# STATEMENT OF NEED AND IMPACT OF THE DRAFT CONDUCT STANDARD – REQUIREMENTS RELATING TO SECURITIES FINANCING TRANSACTIONS

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FSCA

Financial Sector
Conduct Authority

## 1 PURPOSE OF THE STATEMENT

1.1 The purpose of this Statement is to explain the need for, expected impact and intended operation, and the expected impact of the draft Conduct Standard - Requirements relating to Securities Financing Transactions to be made in terms of section 106(1), read with sections 106(2), 106(3) and 108(1) and (2) and of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) (FSR Act) (the Statement).

1.2 This Statement is published in terms of section 98 of the FSR Act, which requires that before a regulator makes a regulatory instrument it must publish the following documents:
(a) A draft of the regulatory instrument;
(b) a statement explaining the need for and the intended operation of the regulatory instrument;
(c) a statement of the expected impact of the regulatory instrument; and
(d) a notice inviting submissions in relation to the regulatory instrument, stating where, how and by when submissions are to be made.

## 2 STATEMENT OF NEED - POLICY CONTEXT AND PROBLEM DEFINITION

### 2.1 BACKGROUND

2.1.1 Security financing transactions (SFTs) are used for the temporary transfer of securities against cash and can typically exist in any one of the following forms:
(a) repurchase and reverse repurchase transactions (repos);
(b) securities lending and securities borrowing;
(c) a margin lending transaction.

2.1.2 Although certain financial sector laws may regulate aspects pertaining to SFTs, a holistic framework to regulate the entering into and intermediation of SFTs does not currently exist. Over a number of years, the FSCA has been working on two regulatory framework interventions focused on SFTs, which are applicable to the financial markets and pension funds environments. These developments are discussed in more detail below.

*Securities financing transactions regulatory framework interventions in the financial markets environment*

2.1.3 In 2016 and 2017 the then Financial Services Board (FSB) engaged a research consultant to conclude technical research in respect of SFTs to unpack SFT practices and risks in the South African market. The research covered, amongst other things, –
- a general overview of SFTs and SFT participants and a landscape exercise of the South African SFT market and practices;
- researching international best practices and developments in respect of the regulation of SFTs;
- unpacking the risks associated with SFTs;
- whether there is a need for policy intervention in the South African SFT market.

2.1.4 The outcome of the research is discussed in more detail below. Following the research, in 2017 the former Registrar of Securities Services of the FSB Board published a draft Code of Conduct for Participants entering into SFTs in terms of the Financial Markets Act, 2012 (Act No. 19 of 2012) (FMA) for public comment. Comments were received and considered and targeted engagements were held with the South African Securities Lending Association

(SASLA) and Banking Association of South Africa (BASA).

2.1.5 A particular concern was raised at that stage on whether SFTs fall within the ambit of the definition of 'securities services' in the FMA, which raises jurisdictional concerns, and this led to the FSB reconsidering how to most effectively regulate SFT related activities.

*Securities lending transactions regulatory framework interventions in the pension funds environment*

2.1.6 In January 2017, the then Registrar of Pension Funds published a draft Notice on Regulation 28 prescribing conditions for securities lending for pension funds (draft Notice) for public consultation.

2.1.7 In October 2020, the Financial Sector Conduct Authority published a second version of the draft Notice for public consultation in the form of a draft Conduct Standard – Conditions for securities lending for pension funds (Securities Lending Conduct Standard).

2.1.8 The Securities Lending Conduct Standard was published in the context of Regulation 28(6), which provides that pension funds may engage in securities lending, and which enables the FSCA to prescribe conditions in respect thereof. Pension fund assets represent a significant portion of investable assets of financial institutions and such assets form a large base of the securities lending in the financial industry. The Securities Lending Conduct Standard was therefore deemed necessary to balance the benefits of securities lending with the possible risks.

*Prioritisation and consolidation of security financing transactions regulatory framework interventions*

2.1.9 Whilst the above regulatory interventions were being developed, a significant change occurred in the financial sector legal architecture. In March 2018, the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) (FSR Act) commenced. The FSR Act, amongst other things, established the Financial Sector Conduct Authority (FSCA), expanded the scope of regulation with an extended definition of financial services and provided the FSCA with broad powers to make conduct standards in respect of financial institutions. The establishment of the FSCA resulted in the reprioritisation of various focus areas and activities, including the draft Conduct Standard.

2.1.10 The regulatory framework interventions focused on securities financing transactions formed part of the reprioritisation process. At the time the FSCA considered how best to prioritise these developments. In addition, the FSCA acknowledged that there is significant overlap between the two developments and that further work has to be done in an attempt to try and harmonise the approach as to avoid duplication, misalignment, regulatory arbitrage, and the like.

2.1.11 The FSCA's 2022[1] and 2023[2] Regulations Plan highlighted that although the FSCA has not lost sight of SFTs, it is not enjoying the highest priority, but it will remain on the FSCA's radar. It was also highlighted that the framework pertaining to SFTs are to some extent dependent on other broader developments[3] and decisions relating to if and how to progress the SFT work will be made as and when there are greater clarity surrounding the broader

[1] Covering the period 1 April 2022 – 31 March 2025.
[2] Covering the period 1 April 2023 – 31 March 2026.
[3] Such as the Financial Markets Review.

developments. Further, it explained that work in relation to the Securities Lending Conduct Standard has been placed on hold pending the finalisation of the broader work focused on securities financing transactions.

