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RESPONSE DOCUMENT

TO INFORM CONSEQUENTIAL AMENDMENTS TO THE FINANCIAL MARKETS ACT

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Abbreviations

ASISA	Association for Savings and Investment South Africa
BASA	Banking Association of South Africa
BCBS	Basel Committee on Banking Supervision
CCP	Central Counterparty
CPMI	Committee on Payments and Market Infrastructures
CPSS	Committee on Payment and Settlement Systems
CSD	Central Securities Depository
FMA	Financial Markets Act
FMI	Financial Markets Infrastructure
FSAP	Financial Sector Assessment Programme
G20	Group of 20 Finance Ministers and Central Bank Governors
G-SIB	Global Systemically Important Bank
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
JSE	Johannesburg Stock Exchange
ODP	OTC derivative providers
OTC	Over-the-counter
PFMI	Principles for Financial Market Infrastructure
SIFI	Systemically important financial institution
TR	Trade repository

Background

Process

In March 2012 Treasury published a consultation document, *Reducing the risks of over-the-counter derivatives in South Africa*[1] with the aim of making recommendations for regulatory and legislative reforms to the South African OTC derivatives market.

The outcome of the report formed the basis for the first draft of the Ministerial Regulations (the Regulations) [2] published on 4 July 2014 together with the accompanying policy framework document[3]. The framework introduces regulatory reforms to the South African OTC derivatives market that are strongly aligned to the relevant international standards, particularly the *Principles for Financial Market Infrastructures*.

The second draft of the Financial Sector Regulation Bill was released for public comment on 10 December 2014, along with the proposed consequential amendments to the Financial Markets Act that incorporated much of the proposals that were initially contained in the first draft Regulations. Thereafter, a second draft of the Regulations[4] and accompanying Board Notices was published on 5 June 2015 for a second round of comments.

Why are we proposing amendments to the Financial Markets Act?

As part of the consultation process on the draft Regulations, a number of stakeholders highlighted that certain provisions should be in primary legislation, rather than in subordinate legislation. In addition, the respective roles of the Prudential Authority and Financial Sector Conduct Authority needed to be better delineated. Consequently, it was proposed to introduce into law matters that deal with recognition and equivalence, central counterparties and external market infrastructure into the Financial Sector Regulation Bill as consequential amendments to the Financial Markets Act. In December 2014, Cabinet approved the second draft of the Financial Sector Regulation Bill with the proposed consequential amendments.

These proposals also draw on international initiatives in this area, particularly the regulation of financial market infrastructures, and are intended to appropriately align South African standards to international best practice. The proposed amendments include provisions broadly in relation to the following:

- **aligning the Financial Markets Act and the Financial Sector Regulation Bill**, in order to reinforce the Twin Peaks principle of regulation and to ensure that amendments link seamlessly with the envisaged architecture
- **equivalence framework for foreign market infrastructure**, to facilitate access for South African market participants to international financial markets while at the same time balancing the possible effects of cross-border market activity and regulation in South African financial markets

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[1] http://www.treasury.gov.za/legislation/bills/2012/FMB/Annexure%20B%20Reducing%20the%20Risks%20of%20OTC%20Derivatives.pdf

[2] http://www.treasury.gov.za/otc/Financial%20Markets%20Act%20Regulations.pdf

[3] http://www.treasury.gov.za/otc/

[4] http://www.treasury.gov.za/otc/Draft%20FMA%20Regulation%20for%20public%20consultation.pdf

- **licensing framework for market infrastructures**, to enhance the regulation and integrity of financial markets and to align regulatory, risk management and governance principles with international standards

International standards and recommendations

In developing the proposed amendments, Treasury took into account relevant international standards, and the reports and recommendations coming out of the International Monetary Fund (IMF) and World Bank Financial Sector Assessment Programme (FSAP) for South Africa which took place in 2014:

- **CPSS-IOSCO *Principles for Financial Market Infrastructure***[5] – the Principles are designed to enhance the robustness of FMIs and apply more stringent governance, risk management and operational standards.
- **Financial System Stability Assessment Report** – South Africa underwent an FSAP financial system stability assessment in 2014. The recommendations are intended to assist policymakers and regulators in identifying key sources of systemic risk in the financial sector, and to provide guidance on implementing policies to enhance its resilience to shocks and contagion.
- **Detailed Assessment Report (DAR) of the implementation of the *IOSCO Objectives and Principles of Securities Regulation*** – the IOSCO Principles and Objectives are aimed at improving and enhancing standards of regulation applicable to the securities markets. An assessment of the level of South Africa's compliance was conducted in 2014, and the findings and recommendations address the regulatory gaps identified and provide guidance on appropriate measures that could be implemented to improve South Africa's compliance with the Principles and Objectives.
- **FSAP Technical Note on reforms in the South African OTC derivatives market** – the Technical note is prepared as a supplement to FSAP Report and provides technical analysis of South Africa's progress in implementing OTC derivatives reforms. The report also provides an assessment of the bilateral and central clearing of OTC derivatives transactions in South Africa, as well as the regulatory, supervisory and oversight framework.

Public comments

Extensive comments from various market participants and stakeholders were received throughout the various consultation phases, which have included banks, corporates, industry associations such as the Banking Association of South Africa (BASA) and the Association for Savings and Investment South Africa (ASISA), as well as domestic and international FMIs including the JSE, Strate, and LCH.Clearnet. Comments have been carefully considered by Treasury as well as an OTC working group comprising of representatives from Treasury, the Financial Services Board and the South African Reserve Bank.

Treasury has strived to engage in an open process that has provided an opportunity for stakeholder participation and debate in the crafting of the Regulations. There have been numerous engagements, on the content of the Regulations and the proposed consequential amendments to the Act in order to gauge and address critical components of the Regulations. Further discussions are planned with all the relevant

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[5] See CPSS-IOSCO "*Principles for financial market infrastructures*"(2012) Available: http://www.bis.org/cpmi/publ/d101a.pdf

stakeholders as the Treasury, the Financial Services Board and the South African Reserve Bank undertake to refine and finalise the Regulations, and to provide certainty of South Africa's commitment to implementing the G20 reforms.

Background to the regulatory framework and reforms

Principles for Financial Market Infrastructures

In April 2012 the Committee on Payments and Market Infrastructures (CPMI)[6] and the International Organisation of Securities Commissions (IOSCO) (collectively CPMI-IOSCO), both recognised international standard setting bodies and members of the G20 international coordinating body, the Financial Stability Board, published the *Principles for Financial Market Infrastructure* (the Principles) in support of the G20 initiative to strengthen core financial markets infrastructures (FMIs). FMIs play a critical role in managing and reducing risk and to maintaining financial stability. The 24 Principles enhance and harmonise previous CPMI-IOSCO risk management standards, and place stronger emphasis on governance, more comprehensive and stringent risk-management, and impose additional safeguards and financial resources to enhance the resilience of FMI to ensure the continued provision of critical services.

G20 countries have committed to reforms to strengthen the financial system and have or are in the process of implementing regulatory frameworks that are aligning to the Principles. Through the Financial Stability Board and the CPMI-IOSCO, the G20 will continue to develop and monitor jurisdictions' implementation of these and other standards to ensure that FMIs, and especially central counterparties (CCPs), establish comprehensive and effective risk management frameworks. South Africa has committed to upholding high standards of financial sector regulation and implementing the G20 and Financial Stability Board recommendations into its legal structures.

FMIs and systemic risk

The adverse consequences of the 2008 global financial crisis prompted G20 Leaders and the Financial Stability Board to review global financial markets, and introduce reforms to enhance the stability and integrity of the financial system, and provide necessary protection to financial market participants. One of the key findings from the crisis revealed material weaknesses in the governance structures of financial institutions, especially risk management which was treated as a source of information rather than an integral part of decision-making and business strategy[7]. Governance has emerged as one of the pillars of financial stability that is enshrined in the Principles. The Principles emphasise the need for strengthened governance and control mechanisms to ensure appropriate management of these financial institutions. The

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[6] The Committee on Payment and Settlement Systems (CPSS) was renamed as the Committee on Payments and Market Infrastructures, or CPMI in September 2014

[7] See OECD "*Corporate Governance: Risk Management and Corporate Governance*" (2014) OECD Publishing. Available: http://dx.doi.org/10.1787/9789264208636-en

importance of an effective risk governance framework is further highlighted in the Financial Stability Board's report on supervisory intensity and effectiveness[8]:

> "*Supervisors and overseers of FMIs need a better understanding of the risks of FMIs and to challenge FMIs to be managers of systemic risk versus efficient, low cost service providers. The lessons learnt for other regulated institutions' risk management practices need to be applied in the supervision of FMIs, where decisions around risk are central to business models and policies, and at the same time risk management practices may be weaker than in [global systemically important banks] G-SIBs.*" (own insertion)

The Principles specifically require FMIs to have objectives that place a high priority on safety and efficiency, and explicitly support financial stability and other relevant public interest considerations. Safe and efficient FMIs contribute to maintaining and promoting financial stability and economic growth, but if not properly structured and managed, can be a source of financial instability. It is necessary that these institutions maintain effective governance structures that ensure independence of risk management functions, as financial stability is dependent on their resilience:

> "*An FMI may also need to focus particular attention on certain aspects of its risk-management arrangements as a result of its ownership structure or organisational form. If an FMI provides services that present a distinct risk profile from, and potentially pose significant additional risks to, its payment, clearing, settlement, or recording function [core functions] the FMI needs to manage those additional risks adequately. This may include separating the additional services that the FMI provides from its payment, clearing, settlement, and recording function legally, or taking equivalent action.*" (own insertion)

The institutional and governance structure of FMIs must ensure that they do not compromise core functions, especially those that combine core functions that have different risk profiles, and should appropriately consider the interests of members, member's clients, the relevant authorities, and other stakeholders. Greater emphasis on risk management and increased governance means systemically important FMIs should separate core functions from other activities, to the extent those activities present a distinct risk profile to the FMI. Operational independence is important to limit interconnectedness that is a source of vulnerability, and FMIs need to maintain sufficient resources and safeguards, including stand-alone capital, to ensure that obligations continue to be met without the possible disruption to the financial system. Other considerations can never take precedence over the establishment of prudent risk management.

The FSR Bill recognises that the foundation for effective supervision are the core principles issued by the standard setting bodies, and accordingly gives the Reserve Bank, as the body responsible for financial stability, the authority to assess the observance of international principles developed for market infrastructures in South Africa. Effective and credible supervision is more than about ensuring compliance with the letter of the law, and requires a much more intensive approach to oversight that delivers pre-emptive, outcomes-based supervision. This requires Regulators to scrutinise and review the governance arrangements of these institutions, particularly those that are wholly-owned or controlled by

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[8] See Financial Stability Board "*Supervisory Intensity and Effectiveness: Progress Report on Enhanced Supervision*" (2014) Available: http://www.financialstabilityboard.org/wp-content/uploads/r_140407.pdf?page_moved=1

another entity, to ensure that observance of the governance principles is not compromised in pursuit of commercial objectives.

CCPs and systemic risk

A central counterparty, or CCP, is a type of clearing house that by definition clears transactions by becoming the legal counterparty to all trades in a given market. Through novation, or other legal processes, the original bilateral contract is replaced by two new separate contracts between each original counterparty and the CCP. The original counterparties are relieved of their obligation to each other, and each counterparty becomes the legal counterparty to the CCP. The CCP assumes the credit risk of the other counterparty.

CCPs perform a systemic function by guaranteeing the performance of transactions cleared through it. There are significant economic and financial stability benefits to this structure, whether a CCP clears exchange-traded or OTC securities. Most notably CCPs minimise counterparty credit risk associated with bilateral transactions and have the ability to reduce risk exposure of clearing members by offering multilateral netting of contracts with other members of the CCP. CCP clearing also significantly improves transparency by making information on market activity and exposures available to regulators and the public[9].

Risk management is a core CCP function that is embedded in the rules, procedures and processes of the CCP, which establish equitable membership criteria, effective collateral arrangements to protect against losses, processes to protect members and the CCP against the adverse impact of a defaulting clearing member, appropriate loss-sharing arrangements in the event of member default, including for the CCP itself to have "skin-in-the-game" by contributing to the default waterfall, and rules-based tools for effective implementation of recovery plans[10]. The CCP is ultimately responsible for monitoring and managing risks it is exposed to and must be capable of independently taking action to mitigate risks in the interest of maintaining financial stability.

