

Part K: The Deloitte & Touche Investigation into the activities of the financial
market participants

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K The Deloitte & Touche Investigation into the activities of the financial market participants

[1] Introduction

1 The Commission appointed Deloitte & Touche (“DT”) to conduct an investigation into the activities of the financial market participants. The investigation was performed by a team of six persons, including treasury, banking, structured finance and auditing experts (“the DT team”).¹

2 In terms of the Commission’s Terms of Reference, the entire rand market required investigation: all institutions involved in transacting, or making markets, in foreign currency in 2001 had to be investigated.

3 Each one of the millions of transactions in the global rand market has the potential to impact on the value of the rand. Foreign exchange transactions arise, inter alia, from investment, hedging, trade, financing or capital transactions, including dividend payments. A forex transaction therefore commonly represents only a part of a related series of financial commitments and structures, all of which require identification, analysis

¹ The DT team prepared a “Report on the Activities of South African Financial Markets Participants” and Mr A J Immelman gave evidence at Record 1574-1612

and understanding in order to assess the likely impact of an individual forex transaction on the rapid depreciation of the rand. Given the size and complexities of the market, the time, cost and effort required to perform a detailed analysis on a transactional basis was considered impractical given the reporting deadlines imposed.

4 Given those limitations, the DT team followed a two-phased approach:

Phase 1

- design, test and implement a methodology for investigating the activities of the market participants;
- which focuses on key periods which should be investigated;
- to lay the basis for forming an opinion on the activities of the institutions concerned;
- to ascertain whether those activities should be further investigated to identify the underlying transactions requiring further investigation;

Phase 2

- and if required, conduct a further detailed investigation to identify and report on the specific transactions and their effect on the value of the rand in accordance with the Terms of Reference.

- 5 The team focussed on the following criteria to identify areas of activity that were unusual or out-of-line and required further investigation:
- limits, trading ethics and the extent and composition of transactions;
 - the size of the bid-offer spread;
 - the level of forex related profits;
 - the magnitude of client transactions;
 - the extent of securities lending activities;
 - the degree of corporate and structured finance foreign exchange related activities; and
 - unusual activities on hot days.
- 6 The financial market participants dealt with by the team included authorised dealers; representative offices of foreign banks (“rep offices”); the Reserve Bank; BESA; the JSE; and South African Futures Exchange (“SAFEX”), a division of the JSE.
- 7 Due to the strategic, competitively-sensitive and authorised dealer-client confidential nature of certain of the information supplied by authorised dealers, the information was treated as confidential and was reported by the team at total authorised dealer level only. Where necessary, the

figures of individual authorised dealers were weighted by their share in terms of US dollar/rand turnover of the foreign exchange market to make average numbers meaningful at total authorised dealer level.

- 8 The team concentrated on the period September to December 2001 although the first eight months of 2001 were not excluded. The reason for the focus on the last four months of the year is that over the period 1 January to 31 August 2001 the rand depreciated by 10.7% or an average of 1.3% per month, while from 1 September to 31 December 2001, the rand weakened by 42% - an average of 10.5% per month.

[2] Approach

9

- 9.1 The major data source for the investigation into market participants' activities on-shore/on-shore and on-shore/off-shore were quantitative and qualitative responses to a questionnaire ("the Questionnaire")² sent to the following market participants: authorised dealers; Reserve Bank; rep offices; BESA; JSE and SAFEX.

² A copy of the Questionnaire is attached to Park K as Annexure "A"

9.2 Given the time restraints, the information supplied in response to the Questionnaires was accepted as correct and reliable and no audit was performed on the responses to verify their accuracy and completeness. Certain data supplied by the authorised dealers were corroborated by data supplied by the Reserve Bank. Mr Immelman explained in evidence the DT team considered very seriously the extent to which reliance could be placed on the responses to the Questionnaires and the time and cost required to perform a detailed audit to verify those responses. The team believed it could rely on the information supplied by the authorised dealers as they are obliged to comply stringently with the requirements of the Reserve Bank. The authorised dealers are subject to regular inspections by the Reserve Bank which are conducted both on-site and off-site. Furthermore, the authorised dealers were aware of the powers of the Commission which included phase 2 of the DT investigations. Accordingly, there was a very real possibility that a team of investigators would perform detailed investigations into detailed transactions.³

