

Credit Ratings Services Bill and Financial Markets Bill

Parliamentary briefing

Presenter: Ismail Momoniat and Roy Havemann | National Treasury | 7 February 2012



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Department:
National Treasury
REPUBLIC OF SOUTH AFRICA



Objective of today

- In the 2011 Budget speech, the Minister announced a wide-ranging set of reforms
- Details of the proposals are contained in *A safer financial sector to serve South Africa better* (“Red Book”)
- A summary of the Red Book was presented to Committee on 21 Sept 2011

“Red book” has essential two streams of work

Two areas of work

- Strengthening the **institutional architecture** of our regulators through implementing a “twin peaks approach”

Prudential	Market conduct
<ul style="list-style-type: none">• Reserve Bank leads on<ul style="list-style-type: none">- Macro-prudential (systemic stability)- Micro-prudential• Responsible for:<ul style="list-style-type: none">- Prudential regulation of banking and insurance- Responding to risks- Crisis planning	<ul style="list-style-type: none">• New Market Conduct Regulator leads on market conduct for financial services• Works 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)

- Strengthening the “**rules of the game**” – e.g. Basel 3, Solvency 2, Financial Markets Bill, OTC derivatives regulation, Credit Rating Services regulation etc.

Today we are presenting on two bills

- Today's discussion focuses on the "rules of the game", particularly two bills that strengthen our oversight and regulation of financial services
 - Credit Ratings Services Bill
 - Financial Markets Bill

Credit Rating Services Bill

Structure

- 1. Background**
2. Key issues
 - Jurisdiction and application
 - Liability
3. Other issues
 - Investor Protection
 - Integrity and Independence
 - Transparency and Accountability

Credit Rating Services Bill provides a legal framework for regulating credit rating agencies

Purpose of the Bill

- The Credit Rating Services Bill introduces new legislation that provides for
 - (i) the registration of credit rating agencies (CRAs);
 - (ii) for the control of certain activities of CRAs;
 - (iii) conditions for the issuance of credit ratings and
 - (iv) rules on the organisation and conduct of CRAs, and for matters connected therewith.
- Reference points:
 - Financial Crisis and G20 outcomes
 - International Organisation of Securities Commissions (IOSCO) “Statement of principles regarding the activities of credit rating agencies”
 - Other jurisdictions- EU, USA, Australia
 - EU equivalency requirements