Clearing House	A clearing house provides a central mechanism for reconciling and confirming payments or securities transfer instructions prior to settlement.
Central Counterparty	A CCP is a type of clearing house that interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer, and thereby ensuring the performance of open contracts. A CCP becomes counterparty to trades with market participants through novation, an open-offer system, or through similar legally binding arrangements.
Qualifying CCP	A CCP is a qualifying CCP (or QCCP) for Basel III purposes[11], which allows bank supervisors to give banks preferential capital treatment to exposures to qualifying CCPs. In order to be recognised as a qualifying CCP, a CCP must

[9] See Cecchetti, Gyntelberg & Hollanders (2009). Available: http://www.bis.org/publ/qtrpdf/r_qt0909f.pdf

[10] See CPMI-IOSCO "*Recovery of financial market infrastructures*"(2014), Available: http://www.bis.org/cpmi/publ/d121.pdf

[11] See BCBS "*Capital requirements for bank exposures to central counterparties*"(2014) Available: http://www.bis.org/publ/bcbs282.pdf

	comply with certain criteria on an ongoing basis: • be licensed to operate as a CCP in the relevant jurisdiction; • be prudentially regulated; • comply on an on-going basis with rules and regulations that are consistent with the CPSS-IOSCO *Principles for Financial Market Infrastructures*; • have a default fund; Bank supervisors have ultimate discretion to determine whether banks subject to their supervision should hold additional capital against their exposures to QCCPs.

G20 measures to mandate central clearing of OTC derivatives have contributed to CCPs growing in systemic significance since the crisis, and are being held to higher standards of risk management and regulation, in the interest of upholding the public policy objective of ensuring financial markets are stable. South Africa has committed to compliance with G20 and Financial Stability Board agreements, and Treasury has announced a phased approach to implementation of OTC derivatives reforms.

The current regulatory landscape

The Financial Markets Act establishes four categories of market infrastructures, namely exchanges, clearing houses, central securities depositories (CSD) and trade repositories (TRs), each of which are required to be licensed for the functions, duties and services that they provide.

Reforms to the South African OTC derivatives market to reduce vulnerabilities and increase transparency are being implemented through the Act and associated Regulations that establish a framework for regulating OTC derivatives in South Africa, and impose statutory obligations in respect of OTC derivative providers or ODPs, CCPs and clearing members, CSDs and TRs. Furthermore, Regulations for banks reflect the Basel III capital requirements for clearing member exposures to CCPs and establish criteria for qualifying CCPs to allow bank supervisors to give banks preferential capital treatment to exposures to those CCPs.

The Act incorporates two types of clearing houses – an associated clearing house and an independent clearing house – that operate under different business and regulatory structures:

- The associated clearing house clears on behalf of the exchange that appoints it and in accordance with the rules of the exchange. It neither authorises nor supervises clearing members.

- An independent clearing house operates independently, and appoints and supervises its own clearing members. As a condition of its licence must fulfil certain regulatory obligations that include establishing clearing house rules, and supervising clearing members' compliance with the clearing house rules, clearing house directives and the Act.

The previous Securities Services Act[12] did not contemplate the concept of a stand-alone clearing house, instead only providing a legal framework through which an associated clearing house could operate. Nevertheless, the inclusion of a regulatory framework for an independent clearing house in the FMA was an important policy decision that was intended to facilitate the establishment of a CCP aimed at promoting central clearing of OTC derivatives[13,14], as the associated clearing house framework is inadequate to accommodate a CCP structure.

The current proposals establish a licensing and recognition regime for domestic and foreign CCPs and TRs that provide services to entities in South Africa.

Comments and responses to consequential amendments

Treasury has carefully considered the views of the commenters in crafting the proposal and substantial components of the amendments are intended to address some of the issues raised. Broadly speaking, the responses are in relation to:

(i) Equivalence and recognition of external market infrastructure
(ii) Licensing and regulatory framework for CCPs
(iii) Independent requirement as proposed in the definition of "central counterparty"
(iv) Licensing and regulatory framework for external market infrastructure
(v) Transitional provisions

Equivalence and recognition

Comments

Section 6A was previously contained in the Regulations and is proposing to establish a framework for "recognition" of external market infrastructures to enable those entities to provide services in South Africa. Commenters submitted that equivalence on its own is not enough to satisfy licensing requirements under the Act, and that the proposal is inconsistent and in conflict with the peremptory provisions of the Act. Commenters suggested that, to the extent that external market infrastructures operate within the Republic, these entities should be assessed and licensed against all the provisions in the Act, and subjected to all requirements imposed on local market infrastructure, otherwise the opportunity for regulatory arbitrage is created.

