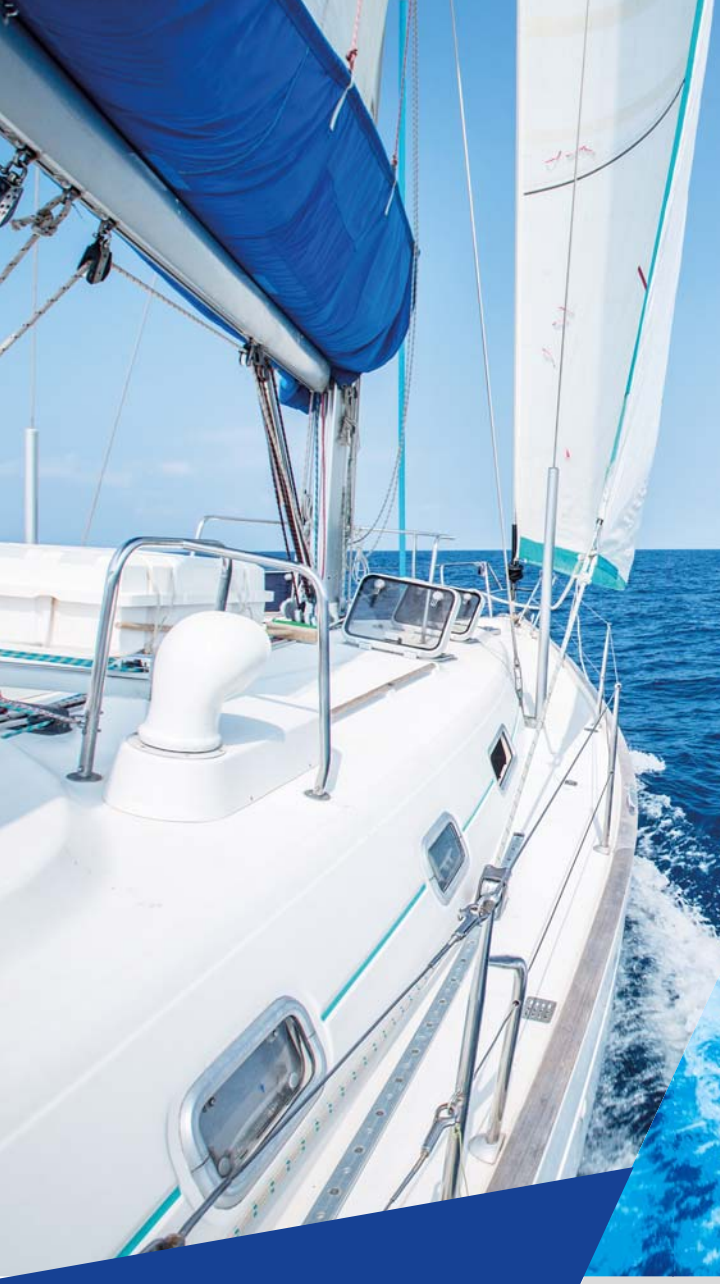

19 FEBRUARY 2018

FINANCE & BANKING ALERT

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THE FATAL FLAW IN OUR LAW – POSTING MARGIN FOR UNCLEARED DERIVATIVES

What is the "fatal flaw" in our law? 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.

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THE FATAL FLAW IN OUR LAW – POSTING MARGIN FOR UNCLEARED DERIVATIVES

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What is the "fatal flaw" in our law? 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 s83(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 his or her favour.

It is critical that the legislature bring about the changes necessary to cure the fatal flaw in South Africa's insolvency and derivatives laws.

The rule that realised proceeds 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, among other things, 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.

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 are already in breach of 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. It would not be advisable to delay the implementation of the required amendments until the Financial Services Laws General Amendment Bill (Omnibus Bill) is drafted.

