

Financial Markets Bill, 2012

Presentation to Standing Committee on Finance

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national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA



Outline

1. The role of financial markets in the South African economy
2. The Financial Markets Bill
 - Purpose, Process, Objectives
3. Policy principles
 - Effective and efficient supervision
 - Financial Stability
 - Protection of investors and clients
 - Other
4. Technical issues

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The context

- *A safer financial sector to serve South Africa better*, announced a number of changes in our approach to regulation:
 - **Institutional architecture of regulation** → Who regulates?
Shift to twin peaks
 - **Strengthening our approach to regulation** → How do they regulate?
New banking regulations (Basel 2.5 and Basel 3)
Financial Markets Bill
Credit Ratings Services Bill
Financial Services General Laws Amendment Bill
 - **Strengthening our approach to market conduct** → How do firms behave?
Important that financial services firms must be held to a higher standard (people's savings and livelihoods are at risk, as is the entire financial system)
Consumer protection regime needs to be

“Twin peak” aims to give equal weight to prudential and market conduct regulation

Prudential Peak

- Reserve Bank leads on macroprudential, microprudential and financial stability issues
- Responsible for:
 - Prudential regulation of banking, insurance
 - Assessing and responding to financial stability risks
 - Crisis planning

Market Conduct peak

- Financial Services Board leads on market conduct for financial services working closely with National Credit Regulator
- Market conduct regulation of all aspects of financial services, including banking, insurance, advisory services etc.

Interagency review process will flesh out timelines, and decide how the prudential and market conduct aspects of certain activities will change (e.g. securities regulation)

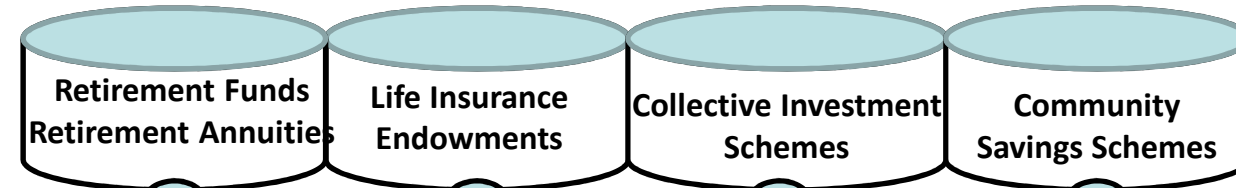
Capital markets convert savings into growth

The central played by capital markets in our economy

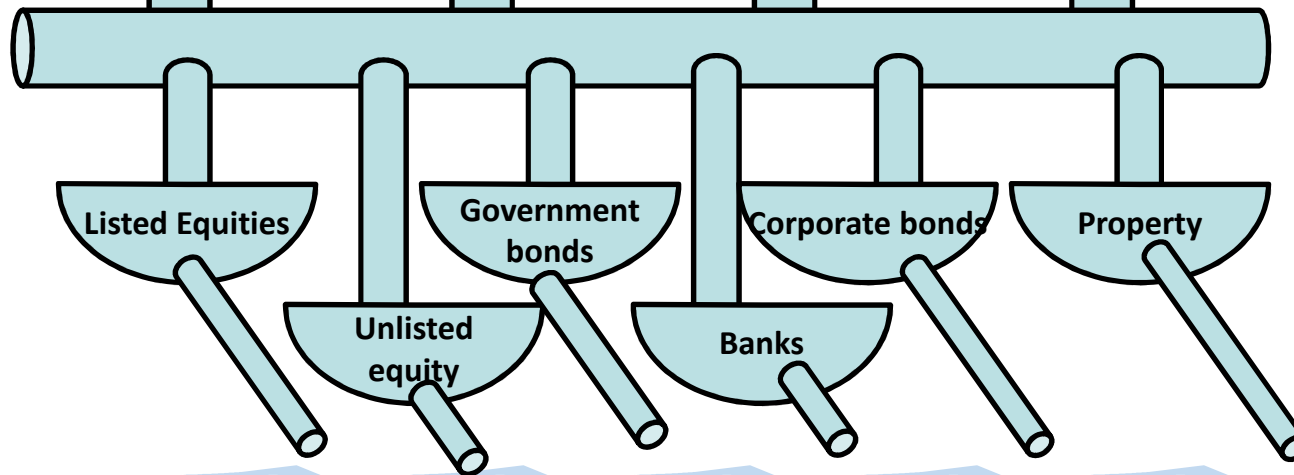
- To stimulate economic growth, savings must be converted into investment in the real economy
- Government and companies access capital through capital markets i.e. issuance of equity, bonds, money market instruments and other
E.g. annual fiscal deficit is financed from bond market
- Allows pension funds to invest directly into companies
PIC has large holdings in the JSE
- Efficient (liquid and secure) financial market means more efficient allocation of capital, lower cost of capital, risk management, and effective access to domestic and foreign savings

