

EXPLANATORY NOTE ON THE PROPOSED RULES AND DIRECTIVES FOR THE INTEREST RATE AND CURRENCY DERIVATIVES MARKETS

1 Introduction

- 1.1 Pursuant to the amalgamation of BESA and the JSE, it has been resolved that the two interest rate markets operated by the JSE, namely the Yield-X market and the BESA market, will be integrated towards the end of the first quarter of 2011. As a result, all trading and/or reporting in JSE listed bonds and interest rate derivatives will thereafter take place on the Nutron trading platform.
- 1.2 From a regulatory point of view, the effect of the integration is that the membership of the two markets has to be integrated, and the Yield-X and BESA rulebooks have to be combined into one set of rules and directives. The currency derivatives market is also currently regulated under the Yield-X rules and that market will form part of the integration. The rules and directives covering the integrated markets will be known as the JSE Interest Rate and Currency ("IRC") rules and directives. A member authorised under these rules and directives will be known as an IRC member.
- 1.3 The Yield-X rules and directives have been used as the base for the integrated rules, with appropriate amendments having been made to give effect to the integration. Once the integrated rules come into effect, the rules and directives applicable to the BESA market will be repealed in their entirety.
- 1.4 The main objectives of the integration of the markets are to integrate trading in JSE listed interest rate products on a single trading platform, and to align the regulatory requirements and the process applied by the JSE in managing trading and settlement of interest rate products under a common set of rules and directives. These integrated rules and directives do not seek to fundamentally change the way in which interest rate products are traded on the JSE. Nevertheless, with an integration of this nature, there will always be certain changes to elements of the market microstructure and the regulatory requirements applicable to the users of the markets.
- 1.5 Members of the BESA market who are not currently members of Yield-X or do not trade bonds under the Yield-X rules will now operate under a rulebook that looks significantly different to the rulebook that they are accustomed to. Many of the principles are the same but the detailed requirements are quite different. We therefore wish to give the members of the markets that are affected by the integration an opportunity to comment on the proposed new set of rules and directives and to ask any questions that they may have on the interpretation and application thereof.
- 1.6 These explanatory notes highlight the most significant provisions that we wish to bring to the members' attention to assist members to identify the impact of the new rules and directives on their firms. Members are, however, requested to review all of the rules and directives to identify and familiarize themselves with all the requirements that will be applicable to them.
- 1.7 Members are requested to provide their comments on or before the **4th February 2011** and to address their comments to IRCGroup@jse.co.za. Once the JSE Executive Committee has approved the new rules and directives there will still be a formal two week comment period in terms of the rules, but the nature and extent of the changes warrants a broad market consultation for a longer period and that is the reason we are commencing the consultation at this stage.

2 References to Yield-X and other terms

All references to “Yield-X” and terms containing “Yield-X” have been replaced. This has been achieved through the global replacement referred to on page 1 of the rules. Therefore, members will not see marked up changes to each of these terms throughout the new rules and directives, but the final set of rules and directives that the JSE will publish will reflect all of those changes. The term “settlement agent” has also been globally replaced.

3 General provisions – Section 1

3.1 Rule 1.120 Transitional Provisions

- 3.1.1 These transitional provisions are particularly important in relation to the status of members of the two markets and the status of officers registered under the two previous sets of rules and directives. Provision has been made for the following-
 - 3.1.1.1 Members of the BESA market who are not members of the Yield-X market will automatically become IRC members authorised to trade in bonds;
 - 3.1.1.2 Members of the Yield-X market who are not members of the BESA market and who have never traded in bonds will remain members of the IRC market authorised to trade in IRC derivatives.
 - 3.1.1.3 Registered traders in the BESA market who have never been authorised to trade in derivative securities will automatically be registered as bond traders under the new rules and directives.
 - 3.1.1.4 Registered dealers in the Yield-X market who have never been authorised to trade in bonds will retain their current authorisation.
 - 3.1.1.5 Registered compliance officers under the two previous sets of rules and directives will be recognized as compliance officers under the new rules and directives, subject to any additional qualification requirements that may be applicable if the member firm subsequently obtains authorisation to trade in additional products.
- 3.1.2 The significance of these transitional provisions is that the member firms and registered officers effectively retain their status under the integrated rules in relation to the products that they were authorised to trade under the previous rules, and they must obtain further authorisation if they wish to trade in additional products. This further authorisation enables the JSE to determine whether the member has made the necessary arrangements to be able to trade in other products and meet all the regulatory requirements associated with trading in those products, or to determine whether the officer has obtained any additional qualifications relevant to the other products.

