BANKING AND FINANCE
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4 September 2018

Bill amending the South African Insolvency Act on OTC derivatives published for comment

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As we have written in a number of previous articles, National Treasury, together with the Prudential Authority and the Financial Sector Conduct Authority, has recently rolled out various pieces of legislation to bring South Africa closer to compliance with its G20 commitment to regulate over-the-counter ("**OTC**") derivatives in South Africa. Detailed requirements are now being harmonised, including through proposed amendments to existing legislation.

On 24 August 2018, National Treasury published the Draft Financial Matters Amendment Bill, Notice 501 of 2018 (the "**Bill**"), among the stated purposes of which is to amend the Insolvency Act, 1936 (the "**Insolvency Act**") "to provide for a process when a creditor realises his or her security in terms of a master agreement". The amendment will facilitate the phasing in of another recently published piece of draft legislation, the Final Draft Joint Standard on Margin Requirements, August 2018 (the "**Draft Margin JS**"). Once the Draft Margin JS comes into effect and is phased in, certain OTC market participants (known as "**covered entities**") will be required to post and collect both initial and variation margin in respect of all of their OTC derivatives transactions. The Draft Margin JS will further guide covered entities in determining amounts of margin, acceptable types of collateral, thresholds and other requirements pertaining to collateral. The effectiveness of one aspect of the Draft Margin JS, however, has been repeatedly questioned by market participants in comments to previous drafts.

Historically, in respect of non-cash collateral (both equity and debt securities), South African counterparties have had a choice of either transferring the collateral outright in security, or pledging and ceding the collateral in *securitatem debiti* (by way of a pledge). Among other considerations, outright transfers gave the secured party the advantage of enforceable post-insolvency netting under section 35B of the Insolvency Act, but offered the posting party no protection in respect of its interest in the collateral. On the other hand, pledges protected the posting party's interest in the collateral, but required the secured party to follow a potentially onerous collateral enforcement procedure set out in section 83 of the Insolvency Act in the event of the posting party's insolvency. As currently drafted, section 83 allows a secured party to realise collateral (including equity and debt securities), but section 83(10) requires the secured party to then pay the net proceeds of the realisation to the trustee or the Master, prove the secured party's preferred claim and then wait for payment of the preferred claim by such trustee or the Master.

Due to the above factors, it has been difficult for South African market participants to understand how two of the requirements of the Draft Margin JS (and its preceding drafts) could be met simultaneously. Paragraph 4.3(1)(*g*) requires that the posting party must have legally enforceable protection against the loss of the collateral, which would direct the use of a pledge of the collateral, while paragraph 4.3(2)(*a*) of the Draft Margin JS would direct the use of an outright transfer, stating in relevant part that "[i]nitial margin must be held in such a manner that it is **immediately available** to the person that collected the initial margin in the event of the counterparty's default…" (our emphasis). As described above, pledged collateral cannot be classified as being "immediately available" to the secured party in the event of the posting party's insolvency due to the secured party being required to pay over all of the proceeds of realisation in terms of section 83(10) of the Insolvency Act.

The Bill proposes to amend section 83 of the Insolvency Act to exempt the proceeds of collateral realised in terms of a "master agreement" as defined in section 35B of the Insolvency Act (which would include an ISDA Master Agreement governing OTC derivative transactions) from the requirements of section 83(10) of the Insolvency Act. Rather, the secured party will be required to notify the trustee or the Master and confirm the terms of the relevant OTC derivative transaction and collateral arrangements, pay over any **excess** proceeds to the trustee or the Master and, should another creditor object, follow a defined dispute resolution procedure.

Market participants will certainly welcome the exemption from section 83(10), but may not be as enthusiastic about other amendments to section 83. In particular, the proposed new section 83(10A)(*a*)(iii) of the Insolvency Act states that "if the net proceeds of the realization are less than the value of the claim, [the creditor must] not submit a further claim against the estate in question for payment of the balance." The effect of this proposed new section will be that OTC derivative transactions for which pledged collateral has been realised on the insolvency of the posting party will become statutorily limited recourse to the extent of the initial margin and/or variation margin posted. No further unsecured claim by the secured party will be permitted. Seemingly, however, a secured party that took collateral by outright transfer would not be limited in the same matter. It is not clear why such a distinction should be made, or why statutory limited recourse should be imposed on certain secured parties in OTC derivative transaction. It should also be considered whether the proposed dispute resolution process undermines the "immediate availability" of the collateral to the secured party.

Comments to the Bill are due by 14 September 2018, and can be sent to commentdraftlegislation@treasury.gov.za.

For more information or assistance in submitting comments on the Bill, please contact:

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