Financial markets channel savings into growth

Catchment Area Dams



Reservoirs

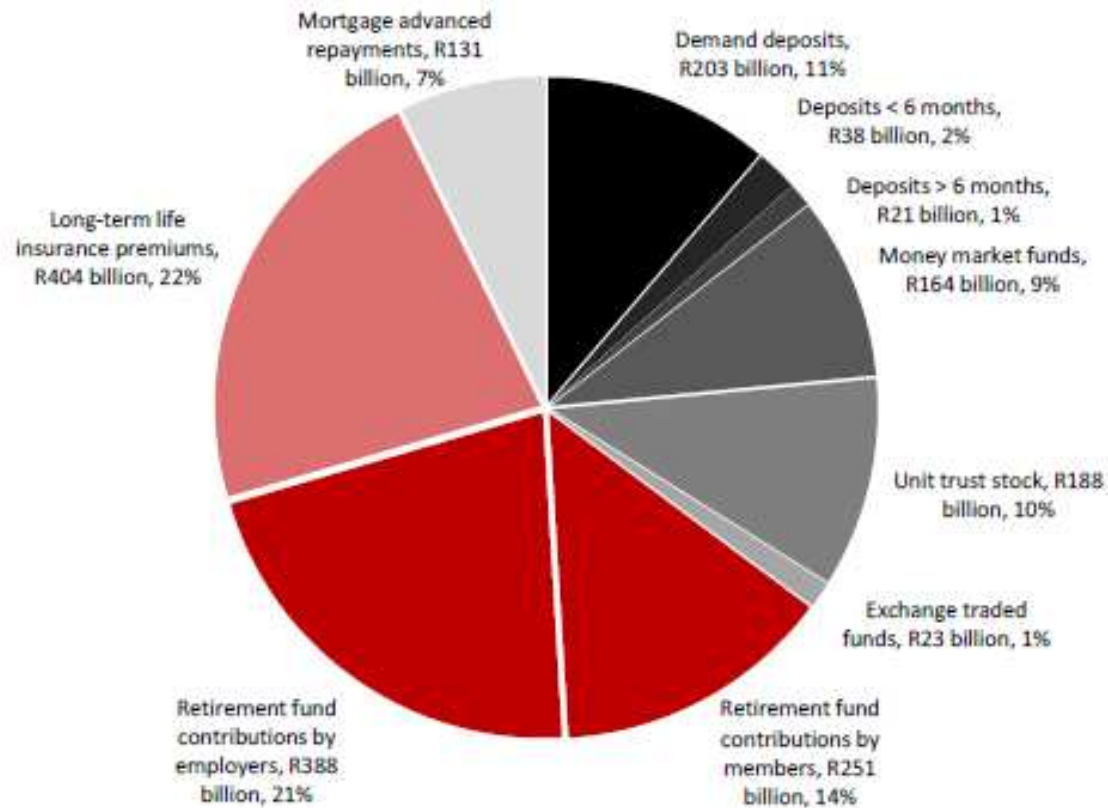


Orchards



Savings flow into financial markets mainly from pensions and life insurance

