High-frequency trading can be thought of as a subset of algorithmic trade decision-making. High-frequency traders attempt to generate mainly arbitrage profits by doing a large number of small-size, small-profit trades with short holding periods that have a frequently of less than one second.

#### Box 5.2: Knight capital

On 1 August 2012 an error (also known as a bug) in its trading software caused losses of USD440 million (ZAR3.6 billion) for Knight Capital. During the first 45 minutes of trading on 1 August 2012, Knight Capital's algorithmic trading system malfunctioned and executed erroneous orders in 148 shares listed on the New York Stock Exchange (NYSE). The scale of orders pushed prices sharply higher or lower. Since May 2010, circuit breakers have been in place to limit wild swings in the price of shares beyond 10% during a five-minute period. However, the circuit breakers did not kick in as they only start operating 15 minutes into the trading day. The NYSE reviewed trades in all 148 shares but broke (or cancelled) trades in only six shares, which left Knight Capital facing substantial losses having amassed a USD7 billion position it had to offload at a loss. Of course, breaking trades underlies the problem of using and being dependent on high-speed trading technology, as once a trade is executed, it triggers a chain of positions that become costly to break.

# Trading venues and technology

## 5.3.2 IN SOUTH AFRICA

With respect to the role of automated and algorithmic trading, market participants believe there are benefits in terms of price discovery, liquidity and the ability to react faster to developments in international markets. But there are concerns that algorithms might drive pricing and/or harm fair access to markets and have market stability implications (e.g. flash crashes).

The JSE encourages high-frequency trading through its colocation programme. In May 2014 the JSE launched its Colocation Centre to allow faster access and reduce latency. The JSE expected this to have ‘a significant impact on trading volumes by attracting a greater share of high-frequency trading’. High-frequency trading was not viewed as a major risk because the JSE was a single execution venue, unlike the US which has multiple exchanges, and circuit breakers are in place for big changes in volatility. (This will not be sufficient in a multiple exchange environment.) This has changed – South Africa is now a multiple-exchange environment. The JSE is the biggest securities exchange in South Africa. Until 2016 it was the only stock exchange. Since then, four additional exchanges have been licensed for equities in South Africa, namely the ZARX (2016), 4AX (2016), A2X (2017) and Equity Express Securities Exchange (2017)<sup>50</sup>.

The JSE has introduced various circuit breakers to address extreme levels of volatility due to algorithmic trading and limits high-frequency trading by restricting the number of trades a broker may submit to 300 orders per second, per broker.

## 5.3.3 INTERNATIONAL STANDARDS AND GUIDANCE

### 5.3.3.1 MIFID II

MiFID II mandates that a person must notify the relevant regulator if he/she engages in algorithmic trading across any of the asset classes. Where a person uses high-frequency trading technique, he/she will generally also be subject to authorisation. In addition to notifying the regulator, the firm must also notify the competent authorities of the trading venues at which it engages in algorithmic trading as a member or participant of the trading venue. The purpose of the organisational requirements is to ensure that the firm undertaking the algorithmic trading has effective systems and controls that are suitable to the business it operates.

Investment firms must also establish an automated surveillance system that effectively monitors transactions, generates alerts for and reports on signs of potential market manipulation. The investment firm must also monitor in real time all algorithmic trading activity that takes place under its trading code, including that of its clients, for signs of disorderly trading, including trading across markets, asset classes or products in cases where the firm or its clients engage in such activities. This monitoring should be undertaken by the trader in charge of the trading algorithm or algorithmic trading strategy, by the risk management function or by an independent risk control function.

MiFID II also contains rules requiring firms to have systems and controls in place when providing direct electronic access (DEA) to prevent trading by clients that may create risks to the clients themselves or create or contribute to a disorderly market.

<sup>50</sup> FSCA has prohibited ZARX and Equity Express Securities Exchange from carrying on high-frequency trading.





# Trading venues and technology

## MIFID II requirements for algorithmic trading include the following:

- Effective systems and controls must be in place to ensure its trading systems are resilient, to maintain trading thresholds and limits, to prevent incorrect orders contributing to a disorderly market, and to prevent breaches of the Market Abuse Regulation (MAR) or the rules of a trading venue.
- The firm must have effective business continuity arrangements to deal with any trading systems' failure and to ensure its systems are fully tested and properly monitored.
- Systems must be fully tested (including conformance testing with the venue) before deployment and deployed or substantially updated only on the authority of a senior management designate and only where there are predefined trading limits.
- The firm must maintain defined pre-trade controls on order entry, monitor all trading activity under its trading code on a real-time basis, and continuously operate post-trade controls, including of its market and credit risk.
- The firm must have emergency 'kill functionality', allowing it to cancel all unexecuted orders with immediate effect.
- If the firm is a member or participant of a European Union (EU) trading venue on which it engages in algorithmic trading, it must notify the venue's competent authority.
- The firm must carry out an annual self-assessment and issue a validation report covering its algorithmic systems and strategies, the governance and control framework, its business continuity arrangements, stress testing, and its overall compliance with the other MiFID II requirements.

### 5.3.3.2 UK FCA – algorithmic trading

The United Kingdom (UK) Financial Conduct Authority (FCA) has identified the following five key areas of focus for algorithmic trading:

- **Defining algorithmic trading:** Ensure firms establish an appropriate process to identify algorithmic trading, manage 'material changes' and maintain a comprehensive inventory of algorithmic trading across the business.
- **Development and testing:** Ensure firms maintain robust, consistent and well-understood development and testing processes that identify potential issues across trading algorithms prior to full deployment.
- **Risk controls:** Ensure firms develop suitable and robust pre- and post-trade controls to monitor, identify and reduce potential trading risks across algorithmic trading activity.
- **Governance and oversight:** Ensure firms maintain an appropriate governance and oversight framework that demonstrates effective challenge from senior management, risk management and compliance on algorithmic trading activities.
- **Market conduct:** Ensure firms appropriately consider the potential impact of their algorithmic trading on market integrity, monitor for potential conduct issues and reduce market abuse risks.

### 5.3.3.3 UK PRA supervisory statement on algorithmic trading

In June 2018 the Prudential Regulation Authority (PRA) published a supervisory statement on algorithmic trading that applies to algorithmic trading activities of a firm, including in respect of unregulated financial instruments such as spot foreign exchange. The supervisory statement sets out the PRA's expectations in respect of a firm's algorithmic trading activities in the areas of governance, the algorithm approval process (by the firm), testing and deployment, inventories and documentation, and risk management and other system and control functions.

# Trading venues and technology

## 5.3.4 RECOMMENDATIONS

There are no regulatory standards pertaining to algorithmic trading in South Africa other than JSE rules and directives. It is recommended that the regulators consider the development of such standards in respect of firms' algorithmic trading activities. The standards could cover governance; risk management (including conduct risk); and model approval, testing, validation and deployment.

It is further recommended that regulators consider condoning the establishment of a management body of the exchanges to determine cross-market standards and controls such as circuit breakers and actions if one exchange suspends or removes a financial instrument from trading.

## 5.4 INNOVATION AND FINANCIAL TECHNOLOGY

### 5.4.1 INTRODUCTION

Financial technology (fintech) is an umbrella term that incorporates a wide range of new business models and technical innovations that have the potential to transform the financial sector. Breakthroughs in technological capabilities – hardware, software, telecommunications, data analytics and artificial intelligence – have provided new ways to communicate, store and process information and enabled the development of several new financial products and services, including crowdfunding, peer-to-peer lending, robo-advisers, high-frequency trading and smart contracts.

#### **Fintech innovations in securities services include:**

- artificial intelligence applications such as high-frequency trading, market sentiment analysis to determine breaking and market-moving events for traders, and market surveillance to detect market manipulation and abuse;
- distributed ledger technology (blockchain) applications such as the trading of securities and post-trade activities such as settlement, corporate actions and record-keeping; and
- infrastructure and distribution software platforms such as direct electronic access to exchanges and other trading facilities (see 5.5) and market structure regulatory safety measures to address extraordinary market volatility such as limit-up, limit-down rules and kill switches.

### 5.4.2 IN SOUTH AFRICA

The South African Reserve Bank (SARB) advised that it will take a balanced approach to technological innovations, considering the potential benefits and risks of each innovation, and in February 2018 established a fintech programme to strategically assess the emergence of fintech in a structured and organised manner, and to consider its regulatory implications. The programme aims to track and analyse fintech developments and to assist policymakers in formulating frameworks in response to these emerging innovations.

#### **The fintech programme has three primary deliverables:**

- Review the SARB's position on private cryptocurrencies to inform an appropriate policy framework and regulatory regime. This review will address regulatory issues such as clearing and settlement risks, exchange control impacts, monetary policy and financial stability, and cybersecurity considerations. The targeted delivery date is the second half of 2018.
- Investigate and decide on the applicability of innovation facilitators (i.e. innovation hubs, regulatory sandboxes and



# Trading venues and technology

accelerators). Clear and transparent eligibility and participation criteria will be developed to assist with the consideration of applicants into a regulatory sandbox. The targeted delivery date is the third quarter of 2018.

- Launch Project Khokha. The project successfully experimented with distributed ledger technologies (DLTs) and gained a practical understanding of DLTs through the development of a proof of concept in collaboration with the banking industry. The project replicated interbank clearing and settlement on a DLT and allowed the SARB and banking industry to jointly assess the potential benefits and risks of DLTs.

There has been some technical innovation by the JSE, the most recent being the implementation of the electronic trading platform for government bonds in July 2018 and the T+3 project initiated in 2013 that finally went live in July 2016. The T+3 settlement cycle aligns South Africa more closely with global market standards, although these standards have now progressed to T+0 and T+2. Another technology initiative is the Integrated Trading and Clearing (ITaC) programme targeted to go live in October 2018.

It is anticipated that South Africa's multi-exchange environment will reduce the monopoly of the JSE by driving down trading costs and facilitating more innovation in securities services. For example, Chapter 4 (market structure) recommends that National Treasury and regulators encourage the implementation of a central order book for most (if not all) financial instruments. Chapter 3 (market conduct) recommends that regulators consider progressing the establishment of trade repositories in all OTC markets (not only OTC derivatives).

South Africa has seen financial innovations in the OTC derivatives market that have not translated into technological innovations. For example, a variety of non-standard OTC derivative products linked to listed equities have developed and trading appears to be growing. Yet, it appears that no attempt has been made to standardise such financial innovations and list them on an exchange to improve transparency and price discovery. The same could be said for interest rate OTC derivatives (see Box 5.1).

## 5.4.3 INTERNATIONAL STANDARDS AND GUIDANCE

**The World Federation of Exchanges (WFE)<sup>51</sup> proposes seven principles to consider when designing rules, standards and guidelines for fintech in market infrastructures:**

1. Innovation should ideally be market driven and not be constrained unnecessarily by regulation.
2. Legislation, rules and practices should only be introduced or adapted if strictly required – the scope of existing regulations should be broadly sufficient to extend to many or most potential fintech initiatives.
3. Any regulatory approach should encourage innovation while ensuring investor protection and system stability.
4. Even as the technology itself may present unique risks, the underlying principles of outsourcing should remain sound and appropriate. Regulated entities' use of new fintech applications and solutions should be treated consistently with the outsourcing of any other function in the absence of other regulatory impacts.
5. There should be open, regular and proactive dialogue between regulators and the market for authorities to understand the technology that underpins fintech applications and to ensure the existence of an appropriate regulatory framework.
6. Fintech is inherently international with global applications and uses. Regulatory principles and guidelines should therefore be developed at the global level to reflect the increasingly global nature of markets.
7. There should be consistency in the application of rules to both incumbents and new fintech entrants in the interests of level playing fields, and integrity, stability and fairness.

<sup>51</sup> The WFE is the global industry association for exchanges and clearing houses. It represents more than 200 market infrastructure providers, of which more than 100 are central counterparties (CCPs) and central securities depositories. South Africa's members include exchange groups and stand-alone CCPs.

# Trading venues and technology

The Financial Stability Board (FSB) identified the following regulatory and supervisory issues around fintech:

- The more efficient processing of information in financial markets may contribute to a more efficient financial system. Regulatory and supervisory applications of artificial intelligence may help improve regulatory compliance and increase supervisory effectiveness.
- Network effects and scalability of new technologies may in the future give rise to third-party dependencies, which could lead to the emergence of new systemically important players that could fall outside the regulatory perimeter.
- Artificial intelligence applications could result in new and unexpected forms of interconnectedness between financial markets and institutions.
- The lack of interpretability or auditability of artificial intelligence models could result in unintended consequences and macro-level risk.
- Fintech raises issues around appropriate risk management and oversight. It will be important to assess uses of artificial intelligence in view of its potential, including adherence to relevant protocols on data privacy, conduct risks and cybersecurity. Adequate testing and 'training' of tools with unbiased data and feedback mechanisms are important to ensure applications do what they are intended to do.

## 5.4.4 RECOMMENDATIONS

It is recommended that regulators consider assessing the competitive landscape of market infrastructures, particularly exchanges and central securities depositories (CSDs), to encourage technological innovation that improves outcomes across financial markets.

It is further recommended that regulators consider encouraging more OTC derivatives contracts to be cleared through central counterparties (CCPs). This may require the standardisation of such OTC derivative products.

## 5.5 FURTHER RESEARCH

Direct electronic access to exchanges and other trading facilities, which is the process by which a person transmits orders on his/her own (i.e. without any handling or re-entry by another person) directly into the market's trade matching system for execution. In several jurisdictions, including South Africa<sup>52</sup>, many customers are granted direct electronic access to markets with or without using an intermediary's infrastructure. This raises the following challenges, which require additional research:

- Customers accessing markets outside of the market infrastructure and/or control of market intermediaries may contest the risk management approaches of intermediaries and make their compliance and monitoring more difficult, particularly with regard to market manipulation and insider dealing.
- Incentives for intermediaries and customers to gain execution advantages based on the type and geographic location of their connectivity arrangements may raise fairness concerns.
- Facilitating algorithmic trading through automated systems raises capacity issues as black box trading systems can transmit thousands of order messages to a market in less than a second.

<sup>52</sup> <https://www.jse.co.za/content/JSETechnologyDocumentItems/Direct%20Market%20Access%20Questionnaire.docx>





**national treasury**  
Department of  
National Treasury  
REPUBLIC OF SOUTH AFRICA



South African Reserve Bank



**FSCA**  
Financial Sector  
Conduct Authority



# 2018 FINANCIAL MARKETS REVIEW

REGULATORY  
FRAMEWORK

# Regulatory framework

## 6.1 SUMMARY OF RECOMMENDATIONS

Table 6.2 (see 6.4.1) recaps the recommendations for the regulatory framework made in chapters 2, 3, 4, 5 and 7.

Additional recommendations are:

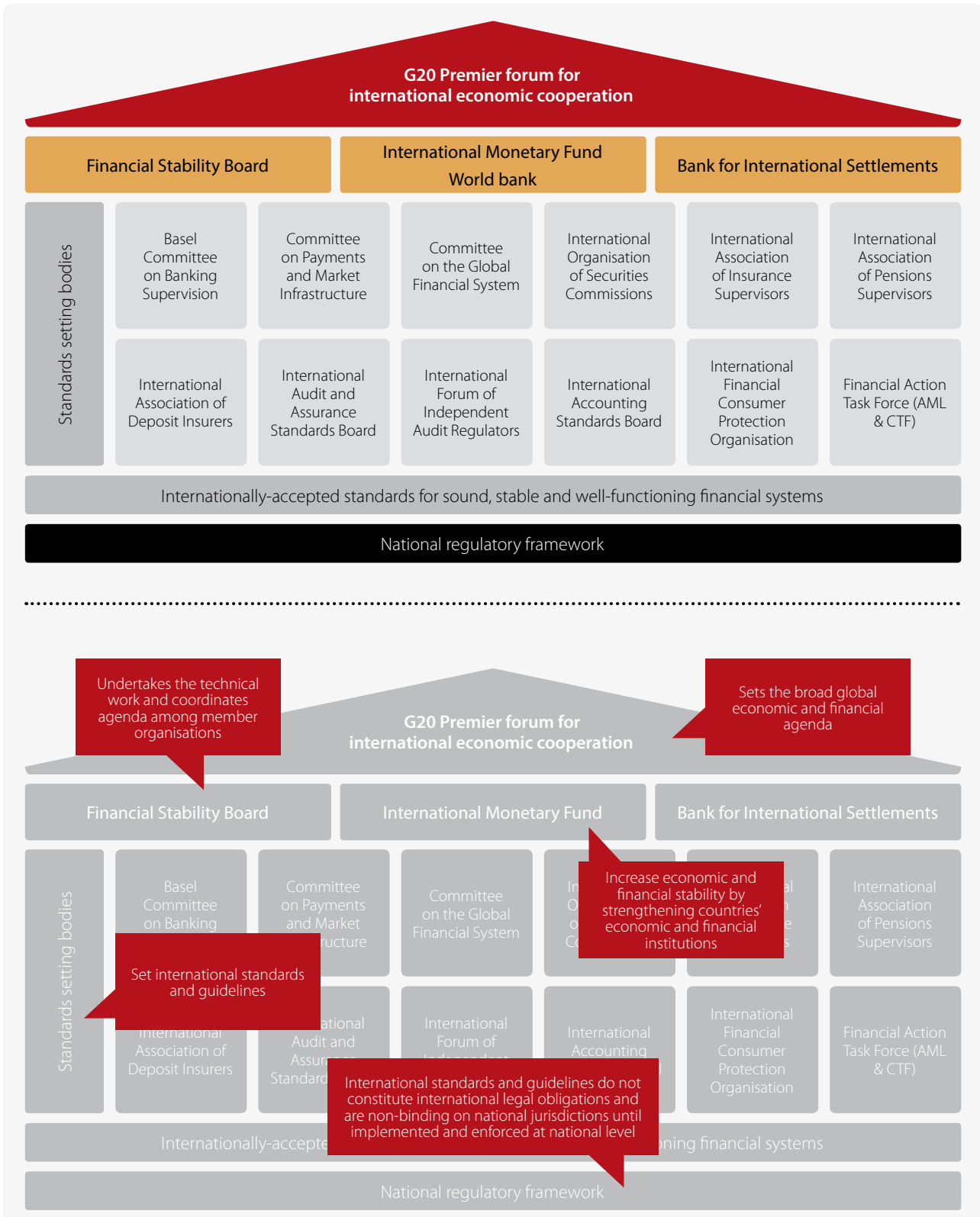
Issue to be addressed	Recommendation
FMA within a Twin Peaks regulatory framework	36. The FMA to be divided into two pieces of legislation – the first in relation to dealing with market infrastructures and alternative trading venues (proposed Market Infrastructures Act) and the second with the handling of the market conduct of financial markets (predominantly market abuse and conflicts of interest), either in the form of a distinct Act or as part of the Conduct of Financial Institutions Act (COFI Act) or as standards under the Financial Sector Regulation Act (FSR Act) 37. National Treasury to consider reassessing whether a separate conduct Act (i.e. COFI Act) is required or whether regulations under the FSR Act are sufficient
Role of self-regulatory organisations (SROs)	38. It is recommended that the SRO model be retained where appropriate. It is further recommended that SROs' delegation of regulatory authority be revisited to maximise the benefits of self-regulation and limit its disadvantages (mainly conflicts of interest). (Note: The FSCA made recommendations to review the FMA in this regard)
Insolvency Act	39. The conflict between the provisions of the Insolvency Act and the margining requirements for over-the-counter (OTC) derivatives to be resolved. (Note: The National Treasury is engaging the Department of Justice on the matter)
Buy-side	40. Equivalent standards of conduct to address market manipulation to be considered for both buy-side and sell-side

## 6.2 INTERNATIONAL STANDARDS AND GUIDANCE

In the aftermath of the worldwide financial crisis of 2007–08 – the worst global downturn since the great depression of the 1930s – the international community embarked on a range of initiatives to strengthen the international financial architecture which, despite its wide scope and sophistication, was unable to prevent or even mitigate the crisis. The international financial architecture consists of the institutions that produce and monitor the implementation of international practices and guidelines that advance global financial stability and help prevent and resolve financial crises in an integrated international financial environment. Figure 6.1 shows the international financial architecture. The top lists the institutions and the bottom their roles.