Treasury response

Treasury supports the view that the cross-border nature of financial markets necessitates an appropriate regulatory framework that promotes the efficiency and competitiveness of the South African financial markets without significantly undermining stability. It must be clarified, however, that Section 6A is

[12] Securities Services Act No. 36 of 2004 (repealed)

[13] NT Policy document, p.42 & 48: http://www.treasury.gov.za/public%20comments/FMB/FMB%20policy%20document.pdf

[14] NT Explanatory Memorandum on the Financial Markets Bill, p.9: http://www.treasury.gov.za/legislation/bills/2012/FMB/FMB%20Explanatory%20Memorandum.pdf

proposing to establish a framework that enables South African Authorities to develop standards that prescribe criteria for the recognition of external market infrastructure, in order to enable those entities to perform similar functions to those set out in the FMA.

Regulatory equivalence is a necessary prerequisite for recognising an external market infrastructure. South African Authorities must assess the foreign regulatory framework, including assessing the foreign country's licensing requirements, rules, regulation and supervision, and must take into account relevant international standards, the degree of systemic risk posed by the activities to South African markets. The outcome of the applicable regulatory framework should be equivalent to that established by the relevant South African laws in respect of the regulatory objectives they achieve.

Treasury is furthermore proposing a licensing framework (including by exemption) that applies to certain external market infrastructure – see below. Recognition allows the South African Authorities to license an external market infrastructure subject to conditions on the entity, e.g. a code of conduct. Treasury is proposing that these amendments are made in order to achieve the abovementioned regulatory outcomes.

Treasury is not agreeable to the suggestion to treat all external market infrastructure the same as local market infrastructures in terms of market access and ongoing domestic regulatory oversight (i.e. national treatment). Such a prescriptive approach lends itself to practical challenges in terms of South African Authorities' ability to exercise enforcement on entities domiciled and supervised in foreign jurisdictions, due to, among other limitations, restrictions imposed by foreign laws, which may have the unintended consequence of undermining the regulatory objectives set out. Treasury is proposing a flexible approach that would allow Authorities to consider applications on a case-by-case basis, and believes that the proposed approach will enhance the goal of ensuring level playing fields, minimise duplication and uncertainty, and reduce opportunities for regulatory arbitrage.

Furthermore, section 6C requires the Authorities to enter into supervisory co-operation and information sharing arrangements with the home regulators. This is particularly important as the operations of the external market infrastructure will have a direct impact on South African markets, particularly if South African banks become clearing members of the foreign CCPs. For this reason, the proposed approach will facilitate access for South African market participants to international financial markets while at the same time balancing the effects of cross-border market activity and regulation in South Africa.

The Financial Sector Authority, the Prudential Authority and the South African Reserve Bank will need to coordinate their effort in developing standards for recognition that will allow them to recognise external market infrastructure and enter into cooperation arrangements with foreign supervisory authorities.

Licensing of central counterparty

Comments

Commenters expressed their view that the draft Regulations have the status of delegated or subordinate legislation, and were concerned that the contents of certain provisions fell outside the authority of the Minister. The commenters felt that since the FMA neither defines a "central counterparty", nor set out the specific functions that attach to a CCP, the proposed Regulations dealing with a central counterparty are

legally impermissible and not consistent with the peremptory provisions of the FMA. The commenters contended that it would be *ultra vires* the powers of the Minister to amend provisions of the Act through Regulations, and proposed that these provisions should be recorded in the FMA.

Treasury response

After carefully considering the comments, Treasury agrees that it is important to clarify the legal status of a CCP within the regulatory regime that is applicable in South Africa in order to ensure that financial markets continue to operate within the policy objectives of maintaining stable financial markets and reducing systemic risk. Treasury is proposing to introduce a new definition of "central counterparty" that is an independent clearing house into the Act, and to establish a framework through which a CCP can be licensed, given the systemic functions that it performs.

The proposed framework requires a CCP to implement and maintain a risk management framework that includes a margin system, collecting and managing collateral for the due performance of obligations, and establishing and maintaining a default fund to limit risk exposures in the event of a default by a clearing member. These proposals are aligned to the FSAP recommendations for South Africa to consider the benefits of establishing a local CCP in addition to a global CCP. The implication is that as there are no CCPs currently licensed in South Africa, any clearing house that is performing the functions of a CCP will be required to undergo a licensing process to operate as a CCP. Furthermore, through the upcoming Financial Sector Regulation Bill, CCPs will be subject to prudential supervision by the Prudential Authority. The South African Reserve Bank will be responsible for monitoring financial stability, and is empowered to take action to mitigate risks to financial stability, including designating certain financial institutions as systemically important financial institutions (SIFIs) and assessing South Africa's observance of the Principles.