9.3 In addition to concentrating on the period 1 September to 31 December 2001, the team imposed special data requirements for those days identified as hot – where the most rapid depreciation

³ Evidence of Immelman, Record 1588-9

occurred – during 2001. Hot days were defined as those days with significant points move in the value of the rand as well as certain notable days. The notable days were identified by economists and financial market participants, such as 12 September 2001, the day after the attack on the World Trade Centre, and 15 and 16 October 2001, the days after the Reserve Bank announced the stricter enforcement of certain exchange control rules. The days regarded as hot in 2001 were 10 January; 8 March; 12, 13 September; 3, 15, 16, 22 October; 5, 21, 29, 30 November; 3-7, 10-14, 17-21, 24, 27 and 28 December.

- 9.4 A materiality test designed to retain at least 95% of transactions in the rand market was applied. If the daily turnover in foreign exchange/rand of an authorised dealer was less than or equal to USD350 million on any hot day, the authorised dealer was considered non-material. Subsequently, the same test was applied to all days in the period 1 September to 31 December 2001, with the same result. The submissions of non-material authorised dealers were scrutinised and since no irregularities were found, they were excluded from further investigation. The material authorised dealers were Absa, BoE, Citibank, DBJ, FirstRand, Investec, JP Morgan, Nedcor, NIB and SBSA.

[3] Results – material authorised dealers

10

10.1 The results to the responses to the Questionnaires were analysed under the following headings: trading and foreign exchange markets; foreign exchange trading profits; client transactions; securities lending; structured finance; and other.

10.2 Trading in foreign exchange markets

10.2.1 Market making and proprietary trading

The material part of the report is to be found in §20 Part D.

10.2.2 Ethical standards applied in the conduct of foreign exchange trading

The material part of the report is to be found in §10 Part G.

10.2.3 Market making activities of banks before and after 14 October 2001

The material part of the report is to be found in §15.2 Part D.

10.2.4 Foreign exchange limits

10.2.4.1 The DT team set out to determine if the foreign exchange limits of authorised dealers were exceeded or increased during 2001 as this might have indicated speculative

position taking. Foreign exchange limits define thresholds that open or unhedged trading positions in foreign exchange may not exceed. They form part of a bank's risk management framework. Limits set by banks include overnight net open positions and intraday limits. All the authorised dealers reported to DT (and gave evidence before the Commission) that their risk management frameworks include comprehensive controls designed and tested to detect and prevent unauthorised activities. Limit structures and monitoring of limits is a key component of a bank's control environment.

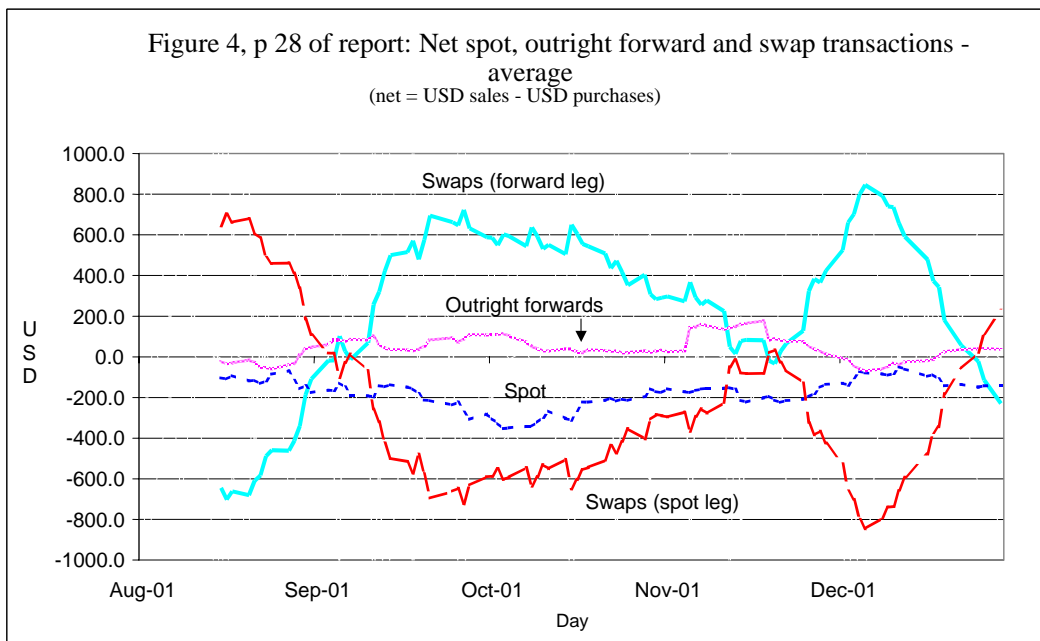
10.2.4.2 The utilisation of the overnight net open position limits during 2001 did not exceed 52%. As a group, and individually, authorised dealers did not increase their risk by holding uncovered positions against the rand overnight during the last quarter of the year at a level greater than prior periods. The