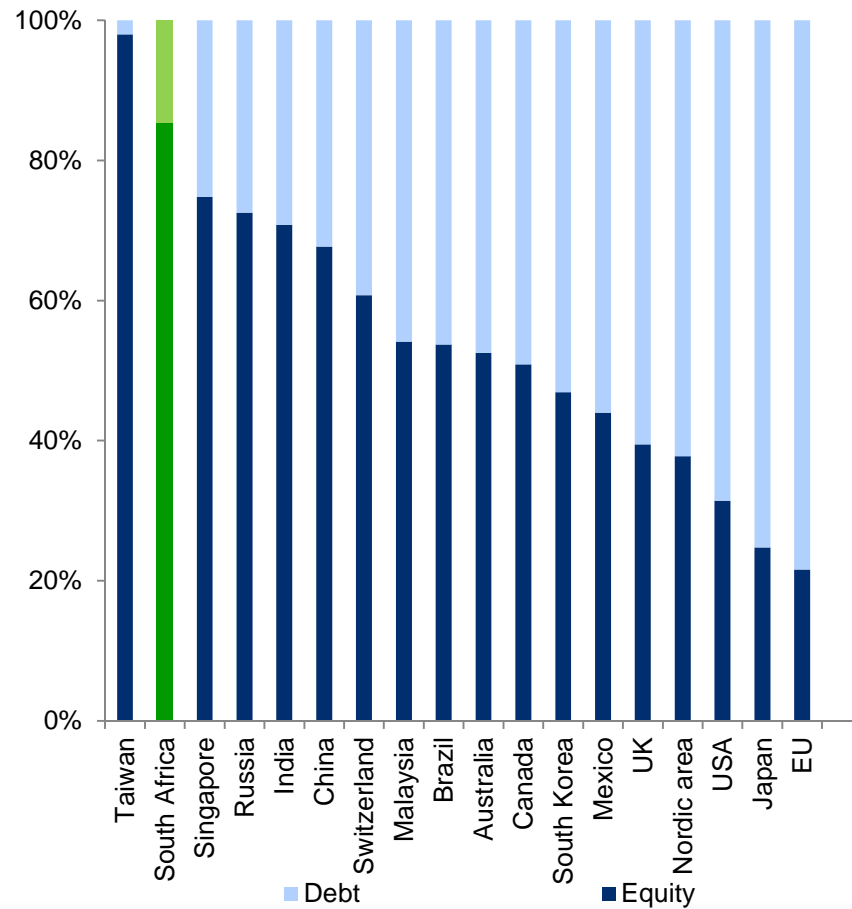
Flow of savings from household savings, 1999-2010



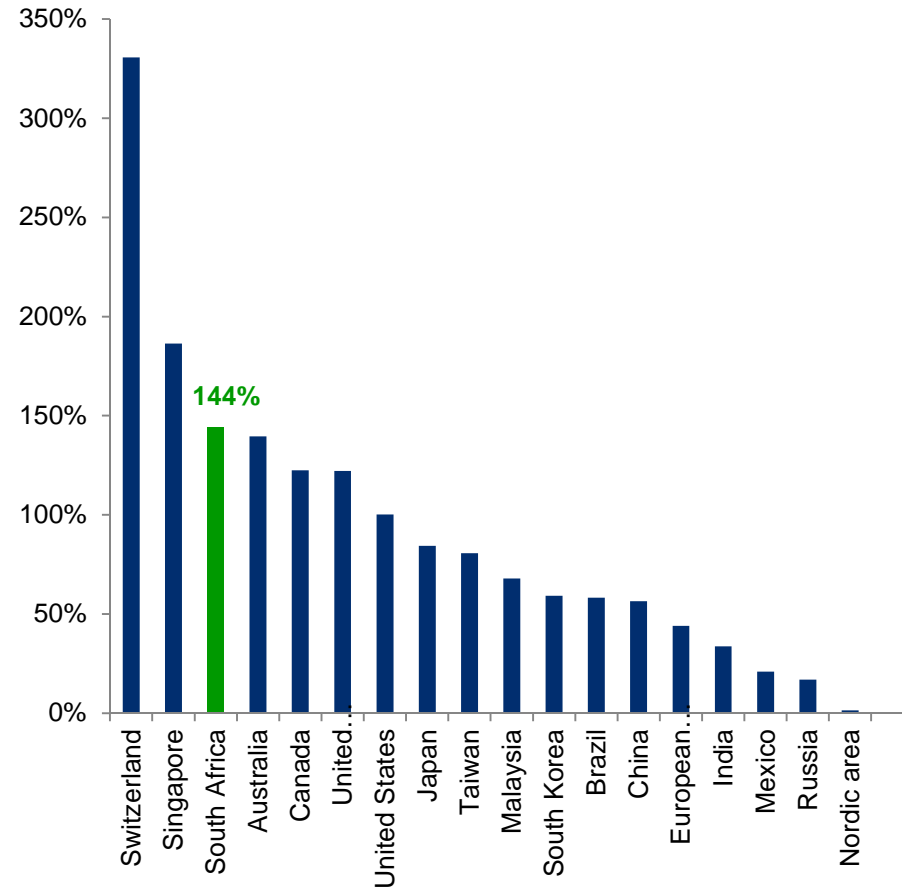
Source: National Treasury, 2012. *Strengthening retirement savings*