2.1.12 More recently, the FSCA's 2024[4] Regulation Plan highlighted that SFTs are now enjoying a higher priority and that a draft Conduct Standard is envisaged to be published for public consultation within the April 2024 – March 2025 business year. It was also highlighted that the Securities Lending Conduct Standard project might be resuscitated in due course.

## 2.2 MARKET PARTICIPANTS IDENTIFIED WITHIN THE SA MARKET

Based on the research conducted, the following participants and their respective roles in the South African SFT market were identified.

### *2.2.1 Intermediation of SFTs*

(a) **Agent intermediaries -** A party to a loan transaction that acts on behalf of a client. The agent typically does not take risk in the transaction. This would typically be a lending agent or intermediary acting on behalf of a lender or a borrower. Most agents are in fact asset managers and custodian banks, who added securities lending and borrowing to the services they traditionally provide to owners of securities portfolios. Custodian banks are the Central Securities Depository Participants which have added securities lending and borrowing to their custody business (e.g. the big banks in South Africa). Third party agents are smaller agents (smaller balance sheet) acting on behalf of clients and are an alternative to custodian banks.

(b) **Broker / Broker Dealer** – An intermediary that is paid a commission to bring buyers and sellers together. The broker's commission may be paid either by the initiator of the transaction or by both counterparties. These brokers or broker dealers act in a principal capacity and essentially bring buyers and sellers together. In the SFT space broker dealers will typically borrow securities on a principal basis and use the same securities to lend to another counterparty or counterparties as a means of market making, to support proprietary trading or based on the requirements of their clients. These are your typical brokers or authorised users acting for their own account or on specifications by a mandate from its client.

(c) **Prime broker** – A service offered to clients by securities houses to support clients' trading, investment and hedging activities. The service consists of clearing, custody, securities lending, and financing arrangements specifically for hedge funds. Prime brokers are also the main players in active securities borrowing and in margin lending activities which is one of the categories of SFTs. Prime Brokers are specialized investment firms, but largely banks and are regulated in terms of different financial sectoral laws.

### *2.2.2 Acting as lender and/or borrower in SFTs*

(a) ***Beneficial owners:*** A beneficial owner in this context is a party which is entitled to the rights of ownership of property. In the context of securities, the term is usually used to distinguish this party from the registered holder (a nominee for example) which holds the securities in trust for the beneficial owner. Beneficial owners with

[4] Covering the period 1 April 2024 – 31 March 2027.

large securities portfolios who typically enter into securities lending and borrowing transactions, as lenders, mostly encompass insurance companies, pension funds, banks, and collective investment schemes:

(b) **Bank** - A bank as defined in the Banks Act, 1990 (Act No. 94 of 1990), a mutual bank as defined in the Mutual Banks Act, 1993 (Act No. 124 of 1993); or a co-operative bank as defined in the Co-operative Banks Act, 2007 (Act No. 40 of 30 2007). Banks can be lenders or borrowers and normally have a separate department within the Bank for participating in a securities lending and borrowing transaction or a repo transaction. Banks are currently regulated under the different Banking Acts and Regulations and the Financial Advisory and Intermediary Services Act to participate in activities of lending and borrowing. Commonly known as lending desks within a Bank.

(c) **Hedge fund -** A specialist investment fund that engages in trading and hedging strategies, frequently using leverage. Hedge funds are typically borrowers and make use of a prime broker or prime brokerage firm to assist with specialized strategies in the market.

*2.2.3 Other parties involved in SFTs*

**Central Securities Depository Participant** (CSDP) - An entity authorised by a licensed central securities depository to perform custody and administration services or settlement services or both in terms of the central securities depository rules, and includes an external participant, where appropriate. They also act in a capacity as agents. CSDPs are custodian banks who added securities lending and borrowing to the services they traditionally provide to owners of securities portfolios.

In summary, in South Africa investment funds, life insurance companies, retirement funds and collective investment schemes, including exchange traded funds, are often involved in SFTs as the beneficial owners of securities being lent (lenders). The actual lending of securities is often facilitated by agent lenders (e.g. custodian banks, specialist lenders such as broker-dealers and prime brokerage firms, which act in an agency capacity or principal capacity) upon instruction from asset managers.

Some funds (e.g. hedge funds) are also involved in securities lending as borrowers of securities, typically to cover short positions. Banks are main securities borrowers, although not the only. Borrowers borrow securities for a wide range of reasons, such as market making, hedging, directional investing, financing, collateral management and timely settlement. Settlement finality is seen globally as one of the biggest motivations for securities lending and borrowing.

## 2.3 RISKS IDENTIFIED FOR THE SOUTH AFRICAN SFT MARKET

Based on the research conducted, the following risks have been identified for the South African SFT market.