# Regulatory framework

Figure 6.1: International financial architecture



Source: Goodspeed, 2018

# Regulatory framework

Global policymakers are striving for stability of the international financial system in a world characterised by capital market liberalisation, financial integration and connectivity, and technological and financial innovations. While policy responsibility lies mainly with sovereign states, the challenge is to promote global financial stability through national actions informed and coordinated through international cooperation.

**The International Monetary Fund (IMF) and the World Bank assess countries’ observance of recognised international standards and codes to help them implement reforms where needed. The aim of this IMF/World Bank Financial Sector Assessment Program is to increase economic and financial stability by strengthening countries’ economic and financial institutions. Standards and corresponding assessment methodologies have been developed by specialised standard-setting bodies and include:**

- banking supervision: BCBS Core Principles for Effective Banking Supervision;
- securities regulation: IOSCO Objectives and Principles of Securities Regulation;
- insurance supervision: International Association of Insurance Supervisors’ Insurance Core Principles;
- crisis resolution: FSB’s Key Attributes of Effective Resolution Regimes for Financial Institutions;
- financial market infrastructures: Committee on Payments and Market Infrastructures’ Principles for Financial Market Infrastructures; and
- market integrity: Revised Financial Action Task Force (FATF) recommendations on anti-money laundering and countering the financing of terrorism.

The international standards and codes central to the work of the Financial Markets Review Committee (FMRC) set out in chapters 1 to 4 are recapped in Table 6.1.

**Table 6.1: International standards and codes**

Chapter	Standard Setting Body	Year	Title (see bibliography for links to the documents)
Governance	FSB	2018	Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices
	FSB	2018	Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors
	FSB	2014	Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture
	FSB	2013	Principles for an Effective Risk Appetite Framework
	FSB	2009	FSF Principles for Sound Compensation Practices
	BCBS	2015	Corporate Governance Principles for Banks
Market conduct	IOSCO	2017	IOSCO Task Force Report on Wholesale Market Conduct
Market structure	FSB	2017	Reforming Major Interest Rate Benchmarks
	FSB	2013	Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos
	IOSCO	2013	Principles for Financial Benchmarks
Trading venues and technology	FSB	2017	Artificial Intelligence and Machine Learning in Financial Services



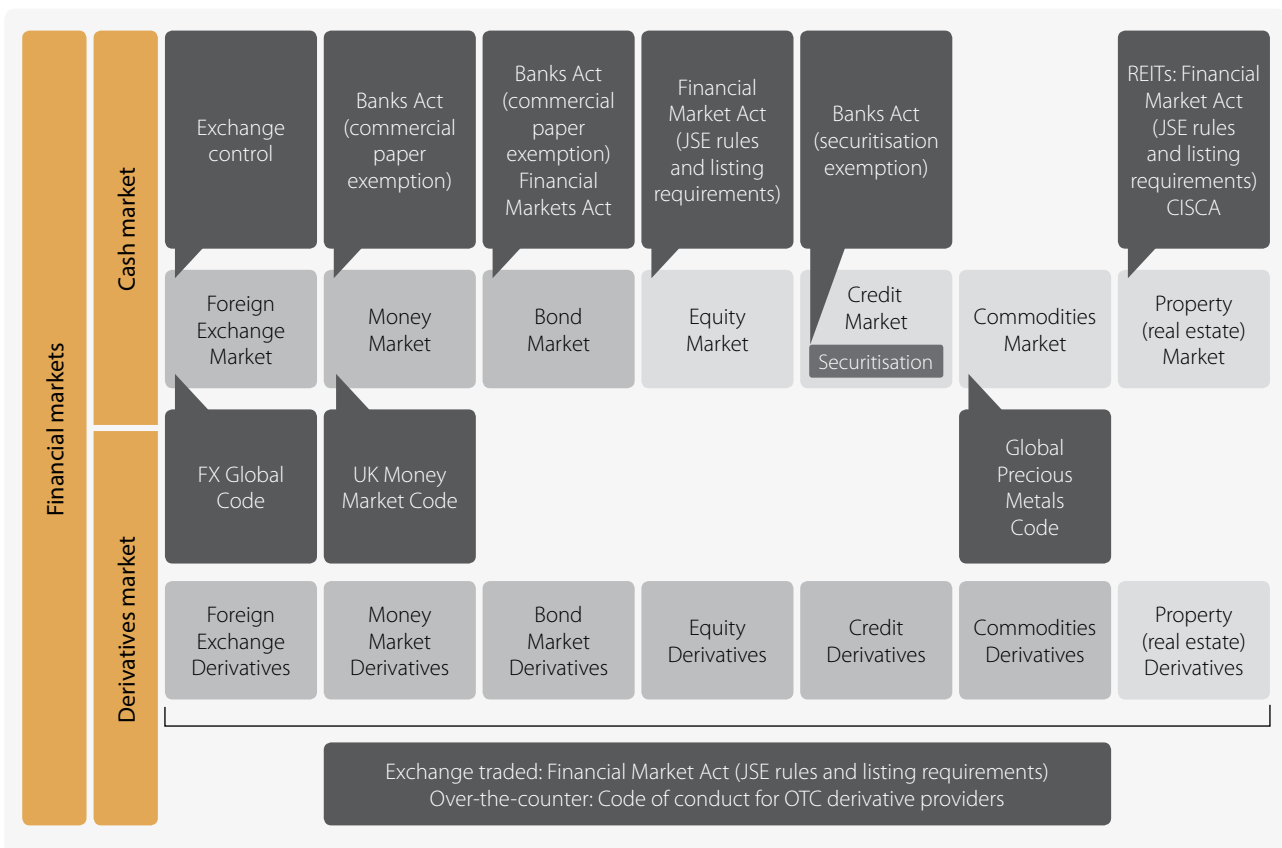
# Regulatory framework

## 6.3 IN SOUTH AFRICA

### 6.3.1 CURRENT REGULATORY FRAMEWORK

The current high-level South African regulatory framework is depicted in Figure 6.2.

Figure 6.2: Current regulatory framework (including self-regulation codes of conduct)



Source: Goodspeed, 2018

In terms of the FSR Act, the regulatory authority for the Financial Markets Act 19 of 2012 (FMA) is the Financial Sector Conduct Authority (FSCA). The FMA is the primary legislation that governs the regulation of financial markets, market infrastructure and securities services. The FMA seeks to ensure that:

- financial markets in South Africa operate fairly, efficiently and transparently to promote investor confidence, reduce systemic risk and promote international competitiveness of South Africa's securities services; and
- the legislative and regulatory framework in South Africa is brought in line with the recommendations of international standard-setting bodies such as the Group of Twenty (G20), Financial Stability Board (FSB), Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO).

# Regulatory framework

The FMA primarily focuses on the licensing and regulation of exchanges, central securities depositories, clearing houses, trade repositories and market infrastructures as well as the prohibition of insider trading and other market abuses.

In addition, the FMA provides a framework for regulating OTC derivatives in South Africa, which is a key G20 commitment.

**National Treasury has set out principles for the development of the regulatory framework for financial markets<sup>53</sup>. These are:**

- **Principle 1:** Adopt best practice standards of international standard-setting bodies such as IOSCO; however, only if appropriate for South Africa.
- **Principle 2:** Develop harmonised and equivalent regulatory frameworks to ensure South African market players can continue to trade across borders. South Africa's regulatory and supervisory framework must be assessed as equivalent by regulators in other jurisdictions to ensure level playing fields, minimise duplication and uncertainty, and reduce the opportunity for regulatory arbitrage.
- **Principle 3:** Align with existing legislation such as the Financial Advisory and Intermediary Services Act (FAIS Act) and the Banks Act to assist in levelling the playing fields between domestic participants as well as avoiding duplication and minimising regulatory arbitrage domestically.
- **Principle 4:** Implement the Twin Peaks model of financial regulation (enactment of the FSR Act),
- **Principle 5:** Minimise market disruptions.

## 6.3.2 VIEW OF MARKET PARTICIPANTS

Market participants believe South Africa should not deviate too far from international standards. This is seen as important to reduce potential arbitrage away from South Africa and impeding possible equivalence determinations. It is noted that most South African market participants are already within the ambit of a plethora of international regulation, and conflicting requirements are discouraged. However, there are unintended consequences of new international banking regulations for the functioning of markets. For example:

- Regulation has made it more expensive for banks to hold risk positions, resulting in lower liquidity and weaker price discovery, and potentially increasing systemic risk.
- Capital requirements and costs associated with credit valuation adjustment (CVA) are affecting pricing and liquidity, and South African banks have become uncompetitive as a result.
- Pricing distortions are caused by the introduction of the net stable funding ratio (NSFR) and liquidity coverage ratio (LCR), including pressure on the cost of retail and wholesale deposits, increasing demand for high-quality liquid assets in the context of limited available stock in South Africa, and pressure on short term rates as banks have attempted to optimise liquidity positions. Uneven implementation of the NSFR is also a concern for the competitiveness of banks.
- Requirements for banks to hold high-quality liquid assets is crowding out institutional asset managers in the corporate bond and Treasury bill markets, as credit spreads and yields are driven lower by forced demand.

Legislative responses to the issues identified should be proportionate to the risk identified and not be overly and unnecessarily burdensome to participants as this may have harmful implications for competition. It is further suggested that it would not be appropriate to adopt all offshore market conduct requirements into local law due to different structures of South African markets and products.

<sup>53</sup> [http://www.treasury.gov.za/otc/Regulating%20over-the-counter%20\(OTC\)%20derivates%20markets%20in%20South%20Africa.pdf](http://www.treasury.gov.za/otc/Regulating%20over-the-counter%20(OTC)%20derivates%20markets%20in%20South%20Africa.pdf)



# Regulatory framework

## Market participants recommended the following:

- The legislation for banks and asset managers should be aligned.
- Legislation appropriate to wholesale markets is needed to cover the liability of controlling persons, liability of supervisors or managers, mapping of senior management responsibilities, regulation of high-frequency trading and direct electronic assess, legal certainty on computer-based forms of trading abuse, clarification of conduct expectations, licensing and registration, and a central registry of individuals involved in misconduct.
- Exchange control is seen as affecting competition, as it prevents entry into South African financial markets and creates an unlevel playing field between local and foreign participants. Exchange control is noted as an obstacle to doing cross-border business for companies with respect to the rules and requirements for hedging. There is the inconsistency in exchange controls on currency risk management where OTC arrangements are limited to six months under active currency management, while it is open-ended for listed currency futures. One response also suggests that foreign exchange limits applicable to pension funds and life companies could be reviewed to create a more competitive environment for policyholders and fund members.
- There is a conflict between the implementation of margining requirements for OTC derivatives and the current provisions in the Insolvency Act. Expected changes to the Insolvency Act are needed to resolve this issue.
- Uncertainties around the timing and content of the draft OTC derivatives legislation has had a significant cost impact, particularly with respect to the technological change required and the pricing for longer-term business.
- There is a gap in the regulation of treasury outsourcing companies (TOCs) as they are not required to disclose any profit-sharing arrangements with banks to their clients. Profit-sharing arrangements may conflict with the duty to act in the best interests of the client. It is suggested that current practices of TOCs and their profit-sharing arrangements should be reviewed.
- Foreign technology companies and aggregators in the South African foreign exchange market (360T, Bloomberg, Thomson Reuters FX) do not currently require licences to operate, in contrast to licensed banks and brokers. It is suggested that this practice is out of step with international markets and puts licensed entities at a disadvantage in terms of their ability to compete. It is suggested that appropriate licensing conditions for these providers be examined.
- There is an absence of regulation of high-frequency algorithmic trading by non-bank participants who access the market via prime brokers. It is suggested that non-bank participants that operate these strategies have no commitment or incentive to ensure stable, fair and effective markets and that their activity is associated with inefficiencies characterised by increased volatility and tight spreads.
- The role of the JSE as both provider and regulator for the bond trading platform and the associated conflict between the commercial and regulatory interests.
- The lumping of foreign exchange intermediaries with other brokers with regard to licensing implies their role is misunderstood.
- Since only primary dealers can submit bids in the weekly government bond auctions, there is unfair access to information and the market.
- There are constraints and inefficiencies in setting up collective investment structures (with reference to the Collective Investment Schemes Control Act 45 of 2002 (CISCA) and the FSB and that foreign regulators are more efficient, which encourages the setting up of offshore funds by South African managers.
- There are barriers to issuance in the regulations for commercial paper, for example some issuers may want to issue more frequently but do not want to pay for each issuance to have an audit opinion.
- The market abuse provisions of the FMA are not explicit or are too high level, with the result that interpretation is left to individual participants, which may result in implementation that is subjective and with materially different standards of compliance and inconsistent application across the market. Further, guidelines at product and market level would be useful. The market abuse provisions of the FMA should be extended to OTC markets.
- The regulation of prohibited trading practices should be aligned with international standards. One example of inconsistency that was provided is the definition of a wash trade. In South Africa this is viewed as a buy and sell transacted by one counterparty, while in the US regulatory context, a wash trade could be across entities under the same group.

# Regulatory framework

## Market participants highlighted specific international rules and their impact as follows:

- Markets that do not comply with MIFID II may experience a fall in activity and liquidity.
- The implementation of margin requirements for non-centrally cleared OTC derivatives under European Market Infrastructure Regulation (EMIR) may have the same result.
- EU and US rules on the contribution to benchmark rates have required additional staff as submitters, with the outcome that banks are forced to withdraw if they cannot meet these requirements.
- In the South African context, there has been a reduction in the number of contributors to the Jibar-setting process, which has led to the rate being more open to abuse or distortion.
- Restrictions on proprietary trading activities within banks globally – for example, the Dodd-Frank Act – have a major impact on market liquidity across international financial markets.

## 6.4 RECOMMENDATIONS

### 6.4.1 REGULATORY RECOMMENDATIONS FROM CHAPTERS 2, 3, 4, 5 AND 7

Chapters 2 to 5 and Chapter 7 made several recommendations for the regulatory framework. These are recapped in Table 6.2 for completeness.

