

FINANCIAL SERVICES BOARD



REPUBLIC OF SOUTH AFRICA

FINANCIAL MARKETS ACT, 2012
(ACT NO. 19 OF 2012)

EXPLANATORY MEMORANDUM

PROPOSAL FOR A DIRECTIVE ON IMPLEMENTING INTEROPERABLE
AND COOPERATIVE ARRANGEMENTS BETWEEN MARKET
INFRASTRUCTURES

MARCH 2016

Acronyms and definitions

CCP	Central counterparty
CH	Clearing house as defined in the FMA
CSD	Central securities depository as defined in the FMA
EACH	European Association of Central Counterparty Clearing Houses
ECSDA	European Central Securities Depositories Association
EMIR	European Market Infrastructure Regulation – Regulation (EU) 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories
ESMA	European Markets and Securities Authority
FESE	Federation of European Securities Exchanges
FMA	Financial Markets Act, 2012 (Act No.19 of 2012)
FMI	Financial market infrastructure as defined by the Committee on Payment and Settlement Systems and IOSCO
FSB	Financial Services Board established under section 2 of the Financial Services Board Act, 1990 (Act No. 97 of 1990)
IOSCO	International Organisation of Securities Commissions
MI	Market infrastructure defined in terms of the FMA
MiFID I	Markets in Financial Instruments Directive (Directive 2004/39/EC)
MiFIR	Regulation on Markets in Financial Instruments
Registrar	Registrar of Securities Services contemplated in section 6 of the FMA
SAMOS	South African Multiple Option Settlement
SARB	South African Reserve Bank (National Payment System Department)
TR	Trade repository as defined in the FMA

1. Purpose of this document

- 1.1. This document is an invitation for comments on a proposed directive on implementing interoperability and cooperation between MIs as defined in terms of the FMA¹. Having taken cognisance of the implementation difficulties between existing and new MIs which point to the requirement for regulatory intervention to maintain the integrity of the financial markets, it is important that the Registrar continues to meet his objectives in terms of the FMA and the objectives of regulation and supervision of securities services in South Africa in the face of new developments in the markets.
- 1.2. The Registrar wishes to ensure that the South African financial markets are fair, efficient and transparent and supportive of the stability of the broader financial system.
- 1.3. It must be noted that this document does not in itself confer any rights; purport to supersede the provisions of the FMA and related legislation, nor prejudice any existent arrangements currently in place between existing MIs.
- 1.4. The Registrar looks forward to receive your comments by **11 April 2016**. Please send your comments to the following e-mail addresses: Michael.Kabai@fsb.co.za or Kgomotso.Molefe@fsb.co.za.

¹ “**market infrastructure**” means each of the following—

- (a) a licensed central securities depository;
- (b) a licensed clearing house;
- (c) a licensed exchange;
- (d) a licensed trade repository.

2. Introduction

- 2.1. The South African financial market is undergoing change, driven primarily by technological developments, increased globalisation of financial markets and regulatory reforms. The financial markets are moving away from being served by single MIs towards being served by multiple MIs. We are beginning to see new market entrants in the securities services value chain from the buying and selling of securities to transaction settlement.
- 2.2. As new market conditions develop at different stages within the upstream and downstream securities services, interconnectivity and cooperative relationships between MIs should be common activity both domestically and internationally. This link between, or connection between MIs is achieved by making them interoperable. This can strengthen the markets they serve and foster stability of the market.
- 2.3. The Registrar is responsible for the regulation and supervision of exchanges, CSDs, CHs, and TRs with the aim of ensuring that the South African financial markets are fair, efficient and transparent. The Registrar is required to uphold the confidence in the South African financial markets, promote the protection of investors, reduce systemic risk and promote the international and domestic competitiveness of the South African financial markets.
- 2.4. The FMA requires that all MIs be licensed and subject to the continuous monitoring of compliance with the FMA requirements and conditions which are imposed in order to protect investors and to ensure fair, efficient and transparent markets².

3. Scope of the Proposal - the Principle of Interoperability (access, interconnection and cooperation)

South Africa

- 3.1. The FMA does not define “interoperability” nor does it make express provision for interoperability relationships or arrangements between MIs. However, links between, or interoperability and /or cooperation between the different MIs such as the exchanges, CSDs in the process of trading securities are naturally implied in the structure of the FMA. For example an exchange must “make arrangements for the efficient and effective

² The FMA enables the Registrar to exercise his discretion in respect of how the requirements applicable to the operation of a market infrastructure must be applied in each case, by for example considering the balance to be struck between sufficient investor protection and the nature, size and scope of the functions of a market infrastructure. See section 6(3)(b) of the FMA.

clearing and settlement of transactions effected through the exchange and for the management of settlement risk”³.