South African capital markets are particularly deep and liquid

Equity to debt composition



Equity to GDP



South African regulatory framework is amongst the best in the world

The Global Competitiveness Index	Rank of 142 2011/12
Frequency of banking crises	1 st
Regulation of securities exchanges	1 st
Strength of auditing and reporting standards	1 st
Soundness of banks	2 nd
Efficacy of corporate boards	2 nd
Availability of financial services.	3 rd
Availability of financial services	3 rd
Financing through local equity market	4 th
Legal rights index, 0–10 (best)*	8 th
Strength of investor protection	10 th
External debt to GDP	11 th
Financial stress index	12 th
Ease of access to loans	36 th
Affordability of financial services	39 th
Venture capital availability	44 th

- Strong scores on regulation of securities exchanges, equity market financing, and strength of local equity financing
- Lower scores on ease of access to loans, affordability of financial services and venture capital availability

Key players in financial markets

1. Providers of market infrastructure

JSE and Strate

2. Users of market infrastructure

Issuers

Stock brokers (authorised users, participants)

Investors

Important that all players are appropriately regulated

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The Bill updates the Securities Services Act

- Repeal & replace Securities Services Act (no 36 of 2004), as amended
- Alignment with International developments
 - G-20 commitments following global financial crisis
 - Financial Stability Board recommendations
 - International best practice: International Organisation of Securities Commissioners
 - IMF and World Bank international assessments (Financial Sector Assessment Program, and Report on Observance of Standards and Codes)
- Changes in principles, laws, e.g. UNIDROIT Convention & international regulatory practices
- Technical/functional issues

Tabling of the Bill after a long process of engagement

- Securities Services Act Review (2009-11)
- Publication of draft Bill on 4 August 2011
- Comments Received
- Public Forum on 5 October 2011
- NT/FSB/SRO Working Group reviewed comments
- Follow up Treasury-led meetings and correspondence
- Consultative workshops with banks and non-bank financial inst.'s
- Additional meetings with stakeholders including IDBs and PDs
- Submission of the revised Bill to Parliament
- Informal briefing to Parliament earlier this year
- Public forum on 9 May 2012

Main objectives of the Bill

Bill aims to:

- Increase confidence in the South African Financial Markets
 - Promote the protection of regulated persons and clients
 - Reduce systemic risk
 - Promote competitiveness of securities services in the Republic
- (Clause 2: Objects of the Act)*

Achieves this through establishing a framework for:

- Efficient and effective supervision
- Financial stability & mitigating systemic risk
- Investor/client protection, taking into account protection against market abuse