**Table 6.2: Recap of chapters 2, 3, 4, 5 and 7 recommendations for regulatory framework**

Chapter	Recommendation
Governance	<ol style="list-style-type: none"> <li>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</li> <li>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</li> <li>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</li> </ol>
Market conduct	<ol style="list-style-type: none"> <li>10. Regulators to consider ensuring equivalent standards of market practice across wholesale financial markets including OTC markets (consider the FAIS Merchant Banking exemption)</li> <li>11. Regulators to consider setting up equivalent regimes to monitor and enforce standards and codes of market practice, whether statutory or voluntary</li> <li>15. Regulators to consider investigating the various conflict of interest requirements for wholesale markets and establish consistent, equivalent and comprehensive regulations for type 1 and type 2 conflicts across exchange-traded and OTC financial markets. Such regulations could specifically address third-party payments (also by market makers) when executing orders on behalf of clients</li> <li>16. National Treasury to consider including a market abuse catch-all clause in the FMA</li> <li>19. Regulators to consider providing standards for surveillance to firms</li> </ol>
Market structure	<ol style="list-style-type: none"> <li>28. Regulators to consider requiring fund managers to disclosure appropriate information on securities financing transactions to investors to allow investors to select investments that meet their risk profiles</li> </ol>
Trading venues and technology	<ol style="list-style-type: none"> <li>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</li> <li>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</li> </ol>

# Regulatory framework

Chapter	Recommendation
FX Review	<ol style="list-style-type: none"><li>41. Regulators to investigate the establishment of a regulatory framework for treasury outsourcing companies (TOCs) within the Twin Peaks regulatory framework for consistency (e.g. authorisation and governance) and equivalency (e.g. conflicts of interest and regulation)</li><li>42. Regulators to investigate the current regulatory framework for interdealer brokers and consider revising it within the Twin Peaks regulatory framework for consistency (e.g. authorisation, capital and governance) and equivalency (e.g. regulation)</li><li>43. The SARB (Financial Surveillance Department) to dispense with the distinction between 6-and 12-month foreign exchange hedges</li></ol>

## 6.4.2 POLICY QUESTIONS AND RELATED RECOMMENDATIONS

During the review, several outstanding policy issues relating to the regulation of financial markets came to light. While not always directly related to the market conduct of wholesale fixed income, currency and commodities (FICC) markets, the FMRC expressed its opinion on them.

### 6.4.2.1 FMA within the Twin Peaks regulatory framework

The FMA has both prudential and market conduct provisions. In terms of schedule 2 of the FSR Act, FSCA is the regulatory authority for the FMA. In terms of section 33(b) of the FSR Act, the Prudential Authority (PA) is expected to promote and enhance the safety and soundness of market infrastructures.

**National Treasury is undertaking a review of the FMA – the first sectorial piece of legislation to enter the next (or second) phase of the implementation of the Twin Peaks regulatory framework. As such policy decisions taken with respect to the FMA may set a precedent for other sectorial laws as they enter the second phase. Given the context, the following is recommended:**

- The FMA should be divided into two pieces of legislation – the first in relation to dealing with market infrastructures<sup>54</sup> and alternative trading venues (proposed Market Infrastructure Act) and the second with handling the market conduct of financial markets (predominantly market abuse and conflicts of interest), either in the form of a distinct Act or as part of the COFI Act, or as standards under the FSR Act.
- The proposed Market Infrastructure Act should include OTC-traded and exchange-traded markets and products; regulate cross-market exposures; promote competitive trading and clearing (and possibly settlement); create a competitively neutral playing field between local and foreign service providers; and ensure minimum infrastructural standards, including governance, risk management, audit, transparency and disclosure.

With respect to the proposed COFI Act, it appears that most (if not all) of its provisions could be implemented using standards in terms of the FSR Act. Consequently, to simplify and streamline the Twin Peaks regulatory framework it is recommended that National Treasury consider reassessing whether a separate conduct Act (i.e. COFI Act) is required or whether regulations under the FSR Act are sufficient.

<sup>54</sup> Payment systems are excluded from market infrastructures (see Box 6.1 for more details)

# Regulatory framework

## Box 6.1: Payment systems and market infrastructures

The Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) Principles for Financial Market Infrastructures (Principles) include systemically important payment systems in the definition of financial market infrastructures (FMIs). This is unfortunate as payment systems are fundamentally and structurally different from market infrastructures such as central counterparties (CCPs) and central securities depositories (CSDs). These Principles define FMIs as multilateral systems inclusive of their participants but specify that an FMI can be a legal or functional entity separate from its participants. This is not the case with payment systems. A payment system is 'a set of instruments, procedures, and rules for the transfer of funds between or among participants; the system includes the participants and the entity operating the arrangement'. In contrast to other FMIs, a payment system is essentially a value chain that cannot be distinguished from its participants and operators.

Market infrastructures (FMIs excluding payment systems) are entities capable of being licensed, inspected, sanctioned, recovered and resolved. Payment systems are not. Instead, they are value chains made up of several participant entities, each of which can be licensed, inspected, sanctioned, recovered and resolved.

Payment systems, as well as Market Infrastructures and their participants, should be subject to governance and the comprehensive management of risk. However, the principle of a well-founded, clear, transparent, and enforceable legal basis is applicable to the participants and system operator of a payment system rather than the payment system itself.

It is therefore questionable whether market infrastructures and payment systems should be regulated under the same piece of law without careful consideration. Whatever the case, access to payment systems should be licensed and open to all fit and proper participants with due regard for systemic risk.

Interestingly, the Principles are formally applied to CCPs and CSDs through the European regulatory regimes (European Market Infrastructure Regulation and Central Securities Depositories Regulation). There is, however, no equivalent legislative framework applying the Principles to payment systems.

### 6.4.2.2 Role of self-regulatory organisations

National Treasury<sup>55</sup> defines a self-regulatory organisation (SRO) as 'an entity that exercises regulatory authority over its industry. This structure serves as an extension of government regulation. Evidence suggests that the SRO model can be a more effective and efficient means to monitor and supervise the industry and its practices. This is because an SRO is positioned close to its industry and may know the industry much better than the government agencies. Therefore, if structured correctly it can provide more effective supervision than government counterparts'.

<sup>55</sup> <http://www.treasury.gov.za/public%20comments/FMB/FMB%20policy%20document.pdf>



# Regulatory framework

The IOSCO Objectives and Principles of Securities Regulation recognises that self-regulation may be a valuable complement to the regulator in achieving the objectives of securities regulation. Principles 6 and 7 suggest the following:

- **Principle 6:** The regulatory regime should make appropriate use of SROs that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.
- **Principle 7:** SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities. Table 6.3 indicates such regulatory responsibilities and their allocation.

**Table 6.3: Division of regulatory responsibilities**

Regulatory responsibilities		Regulatory activities	Responsible
Overall market regulation	Overall supervision of markets and participants' market conduct and trading practices	<ul style="list-style-type: none"> <li>• Rule making</li> <li>• Supervision</li> <li>• Enforcement</li> </ul>	Generally regulatory authority
Market conduct standards	Principles of fair dealing, regulation of insider trading, and deceptive and manipulative trading	<ul style="list-style-type: none"> <li>• Standard setting</li> <li>• Rule making</li> <li>• Supervision</li> <li>• Enforcement</li> </ul>	Generally regulatory authority
Licensing and entry standards	Licensing of SRO and participants. Entry standards including fit and proper standards for individuals and firms	<ul style="list-style-type: none"> <li>• Standard setting</li> <li>• Rule making</li> <li>• Supervision</li> <li>• Enforcement</li> </ul>	SRO licensed by regulatory authority; participants licensed by either regulatory authority or SRO
Issuance of financial instruments	Issuance of standards for financial instruments for each marketplace. Set listing requirements.	<ul style="list-style-type: none"> <li>• Standard setting</li> <li>• Rule making</li> <li>• Supervision</li> <li>• Enforcement</li> </ul>	Regulatory authorities generally approve rules and listing requirements issued by SROs
Exchange trading rules	Market integrity rules and trading practice rules for each marketplace	<ul style="list-style-type: none"> <li>• Rule making</li> <li>• Supervision</li> <li>• Enforcement</li> </ul>	Generally SRO
Market surveillance	Monitoring of trading in each marketplace for compliance with rules	<ul style="list-style-type: none"> <li>• Supervision (market surveillance, trading analysis)</li> <li>• Investigations</li> <li>• Enforcement</li> </ul>	Regulatory authority for cross-market surveillance; SRO for marketplace

The biggest risk of self-regulation is conflicts of interest. Since conflicts of interest are inherent in the concept of self-regulation, the objective is not to eliminate all conflicts but to ensure potential conflicts are properly managed. This can be done by (i) requiring SROs to submit their rules to the regulatory authority for approval to ensure that the rules are fair and balanced and consistent with public policy; and (ii) ensuring that SROs have fair representation of members in their selection of directors. The ability of for-profit SROs to perform regulatory roles effectively, given inherent conflicts of interest with their commercial objectives, continues to be debated globally. Many jurisdictions such as the UK are vesting greater authority in public regulatory bodies to diminish the role of self-regulation.

The FMRC recommends that the SRO model be retained where appropriate. As regulators are inherently limited in terms of resources, they will probably continue to rely on the industry to supply practitioner experience and expertise into the regulatory process. However, there should be checks and balances to maximise the benefits of self-regulation and to limit its disadvantages. It is further

# Regulatory framework

recommended that SROs' delegation of regulatory authority be revisited to ensure an appropriate balance between maintaining effective oversight of SROs and giving SROs the flexibility to develop their own regulatory priorities and programmes.

## 6.4.2.3 Insolvency Act

Parties to OTC derivatives transactions must post additional margins upfront for any transactions not cleared through a central counterparty. In terms of the Insolvency Act, in the event of the insolvency of a counterparty, the margin must be paid over to the liquidator. This limits the risk mitigation purpose of the margin.

It is recommended that the conflict between the provisions of the Insolvency Act and the margining requirements for OTC derivatives should be resolved. The National Treasury is engaging the Department of Justice on the matter.

## 6.4.2.4 The buy-side

**It appears that the regulatory treatment of the buy-side and sell-side is inconsistent. The conduct of banks is heavily scrutinised while the buy-side does not have to adhere to the same conduct rules. There are several ways buy-side participants may manipulate the market:**

- Since it can take fund managers a day – or even several days – to execute large orders, insiders in the firm could potentially use that information for their own personal gain through front-running or tailgating.
- Market manipulation is possible if inside information is received but not identified after a wall crossing when an investment bank explicitly shares inside information when seeking views on a prospective corporate action.
- The risk of insider trading increases when the sharing of inside information is not limited to those who need to know it.

It is recommended that equivalent standards of conduct to address market manipulation be considered for both buy-side and sell-side.







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# 2018 FINANCIAL MARKETS REVIEW

FINALISATION OF  
2015 FX REVIEW

# Finalisation of 2015 FX Review

## 7.1 SUMMARY OF RECOMMENDATIONS

Issue to be addressed	Recommendation
Treasury outsourcing companies (TOCs)	41. Regulators to investigate the regulatory framework for TOCs within the Twin Peaks regulatory framework for consistency (e.g. authorisation and governance) and proportional equivalency (e.g. conflicts of interest and regulation)
Interdealer brokers	42. Regulators to investigate the current regulatory framework for interdealer brokers and consider revising it within the Twin Peaks regulatory framework for consistency (e.g. authorisation, capital and governance) and proportional equivalency (e.g. regulation)
Exchange control 'nuisance' clauses	43. The South African Reserve Bank (SARB) (Financial Surveillance Department) to dispense with the distinction between 6- and 12-month foreign exchange hedges and extend the Active Currency Management Regime accordingly

## 7.2 INTRODUCTION

In 2015 the SARB published the Report of the Foreign Exchange Review Committee (FXRC) on the operations of Authorised Dealers (ADs) in the South African foreign exchange market. The FXRC found scope for improvement in overall market conduct and recommended that:

- the authorisation and regulation of TOCs be reviewed;
- the authorisation and regulation of interdealer brokers be reviewed;
- 'nuisance' clauses in the Exchange Control Policy be reviewed and, if possible, removed;
- An equivalent exercise be undertaken as most major ADs experienced difficulties in retrieving all the relevant records during their internal investigations.

## 7.3 TREASURY OUTSOURCING COMPANIES

### 7.3.1 BACKGROUND

TOCs play a niche role in the foreign exchange market. They facilitate transactions between their clients and ADs by providing a variety of services. There are currently more than 130 TOCs authorised by the SARB, but it is not known how many focus on the foreign exchange market. It is estimated that the 2017 foreign exchange turnover per TOC on behalf of clients ranged from R4 billion to R200 billion per annum – small in comparison to the total turnover in the foreign exchange market but significant nonetheless in terms of customer-related foreign exchange turnover.

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## 7.3.2. THREE-WAY RELATIONSHIP BETWEEN TOCS, CLIENTS AND ADS

### 7.3.2.1 With clients

The relationship between a TOC and its client is governed by a mandate letter, which details the services to be provided as well as the remuneration of the TOC.

#### The services include:

- advice on managing foreign exchange risk and the appropriate timing of transactions;
- foreign exchange deal execution;
- risk management in the foreign exchange market;
- cash and liquidity management;
- back office operations management (i.e. transaction confirmation, settlement and payment execution);
- renting treasury management systems to clients, either for their own use or as part of an outsourcing arrangement; and
- foreign exchange remittances, including the underlying transactions.

#### The customers of TOCs include:

- Large corporate customers: Services rendered by TOCs differ from relationship to relationship. It appears that large corporates prefer paying a retainer to the TOC.
- Small- and medium-sized enterprises (SMEs): SMEs are the mainstay clients of most TOCs. SMEs have regular foreign exchange transactions from imports or exports and find it cheaper to outsource their foreign exchange requirements to a TOC rather than appoint their own foreign exchange dealers and administrative staff.
- High net worth individuals: Wealthy individuals may have foreign exchange requirements such as investing abroad or repatriating money from abroad. They require advice and execution of transactions. Less wealthy individuals with smaller transaction requirements also benefit from the services provided by TOCs.

### 7.3.2.2 With ADs

TOCs deal with ADs on behalf of their clients strictly according to the mandate letter. Without a mandate letter, ADs refuse to deal with a TOC. TOCs are obliged to act as intermediaries and not as principals and match a principal client with an AD (Exchange Control Circular 13 of 2012, D (ii)).

ADs with a relatively smaller branch network are eager to pursue business with TOCs, which they regard as extensions of clients' treasuries and as extensions of their distribution channels.

### 7.3.2.3 With the SARB

#### The SARB regulates TOCs in terms of Exchange Control Circular 13, which states:

- TOCs must apply to the SARB's Financial Surveillance Department via an AD for permission to operate as a foreign exchange intermediary. A letter authorising the TOC to do so is issued by the SARB. However, the SARB stresses that the letter is not a licence and that TOCs cannot refer to themselves as being authorised or regulated by the SARB.
- TOCs may only act in the foreign exchange market as intermediaries, never as a principal. They are required to match a client with an AD and may not buy or sell foreign currency for their own account. If a TOC unintentionally has an open foreign exchange position, the position must be closed out immediately.

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Some TOCs believe that the SARB should not be regulating them. While the positive impact of Circular 13 is acknowledged, they believe the Financial Sector Conduct Authority (FSCA) should be solely responsible for regulating the conduct of TOCs.

## 7.3.2.4 With the FSCA

In accordance with the Financial Advisory and Intermediary Act 37 of 2002 (FAIS Act), TOCs are licensed as Category 1 financial services providers (Forex Investment) in terms of section 8 of the FAIS Act.

## 7.3.3 TOCS' REMUNERATION/COMPENSATION

**Individual client mandates determine how TOCs are compensated. The alternatives are:**

- clients pay the TOCs directly; or
- ADs pay the TOCs and recover the cost, plus a fee in some instances, from the rate applied to client transactions.

The full cost of the transaction is disclosed to clients in every case.

**The remuneration of TOCs can be categorised as follows:**

- Retainer: Some mandates allow only for a retainer to be paid by the client to the TOC. The range of services provided could include transactions, administration as well as extensive treasury services, including access to sophisticated treasury systems.
- Invoice: Some mandates allow the TOC to invoice the client per transaction or service provided. The client pays the TOC.
- Margin: Some mandates allow the AD to do a foreign exchange transaction for a client, at the request of a TOC, at a verifiable exchange rate as displayed on one of the electronic dealing platforms. The AD adds a stipulated margin to the exchange rate. This margin is shared per agreement between the AD and the TOC. The total margin added to the exchange rate and how it is shared between the TOC and AD is fully disclosed to the client. While not all clients and TOCs use the margin method of payment, many clients prefer it. It is administratively easier as no additional invoices, payments and accounting entries are required.

TOCs believe that a margin is not a 'kickback' for turnover. The AD acts as the collecting agent for a fully disclosed margin in accordance with a mandate. However, the quotes from different ADs are not disclosed to clients. To avoid potential conflicts of interest, clients alone should pay TOCs.

## 7.3.4 CONFLICTS OF INTEREST

The conflicts of interest regime applicable under FAIS applies to TOCs. However, market intermediaries, also known as TOCs in wholesale financial markets that receive margin/mark-up from both buy- and sell-side are exempt from FAIS requirements.

## 7.3.5 RECOMMENDATION

It is recommended that regulators investigate the current regulatory framework for TOCs and consider revising it within the Twin Peaks regulatory framework for consistency (e.g. licensing and governance) and proportional equivalency (e.g. conflicts of interest).



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## 7.4 THE AUTHORISATION AND REGULATION OF INTERDEALER BROKERS

There are several interdealer brokers<sup>56</sup> active in the South African foreign exchange market. Interdealer brokers are regulated in accordance with Exchange Control Circular No. 13/2012.

Although interdealer brokers act as intermediaries in the foreign exchange market, they may inadvertently have to act as the principal if they miss a quote and have a resultant foreign exchange exposure. This raises questions regarding capital adequacy which may need to be addressed. Furthermore, as intermediaries in the market, the FSCA may have an interest in their market conduct.

The current legal framework in South Africa does not provide for the regulation and/or supervision of foreign exchange dealers in their individual capacity<sup>57</sup>. The Prudential Authority (PA) has the power to apply fit and proper requirements at executive level, but that power does not extend to foreign exchange dealers. Neither the PA nor FSCA have the power to sanction these individuals in the event of serious market conduct malpractices. Therefore, the regulators do not necessarily have the power to prosecute a foreign exchange dealer for insider trading, front-running of client transactions, or collusion or manipulation of benchmarks other than through criminal prosecutions for fraud and contraventions in terms of the Financial Intelligence Centre Act and Income Tax Act.

