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IN THIS ISSUE

NOTE ON THE FINANCIAL MARKETS ACT, 2012

The Financial Markets Act, No 19 of 2012 (FMA) was assented to by the President on 30 January 2013 and came into force on 3 June 2013 in terms of Government Gazette number 36485 of 31 May 2013.

The FMA replaces the Securities Services Act, No 36 of 2004 (SSA) in its entirety.

The objects of the FMA are, essentially, to bring South African securities law and regulation closer in step with global standards, and accordingly to:

> "provide for the regulation of financial markets; to license and regulate exchanges, central securities depositories, clearing houses and trade repositories; to regulate and control securities trading, clearing and settlement, and the custody and administration of securities; to prohibit insider trading, and other market abuses; to provide for the approval of nominees; to provide for codes of conduct; to replace the Securities Services Act, 2004, as amended by the Financial Services Laws General Amendment Act, 2008, so as to align this Act with international standards; and to provide for matters connected therewith."

'Securities' under the FMA are much the same as under the SSA and are basically any debt, equity or hybrid instruments that grant the holder some form of economic and/or voting rights or interests.

They are defined in the FMA as follows:

(a) listed or unlisted:

(i) shares, depository receipts and other equivalent equities in public companies, other than shares in a share block company as defined in the Share Blocks Control Act, 1980;

(ii) debentures and bonds issued by public companies, public state-owned enterprises, the South African Reserve Bank and the Government of the Republic of South Africa;

(iii) derivative instruments;

(iv) notes;

(v) participatory interests in a collective investment scheme as defined in the Collective Investment Schemes Control Act, 2002, and units or any other form of participation in a foreign collective investment scheme approved by the Registrar of Collective Investment Schemes; and

(vi) instruments based on an index;

(b) units or any other form of participation in a collective investment scheme licensed or registered in a country other than the Republic;

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(c) the securities contemplated in paragraphs (a) (i) to (vi) and (b) that are listed on an external exchange;

(d) an instrument similar to one or more of the securities contemplated in paragraphs (a) to (c) prescribed by the registrar to be a security for the purposes of the FMA; and

(e) rights in the securities referred to in paragraphs (a) to (d).

The term excludes, however, money market securities, except for the purposes of Chapter IV of the FMA, the share capital of the South African Reserve Bank and any security prescribed by the registrar as an excluded security.

According to the Explanatory Memorandum on the Financial Markets Bill, 2012 (April 2012) (*http://www.fsb.co.za/finmarks/FinancialMarketsBill2012/FMB%20Explanatory%20Memorandum.pdf*), the review of the SSA, which lead to the enactment of the FMA, highlighted a number of critical provisions that must be given effect to in legislation in order to ensure that the integrity of the regulatory framework of the South African financial markets is maintained, the regulatory framework continues to meet its objectives and the objectives of financial regulation in general, the regulatory framework is aligned with relevant local and international developments and standards and remains effective in mitigating potential impacts of any possible future financial crisis. The purpose of the review was to assess whether the SSA continues to meet its objectives and the objectives of financial regulation in general, is aligned with relevant local and international developments and standards and continues to be effective in mitigating the impact of the financial crisis. The purpose of the review also included the identification of implementation difficulties that required clarification and technical amendments necessary to maintain the integrity of the legislative framework.

This note highlights some of the material new provisions and changes introduced into South African securities law by the FMA, and compare it to the previous position under the SSA where appropriate.

The duty to act fairly and transparently

One of the stated aims of the FMA is to ensure that the South African financial markets are fair, efficient and transparent (s2 of the FMA).

This is not simply stated as a broad principle or ideal in the preamble and objects section, but applies specifically to the various categories of entities that are regulated by the FMA. Thus, regulated entities such as securities exchanges (or otherwise known as stock exchanges, such as the JSE Limited), central securities depositories (or 'CSDs', STRATE currently being the only CSD in South Africa) and central securities depositary participants (or simply 'participants', or 'CSDPs', being various banks and other financial institutions that hold securities in custody for their clients) must all "conduct [their] business in a fair and transparent manner with due regard to the rights of participants and their clients, and issuers" (s10, s30 and s32 of the FMA).

This adds another dynamic to the host of duties and obligations that were (and continue to be) imposed on such regulated entities, and is clearly aimed at achieving one of the overriding and general purposes stated in the Explanatory Memorandum. If it wasn't clear enough before, the FMA now makes this an express stand-alone duty akin almost to the standards expected of public bodies under the Constitution and administrative law.

Greater potential regulation in the unlisted environment

Under the SSA the rules, prohibitions and sanctions relating to insider trading and prohibited practices (commonly collectively referred to as 'market abuse') applied only in respect of securities listed on a 'regulated market', that is securities on a securities exchange (whether local or foreign).