The activities of credit rating agencies are currently unregulated

International concerns with current role of rating agencies

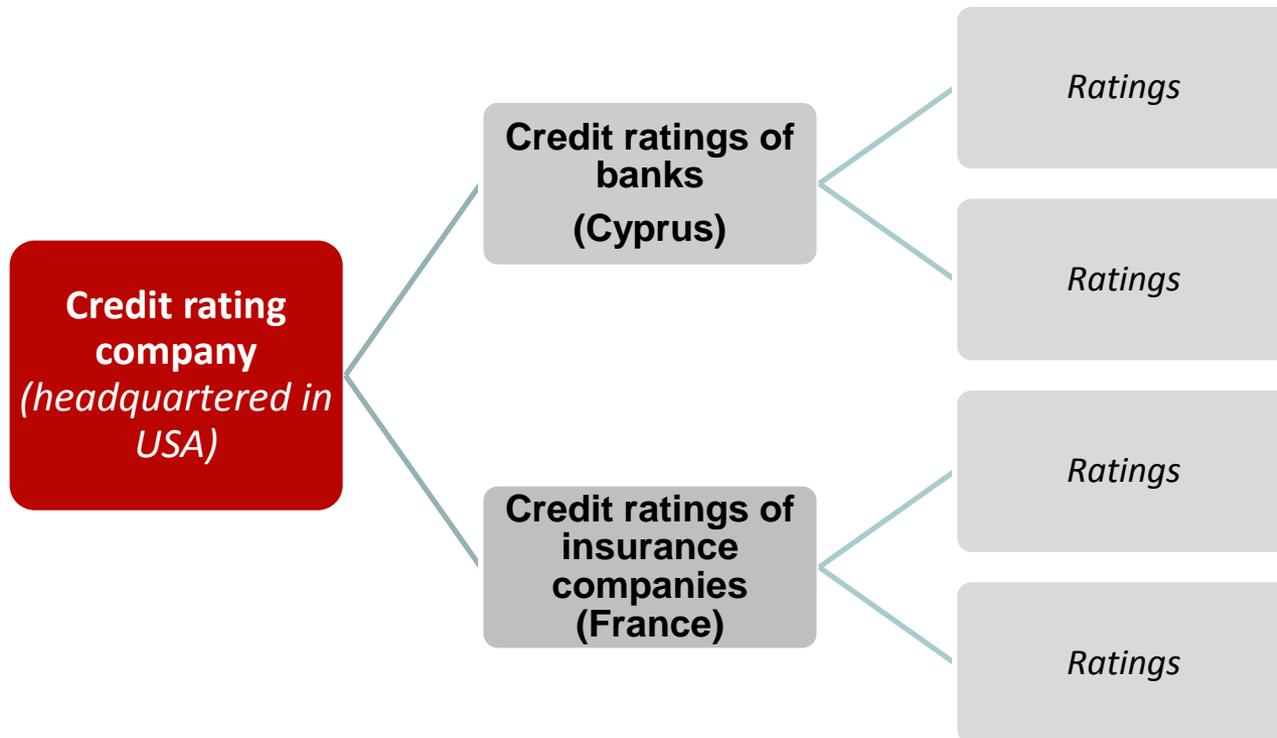
- Credit rating agencies played a central role in the global financial crisis
 - Until close to its collapse Lehman Brothers was AAA-rated
 - Role of credit rating agencies in exacerbating current Eurozone debt crisis
- Pro-cyclicality of credit ratings
- Potential conflicts of interest
 - Credit rating agencies provide consultancy services as well as rating services
 - CRAs play an important role, and should be held to the highest standards of rigour and independence
 - Ratings are a cornerstone of other regulation (e.g. banks)
- G-20 commitments are two-fold:
 - Create a globally-consistent regulatory framework for agencies
 - Reduce the reliance on ratings in legislation

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Credit rating agencies operate globally...

- The three main agencies in South Africa operate as true multinationals, with different services provided in different jurisdictions



... but legislation needs to have teeth domestically

Ensuring legislation is effective

- Key challenge is to create a framework where the regulation will have “teeth”, without extra-territorial powers
 - Section 4: “A regulated person must for regulatory purposes only use credit ratings that are issued or endorsed by credit rating agencies which are registered in accordance with this Act.”
 - For example, this applies to:
 - Banks Act – regulatory capital for banks
 - Pension Funds Act – how pension funds may invest
 - Collective Investment Schemes Control Act – how CIS’s (unit trusts) and money market funds may invest
- Implication: regulated persons have to use registered rating agencies
- However, no such requirement on private investors, and investors are encouraged to do their own research when making investment decisions.

Our legislation follows EU approach and allows for endorsement

Concept of endorsement

- It would be counterproductive to require a CRA to perform all its activities in South Africa
 - Key strength of an agency is its ability to specialise and compare companies with similar companies in other parts of the world
- Rather, agencies will have to meet the following requirements:
 - Registered legal entity in South Africa can “endorse” ratings done by the **same** agency in another jurisdiction (Chapter 4, section 18)
 - If the legal entity “endorses” ratings, then:
 - Ratings may be used for regulatory purposes
 - But agency liable for claims
 - Compliance function and back-office support can be outside SA