*2.3.1 Counterparty credit risk*

Counterparty credit risk can be a risk to either the lender or the borrower. Credit risk can arise due to:

(a) Unsuitable counterparties/agents being approved that are incompatible with the organisation's credit risk appetite (type and amount of risk);
(b) Where an undisclosed principal model exists the one participant will not know there is another counterparty involved, since this is not disclosed. This transaction is performed on an agency basis although the counterparty stated that it is done on a principal basis. As soon as the counterparty becomes aware of the fact that the transaction is performed on an agency basis, they would need to realign their credit risk checks to the actual counterparty's creditworthiness;
(c) Where an undisclosed principal model exists the credit exposure and hence capital required on the exposure is not a true reflection of the risk that is undertaken, since the true counterparty is unknown, and no true creditworthiness assessment can be performed;
(d) The treatment of capital holdings on exposures that exist due to securities lending transactions might differ across entities i.e. some entities might hold risk-based capital and some might not. In the South African environment banks and insurance companies are required to hold capital on any securities lending exposures under the Banks Act (based on Basel III requirements) and Solvency and Assessment Management (SAM) respectively. Where a lender defaults, the borrower has the right to use the securities received as collateral to cover the exposure. There is a risk that the borrower doesn't carry a capital holding for the net exposure that exists from the lender (i.e. exposure value less value of securities received as collateral). There might also be inconsistencies in the treatment and holding of capital in an agency style transaction, especially in an undisclosed principal model, where participants are not defined/known to each other;
(e) Counterparty default can arise in respect of any one or more situations:
    (i) the failure of the borrower to pay or provide manufactured income or equivalent other rights or entitlements on the due date; and
    (ii) the failure of the borrower to pay margin calls as and when obliged to do so. This will cause risk to the lender if the borrower fails to meet his obligations.
(f) Exposures can develop from inadequate margin call practices, such as the failure to re-establish haircuts after a change in collateral values. This is a risk to the lender who must ensure that appropriate management of collateral is undertaken on a daily basis.

*2.3.2 Operational risk*

Miscommunication between lenders and borrowers regarding the terms of transactions between them might lead to incorrect details of transactions being recorded to their CSDPs. This can lead to CSDP requests not being aligned, and the transaction becoming void. This is a risk to both parties involved in the transaction.

Securities lending activities can negatively impact the rest of the firm's investment activities if it is not monitored effectively by portfolio managers. An example of such may occur where a portfolio manager closes-out an equity position, and the same equity is lent out as part of a securities lending transaction and fails to communicate this to the lending desk in due time to be able to recall the securities involved in the transaction. This can lead to a failed trade, penalties being charged or even missed investment opportunities.

Ineffective reconciliation procedures, insufficient controls and inadequate billing processes add to the operational risk. Effective and accurate collateral management is crucial to avoid under-collateralisation and costly interest claims on cash collateral.

Risks arising from processes /systems not calculating margin calls / manufactured dividends or coupons correctly and failure in communicating margin call notifications, security recalls, payment of dividends and fees etc. Such risk occurs in instances where reliance is placed on the counterparty to perform these functions, or the collateral management function is outsourced to the agent.

Ceded non-cash collateral being re-hypothecated to multiple counterparties and not properly tracked/managed could result in complexities when margin calls are made i.e. where manufactured dividends or coupons need to be claimed from multiple counterparties to be able to pass on to the original owner. This is a big risk, especially for a beneficial owner that is the lender, and ideally re-hypothecation should only occur once.

Disputes can arise where positions are valued differently. The time taken to resolve disputes can result in additional risks i.e. counterparty credit risk on the net exposure position. This can be due to incorrect data feeds, valuation system errors or human error.

*2.3.3 Collateral risk*

Collateral risk is one of the primary risks for the lender. The rules relating to collateral management, guarantees and other securities lending functions are not necessarily consistent across different participants and can lead to arbitrage opportunities due to different or limited regulation for some market participants, especially entities that do not have a risk-based capital regulatory regime.

(a) Collateral title risk: if the properties regarding the allocation of title to non-cash collateral to a counterparty or agent is not correctly defined and agreed, it can pose significant risk to the lender when the collateral needs to be used in an event of default. Another risk might occur where rights to cash or non-cash collateral is given to the lender by the borrower, but the cash is held in the agent’s account on behalf of the lender. Should the agent go insolvent the lender there can be a significant time delay to retrieve the collateral.

(b) Collateral adequacy risk: The applicable haircut must be sufficient to cover market fluctuations that may occur between margin call dates; as well as consider the market fluctuation that may occur between the default date and the realization of the underlying collateral. The onus is here on the lender to ensure sufficient collateral management and may want to appoint a CSDP to manage the collateral.

(c) “Wrong-way” risk: Arising where the value of the collateral exhibits a significant correlation with the creditworthiness of the counterparty or the value of the underlying derivatives portfolio. If this occurs, credit risk will be exacerbated in the sense that the collateral value will decline, whilst the exposure to the counterparty increases. This can also occur where collateral is kept in the borrower’s account on behalf of the lender, if the borrower goes insolvent the lender won’t have access to the collateral, since the collateral was kept in the borrower’s own account and will hence form part of the borrower’s normal assets in the liquidation process.

(d) Cash collateral reinvestment risk: Instances where the invested cash collateral incurs losses or underperforms relative to other investment options or relative to the agreed rate to be paid to the counterparty who placed the cash collateral. The risk is that cash collateral reinvestment can involve maturity and liquidity transformation, which if left unchecked can present risks and negative externalities to firms beyond the beneficial owner or agent lender in a stress event. Reinvestment of cash collateral has been the subject of many guidance and reports issues by the Financial Stability Board as well.

(e) Concentration risk: Concentration risk exists where an entity is overexposed to a particular type of collateral, hence when it needs to sell its collateral to cover an exposure it will be overexposed to the risks associated with the particular type of collateral. Further, a large position in a particular security may result in further difficulties when trying to liquidate the collateral in an event of default, as the market may become flooded with that particular security. Risk to the lender.