The structure of the Bill follows these objectives

- Preliminary provisions
 - Definitions, objects of Act (*s 1 and 2*)
- Powers of the Registrar (*s 5*)
- Requirements dealing with the provision of market infrastructure
 - Exchange (*Chapter III*), Central Securities Depository (*Chapter IV*), clearing house (*Chapter V*), trade repositories (*Chapter VI*)
- General provisions applicable to SROs (*Chapter VII*)
- Other matters relating to market infrastructure & its users
 - Code of conduct, unlisted securities, nominees
- Market abuse (*Chapter X*)
- General (*Chapter XI*)
 - Auditing, enforcement

Bill also makes provision for strengthening the regulation of derivatives

- Financial crisis exposed weaknesses in the regulation of derivatives instruments
- Warren Buffet: *financial weapons of mass destruction*
- Key concern is disclosure
 - Over-the-counter derivatives are the “unknown unknowns”
- Introduce new powers to regulate derivatives instruments, and new infrastructure:
 - Trade repository
 - Central counterparty

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Bill defines roles of various players – Minister / Executive

Powers of the Minister

Securities Services Act

Limited to general clause to make regulation (s 113)

Need for reform

Recent financial turmoil highlights need for better information to executive

Need for flexibility given rapidly changing international standards leads to greater role for subordinate legislation

Financial Markets Bill

Explicit role to make regulation in areas of policy (OTC derivatives, foreign participation), (s 5(6), 56(1), 58, 77)

Reporting on systemic risk (s 5(3)(n))

Powers of the Registrar

Powers of the Registrar

Need for reform

Align with legislative developments, international best practice

Financial Markets Bill

Enforcement powers : Conduct on-site visits – s 97(1)(a)

Registrar must approve of amendments to listing requirements (FSAP) -
s 11(6)(b)

Institute or approve business rescue plan /liquidation proceedings – s 102,103

Referral of contraventions to the Enforcement Committee – s 101

Registrar to prescribe fees – operational independence (FSAP) – s 110

Issue directives and guidelines – s 5(3)(k) & 5(4)

EFFICIENT & EFFECTIVE SUPERVISION II

Powers of the Governor of the Reserve Bank (new)

Securities Services Act

No role for Governor

Need for reform

Financial crisis highlights problem of poor regulatory coordination across regulators in international arenas,

Reserve Bank mandated to ensure systemic stability

Twin peaks a policy priority

Financial Markets Bill

Governor has role in areas of systemic risk, oversight of trade repositories and clearing houses

Introduction of Reserve Bank into Financial Markets Bill

SECTION		DESCRIPTION
Minister, Registrar and Deputy Registrar of Securities Services	5(3)(n)	The registrar must inform the Minister and the Governor of any matter that in the opinion of the registrar, may pose systemic risk to the financial markets
Functions of licensed exchange and power of registrar to assume responsibility for functions	9(1)(e)	Exchange must inform the registrar and the Governor of any matter that may pose systemic risk to the financial markets; and provide the Governor with any information requested to monitor and mitigate systemic risk
Licensing of clearing house	48(1)	The registrar may consult with the Governor on whether or not to grant a clearing house licence
Licensing of trade repository	56(1)	The registrar may consult with the Governor on whether or not to grant a TR licence
	56(4)	A TR must obtain written approval from the registrar and the Governor before it may conduct activities outside the Republic, and must adhere to any additional requirements the registrar or Governor may prescribe
Duties of trade repository	57(1)(g)	A TR must provide the Governor with any information requested to monitor and mitigate systemic risk
Reporting obligations	58	The registrar, in consultation with the Governor, may prescribe reporting obligations in respect of transactions or positions in <i>unlisted securities</i> which must be reported to a trade repository

Role of the self-regulatory organisations

What is a self-regulatory organisation (SRO)?

Historically the JSE was a member-owned exchange

This changed when the JSE was demutualised and listed on itself

South Africa follows a “strong” SRO model, i.e. the exchange has relatively wide powers of enforcement, rule-setting etc

Authority of SRO

Securities Services Act

SRO model entrenched in Act, which requires exchanges (Ch. 3) & CSDs (Ch. 4) to regulate their users.