Through licensing standards, governance and other requirements, the proposed regulatory regime is designed to be consistent with the Principles and international best practice, and to preclude entities which are not capable of meeting the high standards required to perform the critical CCP function.

Independent central counterparty

Comments

The proposal for an "independent" CCP has been met with resistance from existing market infrastructure operators that currently operate outside the proposed regulatory and risk management framework. While the commenters acknowledged that Treasury had indicated its intention to propose to the legislature to remove the "associated clearing house" as a category of clearing house within the FMA, there was concern with limiting the ability of an associated clearing house to perform CCP functions in the proposal. Commenters expressed concern with the second draft Regulations that excludes an associated clearing house from the definition of "central counterparty" as this would deny an associated clearing house its QCCP-status. Commenters argued that a clearing house that is acting as a CCP in accordance with the rules of an exchange or in accordance with its own rules is irrelevant, and reasoned that the performance of CCP functions and the extent to which a CCP is regulated is neither conditional nor dependent on the clearing house's status as independent or associated clearing house.

Treasury response

Treasury has carefully considered the comments and is not convinced by the suggestions to broaden the scope of the definition to an associated clearing house. CCPs perform a systemic function and as such must adhere to highest standards of risk management and regulation. In this regard Treasury has had to make policy decisions that place a high priority on objectives that support financial stability and other public interest considerations and maintains that a CCP must have operational autonomy. As proposed, the amendments would require a CCP to be an independent clearing house.

The proposed definition is a modification of the broad definition that was proposed in the first draft of the Regulations. The broad definition did highlight significant structural shortcomings that informed Treasury's position to refine the definition. Firstly, the broad definition is ambiguous and from a stability perspective the lack of clarity is sub-optimal. The definition does not take account of the regulatory and organisational mismatch between an independent clearing house and an associated clearing house that directly impacts on the efficiency and integrity of a CCP structure. The proposed framework is intended to standardise the regulatory and risk management standards applicable to CCPs in order to induce change that brings the regulatory framework towards consistency and comparability with international standards. There should not be differences in the risk management standards, based on whether the type of clearing house is "associated" or "independent", but rather regulatory treatment and standards should be comparable and should be applied consistently. Otherwise there is the risk of creating regulatory arbitrage and unleveled playing fields as a result of CCPs operating under different legal controls and compliance procedures in terms of the law.

On this matter, the FSAP recommendations emphasise the critical importance of requiring a South African CCP to have appropriate safeguards in place and to comply with international standards, given the highly interconnected financial system of South Africa. The CCP must be a "true firewall" in preventing contagion as a result of a defaulting clearing member, as the small number of banks means those surviving clearing members carry the heavy burden of having to support the CCP to maintain operations. To the extent that regulatory and risk management standards differ, clearing members would be exposed to systemic risk, and additional costs as a result of unnecessary operational inefficiencies associated with different sets of compliance standards.

An important issue concerns the diminished operational independence of an associated clearing house. A CCP is an independent systemic entity that presents a unique risk profile from other FMI activities and must be able to carry out its own activities and take action in order to ensure systemic stability. It is Treasury's view that the exchange fits within the scope of activity "*with a distinct risk profile*". The exchange performs systemic functions and duties that have a distinct risk profile from the core functions of a CCP and pursues different business objectives. There should be a clear separation of the trading activities that would expose the CCP to risks that are unrelated to its core functions. The proposal does not prevent a CCP from being part of a group that engages in trading activity, however the CCP and its clearing members must be insulated from losses that may arise from other risky activities, and the entity that is the CCP must be appropriately independent. The fact is the requirements and licence obligations imposed by the FMA on an exchange are neither appropriate substitutes, nor adequate for the proposed standards and obligations for a CCP.