- 3.2. The interoperability generally refers to the measure of the degree to which organisations are able to operate together to achieve a common goal. The specifics of interoperability arrangements between organisations are customised to the situation and may come in various forms and degrees, and may also occur at various levels. For example at strategic, operational and technological levels.
- 3.3. The SARB in relation to the National Payment System describes interoperability as referring to “the ease of interlinking different systems on a business as well as a technology level.”⁴ The SARB's 2011 *Position Paper on Interoperability*⁵ gives a more detailed description of interoperability on the levels of strategy, operations and technology.
- 3.4. According to the SARB, interoperability is defined as “the ability of different types of computers, networks, operating systems, applications and other infrastructure of different banks and relevant stakeholders to interlink and work in partnership effectively, without interruption, explicit communication or translation prior to each event, in order to enhance the efficiency of the payment system.”
- 3.5. The principle of interoperability was entrenched in the Vision and Strategy document agreed to between the SARB and the commercial banks in 1995 (the Blue Book).
- 3.6. The Bank’s Vision 2015 document, *the National Payment System Framework and Strategy*⁶ continues to recognise and place a high level of emphasis on the importance of interoperability.

European Union

- 3.7. Articles 34⁷ and 46⁸ of MiFID I deal with clearing and Securities Settlement Systems in relation to the European Markets and aim to promote an efficient and integrated European

³ See section 8(1)(i) of the FMA, which is a requirement for an applicant for an exchange licence.

⁴South African Reserve Bank, the National Payment System Framework and Strategy Vision, 2010. This publication is available on the following link:

[http://www2.resbank.co.za/internet/Publication.nsf/LADV/DAA203A3059201E4422571570025D8F3/\\$File/Vision2010.pdf](http://www2.resbank.co.za/internet/Publication.nsf/LADV/DAA203A3059201E4422571570025D8F3/$File/Vision2010.pdf)

⁵ South African Reserve Bank, National Payment System Department, Position Paper on Interoperability, January 2011 (Position Paper: NPS 01/2011). The publication is available on the SARB website (www.resbank.co.za)

⁶ South African Reserve Bank, the National Payment System Framework and Strategy Vision, 2015. This publication is available on the Reserve Bank website (www.resbank.co.za).

⁷ Access to central counterparty, clearing and settlement facilities and right to designate settlement system.

⁸ Provisions regarding central counterparty and clearing and settlement arrangements.

capital market for finalisation of the transactions on financial instruments being admitted to trading.

- 3.8. These articles go into a great deal about fair and open access to the Securities Settlement Systems. Fair and open access has not changed in the light of the proposed reforms to MIFID and the new regulation MIFIR⁹ as significant emphasis is placed on “access rights” in market infrastructures in order to level the playing field and to promote access between trading venues and CCPs.
- 3.9. The European Union, through MIFID II¹⁰ and the new MIFIR, recognises that there have been changes in the structure of the European markets, this primarily due to the introduction of new trading venues and market infrastructures as well as technological developments.
- 3.10. The *European Code of Conduct on Clearing and Settlement* (‘the Code’) of 2006 went some way to achieve the scope of Articles 34 and 46 of MIFID I. The Code was drafted by the FESE, EACH and the ECSDA with the aim of eliminating access barriers to securities settlement systems and for purposes of achieving greater efficiency.¹¹
- 3.11. The Code’s framework sets among other principles the standard unilateral access between organisations and interoperability for the purposes of facilitating the interconnection of the organisations and increasing freedom of choice of market participants.
- 3.12. The general considerations addressed by the Code specify the following:
 - (a) CCPs should be able to access other CCPs;
 - (b) CCPs should be able to access CSDs;
 - (c) CSDs should be able to access other CSDs;
 - (d) CCPs and CSDs should be able to access transaction feeds from trading venues;
and
 - (e) A trading venue should be able to access a CSD for its post-trading activities.
- 3.13. With regards to the principles on access and interoperability, the same bodies which drafted the Code issued the *Access and Interoperability Guideline* in 2007 (‘Guideline’) which defines interoperability as meaning those “advanced forms of relationships amongst

⁹ Amending Regulation (EU) No 648/2012.

¹⁰ Replacing Directive 2004/39/EC and amending Directive 2011/61/EU.

