SOUTH AFRICA

SECURITIES

SUMMARY

Foreign participation in South Africa's two securities exchanges and one futures exchange – the Johannesburg Stock Exchange (JSE), the Bond Exchange of South Africa (BESA), and the South African Futures Exchange (SAFEX) – has increased significantly during the past three years. U.S. firms have established a presence in the equities, bond, and derivatives markets and are expanding their involvement steadily.

A restriction on foreign membership in the JSE was lifted in 1996. Several U.S. firms are trading members of the BESA and non-clearing members of the SAFEX. Although the Financial Services Board (FSB) is responsible for the coordination of overall regulatory policy affecting financial markets, the JSE, BESA, and SAFEX operate on a self-regulatory basis subject to the provisions of the Stock Exchanges Control Act of 1985. In order to enhance competitiveness and tighten regulatory oversight, the three exchanges in consultation with the FSB have agreed in principle to amalgamate all trading activities in one national exchange.

Financial authorities expect to present to Parliament a carefully-coordinated array of regulatory proposals within the next year aimed at bringing South Africa's regulatory and supervisory structure into conformity with global best practices. This will facilitate transition to unrestricted cross-border financial transactions based on a policy of national treatment. Looking forward, the Ministry of Finance is laying the ground for regional integration of financial markets by negotiating cross-listing agreements, integrated payments systems, and harmonized regulatory and technical standards with members of the Southern African Development Community (SADC).

A precipitous fall in the value of the South African rand in mid-1998 along with a sharp fall in equity prices caused nonresidents to reassess portfolio positions. According to South African Reserve Bank statistics, nonresident holdings of public sector and Eurorand bonds issued on behalf of South African parastatals increased during the first half of 1998 by R8.9 billion (US$1.4 billion) and R2.1 billion (US$323 million), respectively. Net foreign investment in South African shares during this period amounted to R19.4 billion (US$3.0 billion). Continued pressure on the rand and fallout from other emerging market realignments, however, resulted in a sharp reversal of foreign portfolio investment beginning in May 1998. Foreign investors reduced their holdings of South African bonds by R12.4 billion (US$2.0 billion) between May and July. Yet at the same time, foreigners remained net purchasers of JSE-listed equities in the amount of R12.0 billion (US$1.8 billion). Emerging market volatility and a global reassessment of risk by foreign investors is expected to place continued pressure on South African securities markets to bring regulatory, corporate governance, disclosure, and technological standards fully into line with major exchanges worldwide.

DESCRIPTION OF THE MARKET

Regulation

The FSB, comprising prominent industry representatives, supervises South African nonbank financial markets and portfolio managers. It licenses exchanges, conducts investigations, participates in the approval of new listings, approves amendments to exchange rules (with the right to impose rules unilaterally), and advises the Minister of Finance on regulatory matters. Under the oversight of the FSB, the three exchanges operate as self-regulating entities in accordance with procedures adopted by members in consultation with the FSB.

The regulatory structure of financial markets in South Africa has been undergoing significant change with the aim of reintegration into global markets after years of isolation and foreign exchange controls. The South African government has enunciated the goal of opening markets to unrestricted cross-border participation based on assurances of national treatment, elimination of exchange controls, and regulatory supervision in accordance with international standards.

Foreign Exchange Controls

Although foreign exchange controls have been relaxed significantly since 1994, South African corporations and individuals hold an estimated R2,000 billion (US$308 billion) in domestic assets still subject to capital account restrictions. Most large South African corporations have embarked on strategies of international diversification and are attempting to gain footholds in overseas markets. Many have pursued this goal through exchange-neutral asset swap arrangements with foreign investors approved by the South African Reserve Bank. The rapidly-growing Eurorand market constitutes another external source of funding for South African corporations. Although these factors are gradually venting some of the excess demand for offshore investment, there remains a large overhang of potentially volatile funds among South African investors. This has motivated South African authorities to maintain a carefully-staged approach to exchange control liberalization. Foreign investment in South African equity and debt instruments is not subject to foreign exchange regulation. As noted below, foreign investment and trading in South African securities have risen dramatically in tandem with market liberalization and deregulation.