Approach to liability entrenches common law

- Drafting committee spent substantial time crafting appropriate liability provision
 - *Agencies*: meeting the requirements of the Act should be sufficient, and this should absolve agencies from further liability
 - *Other commentators*: agencies should be held liable for all investor losses if agencies make incorrect rating on which investors act to their detriment.
- Unbiased legal opinion was that common law liability provisions are most appropriate
 - Well-established case law on grounds for liability (negligence, maliciousness i.e. normal rules for delictual culpability) and principles for restitution
 - Act entrenches common law and does not allow agencies to contract out of liability

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The Bill aims to promote *investor protection* by:

Investor protection requirements

- requiring that ratings are defined, reviewed and updated in a timely and non-selective manner;
- refrain from publishing a rating if a credible rating is not possible;
- communicate with investors and the public with respect to questions, concerns and complaints;
- improve disclosure of information to regulators and the market;
- differentiate ratings for structured products;
- provide full disclosure of their ratings track-record and assumptions;
- prepare audited annual financial statements;
- empowering the FSB as regulator, including working with foreign regulatory authorities; and
- provide for common law delictual liability, and not allow contracting out

The Bill aims to promote *integrity and independence* by:

Integrity and independence requirements

- requiring that CRAs be organised in a way that ensures that their business interests do not impair the independence and accuracy of their credit ratings;
- requiring that approval be granted in order for a CRA to provide services other than credit ratings (and ancillary services);
- stipulating strict criteria that must be met for the endorsement by a CRA of a foreign issued/published credit rating;
- requiring that CRAs publish and adhere to a code of conduct;
- requiring that CRAs disclose the general nature of their compensation arrangements; and
- requiring that CRAs must disclose historical default rates of their rating categories;

Integrity and Independence *contd.*

- requiring effective risk management systems and internal controls
- ensuring that at all times the organisation has the necessary knowledge and experience to conduct credit rating services;
- requiring that confidential information be protected;
- requiring that ratings be based on thorough analysis of available information;
- requiring that rigorous and systematic methodologies, subject to validation based on historical information, be used as well as that methodologies, methods and key ratings assumptions be subjected to regular review;
- requiring that the impact of macroeconomic or financial market change on credit ratings be monitored;
- requiring that directors must meet fit and proper requirements
- requiring a permanent, independent and effective compliance function

The Bill also aims at promoting the transparency and accountability of the credit rating industry by:

- requiring that records be kept for 5 years
- requiring that each credit rating agency must provide the registrar with required information
- requiring that each credit rating agency must disclose policies and procedures regarding unsolicited ratings;
- requiring that each credit rating agency must publish and adhere to a code of conduct;
- requiring that each credit rating agency must disclose the general nature of its compensation arrangements;
- each credit rating agency must disclose, every twelve months, historical default rates of its rating categories; and
- each credit rating agency must publish an annual report to the public, which must include, *inter alia*, information on its legal structure and ownership, a description of its internal control mechanism that ensures quality of its credit rating services and financial information on its revenue sources.

Structure of the Bill

Chapter I	contains the relevant definitions and sets out the objects of the Bill. It also indicates how and to whom the Bill and rules made thereunder apply.
Chapter II	provides for the registration, deregistration and suspension of CRAs.
Chapter III	deals with the duties of credit rating agencies, including the appointment of directors, methodologies, models and key ratings assumptions, publication of credit ratings, code of conduct, outsourcing and other services, disclosure requirements, keeping of records, annual reports, the compliance function and accounting and auditing requirements.
Chapter IV	deals with the requirements for the endorsement of external credit ratings.

Structure of the Bill *contd.*

Chapter V	specifies the extent of liability for CRAs and ensures the independence of CRAs.
Chapter VI	deals with the administration of the Bill, particularly the powers and functions of the Registrar and Deputy Registrar of Credit Rating Agencies, including delegation and assignment, power to make rules, on-site visits and inspections, power to issue directives, exemptions, fees and penalties, and relationship with other regulatory authorities.
Chapter VII	provides for enforcement actions and remedies, including referral to the Financial Services Board enforcement committee, civil action, offences and penalties and the right of appeal.
Chapter VIII	provides for regulations, the saving of rights, the amendment of other Acts of Parliament and the short title and commencement of the Bill.