(f) Accrued benefits risk: The lender must be able to accurately determine the benefits to which it is entitled. Normally the accrued benefit up to the relevant record date is considered in calculating margin requirements in an agency model, because it is reflected in the market price of the relevant security. There is an exposure between the record date and the payment date. Usually this is not considered in calculating margin requirements. Only in some cases would a lender wish to ensure that, if securities are on loan over a books' closing date for a distribution, but returned before the distribution payable date, the benefit due is also secured.

(g) Misprice risk: The lender will be exposed if either collateral securities have been over-valued or lent securities under-valued, because the prices used to mark-to-market differ from prices that can actually be traded in the secondary market, i.e. bid-ask spreads.

(h) Margin risk: Swings in the value of collateral relative to loaned securities or loaned funds can result in substantial demands for additional collateral. Margin thresholds need to be set properly since this can lead to operational complexity and burdens if margin calls are made unnecessary and/or too frequently. The risk here, again, lies with the lender.

#### *2.3.4 Legal risk*

This is a risk to both parties involved in the transaction. Legal agreements and contracts in SFTs include:

(a) Global Master Securities Lending Agreement (GMSLA);
(b) Annexures/Schedules to GMSLA;
(c) Agent guarantees; and
(d) other agreements i.e. pledge documentation, collateral agreements, and indemnifications.

Where a transaction exists whereby an agent enters into a GMSLA with the lender, and another agent enters into a GMSLA with the borrower on a bespoke basis, they will use the same GMSLA and similar Schedules to the GMSLA, hence the schedules between the agent and the lender and the agent and the borrower can be different. If they are different there might be risk to one party. Legal complications can arise in determining the legal relationships that exist.

Where margin call documents or schedules don't contain all the relevant information i.e. thresholds, valuation methods of collateral, haircuts etc. or where these documents are different from the agreed terms it can lead to margin call disputes.

The collateral taker may not be able to liquidate the collateral because the collateral arrangement has not been established or perfected in accordance with the requirements of the relevant collateral law. Even if the collateral arrangement has been set up correctly there is the risk that the relevant insolvency law may impose a stay that prevents the collateral taker from quickly liquidating the collateral, i.e. where non-cash collateral is pledged and an event of default occurs the legal title of the collateral might be in question if the pledge was not perfected, the non-cash collateral was "on-pledged" without the consent of both parties, or where the rights to cash collateral is kept in the borrower's account on behalf of the lender.

Each country may have different technical rules for enforceability of the security interest and more than one country's law may apply. A primary difficulty arises in determining which law governs the enforceability and perfection of the security interest in collateral.

Contracts may specifically provide for foreclosure by the lender for breach of a borrower's obligation to provide timely financial information to the lender or the appropriate regulatory agencies which they are not necessarily aware of, such as:
(a) Failing to give notice to the lender of any material adverse change in connection with its business or financial condition;
(b) failing to notify the lender of any regulatory investigation, complaint, or proceeding;
(c) any breach of representation by the borrower; or
(d) failing to remit substitute payments or respond to requests for additional collateral.

*2.3.5 Settlement risk*

Risks emanating from a time-lag between the transfer of the security and the collateral leg can result in an unsettled/failed trade or the transaction settling at different market prices due to the time delay.

This is a risk to both parties involved in the SFT. A time-lag between the completion of the two legs of the transaction i.e. a time-lag between the transfer on the security leg and the collateral leg can result in an

Risks, including time-lags risks, that can lead to unsettled or failed trades, or the transaction settling at different market prices due to the time delay.

This is exacerbated where bonds are used as collateral to secure the loan, since a T+1 settlement cycle is applicable to bonds, and a T+5 settlement cycle is applicable to equity.

Credit risk may arise if any further financial activity is undertaken on the basis of "unsettled" securities lending transactions, where the security is transferred but the collateral is not yet in the lender/agent's account. This can give rise to what is known in the market as "daylight exposure", a period during which the loan is not covered as the lent securities have been delivered but the collateral securities have not yet been received.

*2.3.6 Custody risk*

Custody risk i.e. the risk of losing securities held with a custodian because of insolvency or negligence by the custodian might arise under collateral arrangements. The collateral receiver might impose certain restrictions with respect to the custody of collateral i.e. only allow collateral to be reserved at the collateral receiver's CSDP. This can be seen as a risk to the borrower.

Inconsistencies in the accounting practices and safekeeping procedures employed by a custodian and sub custodians might lead to a material misstatement in the lender and/or borrower's financial statements due to assets being overstated/understated by the collateral amount held by the custodian. Risk to both parties.

Where a CSDP has access to a lender's share account and uses assets without their permission, or outside of the agreed upon limits. This is a risk to the lender.

*2.3.7 Agent risk*

The risks related to making use of an agent can be a risk to both parties but predominantly influences the lender. The possibility that an agent will unfairly exploit a principal's confidence i.e. assets that are used without the permission of the lender, where an entity acts as a CSDP and an agent for the lender.

Agent custodians should also be cognisant of liability that may arise due to their fiduciary responsibilities as a safe keeper of the lendable assets. It is to the mutual benefit of principals and agents to avoid ambiguities in legal agreements.

The risk of non-delivery on guarantee in the event of borrower default where the agent has issued the lender with a guarantee.

The risk of a principal acting as an agent i.e. undisclosed principal model, but the counterparty is not aware of it.