Bond Market

The BESA was licensed by the FSB in 1996 as a self-regulatory financial exchange to replace the previous over-the-counter bond market. Members include major domestic issuers, intermediaries, and financial institutions. Foreign companies must incorporate as a public company in South Africa or register as an external company under the Companies Act of 1973 to acquire membership as either Trading or Broking Members. All members are required to meet capital adequacy requirements based on European Union guidelines. Several U.S. banks are BESA Trading Members, including J.P. Morgan Securities, Merrill Lynch, and Morgan Guaranty Trust of New York. The Ministry of Finance recently introduced an auction-system for primary issues and appointed 12 primary dealers (including five foreign securities companies) for the marketing of South African government capital market debt instruments. Two U.S. firms, J.P. Morgan and Merrill Lynch, are among the 12. These dealers enjoy exclusive dealing rights with respect to all domestic auctions of government bonds.

Compared to the equity market, the bond market enjoys very high liquidity, although trading is restricted to a few issues – primarily government (Republic of South Africa, or RSA) bonds and public utilities bonds. There is no significant corporate bond issuance. Total turnover in 1997 increased by 36 percent to R4.6 trillion (US$708 billion). Foreign participation in the market has risen rapidly since 1994. A sharp rise in Eurorand bond issues since 1995 has led to increased demand for long-term government bonds in the domestic bond market, used by Eurorand issuers as hedges for Eurorand exposure. Typically, Eurorand issues are swapped into other currencies, hedged by an offsetting acquisition of South African bonds.

Equity Market

The JSE, the sole licensed stock exchange in South Africa, initiated a broad restructuring program in 1995 which is expected to bring it into accordance with worldwide technical and regulatory standards by early 1999. In November 1995, membership was opened to foreign companies under new capital adequacy requirements applicable equally to domestic and foreign participants in the market. In 1996, the exchange introduced dual capacity (broker and dealer) trading, negotiated commissions, and introduced a new automated trading system. By early 1999, the JSE expects to have in place a fully-electronic scripless system of clearance and settlement. The JSE is promoting greater cooperation among regional stock exchanges to facilitate regional economic integration, cross-border investment, and foreign participation in the market.

At present, the JSE has 59 members, 11 of which are controlled by foreign companies. Merrill Lynch has purchased a controlling interest in a local securities firm. As of August 31, 1998, the JSE ranked number 21 worldwide in terms of total market capitalization, but remains less liquid than other major world exchanges due to the close-held ownership structure among large South African conglomerates and continued foreign exchange controls. Nevertheless, turnover rose by 77 percent in 1997, reflecting in part the rapid increase in foreign participation in the market. Foreign net purchases of South African equities have risen from R5.3 billion in 1996 (US$815 million) to R26.6 billion (US$4.1 billion) in 1997. Foreign ownership is estimated at 9 percent of total capitalization.

Corporate restructuring of South Africa's large conglomerates, sparked by increased global competition, deregulation, and a refocusing on core business activities, is gradually bringing South African corporate structures into closer conformity with international norms. This has resulted in a broadening of ownership, elimination of corporate "pyramids," restrictions on non-voting shares, enhanced disclosure standards, and greater liquidity in the market. The South African government is currently preparing legislation on competition policy, corporate disclosure, and information dissemination to shareholders. A new Insider Trading Act, based on international best practices, has recently been approved by Parliament. The FSB will be responsible for the administration of this Act.

Market Activity of the Johannesburg Stock Exchange

	1996	1997
New Capital Raised (US$ billions)	6.1	10.3
Value Traded (US$ billions)	25	42.5
Volume Traded (billion shares)	9.0	17.9
Number of Deals (million)	1.4	2.3
Liquidity (percent turnover)	10.9	16.9
Net Foreign Purchases (US$ billions)	1.1	5.4

Source: JSE, converted to US$ at year-end exchange rates.

