

Statement* of the need for, expected impact and intended operation of regulatory instrument:

Joint Standard 1 of 2021 – Requirements relating to central counterparty licence applications

March 2021

* This statement is prepared and published in accordance with and in fulfilment of the requirements under section 98(1) and 103 of the Financial Sector Regulation Act, No. 9 of 2017.

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1 Introduction

- 1.1 In terms of section 98 of the Financial Sector Regulation Act No. 9 of 2017 (FSRA), a financial sector regulator must not make a regulatory instrument¹ unless it has published the following documents:
 - (i) a draft of the regulatory instrument;
 - (ii) a statement explaining the need for and the intended operation of the regulatory instrument;
 - (iii) a statement of the expected impact of the regulatory instrument; and
 - (iv) a notice inviting submissions in relation to the regulatory instrument, stating where, how and by when submissions are to be made.
- 1.2 In fulfilment of the above-mentioned requirements, the Financial Sector Conduct Authority (FSCA) and Prudential Authority (PA) (collectively referred to as the Authorities) have prepared a statement of the need for, intended operation and expected impact of the Joint Standard on requirements relating to central counterparty licence applications.
- 1.3 The Statement takes into account, the responses received on the draft Joint Standard on requirements relating to central counterparty licence applications that was published for public comment on 4 December 2019.

2 Statement of the need — context and definition of policy problem

- 2.1 The Financial Markets Act, 2012 (Act No. 19 of 2012) (FMA) defines a central counterparty (CCP) as a clearing house that interposes itself between counterparties to transactions in securities, becoming a buyer to every seller and the seller to every buyer and thereby ensuring the performance of open contracts. A CCP becomes a counterparty to trades with market participants through novation, an open offer system or through a legally binding agreement.
- 2.2 CCPs have become systemically important since measures to mandate central clearing of over-the-counter (OTC) derivatives have been introduced. CCPs are recognised for the pivotal role they play in reducing systemic risk through centralised risk management, and multilateral netting and risk mutualisation capabilities that contribute to reducing counterparty risk exposure.
- 2.3 The cross-border nature of securities markets requires an appropriate regulatory framework that promotes the efficiency and competitiveness of the South African financial markets without significantly undermining their stability.
- 2.4 In order to facilitate the G20 central clearing obligation, matters that deal with CCPs were introduced into law through the FSRA as consequential amendments to the FMA.

¹ For the purpose of this Statement, this refers to a Joint Standard.

- 2.5 In addition, Ministerial Regulations (Regulations)² were made under sections 5(1), 8(1)(a), 28(1)(a), 48(1)(a), 48(1A), 49A, 53(2A), 55(1)(a), 56A and 107 of the FMA to:
- enhance the governance, operational and risk management requirements for market infrastructures; and
 - set requirements for CCPs.
- 2.6 The Regulations insofar as they relate to CCPs introduced a rigorous framework for their regulation and contain stringent prudential, governance and conduct requirements. The proposed regulatory framework is designed to be consistent with international best practice, and to preclude entities which are not capable of meeting the standards required to perform the critical CCP function.
- 2.7 There are, however, currently no CCPs licensed in South Africa and any clearing house that is performing the functions of a CCP will be required to undergo a licensing process to operate as a CCP. In terms of section 110(6)(b) of the FMA, a clearing house performing the functions of a CCP must be licensed as a CCP and must comply with the requirements as set out in the FMA and the Regulations by 1 January 2022. As a result, the JSE Clear, as the current associated clearing house for the JSE in respect of listed derivatives, is required to comply with the requirements to be licensed as a CCP and be approved as a CCP by 1 January 2022. The Authorities and the South African Reserve Bank have approved JSE Clear in terms of 110(6)(a) of the FMA to perform the functions of a CCP.
- 2.8 In addition, in December 2012, the Registrar of Securities Services approved JSE Clear as a Qualifying Central Counterparty (QCCP) for listed derivatives on the basis that JSE Clear complied with the Principles for Financial Markets Infrastructures (PFMIs) and the requirements set out in the FMA.
- 2.9 Section 47 of the FMA sets out a high-level licensing framework for CCPs, section 47(3) of the FMA enables the Authorities to prescribe the licensing process in more detail. More specifically, section 47 of the FMA provides as follows:
- 2.9.1 Section 47(2) of the FMA provides that a juristic person may apply to the Authority for a clearing house licence or a central counterparty licence.
- 2.9.2 Section 47(3) of the FMA provides that an application for a clearing house licence or central counterparty licence must (emphasis added) –
- (a) *be made in the manner and contain the information prescribed by the Authority;*
 - (b) *show that the applicant complies with the requirements listed in section 48;*
 - (c) *be accompanied by-*
 - (i) *a copy of the founding documents of the applicant;*