- 3.2 Rule 1.130 The Compensation Funds (The BESA Guarantee Fund and the Fidelity Fund)
- 3.2.1 The two compensation funds available under the two previous sets of rules will continue to be available to provide protection for the circumstances that each intend to cover.
 - 3.2.2 The Guarantee Fund will continue to cover a default by a member who has executed a reported transaction in bonds which is not accepted by a clearing member for risk management purposes in terms of the new rules.
 - 3.2.3 The Fidelity Fund will continue to cover margin which a client is unable to obtain a refund of from a defaulting member in respect of a transaction in any IRC security.
 - 3.2.4 All issues relating to the lodgement of claims against the Guarantee Fund and ancillary matters relating to the funds shall be dealt with in detail in the rules of the respective funds. We are still working on these rules and will distribute them for comment in January.

4 Definitions and Interpretation-Section 2

- 4.1 The following are the most significant new definitions which have been introduced in the rules-
- 4.1.1 Broadcast- this is required for new rule 7.30.6 dealing with the broadcast of market prices
 - 4.1.2 Inter-dealer broker or "IDB"- IDBs are referred to in the rules as a sub-category of trading member who wish to be classified as IDBs and subject themselves to the rules applicable to IDBs
 - 4.1.3 Matched principal-describes a type of trade for the purpose of the IDB rules
 - 4.1.4 Name give- up- describes a service provided by trading members facilitating trades between two other counterparties
 - 4.1.5 Rolling of settlement-describes a process initiated by the Settlement Authority to ensure that settlement of a bond transaction still takes place if it cannot be achieved on the original trade date.

5 Membership Requirements-Section 3

5.1 ***Capital adequacy requirements***

- 5.1.1 The capital adequacy requirements for BESA and YIELD-X members are substantially similar and therefore there will be no changes post integration in relation to those requirements.
- 5.1.2 However, with regards to the frequency of the submission of capital adequacy returns and the monitoring by Surveillance of the members' financial positions, the Yield-X approach has been adopted. Therefore, all members who are not subject to specific exemptions as contained in the rules will be required to submit monthly capital adequacy reports to the exchange.

5.2 **Membership**

- 5.2.1 Provision is made for IDB's as a sub-category of trading member.
- 5.2.2 IDBs will be subject to the same provisions applicable to trading members. However, specific provision has been made in the rules restricting an IDB from taking any proprietary positions when transacting in bonds. The IDBs are also obliged to provide to members, a list of their clients who may be counterparties to matched principal trades facilitated by the relevant IDB. These provisions have been adopted from the BESA rules.
- 5.2.3 Members of the BESA market were required in terms of the BESA rules to also be admitted as members of the market associations in order to obtain membership status on BESA. This requirement will no longer be applicable post integration as the market associations will not play a role in the membership application process.

5.3 **Registered Officers**

5.3.1 Settlement Officers-

Provision is made for the appointment and registration of **an alternate settlement officer** to carry out the responsibilities of a settlement officer in the absence of the latter. Directive BD has been amended accordingly to include the requirement for the appointment of an alternate settlement officer. The requirement to register a settlement officer and an alternate is a new requirement for all BESA members, whereas the requirement to register an alternate settlement officer is a new condition for members of the Yield-X market.

5.3.2 Compliance Officers-

The qualification requirements as they applied under the BESA rules have been adopted for compliance officers for the integrated rules. These qualification requirements are set out in Directive BD. However, the BESA requirement to have an alternate compliance officer will not apply in the integrated market. The BESA rules also imposed an obligation on members to appoint representative officers and alternate representative officers. The requirement to have a representative officer will no longer apply post integration.

The status of compliance officers for both the BESA market and the Yield-X market has been discussed in paragraph 3 above.

5.3.3 Dealers/Traders-

The qualification requirements applicable to dealers in the Yield-X market have been adopted in their entirety and will be applicable to all dealers authorised under the new rules.

Directive BB has been amended to ensure that all registered traders under the BESA rules are authorised to trade under the new rules. The transitional provisions in paragraph 3 above clarify the status of all dealers.

6 Disciplinary Matters – Section 4

- 6.1 The Yield-X disciplinary process has been adopted.
- 6.2 In terms of the transitional provisions, this disciplinary procedure will apply to the investigation and prosecution of any offence committed in terms of the BESA rules prior to the repeal of such rules.

7 Dispute Resolution – Section 5

- 7.1 The Yield-X dispute resolution procedure has been adopted.
- 7.2 The Yield-X dispute resolution procedure is similar to that of BESA in most respects, save for the internal complaints handling procedures which members of the BESA market will not be familiar with.
- 7.3 Members of the BESA market will be required in terms of the integrated rules to establish and maintain appropriate procedures for the handling of client complaints.
- 7.4 The transitional provisions as contained in the integrated market rules provide that the dispute resolution procedure will, from the effective date, be applicable to the resolution of complaints and disputes referred in terms of the BESA rules prior to the repeal of the BESA rules.