Role of the self-regulatory organisations

Self-regulatory organisations cntd.

Need for reform

Twin Peaks a policy priority,

An SRO should not be both a referee and player

Conflicts of interest should be explicitly dealt with,

Governance requirements for Directors and Senior Managers to be strengthened.

Role of the self-regulatory organisations

Self-regulatory organisations cntd.

Financial Markets Bill

SRO model to be reviewed, concurrent to Twin peaks

Clearer separation bet. securities services & infrastructure (SRO) function
(e.g. s 29(1)(s),

Engagement/adjudication processes strengthened

s 62, 63, 72(2)-(4) & s 10(6)

Effectiveness of exchange functions & systems – s 7(1)(k) & CSD functions –
s 29(1)(t)

Fit and Proper requirements for directors and senior management of SROs
– s 7(1)(c), s 27(1)(c) & s 47(1)(c)

Directors duties in Companies Act apply – s66

Increased need for co-operation

International regulatory cooperation

Securities Services Act

No direct authority for the Registrar for international cooperation, other than FSB Act

Need for reform

Regulatory surveillance must take account of financial markets that are highly integrated across international borders

FMB

To assist FSB in investigating, inspecting or conducting on-site visits of foreign entities Registrar may enter into MoU with a supervisory authority to strengthen co-operation with regards to the exchange of information - s5(5)(b)
Power to request information from any person - s5(3)(d) (IOSCO MMoU)

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Bill addresses financial stability / twin peaks issues

Financial Stability Issues

Securities Services Act

Quiet on what happens in event of systemic instability, no allowance for a securities ownership register (SOR), limited powers over unlisted securities limited provisions relating to insolvency in the settlement chain.

Need for reform

Must have certain information flows in time of instability, settlement provisions are sound but should comply with Unidroit commitments to enhance cross-border homogeneity, SOR to increase real-time transparency of securities ownership & informs policy and govt debt issuance, OTC derivative instruments must be regulated, require explicit insolvency provisions under securities regulation.

Financial stability

Financial Stability Issues

Financial Markets Bill

SROs to inform the Registrar, Registrar to inform Minister/Governor -
s5(3)(n)

SROs to consult with registrar iro additional business s 62

Definition of “central securities account” extends the entities for which the CSD may hold securities to enable a SOR, building transparency (s. 26).

Financial stability cntd

Central Counterparty - SRO status extended to independent clearing houses to promote the central clearing of OTC derivatives (G20) – s 46-52

Settlement assurance and certainty

- Finality of Settlement: Revocation of settlement instruction, balancing and reconciliation – s 16(2)(bb) & s 34(2)(u)
- Protection of the bona fide purchaser – s 40
- Pledges and Cessions – s 38
- Priority/Ranking of Interest – s 39
- Attachments: level of holding & entry in relevant account – s 44

Introduce new framework for derivatives

Over-the-counter derivatives regulation (G20)

- Prescribe standards, code of conduct & reporting requirements, clearing and settlement standards – *s 77*
- Licensing of a Trade Repository for the reporting of all OTC derivatives transaction data to the TR and disclosed to the registrar and other relevant supervisory bodies
s 4 – s 58
- Insolvency proceedings (Unidroit)
s 16(2)(bb & cc), s 34(2) (u) & (v)

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Bill strengthens client protection...

Segregation of assets and client protection

Securities Services Act

Provides for segregation of assets, client protection & market abuse but can be strengthened.

Financial Markets Bill

Clearer segregation of securities & Balancing and Reconciliation

s 21(1) & (2) & 34(k) & (l)

Rights of clients and authorised users strengthened

s 10(1)(j)

Code of conduct for authorised users, participants and clearing members strengthened

s 75

...and takes steps to combat market manipulation and abuse

Market abuse

Enhancements to insider trading provisions

Protecting integrity of market through enhanced protection against market abuse

- Removing two outdated defences (affected transaction and dealing on behalf of a public sector body)
- Creating new statutory defence: insiders may deal if all parties to the transaction have same level inside information & transaction not designed to benefit from inside information.

s 80(1)(b)(ii)

Also strengthens insider trading provisions

Protecting integrity of market through enhanced protection against market abuse cont.

