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**Developing Securitization-enabling Financial Infrastructure
in Emerging Markets: A Case-study of Zimbabwe**

TAWANDA HONDORA

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Abbreviations

ABSZ	Association of Building Societies of Zimbabwe
ABCP	Asset Backed Commercial Paper
AMC Act	Asset Management Company Act
APS	Asset Protection Scheme
CIS Act	Collective Investment Schemes Act
CDO	Collateralised debt obligations
CDS	Credit Default Swap
CRA	Credit Rating Agency
CRAR Act	Credit Rating Agency Reform Act
DPB	Deposit Protection Board
FSA	Financial Services Authority
GAO	Government Accountability Office
GOZ	Government of Zimbabwe
IMF	International Monetary Fund
IODZ	Institute of Directors of Zimbabwe
IOSCO	International Organisation of Securities Commissions
IPC	Insurance and Pensions Commission
IPC Board	Insurance and Pensions Commission Board
LSZ	Law Society of Zimbabwe
MRI Act	Moneylending and Rates of Interests Act
NRSRO	Nationally Recognised Statistical Rating Organisations
OECD	Organisation for Economic Cooperation and Development
PAA Act	Public Accountants and Auditors Act
PAAB	Public Accountants and Auditors Board
POSB	Peoples Own Savings Bank
RBZ	Reserve Bank of Zimbabwe
RBZ Act	Reserve Bank of Zimbabwe Act
SC	Securities Commission
SPV	Special Purpose Vehicle
TARP	Troubled Asset Relief Programme
TFIR Act	Troubled Financial Institutions (Resolutions) Act
UNCITRAL	United Nations Commission on International Trade Law
USAID	United States Agency for International Development
VAT	Value Added Tax
ZIMRA	Zimbabwe Revenue Authority

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Kuna Ari: Shumba

DECLARATION

I, **Tawanda Hondora** solemnly declare that this thesis is my own work and I warrant that to the best of my knowledge, information and belief it does not infringe the rights of any third party.

Dated the 22nd September 2009

Signature.....

SUMMARY

This legal study identifies through a case-study of Zimbabwe the range of essential legal reforms an emerging market should implement to establish financial infrastructure that enables the structuring of securitization transactions and the prevention and management of risks – such as those highlighted by the 2007 global financial crisis – that can arise from securitization transactions.

The study analyses: (i) laws regulating or relating to prudentially regulated firms that typically use securitization to refinance; (ii) corporate and trust laws to identify legal structures which can be utilised as securitization special purpose vehicles; (iii) the Roman-Dutch law of sale to determine whether it permits the true-sale of financial assets; (iv) various legal risks, including substantive-consolidation, veil-piercing, foreclosure, insolvency and tax risks; (v) the dispute resolution framework; and (vi) the structured finance risk mitigation properties of Zimbabwe's financial market regulatory framework.

The study concludes that Zimbabwe's legal system permits most of the contractual arrangements that constitute a basic securitization transaction. However, its financial services regulatory and gatekeeping framework - which must be reformed - is rudimentary and ill-suited to preventing and managing systemic risks that can arise from securitization.

This is the first comprehensive academic study which investigates the extent to which the Roman-Dutch legal system enables the various contractual arrangements that constitute a securitization transaction. It also presents an analytical model for reviewing the securitization-enabling characteristics of emerging markets' legal systems and the securitization risk mitigation properties of their financial infrastructures.

CHAPTER 1

INTRODUCTION

1.1. Introduction

Through a case-study of Zimbabwe this study presents an analytical model for reviewing the securitization-enabling characteristics of emerging markets' legal systems,¹ and the securitization risk mitigation properties of their financial infrastructures. This study analyses: (i) laws regulating or relating to financial institutions and other entities likely to engage in securitization transactions as originators, providers of securitization transaction services and investors; (ii) corporate and trust laws to identify legal structures which can be utilised as securitization special purpose vehicles; (iii) whether the Roman-Dutch law of sale permits the effective and secure transfer of financial assets to be securitized from an originating firm to a special purpose vehicle; and (iv) legal risks, including re-characterization, substantive-consolidation, veil-piercing, foreclosure, insolvency and tax risks. Given the systemic risks that can be spawned through securitization, this study also evaluates: (a) through a literature analysis, the risks and benefits of securitization; (b) Zimbabwe's financial markets regulatory framework and its gatekeeping liability and regulatory framework; and (c) Zimbabwe's dispute

¹ Zimbabwe is one of the several countries described by Standard and Poor as an emerging market. Standards and Poor (2007) 'Emerging Markets Index', at p. 13. Available at http://www2.standardandpoors.com/spf/pdf/index/SP_Emerging_Markets_Indices_Methodology_Web.pdf The phrase 2007 global financial crisis is used as shorthand to refer to the credit crisis that started in July 2007 over investor concerns relating to U.S. mortgage backed securities, resulting in a liquidity crisis, which later deteriorated into a full blown global financial crisis.

resolution framework. This study concludes that Zimbabwe's legal system permits most of the contractual arrangements that constitute a basic securitization transaction; but its financial services regulatory and gatekeeping framework must be reformed to enable it to effectively prevent and manage systemic risks that can arise from securitization. The legal analysis contained herein is correct as of 30 August 2009.

1.2. Securitization: definition

There does not exist a universal or standard definition of asset securitization.² Most definitions of securitization, including that provided by Zimbabwe's central bank are transactional in nature.³ Sometimes referred to as structured finance,⁴ the term securitization refers to a series of transactions and contractual relationships, involving the use by an income-generating entity of its financial assets to raise finance on the capital markets through the issuance of securities backed by periodic cash-flows generated by the financial assets.⁵ The financial assets are securitized by their conversion into standardized tradable instruments.⁶ Shenker *et al* aptly define securitization as: “[T]he sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a

² This is largely due to the fact that securitization is structured as a series of contractual arrangements between various parties to the transaction.

³ The Reserve Bank of Zimbabwe defines securitisation as: “...a process whereby financial promises or assets are packaged into marketable securities that can be freely traded on the capital and financial markets. It has the effect of transforming a pool of relatively illiquid assets into tradable liquid assets. There are generally two types of securitisation, namely traditional schemes and synthetic securitisation schemes.” Reserve Bank of Zimbabwe Guideline No. 01-2007/BSD: Special Purpose Vehicles, Securitization and Structured Finance, at p. 4. Available at http://www.rbz.co.zw/pdfs/2007mid/Bank_lic_sup1.pdf

⁴ Numerous commentators refer to securitization as structured finance. See for instance Steven L. Schwarcz who states: “The terms ‘securitization,’ ‘asset securitization,’ and ‘structured finance’ are used interchangeably. Each refers to a company’s use of cash flows from its assets to raise funding. The term ‘securitization’ specifically refers to the issuance of securities backed by such cash flows.” Steven L. Schwarcz (1994) ‘The Alchemy of Asset Securitization’, *Stanford Journal of Law, Business and Finance*, vol 1:133, 136. See also Christopher W. Frost (1997) ‘Asset Backed Securitization and Corporate Risk Allocation’, *Tulane Law Review*, vol. 72, 1997, 101, at p. 103.

⁵ Jeremy Shapiro (1999) ‘Innovation in Financial Services: Case Study, Asset Backed Securitization’, *MIT, IPC*, Working Paper No. 99-003, Feb 1999, at p. 5.

⁶ Frost (1997) (note 4, *supra*), at p. 103.

transaction structured to reduce or reallocate certain risks inherent in owning or lending against underlying assets and to ensure that such interests are more readily marketable and, thus more liquid than ownership interests in and loans against the underlying assets.”⁷ According to Jobst, “securitization describes the process and the result of converting regular and classifiable cash flows from a diversified pool of illiquid existing or future assets of similar type, size and risk category into tradable debt and equity obligations (liquidity transformation and asset diversification process).”⁸

Securitization transactions can be classified into several categories, including asset backed securitization (receivables securitization) and future-flow securitization. The essential difference between these two categories lies in the nature of assets to be securitized.⁹ Receivables securitization refers to the securitization of financial assets which are in existence at the time a securitization transaction is structured. Assets in a future-flow securitization are, on the other hand, not in existence at the time a transaction is structured but are generated at a future date. Typical examples of securitization transactions include residential mortgage-backed securitization (RMBS), commercial mortgage-backed securitization (CMBS), collateralised debt obligations (CDOs), and asset-backed commercial paper (ABCP). Most financial

⁷ Joseph C. Shenker and Anthony J. Colletta (1991), ‘Asset Securitization: Evolution, Current Issues and New Frontiers’, *69 Tex. L. Rev.* 1369, 1374-75.

⁸ Andreas A. Jobst (2006) ‘Asset Securitization as a Risk Management and Funding Tool: What Small Firms Should Know’. *Managerial Finance*, Vol. 32, No. 9, 2006, at pp. 731-760. In the U.S., a definition of securitization has now been codified. See Asset-Backed Securities, 70 Fed. Reg. 1508 (7th Jan, 2005). See also Douglas Arner (2002) ‘Emerging Market Economies and Governmental Promotion of Securitization’, *12 Duke J. of Comp. & Int’l L.* 505, at p. 505.

⁹ Raines and Wong state: “Whereas securitization of receivables usually involves the sale of cash flows generated by a company's existing pool of assets, "future flow" transactions are backed by income to be derived in the future by an operating company (the originator).” Mark Raines and Gabriele Wong (2002) ‘Aspects of Securitization of Future Flows under English and New York Law’, *12 Duke J. of Comp. & Int’l L.* 453, at p. 453.

claims can be securitized, including tax, trade, electricity, telephone and toll road receivables,¹⁰ as well as debts such as mortgage, corporate, retail debts.

1.3. Context

Although securitization hit the doldrums in 2007 it was for over two decades the dominant means of enterprise financing in international capital markets.¹¹ Securitization issuances rose from to an estimated US\$12 trillion at its height,¹² dwarfing other forms of financing. Described in hyperbolic terms as “alchemy that really works,”¹³ and “a boon to every participant in the capital markets,”¹⁴ modern securitization was pioneered in the U.S., where most of the world’s issuances took place.¹⁵ Most regions of the world, the European Union, Asia, Latin America and the Caribbean, the Middle East embarked on programmes to create securitization

¹⁰ Sudipto Basu (2005) ‘Securitization and Challenges Faced in Micro Finance’, Available at <http://ifmr.ac.in/pdf/workingpapers/2/Securitization.pdf>

¹¹ Edward M. Iacobucci and Ralph A. Winter (2005) ‘Asset Securitization and Asymmetric Information’, *The Journal of Legal Studies*, vol. 34 (1), Jan 2005, at p. 2.

¹² Ethan Penner (2008) ‘Securitization and the Future of Finance’, Available at www.livinglies.wordpress.com/2008/07/11/securitization-and-the-future-of-finance

¹³ Schwarcz (1994) (note 4, supra), at p. 133.

¹⁴ Frost (1997) (note 4, supra), at p. 104.

¹⁵ A form of securitization called Pfandbriefe was created by Frederick the Great in 1769, though modern securitization is a product of American innovation. See Claire A. Hill (1996) ‘Securitization: A Low Cost Sweetener for Lemons’, *74 Wash. U. L. Q.* 1061, at p. 1065. In the US, the Federal Housing Administration (FHA) was established in the 1930s to insure against default, mortgage loans made to lower-income earners. In 1938, the Federal National Mortgage Association (Fannie Mae) was established to buy and sell mortgage loans insured by the FHA. The Veterans Association (VA), an entity similar to the FHA was established by American war veterans to insure against default, mortgage loans made to those that had served in the US armed forces. In 1968, the government created another institution; the Government National Mortgage Association (Ginnie Mae) whose objective was to develop a secondary mortgages market for FHA and VA insured mortgage loans. In 1970, Ginnie Mae issued the first mortgage-backed securities. To further deepen housing finance liquidity and expand the reach of the benefits of securitizing mortgage loans, the government created another agency, the Federal Home Loan Mortgage Corporation (Freddie Mac) for privately issued and financed mortgage loans. Freddie Mac made its debut mortgage backed securitization issuance in 1971. See Scott, S. Hal and Wellons, A. Philip (2001) *International Finance: Transactions, Policy and Regulation*, 8th ed, Foundation Press, at pp. 777-782. For a discussion of the development and structure of the US secondary mortgages market see, Robert van Order (2003) ‘Public Policy and Secondary Mortgage Market’, at pp. 9-11. Available at www.infor.worldbank.org/ctools/docs/library/156603/housing/pdf/VanOrder_StateSupport.doc

markets.¹⁶ In Africa - a region with the world's least access to cost-effective entrepreneurial capital¹⁷ - only South Africa has an active securitization market.

Securitization has historically benefited originating firms by: (i) reducing agency costs;¹⁸ (ii) enabling lower-cost financing; (iii) liquidity creation and efficient risk allocation;¹⁹ and (iv) by diversifying refinancing and risk management options,²⁰ including regulatory capital arbitrage.²¹ These benefits notwithstanding, the securitization of mispriced U.S. subprime mortgages, compounded by financial market regulatory failures, is blamed for precipitating the 2007 global financial crisis.²² Financial institutions' exposures to the mispriced subprime mortgage-backed securities created a crisis of confidence in structured finance securities generally and resulted in a catastrophic loss of liquidity and a full-scale global financial crisis.²³ The mispriced U.S. subprime mortgage-backed securities were sold worldwide, due in large part to technological innovations, globalization and the interconnectedness of the world's financial markets.

¹⁶ Arner (2002) (note 8, supra), at p. 506.

¹⁷ Milken Institute (2005) 'Best Markets for Entrepreneurial Finance: 2005', *Capital Access Index*, at p. 6.

¹⁸ Iacobucci and Winter (2005) (note 11, supra), at pp. 171-180. But conversely, as shown by the 2007 global financial crisis, securitization increased moral hazard and agency costs. This is discussed in detail in chapter 2 and chapter 8.

¹⁹ The reasoning goes: because securitization results in disintermediation, firms have direct access to capital markets, resulting in lower cost of capital. It ought to be said however that while securitization does result in bank disintermediation, it in fact replaces one middleman (the bank) with several, including the originator, the arranger, the servicer, rating agencies and insurers. These hypotheses have been challenged by the 2007 global financial crisis which saw the evaporation of liquidity and systemic risks in securitization, as a result of the securitization of U.S. subprime and other faulty financial assets.

²⁰ See for instance Jobst (2006) (note 8, supra), at p. 1.

²¹ Steven L. Schwarcz (1990) 'Structured Finance: The New Way to Securitise Assets', *11 Cardozo L. Rev.* 607, 1990, at p. 608.

²² The phrase 2007 global financial crisis is used as shorthand to refer to the U.S. subprime induced global financial crisis that started in 2007 in the U.S. before spreading globally. Calomiris argues for instance that: "Securitization of subprime and CDO conduits have given securitization a bad name and the long-term future of securitization remains uncertain. But already we are seeing that the negative impact on securitization depends on the product line. For example, on the one hand, credit card securitizations seem to holding their own." Charles Calomiris (2008) 'The Subprime Turmoil: What's Old, What's New and What's Next?', at p. 80. Available at http://www.aei.org/docLib/20081002_TheSubprimeTurmoil.pdf

²³ For an apt description of the events that led to and characterized the 2007 global financial crisis refer to Markus K. Brunnermeyer (2008) 'Deciphering the Liquidity and Credit Crunch 2007-2008'. Available at www.princeton.edu/~markus/research/papers/liquidity_credit_crunch.pdf

This notwithstanding, this study is predicated on the assumption,²⁴ and agrees with commentators who argue, that securitization is an efficient risk management tool, if inherent risks are effectively mitigated. Securitization generates benefits and it will remain - possibly in an altered form and in a more regulated environment - an important although possibly not as dominant a refinancing mechanism.²⁵ This study also argues that because credit risk transfer technologies are a feature of the modern international financial landscape, emerging markets' financial infrastructure must accommodate the numerous arrangements that constitute securitization transactions; if not to facilitate the structuring of domestic securitization transactions, then at the very least to prevent and manage inherent risks.²⁶ By mid 2009, governments are still addressing the consequences of the fall out from the securitization and worldwide sale of U.S. subprime mortgage-backed securities. With globalization, no country or financial jurisdiction is an island. The search for entrepreneurial capital is not restricted by borders and financial engineering technologies keep evolving. Structured finance products, such as securitization, are one such example. This requires countries to put in place financial stability frameworks that enable them to prevent and/or manage risks which pose systemic threats. Financial services regulatory systems and capital markets gatekeeping frameworks – regulating among others credit rating agencies, structured finance lawyers, public auditors – must be enabled to prevent and manage risks that arise from, *inter alia*, credit risk transfer technologies. The risks include those highlighted by the 2007 global financial crisis.

²⁴ The benefits of securitization are assumed in this study. This is because this study is legal in nature. It does not engage in the econometric measurement of the various benefits commentators credit securitization with.

²⁵ Steven L. Schwarcz (2008) 'The Future of Securitization', at p. 1. Available at <http://ssrn.com/abstract=1300928> See also Calomiris (2008) (note 22, supra), at p. 3.

²⁶ Caprio *et al* make the point that although developing countries have not been as adversely affected by securitization as have developed countries; there are lessons to be learnt by regulators and supervisors in developing countries. Gerard Caprio., Asli Demirguc-Kunt and Edward J. Kane (2008) 'The 2007 Meltdown in Structured Securitization: Searching for Lessons, Not Scapegoats'. *World Bank Policy Research Working Paper Series*, at p. 45. Available at <http://ssrn.com/abstract=1293169>

Most emerging markets' financial infrastructure cannot easily sustain the numerous legal arrangements that constitute a basic securitization transaction. The problems countries face range from their unfamiliarity with, the complexity of, and the high cost of securitization transactions;²⁷ to underdeveloped capital markets, hyperinflationary economies, lack of quality financial assets, and lack of a robust supporting legal and regulatory infrastructure.²⁸ Indeed, an enabling financial infrastructure - encompassing the legal, regulatory, tax, securities issuance and financial asset transfer framework - is essential for the propagation of securitization.²⁹ It is this predominant factor - a securitization-enabling financial infrastructure - that is the subject of, and evaluated in this study and in relation only to Zimbabwe.³⁰ This Zimbabwe context-specific legal analysis is essential because securitization is a sophisticated financing technique that rests on a complex matrix of legal relationships; and which technique cannot, without more, be morphed into different financial systems.³¹

²⁷ Ketkar Suhas and Dilip Ratha (2001) 'Securitization of Future Flow Receivables: A Useful Tool for Developing Countries', *IMF Finance and Development*, March 2001, vol. 38, No. 1., at p. 8. See also Arner who states that securitization is a sophisticated process that is based on a complex matrix of supporting elements, all of which have a significant legal element. Arner (2002) (note 8, supra), at p. 506.

²⁸ Many commentators agree that the legal systems of most developing countries do not allow the effective and efficient structuring of asset securitization. See *inter alia*, Loic Olivier., Chiquier Hassler and Michael Lea (2004) 'Mortgage Securities in Emerging Markets', *World Bank Policy Research Working Paper* No. 3370, p. 2. Available at: http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2004/08/26/000160016_20040826171659/Rendered/PDF/wps3370.pdf

²⁹ See also Jobst who referring to sovereign securitization in emerging market economies states: "Infrastructural, legal and regulatory shortcomings shape up to be the biggest test for securitization as an alternative source of public finance." Andreas A. Jobst (2006) 'Sovereign Securitization in Emerging Markets', at p. 14. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=929568 For a discussion of the characteristics required of a robust asset securitization-enabling financial infrastructure, see Nick Davis (2000) 'Securitization: A Public Policy Tool', *New Zealand Treasury Working Paper* 008. Available at: <http://www.treasury.govt.nz/workingpapers/2000/twp00-8.pdf>

³⁰ Lakshman Alles notes: "One of the biggest obstacles to securitization in developing countries is that the legal framework within the jurisdiction of the country is not capable of accommodating the numerous legal relationships that need to be established in order to make the securitization process successful." Lakshman Alles (2001) 'Asset Securitization and Structured Financing: Future Prospects and Challenges for Emerging Market Countries', *IMF Working Paper* No. WP/01/147, at p. 9. Available at: <http://ssrn.com/abstract=879953>.

³¹ Arner (2002) (note 8, supra) at p. 506.

1.3.1. Securitization in Zimbabwe

There has been a demonstrable interest in harnessing securitization in Zimbabwe by both the private and public sector.³² The major impediment, it was argued, was the country's high inflationary economy.³³ Between 1998 and 2001 at least four securitization transactions were reportedly structured in Zimbabwe.³⁴ During the same period, with the assistance of the building society and banking industry and the United States Agency for International Development (USAID), the government moved to create a secondary housing mortgage backed securitization market.³⁵ In 2000 the government commissioned research on the introduction of a secondary housing finance market.³⁶ In 2000, the Ministry of Finance, with the objective of facilitating the secondary housing finance market, amended its tax legislation to remove stamp

³² In a 1998 report, the Association of Building Societies of Zimbabwe (ABSZ) states that it first raised the concept of establishing a secondary mortgages market with the monetary authorities in the mid 1980s, but was rebuffed. Association of Building Societies in Zimbabwe (1998) 'Establishment of a Secondary Mortgage Market in Zimbabwe: Economic, Legal and Fiscal Issues', at p. 3. (*Copy in author's possession*).

³³ Claud Bovet., Richard Wilde., Alphious Ncube., Albert M. Rosettenstein and Michael J. Kimberly (2000) 'Legal Analysis of the Housing and Mortgage System in Zimbabwe', at paragraph 1.1. (*Copy in possession of author*); See also Association of Building Societies of Zimbabwe (2000) 'Mortgage Securitization: Legal and Regulatory Environment', at p. 3. (*Copy in author's possession*).

³⁴ The word reportedly is used advisedly as the author has not been able to verify these transactions. Loita Capital Partners International states that it assisted two Zimbabwe domiciled firms originate two asset receivables securitization transactions. The first US\$5 million transaction in 1998 involved a now defunct domestic airline company, Zimbabwe Express Airlines on its foreign currency denominated International Air Ticket Association (IATA) ticket receivables. LOITA also reports that in 1999 it structured a US\$30 million export receivables transaction for the Zimbabwe Steel Company (ZISCO); Zimbabwe's largest and Africa's second largest steel company. LOITA Capital Partners International is an investment banking firm that specialises on Africa. LOITA (2009) 'Transactions', Available at www.loita.com/transactions.htm In 1999 First National Building Society structured a mortgage backed securitization transaction utilising a trust entity which issued pass-through certificates privately-placed with institutional investors. Another company, Houses for Africa completed by 1999 two privately placed mortgage-backed securitization transactions. In addition, a company called Mortgage Bond Corporation was established as a multi-issuer mortgage-backed securitization conduit. However due to a variety of reasons, including hyper-inflation, it never commenced operations. Public-Private Sector Working Group on Establishing a Secondary Mortgage Market System in Zimbabwe (1999) 'Minutes of Meeting of 23 November 1999'. (*Copy in author's possession*)

³⁵ USAID stated: "...In the policy arena, the program achieved major breakthroughs. For example, it assisted in the establishment of the nation's first mortgage securitization mechanism, successfully argued for the removal of burdensome taxes on mortgage holders, and leveraged the first ever privately financed urban sewer and water development program in Zimbabwe. The program has funded an urban credit rating program that has resulted in Zimbabwean cities being rated for credit-worthiness--the first step required to obtain private capital for urban infrastructure development." United States Agency for International Development (2002) 'Zimbabwe: Activity Data Sheet', at p. 3. Available at <http://www.usaid.gov/pubs/cbj2002/afr/zw/613-002.html>

³⁶ Bovet., Wilde., Ncube., Rosettenstein., and Kimberly (2000), (note 33, supra).

duty on the cession of mortgage bonds.³⁷ In 2007, Zimbabwe's central bank, the Reserve Bank of Zimbabwe (RBZ) introduced securitization guidelines.³⁸ This research is therefore premised within an overall context of active stakeholder interest in the use of securitization.

However, the decade-long political and economic crisis in Zimbabwe makes the practical structuring of securitization challenging. On-going land expropriations have given rise to reasonable apprehensions over the sanctity of private property rights. In addition, the land expropriation-marred political crisis has given rise to legitimate concerns about the independence of the judiciary and its ability to safeguard private property rights and interests, especially where perceived foreign interests are implicated. Although, there is no evidence to establish that commercial disputes, unrelated to land expropriations have been affected, there exists a perception that the country is afflicted by high political risk. These perceptions must have an adverse impact on investor confidence. However, this study being legal in nature, it is restricted to analysing whether Zimbabwe's legal system enables the numerous legal arrangements that constitutes a securitization transaction, and whether its financial services regulatory and gatekeeping framework can be used to prevent and manage risks that can arise from the propagation of securitization.

1.3.2. Study's contribution to research

The constituent parts of this research and especially the research questions represent a research methodology model, which can be used for evaluating the securitization-enabling characteristics of emerging markets' legal systems and the securitization risk mitigation properties of their financial infrastructures. Apart from

³⁷ The Association of Building Societies of Zimbabwe (2000) (note 32, supra), at p. 3.

³⁸ RBZ (2007) (note 3, supra).

the report commissioned by the government of Zimbabwe (GOZ) and USAID in 2000 on the feasibility of establishing a secondary housing finance market in Zimbabwe,³⁹ there is a dearth of Zimbabwean securitization literature. The GOZ/USAID research assumes that: (i) Zimbabwe-domiciled financial institutions can engage in securitization transactions without legal difficulty; (ii) SPVs can be established, but without analysing which legal entities are best suited for these transactions; and (iii) financial assets can be transferred from an originating firm to an SPV, but without an analysis of the appropriate asset transfer methods, the true-sale concept,⁴⁰ and the risks that typically afflict securitization asset transfers which have to be mitigated such as tax, re-characterization, substantive consolidation, veil-piercing, insolvency and foreclosure risk. The GOZ/USAID study assessed the tax framework and concluded that it represented a barrier to structuring securitization transactions but did not analyse in detail stamp duty, value added tax and income tax liabilities on securitization transactions. In addition, the study did not analyse the extant capital markets regulatory and gatekeeping framework or the dispute resolution framework. This research addresses these omissions and represents a comprehensive study on the securitization-enabling status of Zimbabwe's financial infrastructure, in addition to making proposals for reform.

This research evaluates securitization risk issues which were not addressed in the 2000 government-commissioned report, and some - such as the Enron fall-out⁴¹ and the 2007 global financial crisis - that arose after its publication. By adopting a comparative methodology, this study aims to inform lawmakers so that Zimbabwe can avoid some of the ill-effects experienced by pioneers of the technique.

³⁹ Bovet., Wilde., Ncube., Rosettenstein., and Kimberly (2000), (note 33, supra).

⁴⁰ The concept of true-sale is discussed below in Chapter 6 at paragraph 6.3.1.

⁴¹ This refers to the collapse of the US energy company, which is alleged to have manipulated its financial reports by a complicated arrangement of pseudo-securitizations. This is discussed in more detail in chapter 8 and 9.

Zimbabwe is currently in the throes of an acute economic recession fuelled in part by poor economic and governance policies and stymied access to international financial markets.⁴² Domestic intermediated financing, although limited in scope and capacity dominates Zimbabwe's sources of finance. Its equities market remains an active means of channelling funds to productive sectors of the economy.⁴³ This study is intended to be a diagnostic toolkit, which can assist in the diversification of Zimbabwean firms' financing options through the introduction of a securitization-enabling infrastructure, and contributory to a post economic crisis financial services sector reform strategy.

There is scarce literature on securitization in Zimbabwe. Reference materials available on the subject are the several articles and letters written by the Building Societies Association of Zimbabwe, and the legal analysis conducted by the GOZ/USAID. To this extent, it is one of the objectives of this study to pioneer academic study on securitization that focuses both on legal and policy issues and identifies measures necessary for the creation of a securitization-enabling and risk mitigating financial framework. It also contributes to literature on the possibilities of using law to reform African emerging markets as part of their financial and economic development strategies.

Zimbabwe is part of the Southern African Development Community (SADC), whose countries share with Zimbabwe, broadly similar commercial legislation and a

⁴² One of the main reasons explaining Zimbabwe's inability to raise hard currency on the international capital markets is the United States enactment, Zimbabwe Democracy and Economic Recovery Act, 2001, Statute 494. Section 4 (2) (c) obliges United States representatives on any multilateral lending agency in the world to vote against (1) any extension by the respective institution of any loan, credit, or guarantee to the government of Zimbabwe; or (2) any cancellation or reduction of indebtedness owed by the Government of Zimbabwe to the United States or any international financial institution. In this regard the freezing out of Zimbabwe from the international intermediated lending market also effectively freezes the country from effectively accessing debt and equity capital markets. In short, financial sanctions imposed by the US against Zimbabwe constitute part of the puzzle behind Zimbabwe's economic crisis.

⁴³ There exists a significant range of asset based financing in Zimbabwe such as leasing, factoring, hire purchase and other project based financing.

common desire for entrepreneurial capital. This study provides a comparator research model for other SADC countries seeking to diversify their financing options through securitization. This study is also intended to enhance both Zimbabwean and SADC policy-makers' knowledge of, and familiarity with securitization. It aims to achieve this by focusing on Zimbabwe – a member state - by drawing together and analysing the various laws and practices relevant to securitization.

1.4. Hypothesis

This study argues that Zimbabwe's Roman-Dutch common law enables financial enterprises and other entities to engage in the majority of the numerous legal arrangements that constitute a basic securitization transaction. To test this hypothesis, the study evaluates laws regulating firms which would be the main securitization participants in Zimbabwe, Zimbabwe's law of persons, law of sale, various legal risks, which include tax, and insolvency risks. South Africa, which shares the same unique Roman-Dutch common law with Zimbabwe, is an example of a country that required little statutory intervention to establish a viable securitization industry.⁴⁴ As noted above, between 1997 and 2001 at least four securitization transactions were reportedly structured in Zimbabwe. *Arguendo*, these transactions and South Africa's securitization experience suggest that Zimbabwe's financial infrastructure permits securitization transactions. This study critically examines this argument, and interrogates whether this conclusion obfuscates real legal securitization risks peculiar

⁴⁴ Section 89 of the Zimbabwe Constitution states: "...the law to be applied by the Supreme Court, the High Court and by any courts in Zimbabwe subordinate to the High Court shall be the law in force in the Colony of Good Hope on 10th June 1891, as modified by subsequent legislation having in Zimbabwe the force of law." Standard and Poors' notes that the securitization transactions that took place in South Africa prior to 2004 were legally predicated on the common law and statutes promulgated under the Banks Act of 1990. Standard and Poor's (2006) 'Introduction of National Rating Opens Door to Rating South African Structured Finance Transactions by Standard and Poor's: A commentary', at p. 4. Available at http://www.securitization.net/pdf/sp/SouthAfrica_30Mar06.pdf

to Zimbabwe. To kick-start securitization transactions, South Africa introduced securitization regulations in 1992.⁴⁵ Similarly, the Reserve Bank of Zimbabwe promulgated securitization guidelines in 2007.

This study argues that through the use of law as a tool of financial engineering - economic, political, and other factors permitting - Zimbabwe can establish a functional and risk mitigating securitization-enabling financial framework. The thesis that law can be used as a tool of financial engineering is not novel. It's the argument Hernando De Soto makes in his book: *The Mystery of Capital*,⁴⁶ regarding capital creation. De Soto argues for the use of law to create a system that captures, registers and recognises the value of poor people's property in developing countries;⁴⁷ which operates to evidence and commoditize illiquid assets. He refers to mortgage backed securitization as but one method through which the industrialised world "injects life into assets and makes them generate capital."⁴⁸ This research applies this theory, through an analysis of Zimbabwe's legal framework and identifies legal reforms required for the establishment of a viable, risk-mitigating securitization-enabling financial infrastructure. In a sense this study agrees with Norton's "law-based financial sector reform" thesis as being a prerequisite and prelude to sustained financial and economic development.⁴⁹

⁴⁵ Securitization Schemes Schedule (GN 153, GG 13723 of 3rd January 1992) and the Commercial Paper Schedule (GN 2172, GG 16167 of 14th December 1994) both of which were promulgated under the Banks Act (Act No. 94 of 1990).

⁴⁶ Hernando De Soto (2000) *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, Basic Books. Hernando De Soto's thesis was not about the mechanics of mortgage backed securitization, but about creating a system of land registration that evidences ownership to unlock idle capital. See also Arner (2002) (note 8, supra) at p. 507, where he refers to Hernando De Soto and states that he proposes reform of legal systems in developing countries to help activate idle capital.

⁴⁷ De Rivero argues that it is a misnomer to suggest that so-called developing countries are actually developing. He prefers to call them Non-viable national economies. Oswaldo De Rivero (2001) *The Myth of Development: The Non-Viable Economies of the 21st Century*, Halifax: Fernwood.

⁴⁸ De Soto (supra, note 46) at p. 7.

⁴⁹ Norton makes an interesting argument about a law based-approach to financial sector reform. He states: "Financial sector reform invariably entails a broad, rule-oriented framework to which unfettered discretion, non-transparency and cronyism must give way." He proceeds to say: "Financial law reform

As noted above, this study assumes that the 2007 global financial crisis, which was caused in part by the securitization of U.S. subprime mortgages and compounded by regulatory and gatekeeping failures is transient; and that the challenges posed by securitization will lead, not to the prohibition or imposition of wholesale restrictions on securitization, but rather to greater appreciation of securitization transaction-attendant risks, better risk management mechanisms and enhanced financial services sector regulation.⁵⁰

1.5. Scope of study and methodology

Transactional and comparative in nature, this study narrowly focuses on Zimbabwe as a case-study and uses, in part, a basic securitization model as a prism to audit Zimbabwe's financial infrastructure and make recommendations for legal reform. This approach permits an intensive and critical analysis of relevant securitization issues as they would arise in an emerging market using Roman-Dutch law as its common law. This research does not seek to establish the econometric benefits of securitization, analyse the extant domestic economic conditions, determine the optimum economic conditions necessary for effective securitization propagation, or subject securitizable assets available in Zimbabwe to an econometric modelling analysis. These issues are beyond the scope of this study. Instead this research focuses

in developing countries is not about the adoption of individual financial laws, but the creation of a viable and coherent financial legal infrastructure suitable for the development of well-functioning financial markets and a sound business environment. In addition to good central and commercial banking laws, securities and securities market laws, a wide range of interconnected and supporting laws are needed. These include modern laws in the areas of contracts, property, property security rights, commercial and finance law, insolvency, corporations (including partnerships and joint ventures), corporate governance, foreign investment, licensing, intellectual property and taxation.” Joseph J. Norton (2007) ‘Taking Stock of the First Generation of Financial Sector Legal Reform’, at p. 32. *SMU Dedman School of Law Legal Studies Research Paper No. 9*. Available at <http://ssrn.com/abstract=981226> See also Joseph J. Norton (1998) ‘Financial Sector Reform and International Financial Crises: The Legal Challenges’, *Essays in International Financial and Economic Law*, No. 16, 1998.

⁵⁰ See the main argument in, Knowledge@Wharton (2008) ‘Coming Soon...Securitization with a New, Improved (and Perhaps Safer) Face’. Available at: <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1933>

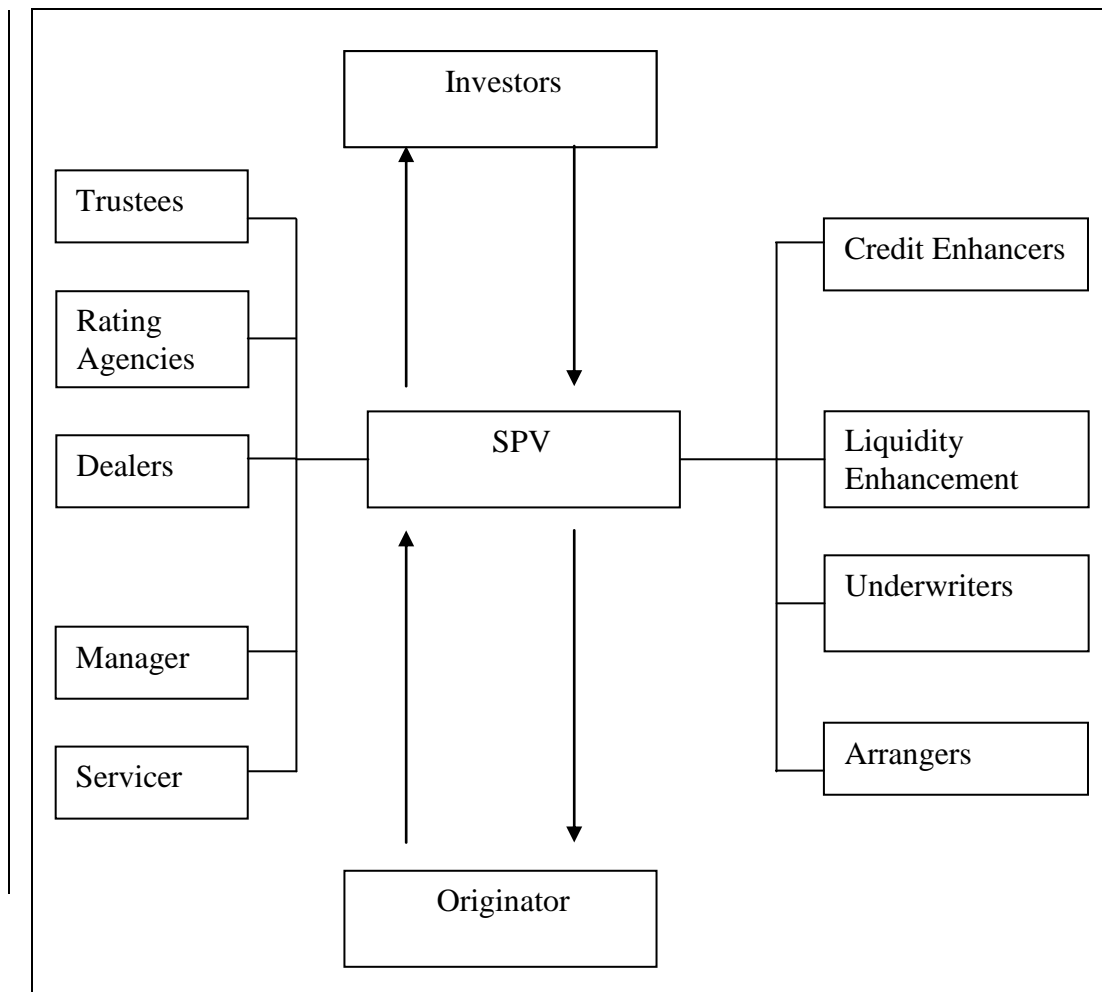
on the *legal* aspects of Zimbabwe's financial infrastructure; subjecting it to a rigorous analysis, assessing whether it is securitization-enabling; and where relevant, it identifies legal reforms required to establish a functional and risk-mitigating securitization-enabling financial framework.

Most of the literature and jurisprudence available on securitization is drawn from the United States. This is hardly surprising given that the United States pioneered modern securitization in the 1970s and accounts for the bulk of securitization securities issues. Reference is therefore made in this study to relevant United States literature, statute law and *stare decisis*, as well selective English and Canadian jurisprudence. Extensive reference is made to Roman-Dutch law as it applies in South Africa, as well as South Africa's securitization experience.⁵¹ As noted above, Zimbabwe and South Africa share a unique legal system – a fusion of Roman and Dutch law with influences of English law. In addition, South Africa has the only active securitization market in sub-Saharan Africa.

Due to the nature of the research subject, a desk research based methodology is utilised. Doctrinal issues arising from or relating to securitization are not separately analysed; rather they are considered where relevant in each chapter of the research. Through a literature analysis, most of the doctrinal issues surrounding the social usefulness of securitization are evaluated in chapter 2.

⁵¹ Both South Africa and Zimbabwe belong to the Southern Africa Development Community (SADC), an economic bloc, one of whose treaty objectives is the promotion of sustainable and equitable economic growth. Refer to article 5 (1) (a) of the "Treaty of the Southern African Development Community." South Africa pioneered and has the only active domestic asset securitization market in Africa and SADC. By 2005 it provided 85% of the volume of the EEMEA region's securitization issuances. Standard and Poor's (2006) 'EEMEA ABS Issuance Expected to Rise in 2006 As New Assets and Structures Emerge' (4th January 2006), at pp. 2-3. The Southern African Development Community (SADC) is made up of fourteen States: (1) Angola (2) Botswana (3) Democratic Republic of Congo, (4) Lesotho (5) Madagascar (membership pending) (6) Malawi (7) Mauritius (8) Mozambique (9) Namibia (10) South Africa (11) Swaziland (12) Tanzania (13) Zambia (14) Zimbabwe

1.6. Basic securitization transaction model: An illustration



The above diagram is a simplified illustration of a basic securitization model. Securitization transactions differ in structure, nature of participants, form and complexity from one to the other. The individual characteristics of different transactions depend on factors such as the originator's investment rating and its finance requirements; the nature and quality of assets to be securitized, the extant legal and regulatory environment, and transaction cost issues such as taxation and bankruptcy proofing considerations. There are numerous distinct participants to a basic securitization transaction: an originator, the special purpose vehicle, the servicer, credit rating agency, credit and liquidity enhancers and investors in securitization securities.

Originator: An entity in possession of financial assets, which refinances using securitization, is known as an originator⁵² or a seller. Typical originators include financial institutions such as banks, building societies, insurance companies, and any other entities that receive statistically predictable income streams.⁵³ Historically, it was argued that firms could securitize almost anything that accrues cash,⁵⁴ had a diversified credit risk profile; and that produced statistically computable and predictable cash-flows, the rights to which could be sold.⁵⁵ Given the credit risks exposed in sub-prime mortgage securities and CDOs, following the 2007 global financial crisis, this statement is obviously subject to a caveat. Financial assets to be securitized are generally referred to as receivables. Those who are obliged to make payments that are the source of the asset's cash-flow are known as obligors.⁵⁶ Typical obligors include mortgage or credit card holders, debtors, etc. Obligor are rarely actively party to a securitization transaction, unless if their consent to the asset transfer,⁵⁷ or diversion of the contract payment from the originator to a third party or an escrow account is necessary.

The originator identifies and isolates a pool of financial assets, either existing assets or future-flow financial receivables with a statistically quantifiable and

⁵² The RBZ defines an originator as "...an institution that, whether at the commencement or during the life of the scheme, transfers assets from its balance sheet or in a synthetic securitization scheme, uses a credit derivative instrument to transfer the risk associated with a specified pool of assets to investors without actually selling the assets. RBZ (2007), (note 3, supra) at p. 3.

⁵³ David J. Cummins (2004) 'Securitization of Life Insurance Assets and Liabilities' *The Wharton Financial Institutions Center*, at p. 4. Available at <http://fic.wharton.upenn.edu/fic/papers/04/0403.pdf>

⁵⁴ See Marcia Myberg for instance who stated: "...one can expect virtually anything that has cash flow to be a candidate for securitization." Marcia Myerberg (2000) 'The Use of Securitization by Investors and Issuers in International Markets', Chapter 12 in Kendall L. and Fishman M, ed, (2000) *A Primer on Securitization*. In 1997 Kim Clark stated that Wall Street could securitize almost anything. Kim Clark (1997) 'On the Frontier of Creative Finance: How Wall Street can Securitise Anything', *Fortune*, April 1997, at p. 50. Available at www.netcopters.com/secany.html

⁵⁵ Anthony Raikes (1999) 'The Management of Special Purpose Companies', at p.1. Available at http://www.securitization.net/knowledge/spv/mgmt_spvml.asp

⁵⁶ FitchRatings (2001) 'Asset-Backed Commercial Paper Explained', at p. 7. Available at www.fitchratings.com In its securitization guidelines, the RBZ defines an Obligor as "a debtor from whom the originator has right to receivables." RBZ (2007) (note 3, supra) at p. 3.

⁵⁷ For instance, where the asset transfer method is a novation, in which case the consent of the obligor is required to perfect the asset transfer.

predictable cash-flow.⁵⁸ The pooling of assets is intended to mitigate, among others, non- and pre-payment risk. The income stream from the underlying assets is structured to service principle and interest payments to holders of issued securities.⁵⁹

Special Purpose Vehicle (SPV): an SPV receives assets to be securitized from an originator and pays for them by issuing securities. Typically, an SPV is a separate legal structure and can be established as an incorporated company or a trust.⁶⁰ Arguably, the characteristics of SPVs that can be used are limited only by the imagination of the professionals involved.⁶¹ Originators can create and use “one-off” or a “multi-issuer” SPVs.⁶² Further SPV can either be pass-through⁶³ or pay-through structures.⁶⁴ In addition, transactions may be structured with at least two SPVs, not necessarily sharing the same legal status. Such structures are referred to as multi-tier structures.⁶⁵

Financial assets can either be sold to an SPV or transferred as security for a loan advance by the SPV. Where the transfer is a sale, this is known as a “true-sale.”⁶⁶ In theory, a true-sale severs an originating firm’s rights, title and interests in the financial

⁵⁸ Steven L. Schwarcz (1993) *Structured Finance, A Guide to the Principles of Asset Securitization*, 2nd ed, Practising Law Institute, at pp. 5-7.

⁵⁹ Kenneth N. Klee and Brendt C. Butler (2002) ‘Asset-Backed Securitization, Special Purpose Vehicles and Other Securitization Issues’, at p. 3. Available at www.ktblaw.com/publications/asset_backed_securit.pdf

⁶⁰ Gary B. Gorton and Nicholas S. Souleles (2005) ‘Special Purpose Vehicles and Securitization’, *NBER Working Paper* W11190, at p.2. Available at <http://ssrn.com/abstract=684716>

⁶¹ Schwarcz (1994) (note 4, supra), at p. 138.

⁶² A “one-off” SPV is created by an originator for a particular transaction after which it is wound up. On the other hand, a multi-issuer enables multiple originators to use a pre-existing conduit for a series of securitization issuances. Schwarcz (1994) (note 4, supra) at pp. 138-141

⁶³ A pass-through structure issues equity securities which represent undivided pro-rate interests in the assets’ cash-flow, which is passed through the SPV.

⁶⁴ A pay-through structure issues debt, equity or hybrid securities that reconfigure the cash-flows from the underlying assets, creating two or more classes of security.

⁶⁵ The Committee on Bankruptcy and Corporate Reorganisation of the Association of the Bar of the City of New York, (1995) ‘Structured Financing Techniques’, *50 Bus. Law* 527 (1995) at p. 573. For a general discussion of the multi-tier structure, refer to Petrina R. Dawson (1998) ‘Rating Games with Contingent Transfer: A Structured Finance Illusion’, *Duke Journal of Comparative and International Law*, Vol. 8:381, 1998, at p. 388.

⁶⁶ A true sale has been defined as a sale that severs the originator’s legal and beneficial interests to a pool of assets and should be sufficient under bankruptcy law to remove the receivables from the originator’s bankruptcy’s estate. See Yuliya A. Dvorak (2001) ‘Transplanting Asset Securitization: Is the Grass Green Enough on the Other Side?’ *Houston Law Review*, vol. 38, 2001, 541, at p. 560.

assets, including rights of ownership, and transfers these to the SPV. In Roman-Dutch law, this is achieved through an absolute cession. If the assets are transferred as security for a loan made by an SPV to an originator, this is known as a non-true-sale transaction. In Roman-Dutch law, this would be referred to as a cession in *securitatem debiti*.

Securities: The type of securities issued by an SPV depend on several factors such as existing market conditions, the prevailing legal and regulatory framework, tax incentives/considerations, the legal status and structure of an SPV, the nature and quality of the securitized assets, whether the securities are to be privately placed or publicly issued and various other cost considerations. Securitization SPVs may issue debt, equity,⁶⁷ or hybrid securities which will typically provide for varying internal priorities, maturities and rates of return; each designed to cater for different investors' risk appetites. Further, short term securities are classified as "conduits" and long term securities are referred to as "term deals."⁶⁸

Bankruptcy Remoteness: The concept of bankruptcy-remoteness is a creation of structured finance methodology. Securitization SPV are in theory structured to be bankruptcy remote, i.e. insulated from an originator's bankruptcy estate. An SPV is typically bankruptcy-protected through a series of measures, including the restriction of its: (i) power, objectives and purposes; (ii) ability to file for voluntary bankruptcy, winding up or liquidation; (iii) ability to incur debt, grant liens or security interests or engage in mergers; and (iv) ability to merge with other entities.⁶⁹

⁶⁷ In securitization, the equity securities have debt-like characteristics, and this is because they derive their value from the specific financial assets sold to the SPV by the originator. See Iacobucci and Winter (note 11, supra), at p. 164.

⁶⁸ Olivier Melennec (2000) 'Asset Backed Securities: A Practical guide for Investors', *The Securitization Conduit*, Vol. 3, No. 1/2, 2000, at p.1. Available at <http://www.asset-backed.com>

⁶⁹ Gorton and Souleles (2005), (note 60, supra), at p.10. For a general discussion of the concept of bankruptcy remoteness and bankruptcy-proofing techniques, refer to Dawson (note 65, supra), at pp. 392-394.

Credit and Liquidity Enhancers: securities issued by an SPV are always credit and liquidity enhanced.⁷⁰ Liquidity enhancers provide facilities which mitigate the risk that an SPV will have insufficient funds to pay scheduled principal and interest payments.⁷¹ An originator may use, among others, one or more of the following techniques to credit and liquidity enhance a transaction: credit default risk insurance, guarantees, letters of credit, irrevocable credit lines, internal reserve funds, over-collateralisation, agreements to purchase defaulted receivables, early amortization, or a senior debt/subordinated debt structure.⁷² Such measures to mitigate default risk enable the securities to be ascribed investment-grade ratings and consequently attract comparatively lower coupon rates.⁷³

Servicer: A servicer is typically engaged to enable an originator to achieve off-balance sheet financing through severing any connection in ownership and management between an originator and an SPV.⁷⁴ In certain instances, it is necessary for the originator to service the receivables. Typically, the servicer will, in terms of an Administration agreement, be obliged to monitor the underlying assets and cash-flow; enforce the underlying contracts, collect cash generated by the assets and ensure that the cash is distributed in accordance with the finance arrangement.⁷⁵ In addition, the servicer typically accumulates the cash receivables in a trust account which is then periodically drawn down by the SPV.⁷⁶ Sometimes, for a fee, a backup servicer is

⁷⁰ Kotecha argues that securitization securities have become safe, liquid and high yielding investments because of the widespread availability and investor acceptance of third party credit enhancement.

Mohesh K. Kotecha (2000) 'The Role of Insurance in Asset-Backed Securities', at p.1. Available at <http://pages.stern.nyu.edu/~igiddy/ABS/guarantees.pdf>

⁷¹ Klee and Butler, (2002), (note 59, supra) at p.28.

⁷² See Dvorak (2001), (note 67, supra) at p. 560.

⁷³ Shwarcz notes: "Companies whose debt securities are rated "investment grade" can usually issue securities in the capital markets at interest rates competitive with, or even lower than, other generally available sources of funds, such as bank loans." Shwarcz (1994) (note 4. supra), at p. 137.

⁷⁴ Raikes (1999), (note 56, supra) at p. 1.

⁷⁵ Klee and Butler (2002) (note 59, supra), p. 4.

⁷⁶ Pelma J. Rajapakse (2005) 'Residential Mortgage Securitization: The Australian Perspective', *Global Jurist Topics*, vol. 5., Issue 3, 2005, at p. 8

retained in case the primary servicer fails to perform as per the terms of the contract. The SPV may, pursuant to a Trust Agreement, use a bank or other entity as a trustee to fulfil most or all of the servicer obligations described above. Further, depending on its legal status, the SPV may be administered by a manager and/or trustees. To minimise transaction costs, the actual day to day management of the SPV's operations may in practice be outsourced to a professional SPV management company.

Arranger: An arranger is typically a third party professional services firm that is engaged - for a fee - to structure a securitization transaction. The arranger may purchase the receivables from an originating firm or establish an SPV. It consults with CRAs, lodges all the necessary compliance papers with the securities exchange and other authorities.⁷⁷

Rating agencies: To reduce agency and transaction costs and to provide securities price guidelines securitization issuances are typically rated by recognised CRAs.⁷⁸ CRAs have traditionally been involved in the structural designing of securitization products, especially where particular investment-grade ratings are sought.⁷⁹ If tranced, a securitization transaction will receive multiple ratings. Credit rating measures default risk. The rating is based on numerous factors considered by the respective rating agency and represents an opinion on the issuer's likelihood of full and timely interest and principal repayment in accordance with the instrument's

⁷⁷ Adam B. Ashcraft and Til Schuermann (2008) 'Understanding the Securitization of Subprime Mortgage Credit'. *Wharton Financial Institutions Center Working Paper* No. 07-43, at p. 5. Available at <http://ssrn.com/abstract=1071189>

⁷⁸ Usually, one of the international credit rating agencies such as Standard and Poor's Rating Services, Fitch Investors Services, Moody's Investors Services is used to rate the transaction.

⁷⁹ Autorite des Marches Financiers argue: "Rating is an integral part of structuring securitization products. The agency is involved at an early stage, and the rating is not an outcome but a target for the arranger, with the agency indicating the factors that need to be addressed to obtain the desired rating. In particular, the agency has an indirect influence on how the tranches are configured to ensure that the senior issue obtains the highest possible rating." Autorite des Marches Financiers, Research Department (2007) 'Is Rating an Efficient Response to the Challenges of the Structured Finance Market?' (March 2007), at p. 6. Available at http://www.amf-france.org/documents/general/7693_1.pdf

terms.⁸⁰ The factors considered by rating agencies include the structure of the transaction, the quality and characteristics of the securitized assets, the credit quality of the underlying obligors, credit and liquidity enhancement measures, sovereign risk issues; and the legal framework, including corporate transparency and disclosure regulations.

Investors: although traditionally institutional in nature, securitization securities in their various forms, including mortgage backed securities and the derivative products are bought by different types of investors.

1.7. Chapter structure: Research issues in detail

The legal questions raised in each chapter of this study are in effect a subset of the twin-research questions above, which are: (i) to what extent does Zimbabwe's legal system enable income generating enterprises and other entities to engage in the numerous legal arrangements that constitute a basic securitization transaction; and (ii) which legal reforms ought to be implemented to create a functional and risk-mitigating securitization-enabling financial infrastructure? **Chapter 2** discusses, through a literature analysis, and in light of the 2007 global financial crisis, the risks and benefits of securitization. **Chapter 3** provides a snapshot of Zimbabwe's financial services industry, sources of finance, its money and bond markets as well as its capital markets. **Chapter 4** analyses laws governing prudentially regulated institutions in Zimbabwe, which are likely to engage in securitization, such as banking institutions, building societies and insurance firms. The chapter assesses whether laws governing or relating to these institutions enable them to (i) engage in securitization transactions; (ii) incorporate or establish securitization SPVs; (iii) provide securitization

⁸⁰ Dvorak (2001) (note 67, supra) at p. 570.

transaction-related services; and (iv) invest in securitization issuances. **Chapter 5** evaluates whether juristic entities that are traditionally used as business vehicles in Zimbabwe such as corporate, partnership and trust structures can be utilised as SPVs in securitization transactions. **Chapter 6** considers several legal issues that typically arise on the transfer of assets from an originating firm to an SPV. It evaluates the question: to what extent does Zimbabwe's legal system permit the effective and secure transfer of financial assets from an originating firm to an SPV? The chapter analyses: (i) the different asset transfer methods - and their bankruptcy risk characteristics - that originating firms in Zimbabwe can use when structuring securitization transactions; and (ii) the structured finance-idiosyncratic true-sale concept, *indicia* for true-sale transactions, and the applicability of the concept to securitization asset transfers arranged in Zimbabwe. It also evaluates re-characterization risk, substantive consolidation risk, the theory and practice of piercing the corporate veil - which has implications for the sanctity of an asset transfer - and foreclosure risk. **Chapter 7** analyses whether Zimbabwe's tax laws permit the cost-effective structuring of securitization transactions. It analyses the likely tax treatment of the various contractual arrangements that constitute a securitization transaction, considering income tax, value added tax and stamp duty liabilities. **Chapter 8** assesses whether Zimbabwe's dispute resolution framework enables the cost-effective and expeditious resolution of disputes likely to arise from securitization transactions. It identifies the court with jurisdiction over typical securitization transaction disputes, whether contractual parties can use arbitration, opt for a foreign law or forum to resolve and adjudicate disputes arising from securitization. **Chapter 9** analyses the risk prevention and management properties of Zimbabwe's financial markets regulatory and gatekeeping framework. Structured finance transactions,

including securitizations, are not risk free; as illustrated by the global financial crisis. The harnessing of this sophisticated technique requires a robust regulatory and corporate gatekeeping framework. Chapter 9 analyses the regulatory jurisdiction and risk management powers of the Reserve Bank of Zimbabwe (RBZ), the Insurance and Pensions Commission (IPC) and the Securities Commission (SC). Each of these regulates banking institutions, insurance firms and public securities exchanges and related entities, respectively. **Chapter 10** evaluates the law regulating key capital markets gatekeepers such as structured finance lawyers, public auditors and CRAs. **Chapter 11** concludes the research by restating findings and recommendations made in each chapter.

1.8. Summary

This chapter introduced and described the concept of securitization, the research problem and hypothesis. It defined the scope and methodology of the study, provided the context that both motivates and influences the research subject matter. It restated that the global financial crisis notwithstanding, it is likely that securitization will remain, including possibly in an altered form, as a significant means of financing profitable enterprises in the world and that emerging markets, such as Zimbabwe, in creating securitization-enabling financial infrastructure should simultaneously create robust risk mitigating frameworks.

CHAPTER 2

RISKS AND BENEFITS OF SECURITIZATION

2.1. Introduction

For close to two decades securitization has been the predominant means of global enterprise financing. It is not however risk free as illustrated by corporate failures and financial crisis from Enron to the 2007 global financial crisis in which securitization was implicated. Through a literature analysis, this chapter provides an historical assessment of the benefits and risks of securitization. The 2007 global financial crisis has cast doubt on some of the touted benefits of securitization. However, the risks spawned by the securitization of U.S. subprime mortgages notwithstanding, notable academic and financial services industry opinion posits that securitization will remain as an integral refinancing measure. This study argues that the risks associated with securitization transactions can and should be mitigated through the creation of robust financial markets regulatory and gatekeeping regulatory and liability frameworks. The legal nature and scope of this research obliges the risk-benefit analysis to be industry-general, non-empirical and to waive the use of industry and country specific econometric arguments and data. Below is a non-exhaustive literature analysis of the risks and benefits of securitization.

2.2. Originator: Risks and benefits

Properly functioning, securitization is liquidity enhancing, constitutes an alternative and cost-effective capital market-based refinancing, risk management, and balance sheet management technique. Securitization, it has been argued, enables firms to attain net cost efficiency benefits by reducing information asymmetries, agency costs, lowering firms' weighted-average cost of capital and by improving asset-liability management. However the extent to which these benefits accrue to originating firms depends on numerous variables.

2.2.1. Increased liquidity

Properly functioning securitization is both a balance-sheet management tool and a liquidity creating technique.⁸¹ Securitization enabled liquidity-seeking financial entities to evolve their business models, from the originate-to-hold to the originate-to-distribute business model. Securitization benefits firms holding illiquid assets such as mortgages, term loans, or other receivables, which can be discounted for cash. Jobst noted that securitization: (i) enabled the partial or full de-recognition of assets – off balance-sheet – thereby allowing favourable accounting; (ii) “reduced economic cost of capital as a proportion of asset exposure associated with asset funding”; (iii) reduced regulatory capital requirements; (iv) enabled firms to access lower cost capital market financing in lieu of intermediated financing; and (v) enabled firms to overcome agency costs of asymmetric information.⁸² However the theory that securitization is as a general rule liquidity-creating was undermined by its role in the 2007 global financial crisis. The 2007 global financial crisis has been characterized by

⁸¹ Brent B. Ambrose., Michael LaCour-Little and Anthony B. Sanders (2003) ‘Does Regulatory Capital Arbitrage or Asymmetric Information Drive Securitization?’ at p. 4. Available at <http://ssrn.com/abstract=557223>

⁸² Jobst (2006) (note 8, supra), at p. 4.

illiquidity,⁸³ high cost of capital, insolvencies, and the nationalisation mostly of financial institutions.⁸⁴ Allen suggests that the liquidity crisis that ensued may in effect not be a problem because it is the result of liquidity hoarding by banks hedging against uncertain aggregate market liquidity.⁸⁵ It has also been argued that it is the securitization of mispriced subprime mortgages and the structuring of complex products, such as CDOs that adversely affected the liquidity-creating attributes of securitization.⁸⁶ In other words, securitization as an engineering technique is liquidity-unlocking, but not when the assets securitized, and the risk calculation methodologies utilised are fundamentally flawed. In support of this argument, commentators have pointed out that traditional securitization securities have not suffered as much delinquency compared to mortgage backed securities, which were tainted by subprime lending.⁸⁷ To ensure that securitization retains its liquidity-unlocking qualities, commentators have suggested excluding complex and difficult to price assets from transactions or reflecting better – in the ratings – the risks attendant to such assets.⁸⁸ In practice, it is unlikely, but time will tell whether, subprime loans will continue being securitized.⁸⁹

2.2.2. Lower cost financing

Historically, securitization has enabled originating firms to raise lower-cost finance. It is argued that by raising capital market funds through the issuance of securities backed by segregated assets as opposed to its overall credit rating, an

⁸³ For a discussion on the liquidity sapping effects that securitization played in the 2007 global financial crisis, see Franklin Allen and Elena Carlletti (2008) ‘The Role of Liquidity in Financial Crises’. Available at <http://fic.wharton.upenn.edu/fic/papers/08/0833.pdf>

⁸⁴ See generally, Franke, G., Krahen J.P. (2008) ‘Securitization and the Efficacy of Monetary Policy’. Available at www.ifk-cfs.de/fileadmin/downloads/publications/wp/08_31.pdf

⁸⁵ Allen and Carlletti (2008) (note 83, supra), at p. 22.

⁸⁶ Schwarcz (2008) (note 25, supra), at p. 3.

⁸⁷ Calomiris (2008) (note 22, supra) at p. 80.

⁸⁸ Schwarcz (2008) (note 25, supra), at p. 4.

⁸⁹ Kravitt (2008) (note 3, supra), at pp. 25- 28.

originating firm can reduce its overall cost of finance.⁹⁰ Integral to this theory is the argument that appropriately structured; the issuing SPV should be bankruptcy remote. And supported by appropriate credit and liquidity enhancement measures, the consequential cost of capital should in theory be lower relative to intermediated forms of financing or funds raised and backed by the originator's own credit rating. However, given the number of variables that influence the cost of finance this argument is obviously subject to several caveats.

Iacobucci *et al* dismissed the lower-cost finance theory as a fallacy, opining correctly, as did Schwarcz that lower rates of interest did not necessarily equate with lower cost finance as securitization transactions generally attracted higher transaction costs.⁹¹ On the basis of the Modigliani and Miller capital structure irrelevance theorem, Iacobucci *et al* argue that apparent gains from securitization should in theory be offset by losses in the quality of other securities.⁹² But because of the existence of imperfect capital markets and in support of securitization, most commentators argue that the technique results in tangible net-cost efficiency benefits to originating firms.

It has also been argued that properly structured, cross-border future-flow securitization enable emerging market structured transactions to obtain higher ratings relative to the relevant sovereign rating. This enables the piercing of the sovereign risk ceiling and can reduce refinancing costs. This is particularly important for firms domiciled in below investment-grade emerging markets.⁹³ It was is argued that securitization of future-flow receivables allows firms domiciled in emerging markets

⁹⁰ Schwarcz states: "securitization debt often has a lower interest-rate cost than corporate debt because it provides a new source of financing, the capital markets, whose rates are systematically lower than the rates at which many companies commonly borrow." Steven L. Schwarcz (2003) *Securitization Post-Enron*, at p. 18. Available at: <http://ssrn.com/abstract=386601>

⁹¹ The following costs are usually incurred in asset securitization transactions: SPV set up costs, legal fees, asset review costs, and rating agency fees, credit enhancement costs, administrative fees, trustee fees, and issuing and paying agent fees. Cummins (2004), (note 53, *supra*), at p. 14.

⁹² Iacobucci and Winter (note 11, *supra*), at p. 169.

⁹³ Dvorak (2001) (note 67, *supra*), at p. 551.

to raise comparative lower-cost finance from international capital markets even during crisis.⁹⁴ And that it may be the only way of accessing capital markets for firms domiciled in countries with very low GDP per capita.⁹⁵ This theory may arguably have been accurate in the golden heydays of securitization and has been undermined by the 2007 global financial crisis.

2.2.3. Net-cost benefits

Some commentators argue that securitization's disintermediation effect results in net-cost benefits accruing to originating firms.⁹⁶ With regards to emerging market economies, it has been argued that high capital cost is partly caused by an inefficient intermediated credit finance sector. And that the disintermediation effect of securitization can, in certain instances and for particular originators, reduce refinancing costs.⁹⁷ Drawing on empirical data, some commentators argue that capital markets rates were generally lower than intermediated credit market rates.⁹⁸ In other words, by changing banking institutions' traditional intermediary function, securitization enabled firms to reduce their cost of refinancing.

Securitization arguably reduces information asymmetries, which result in net-cost benefits to originating firms. Securitization can enhance market participants' knowledge of originating firms' securitized assets through asset partitioning and risk segregation. Claire Hill argued for instance that securitization enabled originating firms to signal to the market that the securitized receivables were not lemons, which created benefits for originating firms as this signalling effect enabled them to avoid

⁹⁴ Suhas and Dilip (2001) (note 27, supra), at p. 7.

⁹⁵ See generally, Nigel Chalk (2002) 'The Potential Role for Securitizing Public Sector Revenue Flows: An application to the Philippines', *IMF Working Paper*, WP/02/10. Available at <http://ssrn.com/abstract=879683>

⁹⁶ Frost (note 4, supra), at p. 106.

⁹⁷ Lakshman (2001) (note 30, supra) at p. 4.

⁹⁸ Schwarcz (2003) (note 90, supra) at p. 18.

the lemons market premium levied on originating firms' general security issuances.⁹⁹ Iacobucci *et al* concur with Hill's lemons theory and in a seminal article expanded on the net-cost benefits argument.¹⁰⁰ They argued that securitized assets were relatively insensitive to managerial effort in comparison with a firm's other general assets. Because securitization partitions securitized assets from the firm, the technique focuses attention on the performance of a firm's other assets which are sensitive to managerial effort. This, Iacobucci *et al* argued, facilitated asset monitoring and led to a reduction of five agency costs;¹⁰¹ leading consequentially to an increase in net firm value.¹⁰² Expanding on the signalling theory, which is in essence similar to Hill's lemons theory, Iacobucci *et al* in addition, argued that securitization enables originators to signal to investors not only the investment-grade rating attained but also that the management team of the originating firm was capable.¹⁰³ They argue that this signalling has positive net cost benefits for the originating firm. These theories have arguably been undermined by the 2007 global financial crisis, which revealed that credit risk was mispriced for some assets, especially U.S. subprime mortgage-backed securities.

⁹⁹ Hill states: "Securitization removes, and sweetens, a slice from the lemon – while leaving the remainder not appreciably sourer than it was before" Hill (1996) (note 15, *supra*), at p. 1066.

¹⁰⁰ See generally Iacobucci and Winter (2005) (note 11, *supra*).

¹⁰¹ Iacobucci and Winter argue that securitization results in enhanced efficiency of a firm's monitoring systems. By focusing on the firm's assets that are sensitive to managerial effort, the quality of the management can be more easily assessed. In addition, the incentive structures to align the interests of the shareholders and management can be enhanced and there will be a better connection between managerial effort on the one hand and remuneration and performance on the other. *Ibid.*

¹⁰² Andreas A. Jobst argues: "asset securitization might also redress conflicts of interest between creditors and shareholders in the capital structure choice of firms concerning possible agency costs from 'underinvestment' and 'asset substitution' due to excessive levels of debt or the presence of non-value maximising investment behaviour respectively." Jobst (2006) (note 8, *supra*), at p. 4.

¹⁰³ Iacobucci and Winter, (2005) (note 11, *supra*), at p. 176.

2.2.4. Diversification of funding sources

Securitization broadens the range of financing and risk management techniques available to originators. It can also enable small to medium enterprises through ABCP programmes to access cost-competitive capital market funding.¹⁰⁴

2.2.5. Risk management and value creation

Some commentators have argued that securitization's risk transfer characteristics create net-value for originating firms. Securitization enables regulatory capital arbitrage. By reducing the amount of risk-weighted capital they would otherwise be obliged to keep in reserve; prudentially regulated financial institutions are able to mitigate regulatory capital costs.¹⁰⁵ In rebuttal, while securitization enabled off-balance sheet financing, banking and other financial institutions remained exposed to credit risks associated with securitization, as discovered in the aftermath of the 2007 global financial crisis. Their exposures were due to "contingent credit lines, reputational risks, revenue risks and counter-party credit exposures."¹⁰⁶

Hill and Iacobucci *et al* downplayed the significance of regulation avoidance.¹⁰⁷

They argue that by reducing information asymmetries, securitization provides significant net cost benefits to originating firms. Other commentators argued that

¹⁰⁴ Jobst (2006) (note 8, *supra*) at p. 15.

¹⁰⁵ Steven L. Schwarcz (1990) 'Structured Finance: The New Way to Securitise Assets', *11 Cardozo, L. Rev.* 607 at p. 608. See also Jobst who states: "...securitization also serves to: (1) reduce...regulatory minimum capital requirements (by lower bad debt provisions) as a balance sheet restructuring tool." *Ibid.*, at p. 3.

¹⁰⁶ International Monetary Fund (2008) 'Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness', at p. 9. Available at www.imf.org/external/pubs/ft/gfsr/2008/01/index.htm

¹⁰⁷ Hill stated: "if securitization's main effect was to take skilful advantage of regulatory benefits, it would be more a triumph for practitioners than a phenomenon of interest to academics." Hill proceeds to argue that "securitization offers significant non-regulatory (efficiency) benefits [such as a reduction in information costs]" Hill (1996) (note 15, *supra*), at p. 1065. In their article, Iacobucci and Winter assert that: "if regulation avoidance [was] the explanation for securitization, it would be appropriate to doubt its social usefulness (assuming that the regulation in question makes sense)" Iacobucci and Winter (2005) (note 11, *supra*), at p. 163.

securitization's risk management characteristics explained its net-cost benefits to originating firms.¹⁰⁸ Jobst argued that securitization acts as an "operational means of risk management, which allows issuers to reallocate, commoditize and transfer different types of risks (e.g. credit risk, interest rate risk, liquidity risk, or pricing risk) to capital market investors at a fair market price."¹⁰⁹ Benston stated that securitization created value by enabling originating firms to better estimate and control risk, lower the concentration of credit risks and reduce both interest and prepayment risks.¹¹⁰ But it is precisely this credit risk transfer characteristic, which resulted in the unchecked transmission of systemic risk within global financial markets. It is likely that changes, especially pertaining to disclosure, will be introduced as part of a new-look securitization system to mitigate risks inherent in securitization.

In the context of U.S. some critics argued that firms could use securitization to mitigate bankruptcy costs.¹¹¹ Iacobucci *et al* acknowledge this; but in rebuttal argue that securitization, by leaving the firm with fewer assets, created value by avoiding the inefficiencies brought about by bankruptcy reorganisation.¹¹² An opposing school of thought to which LoPucki has been the most prominent, challenged these claimed efficiency benefits.¹¹³ Critics contended that securitization is inefficient because it is a bankruptcy-proofing technique, which hurts unsecured creditors and other non-

¹⁰⁸ James A. Rosenthal and Juan A. Ocampo (1988) *Securitization of Credit: Inside the new Technology of Finance*, John Wiley and Sons Inc., at pp. 12-17. See also George J. Benston (1992) 'The Future of Asset Securitization: the Benefits and Costs of Breaking up the Bank', *Journal of Applied Corporate Finance*, vol 5.1 Spring 1992 at pp. 74-75.

¹⁰⁹ Jobst (2006) (note 8, *supra*), at p. 4.

¹¹⁰ Benston (1992) (*supra*) note 108, at p. 74.

¹¹¹ Hill (1996) (note 15, *supra*), at p. 1101.

¹¹² Iacobucci and Winter (2005) (note 11, *supra*), at p. 171.

¹¹³ See the following line of articles by LoPucki: (i) Lynn M. LoPucki (1996) 'The Death of Liability', *106 Yale Law Journal*, 1996, 1, at p. 4; (ii) Lynn M. LoPucki (1998) 'The Essential Structure of Judgment Proofing', *51 STAN. L. REV.* 147, 1998; (iii) Lynn M. LoPucki (1998) 'Virtual Judgment Proofing: A Rejoinder', *107 Yale L.J.* 1413; (iv) Lynn M. LoPucki (1999) 'The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz', *52 STAN. L. REV.* 55, 1999.

adjusting economic participants.¹¹⁴ Schwarcz and Iacobucci *et al* disputed this contention stating that the disposal of assets in a securitization transaction did not of itself diminish the assets available to a firm's non-secured creditors in bankruptcy.¹¹⁵ It is only when an originator disposes of the proceeds of the securitization transaction that judgment proofing occurs.¹¹⁶ In other words, "securitization in and of itself is not a judgment-proofing technique."¹¹⁷

The foregoing review illustrates that no single economic theory explains the use and phenomenon of securitization, or the benefits that may accrue to any particular institution.¹¹⁸ It also confirms the tension between the benefits that accrue to originating firms and the consequences of such transactions on overall macro economic efficiency.

2.3. Investors: Risks and benefits

Although the securitization market is dominated by institutional investors, securities are typically tranching, which appeals to different investors' risk appetites.¹¹⁹ Securitization increased the range of triple-A rated securities, which appealed to prudentially-regulated institutional investors required by law to invest only in

¹¹⁴ See for instance, Chase W. Ashley who argues that the proceeds of the securitization transaction are more likely to be dissipated, thereby hurting unsecured creditors. Chase W. Ashley (1993) 'Comment: When a Company Securitizes, Its Creditors Face Higher Risks', *AM. Banker*, May 7, 1993, at p. 4.

¹¹⁵ Steven L. Schwarcz (1999) 'The Inherent Irrationality of Judgment Proofing,' *Stanford Law Review*, 52, 1-53.

¹¹⁶ Iacobucci and Winter rebut LoPucki's judgment proofing argument by stating that: "...exchanging one asset (future cash flows) for another (current cash) does not in itself judgment proof the firm, although it may assist in a judgment-proofing of the firm." Iacobucci and Winter (2005) (note 11, *supra*), at pp. 163.

¹¹⁷ *Ibid.*, at p. 170.

¹¹⁸ Jobst states: "There is not a single theory for the economic tenet of securitization." Jobst (2006) (note 8, *supra*) at p 3.

¹¹⁹ Brunnermier (2008) (note 23, *supra*) at pp. 5-6. See also Jobst (2006) (note 29, *supra*) at p. 4.

investment-grade securities. The risk distribution and value enhancing effect of tranching¹²⁰ benefits specialised investors.¹²¹

On the other hand however, securitization issuances are comparatively more complex and latterly have proved to be less liquid than other types of securities. CRAs and insurance firms mispriced the risks in U.S. subprime mortgage securities and CDOs, especially the triple-A rated issuances. It was the securitization of U.S. subprime mortgage loans that brought a hiatus to the securitization market and occasioned massive losses to many institutional investors. The same financial institutions that securitized their receivables were also the same ones investing in securitized products and the ones that suffered when liquidity evaporated and the value of their investment holdings plummeted, with the result that some entities went bankrupt or had to be bailed out by governments.

2.4. Economy: Risks and benefits

Up until the start of the 2007 global financial crisis, it is indisputable that countries, which had securitization markets reaped substantial benefits. Because of its liquidity creating attributes, securitization has been an engine for economic growth. It

¹²⁰ The profile of expected cash flows from securitized assets is often reconfigured into different types of securities (different tranches), which have different risk, maturity rates and periods, etc. See Maciej Firla-Cuchra and Tim Jenkinson (2006) 'Why are Securitization Issues Tranched?', at p. 2. Available at <http://www.sbs.ox.ac.uk/NR/rdonlyres/7C2DEAD7-C605-4F9F-B23B-D57DC83D9AF2/1242/Tranching-jan06.pdf>

¹²¹ Cummins notes: "By structuring an asset-backed transaction into tranches with varying degrees of seniority and informational complexity, securitization allows investors with relatively low levels of expertise to take positions in the more senior securities offered by the SPV, leaving the more complicated and risky tranches to be evaluated by specialists who can exploit informational economies of scale and recover their investment in information over a range of transactions." Cummins (2004) (note 54, supra) at pp. 13-14.

enabled broad-based home ownership, especially in the U.S., although, perversely, U.S. subprime mortgage securities contributed to the 2007 global financial crisis.¹²²

2.4.1. Benefits

At its height, securitization enabled the convergence of financial and capital markets with the conversion of illiquid financial assets into marketable securities. Properly functioning, a securitization-enabling financial infrastructure contributes to national capital markets development through the introduction of new and efficient risk management and modelling techniques as well as expanded sources of financing.¹²³ Securitization also leads to specialization in intermediation functions, which can lead to cost-savings and efficiency benefits.¹²⁴ Some commentators argue that innovative financial engineering technologies such as securitization nurture the emergence process of developing countries' capital markets by bringing about a lower national cost of capital which in turn enhances national wealth,¹²⁵ and is therefore welfare enhancing. It can lead to the improvement of living standards as well as making domestic enterprises more competitive in the global market place.¹²⁶ Tranching, which is typical of securitization issuances, attracts a wider class of investors, which potentially increases overall financial depth. The securitization of future-flow receivables enabled small-to-medium scale business enterprises in emerging market economies to access capital market financing. Securitization did

¹²² See the attack made on U.S. government policy for increased homeownership using innovative finance products. Christopher Whalen (2008) 'The Subprime Crisis - Cause, Effect and Consequences', at p.1. Available at <http://ssrn.com/abstract=1113888>

¹²³ Ian H. Giddy (2000) 'Asset Securitization in Asia', at p. 21. Available at <http://pages.stern.nyu.edu/~igiddy/ABS/absasia.pdf>

¹²⁴ Hugh Thomas states: "securitization allows financial institutions to specialise in activities of their comparative advantage." Hugh Thomas (1999) 'A Preliminary Look at Gains from Asset Securitization', *Journal of International Financial Markets, Institutions and Money* (1999) 321-333, at p. 324.

¹²⁵ Jacque, L. Laurent (2007) 'Financial Innovations and the Dynamics of Emerging Capital Markets', at p.1. Available at <http://fletcher.tufts.edu/faculty/jacque/pdf/financial-innovations.pdf>

¹²⁶ Ibid., at p. 1.

enable investment-grade firms domiciled in below-investment grade sovereigns to access international capital markets.¹²⁷ In addition, some commentators argued that: (i) the due diligence processes intrinsic to securitization structuring can produce benefits by making available to international investors valuable information pertaining to emerging markets' domestic financial infrastructure; and (ii) that it also involves reform of the domestic legal and institutional architecture.¹²⁸ Economists caution however, that the securitization of future-flow receivables, particularly future export receivables, future tax revenue, and other similar future-flow assets can increase a country's overall inflexible debt, potentially undermining the respective country's creditworthiness as well as precluding the use of securitized assets as future collateral.¹²⁹ In addition, it is notable that securitization subordinates existing and future creditors and can therefore increase the cost of future borrowing.

2.4.2. Risks

Since the onset of the 2007 global financial crisis, securitization has been pilloried, especially the securitization of mispriced U.S. sub-prime mortgages.¹³⁰ The extent to which securitization as a financial engineering technique - as opposed to its abuse - is liable for the global financial crisis is contested and subject to on-going debates.¹³¹ Opinions vary, with some commentators arguing that the global financial crisis that started in 2007 is the result of an asset price and/or a liquidity bubble, catalysed by the abuse of securitization (through exploitative risk shifting at every

¹²⁷ See generally, Suhas and Ratha (2001) (note 27, supra), at p. 1.

¹²⁸ Ibid.

¹²⁹ Ibid.

¹³⁰ See generally the argument advanced by Kravitt (2008) (note 3 supra).

¹³¹ Gary Gorton, for instance argues that: "Securitization generally is not the problem currently. It is not the cause of the crisis. Securitization is an efficient form of financing and there is no evidence that there is a systematic agency problem in its functioning. Rather, the particular form of the design of subprime mortgages is at the root of the problem. It was highly sensitive to house prices, and this sensitivity was passed through a variety of other financial structures." Gary Gorton (2008) 'The Panic of 2007', at p. 77. Available at <http://ssrn.com/abstract=1255362>

stage of the securitization chain),¹³² human greed, pro-cyclical economic policies, and financial markets regulatory and supervisory failures.¹³³ Regulatory authorities are blamed for failing to stop adverse risk peddling market practices.¹³⁴ Some commentators blame U.S. government policies requiring mortgage providers to provide finance to low-income groups, from which emerged subprime mortgages and derivative products.¹³⁵ It is variously argued that the securitization of U.S. subprime mortgages was exacerbated by: (i) increased predatory lending;¹³⁶ (ii) the perversion of the originate-to-distribute business model, resulting in the origination, securitization and world-wide distribution of mispriced securities;¹³⁷ (iii) the creation of problem opaque, difficult to price, complex securities, such as subprime mortgage-backed securities and CDOs;¹³⁸ (iv) commercial practices beset by moral hazard, with originating firms inappropriately slackening their lending conditions and practices;¹³⁹

¹³² Caprio, Demirguc-Kunt and Kane (2008) (note 26, supra), at p. 7.

¹³³ For a discussion on how human greed, unregulated structured finance markets, abuse of securitization, etc, caused the global financial crisis, refer to Aaron Unterman (2008) 'Innovative Destruction: Structured Finance and Credit Market Reform in the Bubble Era'. Available at http://works.bepress.com/aaron_unterman/2

¹³⁴ Caprio, Demirguc-Kunt and Kane (2008) (note 26, supra) at p. 8.

¹³⁵ David Tarr (2009) 'The Political, Regulatory and Market Failures that Caused the US Financial Crisis: What are the Lessons', at p.2. Available at <http://ssrn.com/abstract=1322297>

¹³⁶ Heather M. Tashman (2007) 'The Subprime Lending Industry: An Industry in Crisis', *124 Banking L.J.* 407, 410 (2007), at p. 410.