8 Trading – Section 7

8.1 Central Order Book

- 8.1.1 The trading system and the rules provide for both a central order book and the ability to report transactions negotiated off the central order book to the trading system. The rules state that all transactions must be executed through the central order book, unless they qualify as report only transactions. See rule 7.10.
- 8.1.2 However, we have not at this stage introduced a requirement for bond transactions to be executed through the central order book. Therefore all bond transactions qualify as report only transactions. Nevertheless, members can obviously use the central order book if this will achieve the best result for them and their clients in executing a bond transaction.

8.2 Trade Reporting

- 8.2.1 The following trade reporting principles have been adopted from the BESA Rules and included in the new rules to give effect to the integration (see rule 7.120.2).
- 8.2.2 The BESA 30 minute reporting rule will apply for the reporting and confirmation of REPORT ONLY transactions. In terms of this rule, members are required to comply, *inter alia*, with the following-
 - 8.2.2.1 where two trading members are party to a reported transaction, one trading member will be responsible for the reporting of the transaction to the trading system while the other trading member must confirm the details of the transaction on the trading system. The reporting and confirmation must occur within 30 minutes of the transaction being concluded; and
 - 8.2.2.2 in order to ensure that the parties discharge their reporting obligations within the prescribed time, the time at which the trade was concluded

must also be recorded on the trading system by the parties to the transaction.

8.2.3 It is important to emphasize that all trades between two members and between a member and a client must be reported within the 30 minute timeframe.

8.2.4 There will be different market times for REPORT ONLY transactions and central order book transactions. These times are set out in Directive CA. All late trades or trades that are concluded by the parties after trading system hours are exempted from the 30 minute rule requirement, BUT they must be reported to the trading system by 09h00 the following business day.

8.2.5 The penalties applicable in the BESA market for contraventions of the 30 minute rule and the reporting time rule have been adopted in the new rules. The prescribed penalties are set out in Directive CJ.

8.3 Broadcasting of bond prices

The price transparency provisions applicable to IDB's in the BESA market have been adopted. This provision requires all members of the exchange who broadcast prices in JSE listed bonds to provide access to those prices to the exchange in order to promote liquidity, transparency and effective regulation of trading in bonds. (see Rule 7.30.6).

8.4 Client agreements

In terms of the transitional provisions, all client agreements concluded between BESA members and their clients in terms of the BESA rules shall remain in effect as at the effective date of the new rules, but those members must ensure that their agreements comply with the terms and conditions as contained in Directives DC and DD. See rule 7.80.1 in this regard.

8.5 Client acceptance procedures

The rules have been amended to recognise that members no longer "register" clients with the JSE by submitting registration forms to the JSE, but instead open accounts for their clients via the trading system and record those personal particulars that are required by the system. See rule 7.80.2 in this regard.

8.6 Aggregation, division and allocation of trades

See rule 7.100.

Members of the BESA market will need to familiarize themselves with this rule relating to the use of agency suspense accounts.

All members should also take note of the clarification provided in new rule 7.100.7 regarding the use of dedicated suspense accounts. Further requirements are contained in Directive CB.

8.7 Principal assignment trades

See rule 7.110.

Members of the BESA market will also need to familiarize themselves with this rule relating to the concept of a principle assignment trade, whereby a member assigns a trade on the central order book to a client at a price that includes the member's profit. Further requirements are contained in Directive CC.

8.8 Correction of trades

Members of the BESA market are permitted in terms of the BESA rules to effect equal and opposites of reported trades themselves. In terms of the new rules, members can only do so up to 10h00 on the day after the original trade date. Any corrections after that time can only be effected by the Settlement Authority and not by the member because these late corrections have an impact on the Settlement Authority's monitoring process. See rule 7.130

9 Clearing-Section 8

- 9.1 The clearing provisions will be applicable only to transactions executed on the central order book and those which are reported to the trading system and accepted by a clearing member for risk management purposes.
- 9.2 The BESA rules did not make provision for the clearing of the securities listed on BESA. Therefore BESA members may not be accustomed to this practice and are obliged in terms of the rules to appoint a clearing member who meets the eligibility requirements as set out in the rules, if they wish to execute transactions on the central order book or have reported transactions cleared by a clearing member. The prescribed clearing agreement is as set out in Directive DB.
- 9.3 Members who are subject to these clearing provisions are also obliged to pay clearing fees in terms of the rules.