average overnight net open position limits decreased over the period 1 September to 31 December 2001. Many authorised dealers indicated that, given the volatility of the rand during this period, it was deemed prudent to cut limits to reduce their exposure and potential for loss. All authorised dealers were obliged to, and in fact did, comply with the limit set by the Reserve Bank. (The Reserve Bank imposes a limit on the overnight position authorised dealers are permitted to carry. The limit is determined by applying a percentage to the capitals of the authorised dealer, or in the case of a local branch of a foreign bank, to the capital of the off-shore parent company.)

10.2.4.3 Intraday positions are permitted to exceed overnight net open position limits as long as they are brought down to within overnight limits by the end of the day.

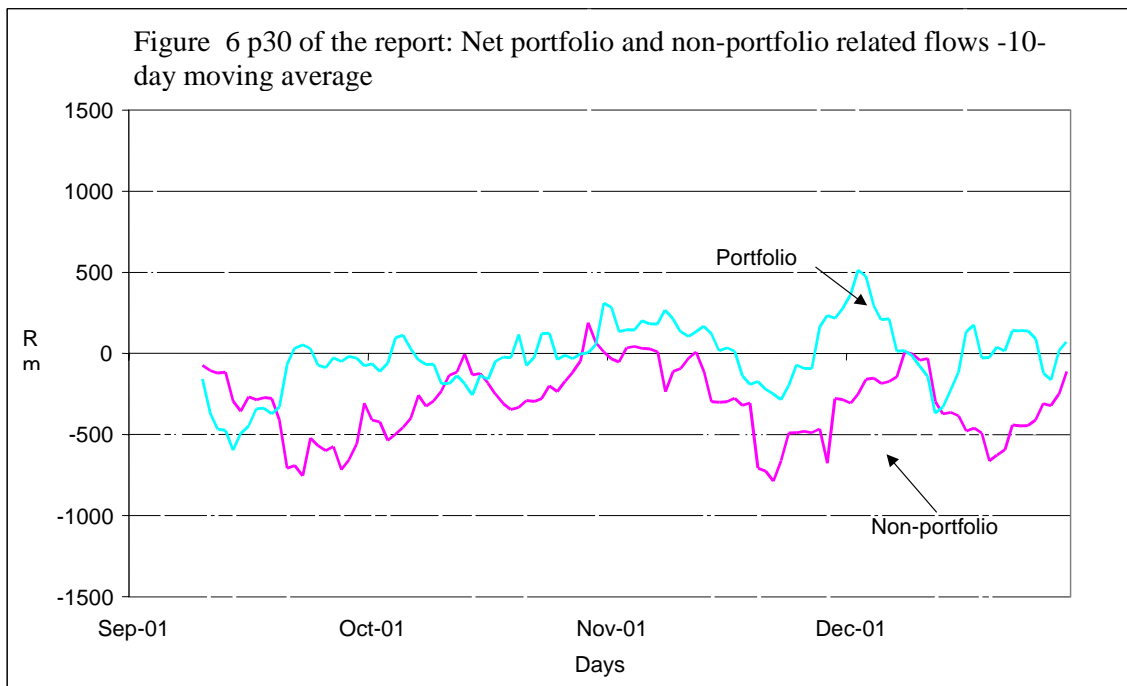
10.2.5 Spot, outright forward and swap transactions

10.2.5.1 The spot transactions of authorised dealers were investigated to establish if there were any inconsistent trading activities that might have resulted in transactions that impacted on the value of the rand. To assess the impact of spot transactions over the last quarter of 2001, the spot transactions were analysed relative to outright forward and swap transactions. The ten-day moving average of net spot, outright forward and swap transactions of authorised dealers is shown in figure 4:

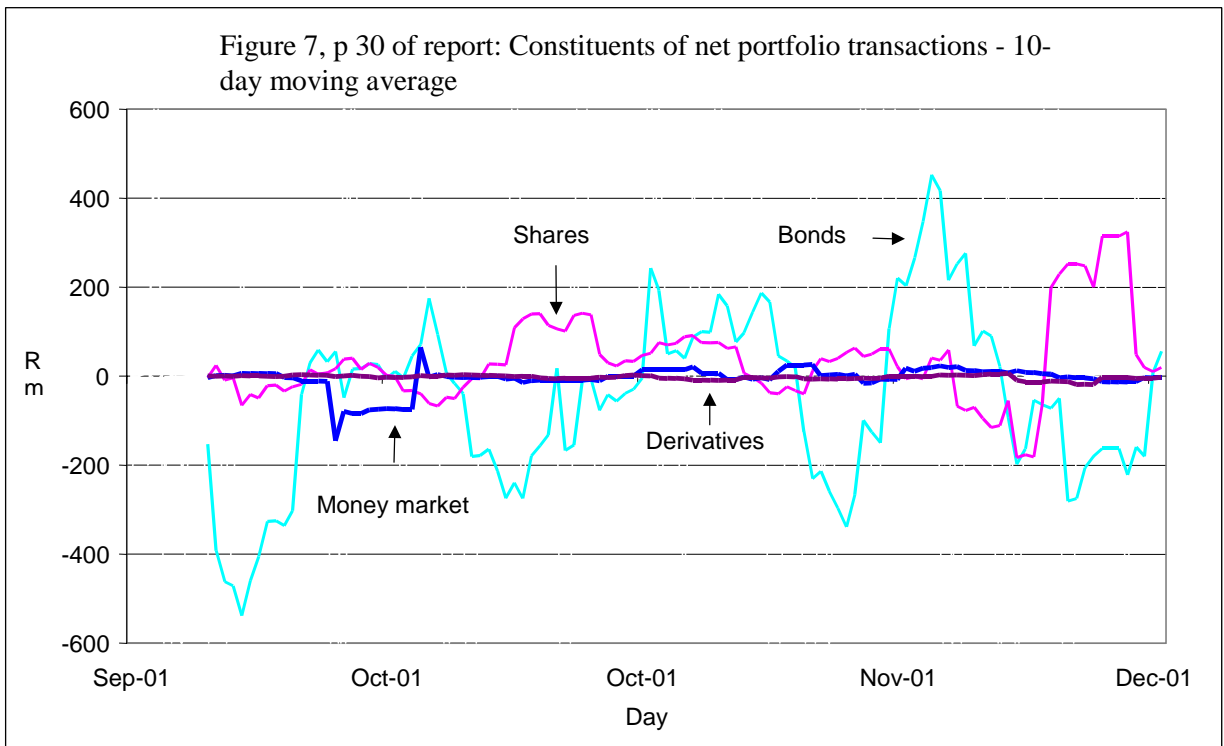


“Net” is defined as sales less purchases of foreign currency. The ten-day moving average of net spot transactions shows a consistent trend over the period – net *purchases* of foreign currency, which implies rand *weakness*.

10.2.5.2 To understand the composition of spot transactions, spot transactions should be seen against the backdrop of portfolio and non-portfolio related forex transactions. As will be seen from Figure 6, portfolio related transactions dominated non-portfolio transactions:



10.2.5.3 As shown in figure 7, flows as a result of bond transactions dominated portfolio transactions:



Non-residents would have concluded the bond transactions. It follows that foreign investors were significant net sellers of bonds during the period putting downward pressure on the rand.

In the latter half of December 2001, they were also net sellers of equity. This would have reinforced the negative impact on the rand.

10.2.5.4 No inconsistent trading activities that might have resulted in transactions that impacted on the value of the rand were identified by the DT team.

10.3 Foreign exchange profits

The material part of the report is to be found in §3 Part H.