¹³⁷ See generally, Amiyatosh K. Purnanandam (2008) 'Originate-to-Distribute Model and the Sub-Prime Mortgage Crisis'. Available at <http://ssrn.com/abstract=1167786> See also Schwarcz (2008) (note 25, supra) at p. 3; Gorton (2008) (note 132, supra) at pp. 68-73.

¹³⁸ For a discussion on how the complexity problem arguably contributed to market failure, refer to Steven L. Schwarcz (2008) 'Complexity as a Catalyst of Market Failure: A Law and Engineering Enquiry'. Available at <http://ssrn.com/abstract=1240863> See also Unterman (2008) (note 133, supra) at p. 37. In 2002, Schwarcz, arguing for a different approach to mitigating principal/agency risks inherent in securitization transactions, stated that Enron's structured finance transactions "were so complex that disclosure either would have to oversimplify the transaction or else provide detail and sophistication beyond the level of not only ordinary but also otherwise savvy institutional investors in Enron's securities." Steven L. Schwarcz (2002) 'Rethinking the Disclosure Paradigm in a World of Complexity', *Duke Law School Public Law and Legal Theory Research Paper Series*, Research paper No. 34, October 2002, at p. 6. Available at http://ssrn.com/abstract_id=336685

¹³⁹ Aaron Unterman (2008) 'Exporting Risk: Global Implications of the Securitization of U.S. Housing Debt', *Hastings Business Law Journal*, vol. 4.1, 2008, at p. 10. See also David Henry and Matthew Goldstein, (2008) 'The Bear Flu: How it Spread', *BUS. Wk.*, January 7, 2008, at p. 30. Schwarcz disputes the moral hazard hypothesis. He argues that mortgage underwriting standards may have become compromised due to other reasons, such as the glut of liquidity and not necessarily due to securitization. But it is arguable, in rebuttal of Schwarcz's argument that the glut in liquidity was partly, if not largely due to the liquidity creating attributes of securitization, as well as low interest

(vi) the erosion of underwriting standards and fraud;¹⁴⁰ (vii) the increased provision of compromised fee-driven securitization-related services such those provided by CRAs, underwriters, etc;¹⁴¹ (viii) financial services industry compensation schemes, which encouraged irrational risk-taking, including the pursuit of short-term profit over long term performance;¹⁴² (ix) the abdication of due diligence by most market participants and misplaced over-reliance on ratings issued by CRAs - institutions riven by conflicts of interest;¹⁴³ (x) the mispricing by CRAs and insurance firms of structured finance securities credit risks; and (xi) regulatory and gatekeeping failures.

As noted above, defaults on underlying U.S. subprime loans caused wholesale-value write-downs on mortgage backed securities, CDOs and other structured finance products. The defaults undermined confidence in structured finance markets, leading to a hiatus in inter-bank lending and the onset of a global financial crisis. In response, governments, especially in the OECD – in addition to interest rate adjustments - were forced to inject capital into distressed financial institutions, effectively part nationalising their financial systems.¹⁴⁴ In some instances, affected institutions went bankrupt. Many countries sought emergency funding from the International Monetary Fund (IMF) to alleviate the effects of the global recession.

rates. See Schwarcz (2008) (note 25, supra) at p. 6. Kravitt also makes the same argument as does Schwarcz. Kravitt (2008) (note 3 supra).

¹⁴⁰ Gorton (2008) (note 132, supra) at p. 73. See also generally Benjamin J. Keys., Tanmoy K. Mukherjee., Amit Seru and Vikrant Vig (2008) 'Did Securitization Lead to Lax Screening? Evidence from Subprime Loans', *EFA 2008 Athens Meetings Paper*. Available at <http://ssrn.com/abstract=1093137>

¹⁴¹ Unterman (2008) (note 133, supra) at p. 35. See also Caprio., Demirguc-Kunt and Kane (2008), (note 26, supra) at p. 16.

¹⁴² See for instance Nouriel Roubini who argues that banker's compensation schemes incentivized them to take unnecessary risks. Nouriel Roubini (2008) 'Ten Fundamental Issues in Reforming Financial Regulation and Supervision in a World of Financial Innovation and Globalization'. Article available at <http://media.rgemonitor.com/papers/0/Nouriel-RegulationSupervisionMarch08.pdf>

¹⁴³ See Schwarcz (2008) (note 25, supra), at p. 7.

¹⁴⁴ The Economist (2007) 'Slouching Towards Nationalisation', (22 December 2007), at p. 43. OECD is the acronym used to refer to the Organisation for Economic Cooperation and Development.

Kaufman argued that securitization creates a liquidity illusion, increases systemic risk,¹⁴⁵ undermines monetary policy and fuels an explosion of debt.¹⁴⁶ He also argued that off-balance sheet financing leads to a decline in the total capital employed in the banking system, which increases the risk of financial instability of domestic and international financial systems.¹⁴⁷ In light of the 2007 global financial crisis, such criticism appears justified.

LoPucki, Kenji Yamazaki *et al* argued that securitization is inefficient because it abuses the law of incorporation by transferring a portion of a firm's assets to a third party SPV.¹⁴⁸ The transfer, if structured as a true-sale places financial assets outside an originating firm's bankruptcy estate; and hence beyond the reach of the firm's non-adjusting creditors such as employees, tort claimants, tax authorities, unsecured creditors, etc. In other words it is argued that securitization is not welfare-enhancing because it hurts non-adjusting third parties. LoPucki argued that firms in financial distress can use securitization to dissipate their assets, effectively making themselves bankruptcy-proof. LoPucki's argument is contested by pro-securitization commentators such as Schwarcz and Iacobucci *et al*, who argue that securitization is actually efficiency enhancing.¹⁴⁹ As noted above, this latter school of thought argued

¹⁴⁵ Kaufman, H. (1998) 'The New Financial World: Policy Shortcomings and Remedies', at p.1.

http://www.bos.frb.org/economic/conf/conf42/con42_19.pdf

¹⁴⁶ Henry Kaufman (1986) 'Debt: The Threat to Economic and Financial Stability', at pp. 22-25.

Available at <http://www.kc.frb.org/Publicat/Econrev/EconRevArchive/1986/4q86kauf.pdf> See also Arturo Estrella (2002) 'Securitization and the Efficacy of Monetary Policy', *Economic Policy Review*, 2002. Available at www.newyorkfed.org/research/epr/02v08n1/0205estr.pdf

¹⁴⁷ Ibid.

¹⁴⁸ Kenji Yamazaki contests the thesis propounded by Schwarcz *et al*. Yamazaki disputes that securitization is Kaldor-Hicks efficient. He argues that the technique has the potential to hurt unsecured creditors. Yamazaki posits that liquidity generated in favour of the originator by an asset securitization transaction is susceptible to over-investment and that benefits generated by asset securitization in the form of lower cost of capital are generally insufficient to off-set the harm to unsecured creditors. Kenji Yamazaki (2005) 'What makes asset securitization "inefficient"?' *ExpressO Print Series*, Paper No. 603, at p. 8. Available at <http://law.bepress.com/expresso/eps/603>

¹⁴⁹ Schwarcz measures "efficiency" using the Kaldor-Hicks efficiency theorem and not the Pareto efficiency theorem. He describes the Pareto efficiency theorem as meaning that a transaction – securitization – would make the parties to it (the originator and investors) better off and no other parties worse off. He dismisses the basis of this theorem arguing that it cannot be met in the real world. He

that securitization creates net value for unsecured creditors because it replaces one type of asset with another, cash.¹⁵⁰ And that absence malfeasance or over-investment on the part of an originating firm, no prejudice should be occasioned to unsecured creditors.¹⁵¹ Schwarcz, rightly, did not dispute that the mechanics of securitization are intended to place assets outside an originating firm's bankruptcy estate. Instead, he argued that securitization is rarely used by firms on the brink of insolvency. He argued in addition that directors' fiduciary duties, fraudulent conveyance laws and preference in bankruptcy are remedies available in the event of malfeasance or over-investment.¹⁵²

Originating firms in financial distress may engage in risk-shifting and over-investment behaviour, which while creating net positive value to a firm's shareholders, can adversely affect unsecured creditors rights.¹⁵³ Schwarcz rebuttal is that securitization is rarely used by firms in financial distress, reducing the risk of over-investment. Yamazaki counters Schwarcz's proposition citing empirical data showing an increase in the U.S. of low-rated securitization issuances.¹⁵⁴ It has been argued that securitization is not a legitimate way of financing because it fosters fraudulent transactions.¹⁵⁵ Indeed the collapse of Enron and the 2007 global financial crisis are testament to this. Enron also illustrated the increased principal/agency risks inherent in securitization transactions.¹⁵⁶ Several commentators however defend

opts instead for the Kaldor-Hicks theorem which is based on the calculation that a transaction is efficient if the aggregate benefit to the parties to a securitization transaction exceed any net harm to other parties such as unsecured third party creditors. Steven L. Schwarcz (2003) (note 90, supra) at p. 13.

¹⁵⁰ Iacobucci and Winter (2005) (note 11, supra) at p. 170.

¹⁵¹ Schwarcz (2003) (note 90, supra) at p. 17.

¹⁵² Ibid.

¹⁵³ Yamazaki (2005) (note 149, supra) at p. 6.

¹⁵⁴ Ibid., at p. 4.

¹⁵⁵ Ibid., at p. 1.

¹⁵⁶ Regarding mortgage backed securitization, Van Order for instance notes that the technique unbundles the four major aspects of mortgage-lending: origination, servicing, funding and accepting credit risk. Because of this unbundling, various participants in the market increasingly have to depend

securitization by finding fault, rightly, with gatekeepers who allowed Enron to engage in fraudulent transactions and also with the complexity of the transactions themselves. As appears in more detail in chapter 9 and 10, this thesis argues that these risks can and should be prevented and managed through the strengthening of financial services regulatory and gatekeeping frameworks.

2.5. Summary

Through a literature analysis, this chapter evaluated the various theories advanced to explain the benefits and risks of securitization. As with any refinancing method securitization generates benefits, as well as risks, to originating firms, investors and to national economies. The risks of securitization have been thrown into sharp focus by the 2007 global financial crisis, buttressing the need for robust financial stability frameworks.

on each other, enhancing principal/agents risks. In this case the principals are the investors and the agents are the originating and servicing institutions. See Robert van Order (2003) Public Policy and Secondary Mortgage Markets, at pp. 3-4. Available at http://infor.worldbank.org/ctools/docs/library/156603/housing/pdf/VanOrder_StateSupport.doc

CHAPTER 3

ZIMBABWE'S FINANCIAL SERVICES INDUSTRY

3.1. Introduction

This chapter provides a snapshot of Zimbabwe's financial services sector. It identifies, as background to the study, the nature of enterprise financing available, the range of institutions that act as providers of finance and other financial services, and which are likely to be active securitization participants as: (i) originators; (ii) investors, and (iii) providers of essential securitization services such as arrangers, SPV management or trustee services, underwriting, and liquidity and credit enhancement.

3.2. The financial services industry

Zimbabwe has a relatively sophisticated and well developed financial services industry, which offers most of the financial services traditionally found in developed economies. The financial services sector is characterised by a range of banking services and products, insurance firms, managed funds, investment and other financial services.¹⁵⁷ The financial services industry has active money, bond, equity markets, as

¹⁵⁷ The World Bank, in a 1995 report stated: "The range and number of financial institutions operating in Zimbabwe is impressive by African or even developing countries standards. The financial sector consists of several layers of institutions: the Reserve Bank of Zimbabwe, commercial banks, merchant banks (also called accepting houses), finance houses, discount houses, building societies, institutional investors, development finance organizations, the Post Office Savings Bank, and the Stock Exchange. Financial activities are also assisted by credit insurance and credit reference institutions." Marcel

well as foreign exchange and commodities markets. Most of the aforementioned financial institutions are active participants on the country's main securities exchange; the Zimbabwe Stock Exchange (ZSE).¹⁵⁸

Zimbabwe's banking industry provides traditional banking services, including providing short and long term finance products, securities investments advice, including trustee services, a range of structured finance transactions such as project finance, factoring, and leasing. Zimbabwe's financial services industry also comprises several types of non-bank financial institutions, including asset management companies, unit trusts, micro-finance institutions, insurance companies, pension and provident funds. Some of these institutions also act as primary dealers in government treasury bills and other securities.

Table 1 below lists the type and number of Zimbabwe's financial institutions.¹⁵⁹

CATEGORY	No/	SERVICES
Reserve Bank of Zimbabwe [this is the central bank in Zimbabwe]	1	The Reserve Bank of Zimbabwe (RBZ) is the ultimate regulatory authority of the banking industry in Zimbabwe. For a full list of banking institutions refer to the RBZ website: http://www.rbz.co.zw/publications/banksurveillance.asp#guide
Discount Houses	6	Almost all discount houses in Zimbabwe operate as and provide much the same services as commercial banks. However, they still engage in discounting and holding bills with funds on call from other deposit taking institutions. They specialise in providing the capital market with call money and short term paper by channelling surplus funds into government and municipal stock, treasury bills and acceptances and negotiable certificates of deposit.

Fafchamps., John Pender., and Elizabeth Robinson (1995) Enterprise Finance in Zimbabwe. Available at www.economics.ox.ac.uk/members/marcel.fafchamps/homepage/zimba.pdf See also Mila Freire., John Petersen., Marcela Huertas., and Miguel Valadez (2004) 'Subnational Capital Markets in Developing Countries: From Theory to Practice', at p. 339. Available at www.siteresources.worldbank.org/INTLACREGTOPURBDEV/FeaturedTopics/20860291/TheorytoPractice.pdf

¹⁵⁸ For a brief historical description of Zimbabwe's financial services sector, See Martin Brownbridge and Charles Harvey (1998) *The Limited Impact of Financial Sector Reforms in Zimbabwe in Banking in Africa*. Africa World Press.

¹⁵⁹ The information contained in this table is correct as of the 31st December 2008.

Commercial Banks	17	Commercial banks offer a wide range of financial services including the provision of loans and overdrafts, operating foreign exchange accounts, providing financial advice and facilities to purchase and sale investments. Of the 17 institutions, the government has substantial interest in at least 3 of these banking institutions.
Merchant Banks	5	With deregulation, merchant banks offer the same services as commercial banks. However they also specialize in providing wholesale banking services, in the money and capital markets. They also offer fee-based services such as corporate advisory services, underwriting of securities and portfolio management. They also provide finance through credit facilities, short and medium term credit, negotiable off-shore financing facilities and foreign exchange facilities.
Finance Houses	3	Apart from general investment advice and factoring, these institutions offer predominantly, asset based instruments such as hire purchase and lease hire advice and advances to the individual and corporate sectors.
Building Societies	5	With deregulation, Building Societies now offer much the same services as do commercial banks. However generally speaking, Building Societies offer savings, fixed deposits, share deposits and mortgage lending services.
People's Own Savings Bank	1	Formerly the Post Office Savings Bank, this institution has the largest branch network of any deposit taking institution in Zimbabwe. It operates savings and fixed deposit facilities.
Asset Management Companies	17	These are either independent or subsidiaries of banking institutions. They provide investment advice to retail and wholesale investors.
Micro-finance Institutions	213	These specialise in the low-income sector providing finance to small scale entrepreneurs.
Insurance (life, funeral, general and re-insurance)	50	Insurance firms in Zimbabwe provide a wide range of services, including credit guarantees, insurance against the risk of default by both domestic and off-shore obligers.
Pension and Provident Funds	2300	Zimbabwe has an established pensions and provident funds industry. This number obviously fluctuates depending on the pensions and provident funds current at any given time.

3.3. Money and equities markets

The banking sector and the securities markets provide the main channels of financing in the country. Zimbabwe's fixed-income markets can be split into two: i.e.

the money market and the bond market. The term money market is used in this context to refer to fixed-interest rate securities with a maturity of one year or less, while securities with a maturity in excess of a year are referred to as bonds. The major participants in Zimbabwe's money market include both deposit and non-deposit taking financial institutions. The deposit taking institutions, which also make up the inter-bank market, include commercial and merchant banks, discount houses, development finance banking institutions, non-demutualized and demutualized building societies and statutory banking institutions.

Zimbabwe has a bond market, but does not have a corporate bond market. Bonds traded include municipal bonds issued by local government authorities and treasury bonds issued by the RBZ. The typical and major money market instruments used in the country are: treasury bills, including special treasury bills, open market operations (OMO) bills, negotiable certificates of deposits, bankers' acceptances, foreign currency denominated bills, quasi-government bills and bonds and municipal bonds.¹⁶⁰ The raising of equity, as opposed to debt finance constitutes an important method of raising finance in Zimbabwe. Equity finance can be raised through the issuance of equity securities (shares/stocks) of various classes. Equity can be raised through the Zimbabwe Stock Exchange, or through a private placement.¹⁶¹

3.4. Sources of finance

Although obviously limited in value, business enterprises in Zimbabwe have several finance raising sources. The most common forms of finance for businesses

¹⁶⁰ According to Fafchamps, *et al*, "The range of financial instruments available to Zimbabwean manufacturers is no less impressive than the list of financial institutions. Short-term finance is organized primarily around overdraft facilities and banker's acceptances, which taken together represent the bulk of lending by commercial banks to the manufacturing sector." Fafchamps., Pender., and Robinson (1995) (note 157, *supra*), at p. 26.

¹⁶¹ *Ibid.*, at p. 27.

include retained profit, trade credit, bank loans - including overdrafts - some although limited foreign direct investment, debt and equity capital, venture capital, leasing, hire-purchase agreements, and remittances etc. The following is a short description of the various financing options.

3.4.1. Short and long-term capital

Commercial banks provide the bulk of short and long term capital. Short term capital is provided usually on an overdraft or loan basis. Where the borrower is a financial institution, short-term borrowing is achieved through the issuance of money market instruments. It is also noteworthy that some of these money market instruments can be securitized through Asset Backed Commercial Paper Programmes (ABCP). Supplier-credit is a form of financing available to firms in Zimbabwe. Long-term financing is available from banking institutions, including the major developmental banks such as Infrastructure Development Bank and Agribank.¹⁶²

3.4.2. Leasing

Finance houses and commercial banks provide leasing and hire purchase facilities. Finance houses tend to be adjuncts of commercial banks or other financial institutions. The purchasing of movable goods can be achieved through hire-purchase contracts. This sort of financing is provided to consumers either through an arrangement with a supplier, or through a financial institution. It is noteworthy that income streams from hire-purchase arrangements can be securitized.

¹⁶² Ibid., at p. 26.

3.4.3. Residential and commercial property finance

Zimbabwe has a well developed residential and commercial property mortgage system. Building societies and commercial banks form the backbone of this primary housing finance system. Local councils have also traditionally provided housing finance through rent-to-buy housing finance schemes, with or without the intermediation of financial institutions. Although trialled, then shelved, in the late 1990s and early 2000, there is at present no secondary market for mortgages in Zimbabwe. Zimbabwe does possess however a small municipal credit market. Local councils can issue municipal bonds to raise finance.

3.4.4. Commercial paper

Commercial paper is used in the inter-bank market by institutions seeking liquidity. In this market, merchant banks, discount houses, and some commercial banks accept and discount bills of exchange, promissory notes and negotiable certificates of deposits, and trade them in the money market.¹⁶³ As noted above, commercial paper can be used as an asset base for ABCP programmes.

3.4.5. Agricultural finance

Finance for agricultural purposes is provided by most financial institutions in Zimbabwe. However the Agricultural Bank of Zimbabwe (also known as Agribank, and formerly the Agriculture Finance Corporation), which is wholly government-owned, specialises in providing medium to long term finance for agricultural purposes. Agribank also provides hire purchase and leasing financing, as well as long term finance for general farm purchases, capital intensive farming inputs and farm

¹⁶³ Ibid., at p. 25.

infrastructure. It is noteworthy that the contracts that underpin this form of financing can also be packaged and used as collateral in asset securitization transactions.

3.4.6. Development finance

Development finance is offered by most financial institutions. Zimbabwe also has specialist financial and non-financial institutions that provide development or project linked finance, such as the Venture Capital Company of Zimbabwe,¹⁶⁴ the Industrial Development Corporation, Infrastructure Development Bank of Zimbabwe (ZDB),¹⁶⁵ the Small Enterprises Development Corporation (SEDCO),¹⁶⁶ as well as commercial banks. Multilateral lending agencies such as the Africa Development Bank and the International Finance Corporation have at various times and stages been actively involved in project and development finance in Zimbabwe.¹⁶⁷

3.5. Insurance

As reflected in the table above, Zimbabwe has an insurance industry that provides a range of insurance and re-insurance cover. Insurance, especially credit default risk insurance, is an important component of securitization structuring, especially where it is used as a credit enhancement measure. In Zimbabwe, credit default risk insurance is available from most insurance firms, but especially through the firm Credit Insurance Zimbabwe. Despite its name, the Credit Insurance Zimbabwe is not a monoline

¹⁶⁴ In addition to the Venture Capital Company of Zimbabwe, other institutions that provide venture capital to firms in Zimbabwe include the Zimbabwe Development Corporation, the African Enterprise Fund, the Manna Corporation, and Hawk Ventures Ltd.

¹⁶⁵ The Infrastructure Development Bank of Zimbabwe was formerly known as the Zimbabwe Development Bank. The bank is created under the Infrastructure Development Bank of Zimbabwe Act [Chap 24:14].

¹⁶⁶ The Small Enterprises Development Corporation (SEDCO) is a development finance institution set up in 1983 under the Small Enterprises Development Corporation Act [Chap 24:12] to provide start-up capital (finance) business management skills and advice and other related support services, to small and medium scale enterprises in the country.

¹⁶⁷ Fafchamps., Pender., and Robinson (1995) (note 157, supra), at p. 25.

insurer. Zimbabwe does not have monoline insurance firms. The Credit Insurance Zimbabwe insures against two principle risks; (i) the risk of commercial non-payment of money due under a contract by domestic obligers, and (ii) the political and commercial risk of non-payment of money due under a contract by off-shore obligers.¹⁶⁸ In addition, insurance companies including the Credit Guarantee Company and the Credit Insurance of Zimbabwe provide credit guarantees, primarily to bankers.¹⁶⁹

3.6. Credit ratings services

Several firms specialise in assessing and issuing credit ratings on companies and individuals. Of the domestic firms, the largest is Dun and Bradstreet.¹⁷⁰ The several stock broking firms and local and international CRAs also provide similar services. The major international credit rating agency operating in, and that provides ratings on, firms operating in Zimbabwe is Global Credit Rating Company, which is a subsidiary of Duffs and Phelps Credit Rating Company. CRAs are regulated by the SC. This is because the law considers that they are in the business of issuing or publishing analyses or reports on securities; which is a licensable activity.¹⁷¹

3.7. Summary

The above provided a brief description of Zimbabwe's financial services industry, reflecting especially on the range of enterprise financing available in the country.

¹⁶⁸ Ibid., at p. 27.

¹⁶⁹ Ibid., at p. 27.

¹⁷⁰ According to Fafchamps, M., Pender, J., Robinson, E: "Dun and Bradstreet disseminates credit reference information about Zimbabwean firms and individuals. Its publications include new registrations of firms with the Registrar of Companies, court judgements passed against firms and individuals, and credit ratings based partly on publicly available information and partly on information collected and held in confidentiality by D&B. Debt collection services are available through D&B and various lawyers offices. Assistance in drawing loan applications is available through SEDCO and the Small Business Units opened recently by the main Commercial banks" Ibid., at p. 27.

¹⁷¹ Refer to section 2 of the Securities Act as read with section 38 of the same.

Although Zimbabwe does not have a corporate bond market, market participants can obviously draw on experience gained from trading and dealing in municipal, treasury bonds and money market instruments when dealing with securitization issuances. Financing of enterprises is dominated by intermediated forms of financing. Securitization offers financial institutions the option of creating secondary markets for their income producing assets, such as mortgages, loans and other time receivables. The country has a broad range of financial institutions and capital market participants that can benefit from and can form the basis for a securitization market. Prudentially regulated financial institutions can draw on the liquidity enhancing and regulatory capital management characteristics arising from the use of securitization. Insurance companies can act as insurance providers, and where relevant acting as originators themselves. CRAs can provide rating information. Investment banks can provide essential investment services, including being involved in underwritings, securities issuances, provision of opinions on securities issuances, etc. Admittedly however, the ability of these institutions and financial industry players to take advantage of securitization is currently hindered by the extant economic conditions.

CHAPTER 4

ORIGINATING INSTITUTIONS

4.1. Introduction

This chapter analyses legislation regulating or relating to firms and statutory entities, which would be the main securitization participants in Zimbabwe as originators, providers of securitization transaction services and as investors. It analyses laws used to regulate: (i) building societies; (ii) banking institutions; (iii) specialised banking institutions such as the Infrastructure Development Bank of Zimbabwe and the People's Own Savings Bank; (iv) local government authorities; (v) insurance firms; and (vi) companies incorporated under the Companies Act [Chapter 24:03]. These and other entities would form the backbone of a securitization industry in Zimbabwe. The chapter assesses, as relevant, whether laws used to regulate these entities enable them to: (a) engage in securitization transactions as originators; (b) incorporate or establish securitization SPVs; (c) provide securitization-related services; and (d) invest in securitization issuances.

4.2. Building Societies

Zimbabwe's main regulatory enactment for building societies is the Building Societies Act [Chapter 24:02]. Building societies offer banking and other financial services, including primarily, mortgage lending. Typically, mortgage loans constitute

the bulk of building societies assets, although with de-mutualisation and liberalisation, most building societies have a varied loan-book portfolio. Although building societies are no longer exclusive providers of mortgage finance in Zimbabwe, they hold the vast majority of outstanding mortgages and would therefore constitute the bedrock of any secondary mortgage market in the country. World-wide, mortgage-backed securitization constitutes a significant portion of structured finance products. The Association of Building Societies of Zimbabwe, (ABSZ) states that in the 1980s, it formally mooted, but failed in its effort to create a secondary housing finance market.¹⁷² The introduction would have assisted building societies to: (i) dispose of illiquid mortgage assets; (ii) better manage regulatory capital costs; and (iii) change from the originate-and-hold to the originate-and-distribute business model. In the 1990s the efforts of the ABSZ bore fruit, as it obtained the support of the RBZ, the Ministry of Finance, the Ministry of Local Government and National Housing as well as the United States Agency for International Development (USAID) in its attempt to create a secondary housing finance market.¹⁷³ As a result, the first exploratory mortgage-backed securitization issuance in Zimbabwe was structured by First National Building Society in 1999.¹⁷⁴ The deteriorating economic conditions however stalled the efforts to create a fully-fledged secondary housing finance market.

¹⁷² Association of Building Societies of Zimbabwe (14 March 2000) Mortgage Securitization: Legal and Regulatory Environment, at p. 2. (*Copy of document in author's possession*).

¹⁷³ In its activity report for 2001, USAID reports that "it assisted in the establishment of the nation's first mortgage securitization mechanism, successfully argued for the removal of burdensome taxes on mortgage holders, and leveraged the first ever privately financed urban sewer and water development program in Zimbabwe". USAID (2002) (note 35, *supra*).

¹⁷⁴ Public-Private Sector Working Group on Establishing a Secondary Mortgage Market System in Zimbabwe (1999) Minutes of Meeting, November 23, 1999, at p. 2. (*Copy of document in author's possession*).

4.2.1. Building societies as originators

Does the Building Societies Act enable building societies to engage in securitization transactions as originators? It is arguable that the Building Societies Act permits building societies to refinance using securitization. *Prima facie*, First National Building Society's reported mortgage-backed securitization transaction suggests that the extant legal framework permits such transactions.¹⁷⁵ Also, it is notable that the RBZ-promulgated securitization guidelines, which provide for the structuring of securitization transactions by banking institutions, also apply to building societies.

The powers of building societies are contained in section 17 of the Building Societies Act. This provision authorises building societies to raise finance through deposit taking, loans and overdraft facilities provided by commercial banks, issuing shares, lending money at interest, investing in money and capital market instruments and through offering specified fee based financial services. However, whether the section permits building societies to engage in securitization is a matter of interpretation.

4.2.1.1. Non true-sale securitization

Section 17(g) of the Building Societies Act states: "...a Society shall the power – to borrow money at interest, other than in the form of [a] deposit, from a registered commercial bank or, if the terms are approved by the Registrar, from any other person and to arrange overdraft facilities with a registered commercial bank and for this purpose to pledge its assets." [Emphasis added]. Clearly, section 17(g) permits building societies to engage in non true-sale securitization transactions. A non true-sale securitization transaction is essentially a secured loan transaction where an

¹⁷⁵ It has not been possible however to obtain and analyse the structuring documents for the First National Building Society's mortgage-backed securitization transaction.

originating firm pledges its financial receivables, such as mortgage bonds to an SPV for money lent and advanced. Section 17(g) therefore permits building societies to pledge their assets in non true-sale mortgage-backed securitization transactions, subject obviously to the Registrar of Building Societies authorising the transactions in question.¹⁷⁶

4.2.1.2. True-sale securitization

The position with regards true-sale securitization is less clear. Section 17(g) does not enable building societies to engage in true-sale securitization transactions. Authority has to be obtained elsewhere in the enactment. Section 17(r) of the Building Society Act states that a building society shall have the power “to do all lawful things incidental or conducive to the powers conferred upon it in terms of this section.” It is arguable that this section as read with section 17(j) of the Building Societies Act permits building societies to engage in all forms of structured finance transactions including true-sale securitization transactions. The *raison d’être* for building societies, as contained in section 17(j) is the provision of financial services including housing finance.¹⁷⁷ Securitization is not unlawful in Zimbabwe. The securitization of mortgages enables the creation of a secondary housing finance market and unlocks liquidity. The Zimbabwe government, building society and banking industry members, and the RBZ acknowledged the importance of creating a secondary housing finance market as a way of boosting affordable housing provision in Zimbabwe hence the creation of a commission to investigate the possibility of creating such a

¹⁷⁶ RBZ (2007) (note 3, supra), at section 2.

¹⁷⁷ “Section 17(j) of the Building Societies Act states: “Subject to this Act, a society shall have the power – to lend or advance money at interest to members and others on the security or mortgages or hypothecations, and to negotiate the purchase or sale and the hiring or letting by members or others of immovable property mortgaged or to be mortgaged to the society.”

market.¹⁷⁸ Arguably therefore, section 17(r) permits building societies to engage in true-sale securitization.

This argument notwithstanding, this study proposes that section 17 of the Building Societies Act should be amended to expressly stipulate that building societies have the power to refinance through the sale, cession, or pledge of their assets including mortgage bonds and other financial assets. As section 17 of the Building Societies Act currently stands, it does not expressly permit building societies to sell and cede mortgage debts. This power is implied from section 17(r), as above. The power of building societies to refinance through the use of securitization can be contrasted with the power granted to the Infrastructural Development Bank of Zimbabwe (hereafter IDBZ). The enabling Act, the Infrastructural Development Bank of Zimbabwe Act (hereafter IDBZ Act) states in Clause 5 of the Schedule to the IDBZ Act that the IDBZ has power: “to acquire, take possession of or dispose of any property in respect of which it has any interest by way of mortgage, pledge or otherwise.” The provision clearly enables the IDBZ to engage in securitization.

In addition to the above, this study proposes that building societies should be expressly granted power to repurchase mortgage debts, relevant bonds, security documents and collateral from a mortgage conduit entity, SPV or banking institution – all powers not specifically provided for under the Building Societies Act, but essential if building societies are to fully take advantage of the financial engineering technique. To its credit, the RBZ has signalled to the financial markets that securitization is permissible, if not encouraged, by producing prudential guidelines.¹⁷⁹

¹⁷⁸ Bovet., Wilde., Ncube., Rosettenstein and Kimberely (2000) (note 33, supra).

¹⁷⁹ RBZ (2007) (note 3, supra).

4.2.2. Establishing securitization SPVs

Where it is not cost-effective or convenient to create a securitization SPV through an independent third party, originating firms will, in practice, often do so using their own in-house professionals. Does the Building Societies Act permit building societies to establish SPVs for use in securitization transactions? Section 17 does not expressly permit building societies to incorporate SPV entities. As above, an argument can be made that section 17(r) as read with section 17(g) and (j) permit building societies to set-up SPVs. Section 17(r) permits building societies to do all lawful things incidental or conducive to the powers contained in the Act. Section 17(g) permits building societies to borrow money on interest, and section 17(j) permits building societies to lend or advance money to its customers. Arguably, in order to fulfil these objectives and responsibilities, building societies should be assumed to have the power to create SPVs to be used in transactions whose purpose is to refinance and/or mitigate a defined risk factor. The above notwithstanding, for purposes of legal certainty, this study argues that the Building Societies Act should be amended and grant building societies express power to establish or incorporate SPVs (trust or corporate), which can be used for structured finance transactions such as securitization.

4.2.3. Provision of securitization transaction-related services

Traditionally, building societies, among other financial institutions, typically provide securitization-related services to originating firms, arrangers or investors. Such services include the provision of liquidity and credit enhancement facilities, underwriting, management services for SPVs or – in the case of mortgage-backed securitization – the provision of mortgage administration services. Section 17 of the Building Societies Act does not expressly permit building societies to provide such

services. On the other hand however, section 6 and 7 of the RBZ securitization guidelines stipulate that regulated institutions may provide securitization transaction-related services. This suggests that the RBZ, as the regulatory authority is of the view that building societies, among other regulated financial institutions are and/or should be permitted to provide these services. This study recommends that the Building Societies Act should be amended and expressly grant building societies the following powers: i.e. the power to provide mortgage administration services to third parties including the power to service mortgage loans which may have been sold to a mortgage conduit company, an SPV, or banking institution in terms of a servicing agreement relating to securitization and to raise a servicing fee.¹⁸⁰ In addition, they should be permitted to set up third party SPVs as part of a range of permissible financial services, including providing underwriting services, etc.

4.2.4. Investing in securitization securities

Section 17(n) of the Building Societies Act places no restrictions on investments that building societies can make, apart from requiring as a condition precedent that Ministerial approval has to be obtained.¹⁸¹ It is also notable that clause 5:15 of the RBZ securitization guidelines stipulates that regulated institutions may invest in securities issued by securitization SPVs. The draw-back with section 17(n) is that Ministerial approval is required for every securities investment decision taken by a building society. This caveat to building societies' power to invest in securities is unduly restrictive and prescriptive. It subjects securities investment decisions, which ideally should be left to the management of building society institutions, to unnecessary political interference. The nature and risk profile of securities that

¹⁸⁰ These proposals are drawn from those made in 2000 by Bovet., Wilde., Ncube., Rosettenstein and Kimberely (2000) (note 33, supra).

¹⁸¹ Section 17(n) of the Building Societies Act.

building societies can invest in are, for prudential reasons, determined by the RBZ anyway – in consultation with the Minister of Finance - including the amount of risk capital that ought to be set aside.¹⁸² It is recommended that section 17(n) should be amended to remove the ministerial caveat.

4.3. Banking institutions

Zimbabwe's banking industry as shown above is made up of different types of banking institutions, comprising commercial, merchant and investment banks, discount and other types of finance houses. Obviously, these banking institutions possess financial assets which can be securitized. These assets include retail and wholesale loans portfolios - car loans, student loans, credit card receivables, mortgages and other receivables. Banking institutions operating in Zimbabwe are regulated by the Banking Act [Chapter 24:20]. The Act defines banking institutions as any "company that is registered or required to be registered in terms of [the Banking Act] to conduct any class of banking business in Zimbabwe." [Emphasis added]. From the definition, it is clear that only a company, incorporated in terms of the Companies Act, can be established and be licensed to operate as a banking institution. The Banking Act defines banking business as "the business of accepting deposits withdrawable or repayable on demand or after a fixed period or after notice and the employment of those deposits, in whole or in part, by lending or any other means for the account and the risk of the person accepting those deposits."¹⁸³

¹⁸² RBZ (2007) (note 3, supra), at paragraph 5.15. – 5.26.

¹⁸³ Section 2 of the Banking Act.

4.3.1. Banking institutions as originators

Does the Banking Act enable banking institutions to engage in securitization transactions as originators? Section 7 of the Banking Act stipulates the range of activities classified as banking activities, i.e. activities that banking institutions are permitted to engage in. The list is expansive, but not exhaustive. As a general rule, the activities that a banking institution can engage in must be contained in its registration certificate.¹⁸⁴ Although section 7 does not specifically refer to securitization, the structuring of the financial engineering technique is arguably permissible because section 7(2) permits banking institutions to engage in “any activity”, including an activity which has not been prescribed as a banking activity in terms of section 7(1) (n).¹⁸⁵ For this reason, this study concludes that banking institutions may legally engage in securitization transactions; notwithstanding that the technique is not specified in section 7 of the Banking Act, as one of the banking activities a banking institution may engage in. In addition, as noted above, the RBZ securitization guidelines stipulate that banking institutions may engage in securitization transactions but after obtaining approval from the RBZ.¹⁸⁶

4.3.2. Establishing securitization SPVs

Does the Banking Act permit banking institutions to incorporate SPV structures under the Companies Act or set up trust structures? The short answer is yes. This power is not derived from section 7 of the Banking Act. Rather, banking institutions derive this power from section 9 of the Companies Act, which imbues companies with the “capacity and powers of a natural person of full capacity in so far as a body corporate is capable of exercising such powers.” As noted above, banking institutions

¹⁸⁴ Ibid., section 6 and 7.

¹⁸⁵ Ibid., section 7(1) and (2).

¹⁸⁶ RBZ (2007) (note 3, supra), at section 2.

are companies incorporated under the Companies Act. As a result, banking institutions in Zimbabwe can incorporate SPV structures under the Companies Act and can settle trusts under the common law.

4.3.3. Provision of securitization transaction-related services

As noted in the RBZ-promulgated securitization guidelines, banking institutions traditionally provide a range of securitization related services.¹⁸⁷ Banking institutions typically provide, *inter alia*: (i) underwriting services; (ii) credit and liquidity enhancement services; (iii) credit reference services; (iv) management services for SPVs; (vi) independent directors or trustees to SPVs; and (vii) they also can act as servicers. The Banking Act and the RBZ securitization guidelines permit banking institutions in Zimbabwe to provide securitization-related services.¹⁸⁸

4.3.4. Investing in securitization securities

Internationally, the market for securitization issuances is predominantly institutional; with banking and other financial institutions being the main investors in structured securities products. The Banking Act does not restrict the type of securities that a banking institution may invest in. Section 7(1) of the Banking Act states that: “the banking activities that may be specified in a registration certificate are – (c) buying and selling instruments, whether for the account of the banking institution concerned or for the account of its customers...” There is no legal impediment therefore to banking institutions trading or dealing in securitization issuances, save for capital adequacy purposes, where exposures are risk-weighted.¹⁸⁹

¹⁸⁷ Ibid., paragraph 1.18 – 1.21.

¹⁸⁸ Section 7(1) of the Banking Act.

¹⁸⁹ RBZ (2007) (note 3, *supra*), at paragraph 5.15 – 5.26.

4.4. State-owned financial institutions

Zimbabwe has several state-owned financial institutions, such as the IDBZ, the Peoples Own Savings Bank [POSB], and the Agriculture Bank of Zimbabwe [Agribank]. The IDBZ, which used to be known as the Zimbabwe Development Bank was established by the government with the primary objective of financing infrastructural projects,¹⁹⁰ and is regulated by the IDBZ Act. Agribank used to be known as the Agricultural Finance Corporation and is the main agricultural bank in Zimbabwe, providing both long and short term finance to the agricultural sector. It is regulated under the Banking Act, and so the arguments made above with regards ordinary banking institutions apply equally to Agribank. The POSB is a state owned banking institution established on 1 January 1905.¹⁹¹ The POSB is essentially a savings bank, drawing deposits initially from the lower-income groups, but has since expanded to cater for high income and corporate clients. It also offers a range of commercial banking and related services, including loan provision. As with building societies and the IDBZ, the POSB is specially regulated under its own Act of parliament; the Peoples Own Savings Bank Act [Chap 24:22] (hereafter, the POSB Act). These institutions, among several other financial institutions established by Acts of parliament possess assets that can be securitized. Because the Agribank is regulated by and under the Banking Act, this section of the study will analyse the IDBZ and the POSB Act only.

4.4.1. IDBZ and POSB as originators

The IDBZ Act and the POSB Act enable both financial institutions to engage in securitization as originators. Unlike all the other banking institutions established by

¹⁹⁰Section 16 of the Infrastructural Development Bank of Zimbabwe Act.

¹⁹¹ The Peoples Own Saving Bank used to be known as the Post Office Savings Bank. The acronym – POSB - by which the banking institution has always been known by, has not changed.

and under an act of parliament, the powers of the IDBZ, as contained in section 17 (2) as read with clause 5 of the schedule to the IDBZ Act, are broad enough to enable it to engage in structured finance transactions. Section 17(2) of the IDBZ Act states: “...the Bank shall...have the power to do...all or any of the things, specified in the Schedule, either absolutely or conditionally and either solely or jointly with others. Clause 5 of the Schedule to the IDBZ Act states that the IDBZ has power: “to acquire, take possession of or dispose of any property in respect of which it has any interest by way of mortgage, pledge or otherwise.” Read together, it is clear that the IDBZ has power to securitize its financial assets. These provisions are broad enough to envisage true-sale and non true-sale securitization transactions. Further, section 17(d) states that the IDBZ “shall have power – to seek other specialised credit facilities including euro-dollar credits.” Structured finance transactions, including securitization can arguably fall under the broad category of specialised credit facilities.

Regarding the POSB, section 4(2) of the POSB Act as read with clause 4 of the same Act permits the bank to refinance using securitization.¹⁹² Clause 4 to the Schedule states that the POSB has power to: “mortgage, pledge any of its assets and, with the Minister’s approval, to sell, exchange, let, dispose of, turn to account, or otherwise deal with any assets which are not required for the exercise of its functions, for such consideration as the Board may determine.” [Emphasis added]. This provision reveals the following: the POSB may pledge its assets as part of a secured loan transaction, including a non true-sale securitization transaction. Of this, there admits little doubt. A strong argument can be made that the same provision also permits the POSB to engage in true-sale securitization transactions. The provision

¹⁹² Section 4(2) of the POSB Act states: “In the exercise of its functions, the Savings Bank shall have power, subject to this Act, to do or cause to be done, either by itself or through its agents, all or any of the things set out in the Schedule, either absolutely or conditionally and either solely or jointly with others.”

states that the POSB may sell any of its assets, which obviously includes financial assets. This power is subject to: (i) the Minister of Finance approving the decision to sell the assets in question;¹⁹³ and (ii) the assets to be sold not being required by the POSB for the exercise of its functions. Section 4(1) (b) and (c) of the POSB Act states as follows: “[T]he functions of the Savings Bank shall be (a)...(b) to provide banking and financial services for the people of Zimbabwe; and (c) to grant loans and advances secured by investments held by the Savings Bank.” This means that if the bank has surplus assets or if the assets earmarked for securitization are not needed to grant loans or advances, then any such structured finance technique would be lawful. The POSB can therefore validly use its financial assets to refinance or mitigate risk using securitization.

4.4.2. Establishing a securitization SPV

Both the IDBZ and the POSB are authorized to incorporate or settle corporate SPVs and trust SPVs, respectively, which can be used for securitization purposes. The IDBZ draws this authority from section 3 of the IDBZ Act, which states: “There is hereby established the Infrastructure Development Bank of Zimbabwe which shall be a body corporate and which shall be capable of suing and being sued and, subject to this Act, of doing or performing all such acts or things as a body corporate may by law do or perform.” [Emphasis added]. This provision is broadly similar to section 9 of the Companies Act. It imbues the IDBZ with the capacity and power of a natural person. This means the IDBZ can, if it so desires, legally establish or settle a corporate or trust SPV, respectively.

¹⁹³ Ibid., at section 2.

Remarkably, unlike the other Building Societies Act, the Banking Act, or even the IDBZ Act, the POSB Act expressly gives the POSB power, subject to approval by the Minister of Finance, to “promote, establish or acquire companies, partnerships or other undertakings.”¹⁹⁴ In addition to this, section 3 of the POSB Act, as with the IDBZ Act, grants the POSB power and capacity of a natural person.¹⁹⁵ Both of these provisions support the proposition that the POSB can incorporate SPV structures under the Companies Act, or settle trusts under the common law. The only criticism with this provision is with the power - which must be removed - exercised by the Minister of Finance over management decisions relating to the operations of the POSB.

4.4.3. Provision of securitization transaction-related services

Both the IDBZ Act and the POSB Act arguably permit the IDBZ and the POSB to provide securitization transaction-related services, such as, *inter alia*: (i) underwriting; (ii) credit and liquidity enhancement; (iii) credit references; (iv) servicer facilities; (v) SPV management; and (vi) the provision of independent directors or trustees to SPVs. The IDBZ derives this power from clause 20 of the schedule to the IDBZ Act, which provides that the IDBZ shall have power to: “generally...do all such things as are calculated to facilitate or are incidental or conducive to the performance of the functions of the Bank or the exercise of its powers in terms of this Act or any other law.” Clause 20 of the schedule to the IDBZ Act is the catch-all provision; i.e. the provision that permits the banking institution to undertake all activities, which are not unlawful, which enhance its operations and enable it to attain its objectives of

¹⁹⁴ Ibid., clause 22 of the Schedule to the POSB Act.

¹⁹⁵ Ibid., at section 3 states: “There is hereby established a body corporate to be known as the People’s Own Savings Bank of Zimbabwe, which shall be capable of suing and being sued in its own name and, subject to this Act, of doing anything that bodies corporate may do by law.”

financing infrastructural development in Zimbabwe. For clarity's sake, the schedule to the IDBZ Act should be amended to specifically refer to, and enable the institution to provide, securitization-related services.

The POSB Act does not expressly stipulate that the POSB may engage in any of the above-mentioned services. What it states however in clause 21 of the schedule to the POSB Act is that: "With the Minister's approval, [the POSB has power] to provide such services as the Board considers could properly be provided by the Savings Bank, and subject to regulations made in terms of section forty-six, to charge for those services such fees as the Board may determine from time to time." In addition, clause 23 to the Schedule to the POSB Act also provides that the POSB may do "anything that is calculated to facilitate or is incidental or conducive to the performance of its functions under [the POSB Act] or any other enactment." From these two provisions, this study concludes that the POSB is given broad discretion, subject to Ministerial approval to engage in securitization-related services.

4.4.4. Investing in securitization securities

Does the IDBZ Act and the POSB Act permit the respective two institutions to invest in securitization issuances? Clause 5 of the schedule to the IDBZ Act and clause 5 to the schedule of the POSB Act are both similarly worded and both arguably grant the two institutions broad securities investment powers. Both sections state that the respective institutions have power: "to draw, make, accept, endorse, discount, execute and issue for the purposes of its functions or duties promissory notes, bills of exchange, bills of lading, securities and other negotiable or transferable instruments." [Emphasis added]. Put differently, both clauses permit the IDBZ and POSB to

“accept” securities, including structured finance securities, for investment or other purposes.

4.5. Local government authorities/Councils

Zimbabwe has a total of 16 urban local government authorities. Bulawayo, Gweru, Harare, Kwekwe, Mutare and Masvingo have city status and each of them is administered by a City Council. The rest, comprising Chegutu, Chinhoyi, Kadoma, Marondera, Masvingo, Redcliff, Bindura, Gwanda, Victoria Falls and Kariba have town status and each is administered by a Municipal Council. Both city and municipal councils are generally referred to as local government authorities. The law governing the establishment, powers and remit of local government authorities in Zimbabwe is known as the Councils Act [Chap: 29:15] (Councils Act hereafter). However each of the 6 local government authorities with city status is governed by a specific Act of parliament. In many countries, notably Latin American countries, cities have successfully used future-flow receivables such as tax revenues and other income-generating assets to raise finance through securitization transactions. Zimbabwe’s urban tax infrastructure is relatively developed with its local government authorities having structured and functional tax systems. A significant portion of local government authorities’ income is derived from taxes and other levies. In addition, they also operate income generating projects; have investments in companies, hospitals, schools, and other interests which produce income.

4.5.1. Local government authorities as originators

The Councils Act arguably permits local government authorities to engage in securitization as originators. Section 198 of the Councils Act states that: “a council

shall have power to undertake, carry out or carry on any or all of the acts and things set out in the Second Schedule.” Clause 54 of the Second Schedule states in the relevant part that Councils have the power “generally to do all such things, whether or not involving the...disposal of any property or rights, as are calculated to facilitate or are incidental or conducive to the performance of the functions of the council...” Another provision of the Councils Act which supports this proposition is section 221, which states that Councils can undertake or have interests in, a variety of revenue raising activities.¹⁹⁶ These provisions arguably enable councils to engage in securitization transactions. The foregoing notwithstanding, authority for the proposition that Councils have power to engage in non true-sale securitization transactions can also be found in section 290 of the Councils Act.¹⁹⁷ Section 290(5) provides that if a council has the necessary borrowing power, it may resolve to raise money with the consent of the Minister from any source, including the issuance of bonds. These sections of the Councils Act permit Councils to engage in securitization transactions as originators.

4.5.2. Establishing securitization SPVs

The Councils Act does not expressly stipulate whether councils can establish corporate or trust SPV entities. This notwithstanding, it is arguable that clause 54 as read with section 198 of the Councils Act (both quoted above) are broad enough to enable Councils intending to set up their own SPVs for securitization purposes to do so. It is also noteworthy that section 221 of the Councils Act permits Councils to “engage in any commercial...or other activity for the purpose of raising revenue for

¹⁹⁶ Section 221(1) of the Councils Act states: “With the written approval of the Minister and subject to such terms and conditions as he may impose, a council may engage in any commercial, industrial, agricultural or other activity for the purpose of raising revenue for the council.” [Emphasis added].

¹⁹⁷ Ibid., at section 290(1) states: “Subject to this Act, a council may borrow money in terms of subsection (5)...”

the council.” Therefore, it is arguable that where the intention of the Council is to raise revenue through securitization, it is likely that the establishment of an SPV will be regarded as a permissible activity.

4.5.3. Investing in securitization securities

Councils’ securities investment discretion is prescribed by statute.¹⁹⁸ Councils are permitted to purchase securities in any of the following situations, if: (i) the securities are locally registered and the issuer is a statutory corporation;¹⁹⁹ (ii) the securities are locally registered and are guaranteed by the State;²⁰⁰ (iii) the institution issuing the securities is registered as a banking institution, or as a building society;²⁰¹ or (iv) if express and specific approval from the Minister of local government and the Minister of Finance is obtained to invest in a particular securities issuance.²⁰² From the foregoing, it is clear that it is unlikely that Councils will be able to invest in securitization issuances. Zimbabwe does not have the equivalent of the U.S. Fannie Mae or Freddie Mac-type institutions. Unless if the government establishes a statutory corporation whose role is to establish and be at the centre of the secondary housing finance market, for instance, it is unlikely that Councils will be able to rely on section 302(1)(c)(ii) to invest in securitization securities. It is possible that the State may guarantee some securitization issuances, but in practice this is likely to be an uncommon or infrequent occurrence. It is also unlikely, although not impossible, that an SPV may be established and registered as a banking institution, and acting as a multi-seller issuer play a role in the ABCP market. From the foregoing, Councils are more likely to invest in structured finance securities if they obtain permission to do so

¹⁹⁸ Ibid., at section 302.

¹⁹⁹ Ibid., at section 302(1)(c) (ii).

²⁰⁰ Ibid., at section 302(1)(c) (ii).

²⁰¹ Ibid., at section 302 (1) (a).

²⁰² Ibid., at section 302 (1) (j).

from the Minister of Finance and the Minister of local government. It is recommended that section 302 be expanded, subject to the necessary prudential caveats, to include structured finance issued securities.

4.6. Insurance firms

Internationally, although insurance firms have engaged in securitization as originators, their traditional role has been to provide credit default insurance and to act as institutional investors. Zimbabwe has a vibrant insurance industry, offering a broad range of insurance services. Through the National Social Security Authority, Zimbabwe has a compulsory employee National Pension Scheme and a Worker's Compensation Insurance Fund. The country also has a multitude of pension and provident funds. In Zimbabwe, insurance firms and pension and provident funds are regulated under the Insurance Act [Chap 24:07] and the Insurance and Pensions Commission Act [Chapter 24:14]. The National Social Security Authority is regulated under the National Social Security Act [Chapter 17:04] and prescribed regulations. Pension and provident funds are regulated under the Pension and Provident Funds Act [Chapter 24:09], and prescribed regulations. Under the provisions of the Insurance and Pensions Commission Act, all pension and provident funds and insurance firms are regulated by the Commissioner of Insurance. Due to space constraints, the analysis below will however focus only on insurance firms regulated under the Insurance Act.

4.6.1. Insurance firms as originators

This study argues that in Zimbabwe insurance firms can act as originators in securitization transactions. It is also noteworthy that the Insurance Act does not

prohibit insurance firms from disposing some of their assets or using their assets as security for funds lent and advanced. Where an insurance firm is a company, it derives its capacity and power to engage in securitization transactions from section 9 of the Companies Act; which clocks it with the capacity and power of a natural person.²⁰³ Section 11(1) of the Insurance Act defines an insurance company as “a company registered in terms of the Companies Act [Chapter 24:03] which is also a registered insurer.” Insurance companies therefore have power to engage in both non true-sale and true-sale securitization transactions. Section 15 of the Insurance Act states that where an insurance firm is a mutual society, on registration by the Commissioner, it “shall be a body corporate by the name under which it is registered and shall, in its registered name, be capable of suing and being sued, acquiring property and disposing of it and, subject to its constitution and [the Insurance Act], of performing all such acts as bodies corporate may by law perform.” As above, this provision imbues mutual societies registered as insurers and carrying on insurance business with the same powers accorded to insurance companies incorporated under the Companies Act. Mutual societies carrying on insurance business can therefore refinance using securitization.

4.6.2. Establishing securitization SPVs

The Insurance Act places no restrictions on the power of insurance companies and mutual societies in Zimbabwe to either incorporate or establish corporate or trust SPV structures, respectively. By virtue of section 9 of the Companies Act insurance companies can incorporate a limited liability company under the Companies Act or

²⁰³ As noted above, section 9 of the Companies Act states that: “A company shall have the capacity and powers of a natural person of full capacity in so far as a body corporate is capable of exercising such powers.”

settle a trust and use either as an SPV. Section 15 of the Insurance Act – quoted above - enables mutual societies to do the same.

4.6.3. Provision of securitization transaction-related services

The Insurance Act does not stipulate, prescribe, or limit the range of insurance services that insurance firms may provide to customers. This means that insurance companies in Zimbabwe are not legally restricted from providing insurance to originating firms, arrangers or SPVs engaged in securitization transactions. And in fact, insurance firms in Zimbabwe provide credit default insurance. Zimbabwe does not however, as noted above, have monoline insurance firms.

4.6.4. Investing in securitization securities

Insurance firms in Zimbabwe are expected by law to create different accounts for each line of insurance business they engage in and to deposit all receipts into each such account as security for potential claims by policy holders.²⁰⁴ For example, an insurance company must *mutatis mutandis*, create a life assurance fund and account for its life assurance business; motor vehicle insurance fund and account for its motor vehicle insurance business. Section 26 of the Insurance Act stipulates that such funds can only be invested in prescribed securities; the breach of which constitutes a criminal offence.²⁰⁵ Put simply, Zimbabwe operates a prescribed securities regime for

²⁰⁴ Section 29 of the Insurance Act states: “(1) Every insurer who carries on insurance business in two or more classes of insurance business shall keep a separate account of all receipts in respect of each class of insurance business carried on by him. (2) The receipts in respect of each class of insurance business referred to in subsection (1) shall be carried to and form an insurance fund to be called a life insurance fund in the case of life insurance business and by the appropriate name by reference to the class of insurance business in the case of insurance business other than life insurance business. (3) The insurance fund of each class of insurance business referred to in subsection (2) (a) shall be held in security for the claims of owners of policies of that class of insurance business; (b) shall not be applied directly or indirectly to any purposes other than those of the class of insurance business for which the insurance fund was established.”

²⁰⁵ *Ibid.*, section 26(1A).

some of its prudentially regulated institutions, of which insurance firms constitute a part. Prescribed securities have been defined to mean: “(a) stocks, bonds or other like securities issued by the State, a statutory body, or a local authority, and includes, in relation to non-life insurers and the class of insurance business carried on by them, treasury bills, or similar short-term bills issued by a statutory body or local authority; and (b) investments approved or prescribed by the Minister from time to time for the purposes of this definition.” The definition of prescribed securities does not permit insurance firms to invest in securitization issuances, save where a specific request has been made to, and approval given by, the Minister of Finance for an insurance firm to invest in such structured finance securities.²⁰⁶ The prescribed securities regime should be reformed in favour of a deregulated system, which permits prudentially regulated institutions to invest in any type of securities considered appropriate by the management of the relevant institution, subject to risk-based formulae being used for purposes of determining capital and liquidity reserves to be set aside. The prescribed securities regime should be reformed to make it less restrictive, enabling insurance firms to invest in structured finance securities.

4.7. Other firms/institutions

Medium to large corporate firms operating in Zimbabwe may also use securitization. Most corporate firms operating in Zimbabwe are incorporated in terms of the Companies Act [Chap 23:03]. As noted above, section 9 of the Companies Act endows incorporated entities with the power and capacity of a natural person of full capacity. Therefore subject to the memorandum and articles of association, as a general rule, firms possessing requisite assets are not legally impeded from engaging

²⁰⁶ Prescribed securities include “investments approved or prescribed by the Minister from time to time for the purposes of this definition.” *Ibid.*, section 3.

in securitization transactions. However, state owned corporations, known as parastatals in Zimbabwe, such as the Zimbabwe Steel Company (ZISCO), National Railways of Zimbabwe (NRZ), Cold Storage Commission,²⁰⁷ Dairiboard Zimbabwe, Minerals Marketing Corporation,²⁰⁸ to name a few are established in terms of either the Companies Act or a statute of parliament, and their powers and mandates spelt out therein. When considering whether these institutions can engage in securitization transactions, principally as originators, reference should be made to the Acts of parliament under which they derive their statutory existence and power.

As noted above, there also exists in Zimbabwe several thousand pension and provident funds. These institutions,²⁰⁹ regulated under the Pension and Provident Funds Act [Chap 24:09], can play a significant part as institutional investors in securitization issuances. But there is need to reform the prescribed securities regime, which restricts the investment discretion of boards/trustees of pension and provident funds.²¹⁰ Another institution, which is one of the largest institutional investors in Zimbabwe, is the National Social Security Authority (NSSA). NSSA is established in terms of the National Social Security Act.²¹¹ Every taxpayer in Zimbabwe is obliged to make national social security contributions, which tax deduction is forwarded and administered by NSSA. But, as with insurance firms, councils, and pensions and provident funds, NSSA is also affected by the prescribed securities regime. It is suggested that this system should be reformed to permit NSSA, among others, to

²⁰⁷ Cold Storage Commission [Chapter 18:06].

²⁰⁸ Minerals Marketing Corporation Act [Chapter 21:04].

²⁰⁹ Section 6 of the Pension and Provident Funds Act states that on registration of the pension or provident fund, such funds “become a body corporate capable of suing and being sued in its corporate name and of doing all such things as may be necessary or incidental to the exercise of its powers or the performance of its functions in terms of its rules.”

²¹⁰ *Ibid.*, section 18.

²¹¹ National Social Security Authority Act.

invest in structured finance securities, without first seeking Ministerial approval, as is currently the case.

4.8. Summary

This chapter analysed legislation that regulates firms, which typically engage in securitization transactions as originators, service providers and investors. It assessed several Acts of parliament which regulate the operations of (i) building societies; (ii) banking institutions; (iii) specialised banking institutions such as the IDBZ and the POSB; (iv) local government authorities; and (v) insurance firms. It concluded that in general, most of the enabling enactments relating to these financial institutions and statutory bodies permit them to (i) engage in securitization transactions; (ii) incorporate or establish securitization SPVs; (iii) provide securitization related services; and (iv) to invest in securitization issuances. In addition, the RBZ, as one of the main regulatory agencies over the financial services sector also acknowledges in its guidelines that these financial institutions can engage in most of the above activities.²¹²

Although the RBZ guidelines imply that building societies can securitize their receivables, there is some ambiguity as to whether the Building Societies Act actually permits them to engage in securitization. The Building Societies Act should be amended to expressly permit building societies to refinance using securitization. The laws regulating banking institutions, including specialist banking institutions such as the IDBZ and the POSB, and insurance societies and companies (generally) permit them to refinance using securitization. However section 7 of the Banking Act should be amended to specifically refer to structured finance technology, including

²¹² RBZ (2007) (note 3, supra), at paragraph 1.18.

securitization, as a permissible banking activity. In addition, consideration should be given to watering down the power of the Minister of Finance over operational decisions of the POSB and insurance firms. Building societies, banking institutions, including the IDBZ and the POSB, and insurance firms can, as a general rule, provide securitization-related services. In addition, these institutions have power to establish corporate and trust SPVs for use in securitization transactions, or to use a third party to do the same.

This study recommends that Zimbabwe's prescribed assets regime should be reconsidered. Under this regime, most prudentially regulated institutions and local government authorities are prohibited from investing in securities other than those stipulated by statute, referred to as prescribed assets. The current prescribed assets do not include most debt and equity securities. This is an obvious anomaly, which unduly restricts the range of securities these institutions can lawfully invest in.

It is unclear if local government authorities are permitted to engage in securitization transactions. This study recommends that the Councils Act should be amended to specifically refer to and enable local government authorities to use the technique to refinance, obviously subject to the necessary prudential controls.

CHAPTER 5

SPECIAL PURPOSE VEHICLES

5.1. Introduction

This chapter identifies entities used in business transactions in Zimbabwe that can be utilised as SPVs in securitization transactions. The chapter analyses laws regulating or relating to incorporated limited-liability companies, trusts and partnerships. It also analyses: (i) the types of securities different SPVs can issue; (ii) the role, responsibilities and fiduciary duties of SPV trustees and directors; and (iii) whether securitization SPVs that issue debt securities will be obliged to register as money-lending agencies under the Money Lending and Rates of Interest Act.²¹³ This chapter concludes that trusts and public limited-liability companies are the only two types of SPV structures that can be used for securitization transactions.

5.2. SPVs: Basic characteristics

SPVs are integral to securitization transactions. Originating firms use SPVs to isolate financial assets from their general business risks and to issue credit and liquidity-enhanced securities.²¹⁴ The transfer of financial assets from an originating firm to an SPV facilitates off-balance sheet financing. If structured as a true-sale the

²¹³ Money Lending and Rates of Interest Act.

²¹⁴ This enables for the reduction in originator associated credit, liquidity and bankruptcy risks. Gorton, and Souleles (2005) (note 60, supra) at p. 1.

transferred assets will in theory fall outside an originator's insolvency estate.²¹⁵ The SPV is at the centre of most of the contractual arrangements that constitute a securitization transaction, such as the Purchase and Sale agreement,²¹⁶ the administration agreement,²¹⁷ the underwriting agreement,²¹⁸ the Security Trust Deed,²¹⁹ the declaration of trust relating to the issued shares of the SPVs,²²⁰ and the prospectus.²²¹

The type of SPV used in a securitization transaction is determined by several factors. These include, *inter alia*, the nature of business vehicles permitted by a country's legal system, SPV entity-tax liability, the insolvency risk characteristics of different entity types, the types of securities which are intended to be issued, and whether the securities in question will be publicly issued or privately placed. In some jurisdictions the SPV can be an incorporated limited liability company - whose form and legal status is determined by the law under which it is created – or can be an unincorporated legal entity such as a trust.²²² In other jurisdictions, particularly civil law countries, which do not recognize the concept of trusts, laws have been enacted enabling the incorporation of specific securitization SPVs.

²¹⁵ In Zimbabwe, as in the UK, the word insolvency is used instead of bankruptcy. In this thesis, both words are used interchangeably.

²¹⁶ This contract document contains the terms and conditions of the sale of the financial assets to be securitized from the originating firm to the SPV.

²¹⁷ SPVs are typically designed to be brain dead, and not to employ workers or carry out their own administrative functions. Generally the servicing and administrative functions are contracted out to professional independent institutions, and the contract document is referred to either as a administrative or servicing agreement.

²¹⁸ This is the contract between the SPV and underwriters (banks and/or other financial entities) which contract to underwrite the securities issuance.

²¹⁹ This document contains the procedures by which the SPV assigns the securitised assets to a security trustee for the benefit of investors to the securities issued by the SPV.

²²⁰ Where the shareholders of the SPV are corporate, to avoid the consolidation of their interests with the SPV, they enter into a declaration of trust in favour of a discretionary class of charities.

²²¹ A prospectus is not a contract, but it contains and discloses information relating to the securities issued by the SPV to members of the public (investors). The International Comparative Legal Guide to Securitization 2005 uses the analogy of a wheel. It states: "if the global securitization market is looked at like a bicycle wheel, an SPV is the hub; the originators, underwriters, investors and market professionals occupy various parts of the tyre; and the multitude of contracts that form the structure of a securitization transaction are represented by the spokes. The International Comparative Legal Guide to Securitization (2005) at p. 9. Available at www.iclg.co.uk/khadmin/Publications/pdf/345.pdf

²²² Gorton and Souleles (2005) (note 60, *supra*) at p. 2.

As a general rule, a securitization SPV should satisfy, *inter alia*, the following key criteria. It must be: (i) a separate legal entity, distinct from the originating firm, its sponsors, promoters and shareholders/beneficiaries; (ii) legally capable of acquiring, possessing and disposing financial assets; (iii) capable of being bankruptcy-proofed;²²³ (iv) ideally tax neutral; (v) legally capable of issuing, and be permitted to issue public securities; and its (vi) objectives, powers and nature and range of activities must be capable of being legally constrained.

5.3. Trust SPVs

Trusts are common SPV structures in many countries that possess securitization markets; and in particular English common law jurisdictions. A trust, as a legal fiction, is an often used structure in Zimbabwe with different types of gratuitous and commercial trusts used for various purposes including estate planning, business and investment purposes.²²⁴ As with its company and partnership law, Zimbabwe's law of trusts is drawn from the English common law. There is sparse literature on the commercial use of trusts in Zimbabwe, with most focusing almost exclusively on gratuitous trusts. However, while it has not codified its laws of trusts, Zimbabwe has enacted legislation, whose provisions modify some aspects of trust law, especially as regards commercial uses of trusts. These enactments include the Collective Investments Schemes Act [Chap 24:19], the Companies and Associations Trustees Act [Chap 24:04], and the Deeds Registries Act [Chap 20:05]. These statutes

²²³ That is, it must be capable of being insulated from possible third-party bankruptcy-inducing claims, including claims by the originating firm or its creditors, and neutered in its ability to file for voluntary bankruptcy.

²²⁴ Trusts are used fairly widely for business purposes in Zimbabwe. For instance, in 1997 Zimbabwe enacted a Collective Investment Schemes Act [Chap 24:19]. This Act provides, *inter alia*, for the creation of unit trusts, their management, the duties, qualifications and obligations of trustees.

notwithstanding, much of the legal jurisprudence relating to trusts in Zimbabwe borrows from English and South African jurisprudence.

As under English law, in Roman-Dutch law, there is no settled single definition of a trust. A trust can be defined as a legal relationship that is formed when a person – the trustee - administers property in trust for the benefit of an identified person (the beneficiary) or impersonal object.²²⁵ Unlike in the USA where as a result of legislative intervention, some trusts are recognised as separate legal entities; in Zimbabwe, as in the UK, trusts are not recognised as separate legal entities.²²⁶ In the *Crundall Bros (Pvt) Ltd v Lazarus N.O. & Anor*, the Supreme Court held: “A trust is not a person. The trustee is the person to be considered for the purposes of the Regulations.”²²⁷

5.3.1. Establishing a trust SPV structure

In Zimbabwe, the creation of a trust SPV structure is a relatively straight forward process, involving very little bureaucracy. Although a trust relationship can exist without the need for elaborate formalities; in practice, an originating firm will settle a trust or cause a third party such as an arranger to establish the trust. Where a third party is chosen to settle a trust, as a bankruptcy risk management measure, such party would in effect be the settlor/grantor of the trust and not the originating firm. The trust

²²⁵ In *Gold mining and Minerals Development Trust Makarau J* refers to a trust as a “as a legal relationship and not as a separate legal entity as a corporation or universitatis even though the trustees may together form a board akin to a board of a company or of a voluntary association.” *Gold Mining and Minerals Development Trust v Zimbabwe Miners Federation* HH-24-2006, at p. 3. The Judge also cites with approval the definition of trusts in T. Honore (1985) *South African Law of Trusts*, 3rd ed. Cape Town, Juta & Co.

²²⁶ *Gold Mining and Minerals Development Trust v Zimbabwe Miners Federation* (note 225, supra), at pp. 2-3. *Crundall Bros (Pvt) Ltd v Lazarus N.O. & Anor* 1990 (1) ZLR 290 (H) at 298 E, and *Commissioner for Inland Revenue v MacNeillie's Estate* 1961 (3) SA 833 (A) at 840.

²²⁷ *Crundall Bros (Pvt) Ltd v Lazarus N.O. & Anor* (supra, note 226), at 128F. It should be noted however that the rules of the High Court of Zimbabwe permit, without granting trusts legal personality, trustees to sue or be sued in the name of a trust. Order 2A, rule 8 of the High Court Rules, 1971. See also and *Women and Law in Southern Africa Research and Education Trust and 2 Others v Dinah Mandaza and 6 Others* HH-202-2003, at p. 19.

is created through the execution of a trust deed before a notary public and lodged at the Deeds Registry's office.²²⁸ The execution of the trust deed creates the trust, and the lodging of the deed with the registrar of deeds evidences the existence of the trust relationship. The trust deed will identify the trustees, which can be either natural persons or incorporated companies, the objectives of the trust, and the powers and duties of the trustees.²²⁹ Trustees will typically purchase from the originating firm, in accordance with the terms of the trust deed, the financial assets to be securitised and then issue securities (trust certificates) to investors.²³⁰ The trustees acquire *prima facie* ownership and management powers over the assets. The issued trust certificates represent equitable undivided beneficial interests in the underlying assets. A trustee holds and manages trust property – the transferred financial assets – in its own name but for the benefit of investors. The trustee is obliged under the common law, and subject to the terms of the trust deed, to manage the affairs of the trust as stipulated and to act in the best interests of the beneficiaries. Trustees are also obliged under the common law to exercise due care and diligence in the discharge of their duties.

As noted above, both natural and juristic persons can act as trustees. Consequentially, an originating firm can arrange for the creation or use of a company to act as trustee, which creates the trust SPV structure. Costs associated with setting up a trust are relatively small. Legal costs arise from the drafting, notarising and lodging of the trust deed. Stamp duty has to be paid on the lodging of the trust deed

²²⁸ Section 5(m) of the Deeds Registries Act [Chap 20:05].

²²⁹ The core duties of the trustees include the duty to abide by the terms of the trust, the duty to account, the duty of good faith and honesty, the duty of care or reasonable prudence and fiduciary duties of loyalty. See John Mowbray, QC., Lynton Tucker., Nicholas Le Poidevin., Edwin Simpson., and James Brightwell (2000) *On Trusts*, 17th ed, (London) Sweet and Maxwell, 2000, Chapters 20 and 34.

²³⁰ A trust certificate is a document that evidences the holder's undivided interest, to the extent specified in the document, in the trust assets. Trust certificates have debt-like characteristics and are repayable from revenue generated by the financial assets subject to the securitization transaction. Schwarcz, Steven (2003) 'Commercial Trusts as Business Organisations: Unravelling the Mystery', *The Business Lawyer* 2003, vol. 58, at p. 6.

with the registrar of deeds. This is a relatively minor statutory fee.²³¹ There is no requirement that trusts to be used as securitization SPVs should be capitalised. Trusts are not required to file statutory returns like incorporated companies. The filing of audited statements, the holding of meetings, operational management of the trust assets, etc are issues regulated by and under the terms of the trust deed.

5.3.2. Limited liability status

Trust law imbues trusts with limited liability-like status. Limited liability status is especially important for SPVs because in theory it enables structurers of securitization transactions to isolate, calculate and mitigate identified risk. While trusts do not have a separate legal *persona*, property subject to the trust is treated at law as legally separate from that of the settlor and the trustee. Trust property stands alone, as a unit, with trust debts and obligations being levied only against the trust property and not against the settlor or the trustees' personal assets. This legal recognition is similar to that which accrues to incorporated entities, especially those whose liability is limited by shares. As a general rule, the liability of shareholders/members of companies limited by shares is limited to the amount of the unpaid up share capital, irrespective of how much the company owes.

An additional feature of trusts is that property subject to the trust is protected from claims made by the settlor or its creditors, an originating firm or its creditors, and the trustee's own creditors, spouse or successors. A trustee's personal creditors cannot claim or levy against the trust's assets, especially where the trustee has made it known that s/he is acting, or holds the assets in his or her capacity as a trustee. In addition, claims by beneficiaries (investors) – absence breach of trust – are also restricted to

²³¹ The amount keeps changing due to the hyperinflationary environment.

trust property. This special legal treatment ensures that trust property is legally segregated from the trustees' personal proprietary and other business interests; and permits the trust property to be the only focal point for any claims arising. As above, the segregation of trust assets from the trustees' insolvency estate and third party claimants makes trusts attractive for use in securitization transactions, mutual, pension and other investment funds.²³²

5.3.3. Fiduciary duties as a form of corporate governance

Unlike incorporated companies trusts are managed by trustees. Under Roman-Dutch law and subject to the terms of the trust deed, trustees are bound by common law fiduciary duties, which can be variously enhanced by an originating firm or arranger.²³³ A trustee has a general duty to act in the best interests of beneficiaries. In addition, in the performance of its duties and powers a trustee is obliged to exercise "care, diligence and skill, which can reasonably be expected of a person who manages the affairs of another and except as regards questions of law, the trustee is bound to exercise an independent discretion."²³⁴ In addition, a trustee is obliged to "comply strictly with [its] mandate and act within the scope of [its] authority, namely, to hand over property, or pay funds over, to some person upon the occurrence of an event. [A trustee is] liable to the person who has an interest in the property or funds if [it acts] without reasonable care and outside the scope of [its] authority."²³⁵ Further, trustees have an obligation to act impartially and not to unduly prefer one or more

²³² Lusina Ho (2004) 'The Reception of Trust in Asia: Emerging Asian Principles of Trust?' *Singapore Journal of Legal Studies*, 2004, at pp. 287-304. Available at <http://ssrn.com/abstract=953593>

²³³ To prevent abuse of legal ownership, the common law imposes several duties upon the trustees, including the duty to abide by the terms of the trust deed, the duty to account, duty to be impartial, duty to act in good faith and honesty, the duty of care or reasonable prudence and fiduciary duty of loyalty. John Mowbray, QC., Lynton Tucker., Nicholas Le Poidevin., Edwin Simpson., and James Brightwell (2000) (note 229, supra), at chapters 20-34.

²³⁴ *De Villiers v James* 1996 (2) ZLR 597 (S) at p. 603; *Chirimuta v Action Property Sales (Pvt) Ltd* HH-5-2007.

²³⁵ *De Villiers v James* 1996 (2) ZLR 597 (S) at p 605.

beneficiaries to the detriment of others.²³⁶ Trustees' duties include a duty to: (a) abide by the terms of the trust deed; (b) account; (c) be impartial; (d) act in good faith and honesty; (e) exercise due care or reasonable prudence; and (f) loyalty.²³⁷ Through these fiduciary duties, effective corporate governance principles – as appropriate – are typically incorporated into trust deeds to regulate trust relationships. These fiduciary duties are applicable even where the trustee is a juristic entity that utilises directors to manage the operations of the SPV. It is this versatility of common law trust entities that makes them attractive as structured finance vehicles to investors seeking to invest in securities backed by income generating assets.

5.3.4. Bankruptcy remoteness

Does the trust structure provide adequate insolvency remoteness when used as an SPV in securitization transactions? Under Roman-Dutch law, once a trust has been settled and assets have been sold or ceded in *securitatem debiti* and transferred from an originating firm to the trustees, per the trust deed, the assets legally cease to belong to the originating firm and will be held in the name of the trustees - but in trust for the benefit of the beneficiaries.²³⁸ Because they are held in trust, these assets do not constitute part of the trustee's personal estate. In addition, the terms of the trust deed can be crafted to include provisions that curtail the trustee's power to deal with or dissipate trust assets. Such provisions in the trust deed can include restrictions on the trustee's ability to liquidate the trust relationship. In addition, under the common law, trustees are obliged to act impartially, and independently of the settlor and the

²³⁶ *Finlayson v Standard Chartered Pension Fund 1995* (1) ZLR 302 (H), at p 317B-C. See also *Communications and Allied Industries Pensioners Association v Communication and Allied Industries Pension Fund SC-29-08* at p 9.

²³⁷ John Mowbray, QC., Lynton Tucker., Nicholas Le Poidevin., Edwin Simpson., and James Brightwell (2000) (note 229, supra) at chapters 20-34.

²³⁸ See section 3 of the Companies and Associations Trustees Act [Chap 24:04], where this common law rule has been codified in relation to the transfer of immovable property.

beneficiaries. If appropriately crafted the trust deed should prevent the settlor or the originating firm from exerting adverse influence on or dictating how the transferred assets should be utilised or disposed of, unless of course either are beneficiaries under the terms of the trust deed. It is these characteristics that ensure a trust structure achieves a measure of bankruptcy remoteness, despite trusts not having separate legal personality.

5.3.4.1. True-sale securitization transactions

If the transfer of assets pursuant to a securitization transaction is structured as an out-and-out-cession, i.e. as a true-sale and the requisite contractual formalities have been completed, Zimbabwe's law of sale will – as a general rule - consider ownership to have passed from an originating firm to the trustees.²³⁹ The assets will become trust property. The trust property will not – at law - constitute part of the originating firm's insolvency estate. In principle, this effectively insulates the assets from any claims relating to the originating firm's insolvency estate. Although this question, i.e. whether the trust structure effectively removes transferred assets from the originator's estate in the event of the latter's insolvency is yet to come before, and has not been determined by courts in Zimbabwe; as a general rule, the trust assets will be regarded as insulated from an originating firm's insolvency estate.

5.3.4.2. Non true-sale securitization transactions

The transfer of financial assets from an originating firm to trustees *in securitatem debiti*, in a non true-sale securitization transaction is most at risk of being impeached

²³⁹ This question is analysed in more detail in chapter 6.

and set aside as a result of provisions of the Companies Act and the Insolvency Act.²⁴⁰ Where the asset transfer is structured as a secured loan transaction, the High Court will, as a general rule, hold that the financial assets constitute part of the originating firm's insolvency estate to the potential prejudice of investors in the issued securities.²⁴¹ The Insolvency Act [Chap 6:04] as read with the Companies Act gives the High Court extensive powers to set aside asset transfers made by an originating firm to third party creditors, including assets transferred to a trust in *securitatem debiti*. The relevant sections, which are analysed in detail in chapter 6, include section 269(3) of the Companies Act, and sections 40, 42, 43 and 44 of the Insolvency Act, as read with section 270 of the Companies Act. It should be noted however that these sections of the Companies Act and the Insolvency Act will apply only if the securitization transaction is a secured, as opposed to a true-sale, securitization transaction.

5.3.5. Taxation

As noted in chapter 7, an additional securitization-friendly feature of trusts is that because they do not have a separate legal *persona*, they avoid entity-level tax.²⁴² Tax on income is levied on the beneficiaries; in this case the investors.²⁴³ This makes trusts cost effective because they are entity-level income tax exempt.

²⁴⁰ This question is analysed in more detail in chapter 6.

²⁴¹ Refer to section 23 of the Insolvency Act as read with section 2 of the Insolvency Act. Section 23 of the Act states that: "(1) The effect of the sequestration of the estate of an insolvent shall be— (a) to divest the insolvent of his estate and to vest it in the Master until a trustee has been appointed and, upon the appointment of a trustee, to vest the estate in the trustee." Section 23 (2) provides that: "For the purposes of subsection (1) and subject to any other law, the estate of an insolvent shall include— (a) all property of the insolvent at the date of the sequestration..." And Section 2 defines property as "movable or immovable property wherever situated within Zimbabwe, and includes contingent interests in property other than the contingent interest of a fideicommissary instituted by will or deed inter vivos." [Emphasis added].

²⁴² Refer below to chapter 7 at paragraph 7.5.1.

²⁴³ This issue is analysed in chapter 7.

5.3.6. Securities issuance

As noted above, trust SPVs issue trust certificates. These securities however can only be privately placed as the Zimbabwe Stock Exchange does not permit trusts to issue publicly traded securities. Under the provisions of the Zimbabwe Stock Exchange Listing requirements, only “companies” may list and issue securities through the Exchange. This means that a trustee incorporated as a public limited liability company would be the only type of entity permitted to issue securities through the exchange. And even then, the listing requirements require companies intending to list to have traded for a minimum of three years. This means that while trusts are appropriate vehicles, the Zimbabwe Stock Exchange listing requirements need to be reviewed and amended in order to facilitate public trade in securitization securities.

In summary, trust structures can be used as SPVs in securitization transactions. They are incredibly versatile, can be bankruptcy-proofed, have a measure of limited liability status, are able to issue marketable securities, known as trust certificates, do not attract entity-level income tax liability, and are not regarded as debtors under the Insolvency Act. In addition, trusts are relatively simple to establish and involve very little bureaucracy. Further, trusts are subjected to minimal statutory regulation compared to incorporated entities like public and private limited liability companies, which makes them cost-effective.

5.4. Corporate SPVs

The establishment of incorporated business enterprises is generally, but not exclusively regulated by the Companies Act [Chap 24:03]. Four types of companies, all of which enjoy limited-liability status, can be incorporated under the Companies

Act.²⁴⁴ These are (i) private limited-liability companies,²⁴⁵ (ii) public limited-liability companies, (iii) companies limited by guarantee,²⁴⁶ and (iv) co-operative companies.²⁴⁷ Subject to the provisions of the Companies Act, once all the prescribed formalities have been complied with and a company is registered, it becomes a separate legal entity and acquires the capacity and power of a natural person of full capacity.²⁴⁸

Of these companies, the entity that can be used as an SPV in securitization transactions is the public limited-liability company. This is because it is the only one that is permitted under the Companies Act to issue debt, equity and hybrid securities to members of the public. The key difference between a public limited-liability company and others incorporated under the Companies Act is that all other companies are not permitted to issue debt and equity securities to members of the public.²⁴⁹ To qualify for use as a securitization SPV, an entity must be capable of issuing debt or equity or hybrid securities to investors, either through private placement or a securities exchange.