It is recommended that regulators investigate the current regulatory framework for interdealer brokers and consider revising it within the Twin Peaks regulatory framework for consistency (e.g. licensing and governance) and proportional equivalency (e.g. conflicts of interest).

## 7.5 EXCHANGE CONTROL 'NUISANCE' CLAUSES

The current general principles around the over-the-counter market (OTC) for ADs revolves around two types of transactions, namely:

- foreign exchange hedges exceeding a 12-month period; and
- hedges for less than a 6-month period (active currency management)<sup>58</sup>
  - In the 12-month period they may provide hedges to residents and non-residents provided they have a firm and ascertained foreign exchange commitment.
  - Within the 6-month periods allows customers to formally hedge their foreign exchange commitments subject to them having a foreign exposure.

South African residents may only conduct their foreign exchange transactions with ADs locally and may not deal directly offshore. The rationale for this is to ensure that settlements take place locally through the South African banking system. Currently, ADs provide monthly details of active currency management activities to the SARB's Financial Surveillance Department, which also receives reporting on its cross-border reporting system, and banks are obliged to keep an OTC register of all trades executed.

<sup>56</sup> Interdealer brokers are specialist brokers that act as intermediaries between dealers. Dealers enter into transactions on both sides of wholesale financial markets seeking to profit by taking risks in these markets. Brokers operate on behalf of other participants to arrange transactions without being party to the transactions.

<sup>57</sup> Section 111 of the FSR Act requires persons who provide a financial service related to the buying and selling of foreign exchange to be licensed

<sup>58</sup> Hedge foreign exchange risk through the active management of currency exposures.

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The proposed relaxation is to dispense with the distinction between 6 and 12 months and extend the Active Currency Management Regime accordingly to allow resident and non-resident retail and corporate customers to actively manage their foreign exchange requirements subject to them having a foreign exposure. This proposal should go a long way in reducing any documentation at the inception of the contracts and remove the onerous exchange controls perceived in the forward foreign exchange market.

There are other exchange control 'nuisance' clauses, such as non-resident and accounting provisions, but these cannot be eliminated until capital controls are removed.

## 7.6 EQUIVALENT FX EXERCISE IN 2018

The FXRC found that in 2015 most major ADs experienced difficulties in retrieving all the relevant records during their internal investigations. In view of these difficulties, it was recommended that an equivalent review be undertaken in future.

The Financial Markets Review Committee (FMRC) requested a follow-up review to be undertaken. The review was conducted by the AD's Compliance Officers and covered all foreign exchange dealer communication to establish if there were indications of malpractice, sharing of confidential information, or otherwise unethical or unlawful behaviour. The review included chat room communication, email communication and telephone transcripts.

The FMRC received the results of the follow-up review. The review found that during their internal investigations ADs experienced little to no difficulties in retrieving all the requested records and found no evidence of malpractice or unethical or unlawful behaviour for the period under review.





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# 2018 FINANCIAL MARKETS REVIEW

ANNEXURES

# Annexure A: Abbreviations

ACTSA	Association of Corporate Treasurers of Southern Africa
AD	Authorised Dealer
ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
ASISA	Association for Savings and Investment South Africa
Banks Act	Banks Act 94 of 1990
BASA	Banking Association South Africa
BCBS	Basel Committee on Banking Supervision
BEAR	Banking Executive Accountability Regime
BESA	Bond Exchange of South Africa
BIS	Bank for International Settlements
board	board of directors
CCP	central counterparty
CEO	Chief Executive Officer
CLS	Continuous Linked Settlement
COFI	Conduct of Financial Institutions
Companies Act	Companies Act 71 of 2008
CPD	continuous professional development
CPSS	Committee on Payment and Settlement Systems
CRD IV	Capital Requirements Directive
CRO	Chief Risk Officer
CSD	central securities depository
CVA	credit valuation adjustment
DIA	Debt Issuers Association
DIS	Debt Instrument Solution
DLT	distributed ledger technology
EBA	European Banking Authority
EBS	Electronic Broking Systems
ECB	European Central Bank
EMIR	European Market Infrastructure Regulation
ESMA	European Securities and Markets Authority
ETME	electronic trade matching engine
ETP	electronic trading platform
EU	European Union
Euribor	Euro Interbank Offered Rate
FAIS Act	Financial Advisory and Intermediary Services Act 37 of 2002
FAIS	Financial Advisory and Intermediary Services
FCA	[UK] Financial Conduct Authority
FIC Act	Financial Intelligence Centre Act 38 of 2001
FICC	Fixed income, currency and commodities
FINMA	[Swiss] Financial Market Supervisory Authority
FinSurv	Financial Surveillance Department
fintech	financial technology
FMA	Financial Markets Act 19 of 2012





# Annexure A: Abbreviations

FMD	Financial Markets Department
FMI	financial market infrastructure
FMP	Financial Markets Panel
FMR	Financial Markets Review
FMRC	Financial Markets Review Committee
FMSB	Fixed Income, Currency and Commodities Markets Standards Board
FMSG	Financial Markets Standards Group
FSA	Financial Services Authority
FSB	Financial Stability Board
FSCA	Financial Sector Conduct Authority
FSR Act	Financial Sector Regulation Act 9 of 2017
FX Global Code	Global Code of Conduct for the Foreign Exchange Market
FX Review	Foreign Exchange Review
FX	foreign exchange
G20	Group of Twenty
G30	Group of Thirty
GFMA	Global Financial Markets Association's
IAIS	International Association of Insurance Supervisors
Insurance Act	Insurance Act 18 of 2017
IOSCO	International Organization of Securities Commissions
IRF	Institute of Retirement Funds
ISDA	International Swaps and Derivatives Association
Jibar Code	Jibar Code of Conduct, Governance Process and Operating Rules
Jibar	Johannesburg Interbank Agreed Rate
JSE	JSE Limited
King IV	King IV Report on Corporate Governance for South Africa, 2016
Libor	London Interbank Offered Rate
MAR	market abuse regulation
MI Act	Market Infrastructure Act (proposed new Act)
MIFID II	Market in Financial Instruments Directive
MIFIR	Market in Financial Instruments Regulation
MMSS	Money Market Settlement System
MTF	multilateral trading facility
NCD	negotiable certificate of deposit
NSFR	net stable funding ratio
ODP	OTC derivative provider
OECD	Organisation for Economic Co-operation and Development
OSSG	[FSB] Official Sector Steering Group
OTC	over the counter
OTF	organised trading facility
PA	Prudential Authority
PD	primary dealer
PRA	Prudential Regulation Authority
PvP	Payment-versus-Payment
repo	repurchase agreement or rate

# Annexure A: Abbreviations

<b>RFR</b>	risk-free rate
<b>Sabor</b>	South African Benchmark Overnight Rate
<b>SAFIRES</b>	South African Financial Instruments Real-time Electronic Settlement
<b>SAIS</b>	South African Institute of Stockbrokers
<b>SAMOS</b>	South African Multiple Option Settlement system
<b>SARB</b>	South African Reserve Bank
<b>SEC</b>	U.S. Securities and Exchange Commission
<b>SFEMC</b>	Singapore Foreign Exchange Market Committee
<b>SFIDvP</b>	simultaneous, final and irrevocable delivery versus payment
<b>SFT</b>	securities financing transaction
<b>SME</b>	small- and medium-sized enterprise
<b>SMR</b>	Senior Managers Regime
<b>SRO</b>	self-regulatory organisation
<b>SSB</b>	Standard setting body
<b>TOC</b>	treasury outsourcing company
<b>UK</b>	United Kingdom
<b>US</b>	United States
<b>USD</b>	US dollar
<b>ZAR</b>	South African rand



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# Annexure C: Glossary

<b>Credit valuation adjustment (CVA)</b>	In the context of Basel III, the fair value of a derivative instrument should reflect the changes of the credit quality of the counterparty over time. To reflect these changes, an adjustment known as the credit valuation adjustment (CVA) is made to the risk-neutral price to account for the specific risk of the counterparty.
<b>Market abuse: floor/ceiling price pattern</b>	Executing transactions or orders to trade to hinder the price of a security falling below or rising above a certain level. The objective is mainly to avoid losses from changes in the price of the security
<b>Market abuse: ping orders</b>	Entering small orders to trade to determine the level of hidden orders and particularly to assess what is on a dark platform
<b>Market abuse: phishing</b>	Executing orders to trade, or a series of orders to trade, to uncover orders of other participants, and then entering an order to trade to take advantage of the information obtained.
<b>Market abuse: abusive squeeze</b>	Taking advantage of a dominant position over the supply of or demand for a security to materially distort the prices at which other parties must deliver or take delivery to satisfy their obligations
<b>Market abuse: inter-trading venue manipulation</b>	Trading on one trading venue or outside a trading venue to improperly move the price of a security in another trading venue or outside a trading venue
<b>Market abuse: cross-product manipulation</b>	Trading on a security to improperly move the price of a related security in another or in the same trading venue or outside a trading venue
<b>Market abuse: painting the tape</b>	Entering into orders to trade or engaging in a transaction or series of transactions that are shown on a public display facility to give the impression of activity or price movement in a financial instrument
<b>Market abuse: improper matched orders</b>	Transactions carried out because of the entering of buy and sell orders to trade at or nearly at the same time, with very similar quantity and similar price, by the same party or different but colluding parties
<b>Market abuse: concealing ownership</b>	Transaction or series of transactions designed to conceal the ownership of a security via the breach of disclosure requirements through the holding of the security in the name of a colluding party (or parties).The disclosures are misleading in respect of the true underlying holding of the security.
<b>Market abuse: wash trades</b>	Entering into arrangements for the sale or purchase of a security, where there is no change in beneficial interests or market risk or where beneficial interest or market risk is transferred between parties who are acting in concert or collusion
<b>Market abuse: trash and cash</b>	Taking of a short position in a security and then undertaking further selling activity and/or disseminating misleading negative information about the security with a view to decreasing the price of the security, by the attraction of other sellers. When the price has fallen, the position held is closed
<b>Market abuse: quote stuffing</b>	Entering large number of orders to trade and/or cancellations and/or updates to orders to trade to create uncertainty for other participants, slowing down their process and/or to camouflage their own strategy
<b>Market abuse: momentum ignition</b>	Entering orders to trade or a series of orders to trade, or executing transactions or series of transactions, likely to start or exacerbate a trend and to encourage other participants to accelerate or extend the trend to create an opportunity to close out/open a position at a favourable price
<b>Market abuse: layering and spoofing</b>	Submitting multiple or large orders to trade often away from the touch on one side of the order book to execute a trade on the other side of the order book. Once the trade has taken place, the orders with no intention to be executed will be removed
<b>Market abuse: no intention of executing orders</b>	Entering of orders which are withdrawn before execution, thus having the effect of giving a misleading impression that there is demand for or supply of a security
<b>Market abuse: excessive bid/offer spread</b>	Moving the bid-offer spread to and/or maintaining it at artificial levels, by abusing of market power

# Annexure C: Glossary

<b>Market abuse: advancing the bid</b>	Entering orders to trade which increase the bid (or decrease the offer) for a security, to increase (or decrease) its price
<b>Market abuse: smoking</b>	Posting orders to trade, to attract other market participants employing traditional trading techniques ("slow traders"), that are then rapidly revised onto less generous terms, hoping to execute profitably against the incoming flow of "slow traders" orders to trade
<b>Market abuse: pump and dump</b>	Taking a long position in a security and then undertaking further buying activity and/or disseminating misleading positive information about the security with a view to increasing its price by the attraction of other buyers. When the price is at an artificial high level, the long position is sold.
<b>Market abuse: marking the close</b>	Buying or selling of a security, deliberately, at the reference time of the trading session (e.g. opening, closing, settlement) to increase, decrease or maintain the reference price (e.g. opening price, closing price, settlement price) at a specific level
<b>Market abuse: market sounding</b>	A communication of information, prior to the announcement of a transaction, to gauge the interest of potential investors in a possible transaction and the conditions relating to it such as its potential size or pricing, to one or more potential investors.
<b>Moral suasion</b>	Using persuasion, implicit threats or appeal to morality to influence or change behaviour as opposed to the use of outright coercion or force
<b>Rolling bad apples</b>	Individuals with a history of misconduct who move between firms







# 2018 FINANCIAL MARKETS REVIEW

## ANNEXURE D: MARKET INTEGRITY REPORT

### FMRC WORKING GROUP ON MARKET INTEGRITY

#### DISCUSSION PAPER

#### **What do we mean by market integrity? General principles for South African wholesale financial markets**

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# Annexure D: Market integrity report

## 1. INTRODUCTION

Market integrity and fairness are typically stated amongst the main objectives of financial regulation worldwide, coupled with efficiency and the overall safety and stability of the financial system.

In South Africa, the Financial Sector Regulation Act of 2017 has as its objective a regulatory and supervisory framework that promotes the efficiency and integrity of the financial system, amongst other important outcomes<sup>1</sup>. The new Financial Sector Conduct Authority (FSCA) will have responsibility for supporting and enhancing the efficiency and integrity of financial markets, alongside protecting financial customers and assisting in maintaining financial stability<sup>2</sup>.

Similarly, in the UK, the Financial Conduct Authority has been tasked with protecting and enhancing market integrity, as well as protecting consumers and promoting competition. The mission of the US Securities and Exchange Commission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. The Australian Securities and Investment Commission describes its work as ensuring that Australia's financial markets are fair and transparent, supported by confident and informed investors and consumers. And in the EU, the European Securities and Markets Authority focuses on the protection of investors and promoting stable and orderly financial markets.<sup>3</sup>

While the importance of financial market integrity is widely understood at a conceptual level, there is no particular internationally-accepted statement of the core characteristics that define market integrity. Academic studies set out various definitions<sup>4</sup>, while IOSCO<sup>5</sup> has provided guidance in its Objectives and Principles of Securities Regulation (Box 2). The need to incorporate market integrity in policy formulation and in the work of regulatory authorities has led to a need for an operational definition. The latter has focused on expectations of behaviours and processes in financial markets that together deliver fair, efficient and transparent markets, consistent with the concept of market integrity. As a consequence, authorities have tended to cast their net wide in terms of the characteristics that define market integrity. While this reduces the likelihood of omitting important features, it creates challenges for setting objectives, measuring performance and managing expectations. In particular, the problem of measurability originates from the absence of well-defined metrics of market integrity to measure the effectiveness of regulators in achieving this objective.

### Box 1: Is fairness the same as integrity?

The concepts of "fairness" and "integrity" frequently appear in discussions on the role of regulation in financial markets and in relation to market standards and practices. The distinction between the two concepts is not necessarily clear and in reality the terms may be interchangeable. Arguably, market integrity captures a broader notion of markets that are not only fair, but also efficient or effective, and transparent. However, these three characteristics are inevitably interconnected. For example, an efficient or effective market should be free from abuse and manipulation – which is also a necessary condition for fair outcomes. Transparency in markets is

<sup>1</sup> In full, the object of the Act is "to achieve a stable financial system that works in the interests of financial customers and that supports balanced and sustainable economic growth in the Republic, by establishing, in conjunction with the specific financial sector laws, a regulatory and supervisory framework that promotes - (a) financial stability; (b) the safety and soundness of financial institutions; (c) the fair treatment and protection of financial customers; (d) the efficiency and integrity of the financial system; (e) the prevention of financial crime; (f) financial inclusion; (g) transformation of the financial sector; and (h) confidence in the financial system." (Section 7.(1) of the FSR Act of 2017)

<sup>2</sup> Section 57 of the FSR Act of 2017

<sup>3</sup> UK: <https://www.fca.org.uk/about/the-fca>; US: <https://www.sec.gov/Article/whatwedo.html>; Australia: <http://asic.gov.au/about-asic/what-we-do/our-role/>; EU: <https://www.esma.europa.eu/about-esma/who-we-are>

<sup>4</sup> For example, in Austin, J, "What Exactly Is Market Integrity? An Analysis of One of the Core Objectives of Securities Regulation", 2017 8 (2) William & Mary Business Law Review 215. <https://ssrn.com/abstract=2814986>

<sup>5</sup> International Organization of Securities Commissions



# Annexure D: Market integrity report

closely linked to fair access and outcomes and also to effectiveness in terms of the pricing and allocation of capital and risk. In this discussion paper, the focus is on this broader notion of market integrity, where fair access and outcomes are viewed as critical components of markets that function well.

This discussion paper reviews recent initiatives in South Africa and internationally to strengthen conduct in wholesale financial markets, with the objective of developing a definition of market integrity applicable to South African markets. The focus is on the key outcomes that characterise market integrity and how these may be supported by codes or standards of conduct, the framework for governance and risk management at financial institutions, and appropriate levels of transparency in markets. The paper also examines the views of South African market participants on the concept of market integrity, drawing on responses to the FMRC Questionnaire.

The concluding section of the paper proposes a definition of market integrity based on principles for key outcomes, behaviours and processes in South African wholesale financial markets. We do not attempt in this paper to examine how well South African markets currently perform relative to these principles – instead these principles are intended to guide the FMRC in its assessment of wholesale financial markets to be set out in the Consultation Paper in 2018.

## Box 2: IOSCO Objectives and Principles of Securities Regulation

**IOSCO set out three core objectives of securities regulation\*:**

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

These objectives are further articulated through 38 principles for the regulation of securities markets.

