STATEMENT OF NEED AND IMPACT SUPPORTING THE DRAFT CONDUCT STANDARD FOR EXCHANGES

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FSCA

Financial Sector
Conduct Authority

1 PURPOSE OF THE STATEMENT

This Statement relates to the draft Conduct Standard proposed by the Financial Sector Conduct Authority (Authority) to be made under sections 106(1)(a) read with section 106 (2)(a) of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) (FSRA) and section 17(2A) of the Financial Markets Act, 2012 (Act No. 19 of 2012) (FMA) in respect of exchanges. The objective of the draft Conduct Standard is to introduce requirements for the conduct of exchanges in response to increased competition due to the introduction of a multiple exchange environment.

This Statement is published in accordance with Section 98 of the FSRA and includes, a –

- notice inviting submissions in relation to the draft Conduct Standard, stating where, how and by when submissions are to be made;
- statement explaining the need for, the expected impact of, and the intended operation of the draft Conduct Standard.

The Authority, in accordance with section 98(1)(a)(iv) of the FSRA, invites submissions in relation to the draft Conduct Standard, attached as Annexure A, which the Authority intends to make under section 106 of the FSRA.

Submissions on the draft Conduct Standard, using the submission template attached as Annexure C, may be submitted in writing on or before **15 July 2020** to the Financial Sector Conduct Authority, at FSCA.RFDStandards@fsca.co.za. The submission template consists of four sections. Section A requires the contact details of the commentator, Section B relates to comments on the drafting, substance and other details of the draft Conduct Standard, and Section C relates to comments on the expected impact of the draft Conduct Standard and finally Section D relates to general comments.

2 STATEMENT OF NEED - POLICY CONTEXT AND PROBLEM DEFINITION

The introduction of competition among exchanges and trading platforms has occurred in a number of foreign jurisdictions over the past few decades. South Africa has not been immune to this general trend towards increasing competition, and now finds itself amidst a transition toward competition with the licensing of a number of new exchanges. Prior to 2016, the JSE Limited ("JSE") was the only licensed exchange in South Africa. This changed when the former Registrar of Securities Services, now the Authority, granted exchange licences to ZAR X (Proprietary) Limited ("ZAR X") and 4 Africa Exchange (Proprietary) Limited ("4AX") during 2016. Exchange licences were subsequently granted to A2X (Proprietary) Limited ("A2X") and Equity Express Securities Exchange (Proprietary) Limited ("EESE") in 2017, resulting in five (5) licensed exchanges.

This brought about the necessity to update the current financial markets legislative framework in South Africa to adequately address the consequences of market fragmentation due to competition between exchanges, and especially the complexities and challenges arising from an environment with the same authorised users as well as the listing and the trading of the same securities across multiple South African exchanges. In particular, the legislation does not contain any provisions relating to interoperability and the need for exchanges to cooperate with each other and to harmonise exchange rules in respect of certain market operations.

The FMA is prescriptive regarding the regulatory functions and responsibilities of an exchange in respect of its obligations to regulate, supervise and enforce legal requirements upon its authorised users. The FMA provides for a decentralised model for the supervision of authorised users, i.e. the exchanges operate as self-regulatory organisations which are responsible for the regulation and the supervision of their authorised users in terms of their exchange rules.

The introduction of a multiple exchange environment with the same authorised users and the same listed securities has introduced the potential for material duplication of regulatory effort (and therefore material duplication of costs), inconsistent standards being applied to common entities, material gaps in regulatory oversight, increased systemic risk, and the erosion of market integrity, all of which require due consideration and the introduction of cooperative arrangements and minimum requirements that must be adopted by each exchange and be harmonised where required with the aim of preventing regulatory arbitrage.

The fragmentation of the market, however, needs to be managed so as not to disrupt the orderly functioning of the financial markets in South Africa. There may be negative net public benefits or at least lesser gains, if competition between equities exchange markets is introduced without a comprehensive framework and rules that support market quality. It is therefore important that the issues of a policy nature, and the particular issues or circumstances in which exchanges should interoperate or cooperate, should be explicitly addressed in a Conduct Standard to ensure a sound, fair, efficient and transparent equity market.

