FINANCIAL SERVICES, FINANCIAL MARKETS & MARKET ABUSE

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Introduction

The offering and provision of financial services in South Africa is regulated in particular by the Financial Advisory and Intermediary Services Act, No. 37 of 2002 (FAIS Act), and the Financial Markets Act, No. 19 of 2012 (FM Act). Broadly, the FAIS Act regulates the rendering of financial advisory and intermediary services, while the FM Act regulates and controls exchanges and trading of securities.

Financial Services

The FAIS Act was introduced to promote good and proper business practice in the financial services industry and to contribute to improving corporate governance and market confidence.

Section 7(1) of the FAIS Act provides that, with effect from 30 September 2004, no person may act or offer to act as a financial services provider unless he or she has been issued with a licence under Section 8 of the FAIS Act.

A "financial services provider" is defined as any person, other than a representative (ie an employee, agent or mandate of a financial services provider), who as a regular feature of his or her business, furnishes "advice" and/or renders any "intermediary service" (collectively, "financial services") to clients in respect of financial products.

It is evident that the FAIS Act is aimed at functions, rather than institutions. The function must be rendered to a client; performed as part of the person's regular business; and relate to a financial product as defined in the FAIS Act.

A "financial product" is defined in Section 1(1) to encompass a broad range of local and foreign securities and financial instruments, including, among others: shares, insurance policies, money market instruments, debentures and securitised debt, bonds, derivative instruments, participatory interests in any local or foreign collective investment schemes, and deposits.

The definitions of "advice" and "intermediary service" are crucial in determining the ambit of the FAIS Act. The term "advice" is defined as any recommendation, guidance or proposal furnished, by any means or medium, to any client or group of clients:

- in respect of the purchase of any financial product;
- in respect of the investment in any financial product;
- on the conclusion of any other transaction, including a loan or cession, aimed at the incurring of any liability or the acquisition of any right or benefit in respect of any financial product; or
- on the variation of any term or condition applying to a financial product, on the replacement of any such product, or on the termination of any purchase of, or investment in, any such product.

These categories are exclusive and will apply irrespective of:

- whether or not the advice is furnished in the course of, or incidental to, financial planning in connection with the affairs of the client; or
- results in such purchase, investment, transaction, variation, replacement or termination, as the case may be, being effected.

Section 1(3) of the FAIS Act sets out specific exclusions from the definition of "advice" as follows:

- mere factual advice, where such advice is given on the procedure for entering into a transaction in respect of any financial product; in relation to the description of a financial product; in answer to routine administrative queries; in the form of objective information about a particular financial product; or by the display or distribution of promotional material; and
- an analysis or report on a financial product without any express or implied recommendation, guidance or proposal that any particular transaction in respect of the product is appropriate to the particular investment objectives, financial situation or particular needs of a client.

An "intermediary service" is defined to mean any act, other than the furnishing of advice, performed by a person for or on behalf of a client or product supplier, the result of which is that a client may enter into, offer to enter into, or enter into any transaction in respect of a financial product with a product supplier; or with a view to:

- buying, selling or otherwise dealing in (whether on a discretionary or non-discretionary basis), managing, administering, keeping in safe custody, maintaining, or servicing a financial product purchased by a client from a product supplier or in which the client has invested;
- collecting or accounting for premiums or other moneys payable by the client to a product supplier in respect of a financial product; or
- receiving, submitting or processing the claims of a client against a product supplier.

Any intermediary service rendered by a product supplier who is authorised under a particular law to conduct business as a financial institution, where the rendering of such service is regulated by or under such law, is excluded.

A "product supplier" is defined as any person who issues a financial product by virtue of an authority, approval or right granted to him or her under any law.

The regulations promulgated under the FAIS Act provide that no person may canvass for, market or advertise any business related to the rendering of financial services by any person who is not an authorised financial services provider or a representative of such provider.

This applies whether that person is within or outside South Africa. Accordingly, even if a foreign financial services provider does not provide any financial services in South Africa, it will be prohibited from canvassing for, marketing or advertising any business related to its financial services business in South Africa without first obtaining a licence as a financial services provider.

