



CONSULTATION PAPER: REGULATION OF EXCHANGES UNDER THE FINANCIAL MARKETS ACT 19 OF 2012

1. Responding to this paper

The FSB invites comments on all matters in this paper.

Comments would be most helpful if they:

- contain a clear rationale;
- include quantitative elements to support any concern; and
- describe any alternatives that the FSB should consider.

All contributions can be submitted on or before 31 January 2014 to:
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2. Introduction

2.1. Historically, the Registrar of Securities Services ('Registrar') did not treat a company facilitating a secondary market for its shares through an infrastructure where interested buyers and sellers trade its shares as constituting an "exchange" as defined in the (now repealed) Securities Services Act, 2004 ('SSA').

2.2. The definition of an "exchange" has been retained in the Financial Markets Act, 2012 ('FMA') which replaced the SSA on 3 June 2013.

2.3. In the FMA, an exchange is defined as:

"a person who constitutes, maintains and *provides an infrastructure-*

- (a) for bringing together buyers and sellers of securities;*
- (b) for matching bids and offers for securities of multiple buyers and sellers; and*
- (c) whereby a matched bid and offer for securities constitutes a transaction"*

- 2.4. Following the promulgation of the FMA, the FSB has received a number of queries regarding public companies facilitating, or wishing to facilitate, a secondary market for their shares through infrastructures, where interested buyers and sellers trade shares. Amongst the questions asked is whether the fact that these companies whose operations are limited to providing infrastructures that bring together buyers and sellers of only the companies' own shares, should be regulated as "exchanges". Concerns have also been raised in the context of market abuse and investor protection.
- 2.5. This paper sets out the Registrar's view on the question and concerns raised, as well as a proposed course of action to regularise the affairs of unlicensed exchanges.

3. What is an Exchange?

- 3.1. The Registrar interprets the legal definition of what constitutes an "exchange" in terms of the FMA as being independent of the number of shares which, or the number of issuers whose shares trade on the infrastructure.
- 3.2. Put differently, a person who maintains or provides an infrastructure which meets the three requirements as set out in paragraph 1.3 above; is deemed to operate an exchange, regardless whether the infrastructure is provided for transactions in only one share.

4. Why the licensing of an exchange is important

- 4.1. The law requires that all exchanges be licensed.¹
- 4.2. The legislature has carefully considered what measures are required to ensure fair, efficient and transparent markets and these are embodied in

¹ Section 7(1) of the FMA.

the FMA. Non-compliance with any one of these requirements could have an adverse effect on investor protection and the market.

- 4.3. Licensing requirements and continuous monitoring of compliance with the FMA requirements are needed to protect investors and to ensure fair, efficient and transparent markets.
- 4.4. When transacting on an exchange, the identity of the counterparty is unknown and the purchaser and seller do not have a contractual relationship. This makes it almost impossible for an investor to institute a civil action against the counterparty. To remedy this potential problem, the legislature has made laws to regulate conduct on such exchanges to ensure investor protection.
- 4.5. The Market Abuse Provisions of the FMA apply to securities listed on licensed and unlicensed exchanges. Without proper disclosure, record keeping, surveillance and other mechanisms, it is unlikely that investors would receive proper protection against offences such as insider trading, market manipulation and the publication of false statements.
- 4.6. The licensed exchange is obliged to pay levies to the FSB, from which the investigation of market abuses and the regulation of the capital markets is funded. Persons purchasing shares on unlisted exchanges may expect a certain degree of investor protection whilst not contributing to the cost thereof.
- 4.7. The proliferation of unlicensed exchanges could have an impact on the systemic soundness of financial markets of South Africa.
- 4.8. Due to the protection offered by the FMA to investors who transact on an exchange, the legislature has excluded securities listed on an exchange from some of the investor protection mechanisms of the Companies Act 2008 (Act No. 71 of 2008). Not regulating the securities listed on the

exchange would thus have the effect that there is no investor protection in respect of such securities.

5. Unlicensed exchanges

- 5.1. Section 7(1) of the FMA requires that an exchange must be licensed in terms of section 9 of the FMA.
- 5.2. All persons who constitute, maintain or provide an exchange infrastructure must thus apply for an exchange licence and must meet the requirements of the FMA.
- 5.3. Any person operating an exchange without an exchange licence would be acting in contravention of the FMA.
- 5.4. The Registrar, as the custodian of the FMA, cannot allow current exchange infrastructures to operate illegally nor can he allow a proliferation of illegal exchanges.
- 5.5. The affairs of all unlicensed exchanges must urgently be regularised, either by these exchanges immediately ceasing the illegal unlicensed exchange activities, or by them obtaining the requisite license to operate an exchange. The situation is exacerbated if these companies do not comply with the disclosure requirements in the Companies Act.