5.4.1. Establishing a public limited liability company

An originating firm or arranger intending to use a public limited liability company as an SPV can either set one up, or simply buy a shelf-company from promoters, both

²⁴⁴ For information on business enterprises that can be established under the Companies Act see Tett and Chadwick, *Zimbabwe Company Law* (2 ed) 13-14; Jericho Nkala and Timothy Joseph Nyapadi, *Company Law in Zimbabwe*, Zimbabwe Distance Education College, at p. 91-112; and R.H. Christie (1997) *Business Law in Zimbabwe* (2 ed) Juta. 129-140.

²⁴⁵ Section 33(1) of the Companies Act.

²⁴⁶ *Ibid.*, at section 7(b) as read with section 26.

²⁴⁷ *Ibid.*, at section 36.

²⁴⁸ *Ibid.*, at section 9.

²⁴⁹ A private company is defined as a company “which by its articles...prohibits any invitation to the public to subscribe for any shares or debentures of the company.” *Ibid.*, section 33.

relatively inexpensive processes.²⁵⁰ As in the U.K., a company requires a promoter, the filing of statutory *pro-forma* documents, including the memorandum and articles of association, with the registrar of companies. The entity will require shareholders, a registered office, the filing of a prospectus, a minimum share capital, etc. Public limited-liability companies are subject to more stringent regulatory compliance prescriptions than private limited-liability companies. For instance, a public company may not commence operations until all prescribed formalities relating to its establishment have been completed. A public company must hold mandatory statutory meetings and provide statutory reports. There are strict restrictions on the number and nature of directors that can be appointed; there are strict stipulations on the shareholding of directors; etc.²⁵¹ Needless to say, these regulatory compliance statutory prescriptions have a bearing on the economic cost structure of one-off securitization deals. On the other hand, a public limited liability SPV structure would be appropriate for use in multi-seller ABCP conduit programmes.²⁵²

5.4.2. Limited liability status

Once incorporated, corporate entities established under the Companies Act, including public limited-liability companies, acquire a separate legal *persona* and

²⁵⁰ For a detailed brief of the mechanics, cost and time it takes to incorporate a company in Zimbabwe refer to a report by the International Finance Corporation on www.doingbusiness.org/exploretopics/startingbusiness/Details.aspx?economyid=208

²⁵¹ For a detailed synopsis of the process of establishing a public limited liability company in Zimbabwe, including the statutory requirements relating to meetings, accounts, the prospectus, underwriting, etc, refer to Christie (1997) (note 244, supra) at pp. 377-420.

²⁵² By end of 2006, ABCP programmes constituted the bulk of asset securitization issuances in South Africa, Zimbabwe's neighbour. Karen Couzyn and Jason van der Poel of Webber Wentzel Bowens (2006) 'Securitization'. Available at <http://www.wwb.co.za/wwb/view/wwb/en/page2018> See also Jobst who states that: "...ABCP programmes have evolved as an alternative form of SME securitization, whose flexibility (in terms of security design and underlying asset type) and disclosure requirements about securitized assets remedy existing market challenges of refinancing SME-related exposures." Jobst (2006) (note 8, supra), at pp. 731-760.

limited-liability status.²⁵³ These characteristics are essential attributes for securitization SPVs, especially where bankruptcy remoteness is sought to be attained.

5.4.3. Bankruptcy remoteness

The separate legal *persona* and limited liability status imbues public limited-liability companies with a measure of bankruptcy remoteness. Additional measures are typically employed to insulate corporate SPVs from possible third party insolvency-inducing claims. Through appropriate changes to the articles and memorandum of association, the ability of an SPV to engage in potentially insolvency-inducing activities can be curtailed and mitigated. But this general proposition is obviously subject to a caveat as illustrated above. As appears in paragraph 5.3.4.2., above, and in chapter 6 below, sections 40, 42, 43 and 44 of the Insolvency Act need to be considered especially when arranging a non true-sale securitization transaction as each can potentially threaten the viability of securitization transactions in the event of the originating firm being placed into insolvency.

5.4.4. Corporate governance

The corporate governance structure of corporate SPVs is typically engineered to ensure that the SPV structure is cost-effective and insolvency-remote. In Zimbabwe, where the originating firm is a financial institution regulated by the RBZ, the majority of directors on a related securitization SPV's board must be independent non executive directors.²⁵⁴ Where the originating firm is not a financial institution

²⁵³ Section 9 of the Companies Act [Chap 24:03].

²⁵⁴ The RBZ guideline states: "A banking institution and its associates may not...have its directors, officers or employees on the board of an SPV unless the board is made up of at least five members and the majority are independent non-executive directors. In addition, the official(s) representing the bank must not have veto powers." Reserve Bank of Zimbabwe: Guideline No. 01-2004/BSD Corporate Governance Guideline, at paragraph 4.4 (b).

regulated by the RBZ, but is listed on the ZSE, the listing rules require companies to comply (although they are not mandatory) with the corporate governance code promulgated by the Institute of Directors of Zimbabwe (IDOZ). This code is referred to as the Principles of Corporate Governance in Zimbabwe: Manual of Best Practice. It is non-binding, but rule 7.F.5. of the ZSE listing rules requires companies to include a statement in their annual reports on their compliancy with the code; and explain any failures.²⁵⁵ The SC has not promulgated corporate governance rules for listed companies. A non-listed public limited-liability SPV is obliged to have at least two directors, per the Companies Act. A public limited-liability company requires directors, a company secretary, and a registered office.²⁵⁶ It needs “to keep statutory books, make statutory filings of audited accounts, tax returns and other corporate matters,”²⁵⁷ and hold statutory meetings. Whether or not the costs associated with utilising a public limited liability SPV outweigh the benefits is an actuarial matter influenced by the nature and value of the securitization transaction. It is clear however that compared to private limited liability companies, public limited liability companies are obliged to comply with more statutory prescriptions.

As a bankruptcy risk management measure, SPVs used in securitization transactions are typically structured to be brain dead. To ensure an SPV attains this characteristic, arrangers typically ensure that SPVs powers and objects are strictly prescribed. In Zimbabwe, this would be done through changes to the corporate SPV’s memorandum of association, which has to be filed with the registrar of companies before incorporation. The objects and powers of an incorporated SPV and the powers of the directors are contained in the memorandum of association. Depending on the

²⁵⁵ Musa Mangena and Venancio Taurigana (2007) ‘Disclosure, Corporate Governance and Foreign Share Ownership on the Zimbabwe Stock Exchange’. *Journal of International Financial Management & Accounting*, Vol. 18, No. 2, 53-85, at p. 62. Available at <http://ssrn.com/abstract=990122>

²⁵⁶ Raikes (1999) (note 56, supra), at p.3.

²⁵⁷ Ibid.

securitization transaction, SPVs are typically empowered to do no more than collect receivables and transmit them to investors. Directors who exceed their powers as contained in the memorandum of association can be interdicted by shareholders of the company or by any other party with *locus standi* on the basis of the *ultra vires* doctrine. As stated above, the SPV's shareholders are likely to be trustees, who hold shares in the SPV entity in trust, for the benefit of investors in the issued securities. Operational management of the SPV is provided by nominated managers, although in practice, such services are more likely to be provided by specialist fee-charging SPV-management companies. In the event that an SPV engages in commercial activities not provided for under the objects clause of its memorandum of association, such activities although *ultra-vires* are binding on the SPV. This is due to the operation of section 9 of the Companies Act, which states that on incorporation a company acquires the capacity and power of a natural person. Irrespective of whether an SPV's management is outsourced or provided in-house, the directors or trustees have the same powers and duties as those applicable to an ordinary company or trust, respectively. Directors of an SPV, subject to the terms of the articles of association or the agreement between the SPV and the management firm have the following duties: duty to exercise their powers in good faith in the SPV's interests; duty not to make a secret profit; duty not to have personal conflicts of interest with those of the SPV; duty to disclose; duty of care and skill; duty to act *intra-vires* the memorandum of association, a duty to exercise an independent discretion and other general fiduciary duties.

5.4.5. Taxation

Unlike trust structures, which are not considered persons, including for taxation purposes, incorporated entities are liable to pay entity-level corporate tax. Currently corporate tax stands at 33% of gross income. As appears below in chapter 7, this study proposes that corporate structures utilised as securitization SPVs should be subject to minimal or no tax in order to facilitate the use of non-trust structures for securitization transactions.

5.4.6. Securities issuance

Unlike private limited-liability companies, co-operative companies or companies limited by guarantee, public limited-liability companies are permitted to issue equity, debt or hybrid securities to members of the public. This makes them versatile, as they can opt and are permitted to place securities privately or through the Zimbabwe Stock Exchange. Public limited-liability companies lend themselves to complex structured finance deals, including those involving tranching and the issuing of different classes and type of securities.

It is notable that in some financial jurisdictions – such as Ireland - allow private companies to raise capital through issuing debt securities. This should be considered in Zimbabwe. In addition to reducing compliance costs, including with regards the filing of statutory reports, minimum number of directors, appointment of auditors, using private limited liability companies as SPVs in securitization transactions will significantly reduce structuring costs. In addition, permitting private companies to issue at least debt securities to members of the public will enable originating firms to save costs and to use as vehicles, private limited liability companies - entities they are familiar with. Further, the regulatory requirements which public companies are

obliged to comply with under the Companies Act are suited to the regulation of large public companies and not (brain-dead) conduits designed to facilitate cost-effective financing or risk management measures. It is arguably anomalous to require private companies intending to securitize to incorporate public company SPVs. In summary, public limited-liability companies make viable SPV structures.

5.5. Partnership SPVs

Some countries use partnership structures as securitization SPVs. Partnerships are commonly used business vehicles in Zimbabwe. Law and accounting firms and a wide variety of other commercial ventures are conducted through the medium of partnerships. Zimbabwe's law of partnership is common law-based and remains largely un-codified. A partnership is defined as an unincorporated business enterprise made up of two or more people, but not exceeding twenty, each of whom agrees to contribute part of the capital and/or labour and share the profits and losses of the enterprise.²⁵⁸ A partnership is relatively easy to establish. Typically, a partnership agreement is drawn up, although there is no requirement that it should be in writing. A tacit universal partnership can exist under Roman-Dutch law without a partnership agreement being executed.²⁵⁹ Where it is in writing, the agreement must be drafted by a lawyer.²⁶⁰ A partnership exists if the following essential criteria exist: "(i) each of the partners bring something into the partnership or binds himself to bring something

²⁵⁸ Section 6 of the Companies Act states: "No company, association, syndicate or partnership consisting of more than twenty persons shall be formed in Zimbabwe for the purpose of carrying on any business that has for its object the acquisition of gain by the company, association, syndicate or partnership, or by the individual members thereof, unless it is registered as a company under this Act, or is formed in pursuance of some other law, Letters Patent or Royal Charter." However, a partnership may consist of more than twenty people if it consists of members of a designated profession, or calling and the partnership was created for the purpose of practicing or carrying on the designated profession or calling. See also Nkala and Nyapadi (1995) (note 244, supra), at p. 17. Brian Bamford (1982) *On the Law of Partnership and Voluntary Associations in South Africa* (Juta & Co. Ltd) 3rd ed at p.1.

²⁵⁹ *Mtuda v Ndudzo* 2000 (1) ZLR 710 (H).

²⁶⁰ Section 10(1) (c) of the Legal Practitioners Act [Chap 27:07].

into it - which could be in the form of money, labour, skill or property; (ii) the business should be carried on for the joint benefit of all parties; (iii) the object should be to make profit; (iv) the contract between the parties should be legitimate.”²⁶¹ Despite the lack of separate legal existence, in practice, partnerships are referred to as firms or businesses.²⁶²

In Zimbabwe, partnership structures do not make suitable securitization SPVs, although they have been used in countries some of whose legal norms are derived from the English common law. In countries, such as the U.S. where it is possible to use partnerships as securitization vehicles, this has been made possible through legislative changes creating separate-legal-*persona* limited-liability partnership structures. Under Roman-Dutch law, a partnership has no separate legal personality and neither does it have limited liability status.²⁶³ In addition, unlike trusts, the partnership property is owned by all partners jointly and severally. Not having a separate legal personality from its members means that a partnership structure cannot technically issue securities in its own name. A partnership’s lack of limited-liability status and legal personality renders the partners in a partnership particularly vulnerable to third party claims. In addition, the solvency of, and the incurring of debt or other financial obligations by any of the partners has an immediate and direct bearing on the creditworthiness of the securities issuance. It is extremely difficult, if not ineffectual to bankruptcy proof such a structure, at least to the risk level required for cost-effective securitization. Although the common law partnership evolved to

²⁶¹ See the following line of cases: Rhodesia Railways v Commissioner of Taxes 1925 A.D. at p. 465; Peacock v Marley 1933 SR 64; Bain v Barclays Bank (DC and O) Ltd 1937 SR 191; Roose v Kidd’s Trustee 1944 SR 18; Blismas v Dardagan 1950 SR 234; Metallon Corporation Limited v Stanmarker Mining (Pvt) Ltd SC-82-2006.

²⁶² Nkala and Nyapadi state: “The formation of a partnership does not create a legal entity although once it is formed the members of the partnership can describe their business as a “partnership” or “firm” as if they constitute a legal persona, as does a corporation, distinct from the individuals who are members. Nkala and Nyapadi (note 244, supra), at p. 18.

²⁶³ Christie (1997) (note 244, supra) at p. 356.

offer a flexible and non-bureaucratic vehicle to transact business, it is still largely rooted in the past and should be reformed. Consideration should be given to creating limited-liability partnership structures, such as exists in South Africa for instance.

5.6. SPVs as moneylenders

Do SPVs used in securitization transactions have to register as moneylending institutions? Under the provisions of the Moneylending and Rates of Interests Act [Chapter 14:14], [MRI Act] persons – natural and juristic – engaged in the business of moneylending are regulated by, are required to be registered with and obtain a licence from, the Registrar of Moneylenders.²⁶⁴ The MRI Act also regulates and controls the rates of interests that can be charged by a moneylender to a borrower. The MRI Act makes it a criminal offence for any person to carry on the business of a moneylender without a licence.²⁶⁵ A moneylender is defined as: “any person who carries on a business of moneylending or who advertises or announces himself or holds himself out in any way as carrying on such business...”²⁶⁶ A borrower is defined as: “any person receiving a loan of money and any person to whom, whether by delegation or otherwise, the obligation of any borrower in respect of any loan of money has passed.” In addition, section 19 of the MRI Act states that the: “... Act shall apply to every transaction which, whatever its form may be, is substantially one of moneylending and whether or not the transaction forms part of any other transaction, and includes any arrangement under which goods are purchased under a condition of repurchase at a higher price...”

An SPV engaged in a true-sale securitization transaction, i.e. a transaction in which it buys financial assets from an originating firm and issues securities to

²⁶⁴Section 2A of the Moneylending and Rates of Interest Act as read with section 3(1).

²⁶⁵ Ibid., at section 3 (1) and (7).

²⁶⁶ Ibid., at section 2.

investors cannot be said to be lending money to the originating firm. The contractual relationship between the originating firm and the SPV is that of a seller and buyer, respectively, of financial assets. But the reverse is true for an SPV engaged in a non true-sale securitization transaction in which one or more originating firms cede in *securitatem debiti* financial receivables for money lent and advanced by the SPV to the originating firm. The contractual relationship between an originating firm and an SPV in a non true-sale securitization transaction is that of a borrower and a lender, respectively, of money; with the SPV lending money to the originating firm on the security of a pool of financial assets.

This begs the question: will an SPV engaged in a non true-sale securitization transaction in Zimbabwe be obliged to register as a moneylender in terms of the MRI Act? There is no case-law that has opined on what amounts to carrying on business as a moneylender. It is arguable that any person who lends money to another as part of a business enterprise or undertaking is carrying on business as a moneylender. A one-off transaction arguably does not amount to carrying on a business of moneylending, but a series of transactions can. A one-off transaction carried out by an entity one of whose objectives – as stated in its memorandum of association or trust deed - is the receipt in *securitatem debiti* of financial assets from one or more persons, in exchange for cash received from investors as consideration for issued securities backed by the financial assets can amount to carrying business of moneylending. It is more likely than not, and this study argues, that a court will hold that an SPV engaged in a non true-sale securitization transaction is engaged in the business of moneylending.

It is a criminal offence for a person to carry out the business of moneylending without a licence.²⁶⁷ In addition, it is illegal for a person carrying on the business of a

²⁶⁷ Ibid., at section 3(7) and (8).

moneylender, registered or not, to charge interest on money lent at a rate that is above the prescribed rate of interest.²⁶⁸ Any interest paid; over and above the prescribed rate of interest can be reclaimed by the borrower.²⁶⁹ Similarly, the lender (SPV) cannot enforce an agreement requiring a borrower to pay more interest than is lawfully chargeable under the Prescribed Rate of Interest Act.²⁷⁰ In the case of a non true-sale securitization transaction, the discount rate on the assets ceded *in securitatem debiti* will be regarded as the interest rate chargeable.

Without an amendment to the MRI Act, to create a safe harbour for securitization transactions, SPVs involved in non true-sale transactions will be bound by the provisions of the MRI Act. This study recommends that the MRI Act should be amended and exempt SPVs incorporated or established for securitization purposes from registration under the MRI Act. There is no reason in principle why an SPV involved in a true-sale securitization transaction should be placed in a more advantageous position than that involved in a non true-sale transaction.

5.7. Summary

This chapter analysed Zimbabwe's corporate, trust and partnership laws with the objective of determining juristic entities, which can be used as SPVs in securitization transactions. This chapter concludes that trust and public limited-liability structures can be used as SPVs in securitization transactions. Of these structures, trust arrangements are the best securitization mediums, as they are easier and relatively cost-effective to settle, as compared to public limited-liability companies. They are extremely versatile, have effective limited liability status, are bankruptcy-remote,

²⁶⁸ In Zimbabwe, interest rates are statutorily controlled, with the Prescribed Rate of Interest Act [Chap 8:10].

²⁶⁹ Section 11 of the Moneylending and Rates of Interest Act.

²⁷⁰ *Ibid.*, at section 9. See also Funding Initiatives International (Pvt) Limited v Constantine Mabaudi HH-20-2007.

enable trust assets to be bankruptcy-proofed and do not attract entity-level income tax. In addition, the law does not need to be changed for trusts to be used as securitization SPVs.

Public limited liability companies can also be used as securitization SPV structures. The only issues to be considered are incorporation costs, the comparatively onerous statutory compliance requirements associated with public companies, and entity-level tax. Consideration should be given to amending the Companies Act to enable private limited-liability entities to issue debt securities to members of the public. This would enable them to be used in securitization transactions.

Consideration should also be given to creating limited liability partnership structures in Zimbabwe. An additional enactment that should be amended, if a cost-effective securitization-enabling financial framework is to be attained is the MRI Act. As the law currently stands, SPVs used in non-true-sale securitization transaction would be obliged to register as moneylenders under the MRI Act and are prohibited from charging interest above the government prescribed rate of interest.

CHAPTER 6

FINANCIAL ASSET TRANSFER AND LEGAL RISKS

6.1. Introduction

This chapter considers a critical aspect of securitization transactions: the legal transfer of financial assets to be securitized from an originating firm to an SPV and attendant risks. It evaluates Roman-Dutch law asset transfer methods and their insolvency-risk characteristics. It discusses the structured finance-idiosyncratic true-sale concept, *indicia* for true-sale transactions, and the applicability of the concept to securitization asset transfers arranged in Zimbabwe. It also analyses several key legal insolvency risks that arise from, or with regards to, the transfer of financial assets in a securitization transaction. These include: (i) re-characterization risk; (ii) insolvency law asset transfer-voiding risks (iii) substantive consolidation risk; (iv) veil piercing risk; and (v) foreclosure risk. This chapter concludes that these risks do not adversely affect securitization transactions structured in Zimbabwe and that in any event they can be structured out of most transactions.

6.2. Transfer of assets: Methods

A typical securitization arrangement involves the legal transfer of financial assets from an originating firm to an SPV.²⁷¹ In theory, the isolation and transfer of financial assets enables originating firms to de-link their own credit quality from the financial assets to be securitized. This process enables them to refinance backed by the credit quality - typically enhanced - of the partitioned assets. It is this legal structuring feat that has enabled firms to access capital-market financing through the securitization of various income-generating financial assets. In Zimbabwe, a firm intending to securitize its assets may arrange the transfer of assets to the SPV either as an outright sale or through a cession in *securitatem debiti* of the underlying assets.

6.2.1. Law of sale: Roman-Dutch

Zimbabwe's law of sale is drawn from Roman-Dutch law. The *locus classicus* of *Hutton v Lippert* defines a contract of sale as: "a contract in which one person promises to deliver a thing to another, who on his part promises to pay a certain price."²⁷² This means there must be an agreement to exchange specific property;²⁷³ the price for the property must be expressed in money and must be fixed by or ascertainable from the contract.²⁷⁴ Two legal issues arise directly from the consummation of a contract of sale, i.e. the determination of: (i) when ownership of property passes from a seller to the buyer; and (ii) where risk of loss of the property lies.²⁷⁵ Under Roman-Dutch law, the mere signature of a contract of sale does not pass rights of ownership. For ownership to pass there must be: (a) an intention to pass

²⁷¹ Association of the Bar of the City of New York: Committee on Bankruptcy and Corporate Reorganisation. (1995) 'Structured Financing Techniques', 50, *Business Law* 1995, 527 at 529.

²⁷² *Hutton v Lippert* (1883) 3 App, Cas 309.

²⁷³ The property in question must be defined with sufficient certainty, and it must be clear that the parties are in agreement on what is being bought and sold. See *Munro v Fletcher* 1916 SR 57.

²⁷⁴ Christie (1997) (note 244, at p. 144).

²⁷⁵ *Ibid.*, at p. 146.

ownership;²⁷⁶ (b) delivery of the property;²⁷⁷ and (c) payment of the price, or the provision of credit or security.²⁷⁸ Ownership of incorporeal assets, such as financial claims, can only be passed through cession. Risk on the other hand passes to the buyer on conclusion of the contract of sale. Similarly any gains (profits) arising from the property subject to the sale accrue to the buyer on *emptio perfecta*.²⁷⁹

Financial claims, current or future-flow, may be sold and transferred from one party to another only through cession. However, there are at least two other contract types that involve the cession of such rights, which result in the sale and transfer of such rights. These are assignment and novation. The following is a discussion of all three contract types.

6.2.2. Cession

Under Roman-Dutch law, a creditor (cedent) can enter into an agreement to cede (transfer) all existing and/or future personal rights to income to a third party, (cessionary). This is referred to as a cession.²⁸⁰ As a result of the cession, the cessionary steps into the shoes of, and becomes the new creditor.²⁸¹ Through a cession, the cedent relinquishes all “[its] rights to institute or continue with legal

²⁷⁶ Weeks v Amalgamated Agencies Ltd 1920 AD 218.

²⁷⁷ Christie (1997) (note 244, supra) at p.146.

²⁷⁸ Laing v South African Milling Co Ltd 1921 AD 218.

²⁷⁹ Fitwell Clothing v Quorn Hotel 1966 RLR 323 (A). See also Christie (1997) (note 244, supra) at pp.150-151.

²⁸⁰ A cession is defined as: “(a)...an act of transfer; (b) the subject matter of the transfer is a right; and (c) the transfer is effected by agreement between the cedent and cessionary.” Johnson v Incorporated General Insurances Ltd 1983 (1) SA 318 (A) at p. 331G. See also Christie (1997) (note 244, supra) at p. 110.

²⁸¹ The High Court of Zimbabwe has stated: “A cession is a bilateral juristic act whereby the cedent transfers his right to the cessionary, with the latter taking over as creditor. The transfer is accomplished by means of an agreement concluded between the cedent and the cessionary arising out of a *justa causa* from which the intention of the cedent to transfer and for the cessionary to become the holder of the right to claim appears or can be inferred. The intention of the parties has to be deduced from the agreement that has been entered into by them.” Malawi Dairibord Limited v Mudyanadzo HH-55-2007, at p. 3.

proceedings over the subject of the cession.”²⁸² A cession is therefore an asset transfer method.²⁸³ A cession does not result in a novation. The cessionary merely becomes entitled to sue on the existing debt, without the consent of the underlying debtor(s).²⁸⁴ It is noteworthy however that rights and not obligations are ceded. The essential elements of a cession are: (i) an intention by the cedent to pass transfer of the debtor’s obligation to the cessionary; (ii) an intention by the cessionary to accept transfer of the debtor’s obligation from the cedent; and (iii) a *causa* for the transfer, i.e. an obligation by a debtor.²⁸⁵

As a general rule, and subject to statutory caveats such as those contained in the Deeds Registries Act [Chapter 20:05], Roman-Dutch law does not prescribe formalities for the creation of a valid cession of incorporeal rights.²⁸⁶ A cession need not be in writing,²⁸⁷ although for evidentiary purposes, it is advisable that a notarial deed of cession be deposited before a notary public, and lodged at the Deeds Registry Office. Cessions of mortgage bonds are required to be registered with the registrar of Deeds.²⁸⁸ In addition, under Roman-Dutch law, the underlying debtor(s), whose debts

²⁸² Syfrets Merchant Bank v Jardine & Others 1999 (1) ZLR 124 (H).

²⁸³ In a South African case, Joubert J.A. held: “cession is a particular method of transferring rights in a movable incorporeal thing in the same manner in which delivery (*traditio*) transfers rights in a movable corporeal thing. It is in substance an act of transfer (“*oordragshandeling*”) by means of which the transfer of a right (*translatio juris*) from the cedent to the cessionary is achieved. The transfer is accomplished by means of an agreement of transfer (“*oordragsooreenkoms*”) between the cedent and the cessionary arising out of a *justa causa* from which the former's intention to transfer the right (*animus transferendi*) and the latter's intention to become the holder of the right (*animus acquirendi*) appears or can be inferred. It is an agreement to divest the cedent of the right and to vest it in the cessionary. Moreover, the agreement of transfer can coincide with, or be preceded by a *justa causa* which can be an obligatory agreement, also called an obligatory agreement, (“*verbintenisskeppende ooreenkoms*”) such as, a contract of sale, exchange or donation.” First National Bank of SA Ltd v Lynn N.O. and 5 others, 1996 (2) S.A. 339 (A).

²⁸⁴ Christie (1997) (note 244, *supra*) at p.110.

²⁸⁵ Malawi Dairibord Limited v Mudyanadzo HH-55-2007, at p. 3.

²⁸⁶ Pillay v Harichand 1976 (2) SA 681 (D). This case is cited by Christie (note 244, *supra*), at p. 110 with approval.

²⁸⁷ In the case of Botha v Fick, it was held that “mere consensus is sufficient to effect a cession.” Botha v Fick 1995 (2) SA 720 (A).

²⁸⁸ Section 14(b) of the Deeds Registries Act.

are being ceded, need not be given notice of the cession and their consent is not essential for the cession to be valid.

For a cession to be valid, the claim being ceded must: (i) be legal; (ii) not be one that can be executed by the cedent only (such as a claim for maintenance or alimony); and (iii) it must be identifiable and transferable.²⁸⁹ In addition, the cession of a debt to several cessionaries pro-rata without the consent of the debtor is unenforceable if it occasions prejudice to the debtor. Such a cession is voidable, not *void ab initio*. The policy reasoning is that the splitting of a claim between various cessionaries causes prejudice to the debtor(s), as they may have to defend several claims instead of one.²⁹⁰ But a cession to several cessionaries jointly and severally is valid, as it does not result in the splitting of the debt and does not impose additional burden on the debtors.²⁹¹

Roman-Dutch law recognises two types of cessions: the out-and-out cession, also referred to as an absolute cession and a cession *in securitatem debiti*. An absolute cession is a sale and transfer of assets, which results in the complete transfer, from the cedent to the cessionary, of the former's rights, title and interests, including rights of ownership over the assets. The cessionary becomes entitled to sue the underlying debtor in the event of default, and is able to enforce the acquired rights against all third parties. Conversely, because the cedent would have been divested of its rights it will no longer have *locus standi* to enforce payment by the underlying debtor.²⁹² The second type of cession is a transfer of assets made by a cedent to a cessionary to secure a loan. As noted above, this is known as a cession *in securitatem debiti*. A

²⁸⁹ Christie (1997) (note 244, supra) at p.110. See also Hersch v Nel 1948 (3) SA 686 (A) 693; Tregoning v Tregoning 1914 WLD 95.

²⁹⁰ The Liquidators of Tirzah (Private) Limited and 3 Others v Merchant Bank of Central Africa Limited and 2 Others SC 123-2002. See also Blaikie and Co Ltd v Lancashire 1951 (4) SA 571 (N) at 576. See also Anglo-African Shipping Co (Rhodesia) (Pvt) Ltd v Baddeley & Anor 1977 (1) RLR 259, at 264H-265C. Mountain Lodge Hotel (1979) (Private) Limited v McLoughlin 1983 (2) ZLR 238 (SC) at 246C.

²⁹¹ Anglo-African Shipping Co (Rhodesia) (Pvt) Ltd v Baddeley 1977 (1) RLR 259.

²⁹² London and South African Bank v Official Liquidator of Natal Investments Co (1871) 2 NLR1.

cession in *securitatem debiti* is akin to a pledge of movable property. The cedent in a cession in *securitatem debiti* retains a reversionary right in the ceded debt, unlike in an out-and out-cession. The cedent, in this type of cession is entitled to the return of the ceded property, together with all fruits and advantages accrued, once s/he has discharged the debt for which the assets were ceded as security.²⁹³ Similarly, the cedent cannot claim against the ceded property for as long as it has not yet discharged its debt, and the cessionary is only entitled to call on the cession if the cedent defaults, subject to the terms of the notarial deed of cession.²⁹⁴

From the foregoing, it is obvious that both types of cessions can be used as asset transfer methods in securitization transactions. The absolute cession is suitable for true-sale securitizations, while the cession in *securitatem debiti* is suitable for non true-sale securitization transactions. This makes cession, in either of its forms, a viable asset transfer method.²⁹⁵

6.2.3. Assignment

In Roman-Dutch law, the term assignment refers to the transfer by a creditor of both its rights and obligations to a third party through a combined cession of rights

²⁹³ Bank of Lisbon and South Africa Ltd v. Master of the Supreme Court and 4 Others [1986] ZASCA 129.

²⁹⁴ In the South African Court of Appeal case of Millman N.O. v E.F. Twiggs and Another, it was held that: “when a right is ceded with the avowed object of securing a debt the cession is regarded as a pledge of the right in question: dominium of the right remains with the cedent and vests upon his insolvency in his trustee who is under the common law entitled to administer it “in the interests of all the creditors, and with due regard to the special position of the pledgee”. (Per Innes J in National Bank of South Africa Ltd v Cohen's Trustee 1911 AD 235 at 250.)” Millman N.O. v E.F. Twiggs and Another [1995] ZASCA 62, at 62. See also Leyds NO v Noord-Westelike Koöperatiewe Landboumaatskappy Bpk en Andere 1985(2) SA 769(A), Bank of Lisbon and South Africa Ltd v The Master and Others 1987 (1) SA 276(A) and Land- en Landboubank van Suid-Afrika v Die Meester en Andere 1991(2) SA 761(A).

²⁹⁵ Christie notes that: “our law, unlike English law, favours cession because of the commercial advantages it offers such as the ability to sell one’s rights...” Christie (1997) (note 244, supra) at p. 110.

and a delegation of responsibilities.²⁹⁶ An assignment is a form of novation, in that it results in the complete substitution of an originating firm for the SPV, as a contractual party. As a general rule, an assignment requires the consent of the debtor. The consent of the debtor is not required where there does not exist an element of *delectus personae*;²⁹⁷ in this case an originating firm may without the consent of its debtors cede all its rights and delegate all its duties.²⁹⁸ In addition, as a general rule, an assignment results in the termination of the creditor's rights, title and interests in the claims assigned. Assignment therefore provides an effective mechanism through which originating firms may segregate and transfer their financial assets to an SPV and issue securities backed by these underlying financial assets. It is notable that both the South African and Zimbabwean securitization regulations stipulate that assignment and novation are the prescribed financial asset transfer methods of choice.²⁹⁹

6.2.4. Novation

A novation (*novatio voluntaria*) describes the consensual cancellation and discharge of a contract between parties and the creation of another contract between the same parties, or with the substitution of one of the parties.³⁰⁰ For securitization purposes, through a novation, an originating firm can sell its rights to an income

²⁹⁶ Simon v Air Operations of Europe AB 1999 (SA) 217 (A) at 228. See also Christie (2001) *The Law of Contract in South Africa*, 4 ed, Juta and Co., at p. 547. See also Securicor (SA) (Pty) Limited and Others v Lotter and Others CA-681-2004.

²⁹⁷ Delectus personae literally means choice of person and arises where the party to the contract seeking to cede and delegate his rights and obligations respectively, was specially chosen and is required to exercise some special skills which cannot be discharged by the cessionary. Christie (1997) (note 244, supra), at p. 111.

²⁹⁸ Ibid.

²⁹⁹ Section 4(2) (f) of the South African Securitization Regulations (Government Gazette No. 26415 of 4 June 2004). See also RBZ (2007) (note 3, supra), at clause (2) (f) to the preamble.

³⁰⁰ D.J. Joubert (1987) *General Principles of Law of Contract*, Juta & Co. 1987, at p. 297. For a restatement of Zimbabwe's law of novation refer to Christie (1997) (note 244, supra) at p. 107-108. See also Mutopola v Southern African Development Community SC 6-07; Ncube and Another v Magaracha and Others HB-40-2002 at p. 4. Zimbabwe's law of novation is for all practical purposes the same as it exists in English law.

stream to an SPV by obtaining the consent of the underlying debtor to terminate the original contract, and substitute the SPV, as the creditor, in the new contract. The new agreement will consist of the original underlying debtor with the SPV replacing the originating firm as a creditor. Because it involves a waiver of existing rights, under Roman-Dutch law, a novation requires the agreement of all the parties to the original contract and will not be presumed.³⁰¹ As a general rule, a contract of sale that results in a novation, i.e. with the complete substitution of an originating firm with an SPV, which is a separate *persona*, severs the originating firm's rights, title or interest in the subject matter of the contract. The originating firm's rights, title and interests are thereby transferred exclusively to the SPV. To this extent, novation constitutes the most effective method of transferring rights and obligations from an originating firm to an SPV.

However, the utility value of novation as an asset transfer method in securitization transactions is debatable. Novation can be used only in transactions where the underlying debtors are few in number and where it is both feasible and cost effective to enter into new contracts with them. Most loan portfolios and receivables, are not amenable to this type of asset transfer method,³⁰² save where a debtor has agreed at the time that it entered into the first agreement that the creditor may at any time thereafter dispose the debt to a third party. In addition, in practice, novation can be more costly than other asset transfer methods, because it may require the re-

³⁰¹ Christie (1997) (note 244, supra) at p. 108. Refer also to the locus classicus of Ballenden v Salisbury City Council 1949 SR 269 at p. 273 (or 1949 (1) SA 240, at 246).

³⁰² Thomas W. Albrecht *et al*, illustrate the dilemma as follows: "While from a legal perspective novation represents the cleanest form of transfer, there are a number of legal and practical reasons why novation is rarely used in securitization transactions." First, he mentions that banks do not want their customers to know that they are securitizing their assets. Second he states that if the loan asset is secured by collateral, the novation terminates the original security interest, which must be replaced by a new security interest. And in the circumstances it may be necessary to make additional filings to perfect the new security interest. Thomas W. Albrecht and Sarah J. Smith (1998) 'Corporate Loan Securitization: Selected Legal and Regulatory Issues', 8 *Duke Journal of Comparative and International Law*, 411, 1998.

registration of mortgage and notarial bonds over assets, where relevant. To attain a *novatio voluntaria* involves more work, negotiating with the various, if not numerous underlying debtors, which also adds greater complexity to transactions. This element renders novation unsuitable for transfer of assets, in relation to which, the originating firm is expected to perform related contractual obligations or where the originating firm enjoys a particular relationship with the underlying debtor(s), which can be scuttled under a novation.

In summary, in Zimbabwe, originating firms intending to sell rights to income have the option of choosing either cession or assignment as asset transfer methods. A novation, which involves the cession of rights, may be equally suitable as an asset transfer method. A cession in *securitatem debiti* enables a firm to use its financial assets as security for money lent and advanced, yet retaining *dominium* over the assets. On the other hand, an out-and-out cession enables a firm to sell and transfer its financial assets to an SPV, terminating in the process all its rights, title and interests in the assets transferred. Assignment on the other hand, has all the benefits of an out-and-out cession as well as being a medium to divest obligations linked to a set of financial assets. Depending on the nature of the assets to be securitized and the intention of the parties, as with an out-and-out cession, assignment enables firms to wholly sever their rights of ownership and interests over assets to be securitized. It is this quality, which in theory, make cession and assignment excellent bankruptcy-proof asset transfer methods. Based on the foregoing, Zimbabwe's common law provides a medium for the effective sale or pledge of income-generating financial receivables in securitization transactions.

6.3. True-sale

The legal characterization and recognition of a transfer of assets from an originating firm to an SPV - either as a sale or secured financing arrangement - is an extremely important legal issue in securitization transactions.³⁰³ Where an originating firm seeks a securities issuance to be ascribed ratings which are higher than its own credit rating, it will typically take measures to insulate the securitized assets from its insolvency estate through the sale to the SPV of assets to be securitized. A properly structured true-sale places the assets beyond the claims of the originating firm, its creditors, liquidator and other third parties. Such a transfer enhances an SPV's bankruptcy-remoteness, and the credit rating of its securities.³⁰⁴ A true-sale ensures that if an originating firm is made subject to winding-up proceedings, capital and interests payments due on the securities will not be stayed as the revenue flows will fall outside the originating firm's insolvency estate.³⁰⁵ But what is a true-sale securitization transaction?

6.3.1. True-sale: Definition

There is no settled definition of this structured finance phrase. In practice it is used to describe the sale and transfer of financial assets from an originating firm to an SPV, which terminates an originating firm's ownership rights and interests in the

³⁰³ Jeffrey E. Bjork (1997) 'Seeking predictability in Bankruptcy: An Alternative to Judicial Recharacterization in Structured Financing', *14 BANKR. DEV. J.* 119, (1997) at p. 127.

³⁰⁴ However, as noted above, although commonly assumed, the sanctity of securitization true-sale asset transfers in the event of the originating firm's insolvency is contested. Some commentators such as Prof Carlson have argued that assets transferred to an SPV by an originating firm may be liable to be included in the originating firm's bankruptcy estate. See David G. Carlson (1998) 'The Rotten Foundations of Securitization', *39 WM. & Mary L. REV.* 1055 (1998). See also Teresa N. Kerr (2000) 'Bowie Bonding in the Music Biz: Will Music Royalty Securitization Be the Key to the Gold for Music Industry Participants?', *7 UCLA ENT. L. REV.* 2000, 367, at pp. 373; Sheryl A. Gusset (1996) 'Bankruptcy Remote Entities in Structured Financings', *AM. BANKR. INST. J.*, (1996) at p. 14.

³⁰⁵ Section 213 of the Companies Act provides for the staying of all proceedings against a company that is being wound up and voids asset dispositions made after the commencement of winding-up proceedings unless sanctioned by a court.

transferred assets.³⁰⁶ Both as a concept and a structuring mechanism, the phrase true-sale was originated to distinguish between, on the one hand, secured financing; and on the other, capital market financing involving securities backed by a segregated pool of credit and liquidity-enhanced assets sold to an SPV by an originating firm. The RBZ securitization guidelines do not define a true-sale, but describe when it occurs. They state: ““True Sale” occurs where (i) the sale is in compliance with legal provisions governing asset sales and the assets are legally isolated from the transferor (i.e. beyond reach of the transferor’s creditors even in bankruptcy); (ii) the transferee is a qualifying SPV and holders of the beneficial interest in that entity have the right to pledge or exchange those interests; and (iii) the transferor does not maintain effective or indirect control over the transferred assets and consideration is other than beneficial interest.”³⁰⁷ As above, this study argues that as a general rule, an absolute cession, an assignment or a novation terminate an originating firm’s rights of ownership in transferred assets and vests those in the SPV. Therefore, for as long as all the formalities of a contract of sale are completed and the law recognises ownership as having passed from an originating firm to an SPV, a true-sale would have been attained.

³⁰⁶ A true sale has also been defined as: “a transfer of financial assets in which the parties state that they intend a sale, and in which all of the benefits and risks commonly associated with ownership are transferred for fair value in an arm’s length transaction.” Pantaleo, V. Peter (1996) ‘Rethinking The Role of Recourse in the Sale of Financial Assets’, 52, *Bus. Law.* 159 at p. 159. In the U.S. a true sale has been described as “an absolute transfer of assets resulting in the transferor no longer retaining any right, title, or interest in the assets and which removes the assets from the transferor’s estate” under the Bankruptcy Code. Association of the Bar of the City of New York: Committee on Bankruptcy and Corporate Reorganisation (1995) ‘Structured Financing Techniques’ (1995), at p. 64. Whether or not it is possible to sever absolutely securitized assets from the insolvency estate of the originating firm is debatable as appears below.

³⁰⁷ RBZ (2007) (note 3, supra), at Part IV to the preface.

6.3.2. True-sale and re-characterization risk

A risk peculiar to securitization transactions is the risk that a transfer of financial assets will be re-characterized as a secured loan transaction. This is referred to as re-characterization risk.³⁰⁸ This is one of the reasons why structurers of securitization transactions will typically obtain an opinion from legal counsel who assesses the robustness of the asset transfer from the originating firm to the SPV. This opinion is referred to as a true-sale opinion. The true-sale opinion assesses whether an asset transfer satisfies the essential elements of a contract of sale, whether ownership has passed from the originating firm to the SPV, and consequently whether the structure will be able to withstand claims from the originating firm, its liquidators and creditors. In Zimbabwe, the RBZ securitization guidelines give some guidance on the constituents of a “clean-sale” for regulatory capital purposes.³⁰⁹ The true-sale opinion is considered and used by other securitization participants, such as auditing firms, which produce audit reports; and by the rating agencies, which produce rating opinions. Originating firms, their liquidators and creditors have been known to seek the re-characterization of an asset transfer as a secured financing arrangement, despite the transaction having been structured and denominated as a true-sale.³¹⁰ A bankruptcy-remote asset transfer is one that is insulated from such claims.

In Zimbabwe, “when, under what circumstances, and to what effect, should a transaction denominated by the parties as a “sale” be treated as something else;”³¹¹ i.e. re-characterized? The true-sale question within a structured finance context is yet

³⁰⁸ Thomas Gordon describes characterization risk as: “the risk that a court will view the originator’s conveyance of assets to the SPV as a secured loan rather than as a true sale.” Thomas J. Gordon (2000) ‘Securitization of Executory Future Flows as Bankruptcy Remote True Sales’, *University of Chicago Law Review*, 2000, vol. 67, No. 4, 1317, at p. 1327.

³⁰⁹ RBZ (2007) (note 3, supra) at paragraph 5.2.

³¹⁰ In the LTV Steel Co. Inc case, the company filed for chap 11 bankruptcy protection and sought to renege on the transfer of assets that it had securitised, contending that it was not a true-sale of assets. *In re LTV Steel Company, Inc., Bankr. N.D. Ohio Feb. 5. 2001.*

³¹¹ Jonathan C. Lipson (2002) ‘Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?’ *11 J. Bankr. L. and Prac.* Vol. 16 (January/February 2002), at p. 24.

to be decided by courts in Zimbabwe. Arguably, the adoption of the concept of true-sale into Zimbabwe's jurisprudence is not essential for the creation of a securitization-enabling financial infrastructure. There are a couple of reasons for this. South Africa's law of sale is essentially the same as Zimbabwe's, and it has managed to propagate securitization without specifically adopting the concept of true-sale.³¹² The second reason is that the High court in Zimbabwe, exercising its equitable jurisdiction can determine if a contract is one for the sale of assets or a secured financing arrangement. This study argues that a contract of sale, which results in the transfer of ownership rights, equates to a true-sale.

It is trite that courts in Roman-Dutch law, as well as English common law jurisdictions, are empowered to evaluate the substance rather than the form of things, including the substance of contractual arrangements.³¹³ Under the Roman-Dutch system, courts will assess all the factors relevant to a contractual arrangement to determine the intention of the parties to a contract.³¹⁴ It is trite that securitization transactions often involve arrangements that are not typically associated with, but which do not necessarily exclude the presence of, a contract of sale as defined under Roman-Dutch law. These include recourse, subordination, over-collateralization and other provisions. Whether the sale characterization of a contract made pursuant to a

³¹² The same is true for the U.K., which also has not specifically incorporated the concept into its law of sale.

³¹³ In the case of Dadoo the court acknowledged "...the fundamental doctrine that the law regards the substance rather than the form of things, - a doctrine common, one would think, to every system of jurisprudence and conveniently expressed in the maxim plus valet quod agitur quam quod simulate concipitur." Dadoo v Krugersdorp Municipal Council 1920 AD 530 at p. 547. See also MBE Ltd v Try Again Bus Co (Pvt) Ltd 1975 (1) RLR 39, 1975 (2) SA 156; Standard Chartered Bank Zimbabwe Ltd v Zimbabwe Revenue Authority HH-26-2007; Stanmaker Mining (Pvt) Limited v Metallon Corporation Ltd HH-36-2006. For an exposition of the English common law position, refer to the instructive case of Welsh Development Agency v Export Finance Co. Ltd [1992] B.C.C. 270.

³¹⁴ McAdams v Fiander's Trustee and Bell NO, 1919 AD 207, at pp. 223-224. This case was cited and approved in the case of The Commissioner for Inland Revenue v Contage (Proprietary) Limited [1999] ZASCA 64 (17 September 1999), where the court stated: "the real transaction was found to be a loan even though the parties had cast their agreement as a sale in the bona fide belief that it would provide security to the "purchaser." But even in such a case, the agreement is plainly a simulation; and it maybe a dishonest simulation depending on what the parties intended to make of it."

securitization transaction will be upheld by a court will in practice depend on whether the court accepts that the contract is indeed in substance a contract of sale and not a secured financing arrangement. The risk of re-characterization is therefore very much fact-sensitive.

There is obviously no international standard for determining whether a contract is a true-sale arrangement. What comparative jurisprudence exists offers little by way of determinative guidance. A case whose reasoning may resonate with the judiciary in Zimbabwe is the English case of *Welsh Development Agency v Export Finance Co. Ltd.*³¹⁵ In this case, the agreement between the parties was described in the contract as a sale, but it also contained at least four features that suggested the agreement was a secured financing transaction. The features which suggested a financing arrangement were: (i) the method of calculating the goods price; (ii) the existence of a discount, which appeared to be an interest charge rather than a true discount; (iii) rights of redemption and (iv) rights of retention. The Court held that it could not conclude that in substance it was not the intention of the parties, as derived from the terms of the written agreement, not to conclude a contract of sale. Arguably, this case provides only minimal guidance on how securitization asset transfers will and should be treated and characterized at law. What it does establish is that the true-sale enquiry is fact-sensitive.

This study recommends that Zimbabwe's judiciary refer to U.S. and Canadian jurisprudence; both sets of which are instructive. In the U.S. a five-pronged test is used to evaluate whether a transaction is a true-sale securitization. Courts assess, as appropriate: (i) the expressed intention of the parties;³¹⁶ (ii) the benefits, if any, of

³¹⁵ *Welsh Development Agency v Export Finance Co. Ltd Co. Ltd* [1992] B.C.C. 270.

³¹⁶ Courts in Zimbabwe would in any event consider the intention of the parties, both as expressed in writing as well as through an analysis of the substance of the transaction. In the U.S. state bankruptcy courts have assessed the expressed intention of the parties; and in instances have gone beyond the

ownership which remain with the originating firm after assets have been transferred to the SPV;³¹⁷ (iii) the extent to which risk of loss is removed from the originator to the SPV;³¹⁸ (iv) the level of control remaining with the originating firm after transfer of the assets has been effected;³¹⁹ and (v) how the sale is treated for accounting purposes by the originating firm. It is important to note that the weight to be placed on each or a combination, or all of the above factors is wholly a question of fact.³²⁰

The Canadian true-sale test, which mirrors in substance the U.S. test, is seven-pronged. It assesses: (i) the intention of the parties as evidenced by the language of the agreement and subsequent conduct; (ii) whether the risks of ownership are transferred to the purchaser and the extent and nature of recourse to the seller; (iii) the right of the seller to surplus collections; (iv) certainty of determination of the purchase price; (v) the extent to which the purchased assets are identifiable; (vi) responsibility

expressed words to assess what the court perceived as the true intention of the parties. To do this, they assessed the parties' practices, objectives, business activities and relationships. See for example the case of Major's Furniture Mart, Inc. v Castle Credit Corp., 602 F.2d 538, 26 U.C.C. Rep. Serv. 1319 (3d Cir. 1979). But contrast this case with the case of Bear v Coben (In re Golden Plan of California, Inc.) where the Court relied almost exclusively on the phrases of choice used by the parties, concluding that the parties intended a sale as opposed to a secured loan transaction. In re Goldren Plan of California, Inc., 829 F.2d 705 (9th Cir. 1986).

³¹⁷In Zimbabwe, if an SPV were to retain some of the benefits and/or risks of ownership, the courts are likely to lean in favour of finding that a transaction is a secured loan transaction. In Major Furniture Mart, 602 F. 2d 538 (3d Cir, 1979) it was noted that if the SPV did not retain any of the risks or obligations of ownership, this would indicate the existence of a secured loan transaction.

³¹⁸Where little or no risk inherent in the underlying assets is shifted from the originating firm to the SPV, the Courts in the U.S. have held such transactions as constituting secured loan transactions as opposed to sales of assets. See Major Furniture Mart, (602 F. 2d 538 (3d Cir, 1979) and the case of Fireman's Fund Insurance Com. v Grover (In re Woodson Co.) 813 F2d 266 (9th Cir 1987). In Zimbabwe, recourse provisions in the contractual agreements between the originating firm and the SPV is likely to result in a finding of a secured financing transaction as opposed to a true-sale transaction. Klee et al state that: "[t]he presence of recourse is the most important aspect of risk allocation because it suggests that the parties intended a loan and not a sale... The greater the recourse the SPV has against the originator, through for example charge-backs or adjustments to the purchase price, the more the transfer resembles a disguised loan rather than a sale." Klee and Butler (2002) (note 59, supra) at p. 52.

³¹⁹Courts in the U.S. have held that if the originating firm retains some element of control or ownership over the transferred assets such as the right to repurchase assets, or the right to surplus funds, then a secured loan transaction is inferred. A U.S. case in point is In re Evergreen Valley Resort, Inc., 23 B.R. 659, 34 U.C.C. Rep. Serv. 1664 (Bankr. D. Me. 1982). See also Robert Dean Ellis who argues that the less control an originating firm has over assets, the higher the chance a court will find for a sale as opposed to a secured loan transaction. Robert Dean Ellis (1999) 'Securitization Vehicles, Fiduciary Duties, and Bondholder's Rights', 24 *Journal of Corporate Law*. 295, at pp. 301-303.

³²⁰For a discussion of all of the above cases refer to the article by Klee and Butler (2002) (note 59, supra), at pp. 49-58.

of the seller in the collection of the receivables; and (vii) whether the seller has a right to redeem the receivables on payment of a specified amount.³²¹ This test is certainly more expansive and recommendable.

The Canadian true-sale test incorporates the issue of price. On closer scrutiny, this is no more than the inclusion of an essential element also found in Roman-Dutch law contracts of sale. This study argues that the price enquiry should extend to the question, whether the SPV paid a fair value for the transferred assets.³²² If no consideration was paid by the SPV for the assets, or if the assets were grossly undervalued, this would suggest that the transaction is a secured financing arrangement and not a true-sale. This stipulation would be consistent with Roman-Dutch law position that parties to a contract of sale “may fix [a] price as high or low as they wish” but it must be real and serious.³²³

Quite apart from court-determined true-sale tests, this study recommends that the Zimbabwe’s Securities Commission (SC) should promulgate securitization transaction rules, which deal, *inter alia*, with true-sale. An issue likely to prove problematic in practice relates to recourse provisions in the event of a trigger event occurring. Although such provisions are standard in securitization transactions, the question of how much risk is required to be transferred to an SPV in order to satisfy the true-sale test arises.

³²¹ Metropolitan Toronto Police Widows and Orphans Funds, et al v Telus Communications Inc. (2003), 30, B.L.R. (3rd) 288 (Ont. C.J.). The true sale test was upheld on appeal. Refer to Metropolitan Toronto Police Widows and Orphans Funds, et al v Telus Communications Inc. (2005) B.L.R. (4th) 251, 75 O.R. (3d) 784, 12 C.B.R. (5th) 251 (Ont.C.A.).

³²² This is a factor already included in the RBZ securitization. RBZ (2007) (note 3, *supra*) at paragraph 5.2 (d). See also Aicher and Fellerhoff who make much the same argument about “the reasonable equivalent of a fair market price.” Robert D. Aicher and William J. Fellerhoff (1991) ‘Characterization of a Transfer of Receivables as a Sale or a Secured Loan Upon Bankruptcy of Transferor’, 65 *AM. Bankr. L. J.* 1991, 181.

³²³ Commissioner for Inland Revenue v Saner 1927 TPD 162. See also Christie, R.H. (1997) (note 249, *supra*), at p. 145.

In summary; although the structured finance true-sale question is yet to be decided in Zimbabwe, this study argues that there already exists well developed jurisprudence on the considerations to be taken into account when determining whether a transfer of assets is a sale, or a pledge of assets to secure a loan. In addition, given the common law tradition of considering persuasive comparative jurisprudence, courts in Zimbabwe will in practice develop *indicia*, which will assist in determining whether a transaction should be treated as a true-sale or secured financing arrangement. This study recommends, subject to the comments above, the Canadian true-sale test, but which must be augmented by rules prescribed by the SC.

6.3.3. True-sale and the *in fraudem legis* principle

It is trite that an asset transfer described by the originating firm and SPV as a true-sale will be set aside if it later transpires that it was tainted by fraud. In Zimbabwe, it is moot whether a court may set aside a securitization asset transfer on the basis that the receivables agreement was *in fraudem legis*. The argument being that the securitization transaction in question was a simulated sale of assets, structured with a view to undermining, if not the letter, then the spirit of Part V of Companies Act as read with the Insolvency Act; i.e. Zimbabwe's insolvency laws. The plea can be made in addition to claims arising from the other anti-asset disposal provisions of the Insolvency Act. Such a plea is obviously fact-sensitive. If successful, it will void the transfer of assets, resulting in the assets being consolidated into the originating firm's insolvency estate.³²⁴

Whether or not a contract is *in fraudem legis* will depend on the intention of the parties as interpreted by the court, and importantly if there is an intention to

³²⁴ It is conceivable that over-collateralisation may be impeached on the ground of a contract *in fraudem legis*, especially where it is considered that the originating firm did not receive reasonably equivalent value. For this argument, see for instance, Klee and Butler (2002) (note 59, supra) at p. 67.

deceive.³²⁵ If the parties do not intend to deceive, but in good faith sought to characterize their transaction as a sale, yet they did not intend ownership to pass, such a sale will still be regarded as a simulated sale and would be re-characterized as a secured financing. An illustrative authority is the South African case of *McAdams v Fiander's Trustee*.³²⁶ However the mere fact that the terms of agreement between an originating firm and an SPV contain provisions that are not typically found in traditional contracts of sale, does not, on its own, suggest dishonesty or that a sale of the assets was not intended. Zimbabwean courts are likely to accept, per custom, that some contract terms in securitization will deviate from typical contract of sale terms.³²⁷

Given that securitization is a widely acknowledged refinancing technique, as reflected in the RBZ securitization guidelines; its use in Zimbabwe is unlikely to result in a court characterizing related asset transfers as simulated contracts of sale; and therefore as contractual arrangements *in fraudem legis*. But poorly structured or fraudulently disguised transactions may fall foul of the *in fraudem legis* principle.

6.3.4. True-sale safe-harbour

The interim decision in the LTV Steel Co case in the U.S. caused a furore within the securitization industry. Most notably, the Court ominously stated: “there seems to be an element of sophistry to suggest that the debtor does not retain at least an equitable interest in the property that is subject to the interim order... [to] suggest that

³²⁵ Christie put it thus: “a contract that is carefully designed to avoid a statutory prohibition will be held as void as being in fraudem legis.” Christie (1997) (note 244, supra) at p. 89.

³²⁶ *McAdams v Fiander's Trustee and Bell NO*, 1919 AD 207, at pp. 223-224.

³²⁷ The *McAdams* case, above, was cited and approved in the case of *The Commissioner for Inland Revenue v Contage (Proprietary) Limited* [1999] ZASCA 64 (17 September 1999), where the court stated: “the real transaction was found to be a loan even though the parties had cast their agreement as a sale in the bona fide belief that it would provide security to the “purchaser.” But even in such a case, the agreement is plainly a simulation; and it maybe a dishonest simulation depending on what the parties intended to make of it.”

the debtor lacks some ownership interest in products that it creates with its own labour, as well as the proceeds to be derived from that labour, is difficult to accept.”³²⁸ This implied the court was of the view that in practice they may never be a true-sale in securitization transactions. There were calls for the enactment of legislation, which would create a statutory safe-harbour by precluding courts from re-characterizing as secured refinancing the sale and transfer of property from an originating firm to an SPV pursuant to a securitization transaction.³²⁹ The Bankruptcy Reform Act of 2001 was drafted but failed to pass after facing stiff opposition following the implosion of Enron.³³⁰ Despite this, in the U.S. states of Delaware, Ohio and Texas laws protecting *prima facie* securitization asset transfers were promulgated to address this perceived judicial excess.³³¹

Interestingly, after the Bankruptcy Reform Act of 2001 was abandoned and in the aftermath of Enron, some members of the U.S. Congress proposed the enactment of an Act called the Employee Abuse Prevention Act of 2002. Section 102 of this enactment granted judges the power, notwithstanding the expressed intention of the contractual parties, to “re-characterize as a secured loan, a sale...if the material characteristics of the sale...are substantially similar to the characteristics of a secured loan.” This legislation also failed to pass. The law as it currently stands in the U.S. is

³²⁸ LTV Steel Co. (note 310, supra), at p. 285.

³²⁹ For a discussion of the LTV case and the question whether securitization is premised on a flimsy legal premise see: Tim Reason (2003) ‘False security? Corporate Insolvencies are Testing whether Securitization is a Stable Structure or a Flimsy Façade’, in *Bankruptcy (2003) CFO: Magazine for Senior Financial Executives*, June 2003. Available at www.cfo.com/article.cfm/3009430?f=related

³³⁰ 35 law professors criticised section 912 in a letter to Congress in a letter.

<http://www.abiworld.org/research> The concerns raised by the 35 professors were largely ignored by Prof Schwarcz, a proponent of asset securitization in his 2002 article. Steven L. Schwarcz (2002) ‘The Impact of Bankruptcy Reform on “True Sale” Determination in Securitization Transactions’, *Fordham Journal of Corporate and Financial Law*, 2002, vol. II, 353. For a criticism of section 912 of the Bankruptcy Reform Act, refer to Lois R. Lupica (2002) ‘Revised Article 9, The Proposed Bankruptcy Code Amendments and Securitizing Debtors and their Creditors’, *Fordham Journal of Corporate and Financial Law*, vol. VII, 321 (2002).

³³¹ Delaware - Asset Backed Securities Facilitation Act, 73 Del. Laws 214; 2001 Del ALS 214; 2001 Del. HB 348; codified in Title 6, Chapter 27A, of the Delaware Code. Ohio - Ohio Rev. Code Ann. 1109.75 (Supp. 2002) - and Texas - Tex. Bus. & Com. Code Ann. 9.109(e) (2002).

that the true-sale character of a securitization transaction asset transfer is determined by U.S. state law and is predominantly left to judge-made true-sale tests. It is not subject to statutory safe harbours, save for a few states such as Delaware.

As noted above, courts in Zimbabwe can re-characterize as a secured financing arrangement, an asset transfer described in the receivables agreement as a sale transaction. Should this common law power be curtailed, with securitization transactions being given a statutory safe-harbour? There is merit in the argument that a statutory law that protects securitization asset transfers from being re-characterised engenders certainty, reduces structuring costs and facilitates the growth and use of securitization transactions. However, this study argues against the ousting of judicial enquiry into whether an asset transfer is a true-sale or secured financing and the use of pre-emptive and prescriptive legislation. Zimbabwe already has well developed legal principles and precedents pertaining to the law of sale. Judicially developed true-sale criteria will build on these established legal principles. Countries with active securitization markets such as South Africa and the U.K. *inter alia*, have not promulgated legislation that prescribe true-sale criteria and have not ousted judicial enquiry into asset transfers made pursuant to securitization transactions. For these reasons, this study does not recommend the promulgation of a Delaware-style safe harbour. The incidence of disputes over true-sale transfers will result in the development of true-sale legal jurisprudence. If rulings by courts impede rather than facilitate securitization transactions, legislative intervention may then become necessary.

A law that precludes courts from looking into and re-characterising asset transfers, where appropriate, in *prima facie* securitization transactions is likely to facilitate fraud and frustrate bankruptcy law and policy. It is reasonable to assume that the negative

externalities of such a law will outweigh the benefits to securitization participants. Permitting the organic growth and understanding of the law relating to true-sales in securitization transactions can facilitate structuring practices that arguably lead to broad standardization and transaction-certainty; while at the same time ensuring that courts' equitable jurisdiction is not unduly fettered. True-sale opinions provided by transactional counsel will and should highlight re-characterization and other transactional risks. Arguably, not having a statutory safe-harbour contributes to securitization issuances coming to market with prices that ideally fully reflect transaction risks; which would be masked by a statutory safe-harbour.

6.3.5. True-sale of future-flow receivables

In principle, current and future rights can be sold and transferred by one party to another through cession. The law of cession as it relates to the sale and transfer of existing rights of action is settled. But the law regarding the cession of future rights, whether contingent or conditional has been a matter of controversy. Roman-Dutch law draws a distinction between an agreement to sell or pledge assets and the act of transfer itself, which is the cession. A cession of assets must be accompanied by this agreement, also known as the obligatory agreement. Since cession is a delivery method, the subject matter of the cession must exist for the act of transfer (cession) to be capable of being effected. The logic is: one cannot transfer *dominium* over non-existent rights. It is now settled that contingent or conditional rights cannot legally be ceded, and that only current rights can be ceded.³³² A caveat: a seller can agree to cede rights to income to a buyer when the rights or financial assets come into existence. That agreement, i.e. the agreement to cede rights when they come into

³³² In *First National Bank* the court stated: "logically speaking a non-existent right of action or a non-existent debt can never in law be transferred as the subject matter of a cession." *First National Bank of SA Ltd* (note 283, supra), at p. 8.

existence at a future date is valid and enforceable.³³³ The cession will be effected if and when the assets come to being. If the assets do not materialise, there will be no cession, and the party described as the cessionary will not acquire any rights of ownership, as the property would not have been delivered.

In Zimbabwe, courts have dealt with this question in relation, not to securitization, but the sale and cession of personal rights in rent-to-buy council properties by council tenants.³³⁴ The question that fell to be decided was whether: (i) rights possessed by rent-to-buy council tenants to receive ownership of the council property after 20 or 25 years of paying rentals were capable of being sold before the expiration of the rent-to-buy period; and (ii) whether the purchaser could enforce those rights against the Council and force the Council to register the purchaser as the new lease-rights holder. The law on this question is now settled; and the courts have held that a rent-to-buy tenant's right to claim transfer of the property on discharging the terms of the rent-to-buy agreement can be validly sold and ceded. However, the cessionary could not legally compel the Council to register it as the new lease rights-holder or seek transfer of the property, unless if the terms of the underlying agreement have been fulfilled and discharged. Once the contract conditions have been fulfilled, in the absence of delivery, the cessionary can seek a court order for specific performance, compelling the cedent to obtain transfer of the property from the Council in terms of the rent-to-buy agreement and thereafter effect transfer to him/her as the cessionary. It is within

³³³ In *First National Bank* it was also held: "...parties may agree in the obligatory agreement to cede and transfer to the cessionary a future or contingent right of action (*spes futurae actionis*), or a future or conditional debt (*debitum conditionale, debitum futurum*) as and when it comes into existence and accrues or becomes due and payable whereupon it will be transferred to the cessionary. If it never comes into existence it will amount to a non-existent right of action or a non-existent debt which cannot qualify as the subject matter of a cession..." *Ibid.*, at p. 9.

³³⁴ See the following line of cases: *Mukarati v Mkumbu* 1996 (1) ZLR 212 (S), at 214H; *Tobaiwa v Kaseke and Another* HH-74-2006; *Jangara v Nyakuyamba* 1998 (2) ZLR 475 (H) at p. 480G- 481A-B; *Magwenzi v Chamunorwa & Anor* 1995 (2) ZLR 332 (S). The following earlier decisions were overturned by the Supreme court on the basis that they had been wrongly decided: *Chikonyora v Pedzisa* 1992 (2) ZLR 445 (S); and *Hundah v Murauro* 1993 (2) ZLR 401 (S).

this context that the law of cession, in so far as it relates to future or contingent rights must be understood.

By parity of reasoning, the same principles can be applied to the cession of future-flow financial receivables. Future-flow financial receivables can therefore be sold, but the sale is deemed to be conditional on the financial assets coming into existence. This construction of the law as it relates to the cession of future and contingent rights presents serious insolvency risks for future-flow securitization transactions. This is because, subject to the terms of the agreement the financial assets will be transferred to the SPV, when, and only when, they have come into existence. And it is only then – assuming an out-and-out cession – that, the SPV will assume ownership of the financial assets, and the cedent's rights, title and interests will simultaneously terminate. If however, the assets or rights of action come into existence after the originating firm has been made subject to a winding-up order, as happened in the First National Bank case,³³⁵ the assets will fall into its insolvency estate by virtue of section 213 of the Zimbabwe Companies Act, which precludes a firm subject to winding-up proceedings from disposing assets without a High court order.

In addition, because an agreement to cede assets from one party to another remains that, an agreement, i.e. until the assets to be transferred come into existence, the seller is at liberty to cancel the agreement before transfer, as with any contract. This is obviously subject to the buyer's remedies for breach of contract. In summary, an out-and-out cession cannot effect, and will not result in, a true-sale transfer of future-flow financial receivables. Under Roman-Dutch law, the cession of future-flow financial receivables has peculiar insolvency risks.

³³⁵ First National Bank (note 283, supra).

6.4. Insolvency risks

It is important that a country's legal infrastructure enables rather than impedes originating firms from creating bankruptcy-remote securitization structures. Crucially, asset transfers made by originating firms pursuant to securitization transactions should be immune from insolvency anti-asset disposal provisions of the Companies Act and the Insolvency Act. The relevant provisions of the two enactments include sections 213(c) and 269(3) of the Companies Act, and sections 42, 43, 44 and 47 of the Insolvency Act, as read with section 269 of the Companies Act. The latter provisions give the High court, sitting as an insolvency court, power to set aside certain dispositions of property made by a company subject to winding-up proceedings. These anti-asset disposal provisions can adversely affect securitization transactions. In practice, true-sale and non-consolidation legal opinions provided in Zimbabwe structured securitization transactions need to consider and analyse the bankruptcy risks inherent in these provisions.

6.4.1. Section 213(c) of the Companies Act and insolvency risk

Section 213(c) of the Companies Act can have adverse effects on securitization transactions. If an originating firm is retained as a Servicer, section 213(c) of the Companies Act can undermine a securitization transaction, if it is subsequently made subject to a winding-up order. The section also affects future-flow securitization transactions. Section 213(c) states that: "every disposition of the property, including rights of action, of the company...made after commencement of the winding-up, shall, unless the court otherwise orders, be void." This means that any disposition of property made by a company after the commencement of winding-up proceedings risks being declared void. But what amounts to a disposition of property and in what

way does this provision affect securitization transactions? The word disposition is not defined in the Companies Act. Section 270 of the Companies Act provides that where there is a *lacuna* in the Companies Act with regards the winding-up of companies, reference should be made to the provisions of the Insolvency Act dealing with insolvent estates. The Insolvency Act defines the word “disposition,” to mean “...any transfer or abandonment of rights to property, and includes a sale, lease, suretyship, mortgage, pledge, delivery, payment, release, compromise, donation or any contract therefor but does not include a disposition in compliance with an order of a court.”³³⁶ This definition is unhelpful. It is very broad and equates different juristic acts. For instance, it places transfer, delivery, payment, release and sale on the same footing, yet the first four are essential elements of a contract of sale under Roman-Dutch law. The definition of disposition in South Africa’s Insolvency Act³³⁷ is exactly the same as the definition in the Zimbabwe statute. In South Africa, courts have implored policy makers to amend the definition on account of its ambiguity.³³⁸

The definition gives rise to a conundrum. Does a disposition occur when: (i) an originator concludes a contract of sale of financial receivables with an SPV; or (ii) financial assets are paid for; or (iii) transfer or delivery is effected by the originating firm; or (iv) on the occurrence of each of the foregoing? The definition is arguably deliberately over-broad to ensure that companies do not use technical arguments to avoid the proscription against asset disposition; for instance, by drawing technical distinctions between a sale on the one hand, and delivery of the *merx* or payment of the purchase price on the other. The latter combination results in the transfer of

³³⁶ Section 2 of the Insolvency Act.

³³⁷ Insolvency Act, Act No. 24 of 1936 (South Africa).

³³⁸ See Cooper and Another v Merchant Trade Centre Ltd 1999 ZASCA 97. See also Estate Jager v Whittaker and Another 1944 AD 246 at 250; Barclays National Bank Ltd v Umbogintwini Land and Investment Co (Pty) Ltd (in liquidation) and Another 1985 (4) SA 401 (D & C); Klerck NO v Kaye 1989 (3) SA 656 (C) at 674 C - J).

ownership pursuant to a contract of sale. It is arguable that the occurrence of any of the three – as above – and depending on the facts, amounts to an unlawful disposition. Viewed in this way, an unlawful disposition occurs whenever a company assumes the right to deal with property, which it owns, or which belongs to a third party, after it has been made subject to winding-up proceedings. This right and privilege to dispose property is – for public policy reasons – exercised by a liquidator, appointed by a court pursuant to the provisions of the Companies Act.

Argued thus, there is a real risk that the transfer of receivables by an originating firm subject to winding-up proceedings to an SPV pursuant to a servicing agreement or a future-flow securitization transaction will be regarded as a proscribed disposition of assets, contrary to section 213(c).³³⁹ For this reason, it is arguable that the use of an originator to service receivables carries serious insolvency risks.

The above notwithstanding, this study does not recommend the amendment of section 213(c) of the Companies Act to create a safe harbour for originating firms acting as Servicers. Originating firms which securitized some of their assets prior to being made subject to winding-up orders, should not be granted preferential treatment to continue dealing in such assets, when others which refinanced using traditional intermediated methods are not granted the same privileges. A safe harbour could result in securitization transactions being deliberately used to undermine Zimbabwe's insolvency framework.

³³⁹ In South Africa, the word disposition has been held to encompass the conclusion of a contract providing for the delivery or transfer of property or payment of money, and also the actual physical transfer or delivery, or payment. National Bank of SA Ltd v Hoffman's Trustee 1923 AD 247 at 251; and Estate Jager v Whittaker and Another 1944 AD 246 at 250.

6.4.2. Section 269(3) of the Companies Act and insolvency risk

Section 269(3) of the Companies Act states: “any cession or assignment by a company [subject to winding-up proceedings] of all its property to trustees for the benefit of all its creditors shall be void.” [Emphasis added]. The application of this section to securitization transactions is debatable. On the one hand, it is arguable that because it refers to instances where a company cedes or assigns all of its property to trustees for the benefit of all its creditors, section 269(3) may apply to, and void, asset transfers made in relation to non true-sale, re-characterized or whole business securitization transactions in which trust structures have been used. On the other hand, it could be argued that a purposive interpretation of section 269(3) would render it inapplicable to securitization transactions. Section 269(3) is obviously a public interest insolvency anti-asset disposal provision, whose objective is the equitable distribution by public authorities of the assets of a person, natural and juristic, unable to pay its debts. Refinancing or risk management is usually the main reason behind *bona fide* securitization transactions, and not the avoidance of bankruptcy law. For this reason, the section is arguably inapplicable to securitization transactions.

However, if a securitization transaction results in an originating firm transferring all or substantially all of its assets to trustees in a non true-sale, or re-characterized securitization transaction, section 269(3) may be triggered and the asset transfer voided. Because of the way section 269(3) is drafted, it follows that the financial health of an originating firm constitutes a relevant factor to be considered by credit rating agencies and investors in non true-sale securitization transactions.

Should section 269(3) be amended to ensure that asset transfers made pursuant to non true-sale and whole business securitization transactions are not voided? Such an amendment would clarify that section 269(3) applies only to insolvency law-

avoidance practices, and not to *bona fide* securitization transactions. But, in rebuttal, it is arguable that a specific exemption for securitization transactions may result in securitization being used as an insolvency law-avoidance mechanism. For the latter reason, the amendment of section 269(3) of the Companies Act to create a safe harbour for securitization transactions is not recommended.

6.4.3. Section 42 of the Insolvency Act and insolvency risk

Section 42 provides for the setting aside of a disposition of property made by a debtor six months before it was placed under a winding-up order, which: (i) had the effect of preferring one creditor over another; and (ii) if immediately after the disposition, the liabilities of the debtor exceeded the value of its assets.³⁴⁰ It is the effect of the disposition, rather than the intention of the debtor, which determines whether the asset disposition is voidable. As a general rule, section 42 would not apply to a true-sale securitization transaction because in this type of transaction, the SPV is not a creditor, but rather a purchaser of a set of financial assets. Section 42 is engaged if the securitization transaction is a non true-sale or re-characterized transaction, in which the SPV is a creditor.

Arguably however, a *bona-fide*, arms length and for fair-value securitization transaction, including a non-true sale, should not cause the liabilities of an originating firm to exceed the value of its assets. A securitization transaction replaces one type of asset with another; i.e. financial receivables with cash, albeit discounted. Therefore, if the liabilities of an originating firm exceed the value of its assets, post completion of a securitization transaction, it must arguably be the result of over-investment or inappropriate action taken by the originating firm and not the result of the transaction.

³⁴⁰ See the case of Madondo (N.O.) v Zimbabwe Banking Corporation HH-5-2008, which considered the meaning and application of section 42 of the Insolvency Act.

If however, the securitized assets were grossly undervalued resulting in the originating firm's liabilities exceeding the value of its assets, the asset transfer may be impeached at the instance of a liquidator or opportunistic creditors.

An SPV in receipt of transferred assets can raise a statutory defence to a claim for the setting aside of an asset transfer. It can argue that the transfer of assets was made in the ordinary course of the originating firm's business and that the transaction was not intended to prefer the SPV over other creditor(s).³⁴¹ The phrase "ordinary course of business" is not defined in the Insolvency Act, or in Zimbabwe's case-law.³⁴² The test for whether a disposition is in the ordinary course of business is an objective one. An instructive, and in Zimbabwe's case persuasive, judicial opinion is contained in the South African case of *Malherbe's Trustee v Dinner and Others*,³⁴³ which interpreted a provision of the South African Insolvency Act, which is exactly the same as the Zimbabwean provision, the court stated: "..... whether the disposition is in accordance with ordinary business methods and principles obtaining amongst solvent men of business; that is to say a disposition, in order to be in the ordinary course of business, must be one which would not to the ordinary man of business appear anomalous or un-businesslike or surprising."³⁴⁴ In the U.S. courts have devised an apt three-tier test to establish if a transaction or payment was made by a firm in the ordinary course of its business.³⁴⁵

³⁴¹ Section 42(3) of the Insolvency Act.

³⁴² Insolvency cases such *Madondo* have not enumerated the test to be followed in Zimbabwe, when determining whether an asset disposition is to be regarded as having been carried out in the ordinary course of business. *Madondo (N.O)* (note 340, supra). For a general discussion on the law relating to undue preferences in insolvency case refer to Tett and Chadwick (1981) (note 249, supra) at pp. 154 - 155.

³⁴³ *Malherbe's Trustee v Dinner and Others* 1922 OPD 18.

³⁴⁴ *Ibid.*, at 22. This dictum has been approved and followed since. See also *Hendricks N.O. v Swanepoel v Swanepoel* 1962(4) SA 338 (A) at 345 B-E and *Van Zyl & Others N.N.O. v Turner & Another N.N.O.* 1998 (2) SA 236 (C) at 245.

³⁴⁵ A creditor subject to a preference risk must prove that: (1) the debt paid was incurred in the ordinary course of the business of the debtor and the creditor; (2) the payment or other transfer was made in the

Although the enquiry is fact-sensitive, it is likely that a *bona-fide*, arms length and for fair-value securitization transaction will be regarded by a court as a refinancing measure and not a ruse to prefer one creditor over others. This is more so, if the transaction is consistent with securitization industry practice and the transaction was completed in accordance with ordinary business terms. For this reason, an amendment of section 42 to create a safe harbour for securitization transactions is not recommended.

6.4.4. Section 43 of the Insolvency Act and insolvency risk

Section 43 of the Insolvency Act provides for the setting aside of a disposition of property made by a debtor, at a time when its liabilities exceeded its assets, with the intention of preferring one creditor over others.³⁴⁶ Section 43 may adversely affect non true-sale or re-characterized securitization transactions. Practically, a liquidator or aggrieved creditor would have to prove on a balance of probabilities that the impugned securitization transaction was consummated with the intention of preferring one creditor over another, as opposed to being a refinancing or risk management measure. An illustrative and persuasive test pertaining to what constitutes an intention to prefer one creditor over others can be found in South African jurisprudence. It has been held that a court should establish what, on a balance of probabilities, was the “dominant, operative or effectual intention in substance and in truth of the debtor for making the disposition.”³⁴⁷

ordinary course of business of the debtor and creditor; and (3) the payment or the transfer was made according to ordinary business terms.

³⁴⁶ Section 43(2) of the Insolvency Act states: “Every disposition of his property made by a debtor at a time when his liabilities exceeded his assets with the intention of preferring one creditor above another may be set aside by a court if the estate of the debtor is thereafter sequestrated.”

³⁴⁷ Cooper and Another v merchant Trade Finance Ltd [1999] ZASCA 97, at paragraph 4-16; See also Pretorius’ Trustee v Van Blommenstein, 1949 (1) SA 267 (O) at 279; Swanepoel, N.O. v National Bank of South Africa 1923 OPD 35 at 39; Pretorius N.O. v Stock Owners Co-Operative Co. Ltd 1959(4) SA 462 (A), at 476 - 477; Giddy, Giddy & White’s Estate v Du Plessis 1938 EDL 73 at 79;

This study does not recommend the amendment of section 43 of the Insolvency Act to create a safe harbour for securitization transactions. This provision will affect transactions effected by firms at a time when they are already in financial distress. It is arguable that for public policy reasons, insolvent firms should not securitize, since to do so, may result in insolvency law-avoidance. This notwithstanding, where from the facts, it is apparent that creditor preference was not the cause of an asset transfer, but rather refinancing or risk management, the impugned asset transfer and consequently the securitization transaction should be section 43-immune.

6.4.5. Section 44 of the Insolvency Act and insolvency risk

Section 44 provides for the setting aside of a disposition of property made by a debtor - before winding-up proceedings - in collusion with another person which had the effect of prejudicing his creditors or of preferring one creditor over others.³⁴⁸ Obviously, this section does not affect true-sale securitization transactions. It can, however, affect non true-sale or re-characterized securitization transactions. Collusion is an act of intention. This means a liquidator or aggrieved creditor would have to prove on a balance of probability that an originating firm, arranger, or SPV intended to collude. Collusion may be inferred, *inter alia*, if the securitized assets were not transferred at arms length or for fair value, or if the court concludes from all the facts that it was not the intention of the parties to engage in a *bona fide* securitization transaction, or that the SPV is nothing more than the *alter ego* of the originating firm. This section is therefore unlikely to adversely affect *bona fide* securitization

Eliasov N.O. v Arenel (Pvt) Ltd 1979 (3) SA 415 (R) at 418 G-H; (vii) Venter v Volkskas Ltd 1973(3) SA 175(T); Van Zyl & Others N.N.O. v Turner & Another NNO 1998 (2) SA 236 (C) at 244 paragraph 30.

³⁴⁸ Section 44 of the Insolvency Act states: “Every transaction entered into by a debtor before the sequestration of his estate in collusion with another person for the disposal of any property belonging to the debtor which had the effect of prejudicing his creditors or of preferring one creditor above another may be set aside by a court if the estate of the debtor is thereafter sequestrated.”

transactions, and that its impact will depend largely on the structuring measures utilised.

The above notwithstanding, the effects of section 44 are ameliorated by section 46.³⁴⁹ An SPV has a defence against any section 44 claims for as long as it acted in good faith, obtained transfer of the assets for value and would suffer loss if the asset transfer was set aside. As a condition precedent to setting aside an asset transfer under section 46, a liquidator is obliged to compensate the SPV first for any loss that it may incur. An SPV would obviously suffer loss if the financial assets backing the securities issuance were consolidated into the originating firm's estate. Without the liquidator providing the SPV with compensation, the asset transfer will not be disturbed. Based on the forgoing, an amendment of section 44 to create a safe harbour for securitization transactions is not recommended.

6.4.6. Section 47 of the Insolvency Act and insolvency risk

Section 47 voids the alienation by a company of any of its assets made otherwise than in the ordinary course of its business, unless the company gives at least eight weeks notice of the intended alienation in three consecutive issues of the Gazette and once a week for three consecutive weeks in a newspaper circulating in the district in which the business is carried on.³⁵⁰ If an originating firm is placed in liquidation, its

³⁴⁹ Ibid., at section 46 states: "A person who, in return for any disposition which is liable to be set aside in terms of section forty, forty-two, forty-three or forty-four, has parted with any property or security which he held or who has lost any right against another person shall, if he acted in good faith, not be obliged to restore any property or other benefit received under such disposition unless the trustee has indemnified him for parting with such property or security or for losing such right. (2) Sections forty, forty-two, forty-three and forty-four shall not affect the rights of any person who acquired property in good faith and for value from any person other than a person whose estate was subsequently sequestrated."