Licensed financial services providers are required to comply with various ongoing obligations, including compliance with the prescribed fit and proper requirements and codes of conduct.

Securities Services

The FM Act, which came into operation on 3 June 2013, repealed the Securities Services Act, No. 36 of 2004 (SS Act). The objectives of the FM Act are to:

- ensure that the South African financial markets are fair, efficient and transparent;
- increase confidence in South African financial markets;
- promote the protection of regulated persons and clients;
- reduce systemic risk; and
- promote the international competitiveness of securities services in South Africa.

The FM Act regulates "securities services", being:

- services provided in respect of the buying and selling of securities;
- the use of the trading system or infrastructure of an exchange to buy or sell listed securities;
- the furnishing of advice (relating to securities) to any person;
- the custody and administration of securities;
- the management of securities by an authorised user (member of an exchange); and
- the clearing and settlement of transactions in listed securities.

The FM Act also regulates market abuse such as insider trading and market manipulation. The term "securities" is widely defined in the FM Act to include, *inter alia*, listed and unlisted shares, stocks and depository receipts in public companies and other equivalent equities, notes, derivatives instruments, bonds, debentures, participatory interests in a collective investment scheme and instruments based on an index, but specifically excludes money market instruments (except as regards the custody and administration of securities).

In terms of the FM Act, no person may operate as an exchange, central securities depository or clearing house unless that person is licensed in terms of the FM Act. Furthermore, no person may act as an authorised user or a participant (a person that holds in custody and administers securities or an interest in securities) unless authorised by an exchange in terms of the exchange rules, or accepted as a participant in terms of the rules of a central securities depository.

The FM Act furthermore:

- seeks to strengthen the regulatory independence of the Financial Services Board (FSB) and enables it to publish the detail, status and outcome of inspections and on-site visits;
- will regulate Over-The-Counter derivatives (OTC derivatives), seeking to improve investor protection and reduce systemic risk by increasing the scope of regulation for unlisted securities (to include OTC derivatives), and enhance transparency in these instruments by providing for the establishment of a trade repository to which all trades in these instruments will be reported and monitored (this will be achieved through subordinate legislation that will be promulgated under the FM Act);
- will allow for the establishment of an independent clearing house as a stand-alone, self-regulatory organisation, aimed at promoting the central clearing of OTC derivatives; and
- provides for foreign entities to be members of the South African financial markets infrastructure, thus increasing competition and better regulating cross-border transactions.

Exchanges

There is currently only one licensed exchange in South Africa, namely the Johannesburg Stock Exchange (JSE). Prior to June 2009, the Bond Exchange of South Africa (BESA) operated as an independent exchange for Government and corporate bonds. BESA became a wholly owned subsidiary of the JSE on 22 June 2009. The merger between the country's two exchanges was primarily aimed at combining their respective areas of expertise to deliver increased liquidity, increased functionality and a broader range of products and services to market participants, bond issuers and investors.

The JSE currently operates three markets each with their own listings, membership requirements and rules:

- the JSE equities market gives investors access to a multitude of listed securities including equities, exchange traded funds and warrants;
- the JSE's derivatives market is colloquially referred to by its former name "SAFEX" internally, however, the JSE refers to this division of its business as the derivatives market; and
- the JSE's interest rate market provides investors with the opportunity to trade interest rate products (including corporate and Government bonds) in both the cash and the derivative markets.

The JSE is the only securities exchange providing fully electronic trading, clearing and settlement in equities, derivatives and other associated instruments. It is a company registered and incorporated with limited liability under the company laws of South Africa and is licensed as an exchange under the SS Act (the JSE will in due course become an exchange specifically licensed under the new FM Act).

Following the enactment of the SS Act, which provides for the demutualisation of exchanges, the JSE demutualised on 1 July 2005. The existing rights holders of the JSE became its first shareholders and, for the first time, any person who was not an authorised user of the JSE (member of the JSE) or a stockbroker could obtain an ownership interest in the JSE.