While these three objectives overlap to some extent, the concept of market integrity is most closely reflected in the objective of markets that are fair, efficient and transparent. IOSCO provide the following explanation of this objective\*\*:

*“The fairness of markets is closely linked to investor protection and, in particular, to the prevention of improper trading practices. Market structures should not unduly favor some market users over others. The regulator’s approval of exchange and trading system operators and of trading rules helps to ensure fair markets.*

*Regulation should detect, deter and penalize market manipulation and other unfair trading practices. Regulation should aim to ensure that investors are given fair access to market facilities and market or price information. Regulation should also promote market practices that ensure fair treatment of orders and a price formation process that is reliable.*

*In an efficient market, the dissemination of relevant information is timely and widespread and is reflected in the price formation process. Regulation should promote market efficiency.*

*Transparency may be defined as the degree to which information about trading (both for pre-trade and posttrade information) is made publicly available on a real-time basis. Pre-trade information concerns the posting of firm bids and offers as a means to enable investors to know, with some degree of certainty, whether and at what prices they can deal. Post-trade information is related to the prices and the volume of all individual transactions actually concluded. Regulation should ensure the highest levels of transparency.”*

\* IOSCO: *Objectives and Principles of Securities Regulation* (May 2017)

\*\* IOSCO: *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* (May 2017)

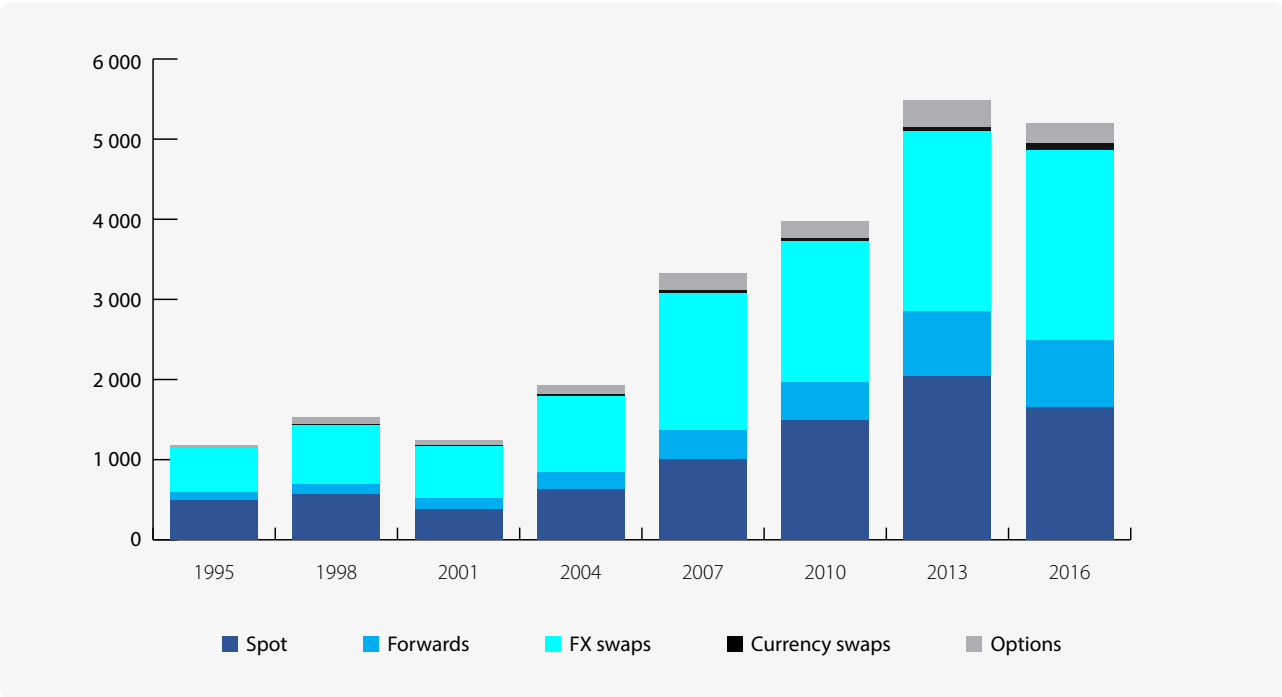
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## 2. BACKGROUND

Wholesale financial markets are inhabited by sophisticated financial institutions and clients with large balance sheets, for instance including the corporate treasuries of multinational companies. Globally, these markets are huge, with a diverse range of financial instruments – standardised and bespoke – meeting the strategies and needs of varied participants.

For example, turnover in the global foreign exchange market amounted to a daily average of US\$5.1 trillion in April 2016, including spot and forward foreign exchange contracts, swaps, options and other products (Figure 1). Turnover in over-the-counter (OTC) interest rate derivatives added a further US\$2.7 trillion in daily activity (Figure 2). The total gross market value of OTC derivatives contracts (i.e., the cost of replacing all outstanding contracts at current market prices) stood at US\$15 trillion at the end of 2016 (Figure 3) – or US\$483 trillion measured on the basis of notional amounts outstanding. In South Africa, foreign exchange and OTC derivatives markets are large and well-developed: an average daily turnover of US\$21 billion in foreign exchange contracts and US\$9 billion in interest rate contracts in April 2016 (Figures 4 and 5).

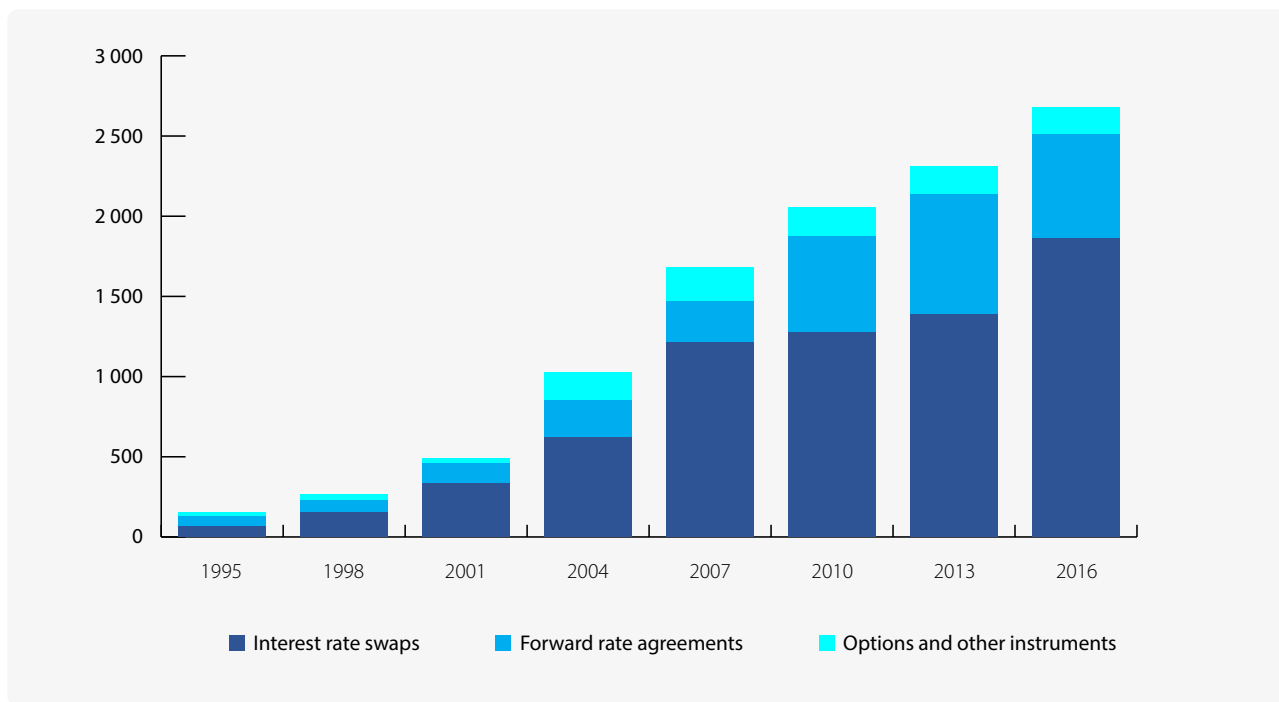
Figure 1: Global foreign exchange market. Average daily turnover in April, US\$ billions



Source: BIS Triennial Central Bank Survey

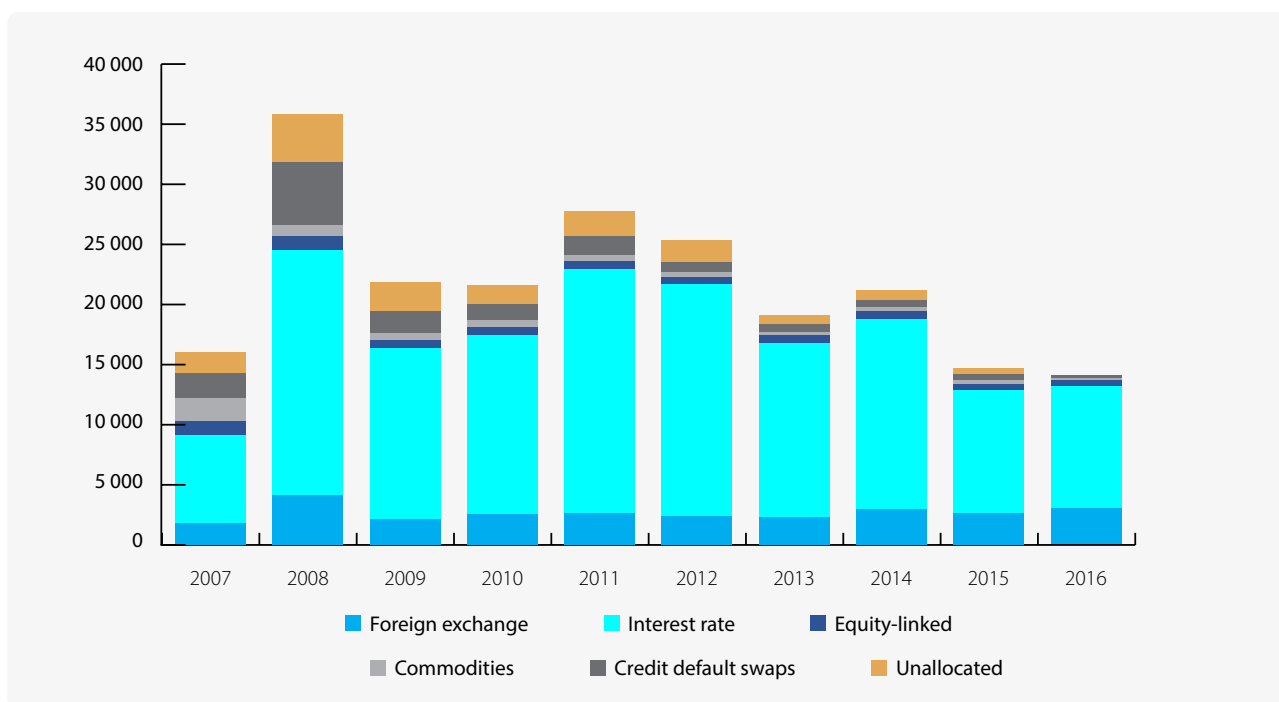
# Annexure D: Market integrity report

Figure 2: Turnover in OTC interest rate derivatives. Average daily turnover in April, US\$ billions



Source: BIS Triennial Central Bank Survey

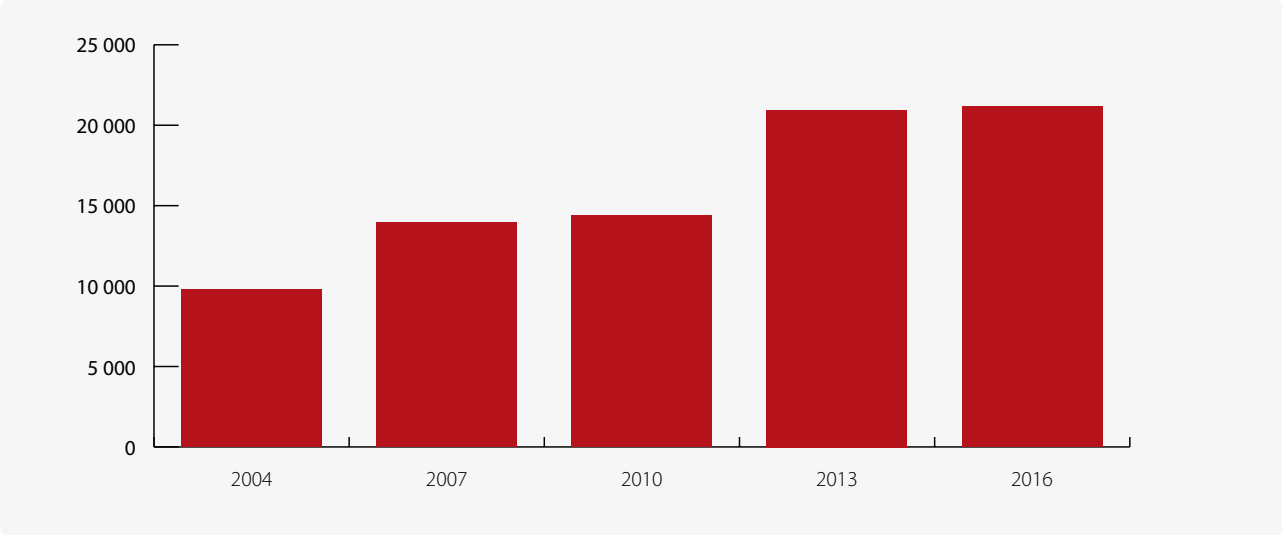
Figure 3: Gross market value of OTC derivatives markets at end of year, in US\$ billions



Source: BIS Semi Annual OTC Derivatives Statistics. Data cover 13 jurisdictions, accounting for the bulk of outstanding positions.

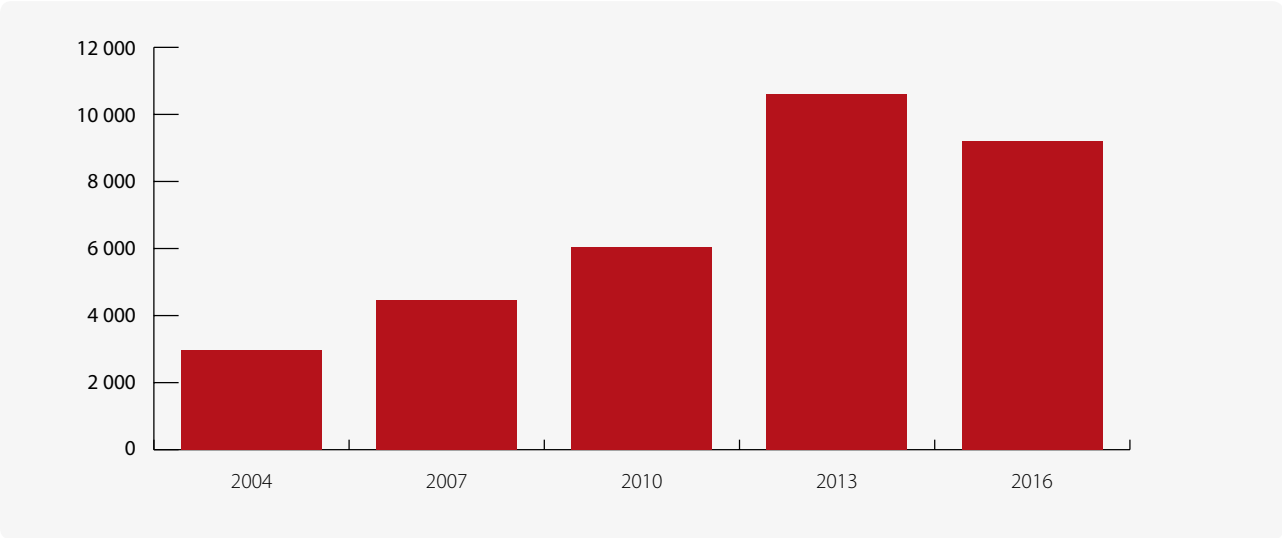
# Annexure D: Market integrity report

Figure 4: South African foreign exchange market. Average daily turnover in April, US\$ millions



Source: BIS Triennial Central Bank Survey

Figure 5: OTC interest rate derivatives in SA. Average daily turnover in April, US\$ millions



Source: BIS Triennial Central Bank Survey

# Annexure D: Market integrity report

Wholesale financial markets have an important function in the global economy through their role in setting exchange rates, interest rates and commodity prices and, more generally, in the global allocation of capital. These markets impact on the lives of ordinary people in various ways: for instance, from affecting the level and volatility of food and energy prices to influencing the affordability of government's social programmes through the cost of public borrowing. And they have an important role in the financing of productive investment and trade – which in turn feeds into job creation and economic growth. Market integrity – in the broadest sense of markets that function well - is therefore a public policy concern, affecting well-being far beyond the direct participants in these markets.

Wholesale markets are distinct from retail financial activities because of the sophisticated nature of market participants. There is an expectation that financial institutions, large corporate treasuries and major investors in these markets are familiar with the environment in which they operate and generally understand the structure and risks of the instruments that are bought and sold – in contrast to the information asymmetries and limits to financial literacy that typically characterise retail financial services. Nevertheless, recent misconduct cases involving the attempted manipulation of market prices, misuse of information, and collusion have damaged public trust and confidence in the ability of wholesale markets to deliver fair outcomes. Furthermore, the opaque structure of complex financial instruments can disadvantage professional investors – most notably illustrated in the securitised mortgages that sparked the global financial crisis. Technological developments are bringing fundamental changes to the participants and activities in markets, such as algorithmic trading and high frequency strategies, and with this comes new challenges for maintaining market integrity.

In this light, the historical light-touch regulatory approach to conduct in wholesale financial markets has now been replaced by a widespread recognition amongst international regulators and market participants that tools to underpin sound market conduct are needed to regain public trust in the fairness and integrity of the financial system. International initiatives to develop codes and principles to govern conduct in wholesale financial markets are an important outcome of this increased focus on market integrity, coupled with an emphasis on an appropriate balance between the role of regulation and market-led culture and standards in establishing financial markets that function well.