A CCP must be capable of making decisions independently, at the very least the ability to appoint its own clearing members, and monitoring and managing risks it is exposed to. The associated clearing house in the context of a CCP model may not achieve the regulatory outcomes of ensuring increased overall safety and efficiency and enhancing financial stability, as envisaged by the Principles. The operational independence of the CCP provides scope for levelling the playing field, will limit interconnectedness and complexities that lead to vulnerabilities, improve resolvability of the CCP, and lead to increased transparency by giving authorities a wider view of exposures.

Treasury is supportive of the proposal that the CCP must be an independent entity. This view is consistent with the Principles and is supported by the well-documented policy stance to establish a legal framework to promote central clearing through an independent clearing house that is operationally independent, and is especially important given the G20 requirement to mandate central clearing of standardised OTC derivatives. The policy approach was approved by Parliament and Cabinet when it adopted the Financial Markets Act.

Licensing of external market infrastructure

In response to commenters that the regulations purport to allow external market infrastructures to fulfil functions and duties in South Africa without being required to be licensed in terms of the Financial Markets Act, Treasury is proposing to introduce a licensing framework that extends to external CCPs and trade repositories.

Table 1: Domestic vs Foreign CCP

	External CCP	Licensed *External*	Licensed *Domestic*
Recognition and equivalence	✗	✓	✓
Standards	✗	✓	✓
Functions / services in South Africa	✗	✓	✓
Insolvency Act protections	✗	✓	✓

The external CCP must comply with license obligations if a license is granted. An external CCP that is authorised to perform CCP functions and provide services in its home jurisdiction, the Authorities may grant the applicant a South African CCP license that authorises the applicant to provide the same services in South Africa. The application must be done in accordance with section 49A and the granting (or exemption) of a license is subject to the entity being granted recognition by the South African Authorities, pursuant to section 6A. The Authorities may impose additional obligations on the external CCP that is licensed to perform CCP functions and provide services in South Africa. It is also important to clarify that licensed external CCPs may benefit from the Insolvency Act protections. For this purpose, the "licensed" external CCPs must have domestic presence. To the extent that South African clearing members will be impacted by a CCP's default, there should be a mechanism for South African authorities to be able to approve rules that will impede on the proper functioning of the domestic market.

Transitional provisions

Comments

Commenters had requested that implementation of the regulations should be appropriately phased-in to ensure that markets and participants are able to comply with the requirements and to minimise disruption to the proper functioning of the financial markets. Although some commenters generally were resistant to the proposed requirement for the CCP be an independent clearing house, they have stated that the proposed amendments would require substantive review of policies and redrafting of rules, and requested that the transitional provisions provide adequate time to implement the necessary changes.

Treasury response

Treasury has considered the requests to phase-in the implementation of certain amendments. Amendments to section 110 are accordingly proposing for the Minister to prescribe in Regulations a date for when the requirements proposed in relation to certain matters would be effective, from the date of the Financial Sector Regulation Act coming into effect, given the extent of the transition to the new framework. This approach will allow the Authorities and the South African Reserve Bank to coordinate their activities with respect to the oversight, regulation and supervision of market infrastructure, while supporting efforts to uphold the integrity of South African financial markets. The implementation of the proposed amendments will bring South Africa closer to international standards of regulation and risk management for systemically important FMIs.

Treasury is proposing to empower the licensing Authority, with the concurrence of the Prudential Authority, to exempt an existing licensed associated clearing house that applies to be licensed as a CCP for a period of 5 years from the requirement to be an "independent clearing house", if the Authority considers it appropriate to do so. This is to enable an existing associated clearing house to operate as a CCP and minimise disruption to the financial system while transitioning to the new framework. The dispensation is not intended to apply to new market entrants. An associated clearing house that becomes licensed as a CCP will be required to conform to all regulatory and risk management requirements that are applicable to CCPs, and must ensure that it observes with the Principles. Recommendations coming out of the FSAP technical analysis stressed the importance of strengthening safeguards, given the high interconnectedness with the clearing members to the clearing house. The associated clearing house, and the exchange that appoints it, will need to strengthen governance arrangements and risk management standards, and manage and mitigate potential conflicts of interest.

Conclusion

Treasury would like to thank stakeholders for actively participating in the review process, and would encourage further engagement over the Parliamentary review process. While every effort has been made to address the concerns raised and to clarify contents proposed in the Regulations, it is necessary to make amendments to the Financial Markets Act, through the Financial Sector Regulation Bill consequential amendments to the extent necessary to address deficiencies and to ensure the efficient implementation of the proposed regulatory framework.