6. The Registrar's approach to the licensing of exchanges

- 6.1. South Africa has traditionally followed a model of self-regulation in respect of exchanges, i.e. the Exchange is responsible for authorising and supervising its authorised users in terms of its rules. Only one exchange, namely the JSE Ltd, is currently licensed in terms of the FMA.

- 6.2. It is unlikely that all of the unlicensed exchanges currently operating would be able to fully comply with the stringent requirements that flow from the self-regulating model.
- 6.3. The FMA enables the Registrar to exercise his discretion in respect of how the requirements applicable to the operation of an exchange 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 an exchange.
- 6.4. Section 6(3)(m) of the FMA provides the Registrar with powers to grant persons exemptions from certain provisions of the FMA.
- 6.5. Any relaxation or exemption must further the objects of the FMA, of which investor protection and promotion of fair, efficient, transparent and systemically sound financial markets are paramount.
- 6.6. In light of the aforesaid, the Registrar does not believe that any relaxation from the self-regulating model requirements is prudent in respect of exchanges that facilitate transactions in respect of multiple securities.
- 6.7. The Registrar however believes that it may be feasible to consider relaxations or exemptions in respect of an exchange operated by a company that brings together buyers and sellers of the company's own shares. The main driving force behind such an exchange would thus exclude deriving a profit from transactions on the exchange or raising capital.
- 6.8. Aspects such as (but not limited to) the instrument type, volume of shares traded, market capitalisation and number of investors in a share could play a role in determining what investor protection is needed.

7. Transitional arrangement applicable to existing unlicensed exchanges

7.1. The Registrar invites companies that provide an infrastructure for bringing together buyers and sellers of only their own shares to apply for a temporary exemption from the exchange licensing requirements pending their application to be licensed as an exchange.

7.2. Applications for a temporary exemption will only be considered if the applicant:

7.2.1. advises the Registrar within sixty (60) days from date of publication hereof that it intends to apply for an exchange licence and furnishes detailed motivations² as to why the Registrar should grant a temporary exemption to it.

7.2.2. submits a complete application for an exchange licence to the Registrar within six months from date of publication hereof. An application will only be considered complete:

- a) if it provides full particulars of the applicant's compliance with every relevant provision of the FMA; and
- b) if the applicant is not able to comply with any provision, it provides a detailed explanation as to why it is not able to fully comply and motivates why such non-compliance would not adversely affect investors; and
- c) on payment of the prescribed fee under Board Notice 98 of 2013.

7.2.3. accepts the following conditions:

² The detailed motivations must include, but not be limited to, the name of the share that trades on the platform, the number of shares traded on a daily basis during the last year, the number of shareholders, whether the shareholders are limited to any specific group, the value of daily share transactions during the last year, how the infrastructure operates and what investor protection measures it currently has in place.

- 7.2.3.1. it undertakes to not market itself as an exchange as defined in the FMA and does not create the impression that it is regulated in the same manner as a licensed exchange;
- 7.2.3.2. it records all information with regard to transactions that take place on the exchange trading platform;
- 7.2.3.3. it has arrangements in place for efficient and effective security and back-up procedures to ensure the integrity of the records of transactions effected through the exchange;
- 7.2.3.4. it puts in place sufficient arrangements for the efficient and effective surveillance of all transactions effected through the exchange to identify possible market abuse;
- 7.2.3.5. it makes provision for simultaneous and comprehensive disclosure of price sensitive information;
- 7.2.3.6. it ensures that adequate arrangements are put in place for the segregation of individual client funds and securities;
- 7.2.3.7. it collects and pays to the Registrar the investor protection levies determined by the Registrar;
- 7.2.3.8. it immediately complies with all requests for information from the Registrar; and that
- 7.2.3.9. it immediately implements any other measure that the Registrar may require.

8. Application for an exchange licence

- 8.1. All exchanges must be licensed in terms of the process provided for in the FMA.

- 8.2. Where an applicant is unable to comply with any provision of the FMA that is applicable to an exchange, it must fully motivate why it is not able to do so and why such non-compliance would not adversely affect investors.

9. Nature of this consultation paper

9.1.1. This consultation paper, and any responses received thereto, do not create any rights or obligations for the Registrar or any other party.

9.1.2. It is intended purely as an invitation for comments and to stimulate discussion on the regulation of unlicensed exchanges operated by companies that provide an infrastructure for transactions in their own shares.

9.1.3. The Registrar looks forward to receive your input on the abovementioned aspects by 31 January 2014.