## 3. DEFINING FAIRNESS AND EFFECTIVENESS – THE UK FAIR AND EFFECTIVE MARKETS REVIEW

One possible view of market integrity is that it captures the notion of markets that deliver fair and effective outcomes. Here, the UK Fair and Effective Markets Review (2014-15) proposed a broad definition of “fairness” and “effectiveness” for wholesale financial markets<sup>6</sup>. The UK Review sets out a number of core features of well-functioning financial markets, summarised and discussed below.

<sup>6</sup> This section draws on two documents from the UK's Fair and Effective Markets Review, conducted jointly by the Bank of England, Financial Conduct Authority and HM Treasury: “How fair and effective are the fixed income, foreign exchange and commodities markets?”, Consultation document, October 2014. Section 3: What does ‘fair and effective’ mean for the FICC markets? Fair and Effective Markets Review Final Report, June 2015. Section 1: What do ‘fair’ and ‘effective’ mean for FICC markets?

# Annexure D: Market integrity report

**Fairness** is characterised by:

**Clear, proportionate and consistently applied standards of market practice:** This requires a widely understood and accepted framework of rules and guidelines for market practice that deliver fair outcomes for market participants. Some elements of the framework of market standards may be common across wholesale markets, while others may be tailored to specific features of particular markets. Reinforcing this framework will be the allocation of responsibilities and accountability for conduct within individual financial institutions, encompassing the Board of Directors and senior management, line managers and desk heads, and individual staff.

**Sufficient transparency to verify that standards of market practice are consistently applied:**

Transparency in financial markets provides clients with information to confirm that their transactions have been executed according to their instructions, consistent with market standards and in line with prevailing market conditions. Transparency also has a wider role in supporting financial stability – through promoting the informed pricing and allocation of risk in the financial system. Transparent outcomes can be a standard feature in some markets - for example where transactions in standardised products take place on exchanges or through widely used electronic platforms. However, in more specialised markets there may inevitably be limits to in-built transparency – in such cases, there should be enough transparency to support confidence that standards of market practice are maintained.

**Confidence that market participants behave with integrity:** Reinforcing the features above, fair markets also require that all participants behave honestly. This implies that participants should be confident that they will not be subject to unethical or illegal practices in their relationships with agents and counterparties. Confidence in the integrity of participants is further bolstered by surveillance and enforcement systems that can detect wrong-doing with appropriate penalties applied.

**Open access to markets:** Open access to wholesale financial markets implies that participation is possible on reasonable terms. While this may vary across markets and the particular roles of different participants, it is generally understood to imply that there is fair access and that large or incumbent firms are not able to exercise unfair advantages. Open access should also be possible through an effective system of intermediation. For wholesale financial markets, the concept of open access is qualified by an understanding that market participants will be financial institutions and professional investors – in this space, open access is not expected to extend directly to retail clients.

**Competition the basis of merit:** Competitive markets allow new entrants to challenge incumbent firms on the basis of price and quality, supporting innovation in products and services and enabling consumers to exercise choice. Firms that invest in capabilities and innovate to provide better products and services to clients should be able to win a commensurate market share. But innovation or an incumbent position should not establish a permanent barrier to market entry by other firms to the detriment of the end-users of products or services.

**Effectiveness** captures how well financial markets achieve their principal role in the economy, namely the channelling of savings into investment, the provision of capital to firms, governments and households, and the appropriate allocation of risks. Effective markets have robust and predictable market mechanisms and infrastructures that enable participants to undertake transactions with confidence. There should be sufficient levels of liquidity to allow markets to function and competitive price formation to support an appropriate allocation of capital. It follows that, in line with the definition of fairness, effective markets should also be free from unethical practices and unwarranted barriers to market access.





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The definitions of fairness and effectiveness developed in the UK Review suggest a number of overarching characteristics of market integrity of relevance to South African wholesale financial markets. In particular, emphasis is given to:

- Clear and consistent standards of market practice and participants that behave with integrity
- An open and competitive market environment, with sufficient transparency
- Robust market mechanisms and infrastructures, and
- Fair and effective outcomes in the pricing and allocation of capital and risk in the economy.

## 4. PUTTING INTEGRITY AT THE HEART OF CONDUCT STANDARDS: INTERNATIONAL PRINCIPLES AND CODES

A further view of market integrity is that it captures an expected set of behaviours and processes that are consistent with fair, efficient and transparent outcomes in markets. Recent international initiatives on wholesale market conduct have developed principles and codes that give effect to this view of market standards and integrity.

Two important examples of international coordination in this area are summarised below. The IOSCO Task Force Report on Wholesale Market Conduct and the FX Global Code.

### IOSCO TASK FORCE REPORT ON WHOLESALE MARKET CONDUCT

The IOSCO Market Conduct Task Force was formed in 2015 to review regulatory approaches to conduct and related IOSCO work in this area. The objectives are to raise awareness of the market conduct tools and approaches used by IOSCO members and to highlight relevant examples in the context of wholesale financial markets.

The Task Force report released in June 2017 has a particular focus on the risk of misconduct by individuals and, in this context, sets out core expectations regarding the behaviour of individual participants in wholesale markets, drawn from IOSCO work. These core expectations, together with the types of regulatory approaches, are summarised below:

**Honesty:** Market participants are expected to act with honesty, such that clients and counterparties are able to rely on their statements and undertakings. This expectation is given effect through prohibitions on misleading or deceptive statements and conduct, to support trust in markets.

**Upholding market integrity:** All market participants are expected to uphold market integrity, meaning that there is confidence that participants play by the same rules with fair market outcomes. This expectation of conduct is usually buttressed through various prohibitions on market manipulation.

**Competence:** Market participants are expected to have the skills and knowledge required for the services they provide and to exercise due care and diligence. This expectation is backed by minimum qualification requirements, licensing requirements, and ongoing training requirements.

**Management of conflicts:** At individual and firm level, there is an expectation that conflicts of interest will be avoided or disclosed and managed appropriately. Obligations to identify and manage potential and actual conflicts support confidence that participants are acting in the best interests of their clients.

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**Communication and confidentiality:** Market participants are expected to disclose relevant information in a clear and timely manner and to respect client confidentiality. Obligations apply to both firms and individuals in these two areas.

Supporting these core expectations of conduct for individuals will be regulatory principles and requirements regarding organisational, control and governance frameworks within firms, as well as mechanisms to hold firms and senior management accountable for standards of conduct.

## FX GLOBAL CODE

The FX Global Code (May 2017) is a set of principles of good practice in foreign exchange markets, developed by central banks and market participants from 16 jurisdictions. The Code aims to promote the integrity and effective functioning of the wholesale FX market, further described as:

*"...a robust, fair, liquid, open, and appropriately transparent market in which a diverse set of market participants, supported by resilient infrastructure, are able to confidently and effectively transact at competitive prices that reflect available market information and in a manner that conforms to acceptable standards of behaviour."*

**The Code contains six leading principles, further elaborated in more detailed principles for market practices<sup>7</sup>. The main themes of these principles are briefly summarised below:**

**Ethics:** Market participants are expected to behave in an ethical and professional manner. Ethical behaviour includes acting honestly, fairly and with integrity. Professionalism includes knowledge of and compliance with applicable law, relevant experience, knowledge and qualifications, acting with competence and skill and with professional judgement. Ethical and professional behaviour also requires the identification and elimination or appropriate management of conflicts of interest.

**Governance:** Market participants are expected to have a sound and effective governance framework. This requires adequate and effective measures for oversight, supervision and control of market activity and a strong culture of ethical and professional conduct in firms. Remuneration and promotion structures should promote practices and behaviours consistent with ethical and professional conduct. Effective policies and procedures should be in place to handle improper practices and behaviours.

**Execution:** Market participations are expected to exercise care in negotiating and executing transactions. They should be clear about the capacities in which they act and handle transactions fairly, with transparency, and consistent with principles set out for specific practices. Market participants should not engage in activities that hinder the functioning of the market and the price discovery process.

**Information sharing:** Market participants are expected to be clear, accurate, professional and not misleading in their communications. Confidential information should be identified and protected. Clear guidance should be provided to personnel on approved methods of communication with other market participants.

<sup>7</sup>The FX Global Code contains 55 principles, grouped under the six leading principles.



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*Risk management and compliance:* Market participants are expected to promote and maintain a robust control and compliance environment, including appropriate frameworks and processes for risk management and compliance, and for the review of the effectiveness of these functions.

*Confirmation and settlement processes:* Market participants are expected to have robust, efficient, transparent and risk-mitigating post-trade processes to promote the predictable, smooth and timely settlement of transactions.

A similar set of underpinning principles is set out in the UK Money Market Code (Bank of England, April 2017), aimed at promoting “an open, fair and effective market”. The underpinning principles cover: ethics; governance and risk management; information sharing, confidentiality and communications; execution, surveillance, confirmations and settlement.

The Global Precious Metals Code (London Bullion Market Association, May 2017) is also organised around four leading principles aimed at supporting “fair, effective, open, transparent and responsible engagement within the market”. These leading principles cover ethics; governance, compliance and risk management; information sharing; and business conduct and the management of the transaction life cycle.

While these examples of new Codes for wholesale markets all have elements that are specific to practices in those particular markets, there are common themes that apply across financial markets, as is also reflected in the general expectations of conduct set out in the IOSCO report. This suggests that there is growing convergence internationally towards the meaning of market integrity and a consistent framework of general principles for behaviours and processes. These include:

- The ethics, honesty, competence and diligence of market participants;
- High standards of conduct, for example, in the management of conflicts of interest and in the communication and management of information, as well as in practices specific to particular markets;
- Appropriate frameworks for governance, oversight and accountability, control and compliance and risk management in financial institutions;
- Robust, efficient and transparent practices and processes for transactions.

## 5. DELIVERING MARKET INTEGRITY IN SOUTH AFRICA: PROGRESS ON POLICY, CODES AND STANDARDS

Financial sector policy and legislation in South Africa supports a framework to promote fairness and integrity in wholesale financial markets. The Twin Peaks reforms will introduce a new regulatory framework to enhance market conduct and integrity, with the objective of protecting financial consumers and investors and supporting the safety and stability of the financial system.

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## POLICY FRAMEWORK FOR MARKET INTEGRITY

Much of the focus on market conduct to date relates to the protection of financial end-users and, in particular, has emphasised the “Treating Customers Fairly” principles from a retail perspective. From the perspective of wholesale financial markets, principles and requirements in respect of market integrity, together with the oversight of the FSCA, have been outlined in a National Treasury discussion document on market conduct in 2014<sup>8</sup>.

Some of the general principles include that financial markets should not unduly favour some market users over others and that there are the highest practicable levels of transparency and efficiency in financial markets, with investors given fair access to markets and information. The document furthermore identifies the role of regulation in deterring, detecting and penalising market abuse.

The policy document identifies certain elements to underpin market integrity. Regulated entities should have: proper governance and risk management frameworks; appropriate disclosure and transparency mechanisms; sound legal and accounting systems; and efficient fit and proper vetting mechanisms for key staff and officers. There should be an effective enforcement regime for securities laws, backed by an effective whistleblowing procedure and an efficient judicial system for criminal prosecution of violations of laws relating to market integrity. These elements are in line with global principles for market integrity discussed above.

## LEGISLATION SUPPORTING MARKET INTEGRITY

**The Financial Sector Regulation Act (2017) provides for a new regulatory approach to market conduct to be implemented by the FSCA. The FSCA's mandate will be to:**

- enhance and support the efficiency and integrity of financial markets;
- protect financial customers; and
- assist in maintaining financial stability<sup>9</sup>.

The FSR Act furthermore provides appropriate tools for the FSCA, including the setting of conduct standards, to fulfil its mandate<sup>10</sup>.

**Complementing this approach, the Financial Markets Act (2012) has a specific role with respect to the fairness and integrity of wholesale financial markets. The objectives of the FMA are to:**

- ensure that South African financial markets are fair, efficient and transparent;
- increase confidence in South African financial markets by:
  - requiring that securities services be provided in a fair, efficient and transparent manner; and
  - contributing to the maintenance of a stable financial market environment
- promote the protection of regulated persons, clients and investors;
- reduce systemic risk; and
- promote the international and domestic competitiveness of South African financial markets and securities services.<sup>11</sup>

<sup>8</sup> Treating Customers Fairly in the Financial Sector - A Draft Market Conduct Policy Framework for South Africa, Discussion Document, National Treasury, December 2014

<sup>9</sup> Section 57 of the FSR Act (2017)

<sup>10</sup> Section 106 of the FSR Act (2017)

<sup>11</sup> Section 2 of the Financial Markets Act (2012)



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Under the Financial Markets Act, the regulator may prescribe conduct standards for regulated entities in support of these objectives. The FMA specifies that such conduct standards should be based on certain principles, including that participants act honestly and fairly, with due skill, care and diligence, avoid or mitigate conflicts of interest, and uphold the integrity of financial markets<sup>12</sup>. Furthermore, the FMA promotes market integrity by setting out prohibitions on market practices that constitute market abuse, namely, insider trading, market manipulation, and the making of false, misleading or deceptive statements, promises and forecasts.

Two important frameworks for sound conduct and integrity in the South Africa financial system given effect through legislation are: (i) conduct requirements set out in the JSE Rules and Directives that apply to the JSE equity, debt and derivatives markets, consistent with the FMA - and similarly the rules and regulations set by the newly-licensed exchanges in line with the FMA; and (ii) the general code of conduct for authorised financial services providers under the Financial Advisory and Intermediary Services Act (2002). The overall approach will be strengthened by new codes of conduct that will apply to over-the-counter (OTC) markets, discussed further below.

## NEW CODES OF CONDUCT FOR OTC MARKETS

There has been progress in further strengthening the market integrity framework through a proposed draft code of conduct for over-the-counter financial markets and through a draft code of conduct for authorised over-the-counter derivative markets.

### Draft Code of Conduct for OTC Markets<sup>13</sup>

Against the backdrop of various investigations undertaken following actual and alleged instances of misconduct in foreign exchange markets, the South African Reserve Bank and the Financial Services Board launched a review of foreign exchange trading operations in 2014-2015. Among other things, the review led to the development of a draft Code of Conduct for OTC financial markets in South Africa. The Code, currently under review by the South African Reserve Bank and shortly to be finalised, is intended to serve as a general code for those market participants not covered by a specific code of conduct pertaining to their market segment.

The principal aim of the Code is to ensure the highest level of professionalism in order to preserve the integrity of the capital markets system, while also seeking to ensure fair and equitable treatment of all participants within South African financial markets. Initially, the principles outlined in the Code specifically related to banks acting as market participants and their dealings with clients or counterparties. The scope and principles have since been expanded to cover all market participants active in OTC markets – both retail and wholesale – including, inter-dealer brokers, prime brokers and treasury outsourcing companies.

Importantly, the draft OTC Code places strong emphasis on trust, honesty and good faith in ensuring the integrity and efficient functioning of OTC financial markets. Together with specific requirements of the Code relating to market practices, some of the key general features relating to market integrity are expected to include:

- Participants dealing in OTC financial markets are required to have proper governance arrangements to provide an oversight function and to review conduct of its trading activities.
- Participants must have the necessary knowledge, skills and training to carry out operations. Staff must be aware of their responsibilities and trading mandates and act with due care and diligence, in an honest and fair manner.

<sup>12</sup> Chapter VIII of the Financial Markets Act (2012)

<sup>13</sup> First released as Draft Code of Conduct for the South African Over-the-Counter Markets, South African Reserve Bank and Financial Services Board, October 2015



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- Mechanisms must be in place to manage client information in a confidential manner; to circumvent any potential or actual conflicts of interest that arise; and to prevent market abuse.
- Participants must ensure that appropriate risk management frameworks are in place.

Over and above these requirements, the OTC Code seeks to promote transparency and competitiveness of the South African OTC financial markets and places the responsibility of market integrity on the shoulders of market participants through ethical conduct and professional treatment of clients.

## Draft Code of Conduct for Authorised OTC Derivatives Providers

The Code of Conduct for OTC derivatives markets applies to authorised OTC derivatives providers (ODP). This is currently in the form of a draft Board Notice issued by the Financial Services Board in terms of the Financial Markets Act<sup>14</sup>.

### The draft Code sets out a number of important general principles that ODPs are required to meet, including:

- Providers must act fairly and honestly, with due skill, care and diligence in the interests of clients and counterparties and market integrity.
- Providers are required to communicate information to clients and counterparties with transparency - clear, fair and not misleading<sup>15</sup>.
- Conflicts of interest must be managed and resolved in a fair manner.
- Providers must observe proper standards of market conduct, maintain knowledge and act in terms of applicable laws and regulations, and engage with the regulator in an open and cooperative way.

The draft Code further requires the distinction of clients and counterparties, with associated requirements to support the protection of clients, including the appropriateness of products for the particular client and disclosure of information. Clients are considered to be less sophisticated than professional counterparties and therefore specific protections are incorporated into the Code. ODPs in dealing with clients are required to provide information on the product/transaction timeously and in plain language and provide information on the material terms in order for the client to make an informed decision on the transaction. The Code specifies the nature of written agreements setting out the terms governing the trading relationship for both clients and counterparties. The draft Code incorporates specific requirements for ODPs to have in place suitable risk mitigation measures. Additional principles cover the confidentiality of client and counterparty information and the safeguarding of assets.

The draft Code is currently under review by the Financial Services Board and the effective date is dependent on the implementation of the FMA regulations that provide for ODPs to be regulated entities, expected to come into effect before the end of 2017.