10 Settlement-Section 9

- 10.1 The provisions applicable to the settlement of transactions in bonds are set out in section 9 of the integrated rules.
- 10.2 The JSE Settlement Authority is responsible for the management of the settlement of transactions in bonds.
- 10.3 Members must note that the deadline for the commitment to settle by a CSDP has been changed from 12h00 on T+2 to 11h00 on settlement date.
- 10.4 Non-member settled clients must, by 16h30 on S-1, ensure that their CSDP will be in a position to settle on settlement day (see rule 9.80).
- 10.5 Member settled clients must ensure that by no later than 12h00 on T+1 the member who effected the transaction will be in a position to settle the transaction on settlement day. See rule 9.90.
- 10.6 Trading members must ensure that by 16h30 on S-1, their CSDP will be in a position to settle the member's own transactions and those of its member settled clients on settlement day. See rule 9.100.
- 10.7 Trading members have an obligation to notify the Settlement Authority if for any reason settlement is unlikely to take place.

10.8 Failed trade procedures

10.8.1 The rules make provision for failed trade procedures applicable to trades that are subject to clearing (see rule 9.140) and to reported transactions (see rule 9.150).

10.8.2 The failed trade procedures will be applied by the Settlement Authority if a trade is not going to settle on settlement day and the Settlement Authority does not deem it appropriate to roll the settlement to a revised settlement date.

10.9 Rolling of settlement

Provision is made in rule 9.130 for the rolling of settlement if the Settlement Authority, in its discretion, believes that the rolling of settlement is the most appropriate action to take to ensure that a trade still settles.

10.10 Other Settlement Authority actions

Rules 9.160 to 9.180 provide for various actions that can be taken by the Settlement Authority to facilitate settlement of a transaction on settlement day.

10.11 Margin Requirements

The margin requirements in rule 9.120 will be applicable ONLY in respect of central order book transactions or trades which are accepted for risk management by clearing members.

10.12 Penalties and fees

The Settlement Authority is entitled in terms of the rules to impose a penalty on a trading member which fails to effect instructions or settlement in accordance with the settlement timetable as prescribed by Directive EI, and to charge fees for various actions associated with the settlement process.

10.13 Settlement Directives

Members should also familiarize themselves with the settlement provisions in Section E of the Directives. These Directives expand on many of the principles in the settlement rules, and incorporate a timetable of the actions that need to be taken both prior to the execution of trades and during the settlement period to ensure that settlement will take place.

11 Conduct of Business - Section 10

11.1 The provisions relating to conduct of business by trading members as contained in the Yield-X rules have been adopted and will be applicable to members operating under the integrated rules. The attention of members is drawn in particular to the following provisions:

11.2 Telephone recordings

11.2.1 The BESA rules provided an option to members to keep telephone records in order to use them in the event of a dispute that may arise. There was no specific period attached to this provision in the BESA rules.

11.2.2 The integrated rules impose an obligation on all members to retain the records of all their telephone calls for a period of at least 14 days.

11.3 Segregation of members' and client funds

The Yield-X provisions have been adopted. See rule 10.40.

11.4 Rule 10.50-Management of funds by SAFCOM

This provision allows trading members to, *inter alia*, deposit additional or retained margin with SAFCOM.

11.5 Rule 10.70-Trading member bank account

This provision shall apply where additional margin or retained margin is not deposited by the clearing member with SAFCOM. The provision requires the trading member to keep separate trust accounts and a proper record of all margin deposits made by its clients to ensure that all required amounts to cover client positions are available.

11.6 Rule 10.80-Members accounts with the CSDP's

This provision imposes an obligation on the member to keep separate accounts with its CSDP for the purpose of segregating clients' bonds from its own positions.

11.7 Rule 10.90-Trading member's holdings

This provision imposes an obligation on the member to keep proper records of the bond holdings of its clients. The ownership of such bond holdings must be properly identified by the member.

11.8 Rule 10.105-Acceptance of cash deposits

This provision prohibits members from accepting or receiving cash deposits from any client in an amount exceeding R5000.

11.9 Rules 10.110 to 10.150

These provisions are applicable to members who have Non-resident and Emigrant clients.

11.10 Rules 10.160 to 10.180

These provisions are relevant to members who are responsible for the management of investments

11.11 Rule 10.190

Deals with the management of foreign investments

11.12 Rule 10.200

Makes provision for transactions with a discretionary financial services provider ("FSP") to ensure that they are authorised to act as an FSP in terms of the FAIS Act when a trading member transacts on their behalf.

11.13 Rule 10.210

Makes provision for the provision of written statements of account to clients by a member authorised to manage client investments.

11.14 Rule 10.215

Makes provision for investment advice to only be provided by employees of members who have obtained the prescribed qualification requirements in terms of the Directives.

12 Defaults - Section 11

The default provisions as contained in the Yield-X rules have been adopted.