Financial Markets Bill

Outline

1. Purpose of Bill
2. Process and Upfront Clarifications
3. Main Objectives
4. Policy/Principle Issues
5. Registrar's Powers
6. Market Abuse
7. Changes Since August Bill
8. Technical/Functional Issues
9. Legislative Impact

The purpose of the Bill

- Modernise our approach to financial markets regulation
- Alignment with International developments
 - G20 & FSB
 - IOSCO
 - FSAP
- Changes in principles, laws, e.g. UNIDROIT Convention, and international regulatory practices
- Technical/functional issues
- Replace Securities Services Act

Process followed

- SSA Review (2010-11)
- Publication of FMB on 4 August 2011
- Comments Received
- Public Forum on 5 October 2011
- NT/FSB/SRO Working Group to review comments
- Follow up Treasury-led meetings and correspondence
- Consultative workshops with banks and non-bank financial inst.'s
- Finalisation of the revised Bill
- Additional meetings with stakeholders including IDBs and PDs
- Submission of the revised Bill to Parliament

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; and
- promote competition in and international competitiveness of securities services in the Republic

Policy / Principle Issues (1)

- **Regulatory Model/Effectiveness**

- Strengthen and enhance efficiency and effectiveness of SRO regulatory approach
- Effectiveness of Exchange functions & systems & CSD functions
- Conflict of Interest – Prohibition or requirements iro additional business/function/service
- Fit and Proper requirements for directors and senior management of SROs
- Directors' duties in Companies Act apply
- Securities & securities services (**definition** authorised user, Participant, clearing member)

Policy / Principle Issues (2)

- **Investor/Client protection**
 - Segregation of securities & Balancing and Reconciliation
 - Rights of clients and authorised users
 - Code of conduct for authorised users, participants and clearing members
- **Systemic risk**
 - Registrar to inform Minister, Governor & SROs to inform the Registrar
 - SROs to consult with registrar iro new business

Policy / Principle Issues (3)

- **Central Counterparty**
 - SRO status extended to independent clearing houses to promote the central clearing of OTC derivatives (G20)
- **Financial Stability**
 - Insolvency Proceedings (Unidroit)
- **Cross-border Participation**
 - Remote membership (**definition** of authorised users, clearing members, CSD participants)
 - Linkages between local CSDs and foreign CSDs (**Definition of External CSD**)

Policy / Principle issues (4)

- **Securities Ownership Register**

Enables an SOR

- **IFRS (G20)**

Prescribes that AFS must conform to the financial reporting standards prescribed under the Companies Act.

Policy / Principles (5)

