COMPETITION TRIBUNAL OF SOUTH AFRICA

Case No: 22/LM/Feb09

In the matter between:

JSE (Pty) Ltd	Acquiring Firm
And	
Bond Exchange of South Africa (Pty) Ltd	Target Firm

Panel	:	Y Carrim (Presiding Member), M Mokuena (Tribunal Member) and N Theron (Tribunal Member)
Heard on	:	03 June 2009
Order issued on	:	03 June 2009
Reasons issued on	:	06 August 2009

Reasons for Decision

INTRODUCTION

[1] On 03 June 2009 the Tribunal unconditionally approved the acquisition by the JSE Ltd of Bond Exchange of South Africa Ltd. The reasons follow below.

PARTIES

[2] The primary acquiring firm is the JSE Ltd ("JSE"), a public company listed on the JSE main Board. The five largest shareholders of the JSE are as follows:

- Public Investment Corporation 5.62%
- Arch Equity Market Holding (Pty) Ltd 4.14%
- Standard Financial Markets (Pty) Ltd 3.46%

- JP Morgan Securities Ltd (Equities) 3.44%

  American Funds Smallcap World Fund 3.22%

[3] The primary target firm is the Bond Exchange of South Africa ("BESA"), a private company with the following five largest shareholders:

- NZX Holdings No.3 Ltd 22%
- Investec Bank Ltd 14.15%
- Standard Bank CIB 6.9%
- PSG Prime (Pty) Ltd 5.98%
- Purple Capital Ltd 5.34%

DESCRIPTION OF THE TRANSACTION

[4] BESA's shareholders agreed to transfer BESA's business to the JSE so as to enable the JSE to conduct the business of BESA with its existing businesses in an efficient manner. It is the JSE's intention to integrate BESA's business into its business through consultations with all stakeholders in the formulation of the fixed income growth strategy. Upon successful completion of the transaction, BESA would be wound up.

[5] The transaction was also approved by the Financial Services Board ("FSB"), the regulator of all financial exchanges in South Africa, in terms of section 57 of the Securities Services Act 36 of 2004 ("SSA").

ACTIVITIES OF THE PARTIES

[6] The JSE is broadly involved in a number of markets that provide trading, clearing and settlement services across a number of asset classes which include equities, equities derivatives, agricultural derivatives and interest rate derivatives.

[7] Through the functioning of these markets, a wide range of professional and public financial data is generated which is provided to a wide selection of users, ranging from trading firms, data vendors, investors, financial institutions and financial managers.

[8] BESA's core activity involves providing service is to the interest–rate market, listing debt instruments and derivatives as well as providing electronic trade capture and matching for authorised users.

RATIONALE FOR THE TRANSACTION

[9] The JSE envisages, amongst others, that this transaction will result in the introduction of improved, common risk management processes, the need of which has been amply demonstrated by the current global financial market turmoil. The JSE further envisages that this merger will bring about enhanced product variety and increased liquidity through the establishment of a single venue for the trading of spot and derivative interest rate securities.

[10] BESA is considered to be more knowledgeable in debt markets and debt market surveillance and is also better networked in this field. This BESA strength is envisaged to be enhanced by combining with the JSE which is better resourced in the managing of on-exchange trading through a central order book, market surveillance, risk management through clearing systems and market regulation.

RELEVANT MARKETS

[11] The Commission identified two markets where the activities of the JSE and BESA overlap. These markets are the spot bond market and the interest rate derivative market. The Commission went on to further define three separate market segments for both these markets. For spot bonds the markets are listing and trading services, trade reporting and exchange related services and clearing and settlement. For interest rate derivatives the markets are trading services, trade reporting and exchange related services and clearing and settlement services.

1. Spot Bonds

[12] A bond is a certificate of debt with which an issuer contracts to pay the holder a fixed principal amount on a future date and usually, a series of interest payments during its life. A spot bond is a bond traded in the spot market, i.e.

a market in which financial instruments are sold for cash and delivered immediately.

[13] The trading of bonds comprises of the following services: pre-trade, trading and post-trade. Pre-trade entails the communication between counterparties to the trade that occurs before the trade itself. This communication can be done through the use of an exchange such as the JSE's Yield-X (a platform where bids and offers are posted) or off-exchange. In South Africa, trades mostly occur off-exchange, in a market known as the "Over-The-Counter" market ("OTC"). This market will be discussed further below.

[14] The trading itself primarily involves the matching of a buyer and a seller as well as the determination of terms and particulars of the trade. Once the pre-trade and actual trade services have been performed, post trade services will ensue. These services mainly involve the reporting of the trades on an exchange. In this regard, both exchange and OTC trades are typically reported to an exchange and this is where the merging parties mainly feature in the trading value chain.