Immediately on demutualisation, JSE rights were converted into JSE shares and each rights holder received 1 000 JSE shares for every one JSE right held. The JSE retained its board of directors (representative of a broad interest base) and an advisory committee structure.

The JSE listed its issued shares on the Main Board of the JSE in the General Financial – Investment Services sector on 5 June 2006. Apart from increasing the number of JSE shares by subdividing each ordinary JSE share of ZAR 1 into 10 ordinary shares of 10 cents each (to meet the listings requirement to have 25 million shares in issue for a Main Board listing), listing required no structural changes to the JSE.

The JSE's commitment to transformation in the financial services industry is reflected in its introduction of the Broad-Based Black Economic Empowerment (B-BBEE) Initiative. This comprises the:

- JSE Empowerment Fund (JEF) Initiative, aimed at providing financial assistance for education initiatives targeted specifically at bringing black people into the financial services sector;
- Black Shareholder Retention Scheme, aimed at encouraging black shareholders to retain their JSE shares; and
- Employee Scheme, a cash-settled, long-term incentive and retention bonus scheme to facilitate the retention of key JSE employees.

Trading in Securities

The FM Act restricts the buying and selling of listed and unlisted securities. The term "unlisted securities" includes securities listed on an external exchange.

In this regard, except in certain prescribed circumstances, a person may not carry on the business of buying or selling listed securities (ie securities listed on a South African exchange) unless that person:

- is an authorised user of the relevant exchange;
- effects such buying or selling through an authorised user; or
- is a financial institution transacting as principal with another financial institution also transacting as principal.

The Registrar of Securities Services may:

- prohibit a person from carrying on the business of buying or selling unlisted securities (if that person carries on such business in a manner that defeats one or more of the objects of the FM Act);
- impose conditions for the carrying on of such business; and/or
- prescribe conditions in terms of which specified types of unlisted securities may be bought or sold.

A person who buys unlisted securities from, or sells unlisted securities to, a person who contravenes or fails to comply with such a prohibition or condition may cancel the transaction.

Listing on the JSE

Companies can seek a Main Board Listing or a listing on the Venture Capital Market (VCM) or the Development Capital Market (DCM). The VCM and DCM are relatively small markets and it is expected that the JSE will be phasing these out. Small to medium companies that are in a growth phase can seek a listing on the Alternative Exchange (AltX).

The JSE has also launched the Africa Board segment of the Main Board, which showcases top African companies. The Africa Board forms part of the JSE's long-term strategy to promote the growth of capital markets on the African continent. It has been developed to attract foreign capital to the African market, by allowing investors access to the very exciting opportunities that exist in Africa.

An applicant seeking a listing on the Main Board must have:

- a subscribed capital (including reserves, but excluding minority interests and revaluations of assets and intangible assets that are not supported by a valuation by an independent professional expert acceptable to the JSE prepared within the last six months) of at least ZAR 25 million;
- not less than 25 million equity shares in issue and a satisfactory audited profit history for the preceding three financial years, the last of which reported an audited profit of at least ZAR 8 million before taxation; and
- 20% of each class of equity securities being held by the public and the number of public shareholders must be at least 300 for equity securities, 50 for preference shares and 25 for debentures.

An applicant seeking a listing on the VCM must have:

- a subscribed capital (including reserves, but excluding minority interests and revaluations of assets and intangible assets that are not supported by a valuation by an independent professional expert acceptable to the JSE prepared within the last six months) of at least ZAR 500 000.
- not less than one million equity shares in issue and a minimum of 10% of each class of equity share being held by the public; and
- at least 75 shareholders for equity securities, 25 for preference shares and 10 for debentures.

An applicant seeking a listing on the DCM must have:

- a subscribed capital (including reserves, but excluding minority interests and revaluations of assets and intangible assets that are not supported by a valuation by an independent professional expert acceptable to the JSE prepared within the last six months) of at least ZAR 1 million;
- not less than one million equity shares in issue and a satisfactory profit history for the preceding two financial years or, in exceptional circumstances, a lesser period, the latest of which reported an audited profit level of at least ZAR 500 000 before taxation; and
- a minimum of 10% of each class of equity share being held by the public and the number of public shareholders must be at least 75 for equity securities, 25 for preference shares and 10 for debentures.