³⁵⁰ Ibid, at section 47 states: "(1) Every alienation by a trader...of any goods or property forming part of that business, otherwise than in the ordinary course of that business, shall, unless the trader has, not more than eight weeks before the alienation, given notice of the intended alienation in three consecutive issues of the Gazette and once a week for three consecutive weeks in a newspaper circulating in the district in which the business is carried on— (a) be void as against his creditors for

creditors can use section 47 of the Insolvency Act to petition a court for a declaration that the asset transfer made by the originating firm to an SPV pursuant to a securitization transaction is void and that the transferred assets should be consolidated into the originating firm's insolvency estate. The asset transfer will not be voided, if it was consummated in the ordinary course of business. As argued above, this study argues that a *bona-fide*, arms length and fair-value securitization transaction will most likely be regarded by a court as alienation of property in the ordinary course of business and not a ploy to defeat bankruptcy law. Put differently, it can be safely argued that assets transferred to an SPV pursuant to a securitization transaction will not be adversely affected by section 47.

In summary, as a general principle, true-sale securitization transactions will not be affected by sections 42, 43, 44 and 47 of the Insolvency Act. However, these sections as well as sections 213(c) and 269(3) of the Companies Act can in certain circumstances adversely affect asset transfers and especially in relation to non true-sale or re-characterised securitization transactions. This study does not recommend the amendment of these provisions, as *bona fide*, arms length and fair-value securitization transactions are arguably largely immune from their effect. In addition, there is no reason in principle why a non-true-sale securitization transaction should be accorded better protection than other secured loan arrangements. To do so would arguably result in securitization being used as an insolvency law-avoiding mechanism. In addition, it is not necessary to protect poorly constructed securitization transactions that are subsequently re-characterised by a court. The setting aside of securitization asset transfers in accordance with sections 42, 43, 44 and 47 of the Insolvency Act and sections 213(c) and 269(3) of the Companies Act will not undermine well-

the period of six months immediately following the alienation; and (b) be void as against the trustee if his estate is sequestrated within the period of six months immediately following the alienation..."

structured securitization transactions. These sections prevent financially distressed companies from attempting to defeat insolvency policy by engaging in pre-petition/per-insolvency arrangements that prejudice or prefer some creditors. Amendments to sections 42, 43, 44 and 47 of the Insolvency Act and sections 231(c) and 269(3) of the Companies Act will undermine rather than advance bankruptcy policy. This study concludes therefore that Zimbabwe's insolvency laws do not create undue insolvency risks for securitization transactions.

6.5. SPV substantive consolidation risk

The legal recognition of separate juristic entities, especially in insolvency, is a critical aspect of structured finance transactions. As aforementioned, in a basic securitization model, an originating firm will utilise a separate entity (SPV) to refinance through the cession to the SPV of a pool of financial assets in return for cash. The SPV will fund the asset acquisition through the issuance of capital market securities. The SPV can be a subsidiary of the originating firm, or an unrelated third party entity. It may be a trust, corporate or a hybrid structure. It is conceivable that a liquidator or creditor of an originating firm may seek to have juristic entities that were created by, or are affiliated with, the originating firm, especially those where it holds a controlling shareholding, consolidated into the originating firm's insolvency estate. If such an order is granted, the court would disregard the separate legal existence of an SPV and consolidate it into the originating firm's insolvency estate. Essentially, the SPV and originating firm will be treated as one and their assets commingled. The risk that an SPV's separate legal status will be disregarded, and its assets commingled with those of the originating firm is referred to in (U.S.) structured finance parlance as substantive consolidation risk. Where substantive consolidation is ordered, as opposed

to an administrative consolidation, the SPV will – for practical purposes - also be placed into bankruptcy.

6.5.1. Substantive consolidation: Definition

The doctrine of substantive consolidation only arises in the context of insolvency proceedings. Although uniquely a U.S. concept, the origins of this doctrine can be traced to the English common law equity doctrine known as the piercing of the corporate veil. However, substantive consolidation is different from corporate veil piercing in that it takes into consideration factors that arise in bankruptcy proceedings. It is an equitable doctrine which has been defined as the “effective merger of two or more legally distinct (albeit affiliated) entities into a single debtor with a common pool of assets and a common body of liabilities.”³⁵¹ The entities in question can be a parent company and one or more subsidiaries of the parent company. On the other hand, piercing the corporate veil involves making the shareholder(s) liable for the liabilities of an entity, i.e. the corporate veil is pierced and liability is ascribed to a shareholder or director.

6.5.2. Substantive consolidation doctrine: As applied in the U.S.

In the U.S. there continues to be much debate on the test to use, the factors and principles to be taken into account, and the weight to be accorded to such factors and principles, when determining whether to substantively consolidate two or more related

³⁵¹ Mary E. Kors (1998) ‘Altered Egos, Deciphering Substantive Consolidation’, *59 U. PITT. L. REV.* 381, 381 (1998). See also *Eastgroup Properties v Southern Motel Association.*, 935 F. 2d 245, 248 (11th Cir. 1991). The doctrine is an equitable one to the extent that it is judicially created, and it is aimed at addressing some material impropriety arising from the use of corporate structures. See also generally Steven L. Schwarcz (2003) ‘Collapsing Corporate Structures: Resolving the Tension Between Form and Substance’, *Duke Law School, Public Law Research Paper No. 41*. Available at <http://ssrn.com/abstract=436642>

juristic entities.³⁵² Since the 1980s, U.S. state courts followed either of two lines of cases; the *in re Augie/Restivo Baking Co., Ltd* case³⁵³ or the *in re Auto-Train Corp* case,³⁵⁴ when considering substantive consolidation applications.³⁵⁵ This led to inconsistent judicial pronouncements. However, U.S. courts appear – at least for now – to have settled on a substantive consolidation analysis contained in the *In re Owens Corning* case.³⁵⁶ The court in *in re Owens Corning* case stated that an applicant seeking an order for the substantive consolidation of one entity into another must establish, *prima facie*, either that, (a) pre-petition, the entities “disregarded separateness so significantly that creditors relied on the breakdown of entity borders and treated them as one legal entity;”³⁵⁷ or (b) “post-petition, the debtors’ assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.”³⁵⁸ The decision also listed a set of principles constraining courts’ discretion in substantive consolidation cases. It stated: (i) absent compelling circumstances, courts must respect the separate *legal persona* of different juristic entities; (ii) the harm substantive consolidation addresses is nearly always that caused by debtors who disregard separateness; (iii) mere benefit to the administration of the case does not justify substantive consolidation; (iv) substantive consolidation is “extreme” and imprecise, and should be used rarely and as a remedy of last resort after considering and rejecting other remedies; and (v) substantive consolidation may not be used offensively, i.e.,

³⁵² For an analysis of the substantive consolidation doctrine, see: William H. Widden (2007) ‘Corporate Form and Substantive Consolidation’, *The George Washington Law Review*, vol. 75, No. 2. 237 (2007)

³⁵³ Union Sav. Bank v Augie/Restivo Baking Co. Ltd (*In re Augie/Restivo Baking Co., Ltd* 860 F.2d 515 (2d Cir. 1988).

³⁵⁴ Drabkin v Midland-Ross Corp. (*In re Auto-Train Corp.*, 810 F. 2d 270, 276 (D.C. Cir 1987).

³⁵⁵ In *In re Augie/Restivo Baking Co.*, the court held that: substantive consolidation may be granted to a petitioner where (1) the creditors dealt with the entities as a single economic unit and did not rely upon their separate identity in extending credit; and (2) the affairs of the debtor are so entangled with those of the affiliated entity that consolidation will benefit all creditors. In *In re Auto-Train*, the court developed a slightly different approach and stated that: (1) there must be substantial identity between the entities to be consolidated; and (2) consolidation must be necessary to avoid some harm or to realize some benefit.

³⁵⁶ *In re Owens Corning* 419 F. 3d 195 (3d Cir. 2005).

³⁵⁷ *Ibid.*, at p. 211

³⁵⁸ *Ibid.*

having a primary purpose of disadvantaging tactically a group of creditors in the plan process or altering creditors' rights.³⁵⁹

6.5.3. Substantive consolidation doctrine: Application in Zimbabwe

Does the High Court of Zimbabwe have jurisdiction to order that an SPV incorporated under the Companies Act be substantively consolidated with another company (originator) subject to winding-up proceedings? This is a moot question. Part V of the Companies Act which provides, *inter alia*, for the winding up of companies does not give the High Court statutory authority to substantively consolidate two legally separate but related entities. In the U.S., courts claim to derive their equity jurisdiction to order substantive consolidation of entities from section 105(a) of the Bankruptcy Code. The section states, a bankruptcy court “may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title;” i.e. the bankruptcy code. Zimbabwe does not have a similar provision in its Companies Act or the Insolvency Act; the two enactments which deal with winding-up of corporate entities. The High Court would not be able to exercise jurisdiction on the basis of section 13 of the High Court Act, which states that the High Court is a court of inherent jurisdiction. This section gives the High Court power to control proceedings only and not the power to create law. Where a particular issue is determined by a statute, the High Court is obliged to base its decisions on the basis of the statutory enactment in question. This study concludes that Zimbabwe’s High Court does not have the enabling authority and power to substantively consolidate separate juristic entities as do U.S. courts.

³⁵⁹ Ibid.

Arguably, this conclusion is subject to at least two, albeit theoretical caveats: First; the High Court can order a securitization SPV to be substantively consolidated with an originating firm, if the originating firm holds a majority shareholding in a corporate SPV, and if it passes a special resolution authorising the winding-up of the SPV in question.³⁶⁰ In other words, a subsidiary-entity SPV can be substantively consolidated with an originating firm, if the latter catalyses winding-up proceedings against the SPV entity. As illustrated by the U.S. case of LTV Steel Co., an originating firm may attempt to get legal possession of assets that it had previously transferred to an SPV pursuant to a true-sale securitization transaction. The likelihood of this occurring in Zimbabwe is small. This risk can be structured out through restricting the discretion of boards of SPVs to initiate insolvency proceedings. In addition; the utility of such an application is dubious, especially as regards true-sale securitization transactions, which by their nature result in the termination of the originating firm's rights, title and interests in the transferred assets. An originating firm would resort to this application, if it knew it would be able to establish some impropriety with the initial asset transfer, which would vitiate its legality, leading to the conflation of both entities' assets. Further, assuming a non true-sale transaction; an application for the winding-up of a securitization SPV would be unnecessary as the originating firm's claims with regards assets ceded in *securitatem debiti* fall into its insolvency estate anyway, and liable to be distributed, per the normal rules, by a liquidator.

Secondly; it is conceivable that an originating firm subject to winding-up proceedings, with an equity holding in a securitization SPV may request the High court to order the winding-up of the SPV on the basis that it is "just and equitable"

³⁶⁰ Section 242(b) of the Companies Act.

that it be wound-up.³⁶¹ This application would not be granted in the absence of some just and equitable reason, more probably an impropriety, which ought not to exist in *bona fide* securitization transactions. Even if successful, this application would not necessarily result in the consolidation of the two entities' assets. The originating firm would have to make a further application for the setting aside of the asset transfer. This would conclude the substantive consolidation procedure. Such an application can only succeed if there exists a cause of action, such as fraud. Again, this is highly unlikely in a *bona fide* true-sale securitization transaction. Additionally, as noted above, such an application is unnecessary in the case of a non true-sale securitization transaction.

Originating firms' ability to petition the High court for the winding up of securitization SPVs can be curtailed through the use of third-party securitization SPV structures, i.e. entities in which originating firms do not have a shareholding. If the originating firm has a controlling stake in an SPV, its ability to place the SPV into liquidation can be neutered through the SPV's articles and memorandum of association. For instance, the structure may include a requirement, and the RBZ securitization guidelines do actually require, that independent director(s) sit on the board and that their written consent is required before the SPV can be wound-up. If this condition is breached, the directors can institute a court application to interdict the board from winding-up the SPV. If the independent directors are improperly influenced to agree to the winding up of the SPV, investors in securities issued by the entity may rely upon the directors' fiduciary duties and sue them for damages. In addition, as it customary, the SPV can be expressly prohibited through its memorandum of association from filing for voluntary winding-up.

³⁶¹ *Ibid.*, at section 206(g).

Does the High court have jurisdiction to order a securitization SPV to be consolidated with an originating firm subject to winding-up proceedings at the instance of the originating firm's creditors? Creditors who are unable to satisfy their claims from an originating firm's insolvency estate may attempt to levy their claims against the assets of SPV entities affiliated or associated with the originating firm. In theory, they can do so by seeking to consolidate the SPV with the originating firm. If successful, the impact of their claim would lead to the securitization SPV being placed into bankruptcy as well. This theoretical consideration notwithstanding, in Zimbabwe, creditors of an originating firm do not have *locus standi* under the Companies Act to apply for the winding-up of a separate-entity SPV with whom they do not have a relationship. The categories of applicants that can apply for the winding up of a firm incorporated under the Companies Act include the company – through its management, its creditors, and contributories.³⁶² It is noteworthy that a securitization SPV is typically structured not to have creditors; and the originating firm's creditors would not – as a general rule - be considered to be creditors of a separate entity securitization SPV.

In summary, this study argues that in Zimbabwe, substantive consolidation risk is largely theoretical. It is debatable if it exists as a remedy. What is obvious is that creditors of an originating firm do not have *locus standi* to apply for the substantive consolidation of a subsidiary (SPV) of an originating firm in insolvency on the basis that the originating firm owes them money. The creditors would not have a claim against the SPV, not in contract and not in tort.

³⁶² *Ibid.*, at section 207.

6.6. Veil-piercing risk

In Roman-Dutch law, as it is under the English common law, the disregarding by a court of the separate existence of a registered corporate entity and the treatment of its rights, liabilities or activities as those of its shareholders or directors is referred to as piercing the corporate veil.³⁶³ A corporate veil can be pierced, either by virtue of a statutory provision or common law principles of equity. The Companies Act permits the High Court to disregard the corporate veil in certain circumstances, but these are not analysed here as they do not impinge on securitization transactions.³⁶⁴ What is discussed below is the common law equitable principle of piercing the corporate veil.

6.6.1. Veil-piercing doctrine: As applied in Zimbabwe

In Zimbabwe the starting off point in the discussion about piercing the corporate veil is the English *locus classicus* of *Salomon v Salomon*.³⁶⁵ The *Salomon* case laid the principle that a company, after incorporation becomes a separate legal entity, distinct from its members, and is neither an agent nor a trustee of its members.³⁶⁶ Incorporation imbues a company with limited liability; meaning that members are not liable for its obligations or liabilities. The *Solomon v Salomon* principle is now statutorily enshrined in section 9 of the Companies Act. It is also a trite principle that an incorporated company's separate legal personality is not inviolable or absolute. The veil of incorporation can be pierced – in the case of Zimbabwe – by the High Court exercising equitable powers under the common law. The act of piercing can

³⁶³ For a discussion on piercing the corporate veil, and a list of when, drawing on statutory authority and its equitable jurisdiction, a court will do so, refer to Nkala and Nyapadi (1995) (note 244, supra) at pp. 91-112.

³⁶⁴ For example, sections 32 and section 318 of the Companies Act.

³⁶⁵ *Salomon v Salomon* [1897] AC 22.

³⁶⁶ The *Salomon v Salomon* principle was affirmed as part of Roman Dutch law by the case of *Dadoo Ltd and Others v Krugersdorp Municipal Council* 1920 AD 530 at 550., where it was held: “a registered company is a legal persona distinct from the members who compose it.” See also *Sibanda v JFL (Private) Limited and Sibanda* SC-117-2004, at p. 8.

result in the rights, liabilities or activities of a company being treated as those of its shareholders or its management.³⁶⁷

In common with the position in English common law jurisdictions, Zimbabwe's law on the piercing of the corporate veil is not settled. Unsurprisingly, it has proved difficult to establish a consistent set of principles underlying why and when an entity's corporate veil should be pierced. Zimbabwean case-law and (sparse) jurisprudence on the subject reveals that the corporate veil will be pierced where fraud has been established, to prevent some manifest injustice,³⁶⁸ or where the company in question is merely the *alter ego* of a shareholder.³⁶⁹ Zimbabwe's *stare decisis* does not, however, lay down well-defined criteria to be taken into account when determining whether an entity's corporate veil should be pierced. Judicial opinion tends to repeat, without much analysis, old English law cases in which the corporate veil was pierced and liability ascribed to an entity's shareholders.³⁷⁰ In the case of *Mkombachoto v Commercial Bank of Zimbabwe Limited* the court held: "It does not appear that the law is settled as to the circumstances in which the court can or should "lift" or "pierce the veil" of corporate personality."³⁷¹ Regrettably, despite making this erstwhile observation, the court did not refer, as is customary in the absence of binding or consistent authority, to persuasive comparative jurisprudence, or attempt to draw key factors that ought to be considered in such cases. The court did not address the doctrine in any systematic manner, or refer to developments in England, South

³⁶⁷ *Atlas Maritime Co SA v Avalon Maritime Ltd (No 1)* [1991] 4 All ER 769, at p. 779.

³⁶⁸ *Mkombachoto v Commercial Bank of Zimbabwe Limited and Registrar of Deeds* HH-10-2002 in which the Judge held: "In my view, the court has no general discretion to disregard the company's separate legal personality whenever it considers it just to do so. The court may "lift the veil" only where otherwise as a result only of its existence fraud would exist or manifest justice would be denied"

³⁶⁹ *R.P. Crees (Pvt) Ltd v Woodpecker Industries (Pvt) Ltd* 1975 RLR 151.

³⁷⁰ An example is the cases of *Sibanda v Sibanda* SC-117-2004 in which the Court cites an old English law case of *Wallersteriner v Moir* (1974) 3 All ER 217 and the case of *Gering v Gering and Another* 1974 (3) SA 358 (W), yet there is in existence much more recent case-law upon which the Supreme Court could have relied.

³⁷¹ *Mkombachoto* (note 368, *supra*).

Africa and other common law countries where courts have equitable power to pierce the corporate veil, albeit in a manner criticised by Professor Farrar as “incoherent and unprincipled.”³⁷²

The judiciary in Zimbabwe should clarify the ambit and application of the doctrine. This is not to suggest that courts should establish rigid definitive criteria of the instances when courts will or should pierce the corporate veil, as was tried in two South African cases of *Lategan v Boyes*³⁷³ and *Botha v van Niekerk*,³⁷⁴ only to be overruled in *Cape Pacific v Lubner Controlling Investments (Pty) Ltd.*³⁷⁵ Instead, this study proposes that courts should clarify, broadly, the instances when, subject to the facts of each case, the corporate veil of a company may be disregarded. This will greatly assist practitioners, including of securitization transactions, to calculate the risk of the corporate veil of an incorporated entity being pierced.

6.6.2. To lift, to peer or to pierce?

Courts and commentators in Zimbabwe, as in South Africa and elsewhere, have over the years interchangeably and confusingly used the verbs: lift, peer, and pierce to refer to a situation where a court disregards the separate existence of a company with the result that the rights, liabilities or activities of a company are treated as those of its shareholders or its management. Zimbabwean courts are yet to, and should, distinguish these three verbs in veil-piercing cases; as happened in England and South

³⁷² J. Farrar (1990) 'Fraud, Fairness and Piercing the Corporate Veil', *16 Canadian Business Law Journal* 474, 1990, at p. 478.

³⁷³ *Lategan and Another v Boyes and Another* 1980 (4) SA 191 (T). In *Lategan*, Fleming J held the corporate veil of a company should not be pierced in the absence of fraud. Needless to say, this was too restrictive a formulation of the circumstances when a court should pierce the corporate veil of a company.

³⁷⁴ *Botha v van Niekerk* 1983 (3) SA 513 (W). In *Botha*, the court referred to Fleming J's formulation in *Lategan*, criticised it for being too narrow, and instead held that the corporate veil should be disregarded if it was proved that unconscionable injustice had been caused. *Botha v van Niekerk* 1983 (3) SA 513 (W), at 525F.

³⁷⁵ *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and two Others* 1995 (4) SA 790 (A).

Africa.³⁷⁶ Staughton LJ in the case of *Atlas Maritime Co SA v Avalon Maritime Ltd* (No 1)³⁷⁷ aptly captures this issue and notes: “To pierce the corporate veil is an expression that I would reserve for treating the rights and liabilities or activities of a company as the rights or liabilities or activities of its shareholders. To lift the corporate veil or look behind it, therefore should mean to have regard to the shareholding in a company for some legal purpose.” This study recommends Staughton LJ’s formulation and uses same in the analysis below.

6.6.3. Veil-piercing of an SPV by an originating firm’s creditors

Can an originating firm’s creditors, who being unable to satisfy their claims against the firm’s assets, obtain a court order piercing the corporate veil of an SPV used by the originating firm in a securitization transaction with the result that they are able to levy their claims against the SPV’s assets? In theory this risk exists. Creditors of an originating firm can apply to court for an order piercing a related securitization-SPV’s corporate veil. The risk is two-fold. If a court were to grant an order to pierce the corporate veil of a securitization SPV, thereby placing it in bankruptcy proceedings; this would be a risk on its own, irrespective of whether the originating firm’s creditors in reality are able to levy their claims against the SPV’s assets. The second risk is actually the levying of claims against the SPV’s assets as concurrent creditors, which is unlikely assuming a true-sale transaction involving *bona fide* asset transfers. To date there has been no case in Zimbabwe where creditors of an originating firm have sought to pierce the corporate veil of an affiliated structured finance SPV.

³⁷⁶ Ibid.

³⁷⁷ *Atlas Maritime Co SA* (note 367, supra), at p. 779.

As noted above, Roman-Dutch case-law provides that a company's corporate veil will be pierced where fraud has been established, to prevent some manifest injustice, where the company in question is the *alter ego* of a shareholder.³⁷⁸ Notably however, the general rule under Roman-Dutch law is that courts will not lightly disregard a company's legal personality.³⁷⁹ Indeed, an applicant seeking the piercing of the corporate veil of a company has to establish "an element of fraud or other improper conduct in the establishment or use of the company or the conduct of its affairs."³⁸⁰ Whether a court will order a securitization-SPV's corporate veil to be pierced will in practice depend on the facts of each case, and in particular, the characteristics of the impugned transaction, the factual contentions made by the litigants, and whether the court is persuaded that the transaction in question was not a *bona fide* commercial transaction.

6.6.3.1. Fraud

The transfer of assets to an SPV by an originating firm, pursuant to a securitization transaction, which is tainted by fraud, runs the risk of being impeached at the instance of the originating firm's creditors or its liquidator. Where fraud is established, an asset transfer can be set aside by a court using common law equity principles. A *bona fide*, arms length, for fair value securitization transaction should not be exposed to the risk of having its assets consolidated with those of the originating firm on this basis.

³⁷⁸ R.P. Crees (Pvt) Ltd v Woodpecker Industries (Pvt) Ltd 1975 RLR 151.

³⁷⁹ Cape Pacific Ltd (note 375, supra).

³⁸⁰ The Shipping Corporation of India Ltd v Evdomon Corporation and Another 1994 (1) SA 550 (A) at 566C-F.

6.6.3.2. Alter ego and manifest injustice

The corporate veil of a company can be pierced to prevent some manifest injustice, if it is established that such an entity is nothing more than the *alter ego* of a shareholder or director.³⁸¹ Creditors of an insolvent originating firm may in theory levy their claims against financial assets transferred to an SPV pursuant to a securitization transaction by contending that the SPV is nothing more than the *alter ego* of the originating firm, and that some manifest injustice would be occasioned if its corporate veil is not pierced. The leading case for this proposition is the case of *Cattle Breeders Farm (Pvt) Ltd v Veldman*.³⁸² In the case, Mr. Veldman was the sole shareholder and director of Cattle Breeders (Pvt) Ltd. The company owned the farm on which Mr Veldman lived with his family. After Mr and Mrs. Veldman's marriage broke down, Cattle Breeders (Pvt) Ltd instituted eviction proceedings against Mrs. Veldman. The High court refused to grant the order for eviction against Mrs. Veldman. It held that: (i) the company was no more than the *alter ego* of Mr. Veldman; and (ii) Mr. Veldman intended to evict his wife from the farmhouse, which was for all accounts their marital home, without providing her with alternative accommodation, as he was required to do under Zimbabwe's laws. The *ratio decidendi* in this case has since been reaffirmed in numerous other matrimonial cases.³⁸³

Despite this jurisprudence, which emanates from matrimonial cases, this study argues that the risk of the corporate veil of an SPV being pierced by a court at the instance of an originating firm's creditors is slight and can be eliminated through appropriate securitization transaction structuring arrangements. The risk that an SPV's

³⁸¹ *Cattle Breeders Farm (Pvt) Ltd v Veldman* 1974 (2) RLR 89; 1974 (1) S.A. 169.

³⁸² *Ibid.*

³⁸³ *Sibanda v Sibanda* SC-117-2004, a divorce case in which an entity's corporate veil was pierced by the Court in order to determine the amount of matrimonial property for purposes of the divorce proceedings. See also *Mangwendeza v Mangwendeza* HB-45-2007.

integrity will be imperilled by creditors of the originating firm on the basis that it is the latter's *alter ego* will in theory exist if: (i) the SPV in question was established by the originating firm; (ii) the SPV is for all practical purposes operated/administered or controlled by, and is not independent of, the originating firm; or (iii) if the management of the affairs of the originating firm and the SPV are not adequately separate or distinct. Arguably therefore, a properly structured securitization transaction in which the SPV is not controlled or managed by the originating firm should be insulated from claims made by the originating firm's creditors.

In addition to the *alter ego* element, creditors of an originating firm would have to establish - on the facts - some manifest injustice. What is manifest injustice? It would appear, although this is by no means settled, that courts in Zimbabwe will not pierce the corporate veil of a company merely because it considers that it is in the "interests of justice to do so."³⁸⁴ Although not cited by the High Court in any of their decisions on piercing the corporate veil, this proposition is similar to that enunciated in the South African case of *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others*,³⁸⁵ and the English case of *Adams v Cape Industries*.³⁸⁶ The facts of the case of *Mukombachoto v Commercial Bank of Zimbabwe Ltd* are particularly instructive. The applicant owned money to the respondent (bank) by way of an overdraft facility, secured by a mortgage bond over her immovable property. In addition, she had guaranteed, in her personal capacity, two loans issued to two companies in which she was both a director and a shareholder. The mortgage bond over her immovable property did not cover the two loans issued to the companies. The

³⁸⁴ In *Mkombachoto Ndou J*, held: "In my view, the court has no general discretion to disregard the company's separate legal personality whenever it considers it just to do so. The court may "lift the veil" only where otherwise as a result only of its existence fraud would exist or manifest justice would be denied." [Emphasis added]. *Mkombachoto* (note 368, supra), at p. 7.

³⁸⁵ *Cape Pacific Ltd* (note 375, supra).

³⁸⁶ *Adams v Cape Industries Plc* [1990] Ch 433.

applicant paid off her overdraft and sought cancellation of the mortgage bond over her immovable property. The respondent refused, arguing that the applicant still owed it money and that, *inter alia*, the corporate veil of the two companies must be pierced so that liability for the companies' debts should be ascribed to the applicant in her personal capacity; which debts would then be set off against the mortgage bond. On the facts, the court concluded that the transactions were not fraudulent. The court went on to hold: "...the only other issue I have to determine is whether manifest injustice would be denied if I do not 'lift the veil'. As indicated...the problems of the first respondent seem to be self-inflicted. The first respondent should have sought security for the indebtedness that the two companies were about to incur. First respondent, in its wisdom, chose not to do so. The first respondent can still sue and recover from the applicant and other guarantors for the companies' indebtedness. I do not think that manifest justice would be denied in such circumstances. I, therefore, cannot disregard the separate legal personalities of the two companies under consideration." Taking the case of *Mkombachoto* as precedent, it is arguable that the failure by creditors of an originating firm to satisfy their claims against its assets is unlikely to be considered by the courts as constituting manifest injustice justifying the piercing of a related SPV's corporate veil.

In practice, the interests of an originating firm's creditors will be counterbalanced by the interests of investors in securities issued by the SPV, which are backed by the securitized financial receivables. This point is well made in the leading South African case of *Cape Pacific Ltd v Lubner Controlling Investments (Pty) Ltd and Others* in which it is stated that where fraud, dishonesty or other improper conduct is established, a court should balance on the one hand the "need to preserve the separate

corporate identity”³⁸⁷ of the firm “against policy considerations which arise in favour of piercing the corporate veil.”³⁸⁸

In summary, courts in Zimbabwe can in theory pierce the corporate veil of an entity, including a corporate securitization SPV, if established that it is the *alter ego* of the originating firm, and that manifest injustice will be occasioned if its corporate veil is not pierced. The risk of this happening with regards securitization SPVs is small given that true-sale securitization transactions transfer ownership rights from an originating firm to an SPV. There is no need to apply for the piercing of the corporate veil where non true-sale securitization transactions are involved. In the absence of some asset transfer-busting malfeasance, an application to pierce the corporate veil will therefore not serve any useful purpose for creditors, although it can seriously affect a securitization transaction.

6.6.3.3. Agency

Can creditors of an originating firm, which securitized some of its financial receivables, obtain a court order piercing the corporate veil of a subsidiary-entity SPV on the basis that the latter is an agent of the originating firm? If granted, such an order would permit creditors to levy their claims against the SPV’s assets. The theory that a company’s corporate veil can be pierced if it is an agent of another emanates from the English case of *Smith, Stone & Knight Ltd Co. v Birmingham Corporation*;³⁸⁹ in which the court held that a subsidiary company was an agent of the parent company. This case no longer represents the law in England, having been superseded, as appears

³⁸⁷ *Cape Pacific Ltd* (note 375, supra), at p. 31-32.

³⁸⁸ *Ibid.*

³⁸⁹ *Smith, Stone & Knight Ltd co. v Birmingham Corporation* [1939] 4 All ER 116. The principle established in this case was followed in other cases, including *In re F.G. (Films) Ltd* [1952] 1 WLR 483.

below, by cases such as *Adams v Cape Industries*³⁹⁰ and *In re Polly Peck*.³⁹¹ These cases declared that an agency relationship is not to be inferred simply because of the existence of a group of companies. There is no case-law precedent on this point in Zimbabwe.

The case which is especially relevant to structured finance transactions is the case of *In re Polly Peck*. Creditors of Polly Peck, a company in liquidation made an application for the piercing of a corporate veil of a bond issuing off-shore subsidiary-entity SPV on the basis, among others, that it was an agent or nominee of the parent company in liquidation. It was contended that the factors that were indicative of the agency relationship were that the SPV had been incorporated solely to issue bonds, had no separate and independent management and it had a very small paid-up share capital. Such features are typical of securitization SPVs. *In re Polly Peck*, the court refused to accept this argument and held: "...neither agency nor nominee-ship – nor still less, sham or something akin to sham – is to be inferred simply because a subsidiary company has a small paid-up capital and has a board of directors all of whom or most of whom are also directors or senior executives of its holding company."³⁹² If the contention had been accepted the SPV's assets would have been consolidated with those of the parent company. On this point, the *ratio decidendi* in *Polly Peck* will be considered as persuasive authority on the subject of piercing the corporate veil on account of an agency relationship between an originating firm and a securitization SPV.

Although not yet decided in Zimbabwe, it is arguable that drawing on both South African and English law jurisprudence on the subject, the corporate veil of an SPV may be lifted if proven on the facts that it is the agent of an originating firm and if to

³⁹⁰ *Adams* (note 386, *supra*).

³⁹¹ *In re Polly Peck International plc (in administration)* [1996] 2 ALL ER 433.

³⁹² *Ibid.*, at p. 445.

do so will avoid some grave impropriety. It is notable however that agency is a matter of fact, has to exist in reality, and is not to be inferred from the mere fact that the entities in question are part of the same groups of companies. In conclusion, following the decision *in re* Polly Peck case, it is arguable that in Zimbabwe, the likelihood of creditors of an originating firm piercing the corporate veil of a subsidiary SPV on the basis of agency is small. And in any event, the risk can be structured out of securitization transactions by ensuring that the originating firm and SPV are unrelated entities.

6.6.3.4. Single economic entity

Can creditors of a firm, which securitized some of its financial assets, obtain a court order piercing the corporate veil of a subsidiary-entity SPV on the basis that the two constitute a single economic entity? Such an order would result in creditors, in theory, being able to levy their claims against a securitization SPV's assets. There is no case-law precedent in Zimbabwe on this point. Following South African and English precedent on the issue, this study argues that the risk of the corporate veil of a securitization SPV being pierced on account of the originating firm holding all or the majority of the SPV's shareholding is small; and only exists, arguably, if it is established from the facts that the subsidiary is a façade or a sham, and has not used in a *bona fide* securitization transaction.

In both South Africa and England, it is fairly settled that the corporate veil of a subsidiary SPV will not be pierced simply because the parent firm (the originating firm) and the SPV are a single economic unit or entity. A recent South African case to rule to this question is the case of Mohammed Abdulmohsin and Others v Pema and

Others.³⁹³ In the case, *Malan J. cited with approval the case of Shipping Corporation of India Ltd v Evdomon Corporation and Another*³⁹⁴ and the dictum contained in LAWSA, which states: "...except where the wording or purpose of a particular statute or contract justifies the treatment of parent and subsidiary as one unit or undertaking, the mere fact that a group of companies constitutes a single economic unit (even where it consists of a holding company and wholly owned subsidiaries) does not in itself justify the treatment of the group as a single company. The position is of course otherwise where a subsidiary is a mere façade or a sham."³⁹⁵

The *ratio decidendi* in the cases of *Woolfson v Strathclyde Regional Council*,³⁹⁶ and *DHN Food Distributors Ltd v Tower Hamlets London Borough Council*, in which the courts permitted the piercing of the corporate veil of an entity on the basis that it constituted a single economic entity with its parent company, no longer reflects the law in England. The law now provides, as noted in Gower's *Principles of Modern Company Law*: "there is no general principle that all companies in a group of companies are to be regarded as one; on the contrary, the fundamental principle is unquestionably that each company in a group of companies...in a separate legal entity possessed of separate rights and liabilities."³⁹⁷ Similar pronouncements and decisions

³⁹³ Mohammed Abdulmohsin Al-Kharafi & Sons for General Trading, General Contracting and Industrial Structures WLL and Another v Pema, Jayant Daji N.O. and Others [2008] ZAGPHC 273

³⁹⁴ In *The Shipping Corporation of India Ltd v Evdomon Corporation and Another* the court held: "It is of cardinal importance to keep distinct the property rights of a company and those of its shareholders, even where the latter is a single entity, and that the only permissible deviation from this rule known to our law occurs in those...rare cases where the circumstances justify 'piercing' or 'lifting' the corporate veil...I do not find it necessary to consider, attempt or define, the circumstances under which the Court will pierce the corporate veil. Suffice it to say that they would generally have to include an element of fraud or other improper conduct in the establishment or use of the company or the conduct of its affairs. In this connection the words 'device', 'strategem', or 'cloak' and 'sham' have been used..." The Shipping Corporation of India Ltd v Evdomon Corporation and Another 1994 (1) SA 550 (A) at 566.

³⁹⁵ Law of South Africa, at paragraph 47.

³⁹⁶ Woolfson v Strathclyde Regional Council 1978 SLT 159.

³⁹⁷ Davies L. Paul (2003) *Gower's Principles of Modern Company Law*, 7th ed., Sweet and Maxwell (2003) at p. 184.

have been made in the cases of *Ord and Another v Belhaven Pubs Ltd*,³⁹⁸ *Adams v. Cape Industries plc*³⁹⁹ and *in re Polly Peck*.⁴⁰⁰

In conclusion, this study argues that the above will be considered as highly persuasive and will be applied in Zimbabwe. It is unlikely, although not inconceivable, that a court will pierce the corporate veil of a securitization SPV in order to permit the originating firm's creditors to levy their claims against an SPV's assets. However, the circumstances under which an SPV's corporate veil can be pierced are severely circumscribed and are unlikely to affect *bona fide*, arms-length, for fair value securitization transactions.

6.6.4. Veil-piercing of a subsidiary-entity SPV by an originating firm

It is not inconceivable that an originating firm in financial distress may seek the return of financial receivables it ceded and transferred to an SPV as part of a securitization transaction. A case that illustrates this risk is the case of *LTV Steel Co, Inc.*⁴⁰¹ In brief: after securitizing its receivables, *LTV Steel Co, Inc.*, got into financial difficulties and applied for Chapter 11 bankruptcy protection. In its application it alleged that the financial asset transfers to its wholly-owned subsidiary SPV (*LTV Sales Finance Company*) were not true-sales, but disguised secured refinancing transactions. The case was settled out of court without a pronouncement by the Court on whether a parent company can obtain an order declaring that, a true-sale securitization transaction notwithstanding, a subsidiary-entity SPV is nothing more

³⁹⁸ *Ord and Another v Belhaven Pubs Ltd* [1998] BCC 607 (CA) at 615E-F.

³⁹⁹ In *Adams* the court held: "Save in cases which turn on the wording of particular statutes or contracts, the court is not free to disregard the principle of *Salomon v A. Salomon & Co Ltd* [1897] AC 22 merely because it considers that justice so requires. Our law, for better or worse, recognises the creation of subsidiary companies, which though in one sense the creatures of their parent companies, will nevertheless under the general law fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities." *Adams* (note 386, supra).

⁴⁰⁰ *In re Polly Peck* (note 391, supra).

⁴⁰¹ *In re LTV Steel Co.* (note 310, supra).

than a refinancing stratagem, whose assets during periods of financial distress can be made available to the originating firm.

What is the likelihood that an originating firm in Zimbabwe will be able to obtain a court order piercing the corporate veil of a subsidiary-entity SPV in order to get its hands on securitized assets? What is obvious is that if an originating firm has a controlling interest in an SPV, and it is an entity incorporated in terms of the Companies Act, the originating firm can – per section 206(a) of the Companies Act - pass or cause to be passed a special resolution for the SPV to be wound up by the High Court.⁴⁰² But this risk can be easily structured out of securitization transaction arrangements. And in any event, the order does not result in the originating firm being able to use as it pleases the assets held by the SPV. Investors in the assets issued by the SPV will also be claimants, if not treated as secured creditors.

What is the risk that the High court will pierce the corporate veil of a subsidiary-entity SPV on the basis of a contention by the originating firm that the securitization SPV in question is a sham, a stratagem, or an instrumentality used in a refinancing transaction? Although not inconceivable, the likelihood of this happening is negligible as regards *bona fide* securitization transactions. In a true-sale securitization transaction, the originating firm's rights of ownership are extinguished on the sale and cession of its financial receivables. This should preclude the originating firm from piercing the corporate veil of the SPV by successfully contending that it retains ownership rights or interests in the assets subject to the securitization transaction. The same is not true however for non true-sale securitization transactions where the originating firm retains ownership rights and may in practice breach the terms of the agreement of cession in *securitatem debiti*. It is conceivable that an originating firm

⁴⁰² Refer to section 206 of the Companies Act, which states: “A company may be wound up by the court – (a) if the company has by special resolution resolved that the company be wound up by the court.”

may argue that the sale of assets to an SPV was simulated. But if it does so, it exposes itself to a claim of securities fraud – under the Securities Act - especially at the instance of investors in the SPV’s securities issuance.⁴⁰³ It is unlikely that a court would order the piercing of the corporate veil of a subsidiary-entity SPV at the instance of the originating firm, without hearing from, or upholding the interests of, investors in the securities issued by the SPV. If a court were to pierce the corporate veil of such a subsidiary-entity SPV, it may in reality facilitate fraud. It is arguably fraudulent for an originating firm to set up a subsidiary-entity SPV, which it effectively controls, and to which it transfers assets for the issuance of securities, only to turn around and seek to pierce the SPV’s corporate veil with the view of clawing back those same assets, without compensating investors in securities issued by the SPV for their loss.

In addition, in practice it is likely that directors of a securitization SPV will oppose an application for the piercing of the corporate veil of the SPV, which if successful would result in the SPV losing the assets securing its securities issuance. If an SPV’s directors fail or refuse to contest a claim made by an originating firm, any losses made by the SPV or investors in securities issued by the SPV may be recovered from the directors in their personal capacity. Directors of corporate entities have fiduciary duties, which include a duty to act *bona fide* and in the interests and benefit of the company.

In conclusion, although in theory there is a risk that an originating firm may make a court application seeking the piercing of its subsidiary SPV’s corporate veil; this risk is typically mitigated through appropriate structuring arrangements. In addition, the nature of a true-sale securitization transaction should in practice preclude an

⁴⁰³ Section 97 of the Securities Act [Chapter 24:25] outlaws the fraudulent inducement of another to trade or deal in securities.

originating firm from seeking to pierce the corporate veil of its subsidiary securitization SPVs.

6.6.5. Veil-piercing of a trust SPV by an originating firm's creditors

The above analysis concentrated on substantive consolidation and piercing of the veil of companies incorporated under the Companies Act. This section addresses a question, not yet decided in Zimbabwe, but one which is relevant to securitization transactions, which is: does the veil-piercing doctrine apply to trust structures? The answer to this question will determine whether a liquidator or creditor of an originating firm subject to liquidation proceedings has a cause of action, which permits it to ask a court to pierce the veil of a trust SPV and thereby levy claims against trust assets. There has been no case in Zimbabwe, South Africa and the U.K. where the doctrine of piercing the veil has been successfully applied to trusts. In Zimbabwe, as argued below, although it is conceivable, it is unlikely that the doctrine will be applied to trust entities. There is a theoretical risk that an originating firm's creditors may seek to levy their claims against assets transferred to a trust SPV by an originating firm through a court order declaring that the trust SPV is a sham, or an instrumentality of the originating firm set up to avoid its liabilities. A similar contention was made, albeit unsuccessfully, by applicants in the case of *Grupo Torras S.A. and Culmer v Al-Sabah and four others*.⁴⁰⁴ The *ratio decidendi* in this case is particularly instructive.

In *Grupo*, the applicants cited several cases to the court which appeared to suggest that the veil of a trust structure could be pierced.⁴⁰⁵ However all of the decisions cited

⁴⁰⁴ *Grupo Torras S.A. and Culmer v Al-Sabah and four others* [2003] JLR 188.

⁴⁰⁵ Refer to the following cases: (1) *In re a Company* [1985] BCLC 333; (2) *TSB Private Bank International S.A. v Chabra* [1992] 1 W.L.R. 231; (3) *International Credit and Investment Company (Overseas) Ltd v Adham* [1998] BCC 134.

were interlocutory Mareva injunction cases and none addressed the question whether the doctrine of piercing the veil applied to trusts. It is arguably an oxymoron to refer to the veil of a trust. As argued in *Grupo*, trusts do not have a veil, being very different in legal construction compared to corporate entities. Incorporated entities have a legal *persona*; trusts do not. Whereas incorporated entities have shareholders who can lawfully exercise control or power over the management of the company, the settlor of a trust has no such power, outside the terms of the trust deed; and the trustees hold and manage trust property for and on behalf of nominated beneficiaries. In other words, the difference between the control over an entity's affairs that can lawfully be exercised by a controlling shareholder on the one hand and a settlor of a trust on the other hand explains why a company's veil can be pierced and a trust having no veil to pierce.⁴⁰⁶

It is of course correct that trusts are in practice, although not in law, often treated as separate legal entities; and that for this reason it is arguable that they should be treated the same as incorporated entities.⁴⁰⁷ A counter argument however would be that the veil-piercing doctrine permits courts to remedy misuses of the corporate form, where managers are mostly controlled by the majority shareholder(s). On the other hand however, the common law has equitable remedies for misuses of the trust structure, which render it unnecessary to talk of piercing the veil. If trustees, who at common law are obliged to act in the best interests of the beneficiaries of the trust assets, subject to the terms of the trust deed, breach their fiduciary duties, courts will intervene and remedy the breach in question. In *Grupo*, the court held that if the doctrine of piercing the veil applied to trusts, the level of control required of the settlor should – by parity of reasoning - equate to that of a controlling shareholder in

⁴⁰⁶ *Grupo Torras* (note 404, supra), at paragraphs 97-105.

⁴⁰⁷ Makarau J makes a similar point in *Gold Mining and Minerals Development Trust v Zimbabwe Mines Federation* HH-24-2006, at p. 4.

an incorporated entity. In addition, the applicants bore the onus of establishing that the trustees not only followed the wishes of the settlor, but did so without exercising *bona fide* discretion.⁴⁰⁸ This test sets a very high threshold.

What if a settlor transfers a set of assets to a trust SPV as part of a fraudulent scheme, structured as a securitization transaction? Where fraud is present, the asset transfer can be set aside by a court under the common law. There is no need to pierce the veil in this particular instance. It is conceivable that a financially distressed firm, abusing its informational advantage, may hive off some of its assets to a trust SPV structure, pre-liquidation, to avoid paying some of its creditors and structure the arrangement as a securitization transaction. As above, in this instance, using provisions of the Companies Act and the Insolvency Act, the asset transfer will be set aside at the instance of the liquidator or creditors of the originating firm.

In summary, this study concludes that the risk of an SPV's corporate veil being pierced at the instance of an originating firm and its creditors is largely theoretical. In the absence of fraud, it is highly unlikely that a court in Zimbabwe will impeach an asset transfer made by an originating firm to a trust SPV on the basis of the veil-piercing doctrine. And that in any event, the risk can be structured out of most securitization transactions, especially true-sale transactions.

6.7. Foreclosure risk

A securitization-enabling financial infrastructure should ideally have foreclosure laws and practices that enable securitization SPVs or servicers to sue for and recover amounts due on the underlying financial receivables, and to attach and sell - in execution - assets secured by mortgage and notarial bonds or other financial

⁴⁰⁸ Grupo Torras (note 404, supra), at paragraphs 115-124.

instruments, in the event of an obliger breaching the terms of, or defaulting on, the underlying agreement. This section focuses on mortgage and notarial bonds as these are the main hypothecating instruments in Zimbabwe. And it evaluates the question: what is the risk that an SPV will be unable to efficiently, expeditiously and cost-effectively foreclose on and realise property hypothecated through either a mortgage bond or a notarial bond ceded to an SPV pursuant to a securitization transaction? This question is obviously best answered by reference to the terms of the receivables agreement between the parties and the nature of the financial assets transferred to the SPV. For this reason, the analysis below is largely general in nature.

6.7.1. Mortgage bonds

Mortgage bonds, it is often argued, provide the soundest form of security.⁴⁰⁹ They are used to hypothecate immovable property and historically constitute a significant part of financial instruments used in securitization transactions such as residential and commercial property mortgage-backed securitization. This section evaluates the question: In Zimbabwe, what is the risk that an SPV will be unable to efficiently, expeditiously and cost-effectively foreclose on and realise property hypothecated through a mortgage bond, which was ceded to an SPV pursuant to a securitization transaction?

⁴⁰⁹ This claim is made, in addition, because of the operation of section 50 of the Deeds Registries Act “which prohibits the transfer of mortgage land, except in execution, insolvency, assignment or liquidation, without the mortgagee’s consent. Christie R. H. (1997) (note 249, supra), at pp. 447-448.

6.7.1.1. Definition of a mortgage bond

A mortgage bond is an instrument of hypothecating immovable property.⁴¹⁰ Hosten defines a mortgage as: "...the real rights possessed by one person, who is called the mortgagee, over the property of another, who is called the mortgager, as security for the payment or fulfilment of a debt or some other personal obligations due by the latter to the former entitling the former to have his claim satisfied out of the proceeds of the property mortgaged in preference to such of the mortgagor's other creditors who have not a prior right or better right over the property."⁴¹¹

At least three different types of mortgage bonds are recognised in Roman-Dutch law. A bond passed in favour of a creditor for money lent and advanced for the purchase price of land is called a *kusting brief*.⁴¹² Although not referred to by any special name, the second type of mortgage bond is one that is passed over the immovable property of a debtor in respect of money lent and advanced. It need not be linked to the purchase of immovable property. The third type of mortgage bond is referred to as a covering bond. This type of mortgage bond is passed in respect of money lent and advanced *and* money to be lent and advanced, or simply in respect of money to be lent and advanced to the mortgagor in the future.⁴¹³ A mortgage bond creates and evidences both personal rights in, and real rights to, property which is subject to the mortgage bond. Before registration, a mortgage bond evidences the agreement entered into between the mortgagee and the mortgagor and in so doing sets out the range of personal rights enjoyed by each party under the terms of the mortgage

⁴¹⁰ See for instance, Van der Merwe, who, writing on Roman-Dutch law, defines a mortgage bond as an instrument that creates and evidences "a real right in respect of specified immovable property" and which secures "a principle obligation between a creditor and a debtor. C.G. Van der Merwe and J.E. Du Plessis (2004) *Introduction to the Law of South Africa*, Kluwer International (2004), at p. 229.

⁴¹¹ W.J. Hosten (1997) *Introduction to South African Law and Legal Theory*, Butterworths (1997), at p. 652. In the Deeds Registries Act a mortgage bond is defined simply as: "a bond attested by the registrar specially hypothecating immovable property. Section 2 of the Deeds Registries Act [Chapter 20:05]

⁴¹² Van der Merwe and Du Plessis (2004) (note 410, *supra*) at p. 232.

⁴¹³ See section 44(2) of the Deeds Registries Act [Chapter 20:05].

agreement. A creditor's personal rights under a mortgage bond are turned into a limited real right of security only on the registration of the mortgage bond at the Deeds Registries, in terms of the Deeds Registries Act.⁴¹⁴ Under Roman-Dutch law a mortgage bond must refer to and bind specific immovable property. A mortgage bond that purports to bind all of the mortgagee's property, i.e. all its immovable and movable property is invalid and will not be registered by the registrar of deeds.⁴¹⁵ This means that such a bond will not pass to the mortgagee any rights *in rem* over the property sought to be used as security.

6.7.1.2. Foreclosing on a mortgage bond

Where a mortgage bond has been passed over specific immovable property and the mortgagor breaches a term of the mortgage agreement or defaults on agreed periodic payments, the mortgage bond holder, i.e. either the mortgagee or the cessionary can seek to have the property over which the mortgage bond was passed sold in execution to recover payment of the outstanding debt. This is the issue, which is of relevance to structurers of securitization transactions. The contractual rights of the mortgage bond holder to terminate the mortgage agreement and foreclose on the immovable security are subject to common and statutory law stipulations.

Parate Executie: Under Roman-Dutch law, a provision in a mortgage bond entitling the mortgage bond holder to take possession and sell hypothecated immovable property in the event of default by a mortgagor without recourse to the

⁴¹⁴ Van der Merwe and Du Plessis (2004) (note 410, supra), at p. 230. See also Badenhorst *et al*, who state: "Two distinct phases are...distinguished; the first phase in which personal rights between the parties are agreed to in the bond agreement and the second phase, registration, which effectively establishes real security over the burdened property." P.J. Badenhorst., J.M. Pienaar., and H. Mostert (2003) *Silberberg and Schoeman's The Law of Property*, 4th edition LexisNexis Butterworths (2003) at p. 349. See also the Zimbabwean cases of: (i) Goncalves v Rodrigues HH-197-2003, and Takafuma v Takafuma 1994 (2) ZLR 103(S).

⁴¹⁵ Section 47 of the Deeds Registries Act [Chapter 20:05].

mortgagor or a court is void. Such a clause is known as a *parate executie* clause. *Parate executie* clauses are regarded as void contractual provisions because they are a form of oppressive self help on the part of mortgagees.⁴¹⁶ However, this proscription is subject to the following caveat: it is lawful for a mortgagor to enter into an agreement with a mortgage bond holder, post-default, for the latter to perfect its security by attaching or taking possession of the hypothecated immovable property and selling it in execution in order to realise outstanding debt.⁴¹⁷ Where the mortgagor has entered into an agreement with a mortgage bond holder authorising the latter to sell the hypothecated property to realise the outstanding debt, the mortgage bond holder can only perfect the security by obtaining a court order.⁴¹⁸

Sales in execution of hypothecated immovable property: As noted above, under Roman-Dutch law, a mortgage bond holder can only perfect its security over specific hypothecated immovable property by obtaining an order from the High Court. The order will authorise the judgment creditor to attach and sale the immovable property in execution. The immovable property has to be sold by the Deputy Sheriff through a public auction,⁴¹⁹ although private sales can be effected with the consent of all interested parties. The process of foreclosure is relatively simple. The whole process, depending on the facts of each case, from *litis contestatio* to judgment, to the attachment and sale in execution of the immovable property can take place in a matter of a few months. The law and practice relating to the attachment and sale in execution

⁴¹⁶ Christie (1997) (note 244, supra) at p. 448. The leading case on the legality of *parate executie* clauses in mortgage bonds, which has also been applied in Zimbabwe is the case of Iscor Housing Utility Co v Chief Registrar of Deeds 1971 (1) SA 613 (T).

⁴¹⁷ *Ibid.*, at 616 D-G.

⁴¹⁸ Bock and Others v Duburoro Investments (Pty) Ltd 2003 (2) SA 76 9W).

⁴¹⁹ The mortgage bond holder has to send the writ of execution together with the order of the court to the Deputy Sheriff, simultaneously serving it on the owner of the property and occupier – if the owner is not in occupation of the property and on the Registrar of Deeds. Refer to Rule 347 of the High Court of Zimbabwe Rules, 1971.

of immovable property is contained in Order 40 (rules 322 to 367) of the High Court of Zimbabwe Rules, 1971.

Where the facts are clear and not in dispute, a mortgage bond holder can apply to the High Court for summary judgment and the issuance of a writ of execution. This is a drastic measure and award, granted by the High Court where it is obvious from the facts of the case that the defendant debtor clearly does not have a *bona fide* defence to the claim and that the notice of opposition entered does not disclose a defence or that the notice was filed in order to delay the mortgagee perfecting its security and disposing the immovable property and realising the outstanding amount on the underlying agreement.⁴²⁰

Setting aside sales in execution of immovable property: The grounds upon which sales in execution of immovable properties can be set aside are contained in the High Court of Zimbabwe Rules, 1971. Rule 359 of the Rules of the High Court states: “Any person having an interest in the sale may make a court application to have it set aside on the ground that the sale was improperly conducted or the property was sold for an unreasonably low sum, or any other good ground. Any such person shall give due notice to the sheriff of the application stating the grounds of his objection to the confirmation of the sale. On the hearing of the application the court may make such order as it deems just.” [Emphasis added]

To what extent, if any, does this provision pose a risk to a securitization SPV’s interests of being able to quickly, efficiently and cost-effectively realise the proceeds – through a sale in execution – of immovable properties secured by mortgage bonds sold and ceded to secure a mortgage-backed securitization or other derivative transactions? Rule 359 has certain peculiar features that merit close analysis. First; the

⁴²⁰ Vera v Mitsui and Company SC-65-2004 at p. See also Davis v Terry 1957 (4) SA 98 (SR); Jena v Nechipote 1986 (1) ZLR 29 (SC).

provision accords *locus standi* - to challenge sales in execution of immovable properties - to “any person” who has “an interest” in the subject matter of the sale in execution. In practice this is likely to refer, for instance, to mortgagees, securitization SPVs in possession of ceded mortgage bonds, mortgagors, the wife or minor child of a mortgagor, a liquidator of a mortgagor, a tenant in occupation of the immovable property, or some other person with a real, substantial and legally identifiable interest in the immovable property sold in execution. Second, a person with *locus standi* can challenge the sale in execution of the immovable property on three grounds, namely, that: (i) the sale was improperly conducted, (ii) the property was sold for an unreasonably low sum, and (iii) that there is a good reason why the sale in execution should be set aside.

Locus Standi: It is arguable that rule 359 provides for too broad a category of persons who may exercise *locus standi* in relation to sales in execution of immovable property. And that this poses a risk to the efficient realisation of hypothecated immovable property. This risk is ameliorated however by the prevailing restrictive judicial philosophy pertaining to *locus standi* in disputes involving private as opposed to public interest cases. An instructive case on this point is the High Court case of *Zimbabwe Stock Exchange v Zimbabwe Revenue Authority*⁴²¹ in which Makarau J drew a distinction between public interest versus private interest litigation.⁴²² She cited with approval the case of *Zimbabwe Teachers Association and Others v Minister*

⁴²¹ *Zimbabwe Stock Exchange v Zimbabwe Revenue Authority* HH-120-2006

⁴²² Makarau J stated: “...it seems to me that yet another distinction must be drawn between purely public interest litigation, where a suit is brought in the public interest and to protect a public right and a private interest litigation for the settling of private disputes... The private law of litigation is primarily interested in the settling of private disputes. In my view, the test for locus standi in public interest litigation and private interest litigation ought to be separate and different. While a wider approach may be arguable for public interest litigation, it does not appear to me that a similar wide approach is desirable in private interest litigation. From a reading of the authorities on private interest litigation, it is a settled position that the applicant must show that he or she has a legal interest in the suit that will be affected by the court’s judgment. Whether that is a requirement in public interest litigation is a question I shall leave open for discussion in a suitable case.” *Zimbabwe Stock Exchange v Zimbabwe Revenue Authority* HH-120-2006, at pp. 5-6.

of Education⁴²³ in which it was held: “The petitioners must show that they have a direct and substantial interest in the subject matter and what is required is a legal interest in the subject matter of the action.”⁴²⁴ Makarau J concluded that a “...body will *have locus standi* in a suit where it shows that it has a legal interest in the subject matter of the suit and such interest may be prejudicially affected by the decision of the court. This is what constitutes a direct and substantial interest to found *locus standi* at common law.”⁴²⁵ This case was not appealed, and it sets out the law on *locus standi* in Zimbabwe.

Based on the foregoing, the class of persons likely to be classified as having a legal interest in the sale in execution of an immovable property will, in practice, be an extremely limited one. This is because in order to establish *locus standi*, a party must show that a direct and substantial interest will be or has been affected by the improper disposal of the property, or that the property was disposed for an unreasonably low price or that it seeks the setting aside of the property on “any other good ground.” The first two grounds are relatively straight forward and should not, in practice, impinge on the efficient realisation of immovable property over which there exists mortgage bonds ceded to an SPV in a securitization transaction. The third ground merits closer analysis, as it is a catch-all phrase, which enables any person with a direct, substantial and legally recognisable interest in an immovable property to challenge sales in execution on any good ground.

⁴²³ Zimbabwe Teachers Association and Others v Minister of Education 1990 (2) ZLR 48.

⁴²⁴ *Ibid.*, at p. 57. See also United Watch and Diamond Co (Pvt) Ltd and Others v Disa Hotels and Another 1972 (4) SA 409 (C); Hotel Association of Southern Rhodesia and Another v Southern Rhodesian Liquor Licensing Board and Another 1958 (1) SA 426 (SR); Retrofit (Pvt) Ltd v Post and Telecommunications and Another 1995 (2) ZLR 199 (S); Law Society and Others v Minister of Finance 1999 (2) ZLR 231(S); Capital Radio (Pvt) Ltd v Broadcasting Authority of Zimbabwe and Others SC-128-02.

⁴²⁵ Zimbabwe Stock Exchange v Zimbabwe Revenue Authority HH-120-2006, at p. 6.

Good ground cause of action: The provision in rule 359 of the High Court Rules, which permits the High Court to set aside a sale in execution on any “good ground” raises potential risks for securitization transactions. The “good ground” provision enables the High court to take into account equitable considerations in disputes involving applications to set aside a sale in execution of an immovable property. In the seminal case of *Lalla v Bhura*,⁴²⁶ Davies J held: “the wording of the rule itself is all-important. The concluding portion of the rule provides that ‘on the hearing of the application the court may make such order as it deems just’ and it seems to me these words clearly indicate that in considering what is meant by the rule, and particularly what is meant by the phrase ‘any other good ground’ the court can and should properly have regard to equitable considerations.”⁴²⁷ In interpreting rule 359, courts in Zimbabwe cited with approval the South African case of *Cairns’ Executors v Gaarn*,⁴²⁸ in which Solomon J, when considering a similar provision in the South African High court rules stated: “The discretion of the Court is a very wide one, and, in my opinion, it is impossible, and even if it were possible it would be undesirable, to lay down any hard and fast line as to the principles upon which its discretion should be exercised. Every case must be judged on its own facts, and these may vary indefinitely. But though we ought not, in my opinion, to lay down any principles as to the special circumstances which will justify the Court in granting relief, we are on the other hand bound by the rule itself, and we can only assist a party upon ‘upon sufficient cause shown.’”⁴²⁹

In theory, there is a risk that the *locus standi* rule and the wide equitable discretion exercised by the High Court to set aside sales in execution can combine to frustrate

⁴²⁶ *Lalla v Bhura* 1973 (2) ZLR 280 (GD).

⁴²⁷ *Ibid.*, at page 283 E-F.

⁴²⁸ *Cairns’ Executors v Gaarn* 1912 AD 181. Refer also *Morfopoulos v Zimbabwe Banking Corporation and Others* 1996 (1) ZLR 626 (H).

⁴²⁹ *Cairns’ Executors v Gaarn* 1912 AD 181.

the expeditious and cost-effective realisation of hypothecated immovable property. However, the practice in Zimbabwe, as illustrated by the numerous judicial pronouncements is that sales in execution will not be lightly set aside. Rule 359 of the High Court Rules has been restrictively interpreted and applied. It has been held that rule 359 relates only to conditional sales in execution.⁴³⁰ This means an interested person may only apply to the High Court for the setting aside of a sale in execution of an immovable property, if the highest bidder at the public auction has not been confirmed by the Sheriff as the purchaser, and where transfer from the owner to the purchaser has not taken place. Even then, courts are reluctant to set aside sales in execution of immovable property, including conditional sales. In exercising its equitable discretion, a court typically weighs the advantages and disadvantages of setting aside a sale in execution on equitable grounds; cognisant always of the need to maintain public confidence in such enforced sales.⁴³¹ In the case of *Lalla v Bhura*, in often cited *dictum*, it was held: "...if courts were over ready to set aside sales in execution under rule 359, this might have a profound effect upon the efficacy of this type of sale. Would-be purchasers might well be deterred from attending and bidding if they considered their efforts might easily be frustrated by an application under rule 359, and as a general principle I think it should be accepted that a court will not readily interfere in these matters."⁴³²

⁴³⁰ *Mapedzamombe v Commercial Bank of Zimbabwe & Anor* 1996 (1) ZLR 257 at pp. 260D-261A.

⁴³¹ *Zimunhu v Dr. B. Gwati and 5 Others* SC-43-02, in which Sandura JA, on behalf of the Supreme Court held: "In my view, it is only when the balance of equities is in favour of the judgment debtor that a sale in execution should be set aside on equitable grounds." Gillespie J in the High Court case of *Morfopoulos v Zimbabwe Banking Corporation Ltd & Ors* was even more swingeing when he stated that: "All too frequently, however, the debtor finds himself in an invidious position relating to the loss of his home precisely because of his own failure to address the problem efficiently at an early stage. Where his own tardiness or evasion has contributed to his problems, a debtor cannot hope to persuade a court that equitable relief is his due." *Morfopoulos v Zimbabwe Banking Corporation Ltd & Ors* 1996 (1) ZLR 626 (H) at 634D.

⁴³² *Lalla v Bhura* (note 431, supra) See also the case of *Munyoro v Founders Building Society and Others* 1999 (1) ZLR 344 (H). In *Morfopoulos v Zimbabwe Banking Corporation Ltd*, Gillespie J gave as his reasons for declining to set aside a sale in execution the following reasons, that: "... (a) the

Courts are even more reluctant to set aside sales in execution where a sale has been confirmed and transfer effected to the purchaser. It has been held that where transfer has been effected to the purchaser, following a sale in execution, the sale cannot be impeached on the basis of rule 359. An interested person with *locus standi* would need to make the application under the common law. A sale in execution where transfer has already been effected can only be set aside under the Roman-Dutch common law, if there is a substantiated allegation of bad faith, or if the purchaser had prior knowledge of irregularities pertaining to the sale in execution or if the sale is tainted with fraud.⁴³³

In practice therefore, Zimbabwe's Roman-Dutch law permits mortgage bond holders to effectively foreclose, and realise mortgaged property. The risk of inefficient, inexpedient and costly foreclosure of immovable properties is relatively small and should not impede the structuring of mortgage backed securitization transactions.

6.7.2. Notarial bonds

Under Roman-Dutch law, movable property can be hypothecated in favour of another through the execution of a notarial bond. In practice a finance provider will enter into either an out-and-out cession or a cession in *securitatem debiti* of a set of financial receivables whose payment is secured by a notarial bond. Notarial bonds are

judgment creditor is provided with his just relief; and (b) the reliability and efficacy of sales in execution should be upheld so that potential bidders at auction sales (are) not discouraged from bidding, and thus reducing the potential sale price to be realised." Morfopoulos v Zimbabwe Banking Corporation Ltd 1996 (1) ZLR 626 (H) at p. 627 F-H. See also Maparanyanga v The Sheriff of the High Court and 4 Others SC-132-02.

⁴³³ See Marufu v Wintertons and 5 Others HH-83-2002, at p. 4. Twin Wire Agencies (Pvt) Ltd v Central Africa Building Society SC 46-05 at p. 3. The following cases are cited with approval in both of the two cases cited: Maponga v Jabangwe 1983 (2) ZLR 395 (S) at 396D – E; Gibson N. O. v Iscar Housing Utility Co. Ltd and Ors 1963 (3) SA 783 T at 787A – B; Sookdeyi & Ors v Shadeo & Ors 1952 (4) SA 568 A at 571H – 572A; van den Berg v Transkei Development Corporation 1991 (4) SA 78 (TkG) at 80G – J and Erasmus v Michael James (Pty) Ltd 1994 (2) SA 528 (C) at 552F.

typically utilised where creditors want security for a loan advance, but it is commercially inconvenient, inappropriate, or impractical for a debtor to physically pledge (deliver) its movable assets, or where it does not have immovable assets to mortgage as security.⁴³⁴ This section evaluates the question: what is the risk that an SPV will be unable to efficiently, expeditiously and cost-effectively foreclose on and realise property hypothecated through a notarial bond and ceded to an SPV pursuant to a securitization transaction?

6.7.2.1. Definition of a notarial bond

A notarial bond is defined as: “a bond attested by a notary public hypothecating movable property generally or specially.”⁴³⁵ There are two types of notarial bonds: a general notarial bond and a special notarial bond. A general notarial bond covers and binds all of the debtor’s movable property; while a special mortgage bond only covers specific movable property.⁴³⁶ Once executed, a notarial bond must be registered in the Deeds Registries Office within three months.⁴³⁷ Failure to register a notarial bond within the specified time frame renders it invalid, unless if the High court grants an extension of the time limit.⁴³⁸ A notarial bond does not transmit personal rights of security unless if it is registered.

⁴³⁴ In Roman-Dutch law, one of the means of rendering security for a loan advance is to pledge movables to the creditor. To be legally effective a pledge requires an agreement that specific property is to be held as security, which property must be delivered to the creditor. The nature of the delivery must put the creditor in effective control of the property subject of the pledge. In the modern business world, pledge as a form of security is proving dated and inconvenient as most people or firms often typically require use of their assets for production as opposed to giving them to the creditor where they lie idle. For a brief but well written description of Zimbabwe’s law of pledge, refer to Christie (1997) (note 244, supra) at p. 450.

⁴³⁵ Section 8(2)(b) of the Legal Practitioners Act [Chapter 27:07].

⁴³⁶ Christie (1997) (note 244, supra) at p. 453.

⁴³⁷ Section 55(1) of the Deeds Registries Act.

⁴³⁸ William Bain and Co. (Pvt) Ltd v Pringle-Wood 1973 (2) RLR 108, 1973 (4) SA 443.

The security offered by a notarial bond is inferior compared to a mortgage bond or the pledge of movable assets.⁴³⁹ A notarial bond does not, without more, give the bondholder the rights of a secured creditor.⁴⁴⁰ The registration of a notarial bond does not give the bondholder a real right of security, and neither does it amount to the giving of notice to the world of the existence of the claim.⁴⁴¹ Where a notarial bond contains a perfection clause, which permits the notarial bondholder to take possession of the hypothecated movable property in the event of default or breach of a material contractual provision, and the bondholder exercises this option, a real right of security will accrue to the bondholder.⁴⁴² A notarial bondholder may apply for a provisional court order on an *ex parte* basis for the attachment of the hypothecated property. If a *rule nisi* is granted, on the return day, the creditor can perfect its security by obtaining a final order. Thereafter, the notarial bondholder can sell the attached property in satisfaction of its claim against the debtor. Put simply, it is only on acquiring physical possession of the hypothecated property that a notarial bondholder enjoys a real right of security.⁴⁴³ The rights enjoyed by a notarial bondholder, once it has perfected its security, are similar to those enjoyed by a pledgee.⁴⁴⁴

Prior to the attachment of the hypothecated movable property, the owner of the property (debtor) is at liberty to deal with it as it pleases, including hypothecating it to a third party or even disposing of same. Where the notarial bondholder fails to attach

⁴³⁹ Christie (1997) (note 244, supra) at p. 453.

⁴⁴⁰ Chilanda v Blundell 1940 SR 95.

⁴⁴¹ Fryer's (Pty) Ltd v Ries 1957 (3) SA 575 (A) at 583E-G.

⁴⁴² It has been held: "A perfection clause entitles the holder of the bond to take possession of the movables over which the bond has been registered. Such a clause amounts to an agreement to constitute a pledge and will be enforced at the instance of the bondholder, whereupon the creditor obtains a real right of security." Contract Forwarding (Pty) Ltd v Chesterfin (Pty) Ltd and 3 Others 2003 (2) SA 253 (SCA), at paragraph 4.

⁴⁴³ Contract Forwarding (Pty) Ltd v Chesterfin (Pty) Ltd and 3 Others 2003 (2) SA 253 (SCA).

⁴⁴⁴ It has been held: "Upon...delivery the bondholder acquires a real right over the movables that can be maintained against all comers in the event of the subsequent liquidation or sequestration of the mortgagor. Failing such 'perfection' (by assuming possession of the movables), the bondholder merely obtains a preference over concurrent creditors in the event of the mortgagor's subsequent insolvency." The Development Bank of Southern Africa Limited v J H J van Rensburg N.O. and 2 Others 2002 (5) SA 425 (SCA) (also reported in [2002] 3 All SA 669 (SCA)).

the movable property prior to a debtor going insolvent, for instance, the bondholder will not enjoy the rights of a secured creditor. The bondholder will only enjoy preference rights over other unsecured creditors of the debtor with respect to the proceeds of the assets subject to the notarial bond.⁴⁴⁵ If however, the bondholder perfects its security by seeking and obtaining an order attaching the movable property subject to the pledge, it will, on the debtor's insolvency, enjoy the rights of a secured creditor.

6.7.2.2. Foreclosing on a notarial bond

A notarial bond will typically entitle the bondholder to attach and sale hypothecated property if the debtor defaults, or breaches a material term of the underlying agreement. The notarial bondholder's rights are subject to common and statutory law restrictions. It is typical to find clauses in notarial bonds which entitle the bondholder to attach and sale movables in the event of default or which permit the bondholder to take over the movable property in question.

Parate Executie: while a parate executie clause in a mortgage bond is invalid; the same clause, if contained in a notarial bond, is valid under Roman-Dutch law, "...provided it does not prejudice, or is not likely to prejudice, the rights of the debtor unduly."⁴⁴⁶ It follows, however, that the bondholder would only be able to dispose of the hypothecated property, if it acquires the rights of a pledgee by obtaining physical possession of same. In South Africa, the constitutionality of *parate executie* clauses was challenged on the basis that such contractual clauses amounted to self-help violating the right of recourse to a court enshrined in section 34 of the South African

⁴⁴⁵ Atmore v Tobacco Sales Warehouse (Pvt) Ltd 1978 RLR 202; Contract Forwarding (Pty) Ltd v Chesterfin (Pty) Ltd and 3 Others 2003 (2) SA 253 (SCA).

⁴⁴⁶ Juglal N.O and Jumbo Trust t/a OK Foods Port Shepstone v Shoprite Checkers (Pty) Ltd t/a OK Franchise Division [2004] ZASCA 33; Osry v Hirsch, Louber and Co Ltd 1922 CPD 531; Bock (note 417, supra), at paragraph 7.

Constitution. Overturning the *dictum* in *Findevco (Pty) v Faceformat SA (Pty) Ltd*,⁴⁴⁷ the Supreme Court of South Africa in the case of *Bock and Others v Dubororo Investments (Pty) Ltd*⁴⁴⁸ correctly found that *parate executie* clauses were constitutional because a debtor is not precluded from seeking redress from a court in the event that a notarial bond or sale of hypothecated movable assets is *contra bonos mores*.⁴⁴⁹

Although the constitutionality of *parate executie* clauses has not been contested in Zimbabwe, it is likely that courts will follow the *dictum* in the Bock case. It should also be noted that a clause in a notarial bond, or the sale of hypothecated movable property in circumstances that would be regarded at common law as *contra bonos mores* are also likely to violate the provisions of the Contractual Penalties Act [Chapter 8:04].⁴⁵⁰

In summary, it is clear that under Roman-Dutch law, a securitization SPV in possession of financial assets secured by a notarial bond will, in principle, be able to attach and sell – without the need for a court order – hypothecated movable property. This legal position is favourable to securitization SPVs as it allows, subject to public policy considerations, for the expeditious, cost-effective and efficient realisation of hypothecated movable assets.

⁴⁴⁷ *Findevco (Pty) Ltd v Faceformat SA (Pty) Ltd* 2001 (1) SA 251 (E).

⁴⁴⁸ *Bock and Others v Dubororo Investments (Pty)* [2003] 4 All SA 103 (SCA).

⁴⁴⁹ *Ibid.*, at paragraph 15. See also the criticism of *Findevco* by Prof Susan Scott (2002) ‘Summary Execution Clauses in Pledge and Perfecting Clauses in Notarial Bonds’, 2002 (65) *THRHR* 656.

⁴⁵⁰ Section 4 of the Contractual Penalties Act states that: “(1) Subject to this Act, a penalty stipulation shall be enforceable in any competent court. (2) If it appears to a court that the penalty is out of proportion to any prejudice suffered by the creditor as a result of the act, omission or withdrawal giving rise to liability under a penalty stipulation, the court may— (a) reduce the penalty to such extent as the court considers equitable under the circumstances; and (b) grant such other relief as the court considers will be fair and just to the parties. (3) Without derogation from its powers in terms of subsection (2), a court may— (a) order the creditor to refund to the debtor the whole or any part of any instalment, deposit or other moneys that the debtor has paid; or (b) order the creditor to reimburse the debtor for the whole or part of any expenditure incurred by the debtor in connection with the contract concerned. (4) In determining the extent of any prejudice for the purposes of subsection (2), a court shall take into consideration not only the creditor’s proprietary interest but every other rightful interest which may be affected by the act, omission or withdrawal in question.”

Pactum Commissorium: Notarial bonds can contain provisions which permit the bondholder to take ownership of the security, if the pledgor defaults or breaches a term of the relevant underlying agreement. This is known as a *pactum commissorium* agreement.⁴⁵¹ Under Roman-Dutch law a *pactum commissorium* agreement is void and is not enforceable on public policy grounds.⁴⁵² As illustrated by the case of *Kufandirori*, courts will not only declare a *pactum commissorium* void, they will also have regard to section 4 of the Contractual Penalties Act [Chap 8:04].⁴⁵³ The Act regulates the enforcement of penalty clauses in contractual agreements.⁴⁵⁴ It authorises courts to give equitable relief to litigants who establish that particular contractual provisions, such as *pactum commissorium* and other penalty provisions are unfair.⁴⁵⁵

Sale in execution of movable property secured by a notarial bond: A judgment creditor may approach either the Sheriff, or messenger of court, respectively, for the sale by public auction or private treaty of hypothecated property. Where a judgment and writ of execution was issued by the High Court, the judgment debtor's assets will be attached and sold in execution by the Sheriff of the High Court. Such a sale is governed by the High Court rules, subject obviously to common and statutory law stipulations. Where the judgment and notice of attachment was issued by the Magistrates Court, the disposal of the movable property will be instituted by the

⁴⁵¹ A *pactum commissorium* has been defined as: "a pact by which the parties agree that if a debtor does not within a certain time release the thing given in pledge by paying the entire debt, after the lapse of the time fixed, the full property in the thing will irrevocably pass to the creditor in payment of the debt." *Chimutanda Motor Spares (Pvt) Ltd v Musare and Another* 1994 (2) ZLR 310 (H), at p. 314.

⁴⁵² *Upper Class Enterprises (Pvt) Ltd v Oceaner t/a Enigma Promotions* SC-88-02, at p. 4. See also the South African cases of *van Rensburg v Weiblen* 1916 OPD 247 at 252 and *Graf v Beuchel* 2003 (4) SA 378 (SCA) paragraph 9-11; *Mapenduka v Ashington* 1919 AD 343 at 351.

⁴⁵³ *Kufandirori v Munyaradzi Green Chipuriro and 2 Others* HH-12-2004, at pp. 3-4.

⁴⁵⁴ Section 2 of the Contractual Penalties Act states that a penalty stipulation means: "... a contract or provision in a contract under which a person is liable - (a) to pay any money; or (b) to do or perform anything; or (c) to forfeit any money, right, benefit or thing; as a result or in respect of - (i) an act or omission in conflict with a contractual obligation; or (ii) the withdrawal of any person from a contract; whether the liability is expressed to be by way of penalty, liquidated damages or otherwise."

⁴⁵⁵ *Kufandirori* (note 453, supra), at pp. 3-4.

Messenger of Court. Sales in execution of movables conducted by the Messenger of Court are governed by the Magistrates Court (Civil) Rules, 1980.⁴⁵⁶ An agreement between a debtor and creditor that movables hypothecated in terms of a notarial bond be realised through a private treaty will be upheld.

Setting aside sales in execution of movable secured by a notarial bond: The law regulating the setting aside of sales in execution of movables is contained in the rules of the High court and Magistrates court, depending on which court issued the process. A party with *locus standi*, as discussed above, may challenge a sale in execution, per the rules of the court, on the grounds that the sale was improperly conducted, (ii) the property was sold for an unreasonably low sum, and (iii) that there is a good reason why the sale in execution should be set aside. None of these preceding grounds are detrimental to securitization transactions, *per se*.

In summary, Zimbabwe's foreclosure laws and practice permit judgment creditors to expeditiously, efficiently and cost-effectively foreclose and realise assets ceded to them in *securitatem debiti* or in an out-and-out cession. Mortgage and notarial bondholders' rights are respected. As with any bureaucracy there are administrative functions that can always be improved, but the law is generally adequate and the jurisprudence leans in favour of respecting sales in execution.

6.8. Summary

This chapter assessed asset transfer methods that can be used in domestic securitization transactions. It also assessed a range of key legal risks that in theory can adversely affect the sanctity of an asset transfer from an originating firm to an SPV. Three broad conclusions are drawn in this chapter. First: Zimbabwe's Roman-Dutch

⁴⁵⁶ Magistrates Court (Civil) Rules, 1980 (Statutory Instrument No. 290 of 1980), especially Order 26, Rule 7(2).

law provides an effective medium for the disposal and/or transfer of financial assets from an originating firm to an SPV pursuant to a securitization transaction. Second: a contract of sale of financial assets, which is accompanied by their out-and-out cession from the seller to the purchaser, has the same legal effect as a true-sale. Third: the various securitization transaction insolvency-inducing legal risks – including: (i) insolvency risks inherent in the anti-asset disposal provisions of the Companies Act and the Insolvency Act; (ii) re-characterization risk; (iii) substantive consolidation risk; (iv) veil-piercing risk; and (v) foreclosure risk – peculiar to, and arising from, Zimbabwe’s legal infrastructure do not, as a general rule, adversely impinge on securitization transactions; and in any event can be effectively mitigated.

Regarding true-sale, this chapter suggested comparative true-sale *indicia* and concluded that: (a) the legal effect of Zimbabwe’s law of sale and out-and-out cession was akin to, or resulted in the same legal effect as, a true-sale; (b) *bona fide*, arms length, for fair value securitization asset transfers are unlikely to be characterized as in *fraudem legis* arrangements; (c) under Roman-Dutch law it is not possible to effect a true-sale of future-flow receivables; (d) originating firms do not retain an SPV insolvency-inducing equitable interest in financial assets sold to an SPV; and that (e) there is no need to curtail the judiciary’s equitable discretion to re-characterize securitization asset transfers through the creation of a statutory safe harbour.

Regarding insolvency risk, this chapter concluded that non true-sale transactions, as with any secured refinancing arrangements, were exposed to insolvency risks inherent in sections 42, 43, 44 and 47 of the Insolvency Act, as well as sections 269(3) and 213(c) of the Companies Act. But these sections do not impinge on true-sale securitizations and no legal reform is necessary. Further, the chapter concluded that creditors of an originating firm do not have a cause of action to apply for, and courts

do not have jurisdiction to issue, an order for the substantive consolidation of a subsidiary SPV with an originating firm in insolvency. It also concluded that the veil-piercing doctrine (i) arguably does not apply to trusts; (ii) needs to be clarified and its parameters determined, especially regarding corporate SPVs; and (iii) creates a theoretical risk of creditors obtaining access to assets transferred from an originating firm to an SPV, but the likelihood of this occurring following a *bona fide*, arms-length, fair value securitization transaction is low. Finally, the chapter concluded that Zimbabwe possesses an adequate legal foreclosure framework, which permits judgment creditors to cost-effectively and expeditiously foreclose on an underlying agreement in the event of a material breach of contract or in the event of default.