¹¹ See European Code of Conduct for Clearing and Settlement, 7 November 2006.

organisations where an organisation is not generally connecting to existing standard service offerings of the other organisations but where organisations agree to establish customised solutions.”¹²

3.14. The Guideline introduced the following general principles which must be considered:

- (a) Operational Efficiency Principle - the existing operational efficiency of financial markets should not be significantly weakened by the development of new links;
- (b) Reciprocity Principle - where an organisation is requesting a link with another organisation, the latter has the right to refuse such link where the requesting organisation is not facilitating a respective request for a link with the latter;
- (c) Receiving Party Principle - the organisation requesting a link should comply with legal, fiscal and regulatory arrangements applicable to the organisation receiving the link request;
- (d) Non-extension Principle - the organisation receiving the link request is not obliged to extend the scope of the product; and
- (e) Non-discrimination Principle - all relationships between linked organisations should be maintained on an equal treatment basis.¹³

3.15. The ECSDA explains ‘interoperable systems’ as referring to, “two or more systems whose system operators have entered into an arrangement with one another that involves cross-system execution of transfer orders”¹⁴ and according to this body in practice, it is up to national regulators to determine whether systems are to be considered interoperable or not for the purpose of the settlement finality.

3.16. In 2013 ESMA issued certain guidelines and recommendations¹⁵ with the purpose of establishing consistent, efficient and effective assessments of interoperability arrangements. These guidelines and recommendations were issued pursuant to Article 85(3)(d) of EMIR¹⁶ and specify how requirements for CCPs should be met for the

¹² See Access and Interoperability Guideline, 28 June 2007.

¹³ Ibid.

¹⁴ http://ecsda.eu/wp-content/uploads/2014/07/2012_11_07_Typology_CSD_links.pdf (accessed 19 October 2015).

¹⁵ ESMA, Guidelines and Recommendations for establishing consistent, efficient and effective assessments of interoperability arrangements, 10 June 2013 | ESMA/2013/323. The publication is available on www.esma.europa.eu.

¹⁶ 3. ESMA shall submit to the Commission reports:

- (a) on the application of the clearing obligation under Title II and in particular the absence of clearing obligation for OTC derivative contracts entered into before the date of entry into force of this Regulation;
- (b) on the application of the identification procedure under Article 5(3);
- (c) on the application of the segregation requirements laid down in Article 39;
- (d) on the extension of the scope of interoperability arrangements under Title V to transactions in classes of financial instruments other than transferable securities and money-market instruments;
- (e) on the access of CCPs to trading venues, the effects on competitiveness of certain practices, and the impact on liquidity fragmentation;

purposes of establishing interoperability arrangements. The regulations embodied in the EMIR are designed to consistently implement the Principles for Financial Market Infrastructures, including CCPs developed by the IOSCO¹⁷.

3.17. Article 2 of EMIR defines ‘interoperability arrangements’ as follows:

“‘interoperability arrangement’” means an arrangement between two or more CCPs that involves a cross-system execution of transactions”.

3.18. ESMA explains that reference to “cross-system” implies that there should be a reciprocal link between the two CCPs which would allow one to clear trades through the other and vice-versa¹⁸.

3.19. Article 51 of the EMIR confers a legal access right on the CCP requesting the establishment of the interoperability arrangements.

3.20. Looking at the South African context, interoperability arrangements and cooperation arrangements would refer to those forms of relationships between MIs whose systems are not generally connected to each other entering into arrangements to establish mutual solutions. These cooperative or interoperability arrangements between MIs are contractual and operational agreements simply establishing an intended line of action or mutual accord between MIs.

4. Reasons for the directive

4.1. To enhance accessibility of our financial markets by allowing for new entrants whilst maintaining the safety and efficiency of the financial system.

4.2. Imposing conditions to interoperate solely on a new market entrant with no reciprocal duty on existing MIs, is ineffective. Consequently, new market entrants requesting the

(f) on ESMA’s staffing and resources needs arising from the assumption of its powers and duties in accordance with this Regulation;

(g) on the impact of the application of additional requirements by Member States pursuant to Article 14(5). Those reports shall be communicated to the Commission by 30 September 2014 for the purposes of paragraph 1. They shall also be submitted to the European Parliament and the Council.

¹⁷ Committee on Payments and Market Infrastructures, Board of the International Organization of Securities Commissions, Implementation monitoring of PFMIs: Level 2 assessment report for central counterparties and trade repositories – European Union, February 2015. The publication is available on the IOSCO website (www.iosco.org).

¹⁸ ESMA, Final Report on the extension of the scope of interoperability arrangements, 1 July 2015 [ESMA/2015/1067]. The publication is available on https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1067_-_report_on_io_extension_0.pdf.

establishment of interoperable and cooperative arrangements or relationships with existing MIs may experience difficulties securing the requested arrangement or relationship.