In the case of unlisted securities, parties prejudiced by a seller's concealment of 'inside information' had to rely on common law remedies available in the law of contract such as misrepresentation, fraud or possibly breach of fiduciary duty (if a director was involved in the transaction as a seller or purchaser of shares in the company in question).

That is still (mostly) the case, although two material points in this regard can be noted from the new FMA:

- Section 5(1)(a) of the FMA now vests very wide general powers in the Minister of Finance to prescribe regulations containing "requirements for the regulation of unlisted securities." It would be interesting to see the extent to which the Minister takes any steps in the future to regulate unlisted

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securities and whether this power could be used to apply the various market abuse rules also in the context of the unlisted environment. This is especially so in the (currently) largely unregulated 'over-the-counter' (OTC) public trading context, which is something that the Financial Services Board (FSB) has been eyeing for quite some time now.

- In similar vein is s6(7)(e) of the FMA that permits the registrar (FSB) to, in accordance with the requirements prescribed by the Minister, 'prescribe criteria for the authorisation of issuers of unlisted securities.'

- These are wider powers in connection with unlisted securities than those that were contained in the SSA. Section 20 of the SSA only went so far to grant the registrar the power to regulate or prohibit the carrying on of a business of buying and selling unlisted securities.

- Quite notable in this context is s80 of the FMA, dealing with 'prohibited practices' in relation to securities. These are essentially transactions concluded with the purpose of misleading the market and creating an artificial price in respect of the securities.

- Section 80 provides that:

  "No person-

  (a) may, either for such person's own account or on behalf of another person, knowingly directly or indirectly use or participate in any practice which has created or is likely to have the effect of creating:

    (i) a false or deceptive appearance of the demand for, supply of, or trading activity in connection with; or

    (ii) an artificial price for,

    that security;

  (b) who ought reasonably to have known that he or she is participating in a practice referred to in subparagraph (a), may participate in such practice."

This is not limited to securities listed or traded on a regulated market (in contrast to s75(1) of the SSA which dealt only with prohibited practices only in the context of listed securities). For the avoidance of doubt, 'prohibited practice' does not include insider trading, which is governed separately. Insider trading has been, and continues to be, only applicable to listed securities. The list of specific examples of prohibited practices in s80(3) of the FMA then deals only with listed securities, but the general prohibition in s80(1) does not have this limitation.

The addition of "ought reasonably to have known that he or she is participating in a [prohibited practice]" is also new and imposes a more onerous standard.

The insider trading provisions of the FMA (s78), however, continue to deal only with securities listed on a regulated market.

Possibility of general exemptions from FMA

One of the recent business law statutes that introduced a general exemption provision is the Companies Act, No 71 of 2008, s6(2), that contains a novel and very wide provision in terms of which an application can be made to the Companies Tribunal to exempt anyone from any unalterable provision of the Companies Act on grounds that are fair and reasonable.

The FMA now contains a similar provision, which one did not find in the SSA. Under s6(3)(m) of the FMA, the registrar may exempt any person or category of persons from the provisions of a section of the FMA if the registrar is satisfied that:

- the application of said section will cause the applicant, or clients of the applicant, financial or other hardship or prejudice; and

- the granting of the exemption will not conflict with the public interest or frustrate the achievement of the objects of the FMA.

Clearly, however, from the wording of this provision it does not appear to be very flexible, and an applicant would have to show compelling grounds for an exemption.

More extensive and detailed regulation of amendments to listing requirements

A securities exchange may, under s11(6)(a) of the FMA, amend its listings requirements in accordance with a (more extensive and detailed) consultation process set out in the listings requirements, which process must provide for:

- the persons who are to be consulted; and

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- the manner in which consultation will happen, including the time period or periods allowed for consultation.

An exchange must submit any proposed amendment of its listings requirements, together with an explanation of the reasons for the proposed amendment, and any concerns or objections raised during the consultation process, to the registrar for approval.

The registrar must, as soon as possible after the receipt of a proposed amendment, publish:

- the amendment on the official website; and

- a notice in the Government Gazette that the proposed amendment is available on the official website, calling all interested persons who have any objections to the proposed amendment, to lodge their objections with the registrar within a period of 14 days from the date of publication of the notice.

If there are no such objections, or if the registrar has considered the objections and, if necessary, has consulted with the exchange and the persons who raised such objections and has decided to approve or amend the proposed amendment, the registrar must publish:

- the amendment and the date on which it comes into operation on the official website; and

- a notice in the Gazette, concerning the amendment.

Compared to the SSA, this all entails a more extensive, transparent and consultative process which must be followed by an exchange such as the JSE when it intends amending its listings requirements.