*2.3.8 Liquidity risk*

Large and frequent margin calls related to securities lending transactions may create liquidity pressures for market participants, leading to attempts to unwind large securities positions in order to raise funds to meet the margin calls. Trying to sell any security in a quantity which is high relative to its normal trading volume, is likely to cause the price to fall. A relatively small drop in price, when added to the trading costs, can quickly erode the collateral margin held by the lender, leaving him with a shortfall. This is clearly a risk to the Lender.

Liquidity risk arises from the possibility that a loss of liquidity in collateral markets will force liquidation of collateral at a discount in the event of a counterparty default. Illiquid collateral securities are more likely to be realised at a lower price than the valuation used and again will leave the lender with a shortfall.

*2.3.9 Recall Risk*

The vast majority of securities lending transactions are for an overnight period, meaning they can be terminated on any day. Where the transaction is terminated by the borrower and the collateral was re-hypothecated there is a risk that the collateral cannot be recalled by the lender in time. This is a risk to the borrower.

Where a lender recalls the securities on loan from the borrower due to its own operations or obligations i.e. trading strategies and/or commitments, without sufficient notification, such a recall may not be done in the required timeframe therefore resulting in settlement penalties as a result of a failed trade. In this instance it's a risk to the lender.

*2.3.10 Systemic Risk*

The traceability and legal construct of non-cash collateral received in an event of default or insolvency by the borrower may cause risk to the lender. Where the lender is unable to identify and liquidate the collateral received to cover several large exposures, strain may be placed on the liquidity position of the lender and thus may lead to potential defaults by the lender with other counterparties, creating systemic risk to the market i.e.:

(a) where non-cash collateral is pledged to an agent's CSDP, the lender might not have immediate access to the collateral should an event of default occur due to the title of the collateral not being in the lender's name;

(b) re-hypothecation or re-use of ceded non-cash collateral can create financial stability risks especially if clients are uncertain about the extent to which their assets have been re-hypothecated. The lender can't always track the collateral owner with certainty in the collateral chain that exists. This creates a knock-on effect if the lender has other linked transactions with other counterparties in the market, it will leave the other transactions "open" and create large exposures within the market.

Different entities have different rules relating to the capital holding on exposures (which may not be monitored or applied correctly). If an event of default occurs where a participant doesn't hold capital against the securities lending exposure that exists, either due to no existing capital rules/regulation or not adhering to the regulation that is in place, and where this participant is linked to other participants in the financial sector it might lead to a systemic event when it can't deliver on its other obligations. Other examples of this risk are:

(a) Using an agency model to get around capital requirements, because neither the agency's client nor the agency is keeping capital on the exposure. If a guarantee is issued by the agent to its client the agency needs to have capital for this exposure, if the agency is a bank and regulated per the Banks Act it should adhere to the appropriate regulations; and

(b) where an undisclosed principal model exists the credit exposure and hence capital required on the exposure is not a true reflection of the risk that is undertaken, since the true counterparty is unknown, and no true creditworthiness assessment can be performed.

Inconsistencies in defining agency or principal model in a securities lending transaction, and where participants remain undisclosed to each other. Appropriate risk measures i.e. measuring and monitoring counterparties' credit risk and mitigating undue risk due to the inability to identify the counterparty can't be put in place where this is the case.

## 2.4 INTERNATIONAL DEVELOPMENTS AND APPROACHES

The International Organisation of Securities Commissions (IOSCO), the recognised standard setting body for international securities and capital markets regulation, issued a number of reports that acknowledge the important role of SFTs and the need for its regulation. For example, the ISOCO Discussion Paper: *Short Selling and Securities Lending: Issues for Consideration*, 1997 (the Discussion Paper) highlighted the fact that the use of SFTs can make a significant contribution to the efficiency of the capital markets. The Discussion Paper provides guidance and points out issues for regulators to consider when developing a securities financing framework and explains the objectives of regulating securities lending intermediaries are to promote sound and fair practices and maintain market integrity. To meet these objectives, regulations need to focus on two important aspects: how intermediaries control their risks, and how they treat their clients.

In its paper on *Securities Lending Transactions: Market Development and Implications*, published in 1999, IOSCO proposes that market authorities should develop policies that support and encourage safe and efficient market practices, i.e. taking steps to reduce any legal uncertainties in SFTs and should assess the potential for SFTs to effect market stability or contribute to systemic risk.

The Financial Stability Board (FSB) recognises that SFTs play an important role in supporting price discovery and secondary market liquidity for a variety of securities. They are central to financial intermediaries' market-making activities as well as to their investment and risk management strategies. Such transactions can also be used by market participants to take on leverage as well as engage in liquidity and maturity transformation.

As part of its work to transform the less regulated banking industry into resilient market-based finance, in November 2015 the FSB published a document titled 'Transforming Shadow Banking into Resilient Market-based Finance – Regulatory framework for haircuts on non-centrally cleared securities financing transactions'.[5] The document included 18 policy recommendations aimed at addressing financial stability risks associated with SFTs, such as repos and securities lending. The recommendations relate to –

(a) improvements to regulatory reporting and market transparency of SFTs;
(b) regulation of SFTs – minimum standards for cash collateral reinvestment, principles for regulating governing re-hypothecation of client assets, minimum regulatory standards for collateral valuation and management, minimum haircuts[6] standards for non-centrally cleared SFTs (including numerical haircut floors); and
(c) structural aspects of SFT markets.

This aim to dampen risks and pro-cyclical incentives associated with SFTs that may exacerbate funding strains in times of market stress. According to the recommendations of the FSB, if implemented appropriately, these should eventually introduce consistency in addressing financial stability risks across jurisdictions.