CHAPTER 7

TAXATION

7.1. Introduction

Tax is an extremely important cost factor in securitization transactions. Tax liabilities naturally increase the cost of engaging in, and can impinge upon the viability of, securitization transactions. This is especially relevant in the context of countries whose tax infrastructure is not specifically tailored to facilitate securitization. This chapter analyses the tax liabilities to which an originating firm, SPV and Servicer engaged in a typical securitization transaction is likely to be exposed. It assesses whether in Zimbabwe an originating firm is obliged to: (i) pay and account for income tax on the cash received from an SPV as consideration for received financial assets; (ii) charge an SPV value added tax (VAT) on the sale of financial assets; (iii) pay stamp duty on the cession and transfer of financial assets to an SPV. It also assess whether an SPV is liable to pay: (a) entity-level income tax; and (b) stamp duty and VAT on the issue of securities. Further it assesses whether a Servicer is liable to charge and pay VAT on fees it charges originating firms. As a consequence, this chapter analyses the provisions of the Income Tax Act [Chapter 23:06], the Value Added Tax Act [Chapter 23:12], the Stamp Duties Act [Chapter 23:09], the Capital Gains Tax Act [Chapter 23:01] and the Finance Act [Chapter 23:04]. As the titles of each of these statutes suggest, they govern the assessment,

collection and enforcement of income tax, value added tax, stamp duty and capital gains tax, respectively. The Finance Act governs a variety of tax issues, including rates of tax chargeable.

7.2. Zimbabwe's tax framework: In brief

Zimbabwe has a relatively well-developed system of taxation. The primary regulatory authority is the Zimbabwe Revenue Authority (ZIMRA), which is headed by a Commissioner.⁴⁵⁷ ZIMRA draws its authority and power from the Zimbabwe Revenue Authority Act.⁴⁵⁸ Created in 2001, it is the successor body to the Department of Taxes, Customs and Excise. ZIMRA has the primary responsibility of assessing, collecting and enforcing the payment of taxes in Zimbabwe.⁴⁵⁹ ZIMRA produces publications on the various taxes that it is statutorily obliged to assess, levy and enforce.⁴⁶⁰ Hill's Income Tax Law in Zimbabwe is the primary reference book on income tax law in Zimbabwe.⁴⁶¹ Some tax cases are reported in the Zimbabwe Law Report publication and the South Africa's tax law reports; which is a boon, given that Zimbabwe does not have its own separate tax case-law reports. Zimbabwean tax judgements often cite as persuasive authority South African tax case-law precedents and *vice-versa*.⁴⁶² Zimbabwe's tax statutes are often drawn on, or borrow from, South Africa's tax statutes.

⁴⁵⁷ Section 2 (a) of the Income Tax Act defines Commissioner as: "the Commissioner in charge of the department of the Zimbabwe Revenue Authority which is declared in terms of the Revenue Authority Act [Chapter 23:11] to be responsible for assessing, collecting and enforcing the payment of the taxes leviable under this Act." It should be noted however that the Commissioner is sometimes referred to as the Commissioner General. This emanates from the fact that section 2(b) also defined Commissioner as referring to a Commissioner General.

⁴⁵⁸ Zimbabwe Revenue Authority Act [Chap 23:11].

⁴⁵⁹ *Ibid.*, at section 3.

⁴⁶⁰ See for example, ZIMRA (2007) 'Valued Added Tax: Traders' Guide'. Available at <http://www.zimra.co.zw/Vat/VAT%20GUIDE%202nd%20edition.pdf>

⁴⁶¹ L.W. Hill (1997) *Income Tax in Zimbabwe*, 5th ed, Butterworths.

⁴⁶² See for instance and as an illustrative example the South African Supreme Court of Appeal case of Commissioner for the South African Revenue Services v C.J. Smith [2002] ZASCA 126. See also the

7.3. Tax dispute resolution framework

A taxpayer dissatisfied with a tax decision made by the Commissioner can appeal to one of three tax courts. Appeals against income tax and capital gains tax assessments made by the Commissioner can be made either to the High court or the Special Court for Income Tax Appeals (Special Court).⁴⁶³ Appeals against stamp duty, VAT and customs and excise assessments have to be lodged with the Fiscal Appeal Court.⁴⁶⁴ This tax dispute resolution system – as discussed below - should be rationalised to create a unitary tax court structure. The existing court structure reflects the piecemeal development of specialised courts in Zimbabwe in general, and of tax courts in particular.

7.3.1. Appeals against income tax and capital gains tax decisions

As noted above, appeals against income tax and capital gains tax decisions made by the Commissioner can be lodged by a taxpayer either with the High court or the Special Court. The decision to appeal to either of these courts is at the discretion of the appellant taxpayer.⁴⁶⁵ These two courts exercise concurrent jurisdiction over income tax and capital gains tax appeals.⁴⁶⁶ It is likely that a deliberate decision was taken to retain the High Court’s jurisdiction over income and capital gains tax appeals in case there were insufficient contested cases to justify the retention of a free-

case of *Standard Chartered Bank of Zimbabwe Ltd v Zimbabwe Revenue Authority* where Kudya J. after considering South African and English jurisprudence made the following, albeit trite, observation: “I am, of course, not bound by either English or South African case law. They, however, would be persuasive authority. I am also not bound by the decisions of MAKONI J, who has concurrent jurisdiction with me nor by that of HLATSHWAYO J, in the Special Court, both carry persuasive authority too.” *Standard Chartered Bank of Zimbabwe Ltd v. Zimbabwe Revenue Authority* HH-26-2007, at p. 14.

⁴⁶³ Section 65(1) of the Income Tax Act.

⁴⁶⁴ See sections 12 - 16 of the Fiscal Appeal Court Act as well as sections 17-19 of the same Act.

⁴⁶⁵ Section 65(1) of the Income Tax Act.

⁴⁶⁶ *Ibid.*

standing Special Court. However the Special Court continues to be operational and issues a significant number of the tax judgments in Zimbabwe.

The Special Court derives its jurisdiction over income tax and capital gains appeal cases from section 64 of the Income Tax Act and section 25(2) of the Capital Gains Tax Act, respectively. The High court derives its jurisdiction from section 64 of the Income Tax Act, as well as section 13 of the High Court Act, which gives it full original jurisdiction over all civil matters arising in Zimbabwe. Appeals can only be lodged with either the Special Court or the High court against decisions made, or deemed to have been made, by the Commissioner in terms of the respective enactments. The Special Court is a court of record, although hearings are not public.⁴⁶⁷ Its rules of procedure, largely similar to those of the High court are contained in schedule 12 to the Income Tax Act. The Special Court is headed by a President. Only former judges of the Supreme Court or the High court, or those qualified to be appointed as judges, may be appointed as President of the Special court.⁴⁶⁸ If a tax-payer elects to challenge a tax decision before the High Court, the case would be heard as an ordinary civil appeal matter. It is important to note however, that the procedure for income-tax and capital gains tax appeals made by a tax-payer to the High Court is governed by the provisions of the High court rules as read with the provisions of the Income Tax Act and in particular provisions of the twelfth schedule to Act.⁴⁶⁹

Both the Special Court and the High Court can amend, reduce, withdraw or confirm a tax decision made by the Commissioner, or refer the assessment or decision

⁴⁶⁷ Ibid., at section 65(7).

⁴⁶⁸ Ibid., at section 64(3).

⁴⁶⁹ See for instance the case of Barclays Bank of Zimbabwe v Commissioner General: Zimbabwe Revenue Authority HH-9-2006, at p. 1.

back to the Commissioner for further investigation and assessment or decision.⁴⁷⁰ Appeals against tax decisions made by the Special Court or the High court lie to the Supreme Court,⁴⁷¹ but only on a point of law.⁴⁷² Where it is alleged that the court made an error of fact, the error must be grossly unreasonable to wit it becomes an error of law.⁴⁷³

7.3.2. Appeals against VAT and Stamp Duty

The Fiscal Appeal Court is established in terms of section 3 of the Fiscal Appeal Court Act (Chap 23:05). The Fiscal Appeal Court has primary statutory jurisdiction to hear and determine appeals against assessments of stamp duty and VAT⁴⁷⁴ and customs and excise levies⁴⁷⁵ made by the Commissioner. The Fiscal Appeal Court is a court of record and consists of a President.⁴⁷⁶ The Fiscal Appeals Court Act provides that the President of the Fiscal Appeal Court shall either be the President of the Special Court for Income Tax Appeals, or a current or former judge of the High Court or Supreme Court of Zimbabwe, or an individual who would qualify to be appointed as a judge of either of these superior courts.⁴⁷⁷ Appeals against decisions of the Fiscal Appeal Court lie to the Supreme Court on a point of law only and in line with the rules regulating the noting of appeals from the High court to the Supreme Court.⁴⁷⁸

⁴⁷⁰ Section 65(10) (a) of the Income Tax Act.

⁴⁷¹ *Ibid.*, section 66(1) (a) and (b). With regards capital gains tax, section 25(2) specifically incorporates sections 63-70 of the Income Tax Act as regulating appeals against tax decisions made by the Commissioner.

⁴⁷² *Ibid.*

⁴⁷³ In *Wet Blue Industries (Pvt) Limited, Malaba AJ* in a majority decision held: "...the determination by...the special court, that the amounts of money paid by Wet Blue Industries to the three parties as rebates were part of the gross income it had received during each year of assessment, was a finding of fact which is not appealable unless it is so grossly unreasonable as to amount to a misdirection on the law." [Emphasis added] *Wet Blue Industries (Pvt) Limited v Commissioner of Taxes SC-43-03*, at pp. 6-7.

⁴⁷⁴ Sections 12 to 16 of the Fiscal Appeal Court Act.

⁴⁷⁵ *Ibid.*, at section 17 to 19.

⁴⁷⁶ *Ibid.*, at section 3(2).

⁴⁷⁷ *Ibid.*, at section 3 (2) and (3).

⁴⁷⁸ *Ibid.*, at section 11.

7.3.3. Proposal: Single tax appeals court

Although the above-described court structure works in practice, it has obvious draw-backs. Knowing which court to approach with which tax appeal requires an intimate knowledge of the tax enactments. The Income Tax Act and the Fiscal Appeals Court Act should be amended to create one tax court. This specialist court would obviate the need to maintain the concurrent jurisdiction exercised by the High court in income and capital gains tax cases, which this study recommends should be removed. The creation of a unitary tax court will arguably enable the expeditious and more efficient resolution of tax disputes. This could result in faster decision making, cost-savings for taxpayers and the revenue authority, and would pave the way for the compilation of Zimbabwe's own tax law reports, including the enhancement of tax law jurisprudence.

7.4. Originator tax risks

The transfer of assets by an originating firm to a securitization SPV gives rise to several potential tax liabilities. Depending on several factors, including whether the transfer of assets from an originating firm to an SPV is a sale or a pledge, the transaction may incur VAT, income tax and stamp duty liabilities. The applicability of each of these tax claims as regards originating firm can increase the overall cost of securitization. These are analysed in *seriatim* below.

7.4.1. VAT implications of the receivables' contract

In a true-sale securitization transaction an originating firm will sell its financial assets to an SPV. This begs the question: is the originating firm obliged to charge the SPV VAT on the sell price? This is an important question as the standard rate of VAT

on the provision of goods or services is 15% of the value thereof; which if applicable to the receivables agreement can constitute an extremely high, if not transaction-busting, tax cost.

7.4.1.1. VAT principles: In brief

Until the introduction of VAT in 2003, the tax payable on the supply of goods and services in Zimbabwe was sales tax.⁴⁷⁹ VAT is an indirect tax, unlike sales tax. The VAT Act provides for the assessment, charging and enforcement of VAT with respect to the supply of goods and services. VAT is charged on the value of goods or services supplied at each stage of a distribution chain.⁴⁸⁰ The VAT Act requires all persons “who carry on any trade” as suppliers of goods and services in Zimbabwe to register with ZIMRA for VAT purposes.⁴⁸¹ As a general rule, all traders in goods and services in Zimbabwe are obliged to charge and account for VAT. There are exceptions to this general rule, and these are specifically referred to in the Act.

VAT rates are gazetted in terms of the Finance Act by the Minister of Finance from time to time. There are currently three applicable VAT rates: a 0% rate, a 15% rate (standard rate) and a 22.5% rate, which is referred to as a special rate. As a general rule, all supplies of goods and services are standard-rated at 15% of the value of the goods or services supplied. Certain supplies, not relevant to domestic securitization transactions attract a 0% or 25% VAT rate.⁴⁸² Certain supplies of goods and services are specifically exempted from VAT, per section 11 of the VAT Act. VAT therefore presents a significant tax cost to commercial transactions which

⁴⁷⁹ Sales tax was imposed in terms of the Sales Tax Act [Chap 23:08].

⁴⁸⁰ Section 6 of the VAT Act states: “...there shall be charged, levied and collected, for the benefit of the Consolidated Revenue Fund a tax...on the value of- (a) the supply by any registered operator of goods or services supplied by him on or after the fixed date in the course or furtherance of any trade carried on by the him.”

⁴⁸¹ Ibid., at section 23.

⁴⁸² Ibid., at section 10(1) and (2) as read with the second schedule.

involve the supply of goods and services. If applicable to the various arrangements that constitute a securitization transaction, it is obvious that the levying of VAT either at the standard rate would represent a significant structuring cost.

7.4.1.2. VAT applicability to receivables contracts

Is an originating firm liable to charge and account for VAT on the sale (supply) to an SPV of financial assets to be securitized? This is a moot question; but it is arguable that securitization transactions do not attract VAT. Rights to income, which are the assets sold in securitization transactions, are not “goods,” the supply of which attracts VAT under the VAT Act. Section 2 of the VAT Act defines goods as: “corporeal movable things, fixed property and any real right in any such thing or fixed property, but excluding (a) money; (b) any right under a mortgage bond or pledge of any such thing or fixed property...” [Emphasis added]. It is apparent from the definition that only corporeal and real rights fall into the definition of goods, whose supply attracts VAT. Rights to income (or financial assets) are incorporeal goods. For this reason, the cession or assignment of rights to income does not attract VAT.

It is trite that the cession of financial assets by an originating firm to an SPV in a non true-sale securitization transaction does not attract VAT. Obviously a cession in *securitatem debiti* cannot be described as a sale or a supply of goods. It is a secured loan agreement. It is also notable that the definition of goods in the Act specifically excludes from its ambit “(a) money; (b) any right under a mortgage bond or pledge of any such thing or fixed property...” This means rights under a mortgage bond or a cession or pledge of any incorporeal thing or personal rights therein are not vatable “goods” for purposes of the VAT Act. Consequentially, this study argues that: (i) generally, the cession of financial assets by an originating firm to an SPV pursuant to

a non true-sale securitization transaction is VAT-exempt; (ii) cessions of mortgages or other financial assets are similarly VAT-exempt.

The above notwithstanding: does the sale of financial receivables by an originating firm to an SPV constitute a *supply of taxable services*? The VAT Act defines services to mean “...anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excludes the supply of goods, money or any stamp, as contemplated in paragraph (c) of the definition of “goods.”⁴⁸³[Emphasis added]. As noted above, rights of action are sold and transferred from an originating firm to an SPV through either cession, or assignment. *Prima facie*, the “granting, assignment, cession or surrender of [a] right” to claim a particular income stream by an originating firm to an SPV would arguably fall within the ambit of the definition of taxable services.

Although in theory arguable, this contention is fatally flawed. It ignores the legal difference between a contract of sale accompanied by an out-and-out cession of assets from an originating firm to an SPV, and a contract for the provision of services. The word “sale” is defined in the VAT Act to mean “...an agreement of purchase and sale and includes any transaction or act whereby or in consequence of which ownership of goods passes or is to pass from one person to another.”⁴⁸⁴ A contract of sale of financial assets cannot at the same time be legally characterised as a contract for the supply of services.⁴⁸⁵ To do so would result in an absurdity; which per the rules of statutory interpretation, is presumed not to be the intention of the legislature.⁴⁸⁶

⁴⁸³ Ibid., at section 2.

⁴⁸⁴ Ibid.

⁴⁸⁵ This is not to suggest that a single contractual document cannot embody both types of contracts, i.e. one part constituting a contract of sale of specified goods and another part constituting a contract for the provision of services. But the same transaction involving the sale and transfer of goods cannot be both characterized as a contract of sale and provision of services. They are two legally distinct types of contracts.

⁴⁸⁶ Imperial Asset Management (Pvt) Limited v Fungai Kuipa N.O. and 2 others HH-95-2005.

Based on the foregoing, this study concludes that the sale and cession of financial assets from an originating firm to an SPV is not subject to VAT. However, ZIMRA should promulgate securitization guidelines that clearly stipulate that the sale of securitization assets is not subject to VAT. This will engender certainty about the tax-cost structure of securitization transactions. Uncertainty is costly, as the proper meaning to be ascribed to statutory provisions may be contentious and may end up being settled in court. The VAT Act should be amended and specifically VAT-exempt securitization receivables agreements. This can be done with specific reference to securitization, or by adopting South Africa's definition of VAT-exempt financial services. South Africa's VAT Act No. 89 of 1991 is an example of a tax statute that does not specifically refer to securitization, but which permits the VAT-free disposal of financial assets, such as a company's loan book.⁴⁸⁷ At 15% of the value of the assets sold and transferred to the SPV, the standard VAT-rate represents a significant tax cost, which in practice can so drastically increase the cost of refinancing as to be uneconomic. The express statement of the inapplicability of the VAT Act to securitization asset transfers, or its amendment will facilitate securitization transactions by clarifying the law.

7.4.2. Income tax implications of the receivables' contract

A securitization receivables' contract results in an originating firm receiving money from the SPV as consideration. Is this cash-flow that accrues to the originating firm subject to income tax? This is an important consideration, which in practice

⁴⁸⁷ Section 12(a) of the South African VAT Act exempts financial services from VAT. In South Africa, financial services are defined in section 2 of the VAT Act to mean: "...the issue, allotment, drawing, acceptance, endorsement or transfer of ownership of a debt security..." The Act proceeds to define a debt security as: "an interest in or right to be paid money; or an obligation or liability to pay money that is, or is to be, owing by any person, but does not include a cheque." See also Deloitte (2006) 'South African Securitization Industry, Top 10 Issues for 2006', at p. 12. Available at <http://www.deloitte.com/dtt/research/0.1015.cid%253D101104.00.html>

would influence corporate firms' refinancing and risk management options and strategies. Obviously, it is not a question that can be resolved in the abstract, as transactions are typically designed to achieve idiosyncratic income tax treatment of the cash-flow obtained from the SPV under the receivables contract. For this reason, the following is a general analysis.

7.4.2.1. Income tax principles: In brief

The Income Tax Act governs the assessment, levying and enforcement of income tax. As a general rule, all persons (natural and juristic) are obliged, subject to the provisions of the Income Tax Act, to pay income tax on income received or accrued, or deemed to have accrued. The rate of income tax relevant to this study is corporate income tax, which stands at 33% of a firm's annual income. Income tax is levied in terms of section 6 of the Income Tax Act, which provides: "There shall be charged, levied and collected throughout Zimbabwe...an income tax in respect of the taxable income...received by or accrued to or in favour of any person during the year of assessment..." Income Tax is levied only on the "taxable income" of a person, as stipulated in the Act. There are three stages involved in the calculation of a person's taxable income.

First stage: this involves the computation of the taxpayers' gross income, which is defined in section 8 of the Income Tax Act to mean: "... the total amount received by or accrued to or in favour of a person or deemed to have been received by or to have accrued to or in favour of a person in any year of assessment from a source within or deemed to be within Zimbabwe excluding any amount so received or accrued which is proved by the taxpayer to be of a capital nature ..." [Emphasis added]. In arriving at "the total amount", the taxpayer is obliged to aggregate total

income received, or which accrued in its favour during the tax year. An amount is considered to have “accrued to, or in favour of” a taxpayer, not on the amount becoming due and payable, but when the taxpayer becomes entitled to it.⁴⁸⁸ In other words, a taxpayer is obliged, subject to the permissible deductions, as appears below, to pay income tax on income that it has “become entitled to” in a given tax year, even if the income is yet to be received, and irrespective of whether the amount is immediately enforceable or not.⁴⁸⁹ Mere entitlement, which must not be conditional, is enough to trigger an income tax liability.⁴⁹⁰ Another important consideration is that income of a capital nature is excluded from the amount that constitutes the taxpayer’s gross income. In other words, income of a capital nature is specifically income tax-exempt.⁴⁹¹ The onus to establish that a particular cash-flow is capital in nature and therefore exempt from income tax falls on the taxpayer and not the Commissioner.⁴⁹² In addition, the burden of proof is established on a balance of probabilities.⁴⁹³

Second stage: involves determining a person’s income.⁴⁹⁴ This involves deducting amounts, from the person’s gross income, that are specifically exempted from income

⁴⁸⁸ Standard Chartered Bank Zimbabwe Limited v Zimbabwe Revenue Authority HH-26-2007, at p. 13. See also Building Contractors v Commissioner of Taxes (1941) 12 SATC 182; ITC 1068 (1965) 27 SATC 141; Barclays Bank of Zimbabwe v Zimbabwe Revenue Authority SC 31-2006; Barclays Bank of Zimbabwe v Zimbabwe Revenue Authority HH-162-2004; Barclays Bank of Zimbabwe v Commissioner General: Zimbabwe Revenue Authority HH-9-2006. The South African *locus classicus*, which is also applicable in Zimbabwe, is Lategan v Commissioner for Inland Revenue (1926) C.P.D. 203.

⁴⁸⁹ Commissioner for Inland Revenue v People’s Stores (Walvis Bay) (Pty) Ltd 1990 (2) SA 353, at p. 365.

⁴⁹⁰ The High Court has held: “...an amount is deemed to have accrued in the year of assessment in which the taxpayer becomes entitled to it, despite it being only due and payable to him or her in a future year. Where, however, a taxpayer’s entitlement to an amount remains conditional at year-end, it has been suggested on the basis of the principle in Mooi v SIR (1971) 34 SATC 1, that there is no accrual in that year. Barclays Bank of Zimbabwe v Zimbabwe Revenue Authority (ZIMRA) HH-9-2006.

⁴⁹¹ The difference between income of a capital nature and income of a revenue nature is discussed in detail below.

⁴⁹² Samril Investments (Pty) Ltd v Commissioner for the South African Revenue Service [2002] ZASCA 118, at paragraph 3.

⁴⁹³ *Ibid.*

⁴⁹⁴ Income is defined in the Income Tax Act to mean: “the amount remaining of the gross income of any person for any such year after deducting therefrom any amounts exempt from income tax under this Act.” Section 8(1)(s) of the Income Tax Act.

tax, by virtue of section 14 of the Income Tax Act, as read with the third schedule to the Act.

Third stage: involves determining a person's taxable income.⁴⁹⁵ This is achieved by deducting, from the taxpayer's income – identified at stage two - allowances permitted under section 15 of the Income Tax Act. The allowable deductions include, notably, deductions of “expenditure and losses...incurred for the purposes of trade or in the production of the income.”⁴⁹⁶ The balance remaining is referred to as the taxable income. It is on this residual figure that income tax is levied. For corporate firms, the income tax rate on the taxable income is 33%.

When considering whether a securitization transaction will be subject to income tax, the starting point is section 8 of the Income Tax Act. The general rule is that consideration received by an originating firm from an SPV under the terms of a receivables contract for financial assets sold and transferred will be deemed to constitute part of the originating firm's gross income, unless if the cash-flow is held to be income of a capital nature. If the consideration paid to the originating firm by the SPV is held to be income of a capital nature, the amount will not be included into the computation of its gross income. And if the originating firm made any profit on the receivables transaction, this amount will not be subject to income tax. Similarly, if the originating firm makes a loss on the receivables transaction, such loss will not be deductible from the originating firm's gross income. Losses of a capital nature are not income-tax deductible because of the operation of section 15(2) (a) which provides for permissible deductions. Section 15(2) states: “The deductions allowed shall be – (a) expenditure and losses to the extent to which they are incurred for the purposes of

⁴⁹⁵ Taxable income is defined in the Income Tax Act to mean: “the amount remaining after deducting from the income of any person all the amounts allowed to be deducted from income under this Act.”

Ibid., at section 8(1) (s).

⁴⁹⁶ Ibid., at section 15(2).

trade or in the production of the income *except to the extent to which they are expenditure or losses of a capital nature.*” [Emphasis added].

If on the other hand, the cash-flow under the receivables contract is held to be income of a revenue nature, the amount will be included in the originating firm’s gross income and will be subject to income tax. This is because section 8 of the Income Tax Act only excludes from inclusion into a taxpayer’s gross income, income which is of a capital nature. This means income of a revenue nature is automatically included in the computation of a taxpayer’s gross income. In practice, any profit which accrued to the originating firm on the receivables’ transaction will be reduced by the income tax liability. Conversely, any losses and expenses incurred in the transaction will be income-tax deductible. As above, this is due to the operation of section 15(2) of the Income Tax Act which permits deductions of expenditure and losses incurred in the production of income, where the cash-flow in question is revenue in nature.

The determination of whether cash-flow from the disposal of financial assets is revenue or capital in nature is extremely important for originating firms engaging in securitization transactions. In practice, most financial assets are discounted. It stands to reason that it is more likely than not that originating firms engaged in securitization transactions will seek revenue characterization of the income stream, which would enable them to deduct the discount from their gross income and also claim a deduction of expenses incurred in structuring the securitization transaction. Admittedly, this is a generalization. Whether a revenue or capital characterization is sought will depend on the intended structure.

7.4.2.2. Cash-flow from the receivables' contract: revenue or capital?

Is the consideration paid to an originating firm by an SPV under the terms of a receivables' agreement revenue or capital for income tax purposes? The Income Tax Act does not define what is meant by "income of a revenue nature" and "income of a capital nature." It has been left to courts to establish the broad parameters of what the two phrases means in practice. In addition, because Zimbabwe's Income Tax Act does not make specific reference to securitization, it is difficult in the abstract to categorically state how cash-flows from the receivables' contract will be treated for income tax purposes. Whether cash-flow is treated as revenue or capital can only be established after consideration of factors peculiar to each asset disposal.⁴⁹⁷ Case-law states that legal tests enunciated to resolve the revenue/capital question are not prescriptive but illustrative.⁴⁹⁸

It has been held that in determining whether the proceeds of a transaction are revenue or capital in nature, courts must apply ordinary common sense and business standards,⁴⁹⁹ and should endeavour to establish the true nature of an underlying transaction. Whether a particular income stream is characterized as revenue or capital in nature is a question of law.⁵⁰⁰ However, the characterization is an inference drawn from a wide variety of factors, both intrinsic and extrinsic to the transaction that gave rise to the income streams. These factors include: (i) the expressed intention of the

⁴⁹⁷ Commissioner for Inland Revenue v George Forest timber Co Ltd 1924 AD 516 at pp. 522-223.

⁴⁹⁸ It has been held: "...the expressions receipts "of a capital nature" and expenditure "not of a capital nature" give rise to perennial [problems] and have generated a large number of decided cases, but the tests therein enunciated are not to be regarded as either prescriptive or comprehensive: they do no more than provide guidelines for the solution of the problems which arise. Ultimately each case must be decided on its own facts." Commissioner for Inland Revenue v Pick 'N Pay Employee Share Purchase Trust 1992 (4) S.A. 39 (AD), at p. 16.

⁴⁹⁹ Rhodesia Railways and Others v Commissioner of Taxes 1925 AD 438 at 462.

⁵⁰⁰ It has been held: "It is true that the question is ultimately one of law: whether receipts are of a capital or revenue nature is an inference from facts, and whether the inference can properly be drawn is a matter of law." Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust 1992 (4) SA 39 (A) at page 33.

taxpayer in disposing an asset;⁵⁰¹ (ii) the originating firm's business, its practices, and its objectives as contained in the memorandum of association; (iii) whether the income resulted from a disposal of assets which constitutes on-going business – i.e. a series of transactions; or (iv) whether the disposal was a one-off transaction.⁵⁰² Where the income-stream is part of a firm's trading capital or on-going business or was a scheme of profit making, any loss or gain arising from the underlying transaction will be revenue in nature.⁵⁰³ The caveat, however, is that the cash-flow from the disposal of a capital asset – such as ordinary or subordinated shares held as an investment – remains capital, unless if it is established from the facts that this was an income or profit making scheme.⁵⁰⁴ It is arguable that money received from the disposal of financial assets - mortgage bonds for instance - pursuant to a securitization transaction constitute cash-flow received as part of a firm's on-going business. Mortgage repayments are income of a revenue nature in the hands of the mortgage lender and therefore subject to income tax. The disposal of this income flow – i.e. the mortgage repayments - to an SPV as part of a securitization transaction should not transform the resulting future-flow income into income of a capital nature. Arguably, the income retains its revenue characteristic, albeit discounted with the objective of releasing

⁵⁰¹ Malan v Kommissaris van Binnelandse Inkomste 1983 (3) SA 1 (A) at 10B; Berea Park Avenue Properties (Pty) Ltd v Commissioner for Inland Revenue 1995 (2) SA 411 (A) at 413J-414A.

⁵⁰² Overseas Trust Corporation Ltd v Commissioner of Inland Revenue 1926 AD 441 at 453; Commissioner for Inland Revenue v Pick 'n Pay Employee Share Purchase Trust 1992 (4) SA 39 (A) at 56H-57G.

⁵⁰³ Hefer AP in Samril Investments (Pty) Ltd held: “The usual test for determining the true nature of a receipt or accrual for income tax purposes is whether it constituted a gain made by an operation of business in carrying out a scheme for profit-making. According to the decision of this Court in Commissioner for Inland Revenue v Pick`N Pay Employee Share Purchase Trust 1992 (4) SA 39 (A) at 57E-G this means that the receipt or accrual was not fortuitous but designedly sought and worked for.” Samril Investments (Pty) Ltd v Commissioner for the South Africa Revenue Service [2002] ZASCA 118. In the case of Pick`N Pay Employee Share Purchase Trust, Nicholas AJA held: “Where profit has resulted from the disposal of the taxpayer's assets, it may be either capital or income, depending on the circumstances. If there was a mere realization of capital at an enhanced value, the entire proceeds would remain capital. But if it was an act done in the ordinary course of the vendor's business (if it resulted from the productive use of capital to earn it), then the resulting gain would be income.” Pick`N Pay Employee Share Purchase Trust (note 502, supra), at p. 18.

⁵⁰⁴ See for instance the case of Commissioner for Inland Revenue v Stott 1928 AD 252, at p. 263.

liquidity.⁵⁰⁵ But it is also arguable, if the taxpayer (originating firm) has already paid income-tax on the cash-flow under the receivables' contract by the time it structures a securitization transaction, that at that point, the cash-flow, being effectively residual funds, must - in the hands of the originating firm - be capital. After accounting for income tax, the funds become free-cash, which the taxpayer is free to reinvest or hold. If the taxpayer discounts the rights to the financial assets, it is arguably discounting a capital asset. On that basis, the income earned on the disposal of the receivables is income-tax exempt. It is also arguable that in such circumstances, the intention behind disposing the financial receivables is to realise capital for reinvestment.⁵⁰⁶ But contrast this proposition to the South African case of *Creative Productions (Pty) Ltd* in which it was held that factoring discounts are revenue in nature, therefore deductible, despite the intention of the seller being to raise capital.⁵⁰⁷ The South Africa Revenue Service has argued, in its draft securitization guidelines that if through securitization a firm has substantially sold its business, any resulting cash-flows may be characterised as capital in nature, for purposes of income tax.⁵⁰⁸

The above analysis establishes that the characterization of receivables contract cash-flow as either revenue or capital will determine whether it is liable to income tax. It also establishes that although there exists general principles which can be utilised when determining whether a cash-flow will be characterized as revenue or capital, each case has to be assessed on its own facts. It is difficult to determine in the abstract how cash-flows under the receivables' contract will be treated for income tax purposes. This study recommends however that for clarity's sake, ZIMRA should

⁵⁰⁵ ITC 217, 8 SATC 171.

⁵⁰⁶ Elandsheuwel Farming (Edms) Bpk v Sekretaris van Binnelandse Inkomste 1978 (1) SA 101 (A) at 118A-E.

⁵⁰⁷ CSAR v Creative Productions (Pty) Ltd, 1999 (2) SA 14.

⁵⁰⁸ South African Revenue Service Draft Securitization Guidelines, at p. 11, citing the following cases, ITC 223, 6 SATC 150; and ITC 466, 11 SATC 251.

produce guidelines on how securitization receivables cash-flows are likely to be treated for income tax purposes in the hands of an originating firm.

7.4.3. Stamp duty applicability to asset transfer

Zimbabwe, in common with many countries that borrowed from the English common law system, operates a stamp duty regime for instruments used to transmit certain incorporeal rights, such as mortgage and notarial bonds. This begs the question: does the transfer of assets, pursuant to a receivables' contract, from an originating firm to an SPV attract stamp duty?

7.4.3.1. Stamp duty principles: In brief

The Stamp Duties Act as read with the Finance Act governs the levying, collection and rates of stamp duty. Section 25 of the Finance Act stipulates the instruments which attract stamp duty in Zimbabwe. They are: (i) bonds; (ii) brokers' notes; (iii) cheques; (iv) insurance policies; and (v) title deeds (on lodging at the Deeds Registry office); and (v) notarial deeds, such as deeds of cession of mortgage and notarial bonds.⁵⁰⁹ This means the sale and transfer of receivables, which does not involve the use of any of these instruments stipulated in section 25 of the Finance Act, does not attract stamp duty.

Of the five instruments, bonds are the most relevant to securitization transactions. The word "bonds" is defined in section 25 of the Finance Act to mean: "any mortgage bond or notarial bond, or any cession or substitution of debtor in respect of a notarial bond." Section 25 stipulates further that for every ZW\$100 or part thereof, secured by a bond, the stamp duty chargeable is 40 cents. In other words, stamp duty is charged

⁵⁰⁹ Section 25 of the Finance Act must be read together with section 5 of the Stamp Duties Act, which states: "...there shall be charged, levied and paid upon every instrument or other matter described in Chapter II of the Finance Act...the duties specified therein."

at 0.4% of the value of a bond. A question that arises from the above statutory provisions, which is relevant for securitization purposes is: does the cession of debts secured by mortgage or notarial bonds attract stamp duty?

7.4.3.2. Stamp duty liability on asset transfer

Does a cession of a mortgage and/or notarial bond attract a stamp duty liability?

The short answer is no; cessions of mortgage bonds and notarial bonds are stamp duty-exempt. As noted above, as part of its efforts to create a mortgage backed securitization market, the Ministry of Finance through the Finance Act (No 2) of 1999 made cessions of mortgage bonds stamp duty-exempt in 2000. Section 25 of the Finance Act, which is the exemptions clause, excludes from stamp duty liability the following: “(a) any sum separately secured by a bond to cover any costs incurred in connection with the debt; (b) any bond which is auxiliary or collateral to, or substituted for, a previously made and duly stamped bond executed by the same person and for the same debt or obligation; (c) any bond which is executed by way of suretyship only, where there exists a duly stamped bond for the same debt or obligation executed by the principal debtor or obligor; (d) any cession or substitution of debtor in respect of a bond mentioned in exemption (b), not being a substituted bond; (e) any cession or substitution of debtor in respect of a bond mentioned in exemption (c).” [Emphasis added]. Although inelegantly worded, this provision supports the conclusion that cessions of mortgage and notarial bonds are stamp duty exempt. The cession of a bond which is collateral or substituted for a previously made and duly stamped bond executed by the same person for the same debt or obligation is stamp duty exempt. However, due to the manner in which this section is worded, it is likely to engender uncertainty and litigation. This section should be amended and

clearly stipulate in simple English that cessions of mortgage and notarial bonds are stamp-duty exempt.

In summary, an originating firm is exposed to at least three significant tax claims; VAT, income tax and stamp duty. This study concludes that the sale and cession of financial assets is VAT-and stamp duty-exempt. However, for clarity's sake, both the VAT Act and Stamp Duty Act should be amended and specifically refer to, and make exempt from VAT and stamp duty, respectively, securitization transaction asset transfers. The section also discussed, but without drawing any definitive conclusions, the question whether income accruing to an originating firm from the disposal to an SPV of its financial assets, as part of a securitization transaction, is subject to income tax.

7.5. SPV tax risks

Being the hub of a securitization transaction, SPVs used in securitization transactions receive several asset and cash flows, including: (i) financial receivables to be securitized; (ii) payments made by investors for the issued securities; and (iii) periodic payments made by the underlying obligers. These various income streams and transactions give rise to several tax claims, including income tax, stamp duty, and VAT. If applicable, these tax costs increase the aggregate cost of securitization. Although gains of a capital nature are taxable in Zimbabwe on the disposal of prescribed assets, this tax is not relevant for purposes of this section. The Capital Gains Tax Act (CGT Act) applies only when there is a gain (profit) of a capital nature. SPVs used in securitization transactions issue discounted securities, and consequentially they do not typically realise gains. In addition, the CGT Act exempts from capital gains tax, gains realised on the disposal of marketable securities issued

on a securities exchange.⁵¹⁰ This would cover securitization issuances. As a result, this section focuses only on the following types of taxes: income tax, stamp duty and VAT.

7.5.1. Income tax liability

Because securitization transactions are not accorded special tax treatment, the income tax treatment of securitization SPVs has to be determined by reference to the provisions of the Income Tax Act. In practice, a securitization SPV will receive financial assets from an originating firm, cash following the issue of fixed income securities, and periodic sums of money from obligors, through a servicer. This begs the question: are these cash-flows subject to an income tax claim in the hands of the SPV? It is extremely difficult to answer this question in the abstract. At best, it is possible to draw some general principles on how securitization SPVs will in practice be treated; but much depends on the actual structural mechanics of the transaction employed.

7.5.1.1. Trust SPVs income tax liability

The legal status of an SPV determines whether its cash-flows are subject to income tax. The Income Tax Act defines a taxpayer as: “any person in respect of whom an assessment is made; and includes...any person who is required in terms of this Act to furnish a return.”⁵¹¹ The category of persons classified as taxpayers include: “a company, body of persons corporate or unincorporated (not being a partnership), local or like authority, deceased or insolvent estate and, in relation to

⁵¹⁰ Section 10(j) of the Capital Gains Tax Act.

⁵¹¹ Section 2 of the Income Tax Act.

income the subject of a trust to which no beneficiary is entitled, the trust.⁵¹²

[Emphasis added] It follows that a trust structure used in a securitization transaction, whose trust deed clearly identifies beneficiaries, is income tax-exempt. Income that accrues to a securitization trust, or more aptly, to the trustees, will, therefore, be taxed in the hands of the beneficiaries. A trust structure with beneficiaries, if used in a securitization transaction will be a mere conduit. It is precisely for this reason - i.e. the income tax exemption - that this study argues that in Zimbabwe, trusts structures constitute the most cost-effective securitization SPV structures. A caveat: a trust SPV structure without identified beneficiaries is liable to “entity-level” income tax.

7.5.1.2. Corporate SPVs income tax liability

Unlike trust structures, the general rule for corporate entities is that they are subject to income tax. But whether or not particular cash-flows are taxable is both a question of fact and law. In theory, it is possible to structure an income tax-neutral securitization SPV structure. As noted above, characterization of income flows either as income of a revenue, or of a capital, nature may result in net income tax-cost savings. It is not the case that one and not the other will in all cases give rise to a favourable tax-cost structure. This study posits however that it is more likely than not that securitization SPVs will be structured with a view to achieving revenue treatment of cash-flows. Such treatment permits SPVs to claim deductions for losses and expenditure incurred in the structuring the securitization transaction; but this is by no means a rule of general application.

⁵¹² Ibid., at section 2.

7.5.1.2.1. Revenue treatment

In practice, an SPV can be structured to achieve revenue characterization of its various income streams. In order to attain revenue treatment of its income streams, an SPV would have to establish that it was carrying on a “trade” as defined in the Income Tax Act.⁵¹³ If it does, the SPV will become entitled to deduct from its taxable income “expenditure and losses to the extent to which they are incurred for the purposes of trade or in the production of the income *except to the extent to which they are expenditure or losses of a capital nature.*”⁵¹⁴ [Emphasis added] Buying financial receivables from firms with the purpose of issuing securities can be characterised as “doing trade;” i.e. trade in purchasing financial assets and issuing securities backed by those assets.⁵¹⁵ The definition of trade – cited above – is wide enough to envisage such activity. If challenged by the Commissioner, the SPV bears the onus of establishing that it was engaged in trade.⁵¹⁶ Numerous factors will, in practice, be taken into account when assessing whether in reality the SPV was carrying on a trade. These include *inter alia*: (i) the objectives of the SPV as contained in its memorandum of association and/or trust deed; (ii) the SPV’s business operations and practices as reflected by its statutory reports, board meeting minutes, contract

⁵¹³ “Trade” is so broadly defined in the Income Tax Act as to be almost unhelpful in the determination of whether a taxpayer was carrying out trade or not in practice. Section 2 of the Income Tax Act states: ““Trade” includes any profession, trade, business, activity, calling, occupation or venture, including the letting of any property, carried on, engaged in or followed for anything done for the purpose of producing such income.”

⁵¹⁴ *Ibid.*, at section 15(2). See also the South African case of Richards Bay Iron and Titanium (Pty) Ltd and Tisand (Pty) Ltd v Commissioner for Inland Revenue 1996 (1) SA 311, where the court held: “where a taxpayer is carrying on a trade, any expenditure incurred by him in the acquisition of trading stock is deductible... because it is expenditure incurred in the production of income, and it is not of a capital nature. Income generated by the sale of such stock is of course part of the trader’s gross income.”

⁵¹⁵ A relevant Zimbabwean tax case on this point is the case of Commissioner of Taxes v BSA Co Investments 1966 (1) SA 530 (SR.AD). The case involved an investment company (BSA) which bought securities portfolios, which it used as its stock in trade in its business. The issue in the case was whether loss making parts of the securities portfolio constituted stock in trade and therefore whether expenditure incurred was income-tax deductible or whether it constituted capital.

⁵¹⁶ Commissioner of South African Revenue Service v Contour Engineering (Pty) Ltd 61 SATC 447, at 452.

documents, etc; (iii) the SPV's shareholding; (iv) the nature of its issued securities, i.e. whether it is a pay-through or a pass-through structure.

In addition to establishing that it was carrying on a trade, the SPV would have to establish that the financial receivables constitute its trading stock. Can financial receivables ceded to an SPV by an originating firm be characterized as the former's trading stock? If the financial receivables are not regarded as trading stock, they will be treated as a capital investment, which precludes revenue treatment of the financial receivables for income tax purposes. The definition of "trading stock", which is expansive but not exhaustive, is found in section 2 of the Income Tax Act.⁵¹⁷ In the relevant part it states: "trading stock" includes – (a) goods and other property of any description...which are acquired...in the ordinary course of trade for the purposes of disposal in the ordinary course of trade..." [Emphasis added]. The definition can arguably be split into two parts. First; the property must be "acquired" in the "ordinary course of business." Second; the property must have been acquired "for the [purpose] of disposal in the ordinary course of business." If accepted that the business of an SPV is the buying of financial receivables and the issuance of capital market securities which are secured by these receivables, then it follows that its acquisition of financial receivables constitutes trading in the ordinary course of its business. But does the issuance of securities backed by the financial receivables in the securities markets result in the "disposal" of the financial receivables? The Act requires a disposal of the assets for them to be characterized as its trading stock. The issuance of securities backed by financial assets to investors arguably constitutes a disposal of the underlying financial assets. What the SPV disposes to disparate investors, albeit in an

⁵¹⁷ For an analysis of whether a similar provision in the South African Income Tax Act is exhaustive, refer to the cases of Syfrets Participation Bond Managers Ltd v Commissioner for South African Revenue Service 2001 (2) S.A. 359 (SCA); (2) De Beers v Commissioner for Inland Revenue 1985 ZASCA 84.

altered form, are the rights to income, which it acquired from the originating firm. The Zimbabwean case of *Commissioner of Taxes v BSA Co Investments* is authority for this argument.⁵¹⁸

If this is accepted by the Commissioner that the SPV was conducting trade and that the receivables constitute its trading stock; (i) expenditure incurred in acquiring the assets; and (ii) losses made either in acquiring or disposing the assets; would in both cases constitute allowable deductions, per section 15(2) of the Income Tax Act. In terms of factual sequencing, the SPV would have to establish that (i) the loss and/or expenditure was in fact suffered; (ii) the loss and/or expenditure was incurred in the production of income; (iii) the loss and/or expenditure was not of a capital nature; and (iv) the loss and/or income was incurred for the purposes of the trade of the taxpayer.⁵¹⁹

7.5.1.2.2. Capital treatment

It is conceivable that structurers of a securitization transaction may wish to obtain capital treatment of one or more of the income-flows that transit through an SPV. This is likely where surplus funds are anticipated and the payment of income tax is sought to be avoided. Financial receivables may be characterized as income of a capital nature in the hands of an SPV if, for example, the SPV is a pay-through structure that issues equity-like debt securities, instead of pure debt securities. An example is where an SPV tranches its securities. But the obvious downside to this characterization is that losses and expenditure incurred will not be deductible from the SPV's taxable income.

⁵¹⁸ *Commissioner of Taxes v BSA Co Investments* 1966 (1) SA 530 (SR.AD).

⁵¹⁹ *Commissioner of Inland Revenue v Nemojim* 1983 (4) SA 935 (A).

In summary, the short answer to the question whether a corporate SPV structure is subject to entity-level income tax is in the affirmative. However, the extent of its income-tax liability depends on the individual characteristics of each transaction. It is not inconceivable that an SPV's income tax liability can be reduced to virtually zero. However, there is merit in the argument that as part of a series of measures whose objective is the creation of an effective securitization-enhancing financial infrastructure, consideration should be given to the amendment of the Income Tax Act to exempt securitization SPVs from entity-level income tax. This is the position in the U.S. for instance where the Real Estate Mortgage Investment Conduit (REMIC), the Financial Asset Securitization Investment Trust (FASIT) and the Real Estate Investment Trusts (REIT) structures are exempted from entity-level income tax liability. As part of the creation of a securitization-enabling financial infrastructure, it is recommended that policy makers in Zimbabwe consider amending the Income Tax Act and enable the creation of similar structures with a view to boosting the securitization of financial claims.

7.5.2. Stamp duty liability on securities issuance

In Zimbabwe, marketable securities are exempt from stamp duty as they are not listed in section 25 of the Finance Act among instruments whose use attracts a stamp duty liability. However, where the services of a stockbroker have been used in the selling of securities, a stamp duty cost arises. What attracts stamp duty is not the securities issuance, but the brokers' note.⁵²⁰ A stock brokers' note attracts stamp duty at 1% of the fees raised by the stock broker for its services,⁵²¹ which amount is typically passed on to the issuer or purchaser of securities by the stock broker.

⁵²⁰ Section 17 of the Stamp Duties Act.

⁵²¹ Section 25 of the Finance Act.

Although this stamp duty arises only if an SPV utilises the services of a stock broker, its utility or purpose – given the electronic nature of most securities transactions – is dubious; and consideration should be given to repealing same.

7.5.3. VAT liability on securities issuance

When seeking to determine whether a securities issuance by an SPV is subject to VAT the first question to ask is whether the SPV has made a taxable supply, either of goods or services. An SPV sells securities to raise capital. These securities are by nature incorporeal assets and as a result, as argued above, fall outside the definition of goods contained in the VAT Act, whose supply is subject to VAT. In the VAT Act, the definition of “goods” is restricted to corporeal items. This notwithstanding, is an SPV a service provider? The definition of “services” in the VAT Act is broad. The word “services” is defined to mean: “anything done or to be done, including the granting, assignment, cession, surrender of any right or the making available of any facility or advantage, but excludes the supply of goods, money.”⁵²² This definition is very broad, and arguably covers the operations of a securitization SPV. It is noteworthy that services provided and products sold by banking and building society institutions are described as the supply of financial services in the VAT Act.⁵²³ Does this mean when issuing securities, an SPV must add VAT to the securities issue price? It is important to note that listed companies do not charge VAT on their securities issuance. Stock brokers who deal in securities are the ones obliged to charge VAT on

⁵²² Section 2 of the VAT Act.

⁵²³ Ibid., at section 2 states: ““financial services” means – (a) any service provided by a banking institution registered or required to be registered in terms of the Banking Act [Chapter 24:20]; or (b) any service provided by a building society registered or required to be registered in terms of the Building Societies Act [Chapter 24:02]...”

their fees, which suggests that a securitization SPV securities issuance is VAT-exempt.⁵²⁴

The above notwithstanding, if an SPV is a registered banking or building society institution – an unlikely although not impossible scenario – its issuance of securities will definitely be VAT-exempt. Section 11(a) of the VAT Act states: “The supply of any of the following...services shall be exempt from the tax imposed in terms of paragraph (a) of subsection (1) of section six – (a) the supply of any financial services...” In section 2 of the VAT Act services provided by banking and building societies are characterized as supplies of financial services. In addition, it is clear from a reading of section 11 of the VAT Act, as read with section 2, that the issue of equity securities by a corporate SPV would be VAT-exempt. Section 11 exempts from VAT the “supply of any financial services...” Section 2 of the VAT Act, in the relevant part, defines financial services to mean “...the issue or transfer of ownership of any share in a company or interest in a private business corporation.” [Emphasis added]. The reference to “share in a company” refers to equity securities.

The treatment of a securitization securities debt issuance for VAT purposes is however less certain. It is arguable that the issuance of debt securities by a securitization SPV will be characterised as a provision of a VAT-exempt financial service; and this is why. In the relevant part, section 2 of the VAT Act defines financial services to mean “...the provision of any deposit, loan or credit, including the provision of any guarantee, indemnity, security or bond in respect of the performance of obligations to a deposit, loan or credit...” [Emphasis added]. It is arguable that the issuance of a bond (bond here defined as a debt security) by an SPV to an investor in return for a cash sum is tantamount to the issue of a bond in respect

⁵²⁴ Refer to the dispute over the levying and payment of VAT by stockbrokers that led to the case of Zimbabwe Stock Exchange v Zimbabwe Revenue Authority HH-120-2006.

to the performance of a loan, i.e. the amount that the investor would have paid the SPV. The argument here is that the purchasing of securities by investors basically constitutes a series of small loans to the issuer, which in turn issues bonds as acknowledgement of indebtedness. In support of this proposition it is arguable that the legislature could not have intended to treat equity and debt capital-raising by corporate entities differently for VAT purposes. Put simply; it could not have been the intention of the legislature to exempt equity capital-raising from VAT while subjecting debt capital-raising to VAT. If this proposition is correct, then the raising of capital, through the issuance of equity or debt securities, is also VAT-exempt.

What about trust certificates issued by a trust SPV structure; do they attract VAT on issue? Although it does not possess legal personality, a trust is deemed to be a person for VAT purposes.⁵²⁵ Section 47 of the VAT Act stipulates that where an entity is a trust fund, the person deemed to be responsible for performing the duties imposed by the VAT Act is the person administering the fund in a fiduciary capacity. This means that a trust, for purposes of the VAT Act, is a VAT paying entity. This begs the question: are trust certificates issued by a trust vatable? Section 11 of the VAT Act does not specifically refer to trust securities or proclaim that they are VAT-exempt. But can it be argued that like incorporated SPV entities, trust structures issuing securities pursuant to a securitization transaction are providing a financial service? If so, what kind of financial services? Although in law, trust certificates represent ownership interests in the assets subject to the trust; their issuance is outwith the provision that defines the issue of shares by a company as a VAT-exempt supply. This is because the provision specifically refers to shares “in a company” and a trust is not a company. But is the issuance of trust certificates saved from VAT liability by

⁵²⁵ Section 2 of the VAT Act defines person as follows: ““person” includes any public, local authority, company or body of persons, whether corporate or unincorporated, the estate of any deceased or insolvent person and any trust fund.” [Emphasis added].

virtue of the provision that makes VAT-exempt the “provision...of any security or bond in respect to the performance of obligations related to a...loan...”⁵²⁶ To sustain this argument, it would have to be accepted that the word “security” used in the definition is broad in at least two senses: (i) that it relates to property pledged or ceded as collateral for money lent and advanced; and/or (ii) that it also refers to securities used as investment instruments which in part evidences investors’ claims against the issuer in return for money lent and advanced. If this argument fails, then it is likely that the issue of trust certificates will attract VAT.

This technical approach to determining whether a securities issuance by a securitization SPV is subject to VAT is not ideal. The law should be clarified and it is recommended that securities issuance by SPVs used in securitization transactions should be made specifically VAT-exempt.

In summary, the above analysis established that SPVs used in securitization transactions would, in Zimbabwe, be subject to several tax claims, including notably income tax, stamp duty and VAT. Trust entities used in securitization transactions are income tax-exempt, while corporate entities are not. The income tax treatment and liability of corporate SPVs will depend largely on factors intrinsic to the securitization transaction. It is possible to attain tax-cost savings on both the characterization of a securitization SPV’s cash-flows as either revenue or capital in nature. This study recommends that Zimbabwe’s income tax legislation should be amended with the view to making securitization SPVs income tax-exempt. This would assist in reducing transaction and compliance costs. It would also assist in standardizing structures and promoting transaction certainty. With regards stamp duty, the chapter concludes that the issuance of securities by an SPV is liable to stamp duty, but only if it utilizes the

⁵²⁶ Ibid., section 2.

services of a stockbroker and only on the latter's fees. The chapter also concludes that the VAT Act should be amended and specifically exempt from VAT the issue of equity, debt, hybrid and other securities. In addition, securities issued by banking or building society institutions and equity securities issued by SPV entities incorporated under the Companies Act are VAT-exempt. Although it is arguable that debt securities are also VAT-exempt, this is by no means certain.

7.6. Servicer tax risks

One of the key parties to any securitization transaction is the servicer. The servicer is a service provider, whose main role is the servicing (especially the collection) of periodic cash payments made by obligors, which it forwards to the SPV. The contractual terms between the servicer, the originating firm and the SPV are typically contained in and regulated by a pooling and servicing agreement. Depending on the intention of the parties to the securitization transaction and other variables, the servicer role is typically performed either by the originating firm, or by a third party professional firm. Among a host of responsibilities, the servicer also serves the important role of administering the receivables, ensuring timely payment by the obligors, including initiating recovery and foreclosure proceedings in case of default on the underlying debt.

It is typical for the agreement entered into between an SPV and the servicer to stipulate a fee to be paid to the servicer for its services. This section limits itself to an analysis of the tax treatment of this fee as it is typically the main cash-flow that arises between a servicer on the one hand and the other parties to the securitization transaction. In addition, this section will not analyse the income tax treatment of the fee charged and received by a servicer, as this does not have a direct bearing on the

cost of structuring securitization transactions. Rather, it analyses whether the services provided by a servicer constitute the supply of taxable services under the VAT Act? If it is taxable, then the fee charged by the servicer will have to include VAT, which amount will have to be paid by the SPV to the servicer, in the process increasing the overall cost of securitization transactions.

7.6.1. VAT liability on provision of services

Given the extremely broad definition of the word services in the VAT Act, as noted above, it is clear that services performed by a servicer constitute taxable services for purposes of the VAT Act. An analysis of the VAT Act establishes several principles. If the originating firm is retained as servicer and if it also happens to be a banking or building society institution, the service performed by the originating firm in its capacity as a servicer will be VAT-exempt. This is because section 11 of the VAT Act exempts from VAT “the supply of any financial services.” VAT-exempt financial services include “any service provided by a banking institution registered or required to be registered in terms of the Banking Act [Chapter 24:20]; or any service provided by a building society registered or required to be registered in terms of the Building Societies Act [Chapter 24:02].”⁵²⁷

On the other hand, where the originating firm is not a banking institution or a building society institution, and it acts as a servicer in a securitization transaction; or where the entity chosen to act as the servicer is a third party independent entity, which is not a banking institution or a building society institution, the services that such entity renders for and on behalf of the SPV are taxable at the standard rate of 15%. This is because the provision of such services is not saved from VAT liability by

⁵²⁷ This construction is drawn from a reading of section 11 of the VAT Act as read with section 2 of the same.

section 11 of the VAT Act which stipulates supplies of goods and services which are VAT-exempt.

This study proposes that policymakers in Zimbabwe should consider the cost-implications of VAT on securitization transactions generally. Because securitization transactions by nature consist of a series of contractual arrangements, each such arrangement is likely to give rise to VAT implications. There is merit in the argument that the provision of professional services to a securitization SPV in the collection, administration and forwarding of cash from obligors to the SPV should be VAT-exempt. A question may be asked: why should the provision of servicer services by a banking or building society institution be VAT-exempt, yet the provision of similar services by all others is subject to VAT at 15%? This VAT-cost factor, among others may result in only a few types of firms, especially financial institutions, refinancing using the technique. But where parties are forced for cost reasons to use an originating firm, which is a financial institution, as a servicer, the absence of arms-length transaction may have serious implications for the bankruptcy remoteness of resulting securitization transactions.

7.7. Summary

This chapter analysed (i) Zimbabwe's tax law infrastructure; (ii) the tax dispute resolution framework; and (iii) the likely income tax, VAT and stamp duty risks for originating firms, SPVs and servicers arising from the various arrangements that constitute a basic securitization transaction. This chapter concluded that on the whole Zimbabwe's extant tax infrastructure presents a few impediments to the implementation of securitization transactions. Ideally, ZIMRA should produce guidelines, which address the likely tax treatment of securitization transaction cash-

flows. This would assist in reducing information asymmetries. This chapter recommended that Zimbabwe's tax appeals court system should be rationalised, through the creation of a tax appeals court with original jurisdiction to hear appeals against tax decisions made by the Commissioner. This requires amendments to the Income Tax Act and the Fiscal Appeals Court Act. Appeals against decisions made by the new appeals court should lie to the Supreme Court, and only on points of law.

With regards specific tax risk exposures, the chapter made several findings. First; the income received by an originating firm from an SPV pursuant to a securitization transaction is - as a general rule - subject to income tax, unless if the originating firm establishes and the Commissioner of Tax accepts that the receipt is income of a capital nature. Second; the sale of financial assets by an originating firm to an SPV is arguably VAT-exempt, although the VAT Act should be amended, or ZIMRA should issue guidelines, which clearly stipulate this. Third; cessions of mortgage bonds and notarial bonds are arguably stamp duty-exempt. However, this study recommends that the Stamp Duty Act should be amended and unambiguously state that cessions of mortgage and notarial bonds used for securitization transactions are stamp duty-exempt. Fourth; corporate-entity SPVs used in securitization transactions are liable to pay entity-level income tax, while trust structures are exempt. This study recommends that SPVs used for securitization transactions should specifically be made income tax-exempt. Fifth; a stamp duty liability arises on the brokers note issued by a stockbroker engaged by an SPV or arranger in relation to a securities issuance. Sixth; the issue of securities by a securitization SPV is not a vatable supply of goods or services and is therefore VAT-exempt. Seventh; a Servicer is liable to levy VAT on the fees it charges an originating firm or SPV pursuant to a securitization transaction.

CHAPTER 8

DISPUTE RESOLUTION FRAMEWORK

8.1. Introduction

A crucial component of a securitization-enabling financial infrastructure is an effective and versatile dispute resolution system. This chapter assesses whether Zimbabwe's dispute resolution system permits the effective and expeditious resolution of disputes that can arise from securitization transactions. As noted above, a typical securitization transaction consists of a series of contractual arrangements between an originating firm, the SPV, underwriters, servicers, trustees, credit enhancers and investors in issued securities. Disputes, both public and private law in nature, can arise over any of these contractual arrangements and relationships, including over the: (i) various participants' tax liabilities; (ii) insolvency of either an originating firm, or an SPV; (iii) legal characterization of the asset transfer; (iv) services provision by servicer(s) and credit and liquidity enhancers; and (v) the discharge by trustees or directors of their duties as contained in the trust deed, or articles of association, respectively. This chapter profiles Zimbabwe's court structure and identifies the court with primary jurisdiction over typical securitization transaction disputes. In addition, it analyses: (a) the applicability of arbitration to securitization disputes; and (b) whether parties to a domestic securitization transaction

can lawfully agree that their contractual disputes should be governed by a foreign court or foreign law.

8.2. Zimbabwe's court structure

Zimbabwe's judicial system comprises several statutory courts and tribunals.⁵²⁸ Some of these courts have power to exercise both criminal and civil law jurisdiction – such as the Magistrates court and the High court - while others have a narrow specialist jurisdiction, and others possess only appellate jurisdiction. Zimbabwe's courts can be characterised as comprising Magistrates' courts,⁵²⁹ High courts⁵³⁰ and a Supreme Court.⁵³¹ The Supreme Court is the ultimate appellate authority, although parties alleging a breach of the bill of rights may approach the Supreme Court as a court of first instance.⁵³² There are other specialist courts outside of this general court structure, including the Administrative Court,⁵³³ the Labour Court⁵³⁴ and the Fiscal Appeals court.⁵³⁵ There are other courts including the Small Claims Court,⁵³⁶ and the Customary Law Court.⁵³⁷ The jurisdiction and powers of each category of courts is governed by a relevant Act of parliament, and in the case of the Magistrates, High and Supreme Courts, the acts are complemented by gazetted rules of practice and procedure.

⁵²⁸ A detailed analysis of the court system is unnecessary for purposes of this study.

⁵²⁹ Magistrate's courts are established in terms of the Magistrate's Court Act [Chap 7:10].

⁵³⁰ High courts are established in terms of the High Court Act [Chap 7:06].

⁵³¹ The Supreme Court is the highest appellate body and is established in terms of the Supreme Court Act [Chap 7:13].

⁵³² Section 24 of the Constitution states: "If any person alleges that the Declaration of Rights has been, is being or is likely to be contravened in relation to him (or, in the case of a person who is detained, if any other person alleges such a contravention in relation to the detained person), then, without prejudice to any other action with respect to the same matter which is lawfully available, that person (or that other person) may, subject to the provisions of subsection (3), apply to the Supreme Court for redress."

⁵³³ The Administrative court is established in terms of the Administrative Court Act [Chap 7:01].

⁵³⁴ The Labour court is established in terms of the Labour Act [Chap 28:01].

⁵³⁵ The Fiscal Appeals court is established in terms of the Fiscal Appeals Court Act [Chap 23:05].

⁵³⁶ The Small Claims court is established in terms of the Small Claims Court Act [Chap 7:02].

⁵³⁷ The Customary Law and Local Court is established in terms of the Customary Law and Local Courts Act [Chap 7:05].

8.3. Jurisdiction over securitization-transaction disputes

The court with criminal law jurisdiction over securities law violations - under the Securities Act - is the Regional Magistrates court.⁵³⁸ The civil division of the Magistrates court can exercise jurisdiction over some of the disputes that arise over securitization transactions, subject to the value of the issues in dispute not exceeding the gazetted amount.⁵³⁹ As a consequence, the court which will typically exercise jurisdiction over most disputes that can arise from the various arrangements that constitute securitization transactions is the High court. It is a court of inherent jurisdiction. Section 13 of the High Court Act states that: “subject to this Act and any other law, the High Court shall have full original civil jurisdiction over all matters within Zimbabwe.” This statutory provision has been interpreted in light of the common law position that the High court has power to regulate its own procedures and judgments.⁵⁴⁰ Practice and procedure before the High court is codified in the High court rules, including as interpreted by case-law. The High court’s inherent jurisdiction is not automatically ousted merely because an enactment provides that another court has jurisdiction.⁵⁴¹ Appeals against decisions made by the High court lie to the Supreme Court,⁵⁴² which is the ultimate appellate authority. Its decisions are final and binding on all subsidiary courts in Zimbabwe, although it is not bound by its own precedents.

In the event of dispute, all of the following will be adjudicated by the High court:

(i) contractual disputes between an originating firm and an SPV over the asset

⁵³⁸ Section 117 of the Securities Act.

⁵³⁹ This amount is relatively small. Because of hyper-inflation – at the time of writing this thesis – the amount keeps changing.

⁵⁴⁰ *Post and Telecommunications Corporation v Mahachi* 1997 (2) ZLR 71 and *Vengesai and Others v Zimbabwe Glass Industries* 1998 (1) ZLR 593.

⁵⁴¹ *Hatfield Town Management Board v Mynfred Ponetry Farm (Pvt) Ltd*, 1963(1) SA 737 (SR) at 739, *City of Harare v Gwindi* HH-147-03, *Chawora v Reserve Bank of Zimbabwe* HH-59-2006.

⁵⁴² Section 43 of the High Court Act. See also section 21 of the Supreme Court Act [Chap 7:13].

transfer, or contract performance; (ii) contractual disputes arising from arrangements between the SPV and the credit and liquidity enhancers and other securitization participants; and (iii) dispute between an issuer-SPV and securities investors. It is also noteworthy that the High court has power to enquire into and determine existing, future or contingent rights.⁵⁴³ It can issue declaratory orders, interdicts and make orders for specific performance, or in lieu thereof, damages.

Insolvency, either of the originating firm or the SPV, is a key risk factor in securitization transactions. Indeed, securitization is predicated on the mitigation of various SPV insolvency-inducing risks. All insolvency proceedings – for public policy reasons - are adjudicated by the High court. Section 2 of the Companies Act defines court “in relation to any company” as meaning the High Court, except where criminal law issues arise.

The tax dispute resolution framework has already been canvassed above. In summary, appeals against stamp duty and VAT assessments made by the Commissioner of Taxes lie to the Fiscal Appeal Court.⁵⁴⁴ Appeals against income tax and capital gains and capital gains withholding tax assessments made by the Commissioner can be made either to the High court or the Special Court for Income Tax Appeals (Special Court). Both the Fiscal Appeal Court and the Special Court are the equivalent of the High Court, presided over by Judges - either retired former judges of the High or Supreme courts, or whose experience, qualifications and expertise qualifies them to be appointed judges of the High court.⁵⁴⁵

⁵⁴³ Section 13 of the High Court Act.

⁵⁴⁴ Section 13 of the Fiscal Appeal Court Act.

⁵⁴⁵ *Ibid.*, at section 3. Unlike South Africa, Zimbabwe does not have separate tax law reports. Decisions of the Fiscal Appeals court are reported in the Zimbabwe Law Reports publication. This study recommends that given the number of tax cases before the Fiscal Appeals court, consideration should be given to publishing separate tax law reports. This will go some way in making tax law decisions more accessible to practitioners, members of the public and the business community.

Admittedly, the above is a positivist analysis of the judicial system in Zimbabwe. The analysis has been restricted to legal issues and has not addressed political issues that have dogged the country in recent years. There exist valid concerns about the previous government's⁵⁴⁶ political commitment to the rule of law, independence of the judiciary and respect for private property rights. Much of the adverse criticism stems from a controversial land reform programme initiated by the government in 2000, which resulted in the expropriation of farms previously owned by white farmers. The expropriation programme is now largely complete, although disputes over compensation continue in Zimbabwe, before the Southern African Community Development Community (SADC) tribunal⁵⁴⁷ and the World Bank's International Centre for Settlement of Investment Disputes.⁵⁴⁸ These concerns, although valid, have not been canvassed here because they are arguably transient, are political in nature, rather than legal, and are restricted to an asset type - or political issue - that has minimal direct impact on securitization transactions. In addition, there is no evidence to suggest that political and legal disputes over land have compromised the judicial system or the quality of judgments pertaining to other civil disputes. To the extent that this is a possibility, this would require a separate and full study, which is beyond the scope of this study.

In summary, this study concludes that although needing reform in places, Zimbabwe has a well-developed and structured judicial system that enables the resolution of securitization-related disputes. The High court is the court with power to adjudicate over most securitization disputes. This study has not assessed the quality of

⁵⁴⁶ Between 1980 and 2008, the government of Zimbabwe was constituted by the ZANU PF party. Following political and economic turmoil, ZANU PF and the (then) opposition party Movement for Democratic Change (MDC) now share power in a unity government.

⁵⁴⁷ See for instance the case of Mike Campbell (Pvt) Ltd and Others v Republic of Zimbabwe (2/2007) [2008] SADCT 2 (28 November 2008).

⁵⁴⁸ See for instance the case of Bernadus Henricus Funnekotter and Others v Republic of Zimbabwe ICSID Case No. ARB/05/6.

judgements made by the High and Supreme Courts, except by way of reference throughout this study. They are however, arguably good. This section of the research sought to reflect on whether, challenges notwithstanding, Zimbabwe has a judicial system that is able to intercede and resolve disputes that are likely to arise from securitization transactions. The study concludes that on the whole it does and that most securitization disputes fall to be decided by the High court of Zimbabwe.

8.4. Arbitration

Arbitration is an alternative dispute resolution mechanism. It has been defined as: "...the process by which a dispute or difference between two or more parties as to their mutual rights and liabilities are referred to and determined judicially and with binding effect by the application of law by one or more persons (the arbitral tribunal), instead of a Court of law. The decision of the arbitral tribunal is usually called an award. The reference to arbitration may arise from the agreement of the parties (private arbitration) or from statute. The agreement of the parties is in practice almost invariably in writing..."⁵⁴⁹

8.4.1. Zimbabwe's arbitration framework

In Zimbabwe, as noted by the World Bank in 2000, arbitration is an established and often used alternative dispute resolution mechanism, whose awards are enforced by the superior courts.⁵⁵⁰ An arbitration centre, known as the Commercial Arbitration Centre was established created in Harare in 1995. The centre provides training and

⁵⁴⁹ Halsbury's *Laws of England*, Vol. 2, 4th edition, para 601, at pp. 332-333.

⁵⁵⁰ The World Bank in its report on Zimbabwe stated: "Arbitration is now regularly chosen as the means of resolving commercial disputes and the superior courts have an enviable record of enforcing arbitrage agreements and awards expeditiously, economically and reliably." World Bank (2000) 'Zimbabwe: Report on the Observance of Standards and Codes'. Available at http://www.worldbank.org/ifa/rosc_cg_zimbabwe.html

courses on arbitration and other non-formal alternative dispute resolution techniques, such as conciliation, mediation, negotiation *et al.* The centre also retains a database of arbitrators. It is usual in Zimbabwe for parties to a contract to stipulate that if they cannot agree on an arbitrator to resolve their dispute; either one or all of the parties to a dispute will request the Commercial Arbitration Centre to appoint an arbitrator.⁵⁵¹ The Commercial Arbitration Centre produces a quarterly publication called the Commercial Dispute Resolution Bulletin. In addition, the centre produced and regularly updates its Sourcebook on Arbitration Materials.⁵⁵²

Arbitration offers contracting parties relatively expeditious and cost-effective resolution of commercial disputes. Arbitration is typically less adversarial, less costly, involves less formality and bureaucracy as parties need not comply with the gamut of court procedures. To an extent, because it privatizes dispute resolution, arbitration arguably saves tax-payer funds. Further, arbitration proceedings are typically private in nature, and parties, if they so chose, can appoint, as arbitrators, experts in a relevant field.⁵⁵³ In addition, arbitration is not fettered by monetary jurisdiction prescriptions, as compared, say to the Magistrates' court in Zimbabwe. Further, the grounds upon which arbitral awards can be set aside are extremely limited. This is in furtherance of the public policy objective of ensuring finality in arbitration proceedings.⁵⁵⁴ Arbitral awards are enforceable by, and once registered with, and on application to, the High court, they become an order of the court.

⁵⁵¹ A case that illustrates this is the case of Ropa v Reosmart Investments and Another SC-38-06.

⁵⁵² Sourcebook of Arbitration Materials: edited by Ian Donovan., Robert McMillan and Muchadeyi Masunda (1995) The Commercial Arbitration Centre, Harare, Zimbabwe

⁵⁵³ Christie (1997) (note 244, supra) at p. 463.

⁵⁵⁴ Ropa (note 551, supra).

8.4.1.1. Law and practice

Through the Arbitration Act No. 6 of 1996, Zimbabwe repealed its old arbitration enactment,⁵⁵⁵ and adopted, with minor amendments, the United Nations Commission on International Trade Law (UNCITRAL) model law on International Commercial Arbitration. Some commentators have argued that the almost wholesale adoption of the UNCITRAL model law by Zimbabwe improved the country's arbitration law and practice and enabled them to become consistent with international standards.⁵⁵⁶ It is a well-established principle in Zimbabwe that an arbitration clause in a contract, such as a securitization receivables contract, will as a general rule, be given effect to and will preclude the resolution of the relevant dispute through the formal judicial system.⁵⁵⁷

Contracting parties' discretion to refer disputes to arbitration is limited by section 3(2)

⁵⁵⁵ Arbitration Act (Chap 7:02).

⁵⁵⁶ See for instance the article by Basil Coutsoudis (undated) UNCITRAL instruments in Southern Africa. Available at <http://www.law-online.co.za/IntTradeLaw/UNCITRAL%20Instruments.htm>

⁵⁵⁷ Zimbabwe's law on arbitration is illustrated quite well in the case of Capital Alliance (Pvt) Ltd v Renaissance Merchant Bank Ltd and 4 Others HH-108-2006, where Patel J. stated: "Article 8(1) of the Model Law (viz. the First Schedule to the Arbitration Act [Chapter 7:15]) codifies and restates the common law on arbitral agreements as follows: "A court before which proceedings are brought in a matter which is the subject of an arbitration agreement shall, if a party so requests not later than when submitting his first statement on the substance of the dispute, stay those proceedings and refer the parties to arbitration unless it finds that the agreement is null and void, inoperative or incapable of being performed." In Zimbabwe Broadcasting Corporation v Flame Lily Broadcasting (Pvt) Ltd 1999 (2) ZLR 448 (H), it was held that a clause in a contract to refer a dispute to arbitration is binding on the parties and a party is not at liberty to revoke this clause at any time if he wishes to do so. In PTA Bank v Elanne (Pvt) Ltd & Ors 2000 (1) ZLR 156 (H), it was observed that the question of whether a dispute fell within the arbitration clause in an agreement was primarily a question of interpretation of the agreement and the arbitration clause. Once it is established that the dispute falls within the ambit of the arbitration clause, the onus to show why court proceedings should not be stayed falls on the party challenging the reference to arbitration. See Independence Mining (Pvt) Ltd v Fawcett Security Operations (Pvt) Ltd 1991 (1) ZLR 268 (HC) at 272. As to the approach to be applied in interpreting an arbitration clause, it is instructive to consider the decision in Bitumat Ltd v Multicom Ltd 2000 (1) ZLR 637 (H), at 639-40, where SMITH J stated as follows: "In my opinion, where parties have entered into an agreement which contains an arbitration clause that is clearly intended to be widely cast, the court should not be astute in trying to reduce the ambit of the arbitration clause. Where an arbitration clause exists in any such agreement, the court is required to give effect thereto — see Article 8(1) of the UNCITRAL Model Law which was adopted as part of our law by the Arbitration Act 6 of 1996 and Zimbabwe Broadcasting Corporation v Flame Lily Broadcasting (Pvt) Ltd t/a Joy TV 1999 (2) ZLR 448 (H). It may well be that at some stage after a dispute has arisen, because of changed circumstances, the parties concerned agree that the matter should be determined by a court of law, rather than by arbitration in terms of the agreement in question. In these circumstances, the decision of the parties to abandon the arbitration clause in their agreement must be specific and clearly evidenced. It cannot be implied by the conduct of, or correspondence between the parties — it must be explicit. After all, if the arbitration clause is contained in a written agreement, then the decision to change the agreement must either be in writing or else so clearly evidenced by the conduct of the parties that there is no room for doubt."

of the Arbitration Act. An arbitration agreement will not be upheld and enforced where it relates to: (i) a contract whose provisions are contrary to public policy; (ii) the resolution of a dispute which by operation of law cannot be resolved through arbitration - for instance, criminal and matrimonial law cases, and cases involving minors and persons who are legally incapacitated; (iii) matters concerning a consumer contract - as defined under the Consumer Contracts Act [Chap 8:03] unless the consumer has by separate agreement agreed to refer arising disputes to arbitration.⁵⁵⁸

8.4.1.2. Consumer contracts not subject to arbitration

Disputes arising from a consumer contract cannot be resolved through arbitration.⁵⁵⁹ This means a dispute between contractual parties to a securitization transaction over a contract characterized as a consumer contract, cannot be resolved through arbitration. The Consumer Contract Act defines a consumer contract as a: “contract for the sale or supply of goods or services or both, in which the seller or supplier is dealing in the course of business and the purchaser or user is not, but does not include (a) a contract for the sale, letting or hire of immovable property; or (b) a contract of employment.”⁵⁶⁰

Is a securitization receivables contract a consumer contract? The Consumer Contracts Act does not define the words “goods” or “services”. This is an anomaly which ought to be addressed as the interpretation given to both words determines the application of the enactment to a dispute. This study argues that rights of action are

⁵⁵⁸ Section 2 of the Consumer Contracts Act defines a consumer contract as a “contract for the sale or supply of goods or services or both, in which the seller or supplier is dealing in the course of business and the purchaser or user is not, but does not include (a) a contract for the sale, letting or hire of immovable property; or (b) a contract of employment.” See also Cabri (Pvt) Limited v Terrier Services (Pvt) Limited HH 51-2004 for a discussion on the definition of a consumer contract, especially with regards a contract to provide services, which in Zimbabwe is interpreted broadly.

⁵⁵⁹ Section 3(2) of the Arbitration Act.

⁵⁶⁰ Section 2 of the Consumer Contracts Act [Chapter 8:03].

not goods. It is also noteworthy that the definition of goods for VAT purposes excludes rights of action.⁵⁶¹ Assuming, without conceding, that rights of action constitute goods, it is arguable that because an SPV is in the business of buying or receiving rights of action for the purpose of issuing securities, the receivables contract falls outwith the definition of a consumer contract. Per the definition, the purchaser must not be dealing in the course of business, while the seller should be. The Act is meant to protect consumers. In a securitization context, the SPV will certainly be engaged in the course of business and is therefore not a consumer.

Arguably therefore, an arbitration provision in a receivables agreement will, as a general rule, be enforced. This proposition should also hold true for other securitization transaction contracts. Contractual agreements between an originating firm and a servicer, or an SPV and credit and liquidity enhancers are unlikely – for similar reasons - to be characterized as consumer contracts. This means, arbitration clauses in securitization contracts are more likely than not to be upheld for as long as it is clear from the agreement that it is the contracting parties’ intention to refer disputes arising to arbitration.

8.4.1.3. Arbitration agreements do not oust jurisdiction of the High court

It is important to note that arbitration agreements do not oust the jurisdiction of the High court over civil disputes.⁵⁶² As a general rule, the High court will, in practice, uphold an arbitration agreement by staying litigation proceedings instituted before it, save where it finds that the arbitration agreement is unenforceable for public

⁵⁶¹ Section 2 of the VAT Act.

⁵⁶² Makarau J. in *Cargill Zimbabwe v Culvenham Trading (Pvt) Limited*, stated: “... [a]n arbitration clause does not have the effect of ousting the jurisdiction of the court. It merely seeks to compliment the court process in resolving disputes by engaging in an alternative dispute resolution process but remains under the control of the courts.” *Cargill Zimbabwe v Culvenham Trading (Pvt) Limited* HH-42-2006.

policy or statutory reasons.⁵⁶³ This practice is particularly useful to securitization participants as litigants will be precluded from drawing out the resolution of commercial disputes subject to arbitration by instituting litigation before the High court.

8.4.1.4. Setting aside arbitral awards

An attractive attribute of arbitration as a dispute resolution mechanism is that the arbitral award, once issued is final, and can only be set aside by the High Court in extremely limited circumstances.⁵⁶⁴ This legal position is illustrated by the case of *Ropa v Reosmart Investments and Another*⁵⁶⁵ in which, citing with approval, the South African authors Butler and Finsen's, the court stated: "The most important legal consequence of a valid final award is that it brings the dispute between the parties to an irrevocable end: the arbitrator's decision is final and there is no appeal to the courts. For better or worse, the parties must live with the award; unless their arbitration agreement provides for a right of appeal to another arbitral tribunal. The

⁵⁶³ Edgars Stores Managers Association v Edgars Stores Limited SC 103-2004; PTA Bank v Elanne (Pvt) Ltd 2000 (1) ZLR 156; Zimbabwe Broadcasting Corporation v Flame Lily Broadcasting (Pvt) Ltd 1999 (2) ZLR 448; Independence Mining (Pvt) Ltd v Fawcett Security Operations (Pvt) Ltd 1991 (1) ZLR 268.

⁵⁶⁴ Article 34 of the Arbitration Act lists the circumstances under which an arbitral award may be set aside by the High Court of Zimbabwe, which is the court to which all challenges must lie. Article 34 states as follows: (2) An arbitral award may be set aside by the High Court only if— (a) the party making the application furnishes proof that— (i) a party to the arbitration agreement referred to in article 7 was under some incapacity; or the said agreement is not valid under the law to which the parties have subjected it or, failing any indication on that question, under the law of Zimbabwe; or (ii) the party making the application was not given proper notice of the appointment of an arbitrator or of the arbitral proceedings or was otherwise unable to present his case; or (iii) the award deals with a dispute not contemplated by or not falling within the terms of the submission to arbitration, or contains decisions on matters beyond the scope of the submission to arbitration, provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, only that part of the award which contains decisions on matters not submitted to arbitration may be set aside; or (iv) the composition of the arbitral tribunal or the arbitral procedure was not in accordance with the agreement of the parties, unless such agreement was in conflict with a provision of this Model Law from which the parties cannot derogate, or, failing such agreement, was not in accordance with this Model Law; or (b) the High Court finds, that— (i) the subject-matter of the dispute is not capable of settlement by arbitration under the law of Zimbabwe; or (ii) the award is in conflict with the public policy of Zimbabwe..."

⁵⁶⁵ Ropa (note 551, supra).

issues determined by the arbitrator become *res judicata* and neither party may reopen those issues in a fresh arbitration or court action.”⁵⁶⁶ Gwaunza J.A. further stated: “this position applies with equal force in Zimbabwe” and that there is no appeal against an arbitral award.⁵⁶⁷

The grounds for setting aside arbitral awards are stipulated in article 34(a) (i) to (iv) of the Arbitration Act.⁵⁶⁸ The grounds stated therein are technical and are unlikely to be problematic for securitization transactions. Article 34(b) permits the setting aside of an arbitral award on public policy grounds. Although *prima facie*, article 34(b) is a catch-all provision, in practice, it has been restrictively construed and applied. Regarding this provision, the Supreme Court has held: “... the approach to be adopted is to construe the public policy defence, as being applicable to either a foreign or domestic award, restrictively in order to preserve and recognise the basic objective of finality in all arbitrations; and to hold such defence applicable only if some fundamental principle of the law or morality or justice is violated.”⁵⁶⁹ It stated further: “An award will not be contrary to public policy merely because the reasoning or conclusions of the arbitrator are wrong in fact or in law. In such a situation the court would not be justified in setting the award aside. Under article 34 or 36, the court does not exercise an appeal power and either uphold or set aside or decline to recognise and enforce an award by having regard to what it considers should have been the correct decision. Where, however, the reasoning or conclusion in an award goes beyond mere

⁵⁶⁶ Ropa (note 551, supra), at p. 4.