- **OTC regulation (G20)**

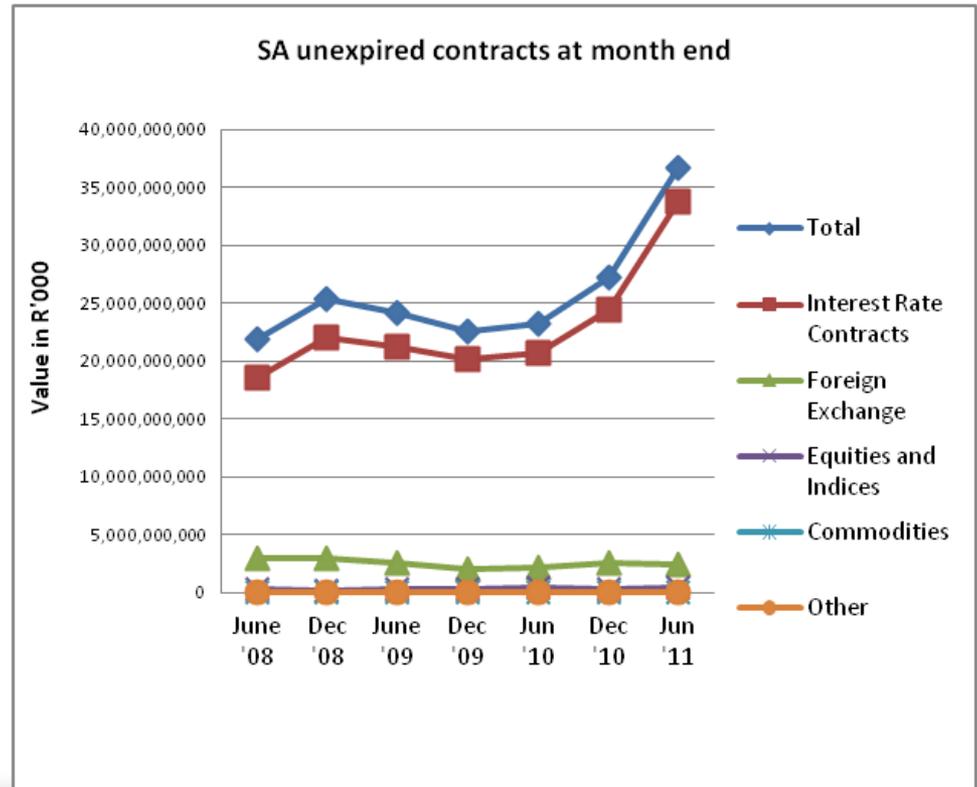
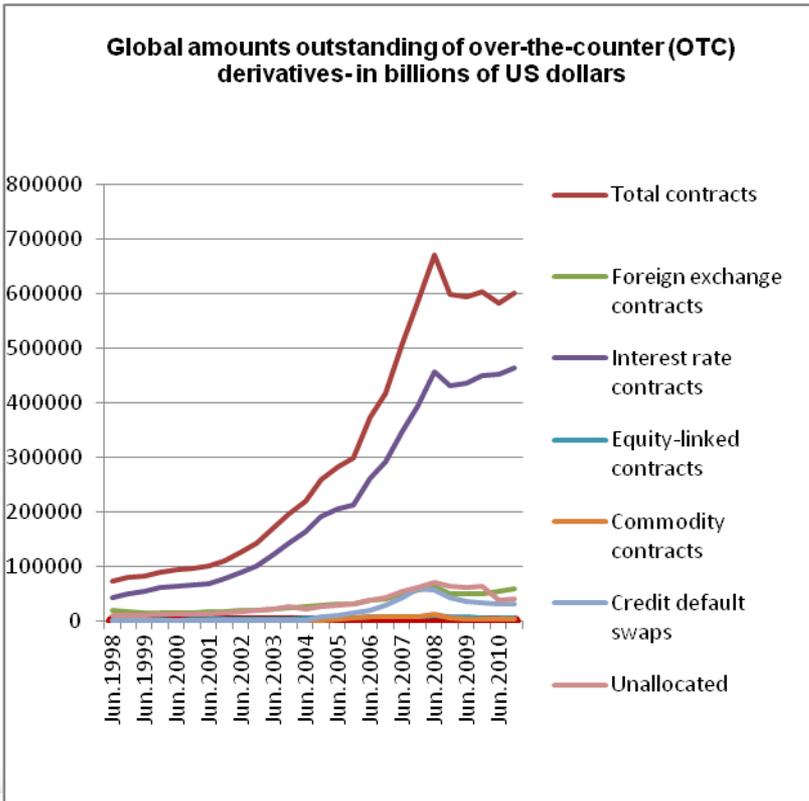
Provides for prescription of standards, code of conduct or reporting requirements, clearing and settlement standards

Licensing of a Trade Repository for the reporting of all OTC derivatives transaction data to the TR and disclosure to the registrar and other relevant supervisory bodies

Treasury and FSB are currently finalising a consultation paper on OTC derivatives