Major Players in the trading of bonds

[15] The major players in the trading of bonds are the Primary Dealers ("PDs") and the Inter-Dealer Brokers ("IDBs"). The PDs in South Africa are ABN Amro, ABSA, Citibank, Deutsche Bank, Investec, JP Morgan Chase, Nedbank, Rand Merchant Bank and Standard Bank. The Primary Dealer System is largely designed to ensure liquidity in the government bonds market. There are certain rules that have been designed in order to allow the implementation of the PD system.

[16] The rules establishes the Department of Finance's (though the National Treasury) formal relationship with the PDs and provides a framework of obligations to which the PDs, the Department of Finance and the South Africa Reserve Bank shall adhere to, in order to ensure a high level of professional discipline. PDs are the only players active in the primary market for government spot bonds.

[17] The Inter-Dealer Broker ("IDB") system facilitates the buying and selling of debt securities between dealers and exchange members. The IDBs (who include Equisec Treasury Services, FCB Harrow Butler, Garban SA, SA International and Cape Market Brokers and TTSA Securities) operate on an agency basis by providing information and matching orders via a "cable" telecommunication process of the rates and nominal amounts. This deal information is simultaneously disseminated to different traders active in this inter-dealer trading process.

[18] As indicated above, the Commission indentified three relevant markets for spot bonds, i.e. listing and trading, reporting and exchange related services and clearing and settlement services. We will now briefly discuss each of these markets.

i. Market for listing and trading services

[19] The listing for bonds focuses on the information required by investors to assess whether the issuer can meet the capital and interest repayments obligations. Almost all bonds in South Africa are primarily listed on BESA, with some having a secondary listing on the JSE's Yield-X. However, all government bonds are primarily listed on BESA. These bonds are traded overwhelmingly in the OTC market. According to the Commission, the parties have in the past tried to bring the OTC trading onto the exchange, with futile results especially on the part of Yield-X (which was introduced mainly to bring the OTC market on exchange).

[20] In relation to trading services, the merging parties submitted that Yield-X is designed as a proper exchange in contrast to the BESA model which is strictly speaking not an exchange as defined in the SSA.[1] According to the merging parties, Yield-X is regarded as a proper exchange because it offers a full suite of services, including a central order book where bids and offers are captured on screen and automatically matched.

[1] The SSA defines an exchange as a person who constitutes, maintains and provides infrastructure for bringing together buyers and sellers of securities, matching the securities of multiple buyers and sellers and whereby a matched order for securities constitutes a transaction.

[21] An important distinction between a central order book and report only-transactions is that with the central order book, trades are executed on the exchange while with report-only transactions trades are executed in the OTC market and only reported on the exchange for settlement purposes. Thus Yield-X is designed to offer pre-trade services related to the communication of trades where bids and offers can be posted. Similarly, matching buyers and sellers is required for a sale to occur and for the particulars of trade to be determined. BESA's model offers neither of these services.

ii. Market for trade reporting and exchange related services

[22] In this market the OTC transactions are reported in an administrative or technological way that commonly serves two functions, i.e. to confirm the details of the OTC transaction and provide each party to the trade with the record of the transaction and to report the transaction to the institutions responsible for settlement.

[23] Each of the merging parties provides customers with electronic means to capture trades that are agreed on the OTC market for subsequent confirmation. The mechanism that is used to report via Yield-X and BESA differ slightly. With Yield-X one party enters the trade and the information is confirmed or edited by the other counterparty.

[24] On the other hand, BESA's model involves both counterparties entering the trade into their BTB system which then reconciles the entries from the two sides to identify discrepancies. Once the transaction is reported, the trade is then posted to Strate Ltd electronically by the BTB or Yield-X. Strate Ltd is a registered Central Securities Depository ("CSD") in terms of the Custody and Administration Securities Act No. 85 of 1992 (for the custody and administration of securities).

iii. Market for clearing and settlement

[25] Clearing and settlement services largely occur in the post-trade segment of the value chain for trading bonds. Clearing services by an exchange or a clearing house are currently not applicable in this value chain as the trading of spot bonds in South Africa occur in the OTC market. However, the Yield-X

model of a central order book would entail the use of a clearing house and hence to the extent that the Yield-X model was to be utilised the clearing services become relevant in this instance.