⁵⁶⁷ Ibid. See also D.W. Butler and E. Finsen (1993) *Arbitration in South Africa - Law & Practice*, Juta & Co. Cape Town, at p 271.

⁵⁶⁸ Article 34(a) (i) to (iv) provides that arbitral awards will set aside if: (i) a party to the arbitration agreement was under some incapacity or the agreement is not valid under the law; (ii) the applicant was not given proper notice of the appointment of an arbitrator or of the arbitral proceedings; (iii) the award deals with a dispute not contemplated by or falling within the terms of the submission to the arbitration; (iv) the composition of the arbitral tribunal or the arbitral procedure was not in accordance with the agreement of the parties.

⁵⁶⁹ Zimbabwe Electricity Supply Authority v Maposa 1999 (2) ZLR 452 (S) at p. 465. See also Smith J’s decision in National Social Security Authority v Chairperson, National Social Security Workers Committee and National Social Security Workers Committee HH-51-2002, at p. 7.

faultiness or incorrectness and constitutes a palpable inequity that is so far reaching and outrageous in its defiance of logic or accepted moral standards that a sensible and fair minded person would consider that the conception of justice in Zimbabwe would be intolerably hurt by the award, then it would be contrary to public policy to uphold it. The same consequence applies where the arbitrator has not applied his mind to the question or has totally misunderstood the issue, and the resultant injustice reaches the point mentioned above.”⁵⁷⁰ This dictum represents the law as it stands in Zimbabwe regarding the setting aside of arbitral awards on public policy grounds. Case-law is replete with attempts by litigants seeking the review of arbitral awards by the High court, but it has consistently refused to accede to such applications.⁵⁷¹

8.4.1.5. Enforcement of arbitral awards

A party seeking to enforce an arbitral award must make a written application to the High Court giving notice to the other litigant(s).⁵⁷² As a general rule, the High court will enforce an arbitral award unless if the other litigant(s) successfully contends that the award should not be enforced.⁵⁷³ The High Court may decline to enforce an

⁵⁷⁰ Zimbabwe Electricity Supply Authority (note 569, supra), at. p 466.

⁵⁷¹ See for instance, the majority decision by Sandura JA in Catering Employers Association of Zimbabwe v Zimbabwe Catering and Hotel Workers Union 2001 (2) ZLR 388 (S) at 392: “The suggestion by the learned judge is that, in addition to the grounds set out in Art 34(2) of the Model Law, an arbitral award may be set aside by the High Court on review on the grounds set out in s 27 of the High Court Act [Chapter 7:06]. I respectfully disagree. In my view, Art 34(2) of the Model Law sets out the sole grounds on which an arbitral award may be set aside by the High Court. That is what Art 34(2) says and that is what this court said in Zimbabwe Electricity Supply Authority v Maposa 1999 (2) ZLR 452 (S) at 458F.” See also Francina Zimayi v Burdock Investments (Private) Limited and Auxillia Danayi Munyeza and William Kenneth Lunt HH-64-2007.

⁵⁷² In Mandikanza and Another v Cutnal Trading (Pvt) Ltd, Uchena J. stated: “Article 36(1)(a) of the Act provides for the party against whom an award is to be invoked requesting the court to refuse to recognize and enforce the award. This suggests the party against whom the award is made must be notified of the application to recognize and enforce the award. When this is considered together with the provisions of Article 35(1) which provides that the award “shall be recognized as binding upon application in writing to the High Court” there can be no doubt that a proper application in terms of rule 226(1) of the High Court Rules 1971 has to be made by the party seeking to register the award. Failure to comply with that procedure is fatal to the recognition and enforcement of the award. It simply means the award has not yet been recognized. It therefore is not yet enforceable.” Mandikanza and Another v Cutnal Trading (Pvt) Ltd and 2 Others HH-189-2004.

⁵⁷³ Article 35 and 36 of the Arbitration Act.

arbitral award on public policy grounds,⁵⁷⁴ or on the grounds stipulated in article 34(a) of the Arbitration Act, which are: (i) a party to the arbitration agreement was under some incapacity or the agreement is not valid under the law; (ii) the applicant was not given proper notice of the appointment of an arbitrator or of the arbitral proceedings; (iii) the award deals with a dispute not contemplated by or falling within the terms of the submission to the arbitration; (iv) the composition of the arbitral tribunal or the arbitral procedure was not in accordance with the agreement of the parties.⁵⁷⁵ On the public policy ground, the High Court has refused to enforce an arbitral award where there was sufficient reason for believing that an arbitrator may have been biased – due to a prior undisclosed association with one of the litigants.⁵⁷⁶ In *Musonzoa (Pvt) Ltd v Standard Fire and General*, the court held that it was against Zimbabwe’s public policy to enforce awards made by arbitrators in circumstances where fundamental rules of natural justice were violated.

In summary, the law and practice of arbitration as an alternative dispute resolution mechanism is established in Zimbabwe. Contractual parties can rely on arbitration for the expeditious, equitable, cost-effective and expert resolution of disputes arising from securitization transactions.

8.5. Choice of law and jurisdiction

Agreements entered into between securitization participants may contain choice of law and jurisdiction clauses. Jurisdiction clauses are sometimes referred to as choice of forum clauses. Choice of law and forum clauses identify, in the event of dispute,

⁵⁷⁴ For the restrictive application of the public policy ground, refer to the Supreme court case of *Provincial Superior of the Jesuit Province of Zimbabwe v Kamoto and Others* SC-84-2006; and the case of *Beazley N.O. v Kabell and Another* SC-22-2003.

⁵⁷⁵ See also *Mtetwa and Another v Mupamhadzi* SC-35-07, at pp. 2-3.

⁵⁷⁶ In the case of *Musonzoa (Pvt) Ltd v Standard Fire and General and Dr. Brian Campbell*, the High Court set aside an arbitral award made by an arbitrator on the grounds that he was biased. *Musonzoa (Pvt) Ltd v Standard Fire and General and Another* HH-85-2002.

the law - either domestic or foreign - which will govern the contractual relationship between the contracting parties, and the adjudicating court, tribunal or forum. It is a generally accepted principle of private international law that contracting parties may choose a law to govern their contractual relationship and in addition agree to refer their contractual disputes to arbitration or to be heard by either a domestic or a foreign court. Although there is scant Zimbabwean literature on this subject, especially as it relates to conflicts of law in commercial contracts, the position in Roman-Dutch law is that choice of law and choice of forum agreements are, as a general rule, upheld and enforced.⁵⁷⁷

8.5.1. Choice of forum

Can parties to a contract in a domestic securitization transaction agree that their contractual disputes will be adjudicated by a foreign court? And secondly, does this choice of jurisdiction oust the High court of Zimbabwe's jurisdiction to adjudicate over the dispute? The general rule is that where parties to a contract have expressly identified a foreign jurisdiction to adjudicate over their contractual disputes; their agreement will be upheld and enforced by the High court. This general proposition is

⁵⁷⁷ C.F. Forsyth (1996) *Private International Law: The modern Roman-Dutch law including the jurisdiction of the Supreme Court*, Juta & Co, Cape Town, at p. 304. Courts in Zimbabwe routinely apply conflict of law rules in family law matters, especially succession disputes, where customary and general law rules are in conflict. As a general rule, the courts consider a range of factors with a view to identifying the law to which the parties and the dispute have the closest connection. For a well-written judgment that cites most of the relevant case-law on the subject, refer to the High court decision in Kusema v Shamva HH 46-2003. Makarau JP stated: "It appears to me that the conflict between customary law and general law will be an issue that will confront the courts in this jurisdiction for some time to come. It is an issue, in my view, that has the potential of causing palpable injustice in some cases, especially for women married under customary law, who may find general law being applied against them to erode whatever positions they may be occupying by virtue of customary law. The relationship between customary law and general law is an issue that has dogged this court before, and in the absence of intervention by Parliament expressly harmonising the two legal systems, injustice may only be avoided by innovation and creativity on the part of judges, creating remedies that straddle, but remain compatible with the two legal systems." And she also proceeded to state: The position that the courts in this jurisdiction may have to make a choice of law between general and customary law is reinforced by the provisions of s 3 of the Customary Law and Local Courts Act, [Chapter 7:05] that provides for the instances when customary law should apply in civil cases.

subject: (a) to the court finding that the foreign jurisdiction chosen is the one closely connected to the dispute in question; (b) that there are no statutory and/or public policy reasons precluding the resolution of the dispute before a foreign court. This is the position in Roman-Dutch law.

It is important to note that jurisdiction exercised by the High court over civil matters in Zimbabwe is not granted or ousted by agreement between contracting parties. The High court exercises jurisdiction by operation of law. The High court's inherent jurisdiction is, as noted above, statutorily entrenched in section 13 of the High Court Act. Practically, where parties to a contract have expressly stipulated in their agreement that all disputes arising from their contract must be adjudicated by a foreign court but one of the parties objects to the enforcement of the contractual term, the High court is obliged to decide if it or the foreign court should exercise jurisdiction over the dispute. In determining the exercise of jurisdiction, the High court would need to consider all the factors relevant to the case and decide if those factors indicate that it has a closer connection to the contractual dispute than the foreign jurisdiction. If the High court will still stay proceedings before it, if the factors pertaining to the dispute strongly point to the foreign jurisdiction being the more appropriate forum to adjudicate over the parties' contractual dispute.

Case-law suggests that a range of factors are taken into account when determining whether a choice of forum agreement is to be upheld. These include the parties residency, domicile, place of business, place where the contract was entered into, place where offer and/or acceptance was made, place where the goods or services are to be delivered or rendered, respectively, place where enforcement of the judgment are to take place, etc. Although not defined in Roman-Dutch law as such, these factors are broadly the same as those considered under the English common law doctrine of

forum non conviniens.⁵⁷⁸ It is not clear if this doctrine, which parties can use to challenge the initiation of litigation before English courts on the basis that another more convenient forum exists, is part of Roman-Dutch law. The absence of case-law on this point suggests to the contrary.⁵⁷⁹

The Zimbabwean case of *Colour Fast Textile Limited v P and O Neidlloyd*⁵⁸⁰ which dealt with choice of forum and choice of law clauses was wrongly decided. In the case, the bill of lading at the centre of the dispute contained a provision which stated that any arising dispute would be governed by English law and adjudicated exclusively by the High Court of Justice in London. The High court found that the applicant, as the consignee, was bound by the terms of the bill of lading. The applicant had lodged an urgent application for the release of goods it had imported into Zimbabwe. Gowora J. presiding stated: “The function of courts is to give effect to provisions in a contract as that reflects the intention of the parties, it is not for the court to depart from those terms and write its own terms. The High Court of Justice in London has been granted exclusive jurisdiction by the contract to adjudicate on the contract as it relates to a claim against the carrier and there is no way that this court can find jurisdiction to hear the matter. The applicant as I have found is bound by the terms of the contract and this court does not have jurisdiction according to the contract. The application is therefore not properly before me.”⁵⁸¹ [Emphasis added]

⁵⁷⁸ The doctrine of *forum non conviniens* is discussed in the House of Lords case of Lubbe and Others v Cape Plc [2000] 4 ALL ER 268 (HL).

⁵⁷⁹ In *Parry v Astral Operations Limited*, Pillay J, in an interesting statement stated: “Party autonomy can be restricted by public policy considerations or by the doctrine of forum non-conveniens, if that doctrine forms part of the South African conflict of laws.” [Emphasis added] Pillay was doubtful that the doctrine is part of South Africa’s conflict of laws, which themselves draw heavily from its Roman-Dutch common law roots. Parry (note 579, supra).

⁵⁸⁰ Colour Fast Textile Limited v P and O Neidlloyd and Manica Freight Zimbabwe Limited HH-70-2005.

⁵⁸¹ *Ibid.*, at p. 5. Refer also to the case of Phyllis Sibanda and Munyama Ngangura v The International Committee of the Red Cross (ICRC) HH-5737-2000 where choice of law was raised albeit obliquely in the case.

The above-cited statement is an incorrect statement of the law relating both to the issue of conflict of laws and jurisdiction as it applies in Zimbabwe. Because it was not nuanced, the statement by Gowora J. gives the impression that the High court's jurisdiction to adjudicate over matters, where parties have chosen a particular law and jurisdiction to determine disputes arising from their contractual relationship, is thereby automatically ousted. This is incorrect and does not reflect the established principle that there is a general presumption against the ouster of the High court's jurisdiction. Gowora's judgment is at odds with Section 13 of the High Court Act, which clearly states: "subject to this Act and any other law, the High Court shall have full original civil jurisdiction over all persons and over all matters within Zimbabwe." The proper position is that the High court is unlikely to lightly uphold an objection to the exercise of civil jurisdiction as happened in the Colour Fast Textiles Limited case. Karwi J. in the case of *Chawora v Reserve Bank of Zimbabwe*, citing authority correctly stated the legal position. He stated: "It is...true that superior courts will jealously guard their jurisdiction and there exists a presumption against the ouster of the court's jurisdiction unless the legislature states so in very clear terms. Thus it is imperative that any statute or contract that purports to oust the jurisdiction of the courts must be restrictively interpreted."⁵⁸²

Gowora J. should have considered whether the facts of the matter indicated that the High court of Justice in London was the court with the closest or most real connection with the dispute in question. She simply took the agreement as determinative of the question on jurisdiction. In the Colour Fast Textiles Limited case, the contracting parties' place of domicile and residency was Zimbabwe; it was the place of performance - the *locus solutionis* - it was where all the contractual parties

⁵⁸² *Chawora v Reserve Bank of Zimbabwe* HH-59-2006, at p. 3 of the cyclostyled judgement. For Roman-Dutch law authority, Karwi J. cited the cases of *Dewet v Deetlefs*, 1928 AD 290 and *R v Pashda* 1923 AD 281 C 304.

carried on their business, and it was where the property, subject of the dispute, was physically present. The applicant was seeking the release of goods that it had bought and paid for *c.f.i.*⁵⁸³ The goods were already in Zimbabwe and it could be argued that although flowing from a bill of lading, the action by the applicant was common-law based and vindicatory in nature, and the issue was whether the second respondent was entitled to retain custody of the goods in the circumstances of the case. A strong case could, on the facts, be made that the cause of action arose in Zimbabwe and therefore the High court should have exercised jurisdiction. Arguably, if opinion has been sought from English legal counsel, it is likely that the parties would have been informed that the High court of Justice in London applied the *forum non conveniens* principle.

In addition to the above, Gowora J. should have considered the issue of choice of law and jurisdiction separately. Her treatment of the issues was cursory at best. Choice of law and choice of forum are two distinct concepts, although in practice they are usually linked.⁵⁸⁴ It is open to the High court of Zimbabwe, as appears below, to hold that despite the foreign jurisdiction clause, it would exercise jurisdiction over the matter, but apply the foreign law chosen by the parties. The High court can so hold because it is a court of inherent jurisdiction, with power to regulate its own proceedings and judgments. Further, Gowora J. should not have refused to exercise jurisdiction. Instead, if she wanted to hold the parties to the choice of forum provision

⁵⁸³ Contracts *c.f.i.* are contracts of sale where the purchaser has paid for the cost of the assets bought, as well as the cost of freight and insurance.

⁵⁸⁴ See for instance the dictum of Pillay D.J in the case of *Parry v Astral Operations Ltd*, in which the honourable Judge held that: “The parties interlinked their submissions on jurisdiction and the choice of law and cited case law that overlaps both issues. There is a tendency to conflate the two, mainly because both involve a process of identifying connecting factors. However, the connecting factors relevant to each are quite different. The fact that foreign law is involved is irrelevant to the issue of jurisdiction. Logically, jurisdiction is determined before the law applicable to the issue in dispute.” *Parry* (note 579, *supra*).

in the bill of lading, she should have stayed the proceedings before her, pending the initiation of proceedings in London.

The ousting of the High court's jurisdiction in circumstances such as those in *Colour Fast Textiles Limited* is yet to be properly and fully argued before the High court, with appropriate authority being brought to the attention of the court.⁵⁸⁵ It is highly unlikely that the High court of Zimbabwe will - in a similar and appropriately considered case - uphold an objection to its exercise of jurisdiction where the only factor connecting the dispute to the foreign jurisdiction is the provision in the parties' contractual agreement, and most or all other factors point to the High court of Zimbabwe being the appropriate forum to resolve the contractual dispute. This would be especially true if Zimbabwe is the place where the contract was entered into, the place of performance, the parties' domicile and residency, place where the parties' business is carried out, etc.

The above analysis illustrates that if parties to a securitization contract have chosen a foreign jurisdiction to adjudicate over their contractual disputes, such an agreement, will, as a general rule be upheld and enforced in Zimbabwe. However, jurisprudence on the issue remains underdeveloped.

8.5.2. Choice of law

In Zimbabwe, parties to securitization contracts may agree to have their contractual relationships governed by a foreign law in place of the *lex fori*. The receivables contract, the trust relationships as determined by the trust deed, the contracts entered into between an SPV, credit and liquidity enhancers as well as other participants such as underwriters and servicers are all examples of contracts where the

⁵⁸⁵ In the *Colourfast* case Gowora J. complains that the lawyers representing the parties had not provided the court with appropriate authorities for their arguments. *Colour Fast Textile* (note 580, *supra*) at p. 2.

parties may choose a foreign law to govern their relationships. There are myriad reasons why parties may choose a foreign law over the *lex fori*. The contract in question may be international in nature, or the parties may prefer the outcome that results from the application of a particular foreign law, or the parties may be of the view that the chosen law is more certain or has been tested before the relevant courts or tribunals and its parameters are well known in the jurisdiction in question.

8.5.2.1. Choice of law identified

Under Roman-Dutch law, if parties to a contract have expressly chosen a foreign law over the *lex fori* to govern their contractual relationship, their agreement will, as a general rule, be upheld and enforced.⁵⁸⁶ If one of the parties to the contract contests the use of the foreign law in question, the court will then proceed to determine the proper law of the contract, or the legal system to which the contract has the closest or most real connection.⁵⁸⁷ The court will also consider whether there are statutory and/or public policy reasons precluding the resolution of the dispute using the particular foreign law.

In assessing the proper law of the contract, where this is in dispute, despite an apparent choice of law having been made by the contracting parties, the court will analyse all the factors relevant to the dispute including the *locus contractus*, the *locus solutionis*, the domicile and the nationality of the parties, among other factors.⁵⁸⁸ This is the law and practice that will be followed in Zimbabwe. The Zimbabwean case of *Colour Fast Textiles Limited* cited and criticised above, should be disregarded as bad law. Persuasive alternative *dicta* can be found in the South African cases of (1) *Parry v Astral Operations Ltd*; (2) *Kleinhans v Parmalat S.A. (Pty) Ltd*, and *Forsyth and*

⁵⁸⁶ *Ekkehard Creutzburg and Another v Commercial Bank of Namibia Ltd*. [2004] ZASCA 117.

⁵⁸⁷ W.A. Joubert (2004) *The Law of South Africa*, LexisNexis Butterworths, Durban, South Africa.

⁵⁸⁸ Forsyth (1996) (note 577, *supra*) at p. 288.

Joubert's publications cited above.⁵⁸⁹ In addition, in Zimbabwe, where choice of law disputes arise, reference should be made, as appropriate since Zimbabwe is not a signatory, to the Rome Convention on the Law Applicable to Contractual Obligations.

Another principle of Roman-Dutch common law is that a choice of law provision in a contract will be given effect to subject to the country's mandatory rules, which the parties cannot contract out of. These include for instance public policy considerations as contained in the Consumer Contracts Act, Contractual Penalties Act,⁵⁹⁰ and other relevant statutes. In other words, the High court is more likely than not, to refuse to use a foreign law to govern a contractual relationship where use of that foreign law would lead to the violation of a right that is publicly protected in Zimbabwe. On this principle, reference can be made to South African cases where labour laws were held to be mandatory domestic laws that parties could not contract out of.⁵⁹¹

Case-law also establishes that where parties allege that a particular foreign law governs their contractual relationship, the parties must provide the law in question. In the South African case of *Parry v Astral Operations Ltd*, Pillay D, J. stated that: “[a] foreign law must be proved by evidence. It is a question of fact not of law. The court may take judicial notice of the foreign law if the sources are unimpeachably accurate and authoritative. A printout from a website on the Internet is not, without more, such a reliable source.”⁵⁹²

⁵⁸⁹ *Kleinhans v Parmalat S.A. (Pty) Ltd* [2002] ZALC 57.

⁵⁹⁰ Contractual Penalties Act [Chap 8:04].

⁵⁹¹ Refer for instance to the case of *Parry v Astral Operations Ltd* [2005] ZALC 15.

⁵⁹² *Parry* (note 579, *supra*), at paragraph 35.

8.5.2.2. Choice of law not identified

Where parties to a contract have not expressly stipulated a law of a particular jurisdiction to govern their contractual relationship, and where the issue arises, a court will, as a general rule, utilise private international law conflict of law principles to identify the proper law of the contract. In cases where there is no international component to a contract and where the offer and acceptance were made in Zimbabwe; where the contract is to be performed in Zimbabwe, by parties based in Zimbabwe, Zimbabwe's common and statute laws will, as a general rule, apply.

Where however, there is an international component, or one party contends that the parties intended that a foreign law apply to their contractual arrangements, reference will, as a general rule, be made to Roman-Dutch jurisprudence and rules of private international law to determine the proper law of the contract. Given Zimbabwe's Roman-Dutch common law background, almost all of the relevant, albeit scant literature, available on this subject is drawn from South African precedent and commentators. It is now relatively well-established, although it was initially a source of some contention, that in the absence of contractual parties electing the law of a particular jurisdiction, the court before whom the parties are appearing will seek to identify the proper law of the contract, which is the law with which the contract has the closest and most real connection. The South African *locus classicus* on this subject - *Standard Bank of SA Ltd v Efroiken and Newman*⁵⁹³ - framed the enquiry as an attempt to find the presumed intention of the contracting parties with regards the law to govern their contractual relationship. In practice this test has largely been discarded in favour of one that is more in line with the dictates of the Rome Convention on the Law Applicable to Contractual Obligations (1980) and

⁵⁹³ Standard Bank of SA Ltd v Efroiken and Newman 1924 AD 171.

international practice.⁵⁹⁴ It is now generally accepted that the test to be used in conflict of laws enquiry is one that seeks to identify the legal system with which the contract has the closest and most real connection. Given the trend in South Africa and the fact that the reformulated test is consistent with the test contained in clause 4 of the Rome Convention, current South African jurisprudence is more likely to commend itself to courts in Zimbabwe. The process of identifying the proper law of the contract, i.e. the legal system with which the contract has the closest and most real connection, involves taking into consideration a myriad of factors. A commentator has correctly held, and this study contends, that a combination of the following factors, drawn from South African case-law, should as appropriate, be taken into account when considering choice of law in contractual disputes arising in Zimbabwe: (i) the *locus solutionis* (the place of performance); (ii) the *locus contractus* (the place of conclusion of the contract); (iii) the place of offer; (iv) the place of acceptance; (v) the place of agreed arbitration; (vi) the domicile of the parties; (vii) the place where the parties carry on business; (viii) the domicile of the agents of the parties; (ix) the future domicile of the parties; (x) the habitual residence of the parties; (xi) the nationality of the parties; (xii) the form, terminology and language of the contract; (xiii) the *locus rei sitae* (the place where the property is situated); (xiv) the *locus libri siti* (the place where the property is registered); (xv) the *locus expeditionis* (the place of despatch); (xvi) the *locus destinationis* (the place of destination) (xvii) the place of registration of the vehicle (means of conveyance) by which the *res vendita* is transferred; (xviii) the

⁵⁹⁴ ⁵⁹⁴ See for instance Laconian Maritime Enterprises Ltd v Agromar Lineas Ltd 1986 3 SA 509 (D) 526D-H and 530H-I; and Improvair (Cape) (Pty) Ltd v Etablissements Neu 1983 2 SA 138 (C) 146H-147B. See also instance article 4 of the Rome Convention on the law applicable to contractual obligations (1980), which refers to the law with which the contract is most closely connected.

currency in which the contractual obligation of payment is expressed; (xix) the incorporation of a statute in the contract.⁵⁹⁵

Needless to say, each case would need to be decided on its facts and the weight to be given to each or a combination of factors will depend on the circumstances prevailing in each case. In the case of *Kleinhans v Parmalat S.A. (Pty) Ltd*, Pillay D, J. aptly noted that: "...in assigning the proper law of the contract, there is no clear conflict rule which can mechanically be applied to yield a certain answer. A coterie of connecting factors, including the *locus contractus*, the *locus solutionis*, the domicile and the nationality of the parties clamour for attention."⁵⁹⁶ In addition, procedurally and consistent with the established legal principle that "he who asserts must prove," the party contending that a particular rule of law applies bears the onus of establishing on a balance of probabilities that the foreign law in question is the proper law of the contract.⁵⁹⁷ Further, it is arguable that the rule of private international law to be applied in Zimbabwe pertaining to the procedural laws to be applied to a contractual dispute governed by a foreign law will be the same as the rule applied in South Africa. In South Africa, the general rule is that the *lex loci contractus*, i.e. the law of the place where the contract was entered into, determines the formalities of a contract. This is the same rule as applies under English rules of private international law.⁵⁹⁸

⁵⁹⁵ These factors are drawn from Forsyth and the following line of South African cases: (i) *Standard Bank of SA Ltd v Efroiken and Newman* 1924 AD 171. (ii) *Guggenheim v Rosenbaum* (2) 1961 4 SA 21; (iii) *Laconian Maritime Enterprises Ltd v Agromar Lineas Ltd* 1986 3 SA 509 (D) 526D-H 530H-I; (iv) *Benidai Trading Co Ltd v Gouws & Gouws (Pty) Ltd* 1977 3 SA 1020; (v) *Ex Parte Spinazze* 1985 3 SA 633 (A) 665H; (vi) *Stretton v Union Steamship Company Ltd* (1881) 1 EDC 315 (vii) *Collisons (SW) Ltd v Kruger* 1923 PH A 78 (SWA); (vii) *Improvair (Cape)(Pty) Ltd v Etablissements Neu* 1983 2 SA 138 (C) 146H-147B.

⁵⁹⁶ *Kleinhans v Parmalat S.A. (Pty) Ltd* [2002] ZALC 57, at paragraph 20.

⁵⁹⁷ This is the same position in South Africa. Refer to the case of *Hay Management Consultants (Pty) Limited v P3 Management Consultants (Pty) Ltd* (439/2003) [2004 ZASCA 116].

⁵⁹⁸ *Creuzburg and Another v Commercial Bank of Namibia Ltd* (29/04) [2004] ZASCA 117 at paragraph 10. See also *Ex parte Spinazze and Another NNO* 1985 (3) 633 (A) at 665 B-C. In the case of *Society of Lolyd's v Price*, it was held that: "according to principles of South African private international law, matters of procedure are governed by the domestic law of the country in which the relevant proceedings are instituted (the *lex fori*). Matters of substance are, however, governed by the

There is a dearth of Zimbabwe-specific legal material on conflict of law pertaining to commercial contracts. This is a disadvantage. However, as noted above, given that the roots of Zimbabwe's common law are largely Roman-Dutch, reference has always been and should be made to South African academic commentary and *stare decisis*, as persuasive opinion. Guidance on how courts in Zimbabwe are likely to approach conflict of law cases with a private international law dimension can be safely gleaned from South African jurisprudence. It is suggested that policy makers in Zimbabwe should give consideration to ratifying and incorporating into Zimbabwean law aspects of the Rome Convention on the Law Applicable to Contractual Obligations (1980). Further, given the paucity of Zimbabwe-specific legal material, transactional counsel engaged in securitization transactions structured in Zimbabwe needs to ensure that contractual agreements contain clear and unambiguous choice of law and dispute resolution clauses.

8.6. Summary

In summary, this chapter concludes that Zimbabwe possesses a civil justice system which can be harnessed to resolve disputes that can arise from securitization transactions. The High court of Zimbabwe is the court that has jurisdiction over most disputes which can arise from securitization transactions. Zimbabwe also possesses an established arbitration legal framework, which can be utilized by parties to securitization transactions. As a general rule, the law regards arbitral awards as final and they can be set aside only on extremely limited grounds. This is obviously an attractive characteristic for participants of securitization transactions who may prefer this private form of dispute resolution, which is expeditious, equitable, and cost-

law which applies to the underlying transaction or occurrence (the proper law or *lex causae*). The same rule applies in English private international law.

effective. The chapter also analysed the law on choice of law and forum, which are typical of commercial contracts. This study recommends that policymakers should consider ratifying the Rome Convention on the law Applicable to Contracts (1980). On the whole, the identified weaknesses notwithstanding, this chapter concludes that Zimbabwe has a generally adequate civil judicial system which enables the resolution of disputes that typically arise in relation to securitization transactions.

CHAPTER 9

FINANCIAL MARKETS REGULATORY FRAMEWORK

9.1. Introduction

This chapter analyses the extent to which laws underpinning Zimbabwe's financial services regulatory framework enable the effective management of risks that can arise from securitization. Zimbabwe's financial services regulatory framework is composed of the Reserve Bank of Zimbabwe (RBZ), the Insurance and Pensions Commission (IPC), and the Securities Commission (SC). As illustrated by the 2007 global financial crisis, securitization is not a risk-free. For this reason, emerging markets' legal infrastructure must - in addition to enabling securitization - enable the prevention and management of securitization transaction risks. The chapter concludes that Zimbabwe's hybrid - functional/institutional - financial markets regulatory framework:⁵⁹⁹ (i) is rudimentary and should be reformed to enable the three regulatory agencies to contribute to the mitigation of securitization transaction risk; and (ii) owing to its underdeveloped state it is inadvisable for firms, in the absence of regulatory reform, for a full blown securitization market to propagate. It also argues for the extant regulatory system to be reconstituted into an integrated regulatory system.

⁵⁹⁹ In this thesis the words regulatory and supervisory are used interchangeably to refer both to rule-making (regulation) and the application of those rules (supervision). For a discussion on the different types of financial services regulatory models, refer below to section 9.5.

9.2. Reserve Bank of Zimbabwe

The RBZ is established pursuant to the Reserve Bank of Zimbabwe Act.⁶⁰⁰ It administers: (i) the Banking Act which regulates banking institutions; (ii) the Building Societies Act which regulates building societies; (iii) the Troubled Financial Institutions (Resolutions) Act (TFIR Act), - used to resolve banking, building society and other money-lending financial institutions deemed to be troubled and whose collapse can threaten financial stability; (iv) the Moneylending and Rates of Interest Act (MRI Act) which regulates firms involved in the business of money-lending; (v) the Asset Management Companies Act (AMC Act) which regulates the operations of asset management companies in Zimbabwe; and (vi) the Collective Investment Schemes Act (CIS Act) which regulates the operations of collective investment schemes.

The RBZ was created in 1956 and is headed by a Governor who chairs the board of directors.⁶⁰¹ It has four deputy governors, who are engaged for five-year terms.⁶⁰² The RBZ has limited real independence, as it is obliged to comply with directives and other prescriptions issued by the government through the Minister of Finance.⁶⁰³ Among other core responsibilities, the RBZ is responsible for supervising banking institutions and for fostering the liquidity, solvency, stability and proper functioning of Zimbabwe's financial system.⁶⁰⁴ This section addresses the question: to what extent do the legal enactments administered by, or relating to, the RBZ enable it to prevent and manage risks that can arise when regulated financial institutions engage in securitization transactions?

⁶⁰⁰ Reserve Bank of Zimbabwe Act [Chap 22:15].

⁶⁰¹ Ibid., at section 14.

⁶⁰² Ibid., at section 15.

⁶⁰³ Ibid., at section 8.

⁶⁰⁴ For a full restatement of the functions and powers of the RBZ refer to section 6 and 7 of the RBZ Act respectively.

9.2.1. Context

As discussed in chapter 2, the global financial crisis and the case of the U.S., clearly illustrate the risks that can arise when regulators fail to effectively regulate banking and other financial conglomerates' involvement in securitization transactions. Securitization enabled banking and other firms to change their capital models from the originate-to-hold model to the originate-to-distribute model. This securitization-enabled capital structure reduced regulatory capital costs, increased liquidity, enhanced profits and consequentially remuneration for financial executives. However, conversely, there was an increase in moral hazard, representing banking corporate-governance and risk-management failures.

Banking regulators failed to effectively regulate the securitization process leading to increased fraud,⁶⁰⁵ predatory lending and other unfair consumer practices.⁶⁰⁶ In the period leading up to the 2007 global financial crisis, there was an overall increase in subprime mortgage lending and issuance of subprime mortgage-backed securities,⁶⁰⁷ including complex, difficult to price CDO securities. The period also witnessed the increased origination and use of derivative instruments, including unregulated credit default swaps (CDS). The increase in subprime mortgages was enabled in part by the poor prudential regulation of loan origination and underwriting standards.⁶⁰⁸

Banking regulators also failed to effectively regulate the banking sector's risk management practices.⁶⁰⁹ Banking regulators and investors over-relied on CRA opinions to determine the risk profiles of financial assets, including for regulatory

⁶⁰⁵ Gorton (note 131, supra), at p. 73.

⁶⁰⁶ Tashman (note 136, supra) at p. 410.

⁶⁰⁷ See generally Yuliya S. Demyanyk and Otto Van Hemert (2008) 'Understanding the Subprime Mortgage Crisis', (December 5, 2008). Available at <http://ssrn.com/abstract=1020396>

⁶⁰⁸ Commentators such as argue that the U.S. Community Reinvestment Act, which encouraged banks to lend to marginalised communities, who previously had been unable to access credit, encouraged the growth of the subprime mortgages market. See for instance Tarr (2009) (note 135, supra).

⁶⁰⁹ United States Department of the Treasury (2009) 'Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation', at p. 5. Available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

capital purposes.⁶¹⁰ This had catastrophic consequences. Following the onset of the global financial crisis, it became clear that some structured finance securities, especially subprime mortgage backed securities, had been grossly mispriced by CRAs.⁶¹¹ This adversely affected the liquidity of assets (some of which had triple-A ratings) held on bank balance-sheets, resulting in massive losses as they sold their assets at fire-sale prices, or re-valued them at mark-to-market prices;⁶¹² which eroded their capital bases and impaired their refinancing abilities.⁶¹³

Regulators also failed to prevent financial institutions from being exposed to high asset concentration risk and other risk exposures.⁶¹⁴ This resulted in banking institutions' prescribed capital and liquidity prescriptions failing to prevent bank insolvencies, necessitating public bailouts to prevent systemic meltdown. In 2009, the U.S. Treasury lamented: "Regulators did not require firms to hold sufficient capital to cover trading assets, high-risk loans, and off-balance sheet commitments, or to hold increased capital during good times to prepare for bad times. Regulators did not require firms to plan for a scenario in which the availability of liquidity was sharply curtailed."⁶¹⁵ The loss of confidence in structured finance securities as a class, following the bursting of the U.S. housing bubble shut down the interbank market as banks - fearing counterparty risk - refused to lend to each other.⁶¹⁶ Banks started

⁶¹⁰ Ibid., at p.46.

⁶¹¹ John P. Hunt (2009) 'Credit Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement'. Columbia Business Law Review, Vol. 2009, No. 1, at pp. 10-12. Available at <http://ssrn.com/abstract=1267625>

⁶¹² For a discussion of fair-value accounting and the impact on asset values following the onset of the global financial crisis, see John P. Hunt (2009) 'One Cheer for Credit Rating Agencies: How the Mark-to-Market Accounting Debate Highlights the Case for Rating-Dependent Regulation', South Carolina Law Review, Vol. 60, 2009. Available at <http://ssrn.com/abstract=1331633>

⁶¹³ Andrew W. Lo (2008) 'Regulatory Reform in the Wake of the Financial Crisis of 2007-2008', at p.14. Available at <http://ssrn.com/abstract=1398207>

⁶¹⁴ United States Department of the Treasury (2009) (note 609, supra) at p. 5.

⁶¹⁵ Ibid.

⁶¹⁶ International Monetary Fund (2008) 'Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness', at p. 55. Available at www.imf.org/external/pubs/ft/gfsr/2008/01/index.htm

hoarding cash as they intensified their recapitalisation efforts, compounding the global recession.

In aggregate, these and other regulatory failures by banking (and securities and insurance) regulators contributed to the credit crisis. Given this context it is axiomatic that an emerging market intending to propagate a securitization-enabling infrastructure must ensure that the legal framework underpinning its banking regulatory system enable the prevention and management of risks that can arise from banking institutions' involvement in securitization transactions either as originators, providers of securitization transaction services or as investors in issued structured finance securities. The following sections analyse whether the RBZ has power to mitigate risks that can be spawned when regulated banking institutions engage in securitization transactions. The phrase banking institutions is used in a general sense, unless stated otherwise, to refer to commercial banks, investment banks, discount houses, finance houses and building societies.

9.2.2. RBZ's regulatory jurisdiction

A fragmented financial services regulatory system – as opposed to an integrated one – is vulnerable to regulatory arbitrage, enabling financial institutions to escape the strictures of regulation, as illustrated by the U.S.⁶¹⁷ To prevent regulatory arbitrage and gaps, it is arguably better to have all banking, building society and other deposit

⁶¹⁷ United States Department of the Treasury (2009) (note 609, supra) at p. 5. The U.S. has a fragmented financial services regulatory model. See below at section 9.5. For an illustrative article on the problem of regulatory arbitrage in banking see Shasha Dai (2009) 'The Ugly Spectre of Regulatory Arbitrage in Bank Deals', *Wall Street Journal* (20 May 2009). Available at <http://blogs.wsj.com/privateequity/2009/05/20/the-ugly-spectre-of-regulatory-arbitrage-in-bank-deals/> See also Cormick Grimshaw (2009) 'Bank Regulatory Arbitrage and Deregulation: the Number of Bank Regulators Matters'. Available at <http://marketpipeline.blogspot.com/2009/06/bank-regulatory-arbitrage-and.html>

taking institutions effectively regulated by one agency.⁶¹⁸ As a general principle, in Zimbabwe, the RBZ regulates banking, building society, asset management and money-lending firms, as well as collective investment schemes. As noted in chapter 4, section 4 of the Banking Act stipulates that commercial banks, investment banks, merchant banks, discount houses, finance houses are regulated and supervised by the RBZ through a Registrar of Banking Institutions. The regulatory jurisdiction of the RBZ over banking institutions is relatively straightforward, but its regulatory jurisdiction over building societies and banking institutions created by an Act of parliament, such as the POSB is subject to caveats, as appears below.

9.2.2.1. Building societies and the POSB

The RBZ regulates the POSB, which as noted in chapter 4 above, is a banking institution created by an Act of parliament. The RBZ regulates the operations of the POSB only because the Minister of Finance used his discretion per section 3 of the RBZ Act to delegate his regulatory and supervisory authority to the RBZ. This authority can be withdrawn or amended by the Minister of Finance at his discretion.⁶¹⁹ But for this delegation, it is notable that the primary regulatory authority over the POSB is the Minister of Finance. The RBZ also regulates building societies in Zimbabwe. Similar to the situation with the POSB, the RBZ exercises regulatory authority over building societies by virtue of a ministerial delegation. But for this

⁶¹⁸ This is an argument that is made by the U.S. Treasury to redress the problem of regulatory arbitrage that afflicts the fragmented U.S. regulatory system. United States Department of the Treasury (2009) (note 611, supra), at p. 5.

⁶¹⁹ Section 3 of the RBZ states: “(1) The Minister may, by notice in the Gazette, direct that all or any of the provisions of this Act relating to banking institutions shall apply, with such modifications and subject to such terms and conditions as he may specify in the notice, to (a) all building societies established in terms of the Building Societies Act [Chapter 24:02] or any particular such building society or class of such building societies; (b) the Peoples Own Savings Bank operating under the Peoples Own Savings Bank Act [Chapter 24:10]; and the provisions concerned shall apply accordingly, notwithstanding anything to the contrary in the Building Societies Act [Chapter 24:02] or the Post Office Savings Bank Act [Chapter 24:10]. (2) The Minister may at any time amend or revoke a direction in terms of subsection (1) or any term or condition thereof.” [Emphasis added].

delegation, the primary regulatory authority over building societies is the Minister of Finance.

This regulatory framework, which subjects the regulation by the RBZ of some banking and building society institutions to the political discretion of a Minister of Finance, is flawed. This should be rectified to ensure that all banking institutions, be they commercial banking institutions, investment banks, building societies, banks created by an Act of Parliament - such as the POSB, or any other money-lending entity are mandatorily regulated by one agency. In addition, such regulatory reform would ensure that any prudential guidelines prescribed by the RBZ to prevent or manage risks, including those associated with securitization, will be binding on all financial institutions undertaking banking, building society or other money-lending business in the country.

9.2.2.2. Mortgage brokers

The RBZ does not have jurisdiction to regulate or supervise the operations of mortgage brokers. A mortgage brokerage firm that is a wholly-owned subsidiary of a banking institution is regulated by the RBZ, pursuant to section 45 of the Banking Act, as an associate of a banking institution. But independent brokerage firms are not. This is a regulatory gap, which can be exploited to escape rules and regulations aimed at ensuring best practice loan origination and underwriting standards by financial institutions. As illustrated by the U.S. subprime crisis, this can lead to an important sector of the economy engaging in activities which potentially threaten financial stability. Because mortgage brokerage firms are not banks, it stands to reason that they must be regulated by a regulator such as an integrated financial services regulator, or at least supervised on a consolidated basis. As argued below in paragraph

9.5., this thesis argues for the establishment of an integrated regulatory agency such as the U.K.'s Financial Services Authority (FSA) or a twin-peaks model such as Australia's Prudential Regulation Agency and the Securities and Investments Commission.⁶²⁰

9.2.2.3. Asset management companies and Collective investment schemes

Zimbabwe has an odd regulatory arrangement for its asset management companies and collective investment schemes. Both are regulated by the RBZ. Section 5 of the AMC Act states that no person may carry on any asset management business without a registration certificate issued by the RBZ. Section 3 of the AMC Act defines the business of asset management as follows: "...a person carries on the business of asset management if he or she, on behalf of one or more clients, invests the property of such client or clients in any one or more of the following ways – (a) in the money market; (b) in a recognised stock exchange; or (c) by purchasing immovable property, motor vehicles or other valuable property for resale within any period of twelve months; with a view of securing a profit for such client..." [Emphasis added]

A collective investment scheme is defined in section 3 of the CIS Act as follows: "a collective scheme is an arrangement with respect to property of any description, the purpose or effect of which is to enable participants to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property, where - (a) the participants do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions in regard to its management; and (b) the arrangement has either or both the following characteristics - (i) the participants' contributions and the profits or

⁶²⁰ The two entities constitute the twin-peaks regulatory model.

income out of which payments are to be made are pooled; (ii) the property is managed as a whole.” Collective investment schemes relate to investments in securities on stock exchanges.

Clearly, collective investment schemes and asset management companies should be regulated by the SC because their main business is investment in securities on behalf of investors. This is a regulatory anomaly, which in practice is likely to lead to regulatory arbitrage and can possibly lead to some areas of these entities’ operations not being regulated at all by the RBZ, because the activities fall outside its regulatory jurisdiction or expertise. The CIS Act and the AMC Act were enacted in 2004 and 2001 respectively. This was before the enactment of the Securities Act, which became law in 2008, and by extension before the existence of the SC. Both the CIS and the AMC Act were promulgated during a period marked by unregulated financial activity, some of which threatened financial stability. These entities should be regulated by the SC and not the RBZ.

9.2.2.4. Consolidated supervision

The above notwithstanding, it is notable that in 2007 with the objective of ensuring overall financial market stability, the RBZ created a framework for the consolidated supervision of banking and non-banking entities. It promulgated RBZ Guideline No. 02-2007/BSD: Consolidated Supervision Policy Framework. The RBZ justified the issuance of the Guidelines on the need to mitigate systemic risk: a crucial consideration in an era of financial conglomerates and where securitization has in effect blurred the traditional finance areas of banking, insurance and securities

trading.⁶²¹ The Guideline enables the RBZ to indirectly supervise any financial conglomerate one of whose related entities is a regulated banking institution.⁶²² The RBZ promulgated the guidelines because there are financial conglomerates in Zimbabwe whose interests span the banking, insurance and securities markets.⁶²³ To an extent this framework can be harnessed to ensure overall financial market stability through the consolidated supervision of firms which are critical to the functioning of financial markets. Laudable though it is, this initiative suffers from a particularly serious weakness. The framework was created through guidelines issued by the RBZ and not through an Act of parliament. It is arguable that these guidelines do not carry sufficient legal authority required to give such consolidated supervision teeth to ensure compliance.

The legal status of RBZ-issued guidelines - within Zimbabwe's banking regulatory framework - is ambiguous. It is unclear if guidelines issued by the RBZ

⁶²¹ The RBZ Bank Supervision Guideline states: "1.5. Financial conglomerates bring with them a number of regulatory and supervisory concerns, including but not limited to abuse of economic power; agency problems; imprudent intra-group transactions and exposures; reputation risk; moral hazard; regulatory arbitrage; conflicts of interest; complex corporate structures; and potential for risk management difficulties. 1.6. In addition, the complexity in structure and size of many conglomerates heightens supervisory concerns in respect of contagion risk (within and between groups), and double / multiple gearing through intra-group holding of capital. 1.7. Consolidated Supervision, therefore, provides a methodology to assess and monitor how effectively a banking group identifies, measures, monitors and controls risk; to recognise incipient problems; and to keep abreast with global trends and current best practice in supervision." [Emphasis added]. Reserve Bank of Zimbabwe, Licensing, Supervision and Surveillance Guidelines No. 02-2007/BSD, at pp. 5-6.

⁶²² Clause 1.4 states: "the primary objective of Consolidated Supervision is not to supervise each and every entity in the group but to supervise the regulated entity as part of the group so as to take into account the potential impact of the various group entities on the banking institution".... In the preamble in clause 2 to 4 thereof, the Guidelines state: "2. The Banking Act [Chapter 24:20], in particular Section 45(1)(c), empowers the Reserve Bank of Zimbabwe to monitor, supervise and investigate associates of banking institutions, hence facilitate supervision of banking institutions on a consolidated basis. 3. This Guideline shall apply to every banking institution, bank holding company, financial conglomerate, mixed activity group, and their associates as defined in section 2 of the Banking Act [Chapter 24:20]. 4. For purposes of Consolidated Supervision, insurance companies shall be included in the consolidation to the extend of providing a qualitative assessment only but excluded with respect to Quantitative Consolidation of the banking group." Ibid., at p. 4.

⁶²³ Examples of such entities include Trust Holdings, Kingdom Financial Holdings, National Merchant Bank of Zimbabwe, Inter Market Financial Holdings. In its January 2009 Monetary Statement the RBZ Governor stated that some banking institutions engaged in regulatory arbitrage by using unregulated conduits to transact non-banking business activities. Reserve Bank of Zimbabwe (2009) 'Monetary Policy Statement', at paragraph 2.6.2. Available at <http://www.rbz.co.zw/pdfs/2009%20Julymps/mpsjul2009.pdf>

have the force of law or are mere instructions or directives. If the guidelines have the force of law, then they are of peremptory application and are binding on all regulated institutions. If on the other hand, they have the legal status of instructions or directives; it means they do not have the force of law; and that if they are breached, the errant banking institution is at liberty to challenge the lawfulness, or reasonability of the instruction or direction.

The sole authority with power under the Banking Act, the Building Societies Act, the AMC Act and the CIS Act to issue subsidiary legislation, which regulates aspects of regulated institutions' affairs, is not the RBZ, but the Minister of Finance. Section 81 of the Banking Act, section 75 of the Building Societies Act, and section 42 of the AMC Act all of which are similarly worded in the relevant parts state: "the Minister may make regulations providing for all matters which by this Act are required or permitted to be prescribed or which, in his opinion, are necessary or convenient to be prescribed for carrying out or giving effect to this Act."⁶²⁴ Section 31 of the Banking Act also states that the Minister of Finance may prescribe regulations providing, *inter alia*, for banking institutions' "assets, liabilities, credits, deposits and, generally, the conduct of their financial affairs."⁶²⁵ No legal provision in the Banking Act, the

⁶²⁴ Section 24 of the Asset Management Act [Chap 24:26] states: "The Minister may, after consultation with the Governor of the Reserve Bank, make regulations prescribing all matters which by this Act are required or permitted to be prescribed or which, in the opinion of the Minister, are necessary or convenient to be prescribed for carrying out or giving effect to this Act."

⁶²⁵ Section 31 of the Banking Act titled: "Prescription of further financial requirements" states: "(1) Subject to this Act, the Minister may, in regulations made under section eighty one, prescribe requirements to be complied with by all banking institutions in regard to their assets, liabilities, credits, deposits and, generally, the conduct of their financial affairs. (2) Regulations referred to in subsection (1) may provide for - (a) the ratios and exposures to be maintained by banking institutions, in regard to their assets, off-balance-sheet items and other categories of their capital base; (b) the aggregate amount of credits that banking institutions may have committed or outstanding at any time; (c) the maturity profile of assets and liabilities of banking institutions; (d) the minimum aggregate liquid resources to be maintained by banking institutions in relation to the value of their assets or their total liabilities to the public; (e) the maximum aggregate amount of credits and investments, or specific categories thereof, that may be made by banking institutions; (f) the classification and evaluation of assets of banking institutions, and provision to be made on the basis of such classification; (g) prohibiting or restricting the accounting of non-performing loans as income; (h) prohibiting, restricting or regulating - (i) the types or forms of credits and investments that may be made by banking institutions; (ii) the matching

Building Societies Act, the AMC Act, the CIS Act, or the RBZ Act extends similar powers to the RBZ.

In the guidelines, the RBZ states that they are issued pursuant to section 45(2)(c) of the Banking Act. Section 45(2)(c) states: “The Reserve Bank’s function of monitoring and supervising banking institutions and other companies may be exercised through all or any of the following methods - (a)... (b)... (c) any other lawful means the Reserve Bank thinks appropriate.”⁶²⁶ This provision does not give the RBZ subsidiary legislation making authority. Subsidiary-law making authority, being a delegation by parliament of its legislative powers, must be expressly stipulated. The power to enact law, including subsidiary law, cannot be implied. If legislative making authority could be implied from such a provision, it would mean that any regulatory, supervisory or administrative body that is given authority to use lawful means to achieve its prescribed objectives could similarly assume that it has subsidiary-law making authority,⁶²⁷ which would be perverse.

It is true that globally, central banks issue guidelines which bind regulated entities. On this account, section 45(2)(c) can be read to authorize the issuance of guidelines

by banking institutions of maturity and interest in respect of assets and liabilities; (iii) the maintaining by banking institutions of unhedged positions in foreign currencies, precious metals or precious stones; (i) terms and conditions applicable to any type or form of financing extended or received by banking institutions, including deposits and contingent liabilities. (2) Any banking institution that contravenes regulations referred to in subsection (1) shall be guilty of an offence.

⁶²⁶ In full, section 45(2)(c) of the Banking Act states: “The Reserve Bank’s function of monitoring and supervising banking institutions and other companies may be exercised through all or any of the following methods - (a) the analysis of documents and information supplied to it in terms of section thirty eight; (b) the inspection of documents and the obtaining of information at the premises of the banking institutions concerned, and the analysis of such documents and information; (c) any other lawful means the Reserve Bank thinks appropriate.”

⁶²⁷ See for instance the case of *Trust Insurance Brokers v The Minister of Finance and The Commissioner of Insurance*. The Minister of Finance who does have subsidiary law making power under the Insurance Act had prescribed regulations that imposed additional qualifications that individuals intending to register as insurance brokers needed to comply with. But the Insurance Act stated the qualifications that those intending to act as brokers had to possess. The applicant argued, successfully, that the Minister of Finance had exceeded his legislative authority. The court held: “subsidiary power must be construed strictly” and that the exercise of that subsidiary legislation making authority had to be clearly stipulated by statute. *Trust Insurance Brokers v The Minister of Finance and The Commissioner of Insurance* SC-6-2008.

by the RBZ because guidelines are instructions or directives and they do not have to be prescribed as subsidiary legislation. If correct, it follows that the RBZ can only issue guidelines on issues that have already been prescribed either by parliament or by the Minister of Finance. This means, if the RBZ issues guidelines on matters not covered, or envisaged, by an Act of Parliament or a statutory instrument, the guideline could be *ultra-vires* the Banking Act or the RBZ Act, whichever is applicable.

For legal certainty, this study recommends the amendment of the RBZ Act, the Banking Act and the Building Societies Act to give the RBZ clearer legal authority to prescribe regulations, which are of peremptory application. The RBZ should be accorded some - circumscribed - subsidiary-law making power. Such power would enable the RBZ to react swiftly to developments in the financial services sector - including in the securitization market - without the inefficiencies of reverting to the Minister of Finance or to parliament for remedial action. In addition, such legal reform would remove any doubts that the RBZ has power to issue guidelines dealing with, *inter alia*, consolidated supervision of financial institutions, banking institutions risk management systems including aspects relating to their assets, liabilities, credits, deposits and, generally, the conduct of their financial affairs.

9.2.3. RBZ's risk-management power

The tools at the disposal of the RBZ to prevent and manage risk are quite expansive, the above notwithstanding. Its power to prevent and manage risks, including risks that can be spawned by regulated entities engaging in securitization transactions, are contained in the Banking Act, the Reserve Bank Act, the Troubled Financial Institutions (Resolutions) Act and the various RBZ Guidelines. These enactments enable the RBZ to prevent and manage, or to prescribe guidelines that

enable it to prevent and manage some of the key risks that can arise from banking, building society and other money-lending institutions engaging in securitization transactions.

9.2.3.1. Risk management powers: In general

As noted above, the RBZ is responsible for supervising the operations of regulated banking institutions, their subsidiaries and holding companies.⁶²⁸ It has power to initiate investigations into the operations of, and impose administrative penalties on, regulated banking institutions.⁶²⁹ It can issue prescriptions relating to, and supervise banking institutions' risk management systems, capital reserves and solvency requirements. If a banking institution contravenes a term or condition of its registration, or a provision of the Banking Act, or a direction, requirement or order issued by the RBZ, as provided for under the Banking Act, the RBZ can: (i) issue a warning; (ii) require the banking institution to appoint a person, who in its opinion is able to advise the institution in the proper conduct of its business; (iii) issue written instructions requiring the institution to take remedial action; (iv) impose a monetary penalty; (v) instruct the institution to suspend or remove any of its directors, officers or employees; (vi) direct the institution to suspend all or part of its banking business; (vii) appoint a supervisor to monitor the institution's affairs; and (viii) impose a term

⁶²⁸ Section 45 of the Banking Act states: "Subject to this Act, the Reserve Bank shall be responsible for (a) continuously monitoring and supervising banking institutions and associates of banking institutions to ensure that they comply with this Act." The term associates of banking institutions is defined in section 2 to mean: "associate", in relation to a banking institution, means - (a) its subsidiary, as defined in section 143 of the Companies Act [Chapter 24:03]; or (b) any company of which the banking institution is the single largest shareholder; or (c) its holding company, as defined in section 143 of the Companies Act [Chapter 24:03]; or (d) where the banking institution is itself a subsidiary of a holding company, as defined in section 143 of the Companies Act [Chapter 24:03], any other such subsidiary of the same holding company; or (e) any person who has power, directly or indirectly, to control the banking institution's management or policies."

⁶²⁹ *Ibid.*, at section 49.

or condition on the institution's continued registration.⁶³⁰ It is also notable that the RBZ has started the gradual introduction of Basel II, which will assist with risk-mitigation,⁶³¹ although notably, it has been implicated as one of the drivers of the U.S. subprime crisis.⁶³² In addition and more importantly, in 2007, the RBZ issued securitization guidelines, which are binding on all regulated entities intending to take part in securitization transactions as originators, service providers and investors in securities.⁶³³

9.2.3.2. Deposit protection Fund

Zimbabwe has a deposit protection fund, whose primary objective is the prevention of bank runs, in the event of a contributory banking and building society

⁶³⁰ Ibid., at section 48. "(1) If, following a report by a supervisor and, where appropriate, after considering any representations made by the institution concerned in terms of subsection (2), the Reserve Bank is satisfied that a banking institution has contravened any term or condition of its registration or any provision of this Act or any direction, requirement or order made under this Act, the Reserve Bank may, subject to this section, do any one or more of the following - (a) issue a warning to the institution; (b) require the institution to appoint a person who, in the Reserve Bank's opinion, is qualified to advise the institution on the proper conduct of its business; (c) issue a written instruction to the institution to undertake remedial action specified in the instruction; (d) impose a monetary penalty not exceeding the equivalent of a fine of level ten a day for each day that the contravention has continued; (e) instruct the institution to suspend or remove any of its directors, officers or employees from his duties; (f) direct the institution to suspend all or any of its banking business; (g) appoint a supervisor to monitor the institution's affairs; (h) convene a meeting of the shareholders or other owners of the institution to discuss the remedial measures to be taken; (i) subject to Part X, place the institution under the management of a curator; (j) recommend to the Registrar - (i) the imposition of any term or condition on the institution's continued registration, or the deletion of any such term or condition; or (ii) the cancellation of the institution's registration."

⁶³¹ Regarding Basel II implementation, the RBZ Governor stated the following in his January 2009 Monetary Policy Statement: "Basel II Implementation ... 2.57 As Monetary Authorities, we wish to advise the banking sector that all banking institutions are required to fully adopt standardized approaches for allocation of capital for credit risk, market risk, and operational risk with effect from 6 February 2009. 2.58 Since 2006, the Reserve Bank embarked on a gradual implementation approach that allows for smooth transition to the new system. 2.59 Banking institutions operating in Zimbabwe are already required to allocate capital for market and operational risk using the standardized approaches. 2.60 Guideline No: 1-2009/BSB: "Technical Guidance on Basel II Implementation in Zimbabwe," will be issued in due course to provide a road-map and expert guidance on full Basel II implementation in the country." RBZ (2009) (note 623, supra) at paragraphs 2.57 – 2.60.

⁶³² For instance, Calomiris argues that: "Other longstanding criticisms have been that the chief pillars of Basel II – reliance on rating agencies opinions and reliance on internal models – have both been roundly discredited by the collapse of subprime." Calomiris (2008) (note 22, supra) at p. 72.

⁶³³ RBZ (2007) note 3, supra), at preface.

institution becoming insolvent.⁶³⁴ Although in practice there can be a myriad of reasons why a banking institution may become insolvent, the 2007 global financial crisis illustrated how the origination and issuance of mispriced structured finance products can impair a banking institution's solvency and result in bank-runs. In the U.K., Northern Rock's business model, which relied on the securitization-enabled originate-to-distribute model and the wholesale market, caused a run on the bank when news leaked that it had sought liquidity from the Bank of England following the hiatus in inter-bank lending; itself the result of a loss of confidence in structured finance products.⁶³⁵ To prevent a systemic run on banks, notwithstanding its deposit insurance scheme, the U.K. government was forced to guarantee all of Northern Rock's deposits and then injected capital into the bank and subsequently nationalised it.⁶³⁶

Zimbabwe's deposit protection fund is administered by the Deposit Protection Board (DPB), which is in effect an adjunct of the RBZ. The DPB was created pursuant to Part XII of the Banking Act. The DPB is composed of the RBZ Governor and three other persons appointed by the Governor of the RBZ from a list of 6 names submitted by an organisation that represents the majority of contributory institutions, i.e. the Bankers Association of Zimbabwe.⁶³⁷ The extent to which Zimbabwe's deposit protection fund can in practice prevent bank runs is yet to be tested. It is notable that the maximum amount guaranteed under the deposit protection scheme is

⁶³⁴ Section 66(3) states that the objective of the deposit protection fund is: "to compensate depositors for losses incurred by them in the event of the insolvency of a contributory institution."

⁶³⁵ For a full report on the events leading to the run on Northern Rock and its nationalisation refer to the House of Common Treasury Committee (2008) 'The Run on the Rock', Available at http://www.parliament.uk/parliamentary_committees/treasury_committee/runontherock.cfm

⁶³⁶ The Northern Rock plc Transfer Order 2008, Statutory Instrument No. 432, 2008. This statutory instrument was passed pursuant to the provisions of the Banking (Special Provisions) Act 2008.

⁶³⁷ Section 67 of the Banking Act.

set from time to time by the DPB.⁶³⁸ The deposit protection fund is available as one of several constituent elements of Zimbabwe's financial stability framework, which can be used to prevent and manage systemic risk that can arise from securitization transactions.

9.2.3.3. Troubled bank resolution framework

Following the onset of the global financial crisis, it became apparent, in the U.S. and the U.K., among other countries, that there was a need to put in place a framework for the efficient and effective resolution of insolvent financial institutions to prevent and manage systemic risk. In the U.K., the government promulgated in 2008, the Banking (Special provisions) Act, which granted the government temporary power to deal with failing banks. This was superseded by the Banking Act 2009. The Banking Act gives the government power to intervene, including by nationalising bank-holding companies and building societies where the failure of a deposit-taking institution within a group could cause a wider threat to financial stability.⁶³⁹ In addition, the U.K. government is drafting a new insolvency regime for financial firms whose collapse could threaten financial stability.⁶⁴⁰ The U.S. is mulling the formal establishment of a similar system, in which the Federal Reserve will be given more powers to ensure the orderly resolution of insolvent bank-holding companies or other non-bank entities whose collapse threatens overall financial stability.⁶⁴¹

⁶³⁸ Following the dollarization of the economy in February 2009, the DPB is yet to announce the maximum deposit amount insured.

⁶³⁹ U.K. HM Treasury (2009) 'Reforming Financial Markets', at p. 13. Available at www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf

⁶⁴⁰ *Ibid.*, at p.5. See also section 220 of the Banking Act 2009, which gives the government power to introduce – through secondary legislation – regulations providing for the special resolution of banking and building society institutions.

⁶⁴¹ United States Department of the Treasury (2009) (note 609, *supra*) at p. 76.

Owing to several bank failures in Zimbabwe in 2003-2004, the government promulgated the Troubled Financial Institutions (Resolution) Act (TFIR Act) to ensure the expeditious resolution of financial institutions in financial distress or which are insolvent with the objective of preventing threats to financial stability. The TFIR Act, unlike the framework proposed in the U.K. and U.S., applies only to firms regulated by the RBZ, i.e. banking institutions, building societies, the POSB, asset management companies and collective investment schemes.⁶⁴² It does not apply to other critical financial services firms, such as insurance firms. This is a shortcoming which should be rectified. In the U.S., the collapse of the insurance firm American Integrated Group (AIG) averted by the government through a bail-out - resulting in its effective nationalisation - illustrates the importance of non-banking financial firms whose failure can threaten financial stability.

The above notwithstanding, the RBZ can use the provisions of the TFIR Act to prevent or manage systemic risks that can arise in the event of a financial institution becoming insolvent or financially distressed. Section 4 of the TFIR Act empowers the RBZ to appoint an inspector to conduct an investigation into the affairs of a regulated entity if: (i) it is indebted and is unable to repay its indebtedness to the RBZ; (ii) will need to receive public funds in order to prevent systemic risk; (iii) has failed to comply or is unwilling to comply with any requirement relating to capital, reserves, assets, liabilities, credits or deposits; or (iv) is not conducting its business in accordance with sound administrative, accounting, corporate governance or risk management practices or procedures. Section 6 of the TFIR Act provides that if following an investigation, these failures are established, the RBZ will declare the affected institution to be a troubled financial institution and appoint an administrator.

⁶⁴² Section 2 of the TFIR Act.

Following a declaration - which is also binding on any associates of the regulated financial institution - and appointment of an administrator, management and control of the “troubled” financial institution is transferred to the administrator.⁶⁴³

A declaration that a regulated financial institution is a troubled financial institution has drastic implications. Such a declaration: (a) places the institution under the control and management of an administrator; (b) suspends the powers of every director, officer and member of the institution, except to the extent permitted by an administrator; (c) nullifies every disposition of property, including rights of action, of the institution and every transfer of shares or alteration in the status of its members, made after the commencement of the administration, unless the administrator otherwise orders; (d) suspends the operation of any set-off by the institution in respect of any amount owing by a creditor of the institution; (e) suspends all rights of action against the institution and every action or proceeding commenced against the institution except by leave of, and subject to terms imposed by, the administrator; (f) vacates any attachment or execution put in force against the assets of the institution after the commencement of the administration; (g) suspends any lien held by any financial institution or other person over the property of the institution except a lien held by the Reserve Bank or by a payment system recognised by the Reserve Bank in terms of section 3(1) of the National Payment Systems Act [Chapter 24:22].⁶⁴⁴

The TFIR Act provides that the object of administration is the safeguarding of the interests of depositors, creditors and members of the troubled financial institution by restoring the institution to a sound financial condition. If the institution cannot be restored to financial health, section 10 of the TFIR Act states that the administrator can: (a) reconstruct the institution through securing the registration of a successor

⁶⁴³ Ibid., at section 6(2).

⁶⁴⁴ Ibid., at section 7.

financial institution which will take over the troubled financial institution's assets and liabilities; (b) amalgamate the troubled financial institution or any part of its banking or other business with one or more other troubled financial institutions and secure the registration of a successor financial institution that will take over the assets, liabilities and banking or other business undertaken by the amalgamated financial institutions; (c) transfer all or any part of the banking or other business of the troubled financial institution to any other financial institution together with all or part of the assets and liabilities of the troubled financial institution which remain after the administration; (d) wind up the troubled financial institution in accordance with section 57 of the Banking Act, if any of the foregoing options are not, in the opinion of the administrator, feasible.

This thesis argues that these powers of the RBZ can - in general - and as argued below, be harnessed to mitigate key securitization transaction risks such as those highlighted by the 2007 global financial crisis, which include, *inter alia*, the abuse or over-reliance on the originate-to-distribute business model, poor regulation and supervision of banking risk management systems and poor corporate governance practices.

However, it is unclear whether the RBZ has the capacity to effectively regulate and supervise securitization transacting by regulated financial institutions. The comprehensive regulation and supervision of securitization requires adequate resources. The RBZ would need a sufficiently high number of specially qualified personnel - lawyers, actuaries, accountants, risk management specialists, etc. to administer the framework. The RBZ's enforcement unit would have to be adequately resourced, including with appropriate technology with which to identify and compute

risk factors and also be allowed to take wide-ranging enforcement actions against errant institutions or persons.

9.2.4. Prescription of securitization-transacting best practice

Does the RBZ have authority to prescribe and require regulated institutions to adhere to securitization transaction best practices? It is notable that in 2007, the RBZ promulgated securitization guidelines, RBZ Guideline No. 01-2007/BSD: Special Purpose Vehicles, Securitisation & Structured Finance. The Guideline provides that every regulated financial institution that seeks to engage in a securitization transaction as an originator, provider of securitization transaction services or as an investor in structured finance securities is obliged to adhere to the prescriptions in the Guideline.⁶⁴⁵ The Guideline stipulates, among others, the following risk management prescriptions: (i) corporate governance and risk management procedures that must be adhered to by regulated institutions taking part in securitization transactions;⁶⁴⁶ (ii) rules pertaining to the purchase and supply of financial assets to a securitization SPV;⁶⁴⁷ (iii) disclosure requirements and corporate governance prescriptions for SPVs;⁶⁴⁸ (iv) rules pertaining to credit and liquidity enhancement, servicing, underwriting and lending to SPVs;⁶⁴⁹ and (v) regulated banking institutions' capital requirements for securitization transactions that should either be based on the standardized approach or the internal ratings based-approach.⁶⁵⁰ The rules also

⁶⁴⁵ The RBZ securitization guideline states: "This Guideline applies to all banking and non-banking financial institutions that are registered and supervised by the Reserve Bank involved in SPVs, securitisation and structured finance transactions. Wherever the term "bank(s)" or "banking institution(s)" is used in the Guideline, it shall also be read to include non-bank financial institutions that are registered and supervised by the Reserve Bank, including Bank Holding Companies." RBZ (2007) (note 3, supra), at clause III.

⁶⁴⁶ Ibid., section 2.

⁶⁴⁷ Ibid., section 5.

⁶⁴⁸ Ibid., section 3.

⁶⁴⁹ Ibid., section 6 and 7.

⁶⁵⁰ Ibid., section 8.

prescribe penalties for non-compliance. In addition to the securitization guideline, the RBZ has promulgated separate corporate governance guidelines for financial institutions,⁶⁵¹ established a framework for the registration and conduct of CRAs intending to rate securities issued by banking institutions⁶⁵² and risk management guidelines.⁶⁵³ These guidelines and applicable statutory instruments can be harnessed to provide for the prudential regulation and supervision of banking and other institutions' involvement in securitization. These guidelines do prescribe some securitization transaction best practice rules, and can be amended to provide for evolving risk management situations.

9.2.5. Originate-to-distribute business model

The securitization-enabled originate-to-distribute business model revolutionized the financial services sector in general and in particular the banking sector and other loan-providing firms. As noted in chapter 2, it enabled banking institutions to: (i) reduce regulatory capital costs; (ii) create liquidity from otherwise illiquid assets; (iii) specialise in various intermediation roles; (iv) access relatively cheaper finance; and (v) enabled - for some firms - rapid business expansion. But conversely the originate-to-distribute model induced and increased moral hazard, fuelled the misalignment of incentives and resulted in banking institutions being exposed to new risks that could not necessarily be mitigated by traditional risk management methods. The originate-to-distribute business model increased systemic risks through the combination of increased: (i) origination of complex and difficult to price securities; (ii) counter-party credit exposures; and (iii) over-reliance for liquidity on wholesale markets. Many U.S. and U.K. financial institutions, including the likes of Northern Rock in the U.K. and

⁶⁵¹ RBZ (2004) (note 254, supra).

⁶⁵² Reserve Bank of Zimbabwe: Guideline No. 04- 2006/BSD Accreditation of Credit Rating Agencies.

⁶⁵³ Reserve Bank of Zimbabwe: Guideline No. 01- 2006/BSD Risk Management Guidelines.

Countrywide Financial and Wachovia Corporation in the U.S. used the liquidity creating attributes of securitization and the originate-to-distribute business model to aggressively expand and maintain their market shares. These institutions failed following the collapse of confidence in structured finance products, which resulted in the freezing of wholesale markets, and with it, their primary source of funding.

The over-reliance by financial firms on the originate-to-distribute business model is a reflection of the poor regulation and supervision of - in particular - banking institutions' prudential risk management systems. Both in the U.S. as well as in the U.K., banking regulators failed to set and supervise appropriate risk management policies and practices. As a result, extreme capital structures such as those employed by the likes of Northern Rock and Countrywide emerged. This over-reliance on the originate-to-distribute business model by banking and other financial institutions has been singled out as one of the key drivers of the global financial crisis.⁶⁵⁴ Does the RBZ have power to prevent such over-reliance - with systemic risk implications - on the originate-to-distribute business model by regulated financial institutions?

No banking institution in Zimbabwe utilizes an originate-to-distribute business model because securitization is yet to propagate and the secondary market for instruments backed by financial receivables is shallow. For this reason, the RBZ's guidelines on risk-based supervision - RBZ: Bank Licensing, Supervision and Surveillance (Risk-based Supervision Policy Framework): Guideline No. 2 - 2006/BSD - do not address such banking capital structures. To reduce moral hazard that can be spawned by financial firms' usage of the originate-to-distribute business model, the RBZ should prescribe regulations which, *inter alia*, require originating

⁶⁵⁴ Gorton (2008) (note 132, *supra*) at p. 68.

firms to maintain skin in the game, i.e. to retain a prescribed interest (risk) in the assets to be securitized.⁶⁵⁵

9.2.6. Loan origination standards and practices

Some financial institutions took advantage of the credit risk transfer characteristics of securitization to originate and underwrite subprime loans, which were later offloaded onto domestic and international financial markets in the form of CDOs and other complex securities. This is especially true of the U.S., where financial executives, arguably spurred by the quest for higher bonuses and profits, increased the origination of subprime loans from the 1990s onwards. Increased subprime loan issuance was fuelled by the combination of: (i) the securitization-enabled originate-to-distribute model; (ii) credit risk mispricing by CRAs - which suffered from severe conflicts of interests - and insurance firms; (iii) a voracious appetite for high yield (and by extension high risk) structured finance securities by investors, including prudentially regulated institutional investors; (iv) overall poor due diligence by both retail and wholesale securities investors; and (v) the deregulation of the financial services sector. Subprime loan origination was an obviously profitable business line for both banking and non-banking financial entities, including mortgage brokers. Securitization and low interest-rate wholesale funding enabled the entry into the loan-origination market of lightly capitalised and highly leveraged entities, some of which were poorly regulated. The growth of subprime loan origination, underwriting and securities issuance also resulted in increased loan fraud and predator lending.

⁶⁵⁵ The EU proposed that originating firms should be required to retain 5% of the risk to be securitized. U.K. HM Treasury (2009) (note 609, supra) at p. 10. Arguably however, a 5% peremptory risk retention may not, in all cases, be sufficient to counter moral hazard and incentive misalignment.

In the U.S., regulators were aware for more than a decade that subprime loan origination and underwriting and the issuance of securities backed by these assets carried significant systemic risks. It was for this reason that the Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller and the Office of Thrift Supervision issued interagency guidelines on subprime lending in 1999. The guidelines noted the higher risks inherent in subprime loan origination and underwriting, and prescribed risk management guidelines.⁶⁵⁶ Does the RBZ have power to prevent a race to the bottom, i.e. the erosion of loan origination and underwriting standards that can arise - largely due to moral hazard with systemic risk implications - from the securitization by regulated institutions of financial receivables?

The RBZ has not promulgated guidelines or regulations that deal with loan origination standards and practices. Although arguable, it is myopic to argue that issues of loan origination and underwriting standards, including issues of predatory lending and fraud are matters of consumer protection, and therefore should not be of primary concern to a central bank; and that these are best regulated and enforced by a consumer protection watchdog. Poor loan origination and underwriting standards by banking institutions can threaten financial stability. And in today's interconnected financial markets, such poor risk management practices and policies can threaten the stability of global financial markets. The transfer of risks inherent in poorly originated or underwritten loans from one entity into the entire financial system, through credit risk transmission arrangements inherent in securitization increases overall systemic risks. It is this realisation that caused the federal banking agencies in the U.S., as far back as 1999 to issue guidelines on the origination and underwriting of subprime

⁶⁵⁶ The Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (March 1999) Interagency Guidance on Subprime Lending.

loans. And the 2007 global crisis has exposed the systemic risks inherent in such financial assets.

The RBZ should introduce a framework - through guidelines or preferably peremptory regulations - that regulates loan origination and underwriting standards to ensure macro financial stability. In its absence, there is a real risk that financial firms may, through the use of the securitization-enabled originate-to-distribute business model, erode loan origination and underwriting standards; spurred by profit-seeking.

9.2.7. Investment in structured finance securities

One of the touted benefits of securitization is that it results in the reduction of risk as it is diffused through various market participants - i.e. from banking and other loan-originating firms to insurance and underwriting firms, and retail and wholesale investors with different risk appetites. But the 2007 global financial crisis showed that contrary to these assertions, securitization in effect obscured risk and led to credit risk concentration in prudentially regulated financial institutions. Firms obliged to invest only in investment grade securities, such as banking institutions, insurance firms and pension funds were disproportionately affected. And these were the institutions, which in search of higher yields invested heavily in triple-A rated structured finance securities, such as CDOs. Following the loss of confidence in structured finance securities, there was a wholesale market liquidity crisis, as a result of which structured finance securities, starting with subprime mortgage-backed securities, turned toxic. They could not be disposed of, except - in some cases at fire-sale prices. Firms unable to refinance collapsed,⁶⁵⁷ merged⁶⁵⁸ were taken over by governments' intent on

⁶⁵⁷ Lehman Brothers filed for chapter 11 bankruptcy protection in September 2008.

⁶⁵⁸ Merrill Lynch merged with Bank of America when faced a run by investors.

avoiding the total collapse of their financial systems,⁶⁵⁹ or their metamorphosed into commercial banking institutions.⁶⁶⁰

The toxic assets clogged up bank balance sheets.⁶⁶¹ In the U.S., the government introduced the Troubled Asset Relief Programme (TARP) to purchase or insure these illiquid assets to reignite bank lending. In 2009 in the U.K., the authorities introduced the Asset Protection Scheme (APS), which enables regulated firms to buy insurance from the Treasury, to cover losses on qualifying financial assets. The objective behind both the TARP and the APS is to get regulated banking institutions to reduce exposures to the toxic structured finance securities and enable the institutions to increase their lending to the productive sector. Can the RBZ regulate and supervise - from a risk management perspective - regulated financial institution's discretion to trade, deal or hold some types of structured finance securities, such as CDOs, or those backed by subprime loans for instance?

Zimbabwe does not have a TARP/APS-type programme. This is unsurprising, since it has not been affected in the manner that developed countries were affected by the global financial crisis. Arguably, to prevent moral hazard, it does not need a permanent TARP/APS-scheme. However, it does operate a prescribed asset regime. It is notable that the RBZ securitization guideline states that regulated financial institutions may purchase securities issued by a securitization SPV subject - for capital adequacy purposes - to risk-weights attached to the securities in question by the RBZ from time to time.⁶⁶² In addition, it is notable that section 31 of the Banking

⁶⁵⁹ AIG is an example of a financial conglomerate that was effectively nationalised in the U.S. In the U.K. Northern Rock, Lloyds TSB and Royal Bank of Scotland were effectively taken into public ownership due to the financial crisis.

⁶⁶⁰ Examples in the U.S. include Morgan Stanley and Goldman Sachs.

⁶⁶¹ This is correct as of the date of submission of this thesis.

⁶⁶² The RBZ Securitization Guideline states: "5.15 A bank may purchase assets issued by an SPV, and treat them for capital adequacy purposes according to the risk weights prescribed by the Reserve Bank from time to time where the following conditions are met: (a) the purchase is conducted at arm's length, on market terms and conditions and is subject to the bank's normal credit approval process; (b)

Act authorises the RBZ to determine banking institutions' minimum equity capital requirements, prudential capital reserves and ratios and general financial requirements pertaining to bank assets, liabilities, credits, investments and their off-balance sheet exposures.⁶⁶³ In short therefore, the RBZ can and does regulate the trade and dealing by regulated institutions in structured finance securities. And if a fully fledged securitization market emerges the RBZ can - if appropriate - impose restrictions on the types of assets traditional banking and building society institutions may hold or prescribe the amount of regulatory capital to be set aside in the event at particular securities investments are made.

9.2.8. Performance-linked compensation schemes

A long standing criticism of banking and other financial institutions' corporate governance structures, in the U.S. and the U.K. is that financial industry performance-linked compensation schemes encouraged excessive short-term risk taking and enhanced moral hazard.⁶⁶⁴ Some commentators argue that performance-linked

the bank has no pre-existing obligation to undertake the purchase; (c) the total value of assets purchased, and held on the books of the banking institution are within the maximum authorized investment limits prescribed by the Reserve Bank from time to time; and (d) where non-performing assets are purchased: (i) the assets must be marked-to-market for financial and regulatory purposes; and (ii) The banking institution demonstrates that the assets are acquired at a fair market value that fully reflects the non-performing status of assets and the presence of any credit enhancement(s) by an independent party. 5.16 Where any of these conditions are not met, the purchase should be regarded as a credit enhancement. 5.17. A banking institution may also purchase securities issued by an SPV, and treat them for capital adequacy purposes according to the risk weights attached to the securities themselves as prescribed by the Reserve bank from time to time, provided: (a) the conditions in clause 5.15. are satisfied; (b) the bank has adequate risk management systems to curb disproportionate accumulation of securities issued by an SPV relative to its total assets and capital; (c) purchases of subordinated securities issued by an SPV should be treated as a credit enhancement, as either a first or a second loss facility depending on the level of loss the securities are supporting. 5.18. Where these conditions are not met, any acquisitions arising from market making activities should be regarded as credit enhancements. 5.19 Where the Reserve Bank assesses that a banking institution's purchase of securities implies that it is supporting investments in an SPV beyond any legal obligation, the bank will be required to hold capital against all the securities issued by the SPV." RBZ (2007) (note 3, supra) at paragraph 5.15 – 5.19.

⁶⁶³ Section 31 of the Banking Act and the Banking Regulations (2000), Statutory Instrument No. 205 of 2000. See also RBZ (2007) (note 617, supra), at section 31.

⁶⁶⁴ See for instance Roubini who argues that banker's compensation schemes incentivized them to take unnecessary risks. Nouriel Roubini (2008) (note 142, supra) See also ACCA (2008) 'Climbing out of

compensation schemes in the financial services sector contributed to the 2007 global financial crisis.⁶⁶⁵ Although the malady did not affect only those financial firms involved in structured finance transactions, there is merit in the argument that the use of performance-linked bonuses, stock options, and golden parachutes, among others, to remunerate and incentivize finance executives did encourage risky behaviour in firms engaged in structured finance. Such incentive structures may ultimately have encouraged the compromised fee-driven origination of subprime mortgages, issuance of subprime mortgage-backed securities, including CDOs and other complex structured finance securities.⁶⁶⁶

Arguably, remuneration structures that include bonuses and stock options enable financial firms to attract and retain talented staff.⁶⁶⁷ But such structures can increase incentive misalignment and agency costs. Holders of stock options benefit when a firm's stock's price rises but do not suffer an immediate financial detriment when prices fall.⁶⁶⁸ Critics of such incentive structures argue that they encourage balance sheet misrepresentation, tax evasion and other corporate malfeasance.⁶⁶⁹ They also shift risk of loss to shareholders, although ultimately, as shown by the 2007 global

the Credit Crunch: Policy Paper', (September 2008), at p. 4. Available at www.accaglobal.com/pdfs/credit_crunch.pdf See also John C. Coffee and Hillary A. Sale (2008) 'Redesigning the SEC: Does the Treasury Have a Better Idea?', at p. 17. Available at http://www.law.columbia.edu/null/Redesigning+the+SEC+Does+the+Treasury+Have+a+Better+Idea,+by+John+C?exclusive=filemgr.download&file_id=161070&showthumb=0

⁶⁶⁵ Friedman and Friedman posit for instance that: "It is now clear that bonuses based on the profits of a particular year played a role in the financial meltdown." Hershey H. Friedman and Linda W. Friedman (2009) 'The Global Financial Crisis of 2008: What Went Wrong?' at p. 20. Available at <http://ssrn.com/abstract=1356193>

⁶⁶⁶ For a concise criticism of the financial services incentive structure see, Pascual Berrone (2008) 'Current Global Financial Crisis: An Incentive Problem', *University of Navarra, Occasional Paper, October*, 2008.