History

Section 83(2) of the Insolvency Act allows a creditor, after giving notice of their secured claim over movable property (ie pledged securities) to the master and to the liquidator (if one has been appointed) and before the second meeting of creditors, to realise the property in accordance with s83(8) of the Act.

The difficulty arose as the creditor's right of enforcement in this manner applied only to three types of movable property, namely a "marketable security", "bill of exchange" or "financial instrument" as defined in the now repealed s1 of the Financial Markets Control Act, 1989 (FMCA).

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The Insolvency Act made no express provision for the treatment of foreign securities owned by South African counterparties that were listed on foreign securities exchanges.

Section 83(2) of the Insolvency Act did not give any guidance as to how the term "marketable securities" should have been interpreted and did not require that that term be interpreted with reference to any other statute or law. Undefined terms are typically given their ordinary, grammatical meaning. However, s83(2) did prescribe that such "marketable securities" could be realised in the manner and on the condition set out in s83(8) of the Insolvency Act.

According to s83(8)(a) of the Insolvency Act, where the property was of a class "ordinarily sold through a stock-broker as defined in Section 1 of the Stock Exchanges Control Act, 1985" (SECA), then the Secured Party, subject to SECA and the rules of the stock exchange could:

- "forthwith sell it" [the property] through a stock-broker; or
- if the creditor was a stock-broker, also to another stock-broker.

The use of the phrase "forthwith" indicated that the creditor could immediately realise these listed securities through or to a stock-broker.

The problem with the definition of "stock-broker" and "stock exchange" in s1 of the old SECA was that these definitions were limited to stock exchanges which were licensed by the registrar of stock exchanges namely the executive officers of the South African Financial Services Board (FSB).

Therefore, SECA regulated only those stock exchanges which were licensed in South Africa and excluded stock exchanges registered in a foreign jurisdiction. Based on the legislation as it then was, s83(8)(a) of the Insolvency Act only permitted the immediate sale of shares through or to a South African stock-broker authorised as a member of a South African stock exchange. However, the Insolvency Act was not clear as to how South African-owned foreign securities should be dealt with in the event of bankruptcy of a South African Security Provider. The Insolvency Act made no express provision for the treatment of foreign securities owned by South African counterparties that were listed on foreign securities exchanges. On a strict interpretation of the Insolvency Act, the secured party would

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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.

have had to deal with the securities listed on a foreign stock exchange either by delivering those securities to the South African liquidator or by realising them on public auction.

Applying s12 of the Interpretation Act, 1957, the reference to a "stock-broker" in s83(8)(a) of the Insolvency Act had to be interpreted with reference to the modified, re-enacted provisions in the Security Services Act, 2004 (SSA), namely to an "authorised user" as defined in s1 of the SSA. Again, on a strict interpretation of the law, SECA and the SSA would have allowed only for the immediate sale of securities listed on a South African stock exchange. It was further not clear whether the South African courts would apply s12 of the Interpretation Act to every subsequent repeal and re-enactment of a particular provision or only to the next succeeding repeal and re-enactment of that provision. For example, it was unlikely that the references to SECA in the Insolvency Act could be construed as references to the Financial Markets Act, 2012 (FMA), a piece of legislation "twice removed" from SECA.

Therefore, 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).

A positive step under Twin Peaks

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 s83(2) and s83(8)(a) so that the definitions under SECA are replaced with the equivalent definitions of "authorised user", "external authorised user", "exchange" and "external exchange" as defined under the FMA. The effect of this change is that it confirms 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.

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Urgent amendment is required to the Insolvency Act so that counterparties to Transactions will be in a position to comply with s4.3(2) of the Margin Requirements,

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 s4.3(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 s4.3(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 s4.3(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 s4.3(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.

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 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. Therefore, the same problem arises.

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.

Proposed solution

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 s83(2) as read with s83(8) of the Insolvency Act. Section 83(8) allows listed securities

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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.

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 s83(2) as read with s83(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 s83(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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Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 3 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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