- 4.3. Interoperability already exists between banks and market participants as the SAMOS¹⁹ system caters for, among others, the settlement of financial market obligations emanating from the equity and bond markets.
- 4.4. The draft Ministerial Regulations for OTC derivatives markets and participants, several obligations with reference to interoperability and interoperability agreements are placed on TRs and CCPs²⁰.
- 4.5. There is presently no policy prescribing interoperability with new market entrants by existing MIs or establishing a duty of reciprocity on existing MIs to interoperate with new market entrants in the segments of the market in which they operate or provide services.
- 4.6. Giving regard to international and domestic best practices and regulatory developments is crucial in the face of the changes which the South African financial market is undergoing.

5. Basis for the proposal

- 5.1. While there are no legal obligations to establish interoperable or cooperative arrangements between existing MIs and new market entrants in the markets they serve, interoperability as a general notion is implicit in section 2 of the FMA²¹. This section enshrines the objects of the FMA and is further bolstered in section 104 of the FMA which makes it clear that the FMA must be interpreted and applied in a manner that gives effect to the objects of the Act as set out in section 2. The Registrar and MIs are legislatively charged to give effect to the objects of the FMA. There is an underlying purport of interoperability carried by the objects of the FMA which are underpinned by international standards and principles which promote and foster interoperability between FMIs.

¹⁹ The SAMOS system is an automated interbank settlement provided by the SARB.

²⁰ Draft Ministerial Regulations issued in terms of the Financial Markets Act (Act No. 19 of 2012), regulation 57. Interoperability arrangements. This publication is available at

<http://www.treasury.gov.za/public%20comments/OTC/Draft%20FMA%20Regulation%20for%20public%20consultation.pdf> (Accessed 6 November 2015).

²¹ **2. Objects of Act.**—This Act aims to—

- (a) ensure that the South African financial markets are fair, efficient and transparent;
- (b) increase confidence in the South African financial markets by—
 - (i) requiring that securities services be provided in a fair, efficient and transparent manner; and
 - (ii) contributing to the maintenance of a stable financial market environment;
- (c) promote the protection of regulated persons, clients and investors;
- (d) reduce systemic risk; and
- (e) promote the international and domestic competitiveness of the South African financial markets and of securities services in the Republic.

- 5.2. There is a general duty placed on both the Registrar and MIs to ensure that financial markets are fair, efficient and transparent and that both MIs and the Registrar are required to act cooperatively and consistently in order to achieve the objects of the FMA and to ensure that markets are stable.
- 5.3. South Africa is a member state in the IOSCO and as such the Registrar is required to strive to ensure compliance with international regulatory standards for the regulation and supervision of financial markets. Market developments, the regulatory framework and the supervisory approach towards the regulation of financial markets must continuously be assessed against the IOSCO principles.
- 5.4. In performing his functions, the Registrar is required to act in a manner which is not only compatible with the objects of the FMA but must also act in a manner appropriate for meeting those objects.²²
- 5.5. The oversight and supervision of the financial market must be primarily aimed at the promotion of efficient markets as a whole and not at individual participants and as such the introduction of new market entrants may create the necessity for coordination, collaboration and interconnection.
- 5.6. The Registrar supports and encourages domestic competitiveness and in so doing is obliged to have regard to international supervisory standards and must also have due regard to the desirability of facilitating innovation in securities services²³.

Giving regard to international supervisory and regulatory standards and practices

- 5.7. The Registrar is legislatively empowered to give due regard to international supervisory standards and the FSB, as a member of IOSCO must be seen to be giving measure to the development, implementation and promotion of adherence to internationally recognised standards of regulation, oversight and enforcement in order to protect investors and to maintain fair, efficient and transparent markets.
- 5.8. In 2012 the IOSCO introduced the Principles for Financial Market Infrastructures ('PFMI') to facilitate the clearing, settlement, and recording of monetary and other financial

²² See section 6(3)(a) of the FMA.

²³ See sections 6(3)(b)(i) and (iii) of the FMA.

transactions.²⁴ The PFMI promote open and fair access and foster interoperability between FMIs²⁵.

IOSCO PFMI 18: Access and participation requirements

- 5.9. A key consideration under this principle is that, an FMI should have objective, risk-based and publicly disclosed criteria for participation, which permit fair and open access, while ensuring the FMIs own safety and efficiency. The IOSCO exemplifies access to existing FMIs by other FMIs as important because of the central role FMIs play in the markets they serve. 'Access' is described as meaning "the ability to use an FMI's services and includes the direct use of the FMI's services by participants, including other market infrastructures and, where relevant, service providers." FMIs are required to base access on objective and fair criteria that are applied in an impartial, non-discriminatory manner pre and post-trade.
- 5.10. Further, fair and open access means access to payment systems, CSDs, settlement systems and CCPs. Limiting access to an FMI's service may disadvantage some market participants (and their customers), other FMIs and service providers that do not have access to the FMI's services.