⁶⁶⁷ But see Cohen who argues that it is a myth that financial services sector executives have to be paid so much to prevent them leaving to other sectors or competitors. William D. Cohen (2008) 'Our Risk, Wall Street's Reward', *New York Times*, Week in Review, 13 (16 November 2008). See also Dan Ariely, who theorized that bonuses may actually lead to worse performance and may not be value creating as is commonly held. Dan Ariely (2008) 'What's the Value of a Big Bonus?', *New York Times*, Op-ed, A43.

⁶⁶⁸ Richard A. Posner (2009), 'Are American CEOs Overpaid, and if So, What if Anything Should be Done about It?' *58 DUKE L.J.* 1013 (2009), at pp. 1026-1030.

⁶⁶⁹ Berrone (2008) (note 666, supra) at p. 2.

financial crisis, ultimate loss is borne by taxpayers when governments intervene to save financial systems from collapse. In the U.K., as part of a raft of measures designed to address the misalignment of incentives in the financial services sector, the FSA prescribed a Code of Practice dealing with remuneration practices. The draft Code of Conduct requires firms to: “...establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.”⁶⁷⁰ Similar proposals have been mooted in the E.U. as well as the U.S. Does the RBZ have power to impose corporate governance practices to guide, among others, regulated firms’ incentive structures?

The RBZ does not currently regulate financial institutions’ compensation structures. Although controversial, there is merit in the argument that the RBZ should consider establishing a corporate governance framework for regulated financial institutions that directly refers to and regulates financial industry compensation schemes to ensure that they do not encourage inappropriate and excessive risk taking and short-termism. Such reforms can be implemented through the amendment of the Reserve Bank of Zimbabwe Guideline No. 01-2004/BSD: Corporate Governance Guideline. This guideline stipulates various corporate governance principles that regulated institutions are expected to adhere to. Amendments to this guideline should ideally link incentive structures with risk management, addressing conflicts of interests and disclosures relating to salaries and other compensation schemes. It has been correctly argued that cash bonuses and stock options should be paid on the basis of long term performance and not on the basis of annual returns.⁶⁷¹ It is also arguable

⁶⁷⁰ Financial Services Authority (2009) ‘Draft Code on Remuneration Practices’, at p. 2. See also generally, the U.K. Financial Services Authority (2009) ‘Reforming Remuneration Practices in Financial Services’, March 2009. Available at www.fsa.gov.uk

⁶⁷¹ Joseph E. Stiglitz (2008) ‘Commentary: How to prevent the next Wall Street Crisis’, *CNN Article*, (17 September 2008). Available at <http://edition.cnn.com/2008/POLITICS/09/17/stiglitz.crisis/index.html>

that firms in financial distress or that have accessed lender of last resort facilities or have received or likely to receive public funds should not be permitted to pay bonuses without authorization from the central bank.

The above notwithstanding, the issue of excessive risk-inducing executive compensation structures is not of prudential interest to banking institutions only. It is an issue of interest to all public companies. To this extent, and to enable the prescription of consistent and holistic principles, compensation structures of public companies, including banking institutions (whether public or not) should ideally be regulated and policed by an integrated regulator.

Based on all the foregoing, it is apparent that there is in existence a framework that enables the RBZ to prudentially regulate and supervise banking, building society and other financial institutions' involvement in securitization transactions as originators, providers of securitization transaction services and as investors. In addition, it is clear that the RBZ can issue guidelines that can enable it to strengthen this framework with the objective of preventing and managing securitization transaction risks. However, the extant prudential framework it is rudimentary. The RBZ should be given power to prescribe binding guidelines or regulations and this should be clearly stipulated through an amendment to the RBZ Act. In addition, the extant regulatory framework should be reformed to enable the RBZ to manage, *inter alia*, risks that can flow from: (i) poorly structured risk management policies and practices; (ii) regulated firms' use of the originate-to-distribute business model; (iii) loan origination and underwriting standards; (iv) misaligned incentive structures - through the promulgation of codes of conduct, including on remuneration practices; (v) moral hazard drivers; and (vi) the dealing, trading or holding of structured finance securities by regulated institutions.

9.3. Insurance and Pensions Commission

In Zimbabwe, insurance firms, mutual insurance firms, pensions and provident funds and insurance brokers are regulated and supervised by the IPC. The IPC is a body corporate, capable of suing and being sued in its own name.⁶⁷² The IPC is headed by the Commissioner of Insurance and Pensions (the Commissioner). The Commissioner is appointed by the Insurance and Pensions Commission Board (the IPC board), in terms of section 19 of the IPC Act. The operations of the IPC are controlled and managed by the IPC board,⁶⁷³ whose members' are appointed by the Minister of Finance on renewable three-year terms of office.⁶⁷⁴

In contrast to the RBZ governor, who is a presidential appointee and the overall chief of the central bank, the Commissioner of the IPC is an employee of the IPC board. Subject to the IPC boards' control, the Commissioner is responsible for supervising and managing the IPC's staff, activities, funds and property; and for performing such other functions as the Board may assign to him or as may be conferred or imposed on him by or under the IPC Act or any other enactment.⁶⁷⁵ The functions and powers of the IPC are contained in section 4 of the IPC Act. The IPC was established in 2001, and is responsible for the registration, regulation and supervision of the operations of insurance firms and insurance brokers in Zimbabwe, ensuring that they meet prescribed standards, as provided for under the IPC Act, the Insurance Act and the Pension and Provident Funds Act, respectively. This section addresses the question: to what extent do the legal enactments administered by, or relating to, the IPC allow it to prevent and manage risks that arise when regulated

⁶⁷² Section 3 of the IPC Act.

⁶⁷³ *Ibid.*, at section 5(1).

⁶⁷⁴ *Ibid.*, at section 7.

⁶⁷⁵ *Ibid.*, at section 19.

insurance firms engage in securitization transactions, especially as providers of credit default risk insurance?

9.3.1. Context

As illustrated by the case of the U.S. and the 2007 global financial crisis, legal frameworks relating to the insurance industry should enable the effective prevention and management of risks that can arise from insurance firms' involvement in securitization transactions as originators, but principally as providers of credit default risk insurance and investors in structured finance securities.⁶⁷⁶ As noted in chapter one, in addition to internal credit enhancement measures, securitization issuances are typically credit enhanced through credit default risk insurance provided by insurance firms, either multiline or monoline insurance firms. In the U.S., the established monoline insurance firms included the likes of MBIA Inc., Ambac Financial Group Inc, which provide one line of insurance business, i.e. credit default risk insurance (bond insurance hereafter). Multiline insurers include the likes of AIG.

Bond insurers are a critical component of structured finance markets infrastructure. Using the backing of their own triple-A ratings, bond insurers guarantee payment to investors in the event of default by an issuer on fixed-income securities' capital and interest repayments.⁶⁷⁷ Because bond insurers assumed the risk of default of all insured structured finance securities issuances, including subprime mortgage-backed securities whose credit risk they had mispriced, their systemic importance was exponentially increased.

⁶⁷⁶ For a synopsis of the challenges faced by insurance firms and the systemic risks posed by their involvement in structured finance securities products see: Stuart M. Turnbull., Michel Crouhy and Robert A. Jarrow (2008), 'The Subprime Credit Crisis of '07', at pp. 14-15. Available at <http://ssrn.com/abstract=1112467>

⁶⁷⁷ Kotecha (2000) note 70, *supra*, at p. 197.

Despite their critical importance within financial markets, insurance regulators, especially in the U.S. context failed to properly regulate and supervise bond insurers risk management systems. Bond insurers were allowed to assume too much risk relative to their prescribed capital and solvency requirements. The 2007 global financial crisis revealed that global capital and solvency frameworks for insurance firms, and especially bond insurers were inadequate.⁶⁷⁸

In addition insurance regulators failed to prevent the over-exposure of bond insurers to subprime mortgage-backed securities market risk. This resulted in credit risk concentration in the few credit default insurers.⁶⁷⁹ This situation increased the risk that the downgrading of a bond insurer's credit rating or its failure would threaten financial stability.⁶⁸⁰ AIG illustrates this risk very well. Fearing that its collapse would exacerbate the global financial crisis,⁶⁸¹ following AIG's structured finance securities-linked liquidity crisis, the government was forced to bail it out.⁶⁸² The U.S. Treasury department and the Federal Reserve justified AIG's bailout by saying: "Given the systemic risk AIG continues to pose and the fragility of markets today, the potential cost to the economy and the taxpayer of government inaction would be extremely high. AIG provides insurance protection to more than 100, 000 entities, including small businesses, municipalities, 401(k) plans, and Fortune 500 companies who

⁶⁷⁸ International Monetary Fund (2008) (note 106, supra) at p. 78; Brunnermier (2008) (note 23, supra), at pp. 15-16. For a short article on Monolines see James Surowiecki (2008) 'Bonds Abound', *The New Yorker* (11 February 2008) at

http://www.newyorker.com/talk/financial/2008/02/11/080211ta_talk_surowiecki

⁶⁷⁹ Lucas *et al*, states: "For credit risk transferred out of the banking system, there is the concern with the extent to which credit risk is being transferred to nonbanks, such as monoline or multiline insurance companies and hedge funds. The overall concern is the impact on the financial system resulting from a failure of one or a few major participants in the CRT market." Douglas J. Lucas., Laurie Goodman, and Frank J. Fabozzi (2007) 'Collateralized Debt Obligations and Credit Risk Transfer', *Yale ICF Working Paper No. 07-06*, at p.13. Available at <http://ssrn.com/abstract=997276>

⁶⁸⁰ International Monetary Fund (2008) (note 106, supra), at p. 78.

⁶⁸¹ Matthew Karnitschnig., Deborah Solomon., Liam Plevin., and Jon E. Hilsenrath (2008) 'U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up' *Wall Street Journal* (17 September 2008), at p.1. Available at

<http://online.wsj.com/article/SB122156561931242905.html>

⁶⁸² *Ibid.*, at p.1.

together employ 100 million Americans. AIG has over 30 million policyholders in the U.S. and is a major source of retirement insurance for, among others, teachers and non-profit organizations. The company also is a significant counterparty to a number of major financial institutions.”⁶⁸³ It is within this context that this section assesses whether the IPC is capable of preventing and managing key risks that can potentially arise due to insurance firms’ exposures to structured finance securities products.

9.3.2. IPC’s regulatory jurisdiction

As noted above, the IPC, through the Commissioner, regulates and supervises the operations of insurance firms, mutual insurance firms, pension and provident funds and insurance brokers in Zimbabwe. Unlike the RBZ whose regulatory jurisdiction is qualified in relation to certain banking institutions established by an Act of parliament, the IPC has regulatory jurisdiction over all insurance firms operating in Zimbabwe. This means all registered insurance firms, whether monoline or multiline insurance firms, are regulated and supervised by the IPC.

9.3.2.1. Insurance-firm holding companies

Does the IPC have regulatory and supervisory jurisdiction over insurance firm-holding companies or non-insurance subsidiary entities? Unlike the RBZ, the IPC does not have power to oversee the operations of insurance firms on a consolidated

⁶⁸³ United States Federal Reserve System, and United States Department of the Treasury (2009) ‘U.S. Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan’ (Press release, 2 March 2008), at p. 1. Available at <http://www.federalreserve.gov/newsevents/press/other/20090302a.htm> The Wall Street Journal also noted that AIG’s collapse: “...could throw a wrench in a wide variety of ultra-safe money-market funds owned by individual investors to complex derivatives used by Wall Street banks and tools used to finance corporations. AIG’s size and complexity meant that its tentacles were spread throughout the financial system, making it almost impossible to be certain about the impact of a collapse - other than to know that it was potentially catastrophic.” Monica Langley., Deborah Solomon, and Matthew Karnitschnig (2008) Bad Bets and Cash Crunch Pushed Ailing AIG to Brink, Wall Street Journal (18 September 2008), at p. 1. Available at www.wgains.com/assets/attachments/WSJBadBets.pdf

basis and has not attempted to do so. Despite having power to issue binding regulations, per section 6 of the Insurance Act, the IPC has not created a framework that enables it to consider regulated institutions' risk management systems and other exposures on a consolidated group basis. To the extent that an insurance firm-holding company is also a bank-holding company, the exercise of regulatory jurisdiction by the IPC on a consolidated basis would amount to a duplication of regulatory jurisdictions. This is an additional reason why an integrated regulatory agency system amounts to a better regulatory system. It minimises regulatory duplication, regulatory gaps, regulatory arbitrage, and allows the effective regulation and oversight of financial conglomerates.

9.3.2.2. Credit default swaps

The losses that AIG experienced leading to its bailout were largely due to its CDS exposures, which constituted part of its bond insurance business.⁶⁸⁴ A CDS is a private contract between one party (the protection seller), which in exchange for a fee, agrees to compensate another party (the protection buyer) if a specified credit event (such as bankruptcy or credit default) occurs with respect to a company (the reference entity) or a debt obligation.⁶⁸⁵ In the U.S. the provision of CDS was not regulated, and AIG, among others, "...was able to pursue a multi-billion dollar CDS business free from regulatory filings, mandated capital requirements and government intervention."⁶⁸⁶ Because of the systemic risks inherent in CDS, in the U.S., legislation - the Derivatives Markets Transparency and Accountability Act of 2009 - to regulate the CDS market is being considered. Proposals to reduce CDS trade-risk

⁶⁸⁴ Langley., Solomon and Karnitschnig (2008) (note 683, supra), at p.1.

⁶⁸⁵ Sjostrom, K. William (2009) 'The AIG Bailout', 66, *Wash. & Lee. L. Rev.* at p. 5. Available at <http://ssrn.com/abstract=1346552>

⁶⁸⁶ *Ibid.*, at p. 41.

include the requirement that these instruments be traded on a regulated securities exchange, subject to minimum disclosure requirements and documentation standardization.⁶⁸⁷

In Zimbabwe, the entity with authority to regulate some CDS contracts is the SC and not the IPC. This is because the word “security” is defined in section 2 of the Securities Act to include some CDS contracts, as follows: “...any contract for differences, that is to say, a right under a contract which does not provide for the delivery of securities or commodities but whose purpose or professed purpose is to secure a profit or avoid a loss by reference to fluctuation in - (i) a share index or index of commodity prices or other similar reference point; or (ii) the price of other particular securities or commodities; or (iii) the interest rate available on money placed on deposit; or (iv) the exchange rate available between two or more currencies.”

It is unclear whether the SC has power to impose conditions or regulate over-the-counter (OTC) securities trades. It is arguable that OTC CDS which do not use the four reference points mentioned in the Securities Act are not regulated by the SC or the IPC. The Securities Act and the Insurance Act must be amended to enable both the SC and the IPC, respectively, to regulate CDS contracts - in all their possible forms - to mitigate risks that can arise from these derivative instruments. This is especially important for insurance firms, which – as part of their bond insurance business also engage in CDS trade. The IPC should promulgate preemptory rules to regulate CDS. Ideally however, to prevent regulatory gaps - because they have “characteristics of a

⁶⁸⁷ Ibid., at p. 42.

security, a contract of sale of a commodity for future delivery and an insurance contract”,⁶⁸⁸ - CDS should be regulated by an integrated regulatory agency.

9.3.3. IPC’s risk-management authority

Although Zimbabwe’s insurance industry regulatory and supervisory framework is basic, it can be harnessed to mitigate some risks that arise from insurance firms’ involvement in structured finance transactions, either as originators or more likely as providers of credit risk insurance or as investors in structured finance securities. The extant framework should however be enhanced to, *inter alia*, enable the IPC to regulate and supervise insurance industry risk management policies, practices and procedures relating to the provision of credit default risk insurance and related consumer protection issues.

The IPC through the Commissioner is empowered to register, regulate and supervise the operations of insurance firms and insurance brokers, among others.⁶⁸⁹ In addition, the Commissioner is empowered to prescribe codes of conduct and standards, which registered insurance firms and brokers, are obliged to comply with.⁶⁹⁰ Further, the Commissioner has power to demand from a regulated insurance entity any document or information.⁶⁹¹ The IPC can initiate investigations into the affairs or operations of any such entity in the following instances, if an insurer: (i) fails to furnish the Commissioner with any documentation or information requested; (ii) furnishes incorrect or incomplete information; (iii) breaches a provision of the Insurance Act; (iv) fails within a thirty-day period to remedy an irregularity that has been identified by an auditor or actuary; (v) breaches margins of solvency prescribed

⁶⁸⁸ *Ibid.*, at 36.

⁶⁸⁹ Section 6(a), (b) and (c) of the Insurance Act.

⁶⁹⁰ *Ibid.*, at section 6(c).

⁶⁹¹ Section 64(1) of the IPC Act.

pursuant to section 24 of the Insurance Act, or (vi) if the Commissioner believes that the rights of any class of policy-owners are being prejudiced by an insurer.

Pending or following an investigation, the Commissioner may impose restrictions on the operations of an insurer, including restrictions on its ability to issue insurance policies. The Commissioner may issue a report, following the investigation, which is submitted to the Minister who may issue any order as is appropriate in the interests of policy-owners.⁶⁹² In addition, the Commissioner has power to declare through the issuance of a Gazette that a specified practice or method of conducting business constitutes an irregular practice or an undesirable method of conducting business.⁶⁹³ And any insurer that violates the prescription commits a criminal offence punishable by a term of imprisonment or a fine or both.⁶⁹⁴ These powers are obviously expansive - especially the power to prescribe codes of conduct and risk management policies and proscribe undesirable practices through the issuance of a Gazette - and can be used to mitigate some of the ill-effects that can arise from insurance firms' involvement in structured finance transactions.

This notwithstanding, a critical shortcoming with this framework, as rightly noted by the RBZ governor in his January 2009 Monetary Policy Statement, is the failure by the IPC to put in place a comprehensive regulatory and supervisory framework for insurance firms. In his January 2009 Monetary Statement the RBZ governor stated: "...2.24 [the] absence of a well defined and comprehensive regulatory and prudential supervision framework for...Insurance Companies...has significantly compromised financial stability... 2.31. We...call upon the Insurance and Pensions Commission...to put in place comprehensive prudential supervision frameworks for the effective supervision of insurance companies, pension funds...based on

⁶⁹² Section 67(6) of the Insurance Act.

⁶⁹³ Ibid., at section 87.

⁶⁹⁴ Ibid., at section 89(2).

international best practice. 2.32 The insurance industry in particular, should be primed for adoption of the provisions of Solvency II, which framework has three pillars namely (a) measurement of assets, liabilities and capital; (b) supervisory review process; and (c) disclosure requirements.”⁶⁹⁵

9.3.4. Capital and liquidity requirements for insurance firms

As noted above, regulators, especially in the U.S., failed to establish and supervise an appropriate risk management capital and solvency prescriptions for insurance firms providing bond insurance. The result was that when the housing bubble burst and foreclosures increased, claims on bond guarantees issued by such insurers as AIG, Ambac and MBIA spiked. But because these insurance firms were lightly capitalised they struggled to refinance following the loss of market confidence in their ability to meet their obligations.⁶⁹⁶ Their business models were based on the erroneous assumption that the risk of systemic default on insured products was highly improbable. Given this context, an emerging market seeking to create a securitization-enabling and risk mitigating financial infrastructure must ensure that the capital and solvency framework for its insurance firms engaged in structured finance transactions, among others, is robust and provides an effective cushion against systemic risk events.

The Insurance Act stipulates capital and solvency rules for insurance firms, but these are not risk-based.⁶⁹⁷ The Insurance Act states for instance that an insurance firm shall be considered as having a margin of solvency sufficient to carry on insurance business if the total value of its assets in relation to the insurance business

⁶⁹⁵ RBZ (2009) (note 623, supra) at p. 49.

⁶⁹⁶ Sjoström (2009) (note 685, supra), at p. 17.

⁶⁹⁷ Section 24 of the Insurance Act.

exceeds its liabilities by more than one million dollars.⁶⁹⁸ This computation of the amount of the capital required to cushion insurance firms from their business exposures is archaic, not risk-sensitive and for this reason is ill suited for modern-day prudential regulation and supervision of firms providing credit default risk insurance. This should be remedied through an amendment of the Insurance Act and - as recommended by the RBZ governor in his January 2009 monetary policy statement - the gradual adoption of Solvency II.⁶⁹⁹

Solvency II: (i) introduces more risk sensitive and economic risk-based solvency requirements; (ii) requires a total balance sheet approach to solvency requirements; (iii) requires insurance firms to put in place appropriate risk management policies and practices; and (iv) requires increased disclosure of information. Regarding insurance industry reforms, it is notable that the Group of 7 countries, following the 2007 global financial crisis, through the Financial Stability Forum called on member countries to strengthen their regulatory and capital frameworks for monoline insurers in relation to structured finance exposures.⁷⁰⁰ Zimbabwe should follow suit for its insurance industry as a whole and especially for firms that provide or are exposed to credit default insurance.

9.3.5. Investment in structured finance securities

Because insurance firms are prudentially regulated, they are often subjected to restrictions regarding the type of securities they may trade, deal or hold as investments. Typically, as is the case in Zimbabwe, they are obliged to invest in

⁶⁹⁸ Ibid., at section 24(1)(a)(i).

⁶⁹⁹ Solvency II rules are similar to Basel II rules, but only for Insurance firms. These are rules prescribed by the E.U. as part of its efforts at creation a common market for the insurance industry and generally ensuring that the capital and solvency prescriptions are risk-based. See also RBZ (2009) (note 623, supra) at p. 52.

⁷⁰⁰ Financial Stability Forum (2008) 'Report on Enhancing Market and Institutional Resilience', at p. 15. Available at: www.fsforum.org/publications/r_0804.pdf

prescribed securities, usually gilts and/or investment grade-rated securities. Because structured finance securities were mispriced and typically ascribed investment grade ratings, insurance firms' balance sheets - similar to those of banks - were left bloated with toxic assets following the collapse of the global structured finance securities market.

The Insurance Act prescribes categories of securities insurance firms are authorised hold.⁷⁰¹ Structured finance securities fall outwith the category of securities that insurance firms are permitted to trade, deal or hold. This study argues that the extant prescribed assets regime unduly limits insurance firms' treasury decisions. Instead of a prescribed assets regime, the Insurance Act should prescribe assets that insurance firms may not trade or deal in, or securities against which high capital reserves must be kept if held by a regulated entity. Structured thus, particularly risky structured finance securities such as CDOs may then be proscribed, or alternatively conditions may be imposed on insurance firms' ability to hold them, including mandatory authorization from the IPC. The IPC should consider imposing risk management rules pertaining to the nature of structured finance securities that regulated insurance firms might deal or trade.

In summary, based on the foregoing, it is apparent that the extant insurance regulatory regime can be harnessed to prevent and manage some of the risks that can arise from insurance firm's involvement in structured finance transactions as credit default insurers and as investors in structured finance securities. But the framework is rudimentary. The extant prudential regulation and supervision framework for

⁷⁰¹ Section 26 of the Insurance Act states "(1) Every insurer shall, in respect of the insurance business carried on by him in Zimbabwe, hold the insurance fund referred to in subsection (2) of section twenty nine in such prescribed securities and in such proportions of prescribed securities as may be specified by the Minister in terms of subsection (2). (1A) An insurer who contravenes subsection (1) shall be guilty of an offence and liable to a fine not exceeding level five or to imprisonment for a period not exceeding three months or to both such fine and such imprisonment."

insurance firms should be reformed. The IPC should establish a framework, regulating especially risk management frameworks of insurance firms engaged in structured finance transactions. The framework should provide for, among others: (i) risk-sensitive capital and solvency rules (including Solvency II adoption); and (ii) corporate governance stipulations that address among others - as argued above in relation to banking institutions - executive compensation, conflicts of interests and other good corporate governance principles. The prescribed asset regime stated in the Insurance Act should be reformed to give insurance firms greater freedom; regulated however for risk management purposes to ensure that insurance firms are prohibited from, or are obliged to keep high capital reserves against, holding specified risky assets. To reduce regulatory arbitrage, regulatory gaps and regulatory inefficiency, there is merit in the argument - as appears below - that an integrated regulatory agency structure should be created that will facilitate the consolidated regulation and supervision of financial institutions, especially in an environment graced with financial conglomerates.

9.4. Securities Commission

The SC is Zimbabwe's capital markets regulator. It is established in terms of section 3 of the Securities Act. The SC consists of between 3 and 5 commissioners appointed by the Minister of Finance. It consists of: (i) the chair of the principle registered securities exchange in Zimbabwe;⁷⁰² (ii) an RBZ employee responsible for financial markets; and (iii) three persons appointed from one or more associations "which represent persons trading or dealing in securities, managing portfolios of

⁷⁰²This refers to the Zimbabwe Stock Exchange.

securities, or recording transfers or other transactions relating to securities.”⁷⁰³ The SC’s primary mandate is to ensure capital markets integrity through the regulation of securities trading - including through the registration, supervision and regulation of securities exchanges and licensed persons - and the protection of investors.⁷⁰⁴

The Securities Act, promulgated into law in 2008, is the primary capital markets regulatory enactment in Zimbabwe. It repealed the Zimbabwe Stock Exchange Act [Chap 24:18],⁷⁰⁵ which used to be the primary regulatory enactment. Although the Securities Act envisages the existence of several exchanges, Zimbabwe currently has one securities exchange, which is the Zimbabwe Stock Exchange (ZSE). The ZSE was established in 1896, making it the second oldest securities exchange in Africa.⁷⁰⁶ Shares, debentures, government stock and bonds, municipal bonds and other quasi-government bonds are the major capital market instruments used in Zimbabwe. Zimbabwe’s capital market is largely institutional, although the promulgation of the CIS Act and the AMC Act resulted in increased usage - primarily through unit trusts - of the ZSE for investment purposes by retail investors.

This section analyses the SC’s regulatory authority over securities trading in Zimbabwe. It evaluates whether the Securities Act enables the SC to: (i) prevent and manage risk that can arise from the trading especially of structured finance securities; and (ii) effectively regulate key gatekeepers to the capital markets, especially structured finance lawyers, CRAs and public auditors. Internationally, and especially in the U.S. context, these gatekeepers’ failures in relation to the structuring of securitization transactions - from the collapse of Enron to the 2007 global financial crisis - elicited a lot of criticism and calls for reform.

⁷⁰³ Section 6(2) of the Securities Act.

⁷⁰⁴ *Ibid.*, at section 4.

⁷⁰⁵ *Ibid.*, at section 119.

⁷⁰⁶ Mangena and Taurigana (2007) (note 255, *supra*) at pp. 53-85.

9.4.1. Context

The 2007 global financial crisis represents not just a failure of regulation of banking and insurance firms, but also of securities markets regulation. In the U.S., the SEC, in common with other global securities regulators, failed to effectively regulate and supervise the process of issuing, and entities that were involved in the issuing, of subprime mortgage-backed securities and CDOs, among others, which are at the heart of the global financial crisis. Securities laws are typically geared to contribute to systemic risk reduction, as well as ensuring efficient capital markets and protecting investors through, *inter alia*, statutorily-prescribed preemptory periodic disclosures of material information by issuers to financial markets participants; and through the effective supervision and enforcement of applicable laws and regulations. Using the example of the U.S., it is clear that the SEC's failure to effectively regulate and supervise the origination and issuance of mispriced, opaque, highly complex and difficult to price structured finance securities contributed to the 2007 global financial crisis.

9.4.1.1. Failure to regulate the issuance of complex securities

A key objective of securities regulation is to ensure that issuers and related service providers (gatekeepers) effect full disclosure of material information relating to an issuer and issued securities. Full disclosure of material information enables transparent, efficient, and fair capital markets. Using the U.S., as an illustration, it is notable that with regards structured finance securities and derivatives, the practices and policies employed the SEC eschewed full disclosure and analysis. Instead the SEC presided over a system in which it and securities investors over-relied on unregulated ratings provided by Nationally Recognized Statistical Rating Organizations

(NRSRO), which arguably became proxies for full disclosure.⁷⁰⁷ NRSROs are CRAs of which the major three - Standard and Poor's, Moodys and Fitch-Ratings - constitute an effective oligopoly. As discussed in detail in chapter 9, CRAs play a critical role in structured finance securities market, and were essential to financial markets' acceptance of structured finance securities. Ratings influence whether an originator can access capital markets, the cost of refinancing and for some prudentially regulated institutions, they determine which assets can be used as regulatory capital.

CRAs played a key role in the 2007 financial crisis, and were responsible for mispricing structured finance securities. This was notwithstanding the enactment of the Credit Rating Agency Reform Act 2006 (CRAR Act), following CRAs' failure to timeously downgrade Enron's stock. CRAs continued to be riven by conflicts of interest, over-rely on mathematical models and on artificial and wrong assumptions, especially relating to real estate prices. The CRAR Act does not regulate the rating process, or require CRAs to disclose their rating methodologies to the SEC or to market participants.⁷⁰⁸ In addition, there is a near total lack of liability for CRA malfeasance. Lack of transparency in rating processes, for a long time the subject of criticism, was not addressed by the CRAR Act.

Credit default risk mispricing by CRAs went largely undetected until the onset of the financial crisis, giving rise to questions about the integrity and usefulness of ratings. Unquestionably, there was a failure to effectively regulate CRAs. There was little, if any, oversight over CRAs ratings opinions, or their methodologies, yet regulators relied, and required issuers and investors to rely, on CRAs' ratings opinions especially with regards structured finance securities.

⁷⁰⁷ Richard E. Mendales (2009) 'Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix it', at p. 2. Available at <http://ssrn.com/abstract=1354062>

⁷⁰⁸ Ibid., at p. 41.

The structured finance securities issuance framework operated by the SEC proved ill-suited to the task of managing securitization transaction risks. The global financial crisis established that trade in highly complex securities can lead to: (i) a failure of investing standards; (ii) the impairment of disclosure; and (iii) the susceptibility of markets to contagion and fraud.⁷⁰⁹ The SEC's primary securitization regulatory enactment, the 2005-enacted Regulation AB,⁷¹⁰ did not address the problems generated by the origination and issue of complex structured finance securities. Regulation AB has been criticised for not requiring: (i) issuers to conduct and warrant that they had undertaken appropriate due diligence measures; (ii) arrangers and underwriters to ensure that underlying loan origination documentation had been verified, audited and characteristics noted for disclosure as part of the issuance process and other risk management purposes;⁷¹¹ and (iii) CRAs to undertake due diligence measures relating to assets backing securities on which they issued opinions. Instead, Regulation AB requires statistical data on the characteristics of an asset pool, "such as yield, cash flows, interest rate sensitivity, total rate of return, and the financial impact of losses 'based on a variety of loss or default experience, prepayment, interest rate and related assumptions.'"⁷¹²

Because disclosure pertaining to structured finance securities was poor, when defaults on underlying mortgages occurred, the resultant panic affected global financial markets. Some commentators argue that the SEC over-relied on CRA-issued ratings because of the increasing complexity of some of the structured finance

⁷⁰⁹ Steven L. Schwarcz (2009) 'Regulating Complexity in Financial Markets', Available at <http://ssrn.com/abstract=1240863>

⁷¹⁰ Securities Act Release No. 8518 ("Asset-Backed Securities") (January 7, 2005), 79 Fed. Reg. 1506. Regulation AB is a codification of a series of no-action letters written by the SEC over the years to securitization industry participants.

⁷¹¹ Mendales (2009) (note 707, supra) at pp. 36-37.

⁷¹² *Ibid.*, at p. 36.

securities.⁷¹³ Proponents of securitization, such as Schwarcz, argued that even if full disclosure had been effected it is highly unlikely that investors and other market participants would have understood them.⁷¹⁴ But it is indisputable that these securities were opaque, led to risk concentration, were extremely sensitive to market liquidity conditions (and did prove to be illiquid), and were too reliant on mathematical models for price discovery.

9.4.1.2. Lax risk management practices and policies

In 2008 the SEC conceded that its regulatory and supervisory framework for investment banks in the U.S. was flawed, which had led to the collapse or re-organisation of the major U.S. investment banks: Merrill Lynch, Goldman Sachs, Morgan Stanley, Lehman Brothers and Bear Stearns Companies Inc.⁷¹⁵ These institutions, which were heavily involved in the structured finance market were regulated under the Consolidated Supervised Entity programme (CSE programme). Among its notable features, the CSE programme freed investment banks from strict debt-to-equity ratios and allowed them to use highly leveraged capital structures under a loosely supervised and voluntary regime.⁷¹⁶ While the CSE programme allowed investment banks to adopt high-leverage business models, resulting in the growth of

⁷¹³ Ibid., at pp. 21-22.

⁷¹⁴ Counterparty Risk Management Policy Group III (2008) 'Containing Systemic Risk: The Road to Reform', at p. 53. Available at <http://www.crmgroup.org/docs/CRMPG-III.pdf>

⁷¹⁵ Securities and Exchange Commission (2009) 'Chairman Cox Announces End of Consolidated Supervised Entity Program' (26 September 2008) at p.1. Available at <http://www.sec.gov/news/press/2008/2008-230.htm>

⁷¹⁶ Securities and Exchange Commission (2009) 'SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program', at p. 2. Available at <http://www.sec.gov/about/oig/audit/2008/446-a.pdf> The CSE programme was created in 2004.

their balance sheets and short-term profitability; it also resulted in the assumption of greater risks, but subject to inadequate capital and liquidity requirements.⁷¹⁷

The capital model enabled by the CSE programme and supervised by the SEC was highly susceptible to liquidity risk; a risk which it seriously underappreciated.⁷¹⁸ The CSE programme employed a “more relaxed alternative net capital rule”⁷¹⁹ as opposed to the more stringent net capital rule applicable to firms regulated by the Federal Reserve. This was compounded by the absence of close supervision and the failure to put in place appropriate prudential risk management guidelines that regulated investment banks’ exposures to particular assets, such as mortgage backed securities, and that required more stringent stress testing of capital and liquidity requirements.

The SEC’s Office of the Inspector General noted that following their entry into the CSE programme, all the major investment banks substantially increased their leverage and debt-to-equity-ratios,⁷²⁰ creating serious insolvency problems. The SEC conceded that it had miscalculated the risks inherent in the risk management policies it expected investment banks to follow, because it had presumed that secured financing could be obtained if a regulated entity had quality assets.⁷²¹ Following the freezing of the wholesale finance markets, Bear Stearns and Merrill Lynch with their debt-to-equity

⁷¹⁷ The SEC noted that Bear Stearns – as was other entities under the CSE programme) was compliant with the CSE capital and liquidity requirements, yet it collapsed, raising questions about the adequacy of these requirements. *Ibid.*, at p. 10.

⁷¹⁸ In its report, the SEC noted: “The collapse of Bear Stearns thus indicates that the CSE program’s liquidity guidelines (implementing the spirit of pillar 2 of Basel II) are inadequate in two respects. First, the time horizon over which a liquidity crisis unfolds is likely to be significantly less than the one-year period. Second, secured lending facilities are not automatically available in times of stress.” *Ibid.*, at p. 15.

⁷¹⁹ John C. Coffee (2009) ‘Analyzing the Credit Crisis: Was the SEC Missing in Action?’, *New York Law Journal*, December 5, 2008. Available at <http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202426495544>

⁷²⁰ Securities and Exchange Commission (2009) (note 716, *supra*) at p. 120.

⁷²¹ In its 2009 report the SEC stated: “The Commission stated that neither the CSE program nor any regulatory model (i.e., the Basel Standards) used by commercial or investment banks considered the possibility that secured financing, even when backed by high-quality collateral could become completely unavailable. Instead, the CSE program only considered that a deterioration of secured financing could occur (e.g., that financing terms could become less favorable) and that unsecured funding could be unavailable for at least one year.” *Ibid.*, at 7.

rations at 33:1 and 40:1 respectively,⁷²² merged with other banks because of their unsustainable debt levels and refinancing problems. Lehman Brothers filed for chapter 11-bankruptcy protection; and Goldman Sachs and Morgan Stanley converted into bank holding companies - which brought them under the regulatory jurisdiction of the Federal Reserve with access to lender of last resort and deposit insurance protection.

The SEC is also accused of failing to regulate and supervise investment banks' asset concentration risk as part of investment banking overall risk management systems. This resulted in investment banks such as Bear Stearns being over-exposed to mortgage securities.⁷²³ Such concentrated exposures to U.S. subprime mortgage-backed securities caused severe losses, eroded capital bases and heightened financial distress as firms struggled to refinance.⁷²⁴ The SEC's regulation of investment banks under the CSE programme formerly ended in September 2008 and the Federal Reserve now regulates them.

9.4.1.3. Inadequate resourcing of the SEC

The SEC has also been criticised for its failure to effectively discharge its securities markets regulatory responsibilities because of inadequate resources. The U.S. Government Accountability Office (GAO) stated for instance that the SEC had inadequate manpower, expertise and technology with which to effectively discharge its mandate; and corporate misconduct investigations were hampered and enforcement staff members were discouraged from issuing penalties against corporations.⁷²⁵ As a

⁷²² Coffee (2009) (note 719, supra), at p. 1.

⁷²³ Securities and Exchange Commission (2009) (note 716, supra) at p. 18.

⁷²⁴ Senior Supervisors Group (2008) 'Observations on Risk Management Practices During the Recent Market Turbulence', at p.2. Available at

http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf

⁷²⁵ In its report the GAO stated: Enforcement management said resource levels have allowed them to continue to bring cases across a range of violations, but both management and staff said resource challenges have delayed cases, reduced the number of cases that can be brought, and potentially undermined the quality of some cases. Specifically, investigative attorneys cited the low level of

result, the SEC struggled to identify market manipulation and protect investors. These are some of the reasons given for the failure to discover, notwithstanding complaints and some investigations, the Ponzi scheme run by Bernard Madoff's hedge fund.⁷²⁶ The following section analyses whether the SC has the necessary tools with which to prevent and manage risks that can arise from the issuance and trade in structured finance securities in Zimbabwe.

9.4.2. Securities Commission's regulatory jurisdiction

As noted above, the SC: (i) regulates the marketing of, and investment in, securities;⁷²⁷ (ii) regulates and registers securities exchanges;⁷²⁸ (iii) regulates and licenses persons who trade or deal in or manage securities;⁷²⁹ and (iv) regulates the establishment and functions of central securities depositories to facilitate the marketing and transfer of securities.⁷³⁰ The SC registers all securities exchanges in Zimbabwe,⁷³¹ and is empowered to impose terms and conditions on securities exchanges licences.⁷³²

In addition, the Securities Act requires the SC to licence and regulate the activities of any person carrying on a licensable activity. A licensable activity is defined in section 2 of the Securities Act to include: "...the giving of investment advice, that is to say - (i) advising other persons on their investments in securities; (ii) issuing or publishing analyses or reports on securities; (iii) on behalf of a client, undertaking the

administrative, paralegal, and information technology support, and unavailability of specialized services and expertise, as challenges to bringing actions. Also, Enforcement staff said a burdensome system for internal case review has slowed cases and created a risk-averse culture." Securities and Exchange Commission (2009) (note 716, supra) at p. 5. Available at www.gao.gov/new.items/d09358.pdf

⁷²⁶ Ibid., at p. 45.

⁷²⁷ Section 4(2) of the Securities Act.

⁷²⁸ Ibid., at Part IV.

⁷²⁹ Ibid., at Part V.

⁷³⁰ Ibid., at Part IX.

⁷³¹ Ibid., at section 29(1).

⁷³² Ibid., at section 31.

management of a portfolio of securities for the purpose of investment, including the arranging of purchases, sales or exchanges of securities through a licensed dealer...⁷³³ [Emphasis added]. The Securities Act lists persons deemed to carry out licensable activities. These include: securities dealers, securities investment advisers, securities investment managers, securities trustees and securities custodian service and securities transfer service providers. This means broker-dealer firms are regulated by the SC. As noted above collective investment schemes and asset management companies are not required to be licensed by the SC,⁷³⁴ which is an anomaly given that their main activities are securities related and should therefore be regulated by the SC and not by the RBZ.

9.4.2.1. Structured finance lawyers, CRAs and auditors

From the definition of licensable activity, it is clear that CRAs and securities lawyers although not mentioned by name, are required to obtain a licence from and are regulated by the SC. CRAs issue reports on securities and for this reason fall within the definition of persons undertaking licensable activities.⁷³⁵ The same applies to securities lawyers since they give advice to investors in, or underwriters of, securities issued by a structured finance SPV, opining whether full disclosure has been effected under the relevant securities laws.⁷³⁶

Whether transactional lawyers and public auditors are obliged to obtain a licence from the SC is less certain. Transactional lawyers advise issuers or arrangers and

⁷³³ The word “securities” is defined broadly to include equity, debt or any other instrument acknowledging indebtedness, including certificates of deposits, futures and swaps. *Ibid.*, at section 2.

⁷³⁴ *Ibid.*, at section 38(3)(b).

⁷³⁵ *Ibid.*, at section (2)(ii).

⁷³⁶ Steven L. Schwarcz (2006) ‘The Public Responsibility of Structured Finance Lawyers’. *Capital Markets Law Journal*, Vol. 1, No. 1, 6, at p. 7. 2006. Available at: <http://ssrn.com/abstract=929859>

produce true-sale and non-consolidation opinions.⁷³⁷ Similarly, auditors verify the accuracy of an issuer client's financial records and produce audit reports. To the extent that true-sale and non-consolidation opinions and audit reports are third-party opinions⁷³⁸ issued in reality for the benefit of securities investors; transactional counsel and auditors engaged to advise securitization transactions, arguably fall within the category of persons whose activities require them to obtain licences from the SC.⁷³⁹ This conclusion is arrived at only by looking at the purpose of third party opinions, rather than the strict legal effect of the contractual relationship between an opining transactional lawyer or an auditor. If a strict legal interpretation were adopted, the necessary conclusion would be that an auditor providing an audit report and a transactional lawyer providing a true-sale or non-consolidation opinion to an issuer/arranger client is not giving advice to another person "on their investments in securities." This definition of licensable activity in section 2 of the Securities Act should be reformulated to clearly stipulate that all structured finance lawyers and auditors involved in structuring securities products to be publicly traded are regulated to that extent by the SC. Alternatively the SC should issue guidance notes which clarify that all structured finance lawyers and public auditors are deemed to be undertaking licensable activities.

Section 38(3) (a) (iv) and (v) of the Securities Act exempts from registration lawyers and auditors registered under the Legal Practitioners Act and the Public

⁷³⁷ Ibid.

⁷³⁸ Macey defines a third party legal opinion as: "...a legal opinion provided for the benefit of some third party who is not the client of the lawyers who write the opinion." Jonathan Macey (2005) 'The Limits of Legal Analysis: Using Externalities to Explain Legal Opinions in Structured Finance', *Texas Law Review* vol. 84:75, at p. 75. Available at: <http://www.utexas.edu/law/journals/tlr/abstracts/84/84macey.pdf>

⁷³⁹ Schwarcz states: "The vast majority of legal opinions in structured-finance transactions, including virtually all true-sale and non-consolidation opinions, are third-party legal opinions, typically provided to or for the benefit of the SPV's investors by outside counsel to the originator." Steven L. Schwarcz (2005) 'The Limits of Lawyering: Legal Opinions in Structured Finance'. *Texas Law Review*, Vol. 84, 2005, at p. 8. Available at: <http://ssrn.com/abstract=774350>

Accountants and Auditors Act, respectively, whose securities advice is incidental to their overall practice. There are a few, if any, lawyers and public auditors in Zimbabwe whose practice will consist exclusively or substantially of providing securities investment advice. Most lawyers' and auditors' practices will include other areas of the law and audit practice, respectively. This creates a risk that in practice very few, if any, lawyers and auditors will seek, or can be compelled to seek, registration with the SC. Lawyers and auditors play a critical gatekeeping function in structured finance markets. Their failures, as reflected by the role of Enron's lawyers and auditors in fraudulent securitization-type transactions, can result in corporate collapses or the undermining of financial stability. This exemption should be removed to ensure that all structured finance lawyers and auditors engaged in securitization transaction are required to obtain licenses from and be regulated by the SC.

Section 38 of the Securities Act also exempts from registration registered banking, building society and insurance institutions. While this exemption is understandable and avoids duplicating regulatory jurisdictions and authority; it is unclear if employees of these institutions engaged as lawyers and auditors and who give securities investments advice are also exempted from registration under the Act and are consequentially not regulated by the SC. This ambiguity should be clarified, as the regulation of the foregoing by the SC should not depend on their employment status.

This study recommends that the CIS Act, the AMC Act and the Securities Act should be amended to provide that persons providing investment advice to, and investing people's assets in the securities markets should be registered, regulated and supervised by the SC. In addition, the Securities Act should be amended to clearly stipulate that structured finance lawyers and public auditors involved in structured finance transactions and who give advice to originating firms, arrangers, issuers, and

investors are obliged to obtain a licence from, and are regulated by, the SC. This would enable the SC to mitigate financial information failure risks that can be caused by the fraudulent, reckless, or negligent provision of financial advice by key capital markets gatekeepers to structured finance market participants through: (a) the promulgation and enforcement of peremptory rules of conduct; (b) surveillance and monitoring; and (c) administrative sanctions, such as deregistration, monetary fines and other penalties.

9.4.3. Securities Commission's risk-management authority

The powers of the SC as contained in the Securities Act are quite expansive. As noted above, the SC registers and supervises the operations of public securities exchanges in Zimbabwe. It can amend or cancel securities exchanges' registration certificates.⁷⁴⁰ It also registers persons carrying on licensable activities and makes rules governing their operations, per section 118 of the Securities Act. The rules prescribed by the SC have the force of law - as subsidiary legislation - once gazetted by the Minister of Finance through a statutory instrument.⁷⁴¹

The SC has power to obtain information or documents - necessary for the prevention, investigation or detection of an offence or breach of the Securities Act - from a licensed person, a registered securities exchange or a securities depository, or from an employee of, or person who has or had any business or dealings with, the foregoing.⁷⁴² In addition, the SC has power to investigate the business, activities or operations of any registered securities exchange, licensed person or central depository. For this purpose, the SC can appoint one or more of its employees or a

⁷⁴⁰ Part IV of the Securities Act.

⁷⁴¹ *Ibid.*, at section 118(6).

⁷⁴² *Ibid.*, at section 101(1).

member of the Public Service Commission to be an inspector.⁷⁴³ Further, the SC can order an investigation if a licensed person, securities exchange or central depository (licensee hereafter): (i) fails to furnish information or documentation that has been requested by the SC, or furnishes incorrect or incomplete information or if the furnished information establishes a breach of the Securities Act; (ii) fails to correct an irregularity in the conduct of its business, activities or operations within 30 days of being ordered to do so by the SC; or (iii) prevents an inspector from exercising its powers as provided for under the Securities Act. The SC can also initiate an investigation if it has reasonable grounds for believing that any class of clients of a licensed person or members of a securities exchange or participants or depositors in a central depository are being prejudiced. An inspector appointed by the SC has extensive powers of search and seizure, and exercises the same powers as a Commissioner appointed under the Commissions of Inquiry Act [Chap 10:07].

With regards a licensee, the SC can, following an investigation by an inspector: (i) issue a warning; (ii) require the appointment of a person who can best advise the licensee on the proper conduct of its business; (iii) issue a written instruction, require the licensee to undertake remedial action specified in the instruction; (iv) impose a monetary penalty; (v) instruct the licensee to suspend or remove any of its officers or employees from their duties; (vi) direct the licensee to suspend all or any of its business; (viii) appoint a supervisor to monitor the affairs of the licensee; (ix) require the licensee - where it is a corporate body to convene a meeting of its members to discuss remedial measures to be taken; (x) cancel the licensee's licence or amend any of its licence terms or conditions; and (xi) in the case of a central securities depository, direct the operator to dissolve same or amend any rules governing its

⁷⁴³ Ibid., at section 101.

operations.⁷⁴⁴ The SC can also apply to Court to interdict a threatened breach of the Securities Act by any person,⁷⁴⁵ and initiate class actions on behalf of aggrieved investors.⁷⁴⁶ Further, the SC has an array of supervisory and enforcement powers over securities law violations. It supervises the framework that penalises the misuse of insider information, improper securities trading, such as fraud, false trading and market manipulation.⁷⁴⁷

Although its powers, as described above, are expansive the SC is yet to create a framework that: (i) regulates and supervises the process of issuing, and the entities that issue, structured finance securities; (ii) regulates the issuance of key types of structured finance securities products, such as basic ABS, or more complex CDOs; (iii) regulates CDS transactions; (iv) ensures the adequate protection of investors in structured finance securities; and (v) ensures overall financial market stability. The SC was criticised by the RBZ Governor in his January 2009 Monetary Statement Policy for these failures.⁷⁴⁸ Given this situation, if firms in Zimbabwe were to originate and issue structured finance securities, the SC would not be able to prevent or effectively manage potential consequential risks, such as those highlighted above.

⁷⁴⁴ Ibid., at section 105.

⁷⁴⁵ Ibid., at section 109.

⁷⁴⁶ Ibid., at section 99.

⁷⁴⁷ Ibid., at Part X and XI.

⁷⁴⁸ The RBZ Governor stated: “Inadequate Regulatory Framework for Non-bank Financial Institutions ... 2.24 The absence of a well defined and comprehensive regulatory prudential supervision framework for the Zimbabwe Stock Exchange, Stock Brokers...has significantly compromised financial stability. 2.25 Inadequate oversight of the capital market...has provided a hotbed for illegal transactions, indiscipline and reckless disregard of rules and regulations. 2.26 Stock-broking firms have continued to mushroom all over the market some of which are under resourced, and are manned by unaccountable one man bands. 2.27 There are no prescribed educational credentials for registration of stockbrokers... As Monetary Authorities, we are cognizant of the fact that financial stability is dependent on the collective stability of financial markets, financial institutions and financial infrastructure. 2.31 We, therefore, call upon the...the Securities Commission (SEC) to put in place comprehensive prudential supervision frameworks for the effective supervision of...capital markets based on international best practice... Similarly, SEC should subject stockbrokers, ZSE, financial advisors and other capital market players to prudential supervision in accordance with the International Organization of Securities Commissions (IOSCO) core principles for effective supervision.” RBZ (2009) (note 623, supra) at p. 49.

This study recommends that the SC prescribe a framework of rules and best practice guidelines governing the origination and issuance of structured finance securities. The SC must: (i) stipulate due diligence requirements that must be undertaken and certified by issuers pertaining to loans to be securitized – to mitigate the risk of moral hazard, incentive misalignment, fraud and other abusive practices; (ii) prescribe risk management rules for issuers, including rules pertaining to minimum capital and liquidity requirements; (iii) establish a framework for the registration, regulation and supervision of CRAs, including the rating process, establishing due diligence thresholds for CRAs rating public structured finance securities issuances;⁷⁴⁹ (iv) create a framework for the registration, regulation and supervision of structured finance lawyers and public auditors, clearly stipulating guidelines for true-sale and non-consolidation opinions as well as audit reports, respectively;⁷⁵⁰ (v) prescribe disclosure rules governing structured finance securities to reduce systemic risk - and possibly require issuers to retain some prescribed risk in securitization structures - and warrant that a prescribed threshold of due diligence has been undertaken by issuers, arrangers, underwriters, third party opinion givers such as structured finance lawyers and auditors, and CRAs; and (vi) establish a framework that results in the standardization of documentation for financial assets to be securitized, but under an enhanced disclosure framework.

9.5. Recommendation: Establishment of an integrated regulatory system

As above, this study argues that Zimbabwe should reform and reconstitute its hybrid financial services regulatory agency framework into an integrated one to ensure that it is capable of preventing and managing risk that can arise from the

⁷⁴⁹ Specific recommendations are made in chapter 10 below.

⁷⁵⁰ Ibid.

securitization. Although the extant regulatory system can in practice be harnessed to prevent and manage some securitization transaction risks, it suffers from some weaknesses, as reflected above. Typified by the U.S. financial services regulatory system, a hybrid regulatory structure is prone to regulatory gaps and enables regulatory arbitrage.

Save for the U.S., it is notable that most other countries that have securitization markets reformed their financial services regulatory systems into integrated models.⁷⁵¹ This is especially true of European countries,⁷⁵² where reforms were driven largely by changes in the nature of financial services,⁷⁵³ such as: (i) financial deregulation; (ii) increased dominance of financial conglomerates; (iii) increasing connectedness and complexity of financial markets and products;⁷⁵⁴ and (iv) the blurring of traditional financial roles and products caused in part by securitization.⁷⁵⁵ In most cases, the number of regulatory agencies was reduced⁷⁵⁶ and their capacity enhanced.⁷⁵⁷

⁷⁵¹ For proposals made in relation to the U.S. see, United States Department of the Treasury (2009) (note 609, supra). For the U.K. see for instance the report by: The Financial Services Authority (2009) 'The Turner Review: A Regulatory Response to the Global Banking Crisis'. Available at www.fsa.gov.uk/pubs/other/turner_review.pdf See also the Group of 30, which recommended (in recommendation 6) that countries re-evaluate their regulatory structures with a view to eliminating unnecessary overlaps, gaps in coverage and complexity, removing the potential for regulatory arbitrage, and improving regulatory coordination. Group of 30 (2009) 'Financial Reform: A Framework for Financial Stability'. Available at <http://www.group30.org/pubs/recommendations.pdf>

⁷⁵² For a synopsis of global regulatory reforms undertaken since 1998, refer to Donato Masciandaro and Marc Quintyn (2008) 'Reforming Financial Supervision and the Role of Central Banks: A Review of Global Trends, Causes and Effects (1998-2008)', at p. 3. Available at www.cepr.org/pubs/PolicyInsights/CEPR_Policy_Insight_030.asp In the U.K. a new Banking Act (2009) was introduced to strengthen the role and power of the Bank of England with regards the resolution of affairs of banking institutions in financial difficulties.

⁷⁵³ Erlend W. Nier (2009) 'Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis', *IMF Working Paper* (WP/09/70), at p. 39. Available at <http://ssrn.com/abstract=1378882>

⁷⁵⁴ See for instance Eilis Ferran (2002) 'Examining the UK's Experience in Adopting the Single Financial Regulator Model', at p. 258. Available at <http://ssrn.com/abstract=346120>

⁷⁵⁵ See for instance Blanchard who states that securitization increased interconnectedness between different types of financial institutions within and across countries. Olivier Blanchard (2009) 'The Crisis: Basic Mechanisms, and Appropriate Policies', *IMF Working Paper* (WP/09/80), at p. 7. Available at <http://www.imf.org/external/pubs/ft/wp/2009/wp0980.pdf>

⁷⁵⁶ Marc Quintyn and Michael W. Taylor (2007) 'Building Supervisory Structures in Sub Saharan Africa - An Analytical Framework', *IMF Working Paper* (WP/07/18), at p. 3. Available at <http://www.imf.org/external/pubs/ft/wp/2007/wp0718.pdf>

⁷⁵⁷ Several commentators argue that there is a trend towards consolidated regulator models. See for instance Coffee and Sale (2008) (note 664, supra) at p. 10. This trend, notwithstanding, apparently,

Integrated regulatory models are considered more effective and efficient at regulating and supervising increasingly sophisticated and globalised financial services.⁷⁵⁸

Although there does not exist one optimal financial services regulatory agency system,⁷⁵⁹ it is notable that the 2007 global financial crisis prompted questions about the effectiveness of hybrid regulatory agencies (U.S.),⁷⁶⁰ universal regulatory agency structures (U.K.)⁷⁶¹ and in those with a twin-peaks system (Australia). Notably, as illustrated by the global financial crisis, each of these jurisdictions failed to effectively manage risks inherent in structured finance. These developments suggest that although important, the structure of a regulator model may be less of an issue compared to how effectively and efficiently: (i) it discharges in practice its regulatory and supervisory functions; (ii) its constituent parts operate and coordinate; and (iii) how well it resolves systemic risk.⁷⁶²

hybrid (functional and institutional) regulatory systems remain in the majority. See also Masciandaro and Quintyn (2008) (note 752, supra) at p. 3; Richard Podpiera and Martin Cihák (2007) 'Are More Integrated Prudential Supervision Agencies Characterized By Better Regulation and Supervision?' at p. 1. Available at <http://ssrn.com/abstract=998624>

⁷⁵⁸ Some commentators posit that domestic politics and corporate scandals influenced some regulatory reform initiatives. The U.K. is an example of a country that reformed its financial services sector regulatory system in part due to internal political considerations. For this argument, see generally Ferran (2002) (note 754, supra). See also Coffee and Sale (note 664, supra) at p. 14.

⁷⁵⁹ See for instance Erlend Walter Nier who states: "The question which regulatory structures are conducive to achieving the goals of financial regulation has long been a difficult policy issue.... It is likely that no single structure will be optimal for all countries, regardless of the state of development of the financial sector and other contextual circumstances." Nier (2009) (note 753, supra), at p. 37.

Regarding the on-going debate in the U.S. about reform of its financial services regulatory system, John Coffee and Hillary Sale argue that a comparative survey of regulatory reforms implemented by other countries reveals that these were mainly driven by internal country politics and scandals and cannot therefore prescribe what the U.S. should do. Coffee and Sale (2008) (note 664, supra) at p. 14.

⁷⁶⁰ United States Department of the Treasury (2009) (note 609, supra) at p. 4.

⁷⁶¹ Willem H. Buiter (2007) 'Lessons from the 2007 Financial Crisis', *Centre for Economic Policy Research: Policy Insight* No. 18, December 2007), at p. 13. Available at: <http://www.cepr.org/pubs/PolicyInsights/PolicyInsight18.pdf>

⁷⁶² See for instance Abrams and Taylor who state: "Maintaining and enhancing supervisory capacity and the effectiveness of supervision should be the primary goal of any proposed regulatory reform. As such the development of regulatory capacity should be given prominence over the issue of regulatory structure, and the latter is only a matter of fundamental concern to the extent that it can assist in achieving this overarching objective." Richard K. Abrams and Michael W. Taylor (2000) 'Issues in Unification of Financial Sector Supervision', *IMF Working Paper* (WP/00/213) at p. 5. Available at <http://www.imf.org/external/pubs/ft/wp/2000/wp00213.pdf> In addition, as noted by Nier, whichever regulatory model is adopted, it must ensure that: (i) the key regulatory objectives of systemic risk reduction and consumer protection are assigned to an agency; (ii) each agency has an internally consistent set of objectives; (iii) conflicting objectives are assigned to different agencies; (iv) required

9.5.1. Arguments for an integrated regulatory model in Zimbabwe

Although there is no universal theory of financial services regulation,⁷⁶³ this study argues that the structure of Zimbabwe's financial services regulatory system should be reformed; not because the system has failed to manage securitization-transaction related risks, but because, as illustrated above, in practice it is likely to prove ineffective at managing risks - such as those exposed by the 2007 global financial crisis. The primary reason for this hypothesis is that Zimbabwe's regulatory system, especially its securities markets regulatory framework, is rudimentary and is under-developed to adequately prevent and manage securitization transaction-related risks.

Although supporting evidence is scant, commentators argue that integrated regulatory agencies deliver higher quality regulation of banking, insurance and securities markets compared to other systems.⁷⁶⁴ Arguably, integrated regulatory structures: (i) are better at regulating financial conglomerates; (ii) reduce the need for, and inefficiencies arising from, inter-agency co-ordination across sectoral lines;⁷⁶⁵ (iii) prevent regulatory arbitrage; (iv) result in the development of a professional body of qualified and experienced regulatory staff, spanning the entire financial services sector; (v) increase regulatory efficiency, reduce the costs of compliance and assist in achieving economies of scale;⁷⁶⁶ (vi) reduce regulatory turf wars and increase regulatory accountability; and (vii) result in greater regulatory agency flexibility,

tools are granted to those agencies tasked with the relevant objective; (v) it creates synergies across tools; (vi) it creates synergies across regulatory institutions; (vii) it reduces the potential for inter-agency frictions; (viii) consistency with pre-existing objectives and (ix) it must reduce duplication. Nier (2009) (note 753, supra) at p. 38.

⁷⁶³ Kenneth K. Mwenda (2006) 'Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator', *World Bank*. Available at http://siteresources.worldbank.org/INTAFRISUMAFRTPS/Resources/Legal_Aspects_of_Financial_Sces_Regulations.pdf

⁷⁶⁴ *Ibid.*, at pp. 18-22.

⁷⁶⁵ Nier (2009) (note 753, supra) at p. 40.

⁷⁶⁶ Donato Masciandaro and Marc Quintyn (2008) 'After the Big Bang and Before the Next One? Reforming the Financial Supervision Architecture and the Role of the Central Bank. A Review of Worldwide Trends, Causes and Effects (1998-2008)', at pp. 6-8. Available at <http://ssrn.com/abstract=1336390>

allowing swifter familiarity with, and responses to, risks peculiar to financial innovations compared to functional or institutional regulation, which may be based on a narrow range of institutions and products.⁷⁶⁷ Obviously integrated systems have their disadvantages. Achieving a balance between conduct of business regulation on the one hand and prudential regulation on the other can be a challenge, a fact noted in the context of the U.K.'s FSA.⁷⁶⁸

This study recommends the jettisoning of the current regulatory system in favour of either the universal or twin-peaks regulatory model or a variant of either. The current hybrid system is fragmented and ill-suited for a modern financial system. A fragmented regulatory system results in regulation based on legal form rather than economic substance.⁷⁶⁹ This criticism, which has been levelled against the current U.S. financial services regulatory system,⁷⁷⁰ applies with equal force to Zimbabwe. As noted above, the RBZ regulates some and not all banking and building society institutions, the IPC regulates insurance firms and pensions and provident funds, while the SC regulates the securities markets as well as some of the securities markets gatekeepers, but it does not regulate collective investment schemes or asset management companies. This system has obvious regulatory flaws, including regulatory gaps and can facilitate regulatory arbitrage especially by financial conglomerates engaged in more than one line of financial services business.⁷⁷¹

⁷⁶⁷ For a good, if slightly dated article which states the pros and cons of integrated financial services regulatory systems refer to Abrams and Taylor (2000) (note 762, supra)

⁷⁶⁸ The Financial Services Authority (2009) (note 751, supra) at p. 87. For some of the disadvantages of the integrated regulatory structure, refer to Nier (2009) (note 753, supra) at pp. 41-43.

⁷⁶⁹ Financial Services Authority (2009) (note 751, supra) at p. 71.

⁷⁷⁰ Ibid.

⁷⁷¹ See for instance the complaint made by the Reserve Bank of Zimbabwe Governor in his Monetary Statement for 2009: "2.24 The absence of a well defined and comprehensive regulatory prudential supervision framework for the Zimbabwe Stock Exchange, Stock Brokers, Insurance Companies and Pension Funds has significantly compromised financial stability. 2.25 Inadequate oversight of the capital market, pension and insurance sectors has provided a hotbed for illegal transactions, indiscipline and reckless disregard of rules and regulations. 2.26 Stock-broking firms have continued to mushroom

Zimbabwe should enact a law that provides for an integrated regulatory agency. As noted above, a weak consolidated supervisory framework has been structured through the issuance by the RBZ of a set of Guidelines.⁷⁷² The Guidelines enable the RBZ to indirectly supervise any financial conglomerate one of whose related entities is a regulated banking institution.⁷⁷³ The RBZ promulgated the guidelines because there are financial conglomerates in Zimbabwe whose interests span the banking, insurance and securities markets,⁷⁷⁴ which exposes the banking system to myriad risks.⁷⁷⁵ The obvious weakness with this consolidated supervisory system, as argued in paragraph 9.2.2.4. is that it was structured through Guidelines and not through an Act of Parliament. This consolidated supervision framework is arguably ineffectual. It cannot be used to effectively regulate and supervise banking, insurance and securities firms and markets. The new integrated framework would enable the consolidated regulation and supervision of: (i) banking, building society, micro-finance and other

all over the market some of which are under resourced, and are manned by unaccountable one man bands.” Reserve Bank of Zimbabwe (2009) (note 623, supra), at p. 49.

⁷⁷² RBZ (2007) (note 621, supra).

⁷⁷³ Clause 1.4. to the introduction the Guideline states: “the primary objective of Consolidated Supervision is not to supervise each and every entity in the group but to supervise the regulated entity as part of the group so as to take into account the potential impact of the various group entities on the banking institution”.... In the preamble in clause 2 to 4 thereof, the Guidelines state: “2. The Banking Act [Chapter 24:20], in particular Section 45(1)(c), empowers the Reserve Bank of Zimbabwe to monitor, supervise and investigate associates of banking institutions, hence facilitate supervision of banking institutions on a consolidated basis. 3. This Guideline shall apply to every banking institution, bank holding company, financial conglomerate, mixed activity group, and their associates as defined in section 2 of the Banking Act [Chapter 24:20]. 4. For purposes of Consolidated Supervision, insurance companies shall be included in the consolidation to the extent of providing a qualitative assessment only but excluded with respect to Quantitative Consolidation of the banking group.” Ibid.

⁷⁷⁴ Examples of such entities include Trust Holdings, Kingdom Financial Holdings, National Merchant Bank of Zimbabwe, Inter Market Financial Holdings. In its January 2009 Monetary Statement the RBZ Governor stated that some banking institutions engaged in regulatory arbitrage by using unregulated conduits to transact non-banking business activities. RBZ (2009) (note 621, supra) at paragraph 2.62.

⁷⁷⁵ The RBZ Bank Supervision Guideline states: “1.5. Financial conglomerates bring with them a number of regulatory and supervisory concerns, including but not limited to abuse of economic power; agency problems; imprudent intra-group transactions and exposures; reputation risk; moral hazard; regulatory arbitrage; conflicts of interest; complex corporate structures; and potential for risk management difficulties. 1.6 In addition, the complexity in structure and size of many conglomerates heightens supervisory concerns in respect of contagion risk (within and between groups), and double / multiple gearing through intragroup holding of capital. 1.7 Consolidated Supervision, therefore, provides a methodology to assess and monitor how effectively a banking group identifies, measures, monitors and controls risk; to recognise incipient problems; and to keep abreast with global trend and current best practice in supervision.” [Emphasis added]. Ibid., at pp. 5-6.

money lending institutions; (ii) non-banking financial institutions, including hedge funds, to prevent the emergence of an unregulated shadow banking system; (iii) non-banking institutions such as insurance firms, pension and provident funds, investment banking institutions, asset management companies and collective investment schemes; and (iv) key gatekeepers to the financial markets.

Such an integrated agency structure is better placed to establish a framework for the regulation and supervision of: (i) the securitization-enabled originate-to-distribute business model for all deposit taking institutions and other financial firms capable of accessing wholesale funding, such as insurance firms; (ii) prescribe and supervise financial institutions' risk management practices, with particular focus on risk-based capital and liquidity requirements for banking, insurance and broker-dealer firms; (iii) securitization transaction best practice guidelines, which deal, among others, with the origination and underwriting of loans – including through standardization requirements; (iv) financial industry-wide compensation schemes and other good corporate governance requirements; (v) structured finance securities issuance, including the regulation of derivative instruments such as CDS; (vi) an enhanced capital markets regulatory framework, including enhanced disclosure rules, especially for structured finance securities, which as shown by the 2007 global financial crisis can be complex and difficult to price.

The integrated framework should be complemented by a law providing for the resolution of financial institutions whose insolvency will undermine financial stability. As noted above, the TFIR Act only applies to banking and building institutions regulated by the RBZ. But as shown by the case of AIG, the collapse of non-banking institutions can threaten financial stability. An integrated regulatory agency will also be able to prescribe a framework that enables the holistic regulation

and supervision of securitization transactions and consequential risks. In addition, an integrated agency would be able to ensure consumer protection, i.e. the protection of consumers of financial products and services as well as investors in securities.

Obviously, to be effective, the integrated agency must be adequately resourced, i.e. with adequate numbers of personnel with appropriate expertise, who are provided with sufficient resources - human, material, financial and technical - to effectively discharge their statutory mandate of prudential financial sector regulation and supervision. In addition, the agency would have to: (i) enforce applicable laws, policies and practices; and (ii) be independent in law and practice from interest groups such as financial industry stakeholders and the government in the discharge of its responsibilities.⁷⁷⁶

9.6. Summary

In summary, this chapter evaluated the law relating to the RBZ, the IPC and the SC; the banking, insurance and securities markets regulators, respectively. Of the three regulatory agencies, the RBZ is the only one that has put in place a framework for the prudential regulation of securitization. The SC is yet to put in place any framework, which among others, would: (i) regulate the origination, trade or dealing in structured finance securities; (ii) create a capital markets gatekeeping regulatory framework;⁷⁷⁷ and (iii) prescribe risk prevention and management rules that can potentially arise from securitization. Similarly, the IPC is yet to create a modern prudential regulatory framework for insurance firms intending to engage in

⁷⁷⁶ A criticism levelled against the U.K.'s FSA is that it was compromised by interest group capture and was lax in enforcing applicable laws, did not have adequate enforcement resources and personnel. John Armour (2008) 'Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment'. *ECGI - Law Working Paper* No. 106/2008, at pp. 19-22. Available at <http://ssrn.com/abstract=1133542>

⁷⁷⁷ Refer to chapter 9.

securitization transactions as originators, providers of credit default risk insurance or as investors in structured finance securities. To this extent, Zimbabwe has an inadequate and incomplete structured finance risk mitigation framework. On this account, this study concludes that it would be arguably imprudent for a full-blown securitization market to propagate in the absence of a reformed and enhanced financial services regulatory framework. From a risk management perspective, such a framework should take the form of an integrated financial services regulatory agency model over the extant hybrid financial services regulatory system.

CHAPTER 10

CAPITAL MARKETS GATEKEEPING FRAMEWORK

10.1. Introduction

This chapter analyses the extent to which Zimbabwe's capital markets gatekeeping framework enables the prevention of risks that can arise from securitization. Failures by gatekeepers to the capital markets (gatekeepers hereafter) which contributed to the 2001 collapse of Enron and the 2007 global financial crisis, illustrate the need for strengthening capital markets gatekeeping frameworks. This chapter evaluates the legal framework relating to structured finance lawyers, public auditors and CRAs. They are among gatekeepers who are critical to structured finance transactions and related risk mitigation. Being a legal study, this thesis does not evaluate whether or the extent to which the risk to the reputations of these gatekeepers mitigates financial information failure risk.⁷⁷⁸ The 2007 global financial crisis has in any event illustrated the limits of reputation and the need to establish effective gatekeeper regulation and supervision frameworks. This chapter concludes that Zimbabwe's framework relating to structured finance lawyers, public auditors and CRAs is underdeveloped must be enhanced to ensure the effective mitigation of securitization transaction related risks.

⁷⁷⁸ Such an analysis would require an empirical analysis which would constitute a separate study of its own, and is beyond the scope of this study.

10.2. Context

A gatekeeper is a private firm that uses its reputation (or expertise) “to assure [financial market participants of] the accuracy of statements or representations that it makes or verifies.”⁷⁷⁹ Underlying this definition is the argument that being reputational intermediaries, these private firms have more to lose than gain by falsifying or certifying transactions or records that are inaccurate or that violate applicable laws or practices.⁷⁸⁰ Investment banks, securities analysts, structured finance lawyers, public auditors and CRAs are all among a group of gatekeepers critical to the efficient functioning of capital markets.

The collapse of Enron epitomised the failure of gatekeepers to diligently discharge their responsibilities, resulting in the transmission of misleading financial information within the financial markets to the prejudice of investors. Enron’s auditors (Arthur Andersen) and lawyers (Vinson and Elkin - including its in-house counsel⁷⁸¹) were complicit in the structuring of pseudo-securitization transactions, enabling it to misstate its financial statements, and consequentially misleading the investing public. In addition, CRAs failed to timeously downgrade Enron’s rating.

In response to Enron’s collapse, the U.S. enacted the Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act). This Act: (i) enhanced public auditors’ and structured finance lawyers’ regulatory

⁷⁷⁹ John Coffee (2004) Gatekeeping Failure and Reform: The challenge of Fashioning Relevant Reforms, Berkley Program in Law and Economics, Working Paper Series 2004, paper 160, at pp. 10-11. Available at: <http://repositories.cdlib.org/blewp/art160>

⁷⁸⁰ Coffee and Sale (2008) (note 664, supra) at p. 2. But the gatekeeping failures leading to the collapse of Enron and to the global financial crisis weaken this definition. Risk to reputation did little, it appears, to incentivise CRAs, for instance, to issue accurate ratings for instance, and neither did it stop lawyers and auditors assisting Enron to enter into transactions that enabled it to manipulate its financial reports.

⁷⁸¹ For example, Enron’s external lawyers, Vinson and Elkin were accused of aiding and abetting securities fraud due to their involvement in the structuring of some of Enron’s off balance sheet transactions. See a critique of the role played by lawyers in the collapse of Enron in Keith, R. Fisher (2004) ‘The Higher Calling: Regulation of Lawyers Post-Enron’. *University of Michigan Journal of Law Reform*, Vol. 37, p. 1017, at pp. 1093-1096. Available at: <http://ssrn.com/abstract=824426> See also Susan P. Koniak (2003) ‘When the Hurlyburly’s Done: The Bar’s Struggle with the SEC’, 103 *COLUM. L. REV.* 1236, 1242-43 (2003).

framework; and (ii) required the enhancement of the CRA regulatory framework. As a result, the CRAR Act was enacted. The CRAR Act did not and arguably could not have prevented CRAs from mispricing structured finance securities. The CRAR Act does not, as highlighted above, empower U.S. regulators to adequately regulate the rating process.

The complicity of lawyers, auditors and CRAs in the issuance of misleading financial information to capital markets participants, as evidence by the case of Enron and the 2007 global financial crisis illustrate the need for robust capital markets gatekeeping frameworks; and especially in emerging markets intending to create securitization-enabling financial infrastructure. The following section analyses Zimbabwean law relating to structured finance lawyers, public auditors and CRAs.

10.3. Structured finance lawyers

Lawyers are integral to securitization transactions as transactional and securities-law counsel. Structured finance lawyers advise issuers or investors; issuing true-sale and non-consolidation opinions and opining on securities law compliance. These opinions are part of transactional due diligence and are often prerequisite to deal closure. Although contested, it is argued that these legal opinions assist in reducing information asymmetries.⁷⁸²

⁷⁸² See for instance Lipson who disputes the informational value of true-sale and non-consolidation opinions. Jonathan C. Lipson (2006) 'Price, Path & Pride: Third-Party Closing Opinion Practice among U.S. Lawyers (A Preliminary Investigation)'. *Berkley Business Law Journal*, Vol. 3, p. 59, 2006; Available at <http://ssrn.com/abstract=808064>

10.3.1. Structured finance lawyers as gatekeepers

Although contested, there is a general consensus that lawyers are gatekeepers.⁷⁸³

Critics argue that lawyers traditionally owe a duty to advocate for, and confidentiality to, their clients; both of which are undermined if they are regarded as gatekeepers.

This notwithstanding, it is generally accepted that structured finance lawyers, whether acting as transactional or securities law counsel, do have gatekeeping functions.⁷⁸⁴

Structured finance legal opinions are intended to assure third parties, especially underwriters and securities investors that appropriate due diligence has been undertaken and that a securitization transaction is bankruptcy remote. Diligently discharging this role, structured finance lawyers can detect and potentially disrupt wrongful conduct by withholding their certifying opinions.⁷⁸⁵ For these and other reasons, it has been argued that structured finance lawyers have, and should be compelled to exercise, gatekeeping responsibilities.⁷⁸⁶ Theoretical disputes

⁷⁸³ There is debate on whether lawyers are or should be compelled to act as gatekeepers to the capital markets. See for instance, Fisch *et al* who question lawyers' gatekeeping role. Jill E. Fisch and Kenneth M. Rosen (2003) 'Is There a Role for Lawyers in Preventing Future Enrons?'. *Villanova Law Review*, Vol. 48, No. 4, p. 1097, 2003. Available at <http://ssrn.com/abstract=367661> See also Fish, B (2004) 'Pointing the finger at Professionals: The Responsibility of Lawyers and Other Gatekeepers for Corporate Governance Failures in Corporate Governance and Securities Regulation in the 21st Century', Poonam Puri and Jeffrey Larson, eds., at p. 114.

⁷⁸⁴ Ganuza *et al* argue: "It is hard to deny that...lawyers do play, in many situations involving the operations of a corporation, a substantial gatekeeping function...Clear examples of these relevant gatekeeping functions of lawyers can be found in the area of corporate disclosures by issuers to raise capital both in the equity market and in private finance." Juan Jose Ganuza and Fernando Gomez (2005) 'Should we Trust Gatekeepers?', *InDRET* 4/2005, at p. 3. Available at www.InDRET.com

⁷⁸⁵ Stephanie Ben-Ishai (2006) 'The Effectiveness of Corporate Gatekeeper Liability in Canada', at p. 452-454. Available at: [www.tfmsl.ca/docs/V6\(7\)%20Ben%20Ishai\(II\).pdf](http://www.tfmsl.ca/docs/V6(7)%20Ben%20Ishai(II).pdf). Similarly, Mark Sargent argues: "Lawyers acting in the context of public companies are not only advocates. They are also gatekeepers. They stand at the approaches to the capital markets...the company lawyer has the duty, and at least some power, to constrain unlawful behaviour by the company as it seeks access to capital. The lawyer can control market access by withholding cooperation from the potential wrongdoer. She can refuse to do necessary legal work, provide legal opinions or otherwise refuse to associate the law firm's name with a questionable transaction." Mark A. Sargent (2003) 'Lawyers in a Perfect Storm', *Villanova University School of Law, School of Law Working Paper Series*, No. 16, 2003, at p. 25. Available at <http://law.bepress.com/villanovawps/papers/art16>

⁷⁸⁶ John Coffee states: "Attorneys can also be gatekeepers when they lend their professional reputations to a transaction..." John C. Coffee (2002) 'Understanding Enron: Its About the Gatekeepers, Stupid', *Columbia Law School, The Centre for Law and Economic Studies Working Paper* No. 207, at p. 5. Available at: http://ssrn.com/abstract_id=325240 In a later article, John Coffee states that structured finance lawyers have "guardianship-like responsibilities to investors who rely upon the disclosures that the securities attorney typically prepares or reviews." John C. Coffee (2003) 'The Attorney as

notwithstanding, this study proceeds on the premise that structured finance lawyers are gatekeepers⁷⁸⁷ and that rules of professional conduct - common to most jurisdictions - require them to exercise gatekeeping responsibilities.

10.3.2. Existing risk management framework

In Zimbabwe lawyers are referred to as legal practitioners. Although in practice a distinction is drawn between advocates (barristers) and legal practitioners (solicitors), the Legal Practitioners Act [Chap 27:07] permits all lawyers right of audience before Courts in Zimbabwe, because the profession is fused. However, advocates may not operate trust accounts, and receive instructions only from lawyers in private practice or from the State. All practising lawyers must be members of the Law Society of Zimbabwe (LSZ), which is the representative body of lawyers. It is self-regulatory and is responsible for the interests and welfare its members, and is responsible for enforcing rules of professional conduct. This section assesses whether the extant gatekeeping regulatory and liability framework enables the prevention of lawyer-facilitated fraud and other misdemeanours, which can arise in the context of structured finance securities origination and issuance.

10.3.2.1. Fraud

The Securities Act proscribes securities fraud. A lawyer commits securities fraud, if s/he assists an issuer/arranger-client to fraudulently induce another to trade or deal in securities by: (i) deliberately or recklessly making a statement - such as a true-sale or non-consolidation opinion - which is false or misleading; and which (ii) s/he knows

Gatekeeper: An Agenda for the SEC', *103 Columbia Law Review*, 1293, 2003, at p. 1295. Available at <http://srn.com/abstract=395181> See also Marc Steinberg (2006) 'The Corporate Securities Attorney as a 'Moving Target'-Client Fraud Dilemmas', *Washburn Law Journal*, 2006, vol. 46 at p. 1.

⁷⁸⁷ Zacharias argues that lawyers have always had a gatekeeping function. Fred Zacharias (2004) 'Lawyers as Gatekeepers', *San Diego Law Review*, 2004, vol. 41, 1387.

is false or misleading; (iii) or if s/he dishonestly conceals material facts.⁷⁸⁸ Section 97(1) is ambiguous and the extent to which it deters lawyer-facilitated securities fraud is open to question. One interpretation of the section is that to secure a conviction, a prosecution must establish that a person was actually induced to trade or deal in securities as a result of a false or misleading opinion made by a lawyer that was aware of its falsity. An alternative interpretation is that the prosecution does not need to establish that a person was induced to trade or deal in securities. The deliberate issuance of a misleading opinion by a lawyer well aware of its falsity, or the deliberate withholding of material information, establishes the offence of fraudulent inducement. This ambiguity needs to be clarified. The SC should issue guidance notes to clarify what - in its opinion - amounts to fraudulent inducement to trade or deal in securities in violation of section 97(1). Such guidance will assist in establishing the type of misleading information whose dissemination constitutes a securities law violation.

Arguably, section 97(1) is only ever likely to be applied against a lawyer in the event of collusion between a lawyer and an issuer to defraud investors by making intentionally misleading legal misrepresentations. Lawyers assist issuers and are not principal actors. In addition, an additional hurdle to establishing liability is that a typical true-sale or non-consolidation legal opinion is a reasoned opinion.⁷⁸⁹ This means it does not guarantee the decision that a court seized with a dispute will reach on a matter covered in an opinion. This makes it difficult to establish the *mens rea* required to establish fraud on the part of the opining lawyer.

⁷⁸⁸ Section 97(1) of the Securities Act.

⁷⁸⁹ Steven Schwarcz states that all structured finance opinions are reasoned opinions; i.e. legal opinions which do not set black-letter legal conclusions, but engage in substantive discussion of the applicable law and qualify the discussions as appropriate with reasonable assumptions, cautionary language and disclosure of uncertainties. Steven L. Schwarcz (2005) (note 739, *supra*), at p. 12.