10.4 Client transactions

Client transactions were investigated to establish their potential impact on the value of the rand and the extent to which the activity of authorised dealers could be ascribed to client transactions. The average balance on the ten largest vostro accounts decreased from November to December 2001. The implication is that foreign banks withdrew their funds from their vostro accounts. The average balance on the ten largest CFC accounts increased over the period October to December 2001. The inference is that the clients of banks tended to hold more foreign currency. An analysis of the client transactions of authorised dealers shows that the clients were reluctant to hold

rand. The movement by clients of their funds from rand into a foreign currency would have negatively impacted the value of the rand.

10.5 Securities lending

The extent of securities lending was investigated in an attempt to determine the degree of short selling in the equity market and whether it was disproportionate with historic trends. Short selling could be seen as a forerunner to rand speculation. The volume of shares traded on the JSE increased over the period September to December 2001 peaking on 20 December 2001 at 152.3 million shares. The average security lending transaction value over the period 1 January to 31 December 2001, while fairly volatile, showed a decreasing trend in the latter half of 2001. The DT team came to the conclusion that there was little evidence of short selling – both at total and individual authorised dealer level – that required further investigation.

10.6 Corporate finance

The corporate finance departments of the authorised dealers reported that they did not have any specific products involving foreign exchange transactions during 2001.

10.7 Structured finance

The majority of structured finance transactions entered into by authorised dealers were rand based and therefore could not have contributed to the rapid depreciation of the rand. Cross-border structured finance transactions were mainly trade finance transactions and did not have any impact on the depreciation of the rand.

10.8 The perspective of the authorised dealers of the reasons for the rapid depreciation of the rand

The material part of the report is analysed in §41 Part D.

10.9 Broad impact on the material authorised dealers of the depreciation of the rand

The material part of the report is analysed in §4 Part H.

[4] Results – the international banking division of the Reserve Bank

11 The International Banking Division of the Reserve Bank indicated in the information supplied by it to the DT team:-

- that it was not aware of any illegal or unethical transactions directly or indirectly entered into or concluded by any person or

entity during 2001 which contributed or gave rise to the rapid depreciation of the rand; and

- that it was not aware of any person or entity who was involved in collusion, made an improper gain or improperly avoided loss through a transaction concluded during 2001 that contributed or gave rise to the rapid depreciation of the rand.

[5] Results – rep offices

12

12.1 Questionnaires were sent to 52 South African rep offices. Replies were received from 49 offices. The rep offices are representative of banks in Austria, Belgium, Canada, China, Cyprus, Denmark, Egypt, France, Finland, Germany, Greece, Italy, Israel, Luxemburg, Malawi, Norway, Nigeria, Portugal, Russia, Sweden, Switzerland, United Kingdom and the USA. All the rep offices reported that their local office was very small. Since all the rep offices indicated that their country limit was not exceeded during 2001 and all transactions were booked off-shore, no further investigation by the DT team was considered necessary.

12.2 All of the rep offices reported that:

- they were not involved in any transactions, nor had they assisted in any transactions, that might have contributed to the depreciation of the rand;
- they were not aware of any illegal or unethical transactions or actions by any person or entity during 2001 that might have contributed or given rise to the rapid depreciation of the rand;
- they were not aware of any person who might have made an improper gain or improperly avoided a loss from the rapid depreciation of the rand.

[6] Results - exchanges

13

13.1 The data provided by the exchanges were included where applicable in the hot day analysis.

13.2 The BSEA and the JSE were not aware of:

- any illegal or unethical transaction, directly or indirectly entered into or concluded by any person or entity during 2001 which contributed or gave rise to the rapid depreciation of the rand;

- any person or entity who was involved in collusion, made an improper gain or improperly avoided loss through a transaction concluded during 2001 that contributed or gave rise to the rapid depreciation of the rand.