Conflicts of interest in the financial markets

An issue that has been highlighted in some of the modern literature on securities law is the potential conflict of interest that arises where demutualised stock exchanges are listed on their own exchange. The JSE is an example, it is both a regulator and a commercial entity listed on its exchange.

This inevitably creates perceived potential conflict of interest issues as, on the one hand, the securities exchange has a regulatory and enforcement function under the securities regulatory law and its own listings requirements, but on the other hand and at the same time it is one of the companies listed on its own exchange.

These issues have been addressed in jurisdictions such as the United Kingdom and Australia, for example, by vesting the monitoring, enforcement and disciplinary function in respect of the listings requirements in a separate regulatory body and not the exchange itself.

Section 62 of the FMA now addresses this potentially controversial issue head-on, and provides that a 'market infrastructure' (a licensed central securities depository, a licensed clearing house, a licensed exchange and a licensed trade repository) must, where applicable, take necessary steps to avoid, eliminate, disclose and otherwise manage possible conflicts of interest between its regulatory functions and its commercial services. The steps must include:

- the implementation of appropriate arrangements, which arrangements must comply with the requirements prescribed by the registrar, be documented and be publicly available; and

- an annual assessment, in the manner prescribed by the registrar, of the arrangements referred to above, the results of which must be published.

Already, the FSB's board notice number 95 of 2013, published in Government Gazette 36494 of 31 May 2013, sets out some of the conditions and criteria pertaining to the admission and listing of an exchange's own securities on its list.

Certain material variations to defences under insider trading rules

As was the case under the SSA and insider trading statutes before that, s78 of the FMA prohibits insider trading.

In basic terms, insider trading occurs where a person who knows that he is in possession of 'inside information' in respect of a listed security (namely material price sensitive information which is not known to the public), deals in that security. As with the SSA, a 'person' includes a juristic person and therefore companies and other corporations can be found guilty of insider trading.

Under the SSA it was irrelevant that the other party to the deal also knew about the inside information, and therefore an offence was still committed in such circumstances - there was no 'big-boy' defence, which is found in other jurisdictions. The rationale of the latter defence is that because both the buyer and seller knew about the information, no-one had an unfair advantage in the deal and therefore there was no prejudice.

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This has changed in the FMA, and is a notable material change in this context. Under the new s78(2)(b)(iii), an insider is not guilty of the offence of insider trading if such insider proves on a balance of probabilities that he or she was acting in pursuit of a transaction in respect of which:

- all the parties to the transaction had possession of the same inside information;
- trading was limited to the parties referred to above; and
- the transaction was not aimed at securing a benefit from exposure to movement in the price of the security, or a related security, resulting from the inside information.

One of the defences to insider trading under s73(2)(b) of the SSA was where the insider proved on a balance of probabilities that he or she was acting in pursuit of the 'completion' of an 'affected transaction' as defined in the Companies Act. 'Affected transactions' are essentially takeovers and mergers in respect of 'regulated companies' being public companies and certain private companies. This defence caused some confusion especially in the context of due diligence investigations where a potential acquirer discovered inside information in respect of the (listed) target company. Could the acquirer and target proceed to consummate the merger despite the acquirer's knowledge, and was this covered by the defence of being 'in completion of an affected transaction'? Was the intention with this defence that takeover law provided enough protection to shareholders? This defence has now been excluded in the FMA and is replaced by the (clearer) new defence referred to above, namely where all the parties to the transaction know about the inside information.

Another defence to insider trading that existed in the SSA and that has not been carried over into the FMA was contained in s73(2)(b)(ii) of the SSA namely that the insider "was acting on behalf of a public sector body in pursuit of monetary policy, policies in respect of exchange rates, the management of public debt or external exchange reserves."

Some issues which the FMA does not address

All in all the FMA is clearly a major effort on the part of the authorities to bring the already advanced and modern securities law of South Africa further in line with world markets.

The FMA did, however, miss the opportunity of clarifying some material issues which existed under the SSA and which will probably continue to linger under the FMA:

- One issue is the potential civil liability for damages suffered pursuant to a breach of the listings requirements of an exchange. Who has *locus standi* to bring an action to enforce the JSE Listings Requirements (for instance, to launch a court application requesting an interdict against conduct which contravenes such rules)? Are investors, or members of the public generally, entitled to do so? Are remedies available in private law for losses and damages sustained as a result of breaches of the Listings Requirements? These would have to be addressed in terms of ordinary principles of the law of contract and delict. Other jurisdictions such as Australia have, in their securities law statutes, made specific provision for this.
- Where a transaction is entered into in contravention of the listings requirements of an exchange, is the agreement 'unlawful' and void, or is it merely the case that sanctions or censures may be imposed on the listed company (such as fines) by the Exchange? Again, other jurisdictions such as the US, UK and Australia have made express provision for the consequences of such transactions and it would perhaps have been useful for the FMA to have taken the opportunity to deal with this question specifically.