[26] Settlement of spot bonds primarily entails the process in which the seller transfers securities to the purchaser in exchange for cash payment. Spot bonds are settled under the so called “T+3”, meaning trades are concluded three days after they have been concluded by counterparties. As part of settling netting occurs - this involves the offsetting of obligations requiring settlement. The effect of netting is that settlement risk is reduced and the settlement process is reduced.

[27] Settlement is exclusively performed by South Africa’s central depository, namely, Strate Ltd, in which the JSE has a 44.5% shareholding.[2]

2. The market for Interest Rate Derivatives

Introduction

[28] Interest rate derivatives are instruments with prices or returns derived from the interest rates underlying other assets. As such these derivatives normally comprise a different asset class for most investors and are utilised by traders for different investment purposes from those of spot bonds.

[29] A peculiar feature about derivatives is their general liquidity and the low transactions costs. In addition, derivatives generally are leveraged instruments, meaning that counterparties can assume larger positions than their capital would otherwise permit. For these reasons, derivatives are usually employed to manage risks inherent in traders’ and investors’ portfolios, an aspect ostensibly different from the reasons dealers and investors hold securities such as bonds.

[30] The Commission found that the trading of interest rate derivatives is very similar to the trading of spot bonds and as such the relevant markets are also the same, i.e. the market for listing and trading services, trade reporting and

[2] According to the merging parties, the JSE was the founding member of Strate and retains a strategic shareholding due to the importance that settlement plays on the international competitiveness of the entire value chain of securities trading.

exchange related services and clearing and settlement services. The only marked difference between the spot bonds value chain and the interest rate derivatives trading chain is the clearing function performed by the exchange on which trades are reported.

i. The market for trading services

[31] Currently in South Africa, interest rate derivatives are also traded in the OTC market directly between counterparties without the involvement of intermediaries. Yield-X offers a platform for trading interest rate derivatives and as with spot bonds, it offers a central order book and report only trading. While Yield-X offers a full spectrum of interest rate derivatives products, the parties submitted that most of these products have never been traded.

ii. The market for trade reporting and exchange related services

[32] Both BESA and Yield-X provide report-only services, offering administrative functions on trades struck in the OTC market between counterparties. BESA only captures an electronic record on its platform. This record simply facilitates electronic capturing of the trades terms by the parties' back offices, thus reducing operational risk on the counterparties.

iii. *The market for clearing and settlement services*

[33] Clearing and settlement is described as the means by which trades are executed so that buyers receive title to the instruments they purchase and sellers receive payment. Derivatives trading across the world utilises clearing houses in order to mitigate the risks inherent in these products. In this regard, the clearing house assumes the liability of default for both parties to the trade, acting as both the seller and buyer to every trade on an exchange.

[34] The JSE utilises the Safex Clearing Company (Pty) Ltd ("SAFCOM") as it's clearing house on its derivative. On the other hand, BESA recently launched BondClear as its clearing house.[3] The Commission found that although the

[3] The parties submitted that at the time of this merger, BondClear had not yet reached implementation stage.

SAFCOM and BondClear provide essentially equivalent functions from a demand side substitutability perspective, the principal difference between them is in their financial backing. In this regard SAFCOM is backed by the guarantees of large regulated South African financial institutions while BondClear uses the balance sheet of Nasdaq OMX.[4]

RELEVANT GEOGRAPHIC MARKET

[35] In the market for trading services, the Commission found that for many companies (except multinationals), the domestic exchange is the natural place because domestic investors are usually better informed about the companies' activities. Further, resident traders do not trade South African bonds in other markets other than South Africa, primarily due to the cost of trading in other international platforms. The Commission, however, decided to leave the exact geographic market definition open since there are no competition concerns under any alternative market definition.

[36] In the markets for reporting and exchange related services and clearing and settlement the Commission found that some international customers are not able to settle transactions in the domestic market but rather settle these across international platforms such as Euroclear.[5] For resident traders, it seems that the market is national as none of their transactions are settled abroad. The Commission did not come to a definite conclusion of the relevant geographic market in these markets as the transaction does not lead to a substantial lessening or prevention of competition.

COMPETITION ANALYSIS

1. **Spot Bonds Market**

   i. *Listing and Trading Services Market*

[37] The Commission came to the conclusion that there is no overlap between the activities of the merging parties in this market as the trading of bonds occurs

[4] Nasdaq OMX, the third biggest derivatives in Europe, is the owner of seven Nordic exchanges and has been assigned an international credit rating of AAA.
[5] Although this appears to be done in small proportions. For example Standard Bank informed the Commission that only 1% of their annual turnover is settled in international markets.

in the OTC market wherein the actual matching of bids takes place and not on an exchange. The Commission also noted that although Yield-X provides a platform for this matching of bids and offers, in practice this platform has never been used by market participants.