<sup>14</sup> Code of Conduct for Authorised Over-the-Counter Derivatives Providers, Draft Board Notice, Financial Services Board, July 2016

<sup>15</sup> In particular, this requirement reflects the complexity and potential information asymmetries present in derivatives products. Clients and counterparties must be provided with sufficient information in order for them to assess the derivatives transactions they enter into such that they are fully aware of the risks.



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## 6. DEFINING FAIRNESS, EFFECTIVENESS AND MARKET INTEGRITY: MARKET PARTICIPANTS' VIEWS

As part of its initial consultation with the market, the Financial Markets Review Committee has undertaken a survey of views on market structures and conduct, governance and market integrity. An open questionnaire was circulated to a broad range of market participants from the buy-side and sellside. To date, responses have been received from 38 institutions, including 14 asset managers and investors, 14 banks, 5 corporate treasuries, 2 market infrastructure providers, and 3 industry associations.

**Three questions in the FRMC Questionnaire explore the definition of market integrity:**

**Question 4.1:** How would you define the concepts of fairness, effectiveness and overall market integrity for South Africa? Please outline the main features or outcomes that best describe these concepts in wholesale financial markets.

**Question 4.2:** What are the main strengths of current market standards and practices in establishing market integrity?

**Question 4.3:** What are the main risks to market integrity arising from current market practices?

The responses to each of these questions were studied in order to identify the main themes or characteristics that market participants associate with the concept of market integrity. A set of 52 key words or phrases were drawn from the responses (see Appendix A). The frequency of these key words or phrases (or variants) across all the responses was then examined. A degree of judgement was often needed in interpreting the responses and categorising according to our list of key words and phrases. The results of this analysis provides an illustration of how the market understands the concept of market integrity.

There is considerable variation in the responses to these three questions and not necessarily a consistent view on current strengths and risks in relation to key market characteristics. The analysis below seeks only to identify important components or characteristics of market integrity, in order to inform our definition of market integrity. For example, one respondent may broadly describe markets as deep and liquid while another may point out areas where liquidity is lacking. In both cases, the respondent will be categorised as identifying "Market depth/liquidity" as forming part of market integrity. An assessment of the strengths and risks in terms of current South African structures and practices (as identified in the questionnaire responses) will be explored in greater length in the full FMRC Consultation Paper.

**Figure 6** shows the frequency of key words and phrases used by respondents when discussing concepts of fairness, effectiveness and market integrity (Question 4.1). Market participants often tended to emphasise aspects of the effective functioning of markets, including transparency, market depth and liquidity, competitive price discovery, and a level playing field. It is also striking that a common feature was the role of the legislative and regulatory framework in market integrity. While some responses noted the importance of well-regulated markets in a general way, others pointed to specific aspects of regulation in South Africa that either supported or hindered market integrity. Fair access to markets and fair outcomes were also amongst the most common themes. Standards of market practice and prevention of market abuse were further features noted by respondents.

**Figure 7** shows the frequency of key words and phrases in the discussion of strengths of current market standards and practices (Question 4.2). By far the most often cited is the legislative and regulatory framework – suggesting that market participants view sound and robust regulation as a core feature of market integrity. Transparency in markets and consistent standards of market practices also appear as important features. The involvement of foreign participants is further seen as a strength, either because it increases liquidity in markets or because it encourages international standards of practice.

**Figure 8** shows the frequency of key words and phrases in the discussion of risks to market integrity (Question 4.3). There tended to be more variety in responses to this question with the result that the frequency of key words and phrases is lower. The main risks identified were associated with inconsistencies in standards of market practice, limits to transparency in particular markets, the risk of market abuse in various forms, the management of conflicts of interest, and weaknesses in enforcement.

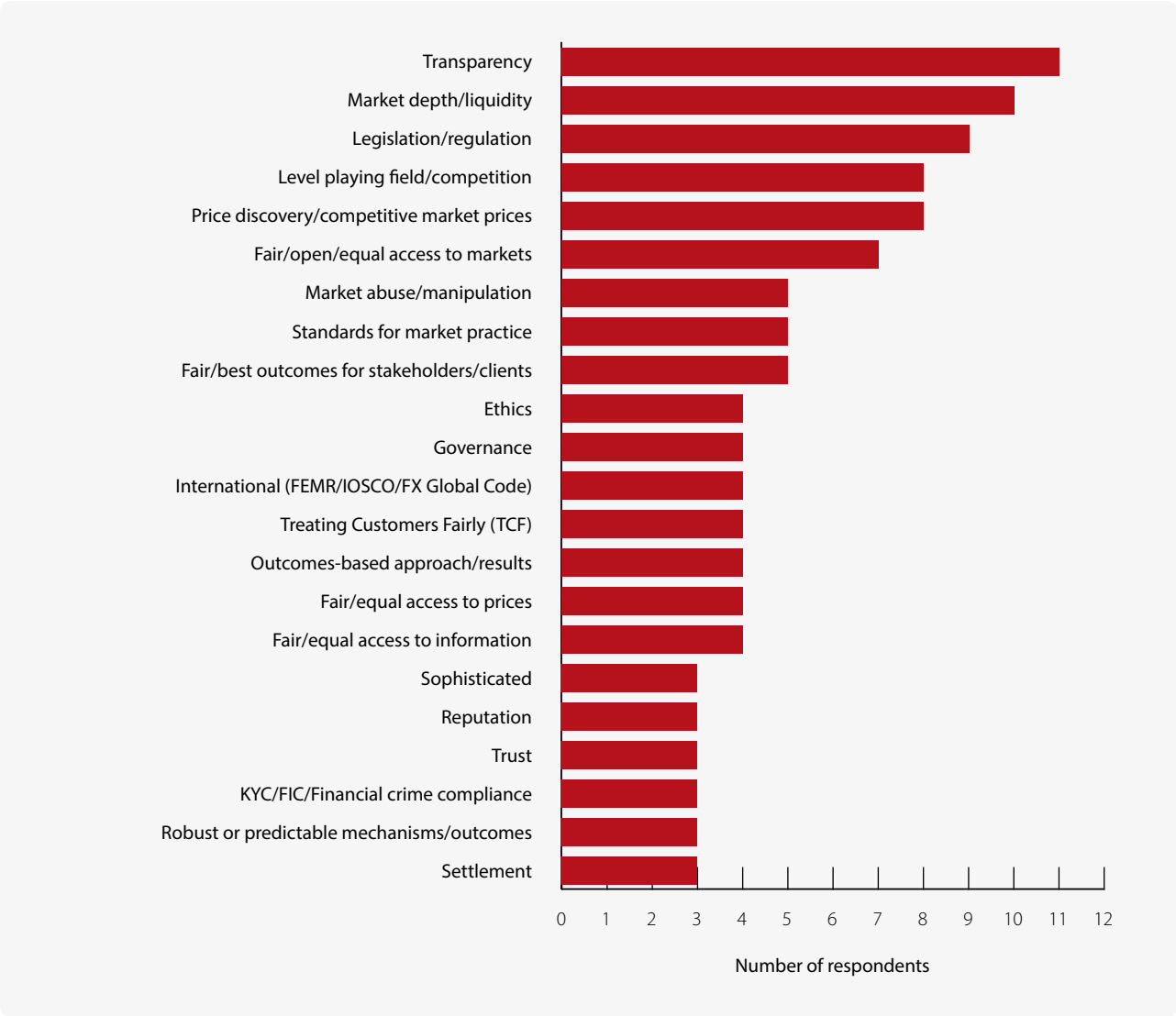
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**Figure 6: FMRC Questionnaire - Question 4.1**

How would you define the concepts of fairness, effectiveness and overall market integrity for South Africa? Please outline the main features or outcomes that best describe these concepts in wholesale financial markets.

The chart illustrates the frequency that key words or phrases (or variants) are used by respondents in discussing the concepts of fairness, effectiveness and market integrity. Key words or phrases are shown in the chart when they appear in at least three responses.

The results are drawn from 29 responses to the FMRC Questionnaire.





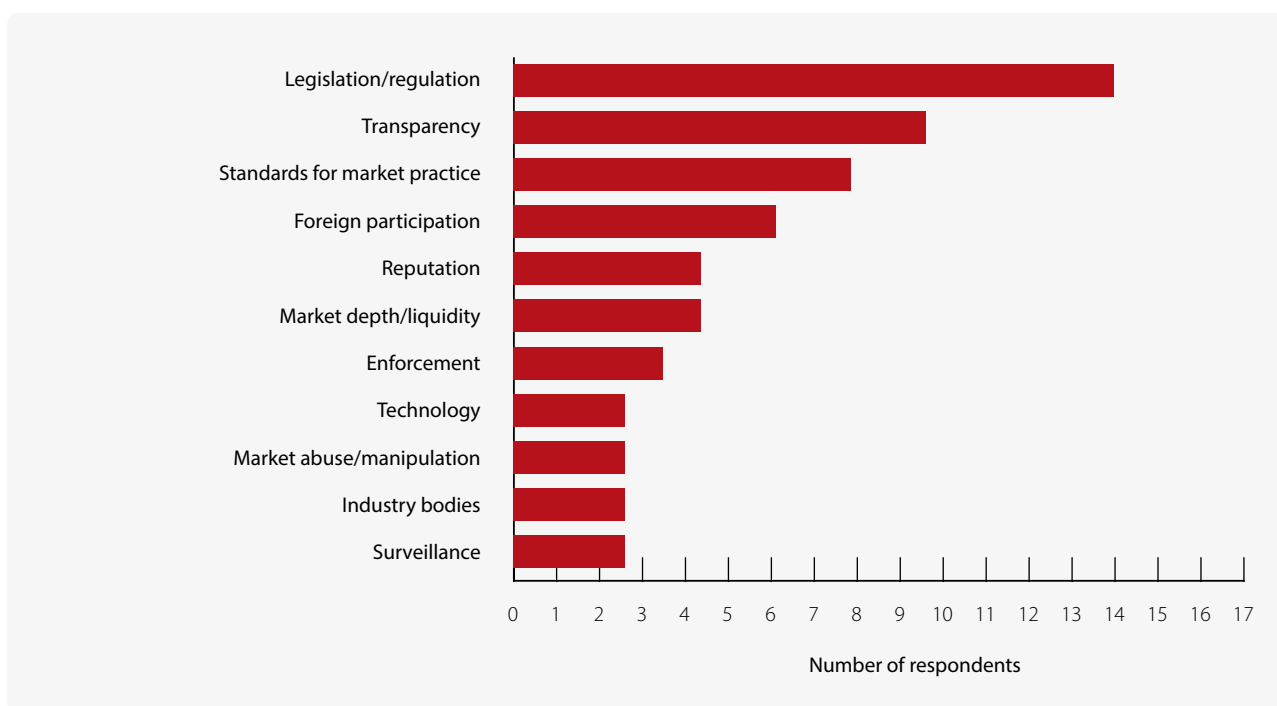
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Figure 7: FMRC Questionnaire - Question 4.2

What are the main strengths of current market standards and practices in establishing market integrity?

The chart illustrates the frequency that key words or phrases (or variants) are used by respondents in discussing strengths of market standards and practices in establishing market integrity. Key words or phrases are shown in the chart when they appear in at least three responses.

The results are drawn from 30 responses to the FMRC Questionnaire.



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Figure 8: FMRC Questionnaire - Question 4.3

What are the main risks to market integrity arising from current market practices?

The chart illustrates the frequency that key words or phrases (or variants) are used by respondents in discussing risks to market integrity. Key words or phrases are shown in the chart when they appear in at least three responses.

The results are drawn from 26 responses to the FMRC Questionnaire.



# Annexure D: Market integrity report

## 7. CONCLUSION: DEFINING MARKET INTEGRITY FOR SOUTH AFRICA

The local and international frameworks for market conduct outlined above reveal several core characteristics of market integrity, broadly spanning market structures, practices, ethics and governance. Many of these features are confirmed by market participants in South Africa in discussing the concepts of fairness, effectiveness and market integrity, together with the strengths and risks associated with current market practices.

We propose to define market integrity in terms of the key outcomes, behaviours and processes in wholesale financial markets. Market integrity exists when:

**Principle 1:** Participants act fairly, honestly and in the interests of the broader South African financial markets in all aspects of business, with the skills and knowledge required for the specific markets in which they operate, and with due care and diligence with respect to expected standards of market practice.

**Principle 2:** Standards of market practice are widely understood and consistently applied by market participants, both the general principles of high standards of conduct in wholesale financial markets and the specific practices required in particular markets. In particular, rigorous standards are applied by market participants in the management of conflicts of interest in their conduct of business, their handling of confidential information, and in their communications.

**Principle 3:** Markets have sufficient transparency and provide fair access to information about prices and issuers of financial securities to reinforce confidence that standards of market practice are upheld and to support a robust price formation process.

**Principle 4:** Markets provide fair, open and non-discriminatory access to financial products and services, either directly or through intermediation, and are competitive in support of innovation and choice to meet the varied needs of market participants.

**Principle 5:** Markets have reliable price formation processes and robust trading infrastructures to deliver fair outcomes for diverse market participants and an appropriate pricing and allocation of capital and risk in the economy.

**Principle 6:** Financial institutions have in place clear structures for governance, accountability, internal controls and risk management, led at the most senior level, and review these on a regular basis to ensure consistency with international good practice.

**Principle 7:** Surveillance and enforcement mechanisms – at financial institutions and the regulatory authorities – effectively deter, detect and penalise market abuse, backed by a sound and robust legal framework.

**Principle 8:** Legislation and regulation is clear, consistent, proportionate and free of undue influence, to underpin fair outcomes in financial markets, stability in the financial system, and an efficient allocation of capital in support of economic growth. Accordingly, supervision by financial regulators is pre-emptive, risk-based and outcomes-focused, and sufficiently intensive and intrusive to achieve these goals.

# Annexure D: Market integrity report

## APPENDIX A: ANALYSIS OF QUESTIONNAIRE RESPONSES – KEY WORDS AND PHRASES

### Access to Markets:

Fair/open/equal access to markets  
Fair/equal access to information  
Fair/equal access to prices

### Outcomes:

Best outcomes for stakeholders/clients  
Outcomes-based approach/results

### Market structures:

Transparency  
Market depth/liquidity  
Price discovery/competitive market prices  
Execution  
Settlement  
Robust or predictable mechanisms/outcomes  
Level playing field/competition  
Foreign participation  
Investment funding and risk transfer

### Market standards:

Standards for market practice

### Legal and institutional framework:

Legislation/regulation  
Relationship with regulator  
Enforcement  
Surveillance  
Investor protection  
KYC/FIC/Financial crime compliance  
Exchange control  
Industry bodies  
Politics/Government  
International (FEMR/IOSCO/Global FX Code)

### Market abuse:

Collusion/Anti-competitive practices  
Market abuse/manipulation  
Conflicts of interest/Chinese walls  
False/misleading information  
Misuse of confidential information

### Governance and compliance:

Governance  
Tone from the top  
Internal control  
Fit and proper  
Skills  
Accountability  
Compliance  
Audit  
Complaints/dispute management  
Fee structures

### Other key words:

Choice  
Inclusion  
Confidence  
Trust  
Ethics  
Reputation  
Safe  
Sophisticated  
Technology  
Complexity



# Annexure E: International governance standards and guidance

## G20 / OECD CORPORATE GOVERNANCE PRINCIPLES

The revised G20/OECD Principles of Corporate Governance were released and endorsed by the G-20 in 2015. The principles have been designated as one of the Financial Stability Board's key standards for sound financial systems; used by the World Bank Group in its country reviews on the observance of standards and codes (ROSC); and serve as the basis for the guidelines on corporate governance of banks issued by the Basel Committee on Banking Supervision, the OECD Guidelines on Insurer and Pension Fund Governance and corporate governance of insurers issued by the International Association of Insurance Supervisors.

There are six principles each supported by several sub-principles (see table E.1).