[7] Financial market activities on hot days

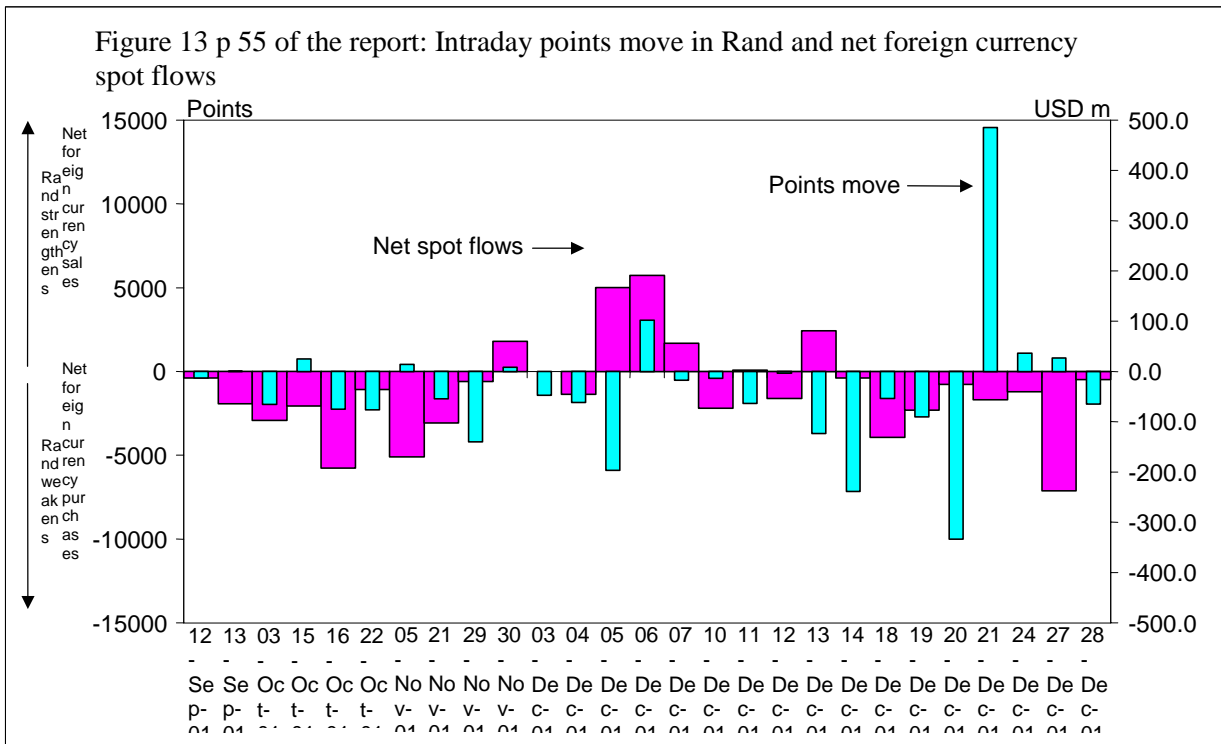
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- 14.1 This section, by showing the magnitude and source of foreign currency activities on hot days, overviews the nature, extent and complexity of the interaction between financial markets and financial market participants and illustrates the myriad of influences at play when attempting to isolate any one transaction that might have impacted on the value of the rand.
- 14.2 The foreign currency activity on hot days is summarised in Table 5. Table 5 shows, for every hot day, the points move in the rand; any notable economic, political or regulatory event on the day; the net foreign currency activity in each financial market; and the net spot foreign currency flow for the day. Foreign currency data are denoted in millions of US dollars. Negative numbers represent the net purchase of foreign currency:

Table 5, p54 of report: Summary of hot days activity

Date	Intraday point move	USD m						Economic and other events
		Portfolio flows			Authorised dealers	Net spot		
		Bonds	Equity	Money Market			Derivatives	
12-Sep-01	-386	-80.7	-38.1	0.2	0.0	106.1	-12.5	September 11 aftermath
13-Sep-01	27	-34.5	11.7	0.1	0.0	-41.2	-63.9	September 11 aftermath
03-Oct-01	-1975	-15.7	-7.8	-1.8	0.0	-71.6	-96.9	Various remarks by SA politicians
15-Oct-01	750	-13.7	0.8	-0.6	0.1	-54.8	-68.3	SARB enforces existing excon rules
16-Oct-01	-2240	37.8	92.3	2.3	-0.1	-324.1	-191.9	Zimbabwe, AIDS, excon rules aftermath
22-Oct-01	-2276	-177.5	-9.1	0.1	0.0	151.5	-35.0	SARB: possible inflationary pressures
05-Nov-01	432	-55.6	11.0	0.1	0.7	-125.9	-169.8	Argentina
21-Nov-01	-1605	16.9	27.5	-25.2	-0.9	-120.9	-102.6	Transnet buys back 20% SAA
29-Nov-01	-4186	205.9	-7.2	0.0	0.1	-218.5	-19.8	SARB: possible interest rate increase
30-Nov-01	253	8.0	10.8	0.8	-0.5	40.8	59.9	3rd Quarter current account deficit
03-Dec-01	-1400	86.8	-6.9	3.7	-1.0	-82.4	0.1	SARB: NOPF and value of Rand
04-Dec-01	-1850	100.3	44.6	1.9	0.3	-192.1	-45.0	Zimbabwe high court ruling
05-Dec-01	-5900	-32.3	-5.5	3.2	3.3	198.5	167.3	Argentina
06-Dec-01	3050	-98.5	3.9	0.4	-0.3	286.1	191.5	Zimbabwe
07-Dec-01	-500	9.3	-110.7	2.3	0.1	155.1	56.1	Zimbabwe
10-Dec-01	-400	37.3	-13.3	-0.3	1.0	-97.9	-73.1	Speculation on exchange control
11-Dec-01	-1900	-9.9	-18.0	0.9	1.0	28.8	2.9	Inflation
12-Dec-01	-100	-62.2	4.2	0.1	0.0	4.7	-53.2	Zimbabwe
13-Dec-01	-3700	-22.6	43.0	-0.2	0.4	60.2	80.7	Zimbabwe
14-Dec-01	-7150	0.8	-68.6	5.8	-13.4	63.2	-12.2	Zimbabwe and Argentina
18-Dec-01	-1600	-6.2	216.3	-0.5	1.6	-342.1	-130.9	Higher November inflation figures
19-Dec-01	-2700	17.4	24.1	-7.2	0.0	-111.2	-76.8	James Cross resigns
20-Dec-01	-10000	-146.6	-5.2	0.3	0.0	126.0	-25.4	Argentina
21-Dec-01	14550	-3.9	-15.0	-1.1	-3.5	-32.1	-55.7	Joint Mboweni / Manuel statement
24-Dec-01	1100	15.5	28.2	0.1	0.0	-84.0	-40.2	Government announces Rand support
27-Dec-01	800	-50.1	8.0	0.0	0.0	-194.8	-236.8	Thin trade
28-Dec-01	-1950	46.6	-11.4	0.0	0.1	-50.8	-15.5	Thin trade

- 14.3 The analysis indicates that there is no clear and consistent correlation between movement in terms of direction and magnitude in the exchange rate of the rand and foreign currency flows in individual markets. On days when there were net sales of foreign currency, ie net purchases of rand, the exchange rate weakened and vice versa.
- 14.4 Figure 13 plots the net foreign currency flows against the point moves in the rand. On the majority of days when there was demand for foreign currency, as evidenced by net spot foreign currency purchases, the rand weakened. However, there was no correlation in terms of magnitude: see 16 October and 14, 20 December 2001. The rand weakened on three of the five days when there was a net supply of foreign currency as indicated by net spot foreign currency sales.



14.5 The team came to the conclusion that there were a myriad of factors influencing the behaviour of participants, all of which collectively impacted on the value of the rand.

[8] Overall conclusions

15

15.1 The investigation by the DT team provided no indication that further investigation of the financial market participants was

required. Phase 2 of the investigation was therefore not performed.

- 15.2 The information provided by the financial markets participants indicates that their activities reflect a uni-directional response to market factors, primarily regulatory, economic and political, and that the depreciation of the rand and the extent of the exchange rate spread was a reflection of uncertainty, reduced liquidity, a pervasive negative sentiment and a reversal of demand for the rand by foreign institutions.
- 15.3 It is not unreasonable to assume that the off-shore/off-shore market activities experienced very similar influences and reacted the same way, placing significantly more pressure on the rand.
- 15.4 The millions of transactions that make up the market, the combined impact of which reflected a demand for foreign currency and an aversion to holding rand, contributed to the rapid depreciation of the exchange rate of the rand.
- 15.5 Any person or juristic entity who, directly or indirectly, entered into, concluded or caused any transactions which contributed or gave rise to the rapid depreciation of the rand relative to other currencies during 2001, did so in response to factors influencing

the market and in a manner that is consistent with standard practice in international financial currency markets.