[38] According to the Commission, the reason why Yield-X's platform has never been used is that the model of central counterparty is considered unworkable for spot bonds trading. This is mainly because South Africa operates a primary dealer model for bond trading, wherein the participants, namely, the PD's, are required by virtue of their licences to quote a bid and an offer to investors.

[39] It is thus not desirable for them to trade at prices that would otherwise be quoted in a central order book model, considering their obligatory position. The Commission went on to submit that using prices that are quoted in the central order book would imply that the PDs have to trade at forced prices and that is why they are unwilling to trade on-exchange as this renders their market-making obligations unprofitable.

ii. *Trade Reporting and Exchange Related Services*

[40] In this market the activities of the merging parties are directly overlapping as both are able to offer reporting and exchange related services for bonds traded in the OTC market. BESA has 83% market share, the London OTC 17% and the JSE's Yield-X 0.01% market share. From these market shares it is clear that Yield-X is not an effective competitor to BESA and therefore there is no competition concern arising in this market.

iii. Clearing and settlement

[41] As mentioned above, all bond trades are settled through Strate regardless of whether they are reported by Yield-X, BESA or by counterparties. A potential concern that could arise from this transaction is that the merged entity could now require that all spot bond trades be reported through them as the JSE is a shareholder in Strate. This concern was addressed by the merging parties who submitted that the JSE would not compel trading counterparties to report

spot bonds via BESA as opposed to settling directly with Strate because of the following reasons:

- Strate does not have regulatory power over traders,
- It is required by conditions imposed by the FSB[6] to grant fair access to its settlement to all participants and finally
- Representatives of the FSB attend all board meetings of Strate and therefore would be in a position to proactively ensure that Strate complies with the conditions on fair and equitable access.

2. Interest Rate Derivatives Market

[42] The Commission found that there are fewer issues arising from this market. Both merging parties have not captured this market as all trades have mainly occurred in the OTC market. In respect of reporting and exchange related services, the merging parties submitted that the interest rate derivatives trades are seldom reported via the exchanges with each of the merging parties comprising less than 1% market share in this market.

[43] In relation to clearing and settlement, the Commission investigated whether the integration of BESA's BondClear and the JSE's SAFCOM would be a competition issue as these are the only two securities clearing houses in South Africa.

[44] In this regard, the Commission found that market participants are in favour of this combination as they foresee better product offerings in this market arising post-merger. Amongst reasons given for this support is the fact that the complementary strengths of BESA and the JSE pooled together would allow for a better development of derivatives products than a situation wherein either merging party would be focusing on duplicating products.

[45] The Commission therefore concluded that there are no major competitive issues arising in any of the markets implicated by the merger. Nonetheless, the Commission further investigated other factors such as barriers to entry,

[6] Pursuant to the merger between Unexor and Strate.

countervailing power, the effects of the transaction on costs of trading and views of market participants.

3. Barriers to entry

[46] The Commission found that barriers to entry in all the affected markets are relatively high. In the listing and trading services a potential entrant needs to establish "network effects"[7] in order for entry to be effective. Further, in order to achieve liquidity, entry must be made on a large scale with the ability to quickly attract buyers and sellers. In the market for reporting and exchange related services the requirement for entry involves setting up technological systems such as the BTB system.

[47] For clearing services the requirements to set up a clearing house are also huge. In this regard, the Commission found that BESA's total costing estimation for establishing BondClear was approximately R48 million, excluding NASDAQ OMX's 20% contribution (paid via discount on the services rendered). Similarly, there has to be considerable establishment of infrastructure in order to settle all instruments requiring settlement.

4. Countervailing power

[48] The major players in the trading arena are large sophisticated commercial or investment banks (particularly the Primary Dealers) who have some considerable countervailing power in the process for trading bonds. The Commission states that this is reflected by the primary dealers' suggestion that they can devise alternative models of trading should any unfavourable outcomes arise from this merger. Further, it appears that pricing decisions by the exchanges are not unilaterally imposed but are rather carried out on a consultative basis.

5. Effect of the transaction on the cost of trading

[7] A network effect is a characteristic that occurs when a good or service is considered to have value to a potential customer which depends on the number of other customers who own the good or are the users of the service.

[49] The JSE has committed to a price freeze on the cost of trading for 2 years in a letter to the shareholders of BESA as well as to the FSB. From the responses received by the Commission, it seems that most market participants are not too concerned about the possibility of significant increases in the cost of trading post–merger. In this regard Future Growth suggested that it could simply trade less frequently should costs increase significantly post-merger. ABSA suggested that it would consider reducing its exposure to bonds and substituting with an alternative product where possible.