3 SUMMARY OF THE DRAFT CONDUCT STANDARD

The main provisions of the Conduct Standard, which aim to address the consequences of competition between exchanges and harmonising minimum requirements, mainly relate to the need for cooperation between the exchanges, member regulation and supervision, risk management, and market quality, which are summarised below.

Cooperative arrangements

The FSCA recognises the importance of mutual cooperation and the sharing of information or data between exchanges that have the same authorised users or where the same securities are listed on more than one exchange. The exchanges need to enter into cooperative arrangements with each other in the performance of their functions under the FMA, in an attempt to harmonise or align operations with regards to the same authorised users or securities listed on more than one exchange.

Risk management and minimum capital adequacy requirements

Different settlement cycles, technology and settlement assurance models introduce operational and settlement risks, especially the probability of failed trades, which may impact the stability and soundness of the South African financial markets. Consideration is given to a coordinated approach to ensure that these risks are mitigated. The Standard requires an exchange to ensure that its authorised users implement an effective process and employ adequate resources for the determination, measurement, management and the disclosure of risk.

Authorised users must maintain adequate financial resources to meet their business commitments and to withstand all the risks to which the business is subjected to. The Standard therefore sets minimum capital adequacy requirements for authorised users.

Clearing and settlement processes and settlement assurance models

An exchange must align its rules in respect of the settlement cycles and ensure that its rules require the exchange to inform and to provide each other with the relevant information when declaring a transaction of an authorised user as a failed trade.

Authorised user default

The exchange rules must provide for arrangements to manage an authorised user's default and must require the exchange to coordinate its efforts, consult and share information with another exchange

of whom the authorised user is also a member, the central securities depository and the participant of the defaulting member to determine whether cross-exchange netting is possible. An exchange must provide a notice to the effect that the authorised user has been declared to be in default to all other exchanges of which the authorised user is a member.

Best execution

The principle of "best execution" requires authorised users to obtain the best possible result for a client when trading in securities on different exchanges on behalf of that client. The Standard requires the rules of an exchange to require authorised users to implement a policy and procedures and to disclose and agree with their clients how they intend to achieve best execution by taking into account a number of factors.

Market operations

The Standard requires exchanges with the same authorised users or the same listed securities to harmonise their market operations and requirements in respect of extreme price movements, off-order book trades, time synchronisation, cancelling erroneous trades and trading disruptions, such as the closure of the whole market or a trading halt or the suspension of a specific security.

Most of the requirements are aimed at the harmonisation of exchange rules, while some requirements are applicable in addition to any other requirement already imposed on exchanges by the FMA. The requirements have been crafted in such a way, so as to avoid inconsistencies with regulatory requirements already in place, however commentators are requested to highlight any potential inconsistencies that may appear.

4 STATEMENT OF IMPACT OF THE CONDUCT STANDARD

It is envisaged that the draft Conduct Standard will not have a material adverse impact on exchanges and authorised users, including financial customers.

However, there may be instances in which the implementation of the Conduct Standard could have a cost implication and administrative burden for exchanges with common authorised users and listed securities.

Some authorised users may decide to install smart routing technology to enable them to achieve best execution for their clients by identifying the best prices across the exchanges of which they are a member. However, this is not compulsory.

Authorised users that are members of more than one exchange, may also encounter additional trading and connectivity costs into the system for authorised users to access multiple exchanges and information streams as well as potentially additional "margin" requirement costs.

Furthermore, having a multiple exchange environment may affect liquidity due to economies of scale and network effects. More fundamental is the potential for competition to impact on the soundness of the financial markets and its underlying integrity.

The introduction of competition may result in additional risks, which could potentially reduce the soundness of the markets in relation to aspects such as market surveillance; supervision of authorised users; market quality such as market transparency, best execution and market operations; and post-trade risk management, all of which would be addressed by the Conduct Standard.