IOSCO PFMI 20: FMI links

- 5.11. The IOSCO explains a link as a set of contractual and operational arrangements between two or more FMIs that connect the FMIs directly through an intermediary. An FMI may establish a link with a similar type of FMI for the primary purpose of expanding its services to additional financial instruments, markets or institutions. Further, an FMI that establishes a link with one or more FMIs should identify, monitor and manage link-related risks.
- 5.12. The IOSCO and European authorities and bodies proactively promote and foster interoperability and interconnection and recognise that links are essential to enable new market entrants to carry on their business. The principle of interoperability is applied in a broad continuum to all FMIs and at the different stages of the securities services cycle.

²⁴ CPSS-IOSCO – Principles for financial market infrastructures, 16 April 2012. The publication is available on the IOSCO website (www.iosco.org).

²⁵ An FMI is described by the IOSCO as a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions.

- 5.13. In the face of new developments and changes which the South African financial market is undergoing it is prudent for the Registrar to re-evaluate the regulatory and supervisory framework and to embark on establishing or adopting new strategies and principles. This is critical to achieving the objects of the FMA.
- 5.14. Although an exchange is not an FMI in the context of the PFMI, it is important to recognise that interoperability can and does occur at many different levels in the securities services value chain. Exchanges in the context of the South African financial market are MIs as defined in the FMA and by extension some of the principles observed and given measure to are applicable in order to further the interests of cooperation and harmonisation of the market.
- 5.15. Ultimately, the critical factors are to have standards for security, interoperability and access to systems by MIs. It is incumbent on the Registrar to monitor developments and implement appropriate mechanisms in the securities services industry in South Africa which take the interests of all stakeholders into account, including clients and investors.

6. The draft directive

- 6.1. Section (6)(4)(a) of the FMA provides that the Registrar may, in order to ensure the implementation and administration of the FMA, compliance with the FMA or achieving of the objects of the FMA, issue a directive to any person, including a regulated person.
- 6.2. The FMA legislatively enjoins the Registrar to give measure to international developments relating to oversight and global regulatory developments in order to support the objects of the FMA and the broader regulatory, supervisory and oversight framework.
- 6.3. This proposal for the directive is implemented in the context of the PFMI developed by the IOSCO and prevailing international developments and regulatory standards, especially those seen in the changes to the market structure in the European Union.
- 6.4. The Registrar wishes to align the South African financial markets where required as well as to align supervisory oversight arrangements and practices with international best practice and standards.
- 6.5. Interoperability arrangements between MIs are important in order to ensure better cooperation and harmonisation of the financial markets. These standards and arrangements must also be geared towards enhancing security of the markets and to maintain international best practice and standards. Efficiency of the financial markets and

competition considerations must be taken into account and must be aligned with international best practice and standards.

- 6.6. It is crucial for new strategies and fundamental principles to be developed so that the financial markets and the FMA remain applicable and relevant.
- 6.7. It is to be kept in mind that the proposed interoperable and cooperative arrangements between MIs should be flexible and modifiable to adapt to the operational needs, standards and practices observed in the securities services industry.
- 6.8. Therefore, acting in accordance with the empowering provisions of section 6(4)(a) of the FMA, the Registrar hereby proposes to issue a directive to all MIs directing them to interoperate with each other and implement specific practices, procedures and/or processes as proposed in the draft directive. The proposed directive will be binding on the MIs.
- 6.9. The MIs are directed to main standards to allow for interoperability and cooperation with other MIs. Although specific actions or measures should be managed through the bounds of interoperability agreements between the MIs, the Registrar requires that standards must be put forward in an effort to implement and facilitate interoperability.
- 6.10. It is important to recognise that the Registrar does not wish to prescribe standards or functionalities but rather to allow the MIs themselves to produce and map their own representation of interoperability through these arrangements detailing interoperable and cooperative processes to support access or appropriate mechanisms to support transactions. For example exchange-to-exchange access, CSD-to-CSD access, exchange-to-CSD access, etc.
- 6.11. The Registrar is of the view that this intervention is necessary and expedient for the achievement of the objects of the FMA. Where the required standard of conduct is not prescribed, this is ripe ground to direct and impose conditions to facilitate interoperability; permit access; and to establish a duty of reciprocity between existing and new MIs.

-Ends-