**Table E.1: G20/OECD Principles of corporate governance**

Principles	Sub principles
Ensuring the basis for an effective corporate governance framework	
The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities	The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and well-functioning markets.
	The legal and regulatory requirements that affect corporate governance practices should be consistent with the rule of law, transparent and enforceable.
	The division of responsibilities among different authorities should be clearly articulated and designed to serve the public interest
	Stock market regulation should support effective corporate governance
	Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.
	Cross-border co-operation should be enhanced, including through bilateral and multilateral arrangements for exchange of information.
The rights and equitable treatment of shareholders and key ownership functions	

# Annexure E: International governance standards and guidance

Principles	Sub principles
<p>The corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.</p>	<p><b>Basic shareholder rights should include the right to:</b></p> <ul style="list-style-type: none"> <li>• secure methods of ownership registration</li> <li>• convey or transfer shares</li> <li>• obtain relevant and material information on the corporation on a timely and regular basis</li> <li>• participate and vote in general shareholder meetings</li> <li>• elect and remove members of the board</li> <li>• share in the profits of the corporation.</li> </ul>
	<p><b>Shareholders should be sufficiently informed about, and have the right to approve or participate in, decisions concerning fundamental corporate changes such as:</b></p> <ul style="list-style-type: none"> <li>• amendments to the governing documents of the company;</li> <li>• authorisation of additional shares; and</li> <li>• extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.</li> </ul>
	<p>Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings</p>
	<p>Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse</p>
	<p>All shareholders of the same series of a class should be treated equally. Capital structures and arrangements that enable certain shareholders to obtain a degree of influence or control disproportionate to their equity ownership should be disclosed.</p>
	<p>Related-party transactions should be approved and conducted in a manner that ensures proper management of conflict of interest and protects the interest of the company and its shareholders.</p>
	<p>Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress. Abusive self-dealing should be prohibited.</p>
	<p>Markets for corporate control should be allowed to function in an efficient and transparent manner</p>
<p>Institutional investors, stock markets, and other intermediaries</p>	

# Annexure E: International governance standards and guidance

Principles	Sub principles
The corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance.	Institutional investors acting in a fiduciary capacity should disclose their corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights
	Votes should be cast by custodians or nominees in line with the directions of the beneficial owner of the shares
	Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments
	The corporate governance framework should require that proxy advisors, analysts, brokers, rating agencies and others that provide analysis or advice relevant to decisions by investors, disclose and minimise conflicts of interest that might compromise the integrity of their analysis or advice
	Insider trading and market manipulation should be prohibited, and the applicable rules enforced
	For companies who are listed in a jurisdiction other than their jurisdiction of incorporation, the applicable corporate governance laws and regulations should be clearly disclosed. In the case of cross listings, the criteria and procedure for recognising the listing requirements of the primary listing should be transparent and documented.
	Stock markets should provide fair and efficient price discovery to help promote effective corporate governance
The role of stakeholders in corporate governance	
The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises	The rights of stakeholders that are established by law or through mutual agreements are to be respected
	Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights
	Mechanisms for employee participation should be permitted to develop
	Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis
	Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and to the competent public authorities and their rights should not be compromised for doing this
	The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights
Disclosure and transparency	

# Annexure E: International governance standards and guidance

Principles	Sub principles
<p>The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company</p>	<p><b>Disclosure should include, but not be limited to, material information on:</b></p> <ul style="list-style-type: none"> <li>• The financial and operating results of the company</li> <li>• Company objectives and non-financial information</li> <li>• Major share ownership, including beneficial owners, and voting rights Remuneration of members of the board and key executives</li> <li>• Information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board</li> <li>• Related party transactions</li> <li>• Foreseeable risk factors</li> <li>• Issues regarding employees and other stakeholders</li> <li>• Governance structures and policies, including the content of any corporate governance code or policy and the process by which it is implemented</li> </ul>
	<p>Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial reporting</p>
	<p>An annual audit should be conducted by an independent, competent and qualified, auditor in accordance with high-quality auditing standards to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects</p>
	<p>External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit</p>
	<p>Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users</p>
<p>The responsibilities of the board</p>	



# Annexure E: International governance standards and guidance

Principles	Sub principles
<p>The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders</p>	<p>Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders</p>
	<p>Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly</p>
	<p>The board should apply high ethical standards. It should consider the interests of stakeholders</p>
	<p><b>The board should fulfil certain key functions, including:</b></p> <ul style="list-style-type: none"> <li>• Reviewing and guiding corporate strategy, major plans of action, risk management policies and procedures, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures</li> <li>• Monitoring the effectiveness of the company's governance practices and making changes as needed.</li> <li>• Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning</li> <li>• Aligning key executive and board remuneration with the longer-term interests of the company and its shareholders</li> <li>• Ensuring a formal and transparent board nomination and election process</li> <li>• Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions</li> <li>• Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards</li> <li>• Overseeing the process of disclosure and communications</li> </ul>
	<p>The board should be able to exercise objective independent judgement on corporate affairs</p> <ul style="list-style-type: none"> <li>• Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration</li> <li>• Boards should consider setting up specialised committees to support the full board in performing its functions, particularly in respect to audit, and, depending upon the company's size and risk profile, also in respect to risk management and remuneration. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board</li> <li>• Board members should be able to commit themselves effectively to their responsibilities</li> <li>• Boards should regularly carry out evaluations to appraise their performance and assess whether they possess the right mix of background and competences.</li> </ul>
	<p>To fulfil their responsibilities, board members should have access to accurate, relevant and timely information</p>
<p>When employee representation on the board is mandated, mechanisms should be developed to facilitate access to information and training for employee representatives, so that this representation is exercised effectively and best contributes to the enhancement of board skills, information and independence</p>	

Source: G20/OECD Principles of Corporate Governance. 2015. available at <http://www.oecd.org/corporate/principles-corporate-governance.htm>. (accessed May 2018).

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In 2017 the Financial Stability Board published a thematic review on corporate governance and implementation by Financial Stability Board member jurisdictions of the G20/OECD Principles of Corporate Governance. The recommendations offered to national authorities in member jurisdictions and financial institutions are listed in table E.2.

**Table E.2: Recommendations of the Financial Stability Boards' peer review on corporate governance**

Principle	Recommendation
Ensuring the basis for an effective corporate governance framework	1. National authorities should eliminate gaps or inconsistencies when corporate governance related requirements or standards are found in multiple sources (e.g. legislation, rules, codes)
	2. National authorities should consider if proportionality in respect of the implementation of corporate governance requirements should consider factors such as ownership structure, geographical presence and stage of development of financial institutions
	3. National authorities should enhance enforcement powers available to supervisory authorities to address weaknesses in financial institutions' corporate governance
The rights and equitable treatment of shareholders and key ownership functions	4. Shareholders should be given the opportunity to vote at shareholder meetings on the remuneration policies of financial institutions and the total value of compensation arrangements offered to the board and senior management
The role of stakeholders in corporate governance	5. National authorities should enhance the effectiveness of whistle-blower programmes, including through policies that protect whistle-blowers.
Disclosure and transparency	6. National authorities should consider improving disclosures related to governance structures, voting arrangements, shareholders agreements and of significant cross-shareholding and cross-guarantees
	7. National authorities should identify remuneration-related information that could usefully be provided to shareholders
Responsibilities of the board	8. Financial institutions should Consider adopting, implementing and disclosing codes of ethics or conduct
	9. Boards should be encouraged to undertake regular assessments of their effectiveness, and to receive training that, in part, helps them remain abreast of relevant new laws and regulations
	10. Financial institutions should improve their procedures and practices as they relate to succession planning and board training
	11. Financial institutions should enhance the transparency of the board nomination process, the qualifications of board members (including skills and experience) and the election process

Source: Financial Stability Board, *Thematic Review on Corporate Governance, April 2017*, available at <http://www.fsb.org/wp-content/uploads/Thematic-Review-on-Corporate-Governance.pdf>

<http://www.fsb.org/2017/04/thematic-review-on-corporate-governance/> (accessed June 2018).

**The recommendations to standard-setting bodies are to review practices with regard to:**

- the effectiveness of rules regarding the duties, responsibilities and composition of boards within group structures;
- the framework for related party transactions, including identifying, approving and disclosing related party transactions;
- shareholder votes on remuneration;
- the disclosure of beneficial ownership; and
- the role and responsibilities of independent directors on the board and board committees.

# Annexure E: International governance standards and guidance

## FSB RISK GOVERNANCE PRACTICES

In February 2013 the FSB published a thematic peer review on risk governance. The report takes stock of risk governance practices at both national authorities and firms and identifies sound risk governance practices (see Table E.3). The recommendations offered by the review are that national authorities should (i) strengthen their regulatory and supervisory guidance for financial institutions; (ii) devote adequate resources to assess the effectiveness of risk governance frameworks; and (ii) provide guidance on the key elements to be incorporated in effective risk appetite frameworks.

**Table E.3: Financial Stability Board sound risk governance practices**

Area	Practices
The board	Avoids conflicts of interest arising from the concentration of power at the board (e.g. by having separate persons as board chairperson and CEO or having a lead independent director where the board chairman and CEO are the same person)
	Comprises members who collectively bring a balance of expertise (e.g. risk management and financial industry expertise), skills, experience and perspectives
	Comprises largely independent directors
	Sets out clear terms of reference for itself and its committees (including tenure limits for committee members and the chairs), and establishes a regular and transparent communication mechanism to ensure continuous and robust dialogue and information sharing between the board and its committees
	Conducts periodic reviews of performance of the board and its committees
	Sets the tone from the top, and seeks to effectively inculcate an appropriate risk culture throughout the firm
	Oversees management's implementation of a firm-wide risk management framework and policies within the firm
	Approves the risk appetite framework and ensures it is directly linked to the business strategy, capital plan, financial plan and compensation
	Has access to any information requested and receives information from its committees at least quarterly
	Meets with national authorities, at least quarterly, either individually or as a group
	Requires a periodic independent assessment of the firm's overall risk governance framework and provides direct oversight to the process
The risk committee	Is a stand-alone committee, distinct from the audit committee
	Has a chair who is an independent director and is not the chair of the board or any other committee
	Includes members who are independent and have experience with regard to risk management issues and practices
	Discusses all risk strategies on both an aggregated basis and by type of risk
	Reviews and approves the firm's risk policies at least annually
	Oversees that management has in place processes to ensure the firm's adherence to the approved risk policies

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Area	Practices
The audit committee	Is a stand-alone committee, distinct from the risk committee
	Has a chair who is an independent director and is not the chair of the board or any other committee
	Includes members who are independent and have experience with regard to audit practices and financial literacy at a financial institution
	Reviews the audits of internal controls over the risk governance framework to confirm that they operate as intended
	Reviews the third-party opinion of the design and effectiveness of the overall risk governance framework on an annual basis
Audit and risk committee	Meets periodically to achieve the effective exchange of information and effective coverage of all risks, including emerging risk issues relative to the risk appetite framework and business plans
The chief risk officer (CRO)	Has the organisational stature, skill set, authority and character needed to oversee and monitor the firm's risk management and related processes, and to ensure that key management and board constituents are apprised of the firm's risk profile and relevant risk issues in a timely manner and on a regular basis. The CRO should have a direct reporting line to the CEO and a distinct role from other executive functions and business line responsibilities as well as a direct reporting line to the board and/or risk committee.
	Meets periodically with the board and risk committee without executive directors or management present
	Is appointed and dismissed with input or approval from the risk committee or the board, and such appointments and dismissals are disclosed publicly
	Is independent of business lines and has the appropriate stature in the firm. His/her performance, compensation and budget are reviewed and approved by the risk committee
	Is responsible for ensuring that the risk management function is adequately resourced, taking into account the complexity and risks of the firm as well as its risk appetite framework and strategic business plans
	Is actively involved in key decision-making processes from a risk perspective (e.g. the review of the business strategy/strategic planning, new product approvals, stress testing, recovery and resolution planning, mergers and acquisitions, funding and liquidity management planning) and challenges management's decisions and recommendations
	Is involved in the setting of risk-related performance indicators for business units
	At a minimum, meets quarterly with the firm's supervisor to discuss the scope and coverage of the work of the risk management function



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Area	Practices
The risk management function	Is independent of business lines (i.e. is not involved in revenue generation) and reports to the chief risk officer
	Has authority to influence decisions that affect the firm's risk exposures;
	<ul style="list-style-type: none"> <li>• Is responsible for establishing and periodically reviewing the enterprise risk governance framework which incorporates the risk appetite framework, risk appetite statement and risk limits.</li> <li>• The risk appetite framework incorporates a risk appetite statement that is forward-looking as well as information on the types of risks that the firm is willing or not willing to undertake and under what circumstances. It contains an outline of the roles and responsibilities of the parties involved, the risk limits established to ensure that the framework is adhered to, and the escalation process where breaches occur.</li> <li>• The risk appetite statement is linked to the firm's strategic, capital and financial plans, and includes both qualitative and quantitative measures that can be aggregated and disaggregated such as measures of loss or negative events (e.g. earnings, capital, liquidity) that the board and senior management are willing to accept in normal and stressed scenarios.</li> <li>• Risk limits are linked to the firm's risk appetite statement and allocated by risk types, business units, business lines or product level. Risk limits are used by management to control the risk profile and linked to compensation programmes and assessment.</li> </ul>
	Has access to relevant affiliates, subsidiaries, and concise and complete risk information on a consolidated basis; risk-bearing affiliates and subsidiaries are captured by the firm-wide risk management system and are a part of the overall risk governance framework
	Provides risk information to the board and senior management that is accurate and reliable, and periodically reviewed by a third party (internal audit) to ensure completeness and integrity
	Conducts stress tests (including reverse stress tests) periodically and on demand. Stress test programmes and results (group-wide stress tests, risk categories and stress test metrics) are adequately reviewed and updated to the board or risk committee. Where stress limits are breached, or unexpected losses are incurred, proposed management actions are discussed at the board or risk committee. Results of stress tests are incorporated in the review of budget, risk appetite framework and Internal Capital Adequacy Assessment Programme processes, and in the establishment of contingency plans against stressed conditions.
	Chief audit executive
Is organisationally independent from business lines and support functions and has unfettered access to the audit committee	
Meets regularly with audit committee members without management	
Is appointed and dismissed with the approval of the audit committee (or chair of that committee)	
Has his/her performance, compensation and budget reviewed and approved by the audit committee	
Has the organisational stature, talent and character needed to provide a reliable independent assessment of the firm's risk governance framework and internal controls, and is not unduly influenced by the chief executive officer and other members of management	
Has the resources (people and systems) needed to effectively carry out the responsibilities of internal audit	
Provides regular reports to the board or audit committee which summarise the results of internal audit's work, including overall conclusions or ratings, key findings, material risk/issues, and follow-ups of management's resolutions or identified issues	

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Area	Practices
Internal audit function	Reports audit findings, significant issues and the status of remedial action directly to the board or audit committee on a regular basis
	Provides an overall opinion of the design and effectiveness of the risk governance framework to the audit committee on an annual basis
	Provides qualitative assessments of risks and controls as opposed to evaluating compliance with policies and procedures
	Assesses whether business and risk management units are operating according to the risk appetite framework
	Provides feedback on how the firm's risk governance framework and risk appetite framework compare to industry guidance and better practices as a means of influencing their development
	Provides input to risk assessments and feedback on internal controls during the design and implementation processes
	Escalates issues and concerns identified during audit work or through internal whistle-blowing, complaint or other processes and situations where appropriate remedial action is not being implemented in a timely manner
	Is aware of industry trends and best practices
	Meets at least quarterly with the supervisor
Third parties	Supplement (but do not replace) internal audit staff to increase coverage
	Complement internal audit's skill sets with deeper expertise in select areas and/or the broader context of industry practices
	Are effectively supervised by the board or internal audit function to ensure accountability remains within the firm

Source: Financial Stability Board, *Thematic Review on Risk Governance, February 2013*, available at [http://www.fsb.org/2013/02/r\\_130212/](http://www.fsb.org/2013/02/r_130212/) (accessed June 2018).

## FSB GOVERNANCE TOOLKIT TO MITIGATE MISCONDUCT RISK

In April 2018 the FSB published a toolkit for firms and supervisors on the use of governance frameworks to mitigate misconduct risk. The toolkit is one component<sup>59</sup> of the FSB's 2015 work plan on measures to reduce misconduct risk. The toolkit addresses three areas: (i) mitigating cultural drivers of misconduct; (ii) strengthening individual responsibility and accountability; and (iii) dealing with rolling bad apples.

<sup>59</sup> Other components are standards and codes of behaviour such as the FX Global Code, reforms to benchmark-setting; IOSCO's toolkit of measures on wholesale market conduct, and the FSB's Principles for Sound Compensation Practices.

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**Table E.4: Financial Stability Board toolkit to mitigate misconduct risk**

Area	Tools
Mitigating cultural drivers of misconduct	Senior leadership of the firm articulates a clear cultural vision to guide appropriate behaviour
	Senior leadership of the firm identifies the cultural drivers of misconduct by reviewing a broad set of behavioural data and applying multidisciplinary analytical techniques to better understand such drivers of behaviour
	Senior leadership takes actions to shift attitudes and behaviours within the firm toward its cultural vision and to reinforce the governance frameworks designed to mitigate misconduct risk
	National authorities build a supervisory programme focused on supervising culture
	National authorities use a risk-based approach to prioritise for review the firms that display significant cultural drivers of misconduct
	National authorities use a broad range of information and techniques to assess the cultural drivers of misconduct at firms
	National authorities engage firms' leadership with respect to supervisory observations on behaviour, culture and misconduct
Strengthening individual responsibility and accountability	Identify key responsibilities through legislative or regulatory requirements, or firms' decisions on their preferred structure, or both, and assign them to the holders of various positions within a firm to promote individual accountability and increase transparency both within a firm and to relevant stakeholders
	Hold individuals accountable through a combination of (i) legislative/regulatory provisions; (ii) a firm's internal processes, including employee contracts; (iii) supervisory action; and (iv) regulatory enforcement
	Firms and/or national authorities undertake assessments of the suitability of individuals (integrity and professional competency, including qualifications and experience) who have been assigned key responsibilities
	National authorities develop and implement a framework for responsibility and accountability that includes holding individuals accountable for the responsibilities to which they have been assigned
	National authorities engage and coordinate with other authorities in the same jurisdiction to understand their approaches to individual accountability

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Area	Tools
Addressing the rolling bad apples phenomenon	Firms communicate clear, consistent messages about high integrity and high performance expectations during the recruiting and hiring processes to deter bad apples from pursuing employment at a firm
	The firm's recruitment process could consider candidates' behavioural competency, conduct history and their potential for adhering to the firm's values as well as their technical competency, experience and qualifications
	Before hiring, firms leverage multiple sources of available information, including knowledge of a candidate's conduct at a previous employer
	Firms update background checks on regular schedules. In some jurisdictions, firms reassess the fitness and propriety of employees in functions deemed capable of causing significant harm to the firm or its customers.
	Firms conduct exit reviews and maintain appropriate records on former employees for their own potential future benefit as well as for prospective employers
	National authorities supervise firms' practices for screening prospective employees and monitoring current employees, particularly employees who pose the greatest risk to the firm or its customers (see tool 16)
	National authorities provide methods for firms to exchange meaningful information on employees, including promoting consistent and more comprehensive information in databases of financial services professionals

Source: Financial Stability Board, Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors, April 2018, available at <http://www.fsb.org/wp-content/uploads/P200418.pdf> (accessed June 2018)











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