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building stronger partnerships
between the public and private sectors



"Emerging Regulatory Issues in Capital Markets
and Investment"

Bert Chanetsa

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DECLARED REGULATORY REFORM AGENDA

Minister Pravin Gordhan stated in his budget speech:

"We will be expanding the scope of regulation to include hedge funds, private equity and credit rating agencies."



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CONTEXT FOR THE DIRECTION IN WHICH REGULATORY REFORM IS GOING

In testimony to the US Congress on 23 October 2008, Alan Greenspan was asked whether he still stood by the following pre-crisis statement:

“My judgment is that free, competitive markets are by far the unrivaled way to organize economies. We've tried regulation. None meaningfully worked.”

Greenspan admitted that he found “a flaw in the model (he) perceived was critical to the functioning structure that defines how the world works.”



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CONTEXT FOR THE DIRECTION IN WHICH REGULATORY REFORM IS GOING (CONTINUED)

Ed Balls, the former Economic Secretary to the UK Treasury:

(September 2006 before the GFC): “The Government’s interest in this area [London Stock Exchange regulation] is specific and clear: to safeguard the light touch and proportionate regulatory regime that has made London a magnet for international business...”

(September 2008 after the GFC had blown up): “Those people who think that the global market can be run without regulation, or with self-regulation, or with light-touch regulation have been entirely routed, have been entirely disproved.”



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CONTEXT FOR THE DIRECTION IN WHICH REGULATORY REFORM IS GOING (CONTINUED)

Admission: Light touch regulation and the promotion of market oriented disciplines were ill-conceived.

Regardless, the Turner Report referring to the Financial Services Authority's 2008/2009 business plan stated:

"that a full analysis will support (the FSA's) move towards a more principles-based approach to regulation with its emphasis on both the FSA and firms management focusing on the consequences of the firm's actions rather than on rigid adherence to specific rules."

Principles-based, rules-based, risk-based etc are separate seminar topics.



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CONTEXT FOR THE DIRECTION IN WHICH REFORM IS GOING (CONTINUED)

Demise of Lehman's, Smith Barney, Northern Rock (UK) and the London based Lexington Insurance Company within the AIG group of companies, signaled the GFC.

Financial Stability Forum

G7

G20

Financial Stability Board



OBSERVATIONS ON EMERGING REGULATORY ISSUES AT VARIOUS G20 AND FINANCIAL STABILITY FORA

Re hedge funds:

- they were seen as active participants in the shadow banking system.
- information about their activities was not readily available;
- stratospheric leverage ratios of 30:1 were recorded in United States;
- there was a lack of regulation;
- they were regarded as contributing to systemic risk



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OBSERVATIONS ON EMERGING REGULATORY ISSUES AT VARIOUS G20 AND FINANCIAL STABILITY FORA (CONTINUED)

Re Credit rating agencies:

- seen as having significant conflict of interest issues.
- product originators tended to design their products to fit into specific parameters set out by credit rating agencies;
- they were unregulated, and one feature that any user of ratings reports was sure to encounter, was a prominent disclaimer;
- often obscure methodologies were utilized;



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OBSERVATIONS ON EMERGING REGULATORY ISSUES AT VARIOUS G20 AND FINANCIAL STABILITY FORA (CONTINUED)

Re Credit rating agencies:

- they probably contributed to systemic risk through unanticipated and abrupt downgrades of ratings;
- they depended on the companies which they rated for income.



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OBSERVATIONS ON EMERGING REGULATORY ISSUES AT VARIOUS G20 AND FINANCIAL STABILITY FOR A (CONTINUED)

Re Over-The-Counter Market and products (OTC's):

- insufficient information is available about OTC markets and products;
- they are regarded as being at the heart of the shadow banking system;
- there are strong sentiments that OTC products should be moved on to regulated markets;



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OBSERVATIONS ON EMERGING REGULATORY ISSUES AT VARIOUS G20 AND FINANCIAL STABILITY FOR A (CONTINUED)

Re Over-The-Counter Market and products (OTC's):

- standardisation of contracts is to be preferred to customised contracts;
- it is conceded though that not all instruments are suitable for exchange trading;
- there is a distinct need for centralised clearing and clear rules for collateral;
- conversely, clearinghouses do tend to concentrate risk



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OBSERVATIONS ON EMERGING REGULATORY ISSUES AT VARIOUS G20 AND FINANCIAL STABILITY FOR A (CONTIUED)

Systemic risk (over and above hedge funds, credit rating Agencies and OTC issues):

- adverse effect on international trade flows;
- counterparty default risk becomes a reality;
- effect on liquidity (credit crunch);
- capital outflows from emerging economies rather than investment;
- this is accompanied by widespread solvency issues;
- the cumulative effect of less rather than more regulation;
- the need for uniform global accounting standards;
- compensation policies and linked risk taking were brought under the spotlight



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REGULATORY RESPONSE

International Organisation of Securities Commissions (IOSCO):

- has membership from 100 jurisdictions including South Africa;
- is represented on the Financial Stability Board;
- conduit to G20
- South Africa is represented at IOSCO by the Financial Services Board

Standard setter for securities regulation

Guidance and recommendations are given due regard by international bodies

Financial Sector Assessment Programme



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REGULATORY RESPONSE (CONTINUED)

IOSCO exists:

- to cooperate and promote high standards of regulation and to maintain just, efficient and sound markets;
- to exchange information and experiences in order to promote the development of domestic markets;
- to unite efforts to establish standards and ensure effective surveillance of international securities and derivatives transactions;
- to provide mutual assistance so as to promote the integrity of markets by a rigorous application of standards and by effective enforcement against offences.



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REGULATORY RESPONSES TO ISSUES RAISED AT G20

Hedge Funds:

IOSCO response

A permanent standing committee on hedge fund regulation has been created.