- Stronger insider trading offence: If trader knows that a client is an insider, that trader would contravene the Act

s 80(3)(a)

- Negligence element in terms of misleading, improper, or false statements – changed to only an administrative offence, but where there is intent, both criminal and administrative liability still apply.

s 82

- A person who made a false, misleading, or deceptive statement without knowing it and becomes aware of it must immediately publish a “full and frank correction with regard to such statement.” *s 83(2)*
- Civil remedy of approaching a court to administer an insider trading penalty (*s. 78 & 80 in SSA*) removed as have become obsolete.

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Additional policy issues (1)

- Cross border participation in SA markets provided for s.t. Minister regulation
- FAIS exemption provision removed, s.t. consequential amendment to s 45(1)(a)(i) of the FAIS Act to make clear that persons licensed and regulated under governing securities legislation are exempt from FAIS provisions, meaning that a corresponding provision in FMB would be duplication.
- Competition & ownership issues:
 - May not acquire more than 15% interest in a SRO without the Registrar's approval – s 65(3)
 - 15-49% shareholding – Registrar's approval s 65(4)
 - Over 49% shareholding – Minister's approval - s 65(5)

Additional policy issues (2)

Liability and accounting standards

- Limitation of liability provision narrowed to ensure that safe harbour applies only to an SRO in performance of its regulatory functions and obligations s 73.
- Reference to “generally accepted accounting standards” in Ch XI amended to refer to ISA, IFRS, and the Companies Act .

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Additional technical / functional issues

- **Technical/Functional issues:**

- Alignment of nominee approval

- s78*

- Publication of detail, status and outcome of inspection and on-site visits

- s 98(f)*

- Auditor's appointment - regulated persons, including private companies

- s 91*

Other provisions aim to align the Financial Markets legislative framework

- Alignment between the Bill and the Companies Act, 2008 & Consequential amendments – mergers include reference to FM Bill
- Exclusion from the provisions of the Consumer Protection Act, 2008 – s 3(6)
- Amendment to the Insolvency Act, 1936 to align with UNIDROIT Principles
- Amendment to the Competition Act, 1998 to make provision for Minister's Certification, no order by CT & decision by CC;
- Removal of reference to exclusion of FAIS;
- Overriding provision; s3(4)

Thank you

Extending the scope of regulation

- **2012 Financial Markets Bill:**

- Addresses regulatory fragmentation/gaps in OTC derivatives market
- Enabling framework that aligns to international standards
- Extends the scope of regulation to unlisted securities
- Allows for independent CH (Chapter V) - aimed at counterparty risk
- Allows for TR (Chapter VI) - aimed at lack of transparency
- Clause 77 - authorises the Registrar of Securities Services to prescribe requirements, conditions and standards to regulate the OTC derivatives market

Chapter V: Clearing House

- **Clearing house** - constitutes, maintains and provides an infrastructure to clear transactions in securities
- FMB Associated vs. Independent Clearing House
- Benefits of central clearing include:
 - Risk-sharing mechanism
 - Multilateral netting
 - Capital reduction
 - Collateral management
 - Reduce systemic risk
- IOSCO recommends a “*bottom-up*” and “*top-down*” approaches in implementing a mandatory clearing regime

CHAPTER VI: TRADE REPOSITORIES

- **Trade Repository** - maintains a centralised electronic database of records of transactions data and is licensed under S56
- S57(1)(a)-(g) of the FMB defines a TR's functions and responsibilities
 - Assessment of systemic risk and financial stability
 - Market surveillance and enforcement
 - Market supervision
- A TR must provide the Governor with any information requested to monitor and mitigate systemic risk
- OTC derivatives discussion document

Phased implementation

National Treasury envisages a phased implementation for OTC derivatives regulation in South Africa:

