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**PROPOSAL FOR FORMALISING CENTRALISED CAPITAL  
MARKETS ON SADC STOCK EXCHANGES**

**Produced by the Bond Exchange of South Africa**

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**PROPOSAL FOR FORMALISING CAPITAL MARKETS ON SADC STOCK EXCHANGES**

◆ **EXECUTIVE SUMMARY**

The requirements for the development of capital markets need to be addressed within the broad macro ambit of, *inter alia* –

- ◆ Financial market legislation
- ◆ The Registrar of Financial Markets
- ◆ The Central Bank role
- ◆ The financial market structure
- ◆ The financial market – participants / investors

There are developments within the financial market structure that also need to be addressed, *inter alia* –

- ◆ Exchange structure
- ◆ Membership /access
- ◆ Rules and directives
- ◆ Systems including trading, clearing, settlement and securities depository
- ◆ Risk management

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## **INTRODUCTION**

This document has been prepared in order to formalise secondary bond trading by market participants in SADC member countries on SADC Stock Exchanges.

The importance of promoting, achieving and co-operating among market participants and SADC Stock exchanges, to develop the secondary bond markets will enhance investment opportunities and the financial markets in the region. The SADC member countries have to now compete with other emerging markets and expand its cross-border activities.

At the advent of the reduction and elimination of Exchange Control Regulation and the possible introduction of a single currency in the SADC region by its SADC member countries the SADC Exchanges will be in a position to facilitate cross-border issuance and investment.

## **PURPOSE FOR THE DOCUMENT**

The development of a debt securities market is an important initial step towards the formation of the basic rudimentary structure of the capital market. It is an important way of attracting both domestic and international funds should be high priority on the agenda of SADC Stock Exchanges, Committee of Governors and the Council of Ministers.

The debt markets sit at the low end of the risk profile of the capital market and provide government, provincial and local authorities, parastatals and major corporations with an important source of short, medium and long-term debt financing.

A functional secondary market will bring together all market participants, leveling the “playing fields”, creating a sophisticated and competitive, efficient financial market.

A developed secondary market will facilitate the creation of a range of new services and debt products.

The development of a yield curve on a wide range of actively traded debt securities will result in a benchmark security which market participants will use in setting up their trading, investment / lending and borrowing policies.

The financial markets thrive on information. An efficient secondary market will ensure transparency, which is about price discovery, together with investor protection via trade reporting, matching, and clearing and settlement and clear regulation.

It is intended that the document be used by different parties for their own specific requirements, as well as to reach consensus on the various issues which are currently delaying, or in future could delay the developments of these bond markets in the SADC region.

In order to achieve this it is necessary to, *inter alia* -

- Define the objectives of the bond market within the structures of SADC Stock Exchanges;
- Identify the cost benefits within the structures; and
- Identify the overall benefits within the structures.

To achieve a developed secondary bond market in SADC member countries it is necessary to bring all market participants together and formalise bond trading.

## **USE OF THE DOCUMENT**

The requirements for the development of secondary bond markets need to be addressed within –

- The financial markets legislation
  - (a) The Act;
  - (b) The Registrar;
  - (c) The Central Bank;
  - (d) The membership;
  - (e) The financial market; and
  - (f) The financial market participants / investors.
- The SADC Stock Exchanges
  - (a) Structure;
  - (b) Membership;
  - (c) Rules and directives;
  - (d) Systems;
  - (e) Services including clearing, settlement and custodial;
  - (f) Risk Management; and
  - (g) Finance.
- To examine the relative advantages and disadvantages of the various market participants.
- To identify means of reducing risk in the market.
- To examine the costs relative to the implementation of a secondary bond market, as well as the cost benefits that can be achieved.
- To explain the reasons for the developments.
- To serve as a decision base for developing bond markets on SADC Stock Exchanges.

## **FORMALISATION OF THE BOND MARKETS**

The possibilities of systemic risk, ie failures of significant market participants or technical failure of the system – systemic risk manifests itself in the financial system during the payment and settlement process if some parties do not meet their obligations. It is a cross-market phenomenon in that problem in one market has “knock-on” effects in other markets. For example the Emerging Markets crisis during 1998 – 1999 affected the South African bond market.

The formalisation of bond markets, as in South Africa, will –

- Safeguard the interest of investors;
- Encourage orderly markets;
- Encourage cross-border investment;
- Encourage the development of more financial products; and
- Level the playing fields (vested interest still remain).

In order to achieve the above, SADC Stock Exchanges need to provide for –

- Organised bond trading;
- Remove restrictions for membership;
- Develop an efficient market wide clearing system, extended to all secondary market participants;
- Centralised market information;
- Settlement of scrip and funds through the establishment of a centralised scrip depository for bonds thereby eliminating tainted scrip.

The SADC Stock exchanges will provide –

- The existing structure to the bond market;
- Obstacles to a more active bond market removed;
- Centralised reporting system / market information;
- Supervision and management of an orderly bond market;
- Standardised Rules;
- Standardisation of financial instruments; and
- Centralised clearing system.

The formalisation of the bond market should provide for the restriction on the buying or selling listed bonds, *inter alia* –

1. No person shall carry on the business of buying and selling –
  - (a) Unlisted bonds on a financial market on behalf of other persons or on his own account; or
  - (b) Listed bonds on behalf of other persons or on his own account unless –

- in the case of such buying and selling on behalf of other persons he is a member of the SADC Stock Exchange;
  - in the case of such buying and selling on his own account, he is a member, or is a person other than a member and the buying and selling is effected through a member of the SADC Stock Exchange.
2. A person shall be deemed to be carrying on the business of buying and selling listed bonds if –
- (a) It is a regular feature of his business to buy and sell bonds on behalf of other persons or on his own account;
  - (b) He holds himself out as a person who carries on the business of buying and selling bonds.

### **SADC STOCK EXCHANGES**

The principles SADC Stock Exchanges need to cover are –

- Self regulation of bond markets;
- Equal competition – provide an environment of fair and secure trading;
- Centralised formal markets – no off-market trading;
- Rationalise clearing – improved quality of information and service;
- Client protection – no counter or third party risk;
- Price integrity – price discovery;
- Market stability – with proper risk management techniques that will embrace cross-market and cross border risks;
- Uninterrupted trading;
- Harmonise the interests of issuers, investors and intermediaries, irrespective of whether they are members or clients; and
- Ensure all participants are of good character and high business integrity; and
- Provide for a system of examinations and to determine the standards of training necessary to be an exchange participant.

### **SADC STOCK EXCHANGE BOND MARKET DIVISION**

In order to develop the operations of a bond market within the SADC Stock Exchange structures the bond market industry representation should include representation from –

- Registrar of Financial Markets / Stock Exchanges;
- The Central Bank;
- The Commercial banks;
- The investment banks;
- Investors (Insurance and Portfolio Managers);
- Issuers;

- Stock brokers; and
- Other intermediaries.

### **CENTRAL BANK ROLE**

The involvement of the Central Bank in the development of bond markets on SADC Stock Exchanges is –

- The Central Bank has an interest in maintaining the safety and soundness of the financial system and the integrity of the payment system;
- The concept of level playing fields between groups of players in the market necessitates the examination of methods to reduce onerous requirements on one group or another in order to aim for a competitively neutral situation;
- The Central Bank, through the regulatory process, has a major interest in cross-market risk. Large exposures in one market may influence the stability of other markets;
- The Central bank is one of the major participants in the market, through its open market and money market functions in Government - Treasury bills and stock.

### **THE MEMBERSHIP**

Membership of a financial exchange should not be limited or restricted to the traditional homogeneous membership and should include financial institutions, banks and inter-dealer brokers, etc.

The membership of the SADC Stock Exchanges Bond Division must be made up of a number of categories of institutions, as well as small less capitalised members. The Exchange's need to cater for all types of members, which will be addressed through the Rules of the Exchange.

The basis of approach to the development of a formal bond market must be centered on the market being open to as wide a membership as possible at the lowest possible cost.

### **THE FINANCIAL MARKET PARTICIPANTS**

The development of the bond market needs to provide for the various groups in a single market. Once this principle is adopted it becomes imperative to move away from the current method of operation which is based largely on counter-party risk. Counter-party risk is to a large extent negated by the use of bank marked cheques.

Bond trading members will be governed in terms of each country's Stock

exchanges / Financial Markets Acts and the Rules of the Exchange. Other market participants will be clients of members.

### **OBJECTS OF FORMAL BOND MARKETS**

The Exchange's will –

- Regulate trade in bonds in terms of its own rules and the specific requirements of the country's Stock exchange / Financial Markets Acts;
- Be viewed to promoting the development, credibility and orderliness of its market(s) in bonds that it lists, which will entail the necessary element of investor protection;
- Provide for foreign / remote or third party / portfolio manager membership tier within the Exchange structure.

### **MARKET NEEDS**

In order for a financial market to operate in an efficient, transparent and secured manner, the information needs to be –

- *Accurate;*
- *Timeously* distributed / available to all on an equitable basis;
- *Uniform;*  
The price dissemination information must be reliable when trades are reported timeously and every market participant should have access to price-sensitive information.
- *Cost effective;*  
The market information must be affordable.
- *Audit trail to source.*  
The audit trail of market information, which may have affected market price movement, can be traced back to its originator.

The elimination of any opportunity for front running, fraud, market rigging by the delay or corruption of market prices through the clean and prompt availability is critical.

The information can be fed to the market real-time from official sources (financial exchanges, clearing-houses and via information vendors).

### **CONCLUSION**

- **CENTRALISED MARKET RULES**

A centralised financial market brings together buyers and sellers, ensures trades take place at competitive prices and maximises liquidity.

A centralized financial market levels the “playing field” under self regulation (exchange rules) where economic efficiencies will attract further business opportunities for market participants with the purpose of market stability, integrity and investor protection.

- **INTERNATIONALLY ACCEPTED SETTLEMENT RULES**

The growth and development of cross-border trading is dependent on whether the host country has implemented the investor protection measurements on clearing and settlement as recommended by the G30 (Group of Thirty) and thus secure delivery versus payment will take place. Most of the SADC Stock Exchanges have implemented a number of these clearing and settlement recommendations.

- **CROSS LISTINGS**

The SADC members should consider, *inter alia* –

- ◆ When there are cross-border offerings or listings, which take place within the SADC region, the issuer must have its registered office in a member country or any other country with acceptable regulation.
- ◆ The host country’s regulations must be recognised by the SADC member countries in which an application for listing has been lodged, without the issuer being required to obtain the approval of the supervisory authorities of that member state(s).

## **RECOMMENDATIONS - LISTING ON EXISTING STOCK EXCHANGE INFRASTRUCTURES**

There is the need to modernise existing or establish new capital markets within the SADC membership. The policy makers should build on the existing Stock Exchange infrastructures to set up a centralised debt securities market and not allow the development of separate licensed Bond Exchanges nor the continuation of the existing fragmented financial market structures. The “one centralised market with all products’ (equity, debt securities and futures) is the overall final objective. This will facilitate the necessary economics of scale, efficiencies, transparency, and price discovery and market integrity.

The SADC members should consider –

- ⊖ That each SADC country establishes a **secondary market in government bonds** as a first step towards the strengthening and development of regional capital markets.
- ⊖ That regional bond markets be established and operated under **centralised market rules and internationally accepted payment and settlement rules (G30 recommendations)**.
- ⊖ That **infrastructure debt issuance be encouraged** and supported and cross listings across SADC member states be facilitated as part of capital market integration and **cross border capital raising and investment**.
- ⊖ The financial market regulators, in particular the central banks, facilitate and institute **market making systems** as a necessary and important financial market infrastructural step that provides liquidity and encourages **broad participation by individuals and institutions**.
- ⊖ That at the outset SADC countries adopts common practices and **harmonisation of bond listing requirements**.