On 22 June 2009, IOSCO published six high level principles:

- hedge funds and their managers or advisors should be subject to mandatory registration;
- there should be appropriate ongoing requirements relating to organisational and operational standards;
- prime brokers and banks providing funding to hedge funds should be subject to mandatory registration, regulation and supervision;
- information relating to systemic risk should be provided to the relevant regulator;
- account should be taken of industry good practices;
- regulators should be able to cooperate and share information with each other



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REGULATORY RESPONSES TO ISSUES RAISED AT G20 (CONTINUED)

Hedge Funds:

South African response

Intention is to bring hedge funds into the regulatory framework

The Financial Services Board is engaging with ASISA and National Treasury

Consensus that any regulatory framework should cater for:

- Retail investors and retirement funds;
- Professional and high net worth investors

Key question: where to house the legislation?



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REGULATORY RESPONSES TO ISSUES RAISED AT G20 (CONTINUED)

Credit Rating Agencies (CRAs)

IOSCO response

IOSCO's amended Code of Conduct Fundamentals for CRAs (in 4 parts) is regarded as the benchmark:

Quality and integrity of the rating process – part 1

- analysts should adhere to the methodologies established by their CRAs;
- treatment of historical data;



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REGULATORY RESPONSES TO ISSUES RAISED AT G20 (CONTINUED)

Credit Rating Agencies (CRAs):

Quality and integrity of the rating process – part 1 continued

- compliance with all applicable laws and regulations covering the activities in their jurisdictions;
- should be no assurance or guarantee of a particular rating;
- analysts should not make recommendations regarding the design of products.



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CRA Independence and Avoidance of Conflict of Interest – part 2

- a CRA's credit rating business should be separated from any other business of the CRA;
- CRAs should adopt written internal procedures and mechanisms;
- CRAs should disclose compensation arrangements with rated entities;
- reporting lines and compensation arrangements for employees should avoid conflicts of interest.



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CRA Responsibilities to the Investing Public and Issuers – part 3

- CRAs should distribute their ratings decisions in a timely manner;
- each CRA should indicate when each of its ratings was last updated;
- a CRA should publish sufficient information about its procedures, methodologies and assumptions;
- protection of confidential nature of information shared with CRAs by issuers in terms of confidentiality arrangements.



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REGULATORY RESPONSES TO ISSUES RAISED AT G20 (CONTINUED)

Disclosure of the code of conduct and communications with market participants – part 4

- CRAs code of conduct should be disclosed to the public.
- Deviations from the IOSCO code should be explained.

South African response

Discussion document

Credit Ratings bill

Legislative protocol



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REGULATORY RESPONSES TO ISSUES RAISED AT G20 (CONTINUED)

OTCs

IOSCO response

Task force on OTC markets and derivatives trading

A questionnaire has been circulated seeking different experiences and insights into:

- **regulatory oversight of:**
 - market access;
 - price formation process, valuations and accounting treatment of structured products;



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REGULATORY RESPONSES TO ISSUES RAISED AT G20 (CONTINUED)

OTCs continued

IOSCO response continued:

- disclosure to investors and regulators;
- mechanisms to promote greater post-trade transparency;
- mechanisms for the reduction of counterparty and systemic risk.



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REGULATORY RESPONSES TO ISSUES RAISED AT G20 (CONTINUED)

OTCs continued

IOSCO response continued

The task force will use the information gathered to make a comprehensive analysis of:

- the different forms of OTC markets and derivatives trading among EMC jurisdictions
- the different approaches to regulating these markets; and
- highlight the lessons learnt from the GFC



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REGULATORY RESPONSES TO ISSUES RAISED AT G20 (CONTINUED)

OTCs: continued

SA response:

Local work group set up

Final report August 2010



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REGULATORY RESPONSES TO ISSUES RAISED AT G20
(CONTINUED)

Systemic risk

IOSCO response

Adopting a new principle to address systemic risk.

Agreed template for the global collection of hedge fund information



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REGULATORY RESPONSES TO ISSUES RAISED AT G20 (CONTINUED)

Systemic risk

IOSCO response continued

There are 11 proposed categories of hedge fund information:

- broad manager and adviser information;
- performance and investor information related to covered funds;
- assets under management;
- gross and net product exposure and asset class concentration;
- gross net geographical exposure
- trading and turnover issues;
- asset and liability issues;
- borrowing;
- risk issues;
- credit counterparty exposure;
- other issues e.g. complexity and concentration.



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REGULATORY RESPONSES TO ISSUES RAISED AT G20
(Continued)

SA response

To take cognizance of the IOSCO guidelines

Regulator's Round Table



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SA SPECIFIC REGULATORY ISSUES

Review of the Collective Investment Schemes Control Act

Detailed review scheduled for 2011

Areas to be covered to include:

- enhancement of the role carried out by trustees in the administration of CISs;
- additional requirements to improve corporate governance for regulated entities;
- legal clarification of the responsibilities of entities.

Private Equity

Looking into:

- systemic risk
- business practices
- investor protection issues



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SA SPECIFIC REGULATORY ISSUES (CONTINUED)

Regulation 1503

- FSB internal review of the proposed amendments is complete;
- anticipate reaching common ground by the end of June 2010;
- submission to the CIS Advisory Committee.

Real Estate Investment Trusts (Reits)

Requested to consider a proposal to accommodate property loan stock companies in a Reits structure under CISCA.



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SA SPECIFIC REGULATORY ISSUES (CONTINUED)

Dark Pools

- Facility is to be introduced towards the end of May 2010.
- Intended to accommodate large orders on the JSE's central order book.
- A hidden order category is to be introduced for trade of a minimum size.

IOSCO 2011

Cape Town from 17-23 April 2011



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THANK YOU