In addition to regulatory measures, a wide range of internal risk management tools include stringent counterparty selection processes, collateral standards and haircuts, daily mark-to-market valuation, concentration limits, limits on the fraction of the portfolio lent at any one time, and periodic counterparty credit evaluations.

Following the FSB review of the shadow banking sector after the financial crisis, many jurisdictions implemented measures to address SFTs. For example, the EU implemented its Securities Financing Transactions Regulation (SFTR). The SFTR applied in part from 12 January 2016 and aims to improve transparency of SFTs. It imposes requirements on all types and sizes of EU entities who enter into SFTs such as repo transactions, securities lending transactions, margin lending transactions and commodities lending transactions. It also applies to non-EU entities if the SFTs is concluded through an EU branch. Requirements include disclosure and reporting, but no direct licensing for being participants in SFTs.

In addition, EU SFTR has registration and operational requirements for TRs offering SFTR repository services, and defined levels of access to data for different authorities. EU SFTR also requires entities that are within the scope of the SFTR to:

(a) report details of their SFTs to a registered or recognised TR;
(b) in the case of funds, meet disclosure requirements relating to the use of SFTs (including disclosure of risks and fees) and total return swaps in pre-investment documentation and regular reports to investors; and

[5] https://www.fsb.org/uploads/SFT_haircuts_framework.pdf
[6] "Haircut" or margin is the extra collateral that a borrower provides in order to mitigate any adverse movements in the value of the loan and value of collateral between the mark-to-market date, and the value of liquidated collateral and repurchased loan securities on the default date.

(c) comply with disclosure obligations to counterparties in relation to the re-use of collateral

(d) comply with the re-use limits and collateral requirements to prevent excessive leverage.

The United Kingdom retained the SFTR but adapted certain reporting and compliance requirements to fit domestic markets. In the United States (US), the Dodd-Frank Act introduced margin requirements and transparency for repos. The US Securities and Exchange Commission also enhanced disclosure obligations around securities lending.

### 2.5 WHY REGULATE SFTS?

The benefits of SFTs are fully understood and supported. It is commonly accepted that the optimal utilisation of SFTs in a well-regulated environment can make a significant contribution to the capital markets and may reduce systemic risks. Securities financing provides an important source of liquidity by allowing market makers and primary dealers to make efficient two-way markets for investors while supporting investment strategies of asset managers. Securities financing is an essential mechanism for transferring collateral within the financial system, which is increasingly important in a context of greater collateral scarcity. It also plays a crucial role in ensuring safe settlement and the prevention of failed trades.

While securities financing may be a useful tool, it presents risk to both the borrower and the lender. The securities lent, or the collateral may not be returned when needed, because of counterparty default, operational failure or legal challenge, for example. The securities would then need to be acquired in the market, perhaps at a cost. Counterparties to securities loans should employ appropriate risk management policies, including conducting credit evaluations, collateralising exposures, marking exposures and collateral to market daily, and employing legal agreements.

Securities financing activities by market participants, including asset managers and funds, can cause financial stability risks that could lead to systemic risk such as insufficient collateral management, re-hypothecation of unencumbered securities, counterparty credit risk as discussed above.

In addition, regulatory gaps exist in many emerging and frontier markets and many lack SFT-specific regulations, leading to opaque securities lending and repo transactions, insufficient investor protection against abusive practices and systemic risk buildup in non-bank financial institutions.

The absence of a robust framework for the regulation of SFTs impedes adequate market transparency and integrity and results in insufficient investor protection as investors may be subject to unfair practices and undisclosed risks. Lastly, the South African regulatory framework pertaining to SFTs are not aligned to international standards and best practices which impacts the attractiveness of the South African market, creates risk for the country[7] and results in regulatory arbitrage.

## 3. SUMMARY OF THE DRAFT CONDUCT STANDARD

### 3.1 Objective and approach

[7] In terms of not meeting international standards, as required through our membership of e.g. IOSCO.

The objective of the draft Conduct Standard is to enhance the efficiency and integrity of South Africa's financial markets and support transparency and responsible conduct within the SFT environment.

As discussed above, there are numerous risks inherent in the SFT market. In approaching the draft Conduct Standard, the FSCA decided that instead of imposing detailed requirements that address each and every risk scenario, the requirements will rather be positioned at a higher and more principles-based level. Therefore, in addressing the identified risks, the draft Conduct Standard reflects a large focus on ensuring that SFTP's have the necessary governance, risk management and internal control frameworks in place to manage many of these identified risks. It is possible that, at a later stage, the draft Conduct Standard may be supplemented with a Guidance Notice to further support consistency in its application, given the level at which the requirements have been positioned.

Further, the draft Securities Lending Conduct Standard, which had a retirement fund specific focus, has been incorporated into the draft Conduct Standard. Many of the requirements contained in the draft Conduct Standard overlapped with the draft Securities Lending Conduct Standard and a view was taken to rather consolidate the two Standards, as keeping them separate creates a risk of duplication, misalignment, regulatory arbitrage, and the like.

## 3.2 Application and scope

The draft Conduct Standard applies to financial institutions that participates in SFTs (SFT participants). Participation in the context of the draft Conduct Standard includes where a financial institution participates in a SFT as a contracting party and/or where it intermediates an SFT. The application will cover a broad scope of SFT participants including banks, insurance companies, retirement funds, collective investment schemes, hedge funds and agents (that are financial institutions).