Mutual Fund Market

South Africa's mutual fund industry has seen rapid growth in recent years. Total unit trust assets were R78.8 billion (US$13.4 billion) in end-June 1998, a 39 percent increase over end-June 1997. The number of mutual funds available reached 165 in end-June 1998. Equity funds represent approximately 70 percent of total assets. Under South African exchange controls, unit trusts can invest 15 percent of their total assets abroad subject to arranging matching capital inflows. Five percent of fund assets must be invested in local money market instruments. As of August 1, 1998, offshore collective investment schemes marketed in South Africa must be registered with the local regulatory authority. Registration criteria include: (1) the home regulatory environment must be at least of the same standing as that applicable locally; (2) the collective investment scheme must enter into a representative agreement or maintain a representative office in South Africa; (3) the risk profile of investments offered must not be significantly higher than that of similar local products; (4) investments offered must be permitted by local legislation; and (5) minimum advertising and information disclosure requirements must be respected.

Futures and Options Market

SAFEX began operations in 1990 under a license issued by the Registrar of Financial Markets which authorizes it to regulate the trading of futures and options as the only derivatives exchange in South Africa. The exchange offers financial and commodity futures as well as options contracts. All trading is conducted electronically. Daily trading volume has risen from 200 contracts in 1990 to roughly 40,000 contracts in 1997. Some 96 percent of futures and options traded through SAFEX are based on JSE equity index futures (the All-Share Financial, Mining Financial, and Industrial indices), with trading volume over twice the value of trades in underlying equities. Futures on individual equities are permitted. A rand/dollar futures contract was listed in 1997 with limited success due to continued foreign exchange controls and a well-developed forward market.

SAFEX offers membership in two classes, clearing and non-clearing members. Clearing members must be registered financial institutions in South Africa with a minimum net worth of R200 million (US$31 million) and provide a surety to the clearing house of R10 million (US$1.5 million). A non-clearing member must have an initial capital of at least R400,000 (US$62,500) and satisfy the executive committee that it has entered into a clearing agreement with a clearing member based on that member's careful evaluation of the non-clearing member's financial standing and integrity. To date, two U.S. companies hold non-clearing memberships in the exchange via local subsidiaries, J.P. Morgan and Merrill Lynch. The U.S. Commodity Futures Trading Commission has pending before it an application for a "no action" position to permit the offer and sale to U.S. customers of the All-Share Index (ALSI40) futures contract, which is based on the JSE's top 40 companies.

U.S. PRESENCE IN THE MARKET

U.S. participation in the South African securities industry is expanding rapidly. Since 1994, several U.S. securities companies have obtained memberships in the JSE, BESA, and SAFEX. Many U.S. firms are active in providing underwriting services and arranging asset swaps for South African government and non-government institutions. Most do not have permanent representation in South Africa, servicing the market out of U.S. or European offices. Financial advisory services, including privatization, corporate restructuring, mergers and acquisitions, and foreign placements (including asset swaps) have provided lucrative service-based business for U.S. bank and nonbank financial institutions.

Foreign investment in South African equity and debt instruments is not subject to foreign exchange regulation. U.S. investors, both individual and institutional, have increased their presence dramatically.

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TREATMENT OF U.S. FINANCIAL INSTITUTIONS

As noted above, there are no legal prohibitions on foreigners operating in the South African securities industry. Financial services currently constitute the most rapidly expanding sector of the economy, with South Africa occupying an important position in the region. Industry and government are working closely together to bring the securities industry into full conformity with international "best practices" on the basis of national treatment for foreign participants and technological innovation, with South African authorities committed to a leadership role for the region in GATS negotiations. A major issue will be the ability of local authorities to phase out exchange controls expeditiously to achieve full integration with world financial markets and remove the inhibiting effects of capital restrictions on foreign participants in the securities industry.

Exchange Rates Used:

August 1998	6.50 R/US$		
June 1998	5.87 R/US$		
Average 1997	4.61 R/US$	Year-end 1997	4.87 R/US$
Average 1996	4.30 R/US$	Year-end 1996	4.68 R/US$