² The Ministerial Regulations were published under Government Notice R98 in Government Gazette 41433 of 9 February 2018.

- (ii) such information in respect of members of the controlling body of the applicant as may be prescribed by the Authority;
 - (iii) the application fee determined in terms of the Financial Sector Regulation Act;
 - (iv) in relation to an application for an associated clearing house licence, particulars of the applicant's proposed appointment by an exchange; and
 - (v) in relation to an application for an independent clearing house licence or a central counterparty licence, a copy of the proposed clearing house rules that must comply with [section 53](#); and
- (d) be supplemented by any additional information that the Authority may reasonably require.

- 2.10 This licensing process, including the manner and information that must be submitted in respect of a CCP license application, have not yet been prescribed by the Authorities.
- 2.11 As there is currently no licensing framework prescribed for CCPs, there is a need for the Authorities to prescribe, through a Joint Standard, a licensing framework for CCPs as enabled through section 47(3) of the FMA.
- 2.12 This essentially means that no CCP can be licensed before the licensing framework has been finalised.

3 Objectives of the Joint Standard

- 3.1 The content of the Joint Standard relates to the manner in which an application for a CCP licence referred to in section 47(2), read with section 47(3), of the FMA must be submitted, and the information that must be contained in such an application.
- 3.2 The information that must accompany a CCP licence application is set out in the Joint Standard and includes the following –
- (a) administrative information;
 - (b) founding documents of the applicant;
 - (c) additional information which must be contained in an application for a CCP licence;
 - (d) details of the compensation funds of the applicant; and
 - (e) proof of compliance with the requirements under the FMA Regulations.

4. Statement of expected impact – Costs and benefits of the Joint Standard

- 4.1 The FMA allows for the licensing of a local CCP or an external CCP. The FMA further allows for an external market infrastructure to be exempt from a provision of the FMA, if the Authority is satisfied, amongst other things that the external market infrastructure complies with any criteria as prescribed in joint standards for the exemption of such entities. The licensing of an external CCP or the exemption of an external CCP must be preceded by an entity being from an equivalent jurisdiction in terms of an

equivalence assessment as contemplated in the FMA. The FMA reflects the policy decisions in order to allow for a local or external market infrastructure to be regulated and supervised in terms of the FMA. The Authorities are putting the necessary supplementary frameworks in place in order to allow for the licensing, equivalence assessment and potentially an exemption framework for an external market infrastructure, in a manner that is aligned to the FMA. The Authorities appreciate that the finalisation of the Joint Standard will allow a local CCP to submit an application to be licensed as a CCP and therefore result in a specific market structure. However, as highlighted above, the Authorities need to prioritise prescribing the requirements as contemplated in section 47 of the FMA given the transitional arrangement in section 110(6) of the FMA.

- 4.2 Based on the comments submitted on the statement, the Authorities are of the view that while compliance with the Joint Standard will have some administrative costs on CCP licence applicants, it is not envisaged that the Joint Standard will have a material adverse impact on the applicants. The view of the Authorities is underscored by statements supporting the implementation of the Joint Standard as received from commentators on the Joint Standard and the statement of expected impact. According to comment received, it is not envisaged that the requirements of the Joint Standard will impose additional compliance costs on the business, apart from the costs associated with employing the services of an independent auditor. It is furthermore, according to the comments received, not anticipated that the requirements of the Joint Standard will materially affect the following:
- (a) operational cost;
 - (b) business models;
 - (c) different customer groups; and
 - (d) increased prices to consumers
- 4.3 As noted above the requirement to be licensed as a CCP is already contained in the FMA and the purpose of the Joint Standard is merely to prescribe the procedures to be followed when applying for such licence.
- 4.4 Additional comments on the statement of expected impact:
- 4.4.1 Notwithstanding the inputs received to the effect that compliance with the Joint Standard will not have a material adverse impact, the Authorities received inputs to the effect that the finalisation of the Joint Standard and the subsequent licensing of a domestic CCP is likely to have the following implications for the South African financial markets:
- (a) the benefits of clearing through a local CCP are limited as local clearing members who clear through the local CCP are not typically as well-resourced as global dealers who participate in global CCPs and therefore the default of a local dealer would be more costly for a local CCP to absorb. This may impact on the desirability of large international banks to participate in the SA market as such banks would rather transact in a jurisdiction where the netting and liquidity benefits are at their greatest;