Please do not hesitate to contact any of our experts in connection with any matter relating to the FMA or other aspects pertaining to securities law.

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THE LAPSING OF THE TWO YEAR 'GRACE PERIOD' UNDER THE COMPANIES ACT, 2008

The so-called two year 'grace period' under the Companies Act 71 of 2008 in respect of companies' memoranda of incorporation (MOI) and shareholders agreements, lapsed on 1 May 2013.

What does this mean, and what are the risks for companies who have not undergone the exercise of updating their constitutional documents and aligning them with the Companies Act?

Firstly, a company is free to file a new MOI at any time, ie 1 May 2013 was not a 'cut-off' date in that regard. A company must however now pay a small filing fee at the Companies and Intellectual Property Commission, being R250.

The significance of the grace period, which commenced on 1 May 2011 (when the Companies Act came into force) was that, subject to certain exceptions, a pre-existing MOI (being the old memorandum and articles of association of a company) prevailed over the Companies Act in the case of any inconsistency between the two, and furthermore (and perhaps more importantly in most instances) a pre-existing shareholders agreement prevailed over both the Companies Act and the pre-existing MOI. This is all set out in the transitional arrangements in schedule 5 to the Companies Act, particularly item 4 thereof. Now that the grace period has lapsed, the ranking now is: first the Companies Act, second the MOI and last the shareholders agreement. The reason that the Act and MOI now trump the shareholders agreement is because the default position in s15(7) of the Companies Act will now apply to pre-existing constitutional documents, and that section provides that a shareholders agreement is invalid to the extent that it conflicts with the MOI or the Companies Act.

Another relevant principle in this whole question is the following: the Companies Act provides that its alterable provisions may be amended, modified or otherwise altered in the MOI of a company, and that its unalterable provisions may be made more onerous in the MOI. It is probably debatable whether this means that the MOI is the only document (as opposed to the shareholders agreement) which can competently deal with these matters, seeing that s15(7) of the Companies Act provides that a shareholders agreement may deal with any matter in relation to the company as long as it is consistent with the MOI. The conservative view held by many for the time being, however, is that such aspects must indeed be dealt with in the MOI in order to be effective.

What then are some concrete examples of problems that may arise in this regard?

What should be borne in mind at the outset is that a lot of aspects dealt with in companies' shareholders agreements are matters on which both the Companies Act and, in many instances, the old MOI are silent. This is then left to private arrangements amongst the shareholders and other parties, which they are free to deal with in a shareholders agreement. In that case, there is no overlap between what the shareholders agreement is saying and what the Companies Act and / or the MOI is saying, and consequentially no concern should arise of an 'inconsistency' which causes the relevant provisions in the shareholders agreement to be void. Typical examples which can be gleaned from many shareholders agreements are clauses relating to loan funding, come-along and tag-along provisions, restraints of trade and non-competition, confidentiality, forced sales / deemed offers, dispute resolution, and BEE arrangements and undertakings.

On the other hand, where there is an overlap, one has to consider whether the relevant provisions in the shareholders agreement may be at risk. Also, consider whether your shareholders agreement is altering an alterable provision or toughening up an unalterable provision of the Companies Act – if that clause is not contained in the MOI, there is a risk that the default position in the Companies Act or MOI will instead apply. Examples which are often found are clauses relating to pre-emptive rights / rights of first refusal on share disposals or fresh share issues, equity finance, governance aspects pertaining to meetings, quorums and thresholds for the passing of resolutions, and the mechanics for the appointment or election of directors (note that under s66(4)(b) of the Companies Act, at least 50% of the directors and alternate directors of a profit company must be elected by shareholders as opposed to being directly appointed by a shareholder or third party – shareholders agreements often provide for direct appointment of all directors). A major aspect which could potentially be at risk is minority protection, the so-called 'reserved matters', 'restricted matters' or 'specially protected matters'. Call them what you will, many of these clauses typically contain limitations (by for instance requiring minority shareholders to consent to the transaction) on the board's ordinary powers to manage the company and to carry out all its functions, as empowered by s66(1) of the Companies Act. Section 66(1) of the Companies Act states that either the Act itself or the MOI may limit the board's powers – does this then create the risk that if you do not have the minority protections in the MOI, they are overridden by the position in the MOI and Companies Act? That concern aside, however, many items listed in minority protection clauses require, as a matter of law under the Companies Act, a special resolution of shareholders in any event which may or may not to some extent mitigate the risk for minority shareholders.

Therefore, the upshot is that the potential risk has to be assessed from company to company, based on its own constitutional documents.

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