Decisions to regulate over-the-counter derivatives is an important step forward

- Rapid expansion in over-the-counter derivative instruments across the world
- Primarily interest rate contracts
- Propose to have a framework by end of 2012



Policy / Principle Issues (6)

- **Settlement assurance and certainty**

- Finality of Settlement: Revocation of settlement instruction, balancing and reconciliation
- Protection of the bona fide purchaser
- Pledges and Cessions
- Priority/Ranking of Interest
- Attachments: level of holding & entry in relevant account

Policy / Principle Issues (7)

- **Regulatory Cooperation**

- Registrar may enter into MoU with a supervisory authority to strengthen co-operation with regards to the exchange of information
- Power to request information from any person (IOSCO MMoU)

- **Competition/Ownership issues:**

- May not acquire more than 15% interest in a SRO without the Registrar's approval
- 15-49% shareholding – Registrar's approval
- Over 49% shareholding – Minister's approval

Policy / Principle Issues (8)

- **Limitation of liability (s73)**
 - SROs may be held accountable for mala fide and grossly negligent acts
 - Authorised users, Participants – grossly negligent & intentional liability iro nominee

The powers of the Registrar

- **Powers of Registrar**

- Enforcement powers : Conduct on-site visits
- Registrar must approve of amendments to Listings requirements (FSAP)
- Institute or approve business rescue plan /liquidation proceedings
- Referral of contraventions to the Enforcement Committee
- Registrar to prescribe fees – operational (FSAP)
- Issue directives and guidelines

Bill provides for the regulation of unlisted securities

Unlisted securities

- Given the strong policy aspect to this area, such requirements are to be jointly determined by the registrar and Minister.
- As these requirements further develop policy on the regulation of unlisted securities and will imply significant economic impact to issuers and traders in these instruments requires that this responsibility rests with the executive authority.

Role of foreign participation in markets

- Global financial crisis has highlighted the need to balance risks of foreign participation on our markets with the benefits
- The powers of the Minister and Treasury have been enhanced.
- Regulatory requirements will be determined by the executive in a manner consistent with broader financial sector and economic policy.

Improvements to accountability

- The registrar is required to make public reasons for his or her deviation from the Promotion of Administrative Justice Act, 2000 (Act No. 3 of 2000).
- This promotes good governance and accountability

Self-regulatory organisations

- South Africa's system of self-regulatory organisations (e.g. JSE and Strate) is similar with many other jurisdictions
- However, during public comments process, many commentators highlighted areas of concern
- In response, we have substantially strengthened the approach:
 - Strengthening of checks and balances for SRO conflicts of interest;
 - Code of conduct will force SRO to have a transparent approach to mitigating conflicts in its role as both regulator and profit-making business entity;
 - Minimum requirements for stakeholder engagement are introduced for rule-making by the SROs; and
 - Requirements for SROs to report systemic issues to registrar.
- We will undertake a review of the SRO model as part of our shift to twin peaks

Improvements to market abuse rules (1)

- Removing two outdated defences (affected transaction and dealing on behalf of a public sector body)
- Creating a new statutory defence: insiders may deal if all parties to the transaction has the same level of inside information, and the transaction was not designed to benefit from the inside information.
- Created an additional insider trading offence: *Dealing on behalf of an insider, if a person knew that such person was an insider.*
- Created an additional price manipulation contravention (contravention of this section is not criminalised) : *Participating if person has reason to suspect that it was a manipulative scheme.*

Market abuse improvements (2)

- The compensation orders for price manipulation and false statements have been removed
- It became apparent that it will be almost impossible to identify persons and quantify losses suffered as a result of these actions. Compensation orders for Insider Trading remain, as it is possible to identify the “victims”.

Market abuse improvements (3)

- Criminal liability for a person who had reason to suspect that he was executing a manipulative transaction has been taken out, but the contravention may be referred to the Enforcement Committee.
- It is believed that this criminal liability would be too onerous and that it should remain an administrative penalty in these circumstances. However, the criminal liability remains for persons who know that they are taking part in a manipulative practice.