- (b) operational strain due to management of local margin and foreign margin in two different jurisdictions and in different currencies;
- (c) retaining liquidity in both local and foreign CCPs would affect risk reduction as it would reduce the effectiveness of banks being able to reduce their gross notional exposure in derivatives portfolios through portfolio compression;
- (d) there is a first mover advantage in creating a CCP – which would result in comparatively (e.g. against a second (external) applicant) higher default risk, higher costs due to a lower number of transactions and lower liquidity due to the number of participants and transactions which would most likely be limited to local firms;
- (e) a local CCP may fragment the global market for rand-dollar interest rate swaps. This will add to the cost and complexity of clearing and place the SA market participants at a competitive disadvantage. Creating a local CCP would bifurcate the markets as the payer of fixed rates would exist locally and the receivers of fixed rates would exist offshore. When SA enters interest rate hedges, the liquidity does not come back into the market; and
- (f) fragmentation and price differentiation due to the licensing of a local CCP as opposed to a foreign CCP.

4.5 These comments on the potential negative consequences as highlighted by industry commentators are noted by the Authorities. However, these comments do not relate to the content of the Joint Standard, but rather relate to the policy position already reflective in the FMA. The comments can therefore not be addressed through the finalisation of the Joint Standard per se. As highlighted above, the development of the Joint Standard is to give effect to the legislative provisions as outlined in section 47 of the FMA and the transitional arrangements as contemplated in section 110(6) of the FMA. The Authorities must therefore create the necessary enabling framework to allow for a clearing house currently performing the functions of a CCP to be licensed as such. The FMA therefore creates an enabling framework for the licensing of a local or external CCP. The Authorities are in the process of creating the necessary enabling frameworks to give effect to the FMA.

4.6 None of the commentators indicated that there is any need for transitional arrangements when implementing the Joint Standard.

5. Statement of intended operation

5.1 The Joint Standard applies to any person seeking to be licenced as a CCP and the content of the Joint Standard is consistent with the objects of the FMA and the FSRA, and specifically the mandate of the Authorities.

5.2 The Authorities will evaluate compliance with the Joint Standard during the assessment of CCP applications received under section 47(2) of the FMA.

5.3 It is envisaged that the Joint Standard will be implemented during the first quarter of 2021 which will enable the Authorities to consider CCP licence applications.

- 5.4 Following the implementation of the Joint Standard, the Authorities will assess and evaluate the effect of the Joint Standard on a continuous basis as part of the regulators' supervisory responsibility to ensure that any unintended consequences of the Joint Standard on the industry are adequately addressed.

6 Conclusion

- 6.1 The Joint Standard and this Statement were prepared in line with section 98(1) of the FSRA and published in terms of the requirements in section 98(2) of the FSRA.
- 6.2 Subsequent to the public consultation process, the Authorities made the necessary changes to the Joint Standard. The Joint Standard was submitted to Parliament for a period of at least 30 days while Parliament is in session. No comments or concerns were raised on the Joint Standard during the 30-day Parliamentary process.
- 6.3 A separate report on the consultation process as well as the general account of the issues raised during all the public consultation processes has been prepared by the Authorities, pursuant to section 103 of the FSRA. The Authorities have made certain amendments and refinements to the Joint Standard in response to the public consultation process.
- 6.4 All the procedures as required in terms of Chapter 7 of the FSRA were followed and the Joint Standard will now be made effective.