A structured finance lawyer convicted under section 97(1) of the Securities Act can be sued for damages under section 98 and/or under the common law for fraudulent misrepresentation.⁷⁹⁰ The lawyer, the law firm and the issuer client can be sued jointly and severally. An aggrieved party would need to establish causation; i.e. that the legal opinion was the proximate cause of its loss. In practice this may prove difficult given that for their investment decisions investors are more likely to rely on an aggregate of factors, including easy-to-digest information such as ratings or the advice of investment experts, and not simply on a true-sale or non-consolidation opinion for their investment decisions. But it is also true that most securitization deals cannot be closed in the absence of these third-party legal opinions.

To establish a cause of action in tort an aggrieved claimant alleging fraudulent misrepresentation has to establish that the legal opinion was the proximate cause of his or her pecuniary loss. To do so, the plaintiff would have to contend and the court has to accept that: (i) the opinion is a third-party legal opinion; (ii) at the material time, the lawyer had a duty of care to the claimant;⁷⁹¹ (iii) the claimant relied upon the opinion, and that it was reasonable for the claimant to rely on the third party legal opinion; and (iv) that as a result of this reliance on the legal opinion, the claimant suffered pecuniary loss (financial detriment).

There is yet to be established rules and jurisprudence on structured finance lawyers' ethical and legal obligations pertaining to third-party legal opinions. There is no statutory framework to give guidance or establish a duty of care threshold. This

⁷⁹⁰ Unlike in the U.S. where, following the Central Bank of Denver, N.A. v First Interstate Bank of Denver, N.A., 511 U.S. 14 (1994) lawyers are generally immune from civil liability in cases where they aided and abetted their client's wrong doing in securities issuances, in Zimbabwe, there is no such restriction. Lawyers can be sued by aggrieved investors and others who suffered loss as a result of fraud, negligence, recklessness, or where the lawyer aided and abetted a client to commit fraud, or deliberately withhold material information.

⁷⁹¹ In the U.S. context Laby argues that lawyers have a duty to exercise reasonable care when providing third party legal opinions used in business transactions. Arthur Laby (2006) 'Differentiating Gatekeepers', *Brook Journal of Corporate Finance and Commercial Law*, vol. 1, 2006, 119, at p. 131. Available at <http://ssrn.com/abstract=953948>

should be remedied through the promulgation and enforcement by the SC and the Law Society of rules of professional conduct for structured finance lawyers. In the absence of such a framework and in the event of dispute, it is highly likely that the High Court will set a standard of care test for lawyers who provide third-party legal opinions. It is arguable and indeed likely that a court will hold that a lawyer engaged to produce a third-party legal opinion owes third-party beneficiaries a duty of care, i.e. a duty to exercise reasonable care, skill, and diligence.⁷⁹² It is likely that a lawyer that intentionally provides a misleading third-party legal opinion with the intention to commit fraud, may be found liable for pecuniary loss occasioned to investors.⁷⁹³ To limit liability, lawyers typically circumscribe those who may rely on their third-party opinions,⁷⁹⁴ and that this may to an extent limit the range of potential claimants. Liability will therefore depend on the facts of each case. The extent of a lawyer's liability for fraud is limited to the extent of their culpability and the loss occasioned to the claimant.⁷⁹⁵ The possibility of such open-ended liability does arguably have a deterrent effect upon would-be tort-feasors.

10.3.2.2. Negligent misrepresentation

An issuer can sue a lawyer in contract and/or tort for pecuniary loss arising from the reckless or negligent provision of wrong legal advice in relation to a securities issuance. The misrepresentation must be material. It is difficult, although not

⁷⁹² Regarding the appropriate standard of care, the American Bar Association asks the question: "What would a lawyer of reasonable skill and knowledge and similarly situated have done under the circumstances?" A.B.A. Comm. on Legal Opinions, (2004) 'Law Office Opinion Practices', *60 BUS. LAW.* 327, 328 (November 2004).

⁷⁹³ Although a factual matter, the damages must not be remote.

⁷⁹⁴ Jonathan C. Lipson (2006) (note 82, *supra*) at p. 82.

⁷⁹⁵ Writing on Zimbabwe, Christie states that: "fraud is a delict... it follows that damages may be claimed against the maker of a misrepresentation..." He also makes the point that: "the measure of... delictual damages is to make good the loss suffered by the innocent party as a direct result of the fraud." Christie (1997) (note 244, *supra*) at p. 81. With respect to Zimbabwean case-law on the computation of delictual damages for fraud, refer to the seminal case of Pocket's Holdings (Pvt) Ltd v Lobel's Holdings (Pvt) Ltd 1966 RLR 150, at pp. 163-4 and 247-8.

impossible however to establish liability for wrong legal advice that occasions pecuniary loss.

A lawyer may also be sued in tort over true-sale and non-consolidation opinions by underwriters and investors who relied on these third-party opinions. They do not have a cause of action in contract, owing to the absence of a contractual relationship with the lawyer. As noted above, in practice, a typical true-sale or non-consolidation opinion does not give guarantees. It is a reasoned opinion, typically with qualified conclusions, which are based on facts as presented to a lawyer by a client. As noted above, to establish a cause of action in tort an aggrieved claimant alleging negligence or recklessness has to establish that the legal opinion was the proximate cause of his or her pecuniary loss.

A lawyer that: (i) violates section 97(1) or any other provision of the Securities Act; (ii) facilitates a securities law violation by its client; (iii) is reckless or negligent in giving structured finance-related legal advice; or (iv) that engages in conduct likely to bring the legal profession into disrepute, can be disciplined by the disciplinary tribunal of the Law Society of Zimbabwe under its Rules of Professional Conduct.⁷⁹⁶ The disciplinary tribunal is empowered - after a hearing - to disbar, suspend from practice for a particular period, order the payment of damages to an aggrieved client, or impose some other penalty.⁷⁹⁷ This study recommends that the SC should establish a similar framework - because none currently exists - for the regulation and supervision of structured finance lawyers.

⁷⁹⁶ Section 23 of the Legal Practitioners Act (Chap 27:07).

⁷⁹⁷ *Ibid.*, at section 28.

10.3.3. Enhanced risk management framework

The SC is yet to establish a structured finance lawyers' regulatory framework. There are no rules regulating the registration and supervision of structured finance lawyers, the provision of securities law advice, true-sale and non-consolidation opinions or any other related codes of conduct. The SC must provide guidance on third-party opinions, which are fundamental legal elements of securitization transactions.⁷⁹⁸

One of the criticisms levelled against lawyers following the collapse of Enron was that they did not intervene to stop, or were involved in, the structuring of fraudulent securitization transactions.⁷⁹⁹ Currently, a lawyer in Zimbabwe who discovers evidence of a material securities law violation by a client is not under an obligation to intervene. Ethics demand the lawyer withdraw representation, but because of confidentiality rules, the lawyer is under no obligation to do more. This study recommends the promulgation of a corporate governance-type rule similar to the Sarbanes-Oxley Act-imposed reporting-up-the-corporate ladder rule. In the U.S., lawyers are obliged to report up the corporate ladder evidence of a "material violation of securities laws or a breach of fiduciary duties or similar violation by a company or any agents."⁸⁰⁰ Although controversial, this stipulation does not breach client-attorney confidentiality and it ensures that lawyers do not ignore evidence of fraud or a

⁷⁹⁸ In the U.S. for instance the SEC regulates structured finance lawyers. The Sarbanes-Oxley Act empowers the SEC promulgate standards of professional conduct. In addition, it is notable that the American Bar Association and TriBar have rules which give guidance on third-party legal opinions. Refer to The Securities and Exchange Commission, Implementation of Standards of Professional Conduct for Attorneys 17 CFR Part 205, Release Nos. 33-8185; 34-47276; IC-25919, issued January 29, 2003, Available at <http://www.sec.gov/rules/final/33-8185.htm>

⁷⁹⁹ For an eloquent criticism of the role played by lawyers in the collapse of Enron, refer to Koniak (2003) (note 781, supra); See also William Simon (2004) 'Wrongs of Ignorance and Ambiguity: Lawyer responsibility for collective misconduct', *Columbia Law School, Public Law and Legal Theory Working Paper Group*, Paper No. 04-80. Available at: <http://ssrn.com/abstract=602627>

⁸⁰⁰ Section 307 of the Sarbanes-Oxley Act (2002). It requires the SEC to adopt rules "requiring an attorney to report evidence of a material violation of securities law or a breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive office of the company (or the equivalent thereof).

material securities law violation.⁸⁰¹ In Zimbabwe a similar rule can be incorporated through an amendment to the Securities Act, the Law Society of Zimbabwe rules of professional conduct, and/or a code of conduct for structured finance lawyers.⁸⁰² Such an amendment, which must define what is meant by a material violation, can arguably improve corporate governance for public issuers,⁸⁰³ and in the process reduce the risk of, among others, fraudulent securitization transactions.

In the U.S. it was proposed that lawyers should issue mandatory “no-violation-of-law” opinions for structured finance transactions. Although such a prescription would enhance the due diligence threshold, it is arguably unrealistic and costly. This proposal would also require lawyers to second-guess opinions made by accountants and others engaged to either assist in arranging, or issue third party opinions relating to, a securitization transaction. Such a requirement would require structured finance lawyers to be trained in accountancy to a high standard in order to be able to review accounting determinations.⁸⁰⁴

This study does not recommend the imposition of an obligation on structured finance lawyers to whistle-blow on their clients through a noisy withdrawal of representation where there is evidence of a material securities law violation or breach of fiduciary duties. Such a proposal was made by the SEC in the U.S. but shelved after opposition from the American Bar Association and others.⁸⁰⁵ A whistle-blowing

⁸⁰¹ See also Sargent (2003) (note 785, supra), at pp. 54-55.

⁸⁰² The American Bar Association amended its Model Rules of Professional Conduct and incorporated rules 1.6., and rule 1.13., which are largely similar to the SEC rules.

⁸⁰³ The corporate governance benefits of Section 307 of the Sarbanes-Oxley Act have been attacked by lawyers and some scholars. For an illustrative article refer to Jill E. Fisch and Kenneth M. Rosen (2003) ‘Is There a Role for Lawyers in Preventing Future Enrons?’. *Villanova Law Review*, Vol. 48, No. 4, p. 1097, 2003. Available at <http://ssrn.com/abstract=367661>

⁸⁰⁴ For a critique of the suggestion that lawyers should be obliged to second guess accounting determinations in certain instances, see Steven L. Schwarcz (2005) ‘Financial Information Failure: Redrawing the Boundary Between Lawyer and Accountant Responsibility’, *Duke Law School Legal Studies Paper No. 89*. Available at <http://ssrn.com/abstract=845510>

⁸⁰⁵ Refer to rule 205.3 (d) Implementation of Standards of Professional Conduct for Attorneys, Securities Act Rel. No. 33-8150 and 34-46868 (Nov 21, 2002) 67. Fed. Reg. 71670, 71670, 71705-06

obligation is objectionable because it breaches client-attorney confidentiality. In addition, it can be argued that such a rule is not required because in Zimbabwe, as in other jurisdictions, ethics oblige a lawyer to terminate representation if continued representation will result in the commission of a criminal offence. A lawyer may not aid and abet the commission of a criminal offence by a client.

Coffee⁸⁰⁶ and Sargent,⁸⁰⁷ - with Schwarcz and others disagreeing⁸⁰⁸ - have argued that structured finance lawyers should be obliged to enquire if a proposed structured finance transaction on which they have been engaged to draft a third-party legal opinion has a legitimate business purpose. The problem with the proposal made by the Coffee *et al* is that it does not define what is meant by legitimate. It is an amorphous term, influenced by subjective considerations. There is a distinction between legal legitimacy and moral legitimacy. To the extent that Coffee *et al* argue that a lawyer should withdraw representation or whistle-blow on a client because of his or her own perceptions of business legitimacy is to introduce an impractical, costly and ill-defined duty on the profession. A lawyer's duty is not to opine on the business legitimacy of a transaction, but rather on the law. Structured finance lawyers should not be obliged to second-guess their client's business decisions. In any event, rules of professional conduct applicable to lawyers in Zimbabwe, as in the U.K and the U.S. already require them not to knowingly assist their clients to engage in criminal conduct. This rule combined with a section 307 equivalent obliging lawyers to report

(Dec. 2, 2002). Both for and against letters sent in to the SEC can be viewed at www.sec.gov/rules/proposed/S4502.shtml

⁸⁰⁶ Coffee for instance vociferously argues that when giving legal advice lawyers should not have a tunnel vision or wear blinders. John Coffee (2005) 'Comment: Can Lawyers Wear Blinders? Gatekeepers and Third Party Opinions', *Texas Law Review* vol. 84, 2005, 59.

⁸⁰⁷ Sargent (2003) (note 785, supra). See also Nathan Koppel (2004) 'Wearing Blinders', *26 American Lawyer* 75 (July 2004).

⁸⁰⁸ Schwarcz notes: "...neither third-party legal opinions nor legal opinions addressed to clients purport to evaluate a transaction's inherent business wisdom. At least heretofore, an opining lawyers has had no duty to evaluate the business merits of the underlying transaction beyond the obvious ethical and legal obligations of not knowingly furthering a fraudulent transactions. Steven L. Schwarcz (2005) (note 739, supra) at p.10.

up-the-corporate-ladder material violations of securities law would seem adequate in the circumstances.

In summary, although Zimbabwe has a basic structured finance lawyer regulation and gatekeeping framework, it must be enhanced. The Securities Act should clearly spell out that structured finance lawyers involved in structuring securities products to be publicly traded are regulated to that extent by the SC. Statutory rules should be promulgated which prescribe rules of professional conduct for structured finance lawyers. These rules should, *inter alia*, regulate third-party legal opinions and structured finance lawyers should be obliged to report up the corporate ladder material violations of securities law.

10.4. Auditors

Independent public auditors and accountants (auditors hereafter) are critical to the functioning and integrity of the capital markets, including in the structuring of securitization transactions. An independent auditor reviews a firm's internally generated financial statements and records and tests their accuracy by examining a sample of transactions which the firm engaged in during the period under review.⁸⁰⁹ Thereafter the auditor produces a certifying opinion.⁸¹⁰ Audit certificates are used, not just by the public company's management and shareholders but also by investors. They are especially important in ABCP programmes and complex structured finance transactions such as CDOs, which involve numerous receivables, including re-securitizations.

In Zimbabwe, public companies - and this would include any listed SPV - are obliged under the Companies Act as well as under the ZSE listing rules and

⁸⁰⁹ David Millon (2003) 'Who caused the Enron debacle?' *Washington and Lee Law Review*, 2003, at p. 2.

⁸¹⁰ This is often referred to as an audit certificate.

regulations to produce audited financial reports.⁸¹¹ Audited financial reports are essential because of the need to ensure the integrity of financial information that is disseminated within financial markets and utilised by the investing public and regulators. Zimbabwe's audit firm industry is relatively large and sophisticated with representation of some of the large international auditing firms.⁸¹²

As noted above, the accounting scandals unearthed in the aftermath of the collapse of Enron illustrated audit industry-related regulatory and gatekeeping failures. Several auditing firms such as Arthur Anderson were complicit or negligent in certifying misleading and in instances fraudulent structured finance transactions.⁸¹³ Lack of auditor independence, conflicts of interest and poor corporate governance structures, which enabled fraud and the production of misleading audit reports, were some of the factors that contributed to auditor gatekeeping failures in corporations in the U.S. and other countries.⁸¹⁴ As a direct result of the corporate scandals, in the U.S. through the Sarbanes-Oxley Act, the auditing profession is now regulated by the federal government. Worryingly however, this new regulatory regime did not stop the auditors of Bernard L. Madoff Investment Securities - a hedge fund - which lost a reported record US\$50 billion of investors' money in a ponzi scheme giving it a clean

⁸¹¹ Part IV of the Companies Act and paragraph 4 of the Zimbabwe Stock Exchange Listing Rules (2002).

⁸¹² Zimbabwe's audit firm industry includes the following PriceWaterhouseCoopers (PWC), Ernst and Young, Kudenga and Company, KPMG, Deloitte and Touche, AMG Global and Company, Matamba and Company, Ruzengwe and Company, O'Connor and Babrock, among others.

⁸¹³ In addition to Enron, Arthur Anderson was also embroiled in other securities fraud allegations, more particularly with regards, Waste Management, Sunbeam, HBOCMcKesson, The Baptist Foundation and Global Crossing. Arthur Anderson was accused of failing to issue qualified audit reports. In 2008 it was discovered that Bernard Madoff's hedge fund - Bernard L. Madoff Investment Securities LLC - although audited by public auditors as required by law, was nothing more than one ponzi scheme, which lost investors circa U.S.\$50 billion.

⁸¹⁴ Of course, these are not the only explanations for the incidence of corporate scandals to have hit the US and the EU since 2000. Some commentators point to stock market bubbles, a decline in business morality, weak boards of directors, an increase in corporate greed, and changes in executive compensation which gave incentives for aggressive accounting and in instances outright fraud. Coffee (2004) (note 779, *supra*), at p. 2.

bill of health.⁸¹⁵ This section evaluates whether Zimbabwe's auditor regulatory framework can mitigate securitization risks that can be caused by auditor gatekeeping failures.

10.4.1. Auditors as gatekeepers

Public auditors are generally regarded as the archetypical gatekeeper. An auditor can withhold or issue a negative audit report and in so doing can prevent fraud or disrupt other corporate misconduct. It is argued that an auditor pledges its reputational capital to "assure the accuracy of statements or representations that it makes or verifies."⁸¹⁶ Because of the limited transactional pay-off, it is argued, an auditor has a lot more to lose than gain by producing false or misleading audit reports.⁸¹⁷ This research proceeds on the basis that auditors are gatekeepers to the financial markets.

10.4.2. Existing risk management framework

The auditing industry in Zimbabwe self-regulates under the rubric of the Public Accountants and Auditors Act (the PAA Act).⁸¹⁸ The PAA Act creates a board called the Public Accountants and Auditors Board (PAAB) to regulate the practice and

⁸¹⁵ For a short synopsis of the ponzi business empire run by Madoff, refer to Hrishkesh D. Vinod (2008) 'Preventing Madoff-style Ponzi enabled by Jewish Reputation, Incompetent Regulators and Auditors'. Available at <http://ssrn.com/abstract=1320069>

⁸¹⁶ Coffee (2004) (note 779, supra), at p. 10. See also Gilson et al who state: "...third party verifiers such as certified public accountants also function as reputational intermediaries. Central to this function is the accountant's reputation for independence; only if the accountant can be expected to treat the client at arm's length is its message of verification believable." See Ronald J. Gilson and Reinier H. Kraakman (1984) 'The Mechanics of Market Efficiency', 70 VA. L. REV. 549 (1984).

⁸¹⁷ Coffee notes that "the gatekeeper receives a far smaller benefit or payoff for its role, as an agent, in approving, certifying, or verifying information than does the principle from the transaction that the gatekeeper facilitates or enables. Thus because of this lesser benefit, the gatekeeper is easier to deter." Coffee (2004) (note 779, supra) at p. 10.

⁸¹⁸ Public Accountants and Auditors Act (Chap 27:12). Only those that have passed prescribed examinations, are persons of good standing, have not been declared insolvent or subject to an assignment or arrangement with creditors, and are either members of the Chartered Accountants of Zimbabwe established under the Chartered Accountants Act (Chap 27:02) or the Zimbabwe branch of the Chartered Association of Certified Accountants incorporated by Royal Charter in the UK may be registered to practice as public accountants and auditors in Zimbabwe, and be issued with a practicing certificate.

affairs of public accountants and auditors. The PAAB's functions include the creation of codes of ethics, conduct and standards, the granting and termination of practicing certificates and the disciplining of its members.⁸¹⁹ The PAAB regulates the conduct of registered auditors and accountants (public auditors hereafter) under the Public Accountants and Auditors (Professional Conduct) By-laws.⁸²⁰ Only public auditors holding current practicing certificates may perform audit services, which are defined as the "the verification or certification of financial statements, financial transactions, books, accounts or records."⁸²¹

It is notable that financial institutions regulated by the RBZ, which engage in securitization transactions, are obliged to produce annual audit reports produced by external auditors that confirm that in their dealings, they complied with the RBZ-promulgated securitization guidelines.⁸²² In the event of non-compliance, the financial institution responsible will be obliged to hold capital against full exposures to related securitization SPVs.

10.4.2.1. Fraud

Section 97 of the Securities Act, which criminalizes the fraudulent inducement to trade or deal in securities, also applies to auditors. An auditor who, in an audit report: (i) makes a false or misleading statement; (ii) dishonestly conceals material facts; or (iii) recklessly or dishonestly makes a statement that is false or misleading can be charged with securities fraud under section 97(1) of the Securities Act.⁸²³ In practice

⁸¹⁹ Section 5 of the Public Accountants and Auditors Act (Chap 27:12)

⁸²⁰ Public Accountants and Auditors (Professional Conduct) By-laws Statutory Instrument No. 144 of 1997

⁸²¹ Section 2 of the Public Accountants and Auditors Act (Chap 27:12). See also the case of Chirombo v Public Accountants and Auditors Board HH-3-2008, which illustrates the seriousness with which the PAAB takes against those that practice without practising certificates.

⁸²² RBZ (2007) (note 3, supra) at paragraph 2.22 – 2.23.

⁸²³ Section 97(1) (a) of the Securities Act, as read with subsection 2.

an auditor is retained by an issuer and/or arranger to provide an audit report. Although an audit report is essential in securitization transactions, it is but one of several third-party deal-closing opinions produced as part of an issuer's due diligence. For this reason, it is unlikely that an auditor would be charged with securities fraud as a principal, unless if there is evidence of collusion between the auditor and the issuer.

If a public auditor does however commit securities fraud in contravention of section 97 occasioning pecuniary loss to an investor who relied on a misleading audit certificate, the audit client and the public auditor can be sued - the former vicariously - for the loss per section 98 of the Securities Act, or in tort. The formula for computing the amount of damages recoverable is determined in part by section 98(3) of the Securities Act.⁸²⁴ If sued in tort, the tortfeasor is liable to pay damages for actual and consequential loss. The complexity of most structured finance transactions makes it difficult, although not impossible, to establish fraud. Forensic auditing maybe required to establish liability.

10.4.2.2. Negligence misrepresentation

Investors that rely on a misleading audit report can sue the auditor and the audit firm for negligent misrepresentation. If liability is established, the damages awarded will be apportioned between the auditing firm, the audit client and aggrieved investor based on the degree of fault of each of the parties.⁸²⁵ However, as noted above, it is difficult to establish liability, and forensic auditing may be required to establish that a particular audit fell below the standard expected of a qualified auditor exercising due care and skill. In addition, auditors who issue an audit certificate that fraudulently or

⁸²⁴ Ibid., at section 98(3).

⁸²⁵ Through the Damages (Apportionment and Assessment) Act [Chap 8:06], Zimbabwe abolished the common law defence of contributory negligence and provides for the apportionment of liability and damages between the parties based on the degree of fault, as determined by the Court.

negligently misrepresents the true nature of an audit client's financial affairs can be subjected to disciplinary proceedings under the Public Accountants and Auditors (Professional Conduct) By-laws, resulting in the imposition of a fine, suspension for a defined period of time, or de-registration

10.4.3. Enhanced risk management framework

The SC is yet to establish a framework which regulates: (i) the registration and practice of public auditors that audit financial reports of listed companies; and (ii) audit firms' corporate governance rules and practices. This makes Zimbabwe's public auditor regulatory framework rudimentary. Consideration should be given to adopting some of the risk mitigation measures adopted in the U.S., where the audit profession is now government-regulated with the objective of protecting investors and ensuring efficient capital markets.⁸²⁶

With a view to managing conflicts of interest, U.S. audit firms are now prohibited from providing certain non-audit consultancy services to their audit clients.⁸²⁷ This proscription seeks to mitigate the lure of non-audit fees generated by audit firms from their audit clients compromising their independence. Audit partners are prohibited from serving on audit engagement teams for more than seven consecutive years;

⁸²⁶ In response to the collapse of Enron and others; and through the Sarbanes-Oxley Act, the auditing profession in the U.S. is now subject to a new regulatory framework. It is no longer self-regulating. Instead, it is regulated by a quasi-governmental body called the Public Company Oversight Board. Refer to Section 101 of the Sarbanes-Oxley Act.

⁸²⁷ Section 202 of the Sarbanes-Oxley Act, codified in Exchange Act section 10A (h), 15 U.S.C. 78j-I (g) (Supp. II 2002). Auditors are now prohibited from providing eight categories of non-audit services: bookkeeping, actuarial, investment, and legal services to their audit client. The view that consultancy services provided by audit firms to their audit clients were compromising their independence is reflected in literature that came up following the collapse of Enron and WorldCom. See for instance, Frankel, Richard (2002) The relation between auditor's fees for non-audit services and earnings management, 77 *The ACCT. Rev.* 71 (Supp. 2002). See also James D. Cox who states: "the prime suspect for the accounting profession's recent sorrowful performance as a gatekeeper against financial frauds is the rising importance of non-audit services in overall operations of the major accounting firms. Non-audit fees now dominate the income statement of the large accounting firms." James D. Cox (2006), 'The Oligopolistic Gatekeeper: The U.S. Accounting Profession', *Duke Law School Working Paper Series*, at p. 279. Available at <http://lsr.nellco.org/duke/fs/papers/58>

arguably to prevent the impairment of auditors' independence.⁸²⁸ There is now a new corporate governance stipulation requiring the reinforcement of the audit function in public companies.⁸²⁹ In addition, the Sarbanes-Oxley Act created an enhanced civil and criminal liability framework for auditors.⁸³⁰ Further, auditors are now required to assess and report on the integrity of their audit client's internal controls.⁸³¹ Although some of these changes have elicited criticism - including allegations that they increased the cost of public company audits⁸³² and that they have unfairly shifted liability onto auditors⁸³³ - this study recommends these legislative changes as they enhance auditors' gatekeeping framework.

In summary, although there is in existence a basic auditor regulatory and gatekeeping framework, this should be enhanced. The SC must (i) clarify that public auditors engaged in providing audit reports on listed firms are regulated by the SC; (ii) establish a registration system and an enhanced auditor civil and criminal liability framework for gatekeeping and other failures; (iii) prescribe best practice rules regulating the audit process for listed firms; and (iv) prescribe corporate governance rules, aimed at reducing conflicts of interests.

⁸²⁸ See Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 8183, 68 Fed. Reg. 6006, 6038 (Feb. 5, 2003).

⁸²⁹ Sections 301 and 302 of the Sarbanes-Oxley Act. The sections seek to strengthen the role, power and responsibilities of audit committees in public companies. They prescribe that audit committees in public companies must be composed solely of independent directors. They place legal responsibility on the chief executive officer and the chief financial officer to certify that certain financial transactions and processes have been carried out that there was nothing untoward as far as they were concerned. They also impose a due diligence obligation on the CFO and the CEO.

⁸³⁰ For instance, the Act increased the criminal penalties for altering or destroying documents (section 802) and for securities fraud (section 807). It also created a protection framework for whistleblowers, providing that public companies may not "discharge, demote, suspend, threaten, harass or in any manner discriminate" against a whistleblower. *Ibid.*, at section 806.

⁸³¹ *Ibid.*, at section 404.

⁸³² See for instance L. Smitherman (2005) 'Corporations Protest Cost to Comply with Law', *The Baltimore Sun* (March 15). See also Scott S. Powell (2005) 'Cost of Sarbanes-Oxley are out of control', *The Wall Street Journal* (March 21): op ed.

⁸³³ Refer to a critique by A.C. Pritchard (2006) 'The Irrational Auditor and the Irrational Liability', *Lewis and Clarke Law Review*, vol. 10:01, 19.

10.5. Credit rating agencies

Zimbabwe has a small but vibrant rating industry. CRAs measure credit risk by providing opinions on the probability of timely interest and capital payments by issuers on their fixed-income securities. Although disputed, CRAs have historically been regarded as intermediaries that reduce informational asymmetries,⁸³⁴ enhance market efficiency and lower issuers' cost of capital.⁸³⁵ In practice, they process public and non-public corporate information, use financial modelling techniques and other subjective considerations to analyse and express opinions on the creditworthiness of an entity or its debt securities. World-wide, investors and other market participants now require, almost as a matter of course, and sometimes in private contractual agreements that rating opinions be obtained, or utilised as reference points.⁸³⁶

CRAs typically provide both unsolicited and solicited ratings; the latter for a fee and pursuant to a contractual agreement between a CRA and the issuer. CRAs denote their rating opinions using alphabetical and/or alphanumerical scales, which differ

⁸³⁴Stephane Rousseau (2005) 'Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach. Credit Rating Agencies: Need For Reform in Canada?', *51 McGill L.J.* 617, at p. 620. Available at: <http://ssrn.com/abstract=797325> Refer also to the Bank of International Settlements: Committee on the Global Financial System (2005) 'The Role of Ratings in Structured Finance: Issues and Implication', (January 2005). BUT see Frank Partnoy who disputes the informational value of ratings arguing that their primary role is in the granting of favourable regulatory treatment to issuers. He argues that once ascribed, ratings often lag behind market determined prices. Frank Partnoy (1999) 'The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies', *Washington University Law Quarterly*, 1999 vol. 77, 619, at pp. 651-653.

⁸³⁵ Christopher C. Nicholls (2005) 'Public and Private Uses of Credit Ratings', *Capital Markets Institute*, at p. 6. Available at http://www.rotman.utoronto.ca/cmi/papers/CRA_Study_Nicholls.pdf

⁸³⁶ Rating triggers are sometimes utilised in private contractual agreements. For example, some contracts may stipulate that if an issuer's credit rating is downgraded the lender becomes entitled to exercise certain contractual options such as raising interest rates, calling of the outstanding debt, payment acceleration, etc. See Pamela Stumpp and Monica Coppola (2002), 'Moody's Analysis of U.S. Corporate Rating Triggers Heightens Need for Increased Disclosure' (Moody's, July 2002). As noted by the U.S. SEC "Credit ratings are used for regulatory purposes around the world, primarily in the context of financial regulations." Securities and Exchange Commission (2003) 'Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets', at p. 28. Available at www.sec.gov/news/studies/credratingreport0103.pdf

from one credit rating firm to another. However, investment-grade ratings typically range from AAA to BBB- while non-investment ratings range from BB+ to D.⁸³⁷

John Moody established the first CRA agency in the U.S. in 1909,⁸³⁸ spawning a new financial intermediary phenomenon in the U.S., which in later years spread internationally. Three of the world's largest CRAs are Moody's Investors Service, Standard and Poor's and Fitch Ratings; although the first two effectively constitute a duopoly. There are many factors that have influenced the successful propagation of CRAs in international financial markets. Chief among these is arguably the practice internationally, requiring regulated institutions to invest only in investment-grade securities, the proliferation of modern financial engineering technologies such as securitization and derivatives, the globalization of financial markets, the increasing use of credit ratings in financial regulation and contracting and the increase in the number of capital market issuers.⁸³⁹

In Zimbabwe, as in most countries, prudential regulatory prescriptions have led to the increasing use and reliance upon credit ratings, but their use is limited largely to the financial services sector. Banking institutions, money market funds, insurance firms and pension funds are required to be rated by an accredited CRA with the institutions permitted to invest only in investment-grade securities.⁸⁴⁰ The Basle II Accord, which require central banks to use ratings to determine risk and liquidity

⁸³⁷ In the U.S. the SEC noted: "rating agencies generally designate ratings of long-term debt through some variation of an alphabetical combination of lower and upper case letters. Fitch and S&P use the same ranking designators: AAA, AA, A, and BBB are investment grade categories; BB, B, CC, C, and D are considered speculative grade rankings. Moody's long-term rating designators are: investment grade: Aaa, Aa, Baa, speculative grade Ba, B, Caa, Ca, and C." Securities and Exchange Commission Report (2003), (note 836, supra) at p. 25. at p. 25. See also Amy K. Rhodes for a detailed description of credit risk categories, rating scales and symbols used by CRAs. Amy K. Rhodes (1996) 'The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?', *20 Seton Hall Legis. J.* 293 (1996).

⁸³⁸ For a synopsis of the history of CRAs refer to Richard Sylla (2002) in 'Ratings, Rating Agencies and the Global Financial System' 19 (Richard M. Levich et al, ed., 2002).

⁸³⁹ U.S. Securities and Exchange Commission (2003) (note 836, supra) at p. 28.

⁸⁴⁰ See generally the RBZ (2004) (note 652, supra).

requirements for some regulated institutions, have only served to underscore CRAs' gatekeeping function; including in Zimbabwe, as noted in the RBZ guidelines.⁸⁴¹

CRAs have been both credited and criticised for the growth and capital markets acceptance of innovative structured finance technologies and derivative products.⁸⁴² CRAs have been criticised for issuing misleading ratings and for their failure to timeously downgrade securities' ratings. There is general consensus that the loss of confidence in credit ratings on U.S. subprime mortgage-backed securities exacerbated the 2007 global financial crisis.⁸⁴³ It is within this context, including the increased international scrutiny of the financial intermediary role played by CRAs and the adequacy of the extant regulatory framework that that this section evaluates, and makes recommendations regarding, CRAs' gatekeeping function in Zimbabwe.

10.5.1. CRAs as gatekeepers

Although disputed by some, CRAs are arguably the archetypical gatekeeper.⁸⁴⁴ CRAs wield enormous power over capital market transactions and participants.⁸⁴⁵

⁸⁴¹ The Reserve Bank of Zimbabwe Guidelines state: "No person, other than an accredited credit rating agency, shall conduct or assign a credit rating to a banking institution conducting banking business in Zimbabwe. The value investors place on a given credit rating agency's opinion depends on the reputation of the agency. The credibility of credit rating agencies can be significantly enhanced by the accuracy of ratings or default predictions; quality and integrity of the rating process; transparency and objectivity; independence and avoidance of conflict of interest; and appropriate use of confidential information." [Emphasis added]. Ibid., at paragraph 1.6.

⁸⁴² The European Parliamentary Financial Services for instance states: "...credit ratings have played a key role enabling new market instruments to develop (e.g. securitization) and are systematically requested by professional investors as an important factor in determining credit risk." European Parliamentary Financial Services Briefing (2006) 'Credit Rating Agencies', at p. 1. Available at www.epfsf.org Autorite des Marches Financiers makes the point: "Rating is an integral part of structuring securitization products. The agency is involved at an early stage, and the rating is not an outcome but a target for the arranger, with the agency indicating the factors that need to be addressed to obtain the desired rating. In particular, the agency has an indirect influence on how the tranches are configured to ensure that the senior issue obtains the highest possible rating." Autorite des Marches Financiers (note 80, supra) at p. 6.

⁸⁴³ Emiliios Avgouleas (2008) 'Financial Regulation, Behavioural Finance, and the Global Credit Crisis: In Search of a New Regulatory Model', at p. 27. Available at <http://ssrn.com/abstract=1132665>

⁸⁴⁴ According to Schwarcz, "the significance of a rating depends entirely on the reputation among investors of the particular rating agency." Schwarcz, L., Steven (2001) 'Private Ordering of Public Markets: The Rating Agency Paradox', *University of Illinois Law Review*, vol. 2002, No. 2, February 2002 at p. 6.

They play a verification, certification and signalling role in the financial markets. Ratings can determine: (i) debt issuers capital market access;⁸⁴⁶ (ii) the liquidity of issued securities; (iii) the cost of capital; (iv) whether a prudentially regulated firms' assets can be regarded as regulatory capital; (v) and can influence investment decisions.⁸⁴⁷ This notwithstanding, CRAs prefer, notably in the US context, to downplay their financial markets intermediary function. Some CRAs argued that they: (i) are financial journalists publishing opinions;⁸⁴⁸ (ii) do not have gatekeeping responsibilities; (iii) do not owe financial market participants a duty of care; and that (iv) they should not be made liable for issuing rating opinions which turn out to be inaccurate and misleading.⁸⁴⁹ Arguably, some of these assertions are in the minority, as internationally, market participants and regulators alike regard and treat CRAs as important financial market gatekeepers.⁸⁵⁰ The challenge, given systemic implications

⁸⁴⁵ Kerwer, D (2004) 'Holding Global Regulators Accountable – The Case of Credit Rating Agencies', *Working Paper 11, School of Public Policy, University College of London*, 2004, at p. 15.

⁸⁴⁶ Partnoy, Frank (2005) 'How and Why Credit Rating Agencies are not Like Other Gatekeepers', at p. 59. Available at http://www.tcf.or.jp/data/20050928_Frank_Partnoy.pdf See also Steven L. Schwarcz, (2001) 'Private Ordering of Public Markets: The Rating Agency Paradox', *University of Illinois Law Review*, vol. 2002, No. 2, 2002, at p. 2.

⁸⁴⁷ According to the Bank of International Settlements: "rating agency 'approval' still appears to determine the marketability of a given structure to a wider market." Bank of International Settlements (2005) *The Role of Ratings in Structured Finance: Issues and Implication*, (January 2005). Committee on the Global Financial System, at p. 3. See also Joseph Liberman's statement before the US Congress. He reportedly stated: "The credit raters hold the key to capital and liquidity, the lifeblood of corporate America and of our capitalist economy. The rating affects a company's ability to borrow money; it affects whether a pension fund or a money market fund can invest in a company's bonds; and it affects stock price." SEC (2002) Hearing Before the Senate Commission on Governmental Affairs, 107th Congress, 116 (2002). *Rating the Raters: Enron and the Credit Rating Agencies*. See also the Securities and Exchange Commission (2003) (note 836, supra) at p. 27. See also Pinto, R. (2006) 'Control and Responsibility of Credit Rating Agencies in the United States', *54 AM. J. COMP L.* 341, 2006, at p. 341-342.

⁸⁴⁸ In the case of County Orange case the Court held: "ratings are speech and absent special circumstances, are protected by the First Amendment..." *County Orange v McGraw Hill Cos., Inc.*, 245 B.R. 151, 156, (1999). Frank Partnoy makes the point that: "Although Moody's might say that it is in the financial publishing business, market participants do not believe it." Partnoy, Frank (2005) (note 834, supra), at p. 66.

⁸⁴⁹ The argument put forward by CRAs that they are financial journalists and hence their opinions are protected by the first amendment (the free speech constitutional provision) is yet to be decided upon by the US Supreme Court. It should be noted however that the jurisprudence coming out of the US courts is not entirely consistent on the issue of CRA civil liability for misleading ratings. For a synopsis of the disparate case law on this issue refer to Partnoy. *Ibid*, at pp. 84-88.

⁸⁵⁰ There are several reasons for arguing that the CRA industry's position, particularly as articulated in the US context, is in the minority. These include, among others, financial markets participants' demand

of CRA gatekeeping failures is to design an appropriate, efficient and cost-effective CRA gatekeeping and regulatory framework.

10.5.2. Existing risk management framework

As noted above, CRAs are regulated by the SC. Before the promulgation of the Securities Act, the RBZ was the only regulatory authority to have promulgated guidelines to regulate the registration of CRAs that intended to rate financial institutions.⁸⁵¹ But these guidelines are only binding on RBZ-regulated financial institutions⁸⁵² and in no way constitute a CRA regulatory or supervisory framework. No doubt these guidelines, which require all financial institutions conducting banking business in Zimbabwe to be rated once every year by an accredited CRA⁸⁵³ were promulgated because of the need to comply with the requirements of Basle II

for, and reliance upon, rating opinions, and prudential regulators' insistence that regulated entities invest only in securities rated investment-grade by a recognised/accredited CRA and the fact that CRAs have been instrumental in the growth and market acceptance of structured finance technologies. Bottinni for instance argues: "The rating agencies frequently downplay their ratings as mere opinions. The extreme importance of these ratings and the reliance upon them by consumer and professional financial analyst alike, however, precludes disregarding ratings as insignificant opinions." Francis A. Bottinni (1993) 'An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies', *30 San Diego L. Rev.* 579, at p. 6. Internationally, in recognition of the importance of CRAs the International Organisation of Securities Commissions came up with an IOSCO Code of Conduct Fundamentals in December 2004. That U.S. law makers clearly regard credit rating agencies as financial gatekeepers is borne by section 2 of the Credit Rating Agency Reform Act which states: "Congress finds that credit rating agencies are of national importance, in that, among other things-- (1) their ratings, publications, writings, analyses, and reports are furnished and distributed, and their contracts, subscription agreements, and other arrangements with clients are negotiated and performed, by the use of the mails and other means and instrumentalities of interstate commerce; (2) their ratings, publications, writings, analyses, and reports customarily relate to the purchase and sale of securities traded on securities exchanges and in interstate over-the-counter markets, securities issued by companies engaged in business in interstate commerce, and securities issued by national banks and member banks of the Federal Reserve System; (3) the foregoing transactions occur in such volume as substantially to affect interstate commerce, the securities markets, the national banking system, and the national economy; (4) the oversight of such credit rating agencies serves the compelling interest of investor protection; (5) the 2 largest credit rating agencies serve the vast majority of the market, and additional competition is in the public interest; and (6) the Commission has indicated that it needs statutory authority to oversee the credit rating industry."

⁸⁵¹ RBZ (2006) (note 652, supra).

⁸⁵² Fixed-income securities issued in Zimbabwe by the Reserve Bank of Zimbabwe, municipalities and other firms are usually rated by an accredited rating agency

⁸⁵³ RBZ (2006) (note 652, supra) at paragraph 2.3.

Accords⁸⁵⁴ and due to the then absence in Zimbabwe of any other CRA regulatory system. As noted above, the SC is yet to establish a CRA regulatory and supervisory framework, notwithstanding the provisions of the Securities Act. This is an anomaly which should be rectified.

10.5.2.1. Fraud

A CRA will, per section 97 of the Securities Act, be criminally liable for fraudulently inducing another person to trade or deal in securities if it: (i) produces a misleading “statement” or “forecast” in the knowledge that it is misleading; (ii) dishonestly conceals a material fact; or (iii) recklessly or dishonestly makes a statement that is false or misleading. If convicted, the punishment is a fine and/or a term of imprisonment not exceeding two years.⁸⁵⁵ As argued above, section 97(1) is ambiguous and its deterrent effect doubtful. The SC should issue guidance notes to clarify the ambiguity inherent in section 97(1) and state what - in its opinion - amounts to fraudulent inducement to trade or deal in securities. Such guidance will assist in establishing the type of misleading information whose dissemination constitutes a securities law violation.

It is trite that a forecast issued by a CRA is not false or misleading simply because it is different from that ascribed by another or is inconsistent with the price at which relevant securities actually trade in the market. In this context, section 97(1) may in fact not apply to ratings issued by CRAs. It may however apply if there is evidence that a CRA and an issuer colluded to use misleading ratings with the objective of fraudulently inducing investors to trade in securities.

⁸⁵⁴ Basle II has been gradually introduced in Zimbabwe since 2004. Reserve Bank of Zimbabwe (2007) ‘Annual Report 2007’, at p. 49. Available at http://www.rbz.co.zw/pdfs/annual_2007/blss.pdf

⁸⁵⁵ Section 97(2) of the Securities Act.

In defence to a charge under section 97(1) of the Securities Act, a CRA can argue that a report constitutes an expression of opinion and is therefore protected speech under section 20 of the Constitution of Zimbabwe, which guarantees freedom of expression.⁸⁵⁶ In addition, a CRA may contend that an express disclaimer in a recommendation precludes a finding of criminal intent. In rebuttal, it is arguable that freedom of expression is not absolute. It can be restricted by law in the “economic interests of the State.”⁸⁵⁷ Should the publication of misleading information about a listed company by a CRA that knows that the information is materially misleading and will be relied upon by investors to their and the financial system’s detriment, be constitutionally protected? There is merit in the argument that it is in the economic interests of the State to promote efficient and fair markets by penalising the fraudulent manipulation of listed securities through the fraudulent communication of misleading information.

Where there is evidence of fraudulent intent, the defence that a rating constitutes protected speech or that it was accompanied by a disclaimer will not absolve the CRA from criminal liability.⁸⁵⁸ The protected speech defence will not suffice where there is evidence of fraud because: (i) rating opinions are arguably not ordinary speech, but

⁸⁵⁶ Section 20(1) of the Zimbabwe Constitution defines freedom of expression as: “[the] freedom to hold opinions and to receive and impart ideas and information without interference, and from interference with correspondence.” In the case of *Capital Radio (Private) Limited v The Broadcasting Authority of Zimbabwe and Others*, the Court held: “...the freedom of expression conferred by section 20 of the Constitution has to be interpreted to include freedom of the press and is also enjoyed by corporate persons.” *Capital Radio (Private) Limited v The Broadcasting Authority of Zimbabwe and 2 Others* SC-128-2002, at p. 17.

⁸⁵⁷ *Ibid.*, at section 20(2).

⁸⁵⁸ For instance Global Credit Rating Company’s disclaimer notice, which is typical of most issued by other credit rating agencies in Zimbabwe, and elsewhere states: “This document is confidential and issued for the information of clients only. It is subject to copyright and may not be reproduced in whole or in part without the written permission of Global Credit Rating Co. (“GCR”). The credit ratings and other opinions contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such rating or other opinion or information is given or made by GCR in any form or manner.” See also Moody’s disclaimer notice at www.moody.com/moodys/cust/AboutMoody/AboutMoody.aspx?topic=rdef&subtopic=moodys%20credit%20ratings&title=Introduction.htm

commercial opinions which in many cases are sourced and paid for by issuers; (ii) ratings are relied upon by most financial markets participants, including regulators and investors; (iii) in many countries, including Zimbabwe, CRAs play a quasi-regulatory function; (iv) and CRAs' gatekeeping failures can contribute to systemic risk, as illustrated by the 2007 global financial crisis.

Section 98(1) of the Securities Act enables an aggrieved party, including a securities investor to sue for pecuniary loss if it relies to its financial detriment on a statement or forecast issued to the public by a CRA in violation of section 97(1). The formula for calculating the amount of damages is contained, as stated above, in section 98(3) (a) and (b) of the Securities Act.

10.5.2.2. Negligent misrepresentation

In theory a CRA that issues a materially misleading rating can be sued in tort by any party that relies on it and suffers financial loss. However, this cause of action may be illusory in practice.⁸⁵⁹ A CRA will be found liable only if a court accepts that it has a duty of care towards the aggrieved claimant. This is a moot question in Zimbabwe. In defence CRAs are likely to argue that they do not have a duty of care towards securities investors; an argument bolstered by reference to ratings disclaimer notices. In jurisprudence likely to find resonance in Zimbabwe, a U.S. a court stated that it was unreasonable for investors to rely on rating opinions as if they were some kind of guarantee.⁸⁶⁰

⁸⁵⁹ See for instance in Canada a country where CRAs are also not regulated. Through the Allen Committee the Toronto Stock Exchange produced a report in which it is stated: "the remedies available to investors...who are injured by misleading disclosure are so difficult to pursue and to establish, that they are as a practical matter largely academic." Toronto Stock Exchange (1997) 'Final Report of the Committee on Corporate Disclosure - Responsible Corporate Disclosure - A Search for Balance', Toronto, 1997. In the US, CRA benefit from the defence of free speech.

⁸⁶⁰ Quinn v McGraw-Hill, 168 F.3f 331 (7th Cir.1999) at p. 336. This case was decided before the failures of CRAs in relation to Enron and the 2007 global financial crisis came to the fore. The apparent complicity of CRAs in what is the world's biggest financial crisis since the Great Depression

CRAs can validly argue that they should not be held responsible for inaccurate/misleading rating opinions because: (i) they rely on issuers and other sources to provide them with accurate and complete information;⁸⁶¹ and (ii) for this reason, ratings are only as good and accurate as the information provided to, and the subjective evaluation of the information employed by, the CRAs.⁸⁶² In addition, CRAs will argue that they do not audit or have the power to subpoena issuer information.⁸⁶³ Some ratings are unsolicited and are therefore based on incomplete information. CRAs will also point out that because of these and other reasons, rating opinions are not recommendations to buy, hold, or sell securities, as typically spelt out in their disclaimer notices. Rather, their ratings are a point-of-time opinion of creditworthiness⁸⁶⁴ and do not assess the economic appeal of investments.⁸⁶⁵ They carry no predictive information and are only one, albeit an important, factor that an investor can opt to take into account when making investment decisions.⁸⁶⁶

On the other hand, the role that CRAs played in structured finance transactions arguably renders them civilly liable for issuing misleading rating opinions that occasion loss to investors. As noted above, structured finance transactions are ratings driven.⁸⁶⁷ CRAs are vulnerable because of their active participation in the structuring process of securitizations and derivative transactions. In structured finance transactions CRAs actively control the security architecture and determine product

may well change the jurisprudence. Arguably, the likelihood of CRAs being held accountable for gatekeeping failures has increased exponentially since the 2007 global financial crisis.

⁸⁶¹ Securities and Exchange Commission (2003) (note, 836, supra) at p. 32.

⁸⁶² Arguably, issuer self-interest and the absence of a compulsion framework impacts the quality of information proffered by issuers to CRAs.

⁸⁶³ Securities and Exchange Commission (2003) (note 836, supra) at p. 32.

⁸⁶⁴ Put differently: “ratings are probabilistic statements of the likelihood of issuer default.” Rousseau (2005) (note 834, supra) at p. 631.

⁸⁶⁵ Amy K. Rhodes (1996) ‘The Role of The SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?’, *20 Seton Hall Legis. J.* 293, 1996, 315-316.

⁸⁶⁶ Jaimini Bhagwati (2006) ‘Tighten regulation of rating agencies’, at p. 1. Available at <http://www.business-standard.com/india/storypage.php?autono=297840>

⁸⁶⁷ John Coffee states: “Structured finance is ratings driven. Absent a rating, the debt of a special purpose entity (SPE) is unmarketable.” Coffee (2005) (note 806, supra) at p. 63.

design standards.⁸⁶⁸ It is not improbable that such active participation by a CRA in the structuring process and the inherently conflicted CRA/issuer relationship can, if sufficient incentives exist, result in the reckless issuance of misleading rating opinions.⁸⁶⁹ The phenomenal growth in the structured finance market was fuelled by CRAs' willingness to extend investment-grade ratings to securities backed by untested U.S. sub-prime mortgages. It has also been contended that ratings on structured finance transactions generated significant revenue flows for some U.S. CRAs, especially Moody's and Standard and Poor's until the market seized.⁸⁷⁰ The accusation: because of the conflicted CRA/issuer relationship and search for profits, CRAs wrongly - deliberately or negligently - mispriced some structured finance

⁸⁶⁸ Timothy J. Riddiough and Risharng Chiang (2003) 'Commercial Mortgage-Backed Securities: An Exploration into Agency, Innovation, Information and Learning in Financial Markets', at p. 1. Available at http://scholar.google.com/scholar?hl=en&lr=&safe=off&q=cache:tgPHB82FijQJ:www.nchu.edu.tw/~Fin/03_research/fin2003/Commercial%2520Mortgage-Backed+Securities See also Mason and Rosner who state that: "The need for rating agencies to objectively assess and verify information rises in structured transactions, since, unlike the traditional rating process in which an enterprise can do little to change the risk characteristics in anticipation of an issuance, in structured finance, the rating agency is an active part of the structuring of the deal. In practice, arrangers will routinely use the rating agencies publicly available models to pre-structure deals and subsequently engage in a process that is 'iterative and interactive' informing the issuer of the requirements to attain desired ratings in different tranches and largely defining the requirements of the structures to achieve target ratings." Joseph R. Mason and Joshua Rosner (2007) 'Where did the Risk go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralised Debt Obligations Market Disruptions', at p. 13. Available at: http://www.hudson.org/files/publications/Hudson_Mortgage_Paper5_3_07.pdf See also the article Autorite Des Marches Financiers, stating that: "The rating agency usually becomes involved at the request of an arranger, acting on behalf of its customer, the seller. The issuer is allowed to halt the process at any time. The agency never initiates the rating process. There are no unsolicited ratings because the agencies are involved early in the structuring process and recommend the entities contact them as soon as possible to present proposed structures." Autorite Des Marches Financiers (2006) 'Ratings in the Securitization Industry- January 2006', at p. 7.

⁸⁶⁹ After an analysis of the disparate judgements on CRA liability, Frank Partnoy notes: "the most that can be said is that to the extent that a credit rating agency played only the role of information gatherer and was not involved in structuring a transaction that it rated, courts have become more sympathetic to the claim that the agency is entitled to qualified protection. However the courts have been more sceptical of free speech claims when the rating agency played a significant role in structuring a transaction that it rated." Partnoy (2005) (note 846, supra), at p. 88.

⁸⁷⁰ Partnoy stated: "Credit rating agencies increasingly focus on structured finance and new complex debt products, particularly credit derivatives, which now generate a substantial share of credit ratings agencies' revenues and profits. With respect to these new instruments, the agencies have become more like "gate-openers" than gatekeepers; in particular, their rating methodologies for collateralised debt obligations (CDOs) have created and sustained that multi-trillion dollar market." Ibid., at p. 60.

securities.⁸⁷¹ CRAs have however disputed that they play an integral role in structured finance transactions.⁸⁷² They argue that their pre-execution/pre-deal opinions are hypothetical, and should not therefore give rise to liability. It is difficult therefore to state with any certainty whether CRAs can be found liable for negligent misrepresentation.

10.5.2.3. Market manipulation

Section 96 of the Securities Act prohibits market manipulation. Section 96(2) states: “No person shall, by means of any false statement or fictitious or artificial transaction or device, maintain, inflate or depress, or cause fluctuations in, the price of any securities on a registered securities exchange.” [Emphasis added]. To what extent does this section affect CRAs that issue misleading rating opinions on listed securities? The proscription in section 96(2) is expansive. But what amounts to the issuance of a false statement which maintains, inflates, depresses or causes fluctuations in the price of a security on a registered securities exchange? This question should be clarified by the SC, with the objective of giving guidance to market participants as well as prosecutors. It is doubtful whether section 96(2) applies to ratings issued by CRAs. CRAs are expected to play a role of issuing forecasts in the

⁸⁷¹ US Banking Committee Chairman Christopher Dodd is reported to have stated – in the aftermath of the 2007 global credit crisis that: “...rating companies may have understated the risks of the securities to win fees for rating debt. [CRAs] also help financial institutions package debt in a way that will receive certain ratings.”

⁸⁷² These contra-arguments indicate that the nature and extent of involvement of, and liability for, any CRA involved in a structured finance transaction are factors to be determined by the available evidence. It is reported that in testimony before the Securities and Exchange Commission, Moody’s and S & P executives disputed that their organisations “structure debt transactions.” Vickie Tillman, executive vice president of Credit-market services for S&P is reported to have stated that: “there isn’t any collaboration between S&P and debt issuers on constructing mortgage-backed securities.” In the same article it is reported that Michael Kanef, group managing director, asset finance group of Moody’s stated that: “Moody’s does not structure, create, design or market securitization products.” He is also reported to have said: “We do not have the expertise to recommend one proposed structure over another and we do not do so.” Jesse Westbrook and James Tyson (2007) ‘SEC Probes Whether Issuers Pressured S&P, Moody’s’, *Bloomberg*, (26 September 2007) Available at www.bloomberg.com/apps/news?pid=20670001&refer=home&sid=a3N1qOU

capital markets. This means any deviation between their forecasts and the rate at which a given security trades in the market cannot and should not qualify as a securities law violation.

10.5.3. Enhanced risk management framework

Since the collapse of Enron through to the 2007 global financial crisis, CRAs have been subjected to withering criticism and calls for greater regulation. There have been calls to increase competition in the CRA industry⁸⁷³ as well as “increasing accountability, consistency, quality and transparency in the rating process.”⁸⁷⁴ What remains unclear is whether stricter government oversight is the preferred regulatory choice, or whether it is further and stricter statutory self-regulation.

In Zimbabwe, the SC should create a framework for the regulation of CRAs. Although there does not exist a standard international CRA regulatory framework, Zimbabwe policymakers should consider, *inter alia*: (i) the CRAR Act; (ii) proposals for CRA reform made in the U.S. in 2008; and (iii) proposals advanced by the International Organisation of Securities Commissions.⁸⁷⁵ Given the nascent nature of the CRA industry in Zimbabwe, policy-makers should seek to create a regulatory framework that fosters rather than stifles the operations of CRAs. This study recommends the strengthening of the Zimbabwe CRA-framework; primarily to mitigate the types of systemic risks exposed by the 2007 global financial crisis.

⁸⁷³ In the U.S. calls to increase competition in the CRA industry led to the enactment of the CRAR Act.

⁸⁷⁴ International Herald Tribune (2007) ‘Credit Crisis Hurts Rating Agencies’, 13 August 2007.

⁸⁷⁵ Zimbabwean policymakers should consider the following: (i) SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations, June 16, 2008, <http://www.sec.gov/rules/proposed/2008/34-57967.pdf> (ii) CESR (2008) Second Report to the European Commission on the Compliance of Credit Rating Agencies with the IOSCO Code and the Role of Credit Rating Agencies in Structured Finance (CCESR/08-277, May 2008) (iii) IOSCO’s Statement of Principles Regarding the Activities of Credit Rating Agencies (IOSCO [2003b]) and the IOSCO’s report on code of conduct fundamentals for CRAs (IOSCO [2004a; 2004b]); (iv) the IOSCO Technical Committee (2008) ‘The Role of Credit Rating Agencies in Structured Finance Markets’; (v) the April 2008 Financial Stability Forum report on Enhancing market and Institutional Resilience. The Forum is a task force of the Group of Seven finance ministers.

Currently, CRAs intending to rate institutions regulated by the RBZ are required to obtain a registration certificate from the RBZ. At the same time, the Securities Act provides that CRAs should obtain licences from the SC. This is an unnecessary duplication of regulatory jurisdictions. There should be one regulatory authority: and that should be the SC, or preferably - as argued in chapter 8 - a consolidated regulator. The regulator should promulgate peremptory CRA rules of conduct which can borrow from, but enhance upon, the current RBZ-imposed code of conduct for Credit Rating Agencies.⁸⁷⁶ The new code of conduct for CRAs must regulate: (i) conflicts of interests; (ii) the rating process, including disclosures of rating methodologies; and (iii) behaviour of rating personnel and communication between CRAs, issuers and the financial market on rating decisions. Violations of the code of conduct should attract administrative, civil and criminal penalties. The rating framework must ensure transparency of the rating process; foster competition, and ensure that it does not create, as in the U.S., high entry barriers, which have resulted in the creation of a duopoly.⁸⁷⁷

Critics argue that the current CRA “issuer-pays” business model and the provision of consultancy services by CRAs give rise to conflicts of interests. Until the 1970s, CRAs derived their revenue from subscribers to their ratings publications. CRAs now derive the bulk of their revenue from fees paid by issuers of debt securities.⁸⁷⁸ CRAs’ activist structuring role in securitization transactions and their perceived gatekeeping failures have accentuated the adverse perception of a highly conflicted relationship. Although CRAs argued - after the collapse of Enron - that they effectively managed conflicts of interest and that there was no empirical evidence establishing they had

⁸⁷⁶ RBZ (2004) (note 652, *supra*) at paragraph 7.

⁸⁷⁷ The CRA industry in the US is dominated by Moody’s and Standard and Poor’s.

⁸⁷⁸ According to Frank Partnoy, “...approximately 90% of rating agency revenues comes from issuers who pay for ratings. Partnoy (2005) (note 846, *supra*) at p. 69.

failed to do so;⁸⁷⁹ subsequent events leading to the 2007 global financial crisis disproved their assertions.⁸⁸⁰ In Zimbabwe, the SC-promulgated CRA code of conduct should anticipate and enable the efficient resolution of such conflict of interest situations

There have been calls to modify the CRAs' business model.⁸⁸¹ Some have called for securities exchanges to pay for ratings to reduce incentives for ratings-inflation and for ratings-shopping; both of which, it has been argued, resulted in the publication of unreliable ratings and contributed to the 2007 global financial crisis.⁸⁸² The proposal to statutorily alter the CRA business model is controversial because it threatens CRAs' profitability. It is arguable that the problem lies, not with the CRA business model *per se*, but with the near total absence of CRA accountability and almost non-existence regulation. Arguably, if CRAs were made liable for issuing misleading rating opinions tainted by fraud, recklessness or that were compromised due to internal conflicts of interest, they would be incentivised to exercise greater due diligence when issuing rating opinions. The proposal to prohibit ratings-shopping is also controversial. It can only work if the current CRA business model is modified, which appears unlikely.

⁸⁷⁹ In 2003, the CRA industry representatives that appeared before the U.S. Congress were unanimous that there was no empirical evidence to conclude that they had failed to address conflicts of interests that arise from this particular business model. It emerged that CRAs were managing conflicts of interest arising from their business model and that this was mostly due to CRAs desire to conserve their reputational capital. See Securities and Exchange Commission report (2003) (note 836, *supra*) at p. 23 and p. 41.

⁸⁸⁰ Frank Raiter and Richard Gugliada, former senior executives at Moodys and S&P pilloried the institutions, the rating process, methodologies and alleging that some credit ratings were guesses. See Credit and Creditability, NOW ON PBS, (Maria Hinajosa, November 21, 2008), available at <http://www.pbs.org/now/shows/446/transcript.html>

⁸⁸¹ See for instance Buiter who calls for the modification of the issuer pays business model. Willem H. Buiter (2007) 'Lessons from the 2007 Financial Crisis', *Centre for Economic Policy Research: Policy Insight No. 18*, December 2007), at p. 4. Available at <http://www.cepr.org/pubs/PolicyInsights/PolicyInsight18.pdf>

⁸⁸² See for instance Jerome Mathis., James Mc Andrews., and Jean-Charles Rochet (2008) 'Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?', Available at: <http://www.carnegie-rochester.rochester.edu/nov08-pdfs/rochet.pdf>

Critics have argued that the provision of ancillary and risk management consultancy services by CRAs to issuers gives rise to conflicts of interest because a: “CRA’s rating decision could be influenced by whether or not an issuer purchased additional services provided by the CRA.”⁸⁸³ Some CRAs provide pre-rating assessments, “public and private firm credit scoring models, international rating systems services, and empirical data on default incidence, loss severity, default correlations, and rating transitions.”⁸⁸⁴ This study proposes, not the proscription of the provision of such consultancy services, but the introduction - through a code of conduct - of preemptory rules to resolve consequential inefficiency-inducing conflicts of interests. These can include corporate governance style measures, such as the requirement that the rating and consulting functions should be separate.⁸⁸⁵ The CRA regulations should in addition, require the disclosure of material information in rating opinions, including a requirement that CRAs disclose ancillary services provided to rating clients.

Critics also argue that CRAs typically receive material corporate information about rated entities or debt securities that is not in the public domain. Such information can enable CRA analysts to either trade on or pass such information to subscribers of their publications and other services. In other words, it is argued that CRA analysts can either engage in or facilitate insider trading, compromising market efficiency.⁸⁸⁶ This concern is addressed in Part X of the Securities Act, which outlaws

⁸⁸³ International Organisation of Securities Commission (2003) ‘Report on the Activities of Credit Rating Agencies’, at p. 11, Available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD153.pdf> See also Securities and Exchange Commission (2003) (note 875, supra) at pp. 43-44.

⁸⁸⁴ Securities and Exchange Commission (2003) (note 836, supra) at p. 42.

⁸⁸⁵ However, contrast this recommendation with the SEC findings that in the U.S. CRAs policies and practices requiring the separation of consultancy and rating services were not implemented in practice. *Ibid.*, at p. 43.

⁸⁸⁶ Stephanie Rousseau notes: “credit rating agencies may provide their subscribers with non-public material information, including information about pending rating changes, which threatens to destabilise the level playing field upon which investors should trade.” Stephanie Rousseau (2005) (note 834, supra) at p. 630.

the improper use of insider information. The CRA code of conduct must also prohibit CRA staff from transmitting to their firm's subscribers such material information, and must require CRAs to create internal governance structures that prevent unlawful transfer of such information. Equally, CRA staff must be prohibited from engaging in financial activities, including securities trading, when they are in possession of material information which is not in the public domain. In addition, anti-insider trading provisions of the CRA code of conduct must envisage and prohibit the passing on of non-public information by CRAs, including their staff, to subscribers of their materials.

CRAs, in the U.S. context, have been accused of engaging in abusive and coercive practices, such as the abusive use of unsolicited ratings. It is recommended that the CRA code of conduct must envisage and provide adequate remedies to mitigate abusive and coercive practices. CRAs routinely issue unsolicited ratings.⁸⁸⁷ In the U.S., CRAs were accused of issuing low unsolicited ratings with the purpose of increasing market share and coercing issuers to engage their services. Some issuers reportedly complained that CRAs sent them bills after issuing unsolicited ratings and in some cases implied that if their services were engaged - for a fee - a higher rating could be obtained.⁸⁸⁸

The practice of unsolicited ratings is controversial for several reasons. Critics argue that such ratings are inherently inaccurate - contributing to market inefficiencies

⁸⁸⁷ Partnoy (2005) (note 846, supra) at p. 71.

⁸⁸⁸ International Organisation of Securities Commission (2003) (note 875, supra), at p. 15. In 1993 Moody's was sued in the U.S. by Jefferson County (Colorado) school district because it had issued a negative outlook on bonds issued by the latter after it had opted to use S&P and Fitch to rate its bond issuance. The negative outlook issued by Moody's forced Jefferson Country School to re-price its bonds and pay a higher interest rate. Although Jefferson County School's suit was dismissed on freedom of speech grounds, it served to illustrate the perception that CRAs sometimes abuse their market position. See Jefferson County School District No. R-1 v Moody's Investor's Services, Inc., 175 F.3d 848 (10th Cir 1999).

- because they are based on incomplete information.⁸⁸⁹ In rebuttal, proponents argue that unsolicited ratings help avoid rate shopping and that in any event, there is little evidence to indicate that unsolicited ratings contribute to market inefficiencies, and that the prohibition of the practice would violate their freedom of speech in addition to raising entry barriers for new CRAs.⁸⁹⁰ In Zimbabwe, this study proposes, not the prohibition of unsolicited ratings, but the imposition of a legal requirement obliging CRAs to disclose that a rating opinion is unsolicited. This would act as a signal to market participants. In addition, the CRA code of conduct must define as abusive conduct the sending of bills for unsolicited ratings.

The 2007 global financial crisis has raised questions over statistical rating methodologies employed by CRAs in pricing structured finance securities' credit risk. CRAs have been accused of credit risk mispricing and ratings inflation, and of due-diligence failures.⁸⁹¹ Despite initial denials, it is now clear that different triple-A rated securities carry different levels of risk.⁸⁹² These disparities have brought into question the integrity and value-add of ratings. Indeed, some critics have called for the quasi-regulatory role played by CRAs in the financial markets to be removed.⁸⁹³ In recognition of this problem, Moody's and Standard and Poor have apparently suggested changing their rating scales for structured finance products.⁸⁹⁴ Rules

⁸⁸⁹ Partnoy states: "it is interesting that credit rating agencies believe that they are capable of publishing unsolicited ratings even if they do have no access to management or inside information and are merely making judgments based on publicly available information." And in a footnote he adds that: "there is an argument that unsolicited ratings are a sign of market failure in the credit rating business, because they indicate that some agencies, particularly Moody's believe that they can extract fees from issuers by threatening to publish unduly unfavourable ratings." Partnoy (2005) (note 837, supra) at p. 73.

⁸⁹⁰ IOSCO for instance notes that: "although unsolicited ratings may pose issues for securities regulators contemplating regulation in this area, regulators should also be aware that new entrants frequently rely on unsolicited ratings to build their reputations. Blanket prohibitions on the activity effectively may constitute a barrier to new entrants." International Organisation of Securities Commission (2004) (note 875, supra) at p. 15.

⁸⁹¹ International Monetary Fund (2008) (note 106, supra), at p. 61.

⁸⁹² For an excellent critique see, Nomura (2006) 'Bond Rating Confusion'. Available at http://www.adelsonandjacob.com/pubs/Bond_Rating_Confusion.pdf

⁸⁹³ Roubini (2008) (note 143, supra) at p. 6. See also Calomiris (2008) (note 22, supra), at p.78.

⁸⁹⁴ International Monetary Fund (2008) (note 106, supra) at p. 55.

imposed by the SC or consolidated regulator would need to capture and mitigate these concerns. Ideally, CRAs should be obliged to undertake some minimum levels of due diligence and should state in their ratings if insufficient information was used in compiling same. In addition, CRA should provide more analytical information with their ratings.⁸⁹⁵

Other issues that should be considered include the disclosure by CRAs of their rating formulae, the standardization of rating criteria and opinions to facilitate easier understanding by investors, regulatory authorities and other market participants of the levels of risk attendant to fixed-income market securities. In rebuttal it is arguable that such stipulations may stifle innovation, and that standardization is difficult given the mathematical formulas utilised, and the subjectivity of opinions. While the publication of formulae utilised may be of interest and use to sophisticated investors, such disclosure maybe of limited value to ordinary investors. It could be argued in response that the structured finance market is largely institutional anyway, and such disclosure will generate efficiencies.

In summary, although Zimbabwe has a CRA regulatory and gatekeeping framework, it is basic in nature. The SC should establish a comprehensive CRA regulatory framework, providing for: (i) the registration of CRAs; the regulation of the ratings process; (iii) corporate governance rules for CRAs; and (iv) an enhanced civil and criminal law liability framework. This extant rudimentary framework leaves the financial services system vulnerable to systemic risks that can arise from financial information failure occasioned by CRAs failing in their gatekeeping responsibilities.

⁸⁹⁵ See the recommendations proposed by the IMF in its 2008 Global Stability Report. *Ibid.*, at pp. 82-83.

10.6. Summary

This chapter established that Zimbabwe's capital markets gatekeeping framework is basic, and that it should be reformed and enhanced to enable it to contribute to the mitigation of risks that can arise from securitization. In its present under-developed state, the extant capital markets gatekeeping framework does not enable lawyers, auditors and CRAs to fully discharge their capital markets gatekeeping functions. Because of its nascent state, this component of Zimbabwe's risk mitigation framework would not be able to efficiently and robustly mitigate risks such as those which contributed to the collapse of Enron and the 2007 global financial crisis. The SC should, as envisaged under the Securities Act, prescribe regulations that establish a registration and regulatory framework for, among others, structured finance lawyers, public auditors and CRAs. The SC should prescribe binding rules that regulate third-party opinions which are critical due diligence components of securitization transactions true-sale and non-consolidation opinions, and audit reports and ratings. To reduce financial information failure risks that can be spawned by conflicts of interests, the SC should ensure that it prescribes corporate governance codes of conduct for capital markets gatekeepers. And in the process, it must clearly stipulate civil and criminal penalties for non-compliance.

CHAPTER 11

CONCLUSION

11.1. Concluding observations

This study assessed (i) the extent to which Zimbabwe's legal system enables financial and other entities to engage in the numerous legal arrangements that constitute a basic securitization transaction; and (ii) the legal reforms which need to be implemented to create an effective and risk-managing securitization-enabling financial infrastructure in Zimbabwe. The study analysed: (a) laws regulating financial firms and statutory bodies which, internationally, have participated in securitization transactions, as originating firms, providers of securitization-related services, and as institutional investors; (b) Zimbabwe's trust and corporate law with the objective of identifying legal structures that can be used as SPVs; (c) Zimbabwe's law of sale and the various legal risks, including re-characterization, substantive consolidation, veil-piercing, foreclosure, insolvency and tax that may impinge a securitization asset transfer; (d) Zimbabwe's financial markets regulatory system as well as the extant gatekeeping liability and regulation framework; and (e) the extant dispute resolution framework.

This study concludes that on the whole, i.e. with a few notable areas of exception, Zimbabwe's financial infrastructure as it is currently constituted does in actual fact permit most of the various arrangements that constitute a basic securitization

transaction. This is perhaps unsurprising given that in South Africa, which shares with Zimbabwe the unique Roman-Dutch common law legal system; firms were able to harness securitization with minimal legal reform – relating to prudentially regulated financial institutions - having been put in place. However this study found – as summarised below - numerous issues that should be clarified or rectified through legal reform. In addition, although Zimbabwe’s financial stability framework can be used to mitigate risk that can be spawned by financial firms engaging in securitization transactions, as originators, service providers or as investors, it is insufficiently developed to prevent or manage risks of the nature that were exposed by the 2007 global financial crisis, some of which emanate from the securitization process. This study argues that Zimbabwe’s financial services regulatory and supervisory framework and the gatekeeping liability and regulatory framework should be extensively reformed; first by creating a consolidated financial services regulatory agency – accompanied by a comprehensive and modern regulatory and supervisory framework; and secondly by creating a comprehensive gatekeeper liability and regulatory framework. In a nutshell, this study finds that although there are a few legal impediments to firms in Zimbabwe engaging in securitization transactions, the extant financial services regulatory and gatekeeping framework is ill-suited to the task of preventing and managing risk that may arise from firms’ involvement in securitization.

11.2. Originating firms

This study establishes that as a general rule, Zimbabwe’s legal framework permits financial institutions, statutory bodies and other income generating enterprises to refinance using securitization, economic and other factors permitting. However a

weakness with the extant framework is legal uncertainty. The RBZ securitization guidelines indicate that as far as the central bank is concerned, banking institutions and building societies operating in Zimbabwe may engage in securitization transactions as originators, service providers and investors. But this is not unambiguously supported by the wording used in the Banking Act or the Building Societies Act. This study recommends the amendment of the Banking Act, the Building Societies Act and the Councils Act to ensure that each enactment refers either to securitization in particular or structured finance transactions in general, as permissible refinancing methods.

The research also concludes that financial institutions are permitted to provide securitization transaction-related services, such as credit and liquidity enhancement, the provision of SPV management services, *et al.* Although there are no legal restrictions on the ability of most financial institutions investing in securitization issuances, this study recommended that consideration should be given to removing or amending the prescribed assets regime, which compels local government authorities, and insurance firms and pension and provident funds among others from investing in securities of their choice without Ministerial approval.

11.3. SPVs

The study establishes that trusts and public limited-liability companies are the only two legal structures that can be used as securitization SPVs. Both legal entities are relatively easy and cost-effective to establish, have limited liability status (or limited liability-like status in the case of trusts) – can be made subject to effective corporate governance prescriptions, enjoy a measure of bankruptcy-remoteness – subject obviously to the intentions of the structurers, and are permitted to issue

securities to members of the public. Because trusts are not subject to entity-level tax liability, they are arguably better securitization vehicles compared to public companies. The study recommends that the Moneylending and Rates of Interest Act should be amended to ensure that SPVs that engage in non true-sale securitization transactions are exempted from registration as moneylenders under the Act.

11.4. Asset transfer

This study establishes that Zimbabwe's Roman-Dutch law provides an effective medium for the transfer of financial assets in true-sale and non true-sale securitization transactions. An out-and-out cession and a cession *in securitatem debiti* effect a true-sale and a non-true sale securitization transaction, respectively. Apart from cession, assignment and novation (which also involves cession where financial assets are involved) are asset transfer methods that can be used in transferring rights of action in a securitization transaction. It establishes that the true-sale concept is envisaged in Zimbabwe's commercial laws. There is nothing in Zimbabwe's legal system that precludes the *description* of a contract, in which ownership over financial assets is effectively transferred from an SPV to an originating firm, as a true-sale. For purposes of transactional counsel's true-sale opinions or dispute resolution, the study identified true-sale *indicia* used by common law jurisdictions, which would be regarded as persuasive authority in Zimbabwe. The study concludes however that under Roman-Dutch law, it is not possible to effect a true-sale of future-flow financial receivables. Ownership over the sold future-flow assets only passes once the assets come into existence. In practice therefore, appropriate credit enhancement strategies would have to be employed to mitigate this added risk inherent in the securitization of future-flow receivables.

This study established that the Insolvency Act and Companies Act anti-asset disposal provisions carry insolvency-inducing risks to non true-sale or re-characterized securitization transactions; but have minimal, if any, effect on true-sale transactions. This study argued against the promulgation of a statutory safe-harbour in the Insolvency Act for non true-sale securitization transactions. Non true-sale securitization transactions are but one species of secured finance transactions. There is no reason in principle why such transactions should be granted special insolvency risk-free status as compared to other secured transactions.

The study also establishes that in Zimbabwe, creditors of an originating firm do not have a cause of action to apply for, and courts do not have jurisdiction to issue, orders for the substantive consolidation of the assets of an SPV with those of an originating firm. However, what cannot be achieved through an application for substantive consolidation may be achieved through an application for the piercing of the corporate veil of an SPV. This research argued that the veil-piercing doctrine does not apply to trust structures. Further, in practice the veil-piercing risk has minimal impact on *bona fide*, arms length, for fair value securitization transactions; and can be structured out of most transactions. The judiciary in Zimbabwe should however clarify the ambit of the veil-piercing doctrine. Further, the study found that in Zimbabwe, foreclosure risk is generally manageable, and does not impinge on securitization transactions. The country has a well developed foreclosure infrastructure framework, which enables judgment creditors to cost-effectively and expeditiously foreclose in satisfaction of judgment debts. In summary, this study concludes that Zimbabwe's legal infrastructure permits the effective management of re-characterization, insolvency, substantive consolidation, veil-piercing and foreclosure risks.

11.5. Taxation

This study established that Zimbabwe's tax regime presents some legal impediments to securitization structuring. A critical flaw with the framework is legal uncertainty about whether, and if so, which of the various cash-flows between an originating firm and an SPV are subject to income tax, VAT and stamp duty liabilities. ZIMRA should issue guidelines on the likely treatment of the various income flows in securitization transactions. This will facilitate transaction certainty and reduce compliance costs.

The Income Tax Act should be amended to enable all types of securitization SPVs and not just trust structures – as is currently the case – to be entity-level income tax-exempt. The VAT Act should be amended and exempt from VAT-liability the cession of financial receivables from an originating firm to an SPV, as well as the issuance of securities by an SPV. To reduce securitization transaction costs, this study also recommends that services provided by a Servicer to an SPV and/or an originating firm pursuant to a securitization transaction should be exempt from VAT. Regarding stamp duty liability, this study recommends that the Stamp Duty Act should be amended to clearly and unambiguously stipulate that cessions of mortgage and notarial bonds used for securitization transactions are stamp duty-exempt. Although possessing an adequate tax dispute resolution system, this research recommended the creation of a single and initial-jurisdiction tax court in place of the Special Court, the Fiscal Appeals Court and the High Court.

11.6. Financial markets regulatory framework

Zimbabwe has an underdeveloped financial market regulatory and supervisory framework, which should be overhauled if the country is to create a financial

infrastructure that is capable of effectively preventing and managing risk that may arise from securitization. In its present state, the financial stability framework would not be capable of effectively preventing and managing securitization transaction risks. The financial services regulatory system is fragmented, which creates risks of regulatory arbitrage and failure. This study recommends the establishment of a consolidated regulator in place of the RBZ, the IPC and the SC, which would regulate all financial services institutions in Zimbabwe. In addition, the consolidated regulator should establish a comprehensive prudential regulatory framework, which covers all financial institutions - banking, insurance, pension funds, securities firms, broker dealer, hedge funds, etc - their subsidiaries and holding companies.

If the current financial services regulatory system is retained, this study recommends its wholesale enhancement. The RBZ's regulatory and supervisory authority should be extended over all banking, building society and micro-finance institutions. The IPC regulatory and supervisory framework needs to be overhauled and complemented by a modern prudential framework that *inter alia*, creates a risk-sensitive capital and liquidity reserves regime. The SC's regulatory and supervisory authority should be extended to cover more key capital markets gatekeepers. In addition, it should create a comprehensive framework for the regulation and supervision of structured finance lawyers, CRAs, public auditors, among others. Further, it should promulgate rules that regulate securities-related disclosures, corporate governance stipulations for public companies, as well as some of the key gatekeepers.

11.7. Capital markets gatekeeping framework

The study concludes that Zimbabwe's capital markets gatekeeping framework – comprising its civil, criminal, and administrative law components – is basic and would not be an effective tool to mitigate risks that can arise from securitization. It can however be used to mitigate typical and basic causes of capital markets financial information failure risks, such as fraud, inadequate disclosure, false-trading and market manipulation, and insider trading. But, the extant framework should be enhanced through, among others, the promulgation of peremptory codes of conduct, especially for capital markets gatekeepers, such as structured finance lawyers, public auditors and CRAs.

11.8. Dispute resolution framework

This study concludes that Zimbabwe has a generally adequate dispute resolution system. The High court has jurisdiction over most typical securitization transaction disputes. In addition, the country has a functioning and established arbitration framework, which is complemented and reinforced by the formal justice system. The study also concluded that Zimbabwe's judicial system permits parties to a securitization transaction to choose the forum and law which they wish to govern any arising disputes. However, as noted above, the country currently suffers from an adverse image problem, over its commitment to the rule of law. This is a political risk problem which, this thesis has argued is transient, and is one that in all likelihood will dissipate with the evolution of the country's political situation.

11.9. Summary

In summary, this study concludes that although needing reform in a few areas, Zimbabwe's legal system, to a large extent, enables income generating enterprises to engage in the numerous legal arrangements that constitute a basic securitization transaction. However, it needs to overhaul its financial stability framework to ensure that the financial services regulatory and corporate gatekeeping system can effectively prevent and manage risks that may arise with securitization. In its present state, it would be inadvisable for a full blown securitization market to blossom. This is because the financial services regulatory and gatekeeping frame is rudimentary and would not be capable of effectively preventing and managing securitization transaction risks.

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3. Securitization Schemes Schedule (GN 153, GG 13723 of 3rd January 1992).
4. Security by Means of Movable Property Act 1993.
5. South Africa's Securitization Schemes Regulations, No. 26415, 2004.
6. Value Added Tax Act, 1991 (Act 89 of 1991).

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2. Credit Agency Reform Act (2006).
3. Employee Abuse Prevention Act of 2002.
4. NASD Rule 2711(b)(1); NYSE Rule 472(b)(1).
5. Ohio Rev. Code Ann. 1109.75 (Supp. 2002) and Tex. Bus. & Com. Code Ann. 9.109(e) (2002).
6. Regulation Fair Disclosure (Regulation FD) issued by the SEC in the U.S. in 2000.
7. Sarbanes-Oxley Act of 2002 (Pub. L. No. 107-204, 116 Stat. 745, and also known as Public Company Accounting Reform and Investor Protection Act of 2002).
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10. Securities and Exchange Act 1934.
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12. SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations, June 16, 2008, <http://www.sec.gov/rules/proposed/2008/34-57967.pdf>

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2. Atmore v tobacco Sales Warehouse (Pvt) Ltd 1978 RLR 202.
3. Bain v Barclays Bank (DC and O) Ltd 1937 SR 191.
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