[50] Tradition Government Bond Brokers & Derivatives Brokers was concerned about price increases after the two year moratorium expired. However, it stated that as an international company, it can, in the face of significant increases in the cost of trading, resort to other alternatives, namely converting to Euroclear and start settling its bonds off-shore. It is also not a requirement that spot bond and interest derivatives trades to be reported on-exchange hence the OTC trade could continue unabated as a result of significant price increases.

[51] The FSB also noted that when Yield-X was launched, its prices were lower than those charged by BESA (the intention here was to attract investors to Yield-X). However, this did not happen even after BESA effected price increases for its members, i.e. trading activity remained at BESA. This also confirms that the level of competition between the merging parties is low.

6. Views of market participants

[52] The majority of market participants contacted by the Commission are in favour of the merger and suggested that South Africa will benefit from a single exchange. Standard Bank is of the view that the bond market would be better served through pooling resources in a unified exchange and focusing on improving scope, breadth and depth in the interest rate product space. The Rand Merchant Bank is of the view that the infrastructure resources of setting up two competing exchanges are counterintuitive considering the size of the South African bond market.

[53] FutureGrowth, Prudential and Investec Asset Management are of the view that having a single exchange is beneficial as it would promote better price discovery (which is deemed to have far more trading cost impact than slightly lower transaction fees that could be brought about by competition).

[54] The FSB, as the primary regulator, approved the transaction as required by section 57 of SSA. The FSB submitted that there are significant benefits arising from this transaction particularly in the area of fixed income product development, risk management, liquidity, elimination of regulatory arbitrage and global competitiveness of South African markets.

[55] In addition, the FSB stated in its submission that it is satisfied that the JSE would not renege on the commitments it made (inter alia, proper consultation with stakeholders on the implications of the integration and no price increases in the next two years) and that should the contrary happen, it reserves the right to impose conditions to the licence of the JSE as may be necessary to ensure the furtherance of the objects of the SSA.

[56] The National Treasury is also in support of the merger and is of the view that the merger should result in a reduction of costs through economies of scale resulting from the consolidation of infrastructure and more efficient use of overheads. The National Treasury also submitted that it recognises the JSE's intention to develop the bond market and to promote liquidity and innovation in the interest rate market, thereby capturing offshore trade back to South Africa. The National Treasury has also set out the following preconditions for the merger to ensure effective monitoring by the FSB:

- Requiring the FSB to monitor the JES's two year costs freeze commitment
- The National Treasury must be guaranteed of having two seats on the JSE Interest Rate Advisory Committee
- That there are no changes to market infrastructure without consultation with the National Treasury
- Requiring the JSE to submit a technology plan to ensure system reliability for the interest rate market and

- Requiring the JSE to present to the FSB and National Treasury a risk management framework for the bond market.

[57] There was only one concern raised about the transaction. This was from Purple Capital Ltd ("Purple Capital"), which has a 5.34% shareholding in BESA. BESA's shareholders had approved the merger. However Mr. Mark Barnes, Chairman of Purple Capital, had submitted some concerns to the Tribunal and had been granted an opportunity to address these concerns at the hearing. He submitted that this merger would result in a monopoly as there would be only one licensed exchange in South Africa. Mr. Barnes's further concern was that current global financial crisis will inevitably lead to the OTC being driven to trade on exchange, by regulatory intervention.

[58] Although this merger results in only one exchange, market participants have indicated that they envisage considerable benefits arising from the transaction such as, inter alia, increased liquidity and functionality as well as a broader range of products and services. Further, major players affected by the transaction have considerable countervailing power and have indicated that they can devise alternative models of trading should unfavourable outcomes arise post-merger. In addition, the JSE has made a commitment that there will be a proper consultation with all the stakeholders with regard to the post merger implementation process.

7. Conclusion

[59] Based on the above, we agree with the Commission that this transaction will not lead to a substantial lessening or prevention of competition in the affected markets as the current level of competition between the merging parties is extremely low. Further, the majority of market participants foresee more benefits than any anti-competitive outcomes arising from this merger. In addition, these participants are of the view that South Africa will benefit from a single exchange than competing exchanges, given the size of the economy.

PUBLIC INTEREST

[60] The transaction does not raise any significant public interest concerns.

____________________	**06 August 2009**
Y Carrim	Date

M Mokuena and N Theron concurring.

Tribunal Researcher	: I Selaledi
For the merging parties	: Adv D Unterhalter SC instructed by Nortons Inc.
For the Commission	: G Mutizwa