In defining SFTs for purposes of the draft Conduct Standard, an approach similar to the EU approach was adopted. SFTs are therefore defined as including repurchase and reverse repurchase transactions; securities lending transactions; and margin lending transactions.

It is acknowledged that there might be instances where a company/person that is not a financial institution (as defined) participates in an SFT and, in that instance, the draft Conduct Standard will not apply to such company/person. Notwithstanding, based on the research conducted, the biggest role-players in the SFT market are financial institutions and the FSCA is therefore not overly concerned with this potential jurisdictional gap. It might be noted that SFTs were also discussed in National Treasury's document titled "Building Competitive Financial Markets for Innovation and Growth – A Work Programme for Structural Reforms to South Africa's Financial Market",[8] better known as the Financial Markets Act Review (FMAR). Work on implementing the FMAR is continuing and the FSCA will closely monitor and participate in these discussions. If the FSCA formulates a view that it necessary to close the aforementioned jurisdictional gap, a proposal will be made to National Treasury for consideration as part of the FMAR.

## 3.3 Summary of provisions

The following provides a summary of the proposed requirements prescribed in the draft

[8] https://www.treasury.gov.za/comm_media/press/2020/FINANCIAL%20MARKETS%20ACT%20REVIEW.pdf

Conduct Standard, which are aimed at giving effect to the stated objectives.

*General obligations and oversight over SFTs*

The draft Conduct Standard proposes general overarching principle-based requirements that are aimed at ensuring responsible conduct. These include adopting prudent practices, and acting with honesty, integrity, transparency, fairness and due skill, care and diligence. It also proposes that SFT participants must –

- avoid, and if avoidance is not reasonably possible, mitigate, manage and disclose any conflict between itself and a counterparty, other relevant SFT participant and any other person that has an interest in securities financing transaction the FST participant participates in;
- ensure that SFTs are executed at fair market prices (to support best execution); and
- avoid excessive leveraging through SFTs.

The draft Conduct Standard also proposes SFT oversight requirements which must be incorporated into its to governance, risk management and internal control frameworks. Matters that must so be addressed include specific policies and procedures, systems and resources, compliance risk, counterparty credit risk, operational risk, market risk, liquidity risk, margin maintenance, exposure risk and collateral management. In respect of collateral management, as explained above, the re-use of collateral is viewed as a significant risk and financial institutions will therefore be required to ensure the responsible re-use of collateral. Responsible reuse includes limiting the re-use of collateral and not re-using collateral unless appropriate disclosures have been made to affected parties.

The draft Conduct Standard also proposes that a financial institution must on an ongoing basis monitor and review the appropriateness and effectiveness of the relevant governance, risk management and internal control frameworks, and specific other matters provided for.

*Disclosure, confidentiality and record keeping*

The draft Conduct Standard proposes to impose a requirement upon a SFT participant to disclose all relevant information pertaining to its SFTs to counterparties, investors and other relevant FSTPs and any other person that has an interest in the SFT the FSTP participates in or intermediates. The information disclosed must specifically include fees, charges, and profit-sharing arrangements. All information disclosed must be clear, fair and not misleading. In addition, a FST participant must act transparently and in good faith when making disclosures. When acting as an agent, certain additional and specific disclosures are required. It might be noted that the FMAR also specifically recommended that the FSCA, through a Conduct Standard, impose disclosure requirements in respect of SFTs.

The draft Conduct Standard proposes that all agreements, documents and statements which govern and are related to SFT in which the financial institution participated, must be kept for a minimum of 5 years.

The draft Conduct Standard also contains a provision that is aimed at ensuring information is kept confidential.

*Outsourcing and intermediation of securities financing transactions*

The draft Conduct Standard proposes to impose certain requirements that are applicable to the intermediation of SFTs and where a financial institution outsourced a SFT activity or duty to another person. These requirements range from having written agreements are in place that provide for certain matters, ensuring the person intermediating or performing the outsourced activity or duty has appropriate governance, risk management and internal control frameworks in place, and the necessary experience, expertise, capacity and resources to perform such activity or duty. The draft Conduct Standard also specifies that a financial institution may not allow intermediation or outsourcing of SFTs if it is likely to materially increase risk to the financial institution.

*Margin lending transactions*

The draft Conduct Standard requires a financial institution to, before it enters into one or more margin lending transaction, enter into a margin lending agreement that provides for a variety of matters as specified in the draft Conduct Standard.

*Repurchase Transactions*

The draft Conduct Standard requires a financial institution to, before it enters into one or more repurchase transaction, enter into a global master repurchase agreement (GMRA), as defined, with the counterparty to the transaction. The draft Conduct Standard defines a GMRA in relation to generally accepted international agreements prescribed by appropriate international associations.

*Securities Lending Transactions*

The draft Conduct Standard requires a financial institution to, before it enters into one or more securities lending transaction, enter into a global master securities lending agreement (GMSLA), as defined, with the counterparty to the transaction. The draft Conduct Standard defines a GMSLA in relation to generally accepted international agreements prescribed by appropriate international associations. The draft Conduct Standard also contains a provision that requires that a securities lending agreement entered into by a pension fund must provide for certain additional matters.

*Additional requirements for pension funds engaging in securities lending transactions*
The draft Conduct Standard include a clause setting out additional requirements for pension funds engaging in securities lending transactions. These include securities lending transaction and counterparty limits, and requirements pertaining to collateral. These requirements were informed by the draft Securities Lending Conduct Standard.

