The 'Fatal Flaw' in South Africa's Financial Regulation

By **Bridget King**, Director, Cliffe Dekker Hofmeyr

The South African financial markets regulatory landscape is changing quickly. So too are the laws that will govern the future of trading over-the-counter derivatives. But what regulatory changes still need to be made to align South Africa with the rest of the world?

What is the 'fatal flaw' in our law?

The rule that the realised proceeds of collateral must be paid to the liquidator of a South African party has come under scrutiny recently, particularly in the context of the OTC derivatives market. In terms of both foreign and South African margin laws, parties to OTC derivatives transactions ('Transactions'), must, inter alia, post additional margin upfront for any transactions which are not cleared through a central counterparty ('Initial Margin'). Given the systemic market risk associated with the OTC derivatives market, regulators in G20 countries have introduced new laws which require the bilateral exchange of Initial Margin as an additional collateral 'buffer' which a

secured party may call upon in the event that its counterparty defaults under an OTC derivatives Transaction and the variation margin held by the non-defaulting party does not adequately cover the secured party's claim.

The Insolvency Act, 1936 ('Insolvency Act') has always made provision for the holder of a pledge and cession in security over 'marketable securities' ('Secured Party'), upon the insolvency of the security provider ('Security Provider'), to immediately realise those marketable securities through or to a stockbroker on a recognised stock exchange. However, in terms of Section 83(10) of the Insolvency Act (as it currently stands), once the pledged securities have been so realised they must be paid over to the liquidator. The lengthy process of proving and paying out the claims of the insolvent's debtors then ensues. The Secured Party may have to wait some time before receiving the proceeds of the sale of the securities which were pledged in the Secured Party's favour.

Urgency

Given the fact that the Margin Requirements under the Financial Markets Act, 2012 ('FMA') were purportedly being phased in from as early as 1 January 2018, and – given that South African banks will be unable to comply with the new Margin Requirements under the FMA ('Margin Requirements'); and that their foreign counterparties may already be obliged to comply with their margin obligations under the margin rules of certain foreign jurisdictions, it is critical that the legislature bring about the changes necessary to cure the fatal flaw in South Africa's insolvency and derivatives laws.

A positive step under Twin Peaks

Originally, the Insolvency Act did not permit a foreign counterparty to sell securities pledged in its favour (even where those securities were located offshore, held in a foreign central securities depository and subject to a pledge and cession or other security interest created under the laws of the foreign jurisdiction in which the securities were located).

However, pursuant to the recently enacted Financial Sector Regulation Act, 2017 ('Twin Peaks Act'), this conundrum has been partly remedied. The Twin Peaks Act amends certain sections of the Insolvency Act to confirm that foreign securities listed on foreign exchanges which have been pledged by a South African Security Provider as collateral, can (upon insolvency) be realised immediately by the Secured Party through or to a foreign stock broker.

The fatal flaw persists

However, these amendments still do not cure the fatal flaw in South African insolvency law, because the realisation proceeds may not be retained by the Secured Party and applied to the Secured Party's claims.

FMA Margin Requirements for OTC Derivatives

The latest South African Margin laws published under the FMA in section 4.3(2) of the Margin Requirements state – "Initial margin must be held in such a manner that it is available to the person who collected the initial margin in the event of the counterparty's default."

It is our view that, from the time a counterparty to a Transaction first posts Initial Margin as required under the Margin Requirements, such counterparty will be in breach of the peremptory requirements imposed in section 4.3(2) of the Margin Requirements.

This is because the Initial Margin will not be available to the person who collected it. To the contrary, the Insolvency Act requires that the Initial Margin must first be paid over to the liquidator of the South African counterparty's estate.

Urgent amendment is required to the Insolvency Act so that counterparties to Transactions will be in a position to comply with section 4.3(2) of the Margin Requirements, as and when each phase of implementation takes effect. If the Insolvency Act is not amended, then none of the Initial Margin posted will qualify as eligible collateral and all Counterparties will automatically be in breach of section 4.3(2) of the Margin Requirements from the moment they commence posting Initial Margin under the Margin Requirements. This unintended consequence has to be remedied before any proposed implementation date.

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Foreign Margin Requirements for OTC Derivatives

Similarly, for a foreign counterparty to be allowed to enter into OTC derivatives transactions with South African banks and financial institutions, the foreign counterparty collecting Initial Margin must comply with its foreign legislation. For example, foreign legislation may require the foreign counterparty to be able to promptly and readily or within a reasonable amount of time, liquidate or realise the Initial Margin in the case of a default by the South African posting party, and be able to use the cash proceeds of the realisation of the Initial Margin to settle their claims or enter into replacement derivative contracts with another counterparty or to hedge (manage) the resulting risk. This is a matter to be determined under the laws of the relevant foreign jurisdiction, but our view is that the same problem could arise.

There is a real risk that foreign banks and financial institutions will be unwilling and unable to conclude derivatives Transactions with South African banks and financial institutions.

Looking forward

Thanks to the limited amendments made under the Twin Peaks Act, pledged foreign and locally listed securities owned by a South African Security Provider may now be realised in terms of the procedure set out in section 83(2) as read with section 83(8) of the Insolvency Act. Section 83(8) allows listed securities to be sold by the creditor immediately through (or to) an authorised user of a local exchange or through (or to) an authorised user of an external exchange, as applicable. These amendments add clarity and bring the old definitions in the Insolvency Act in line with the new definitions under the FMA.

The only further required amendment to the Insolvency Act would be to allow the proceeds of such immediate sale of the property realised in accordance with section 83(2) as read with section 83(8) (ie listed securities) to be retained by the creditor (whether locally or abroad) and applied to that portion of the unpaid debt secured by that property (ie the listed securities).

Initiatives are already under way to lobby National Treasury and the Department of Justice to effect consequential amendments to section 83(10) of the Insolvency Act, to fully cure the impediment to trading with and providing margin to local and foreign counterparties to OTC derivatives Transactions. The question is whether these changes will be promulgated before the implementation of the Margin Requirements under the FMA or if Margin Requirements will be delayed indefinitely until the insolvency laws are updated. ■

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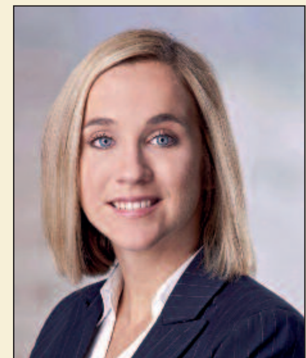

Bridget King joined Cliffe Dekker Hofmeyr as a Director in 2015. Her areas of expertise include financial services and markets regulation, banking regulation, the exchange control regime and over the counter and listed derivatives. She is local South African counsel to ISDA Inc., provides ISDA with industry opinions on the collateral, clearing and margin arrangements under ISDA agreements and assists with ISDA's initiatives in Africa.

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