An applicant seeking a primary or secondary listing on the Africa Board must be domiciled in Africa, outside of South Africa; or have the majority of its activities geographically located in Africa, outside of South Africa; and it must meet the Main Board listing criteria as set out above in conjunction with the requisite primary and secondary listings conditions of the JSE.

Additional and alternative requirements relating to conditions for listing apply to mineral companies, property companies, pyramid companies, investment entities, dual listings and listings by external companies and specialist securities.

When applying for a listing on the VCM, DCM and Main Board, it is mandatory for a company to appoint a sponsor. The responsibilities of a sponsor appointed by an issuer are twofold, namely to assist the issuer with an application for listing that requires the production of listings particulars, and to give continuing advice regarding the application of the listings requirements.

Government encourages overseas-controlled companies to seek a listing on the JSE and so provide the public with an opportunity of obtaining a stake in the equity of companies trading in South Africa. An overseas company seeking a listing on the JSE must comply with all relevant listing requirements applicable to all listed companies generally, with certain modifications depending on whether the company is seeking a primary or secondary listing.

Debt Listings Requirements

In the wake of the integration of the former BESA into the JSE's Interest Rate Market, the JSE published a separate set of Debt Listings Requirements.

The Debt Listings Requirements provide that applicant issuers (ie issuers of debt securities who want to list their debt securities on the JSE's Interest Rate and Currency Market) must appoint a debt sponsor when making an application for listing of debt securities.

The Debt Listings Requirements impose a number of obligations on sponsors. In order to list a debt security on the JSE Interest Rate and Currency Market, the applicant issuer must be duly incorporated or otherwise validly established under the law of its country of incorporation, and must be operating in conformity with its memorandum and articles of association or other constitutive documents, as the case may be, and all laws of its country of incorporation or establishment.

"Debt Securities" are defined in the SS Act as such securities which are designated as debt securities by the JSE, including, without limitation, debentures, debenture stock, loan stock, bonds, notes, certificates of deposit, preference shares or any other instrument creating or acknowledging indebtedness.

Debt securities for which a listing is sought must be issued in conformity with the:

- law of the applicant issuer's country of incorporation or establishment; and
- applicant issuer's memorandum and articles of association (if applicable) or other constitutive documents as the case may be.

In addition, all authorisations needed for their creation and issue under such law must have been duly given.

The JSE must be consulted for a ruling if it is not possible to comply with the Debt Listings Requirements as a result of conflict between the Debt Listings Requirements and the relevant legislation in the applicant issuer's country of incorporation. The debt securities for which listing is sought must be fully paid up according to the terms and conditions of the debt security and freely transferable, unless otherwise required by law.

An applicant issuer must satisfy the following minimum criteria for listing:

- be generally acceptable to the JSE, having regard primarily, but not only, to the interests of investors and the objects of the SS Act;
- have obtained the necessary statutory consent; and
- be duly authorised to issue debt securities in terms of its memorandum and articles of association or other constitutive documents as the case may be.

A preliminary approval of the relevant placing document must be obtained from the JSE prior to any offering, road show or other marketing of debt securities which are to be listed.

Alliances Concluded by the JSE

The JSE offers technical and other kinds of assistance to stock exchanges in the Southern African Development Community (SADC) and other stock exchanges in Africa. It has signed memoranda of understanding with stock exchanges in Egypt, Ghana, Kenya, Mauritius, Namibia and Nigeria.

As part of its global vision, the JSE also entered into a strategic alliance, consisting of a Business Agreement and a Technology Agreement, with the London Stock Exchange (LSE) in April 2001. The alliance aims to help the exchanges' member firms and issuers to access one another's markets more easily.

The Technology Agreement comprises the provision of core technology services by the LSE to the JSE through the trading system Sequential Equity Trading System (SETS) and the information dissemination service (LMIL). The Technology Agreement was implemented during May 2002.

In April 2009, the JSE announced that it would be adopting FIX across all the JSE Markets. This internationally recognised messaging system is short for Financial Information Exchange Protocol and is the industry standard for banks, broker-dealers, exchanges, institutional investors and information technology providers throughout the world. By adopting FIX, the JSE can offer more cost-effective and efficient message-routing services to meet client demands.

The JSE has also entered into an agreement with global index provider FTSE to supply internationally recognised index products for the international and domestic markets. The FTSE commenced calculating certain FTSE/JSE Africa Indices using free-float methodology from 2 February 2002 and additional indices from 13 May 2002.

With effect from 24 June 2002, the FTSE officially started calculating the FTSE/JSE Africa Index Series, which incorporates new ground rules, the FTSE Global Classification System and the calculation of Total Return values. The Socially Responsible Investment Index was implemented by the JSE and FTSE at the end of 2002.

From 1 March 2008, the Industry Classification Benchmark (ICB), the joint classification system launched by FTSE Group and Dow Jones Indexes, enhanced its four-tier industry classification system. Enhancements to the FTSE/JSE Africa Index Series were implemented with effect from 30 November 2009.

Towards the beginning of 2012, the JSE became part of a joint initiative by the exchanges of the BRICS countries (BRICSMART) to expose investors to benchmark equity index derivatives, offered in local currencies on the various BRICS exchanges. Under BRICSMART, the various exchanges of the BRICS countries have agreed to cross-list certain of their respective derivative products on each other's exchanges.

This initiative brings together the BM&FBOVESPA from Brazil, MICEX-RTS Exchange from Russia, the BSE Limited (formerly known as Bombay Stock Exchange) from India, Hong Kong Exchanges and Clearing Limited (HKEx), as the initial Chinese representative, and the JSE.

Uncertificated Securities

The process of the dematerialisation of securities in the South African equities market was started in March 2001 and completed in 2003, replacing manual settlement of share transactions with electronic settlement. Only dematerialised shares are good for settlement on the JSE.

The FM Act generally enables the conversion of all types of certificated securities to uncertificated securities, as well as the issuing of uncertificated securities. Uncertificated securities may be deposited into a central securities depository licensed under the FM Act. At present, the only licensed central securities depository in South Africa is Share Transactions Totally Electronic Limited (STRATE), which acquired the other two central securities depositories, the Universal Exchange Corporation (UNEXCOR) and the Central Depository (CD LTD), with effect from 1 August 2003.

STRATE effects electronic settlement of equities, bonds and money market instruments and is by far the biggest central securities depository in Africa and one of the largest in the Southern Hemisphere.

STRATE is regulated by the FSB and exercises its powers and carries out its functions under the oversight of the executive officer of the FSB. As a public company incorporated in terms of the Companies Act, No. 71 of 2008, STRATE is also regulated by the Registrar of Companies.

STRATE has determined its own rules and procedures and were initially published in the Government Gazette under the auspices of the repealed Custody and Administration of Securities Act, No. 85 of 1992.

STRATE amended its rules on 8 July 2005 and again on 9 December 2005 so as to comply with the requirements of the SS Act. STRATE is required to supervise compliance by its participants with the SS Act and the STRATE rules.

Any person who wishes to deposit securities in STRATE must first open an uncertificated securities account with a central securities depository (CSD) participant who has been accepted by STRATE.

Under the STRATE system, there are essentially two types of clients: controlled and non-controlled. A controlled client is one who elects to keep his or her shares and cash in the custody of his or her broker and, therefore, indirectly the broker's chosen CSD participant. As CSD participants are the only market players who liaise directly with STRATE, all brokers must have accounts with CSD participants. A non-controlled client is one who appoints his or her own CSD participant to act on his or her behalf.

Any deposit, withdrawal, transfer, pledge or cession of securities in STRATE is affected by the CSD participants by means of entries in the uncertificated securities accounts. Rights exercised against a central securities depository in respect of deposited securities must be exercised through a CSD participant, in its own name and on behalf of the relevant clients.