*Right of recall and delivery of securities*

The draft Conduct Standard proposes to impose an obligation an SFT participant to familiarise itself with the procedures for recalling of securities as stipulated in the relevant legal agreements and to have a clear understanding of the process to follow if recalled securities cannot be delivered. It also proposed that a SFT participant must be aware of the procedures to be followed in the event of failed trades in any market in which the securities are traded.

*Reporting obligations*

The draft Conduct Standard proposes to impose an obligation upon an SFT participant to report details of all SFTs concluded, as well as any modification or termination thereof, in the form, to a licensed trade repository. It is proposed that the required information must be reported no later than the business day following the conclusion, modification or termination of the securities financing transaction (T+1). This approach is in line with the approach adopted in many foreign jurisdictions.

The information that must be reported include counterparty data, details of the security involved, transaction details, loan and collateral data, information pertaining to collateral re-use, reporting party information, and any other information the FSCA determines by notice on its website. The reporting framework is also proposing to apply an approach that incorporates Legal Entity Identifiers (LEI's), Unique Transaction Identifiers (UTI's) and Unique Product Identifiers (UPI's). LEI's, UTI's and UPI's are unique identifiers typically used in the financial sector to identify entities, transactions and products/securities, respectively. The benefit of using LEI's, UTI's and UPI's together is that they provide a comprehensive system for uniquely identifying parties and specific products/securities involved in a transaction, enabling accurate and efficient data aggregation, risk management, and regulatory reporting, by clearly distinguishing between the legal entities involved, the specific transaction itself, and the type of product/security traded. In this regard please also refer to FSCA Communication 9 of 2024 (General) titled 'Adoption of the legal entity identifier in South Africa' (Communication 9) which was published in March 2024. Communication 9 further elaborates on why the FSCA views the adoption of LEI's as important and beneficial and specifically highlights that it is envisaged that the draft Conduct Standard will require the use of an LEI.[9]

To ensure clarity, the FSCA will determine the form, content and manner of reporting through a separate publication that will be consulted on in due course.

## 4 STATEMENT OF IMPACT OF THE CONDUCT STANDARD

4.1 As explained above, optimal utilisation of SFTs has the potential of significantly contributing to the capital markets and may reduce systemic risks,[10] if well-regulated. A robust regulatory framework for SFTs that is aligned to international standards will enhance confidence and trust in the South African market, prevents regulatory arbitrage, and supports market stability. It will also create a more conducive environment for engaging in SFTs in South Africa.

4.2 It is envisaged that the draft Conduct Standard will have a very positive impact on mitigating risks and improving practices within the SFT market, and potentially enhance the attractiveness of the SFT market. The draft Conduct Standard is also envisaged to enhance market transparency and integrity by supporting more visibility into SFT transactions, reducing hidden risks, preventing market abuse and facilitating better price discovery leading to fair competition. Further, the draft Conduct Standard is likely to support stronger investor protection through, amongst other things, ensuring investors are aware of risks when engaging in SFTs and are protected against undisclosed rehypothecation of assets.

4.3 However, it is acknowledged that there is a fine line between imposing requirements that support confidence in the SFT market, and imposing requirements that are overly burdensome and disincentivize activity within the SFT market. The FSCA attempted to mitigate the latter risk by adopting the approach explained in paragraph 3.1. Notwithstanding, the FSCA welcomes views from stakeholders in this regard and would support further engagement to ensure that the draft Conduct Standard strikes the correct balance.

[9] See paragraph 3.2(f) of Communication 9.
[10] For example, SFT's could reduce the risk of fire sales during crises by ensuring adequate collateralisation and could prevent excessive leverage in non-bank financial institutions.

4.4 In terms of the potential regulatory cost implications of the draft Conduct Standard, it is acknowledged that it is likely that there will have to be revisions to governance, risk management and intern control frameworks which could have cost implications. It is also possible that some system changes will have to occur, including in respect of ensuring the necessary systems are in place to give effect to reporting as contemplated in the draft Conduct Standard. With regards to some of the requirements, the FSCA does not envisage substantial regulatory cost implications (e.g. the requirements pertaining to entering into specific agreements, as this is already standard practice within the market).

4.4 However, the FSCA is of the opinion that these regulatory cost implications will not be overly substantial as financial institutions should, to a large extent, already have many of the required controls in place. Notwithstanding, stakeholders are specifically requested to provide input on the envisaged impact of the draft Conduct Standard and the FSCA will take any such submissions into consideration before finalising the draft Conduct Standard.

## 5 STATEMENT OF INTENDED OPERATION OF THE DRAFT CONDUCT STANDARD

5.1 The draft Conduct Standard applies to all financial institutions that participates in SFTs. The proposed requirements prescribed in the draft Conduct Standard are consistent with the objective of the FSR Act, the respective objectives of the FSCA, and specifically the mandate of the FSCA to maintain a transparent, efficient and stable financial system that functions in the interests of financial customers and supports balanced and sustainable economic growth.

5.2 Subject to the outcome of the consultation process, the draft Conduct Standard will be made after the process prescribed in the FSR Act has been concluded. The draft Conduct Standard currently provides for a 12-month transitional period to ensure impacted financial institutions have sufficient time to prepare for implementation.

5.3 Following the implementation of the draft Conduct Standard, the FSCA will assess and evaluate the effectiveness of the draft Conduct Standard on a continuous basis as part of its regulatory and supervisory responsibility to ensure that any unintended consequences of the draft Conduct Standard affecting the industry are adequately addressed.