Market abuse improvements (4)

- It was contemplated to add a negligence element to the Insider Trading provisions but after receiving industry comments it was decided to remove this provision
- Insider Trading is a criminal offence and it would be too onerous to expect traders to do a full investigation before each and every trade.

Alignment issues

- Improved alignment between the Bill and other legislation, in particular
 - the South African Reserve Bank Act, 1989 (Act No. 90 of 1989),
 - the Banks Act, 1990 (Act No. 94 of 1990),
 - the National Payment Systems Act, 1998 (Act No. 78 of 1998),
 - the Financial Intelligence Centre Act, 2001 (Act No. 38 of 2001) and
 - the Consumer Protection Act, 2008 (Act No. 68 of 2008).

Additional provisions

- Improved clarity with respect to insolvency proceedings in terms of both transactions in the securities trading and settlement systems, as well as the entities themselves that are regulated under this Bill, like banks.
- Requirements that ensure better alignment between rules made by different SROs.
- Stricter licence requirements for users of the financial market infrastructure, namely authorised users, participants and clearing house members.
- A provision that allows the registrar to exempt entities regulated in terms of the Bill from requirements imposed by the Bill, as may be required should the requirements of the Bill in limited circumstances have unintended consequences.
- That the registrar can provide for transitional arrangements for the implementation of the Bill to ensure that new requirements do not disrupt the effective and stable functioning of the financial markets.

Technical and functional issues

- **Technical/Functional issues:**
 - Alignment of nominee approval
 - Publication of detail, status and outcome of inspection and on-site visits
 - Auditor's appointment - regulated persons, including private companies

Legislative alignment

- 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
- 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;

Structure of the Bill

Chapter I	contains the relevant definitions and sets out the objects of the bill. It also indicates how and to whom the bill and rules made there under applies, and prohibits certain activities.
Chapter II	provides for the powers and functions of the Minister, Registrar and Deputy Registrar of Securities Services and the Financial Markets Advisory Board.
Chapter III	deals with the licensing, functions, funding and rules of an exchange, and related to this, exchange listing requirements, removal of listings and disclosures by issuers of listed securities, the specific obligations of authorised users and the use of the term “stockbroker”. It also deals with the buying and selling of listed securities and the reporting of off-market transactions in listed securities.

Structure of the Bill *contd.*

Chapter IV	deals with the custody and administration of securities. In doing so it also deals with the licensing, functions and rules of a central securities depository and its participants.
Chapter V	deals with the licensing, functions and rules of an independent clearing house, and matters relating to the amalgamation, merger, transfer or disposal of an associated clearing house.
Chapter VI	deals with the licensing, duties and reporting obligations of a trade repository.
Chapter VII	deals with self-regulatory organisations. The bill confers the status of a self-regulatory organisation on exchanges, central securities depositories and independent clearing houses. This Chapter also deals with various matters relating to licensing, reporting, institutional form and mergers and amalgamations.

Structure of the Bill *contd.*

Chapter VIII	provides that the Registrar may prescribe a code of conduct for authorised users, participants or clearing members of independent clearing houses.
Chapter IX	deals with general provisions relating to listed and unlisted securities. It authorises the Registrar to regulate trading in unlisted transactions and prohibit undesirable advertising or canvassing relating to securities.
Chapter X	prohibits market abuse and deals with the functions of the Directorate of Market Abuse in dealing with market abuse related offences.
Chapter XI	obliges regulated persons to have audited financial statements, deals with the role and functions of the auditor, the powers of the registrar and the Courts in ensuring compliance with the legislation.

Structure of the Bill *contd.*

Chapter XII

provides for general provisions which include offences and penalties and matters relating to fair administrative action, right to appeal, the certification of documents, regulations, savings and the like.

Thank you