Automated securities lending and borrowing for CSD participants, the settlement authority and STRATE became operational on 6 August 2001. From 12 November 2001, all new warrant issues have been issued electronically and settled by STRATE. Existing warrants continue to be settled manually, but new warrants enjoy the benefits of electronic settlement. STRATE-eligible warrants are purely electronic instruments and no certificates will be issued for them. STRATE wishes to settle all securities in the future.

Market Abuse

South Africa has had insider trading legislation for the past 30 years, although it is probably fair to say that it was relatively ineffectual until the promulgation of the Insider Trading Act, No. 135 of 1998 (Insider Trading Act), on 17 January 1999.

With effect from 1 February 2005, the Insider Trading Act was repealed and its provisions incorporated into the SS Act with some refinements. The FM Act retained most of the provisions contained in the SS Act with a few modifications.

What used to be the Insider Trading Directorate is now the Directorate of Market Abuse. Its reach has been extended to include manipulative, improper, false or deceptive practices of trading. The criminal penalty for committing market abuse practices has been increased substantially to a fine not exceeding ZAR 50 million and/or imprisonment for a period not exceeding 10 years.

The market abuse provisions of the SS Act are limited to those securities that are dealt in on a regulated market (whether domestic or foreign), but will apply even if the actual dealing takes place over the counter. Provision has been made for both criminal and civil actions to be brought against any person who contravenes the market abuse provisions.

The FM Act creates a number of insider trader offences which may be committed by an insider who knows that he or she has inside information and who cannot prove any of the prescribed defences on a balance of probabilities. These are:

- dealing in the relevant securities for his or her own account while having inside information;
- dealing in the relevant securities for any other person while having inside information;
- dealing in the relevant securities for another person while knowing that such other person has inside information;
- disclosing inside information to another person;
- encouraging or causing another person to deal in the relevant securities; and
- discouraging or stopping another person from dealing in the relevant securities.

The Directorate of Market Abuse is given a derivative civil action against persons who contravene the insider trading provisions. In order for civil liability to attach to a person with inside information who dealt for his or her own account (the main defendant), he or she must have made a profit, or would have made a profit if the securities had been sold at any stage, or avoided a loss.

Those with inside information who disclose it, encourage or discourage another to or from dealing, or deal for another, are jointly and severally liable for the same amount as the main defendant (save for the amount of the penalty). Each defendant is also directly liable to the Directorate of Market Abuse for a separate penalty equal to three times the amount of the profit made or the loss avoided, together with all commission or consideration for disclosing, encouraging, discouraging or dealing.

In addition to the insider trading offences outlined above, the FM Act prohibits trading practices which, inter alia:

- will have the effect of creating a false or deceptive appearance of active public trading in connection with, or an artificial price for, securities;
- will unduly or improperly influence the market price of securities;
- will create or induce a false or deceptive appearance of demand for or supply of securities;
- will maintain a level of artificial prices;
- will effect or assist in effecting a market corner;
- are aimed at defrauding any person; or
- are deceptive or likely to have that effect.

The FM Act also prohibits the making of false, misleading or deceptive statements, promises and forecasts. Allowance is made in the FM Act for the introduction of price stabilising mechanisms, regulated by the rules or listing requirements of an exchange. The purpose of such mechanisms is to promote an orderly secondary market following a new issue of shares, but only for a limited period of 30 days. Price stabilisation does not constitute a manipulative practice or insider trading.

The so-called Enforcement Committee (which is established under the Financial Services Board Act, No. 97 of 1990) has the power to impose administrative penalties on persons who contravene or fail to comply with the provisions of the FM Act, or (in the case of insider trading) to require such a person to pay compensation.

Conclusion

South Africa has a vibrant and well-regulated financial services industry that is backed by legislation, regulation and specific rules that have been adopted by industry participants. The FSB and the various registrars that operate under its auspices, together with the JSE play an important role in administrating and enforcing the financial services legislation on which South Africa's financial services sector rests.