On the other hand, a multiple exchange environment has the potential to improve welfare and market outcomes by eliminating monopoly profits. It may also result in improved consolidated liquidity and volumes, driving down the cost of trading and encourage inter-market competition and may stimulate

innovation in the financial sector, i.e. enhanced technological applications and sophistication; improved and differentiated trading functionality; and also differentiated business and operational models which may target to serve an expanded set of firms and financial customers, and enhance the quality of service and choices available to authorised users and financial customers.

The possible negative consequences of a multiple exchange environment do not imply that competition should not occur. With the correct measures and regulatory interventions in place, these risks can be largely mitigated and managed. Although these interventions, e.g. the Conduct Standard, may add a layer of complexity and cost, in most instances only relatively modest interventions are required. It should, however, be noted that the extent of these risks, and the required regulatory responses depend, to some extent, on the nature and business model of a particular entrant.

The Authority acknowledges that this is a preliminary desktop assessment of the potential impact of the draft Conduct Standard and that subject to additional input that may be submitted by affected stakeholders (exchanges, authorised users, etc.) as part of the comments process, this Statement may be updated. Commentators should therefore clearly identify the risks, benefits and impacts of the draft Standard in Section C of the comments template.

The Authority further acknowledges that there may be instances in which the implementation of the draft Conduct Standard could have a cost implication for exchanges or authorised users, as discussed above. In recognising this, all stakeholders and commentators are requested to answer the questions set out under Section C of the comment template published with this statement. The responses will be analysed to understand the anticipated cost and other impacts, of implementing the draft Conduct Standard once it becomes effective. This includes the extent to which transitional provisions are required in respect of some of the requirements proposed in the draft Conduct Standard.

5 STATEMENT OF INTENDED OPERATION OF THE CONDUCT STANDARD

The draft Conduct Standard is consistent with the objective of the FMA and the FSRA, and specifically the mandate of the Authority to ensure the efficiency and integrity of financial markets. All exchanges and its authorised users will be required to comply with the Conduct Standard within 6 months after it came into operation.

To manage compliance with the requirements in the draft Conduct Standard, the exchanges will have to amend its rules and/or directives to achieve the required harmonisation of certain market activities and requirements, and will have to coordinate operations and closely cooperate with each other.

The Authority will monitor compliance with the draft Conduct Standard by using pro-active supervisory approaches in which potential areas of concern, with a greater emphasis on pre-empting negative customer outcomes where possible, is identified. This proactive approach will cover both emerging risks within a specific exchange (micro conduct risks), as well as concerns at sector or business model level (macro conduct risks). Once risks have been identified, the Authority will have an engagement with the exchange concerned to try to rectify the situation and pre-empt consumer harm or seek redress where harm has occurred.

To operationalise the pro-active supervisory approach, the Conduct Standard requires exchanges to provide the Authority with a written progress report on compliance or proposed actions to comply with the requirements of the Conduct Standard within 90 days of the Standard coming into operation. The exchanges must also inform the Authority without delay should they fail to conclude the arrangement or reach agreement on any subject matter in the Conduct Standard, in which case the dispute resolution mechanisms under the cooperative arrangements will be applied with the aim of resolving the matter. In addition, in terms of section 59 of the FMA, the Authority must annually assess whether an exchange complies with the FMA, its rules and directives as well as the requirements of the Authority in terms of the FMA.

Apart from off-site supervision, on-site supervision and interactions with the exchanges will also be conducted to examine and assess compliance with the Conduct Standard.

6 WAY FORWARD

The draft Conduct Standard is published in terms of section 98(2) of the FSRA for public comment for a period of 8 weeks, and comments are due to the FSCA on or before **15 July 2020**. After careful consideration of all submissions received on the draft Conduct Standard, the FSCA will make any necessary changes to the draft Conduct Standard and submit the updated draft Conduct Standard to Parliament for a period of at least 30 days while Parliament is in session.[1]

Please note that this statement supporting the publication of the draft Conduct Standard may be updated to better reflect the expected impact of the draft Conduct Standard based on the submissions received under Section C of the comment template.

[1] Unless amendments or revisions to the conduct standard results in it being in a materially different form from the draft conduct standard that was published (section 99 of the FSRA refers).