Synthetic securitisation in South African law

by

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# Table of contents

| Title page                                      | 1 |
| Table of contents                              | 3 |
| Declaration of originality                      | 9 |
| Summary                                        | 11 |
| Key Terms                                      | 13 |
| Acknowledgments                                | 15 |
| **Chapter 1: General introduction**            | 17 |
| 1 Introduction and purpose                     | 17 |
| 2 Methodology                                  | 21 |
| 2.1 Problem questions                          | 21 |
| 2.2 Ambit of the study                         | 21 |
| 2.3 Comparative aspects                        | 24 |
| 2.4 Structure of this thesis                   | 25 |
| 2.4.1 Chapter 1: General introduction          | 25 |
| 2.4.2 Chapter 2: Synthetic securitisation schemes in definition and context | 25 |
| 2.4.3 Chapter 3: Parties acting in a primary role | 25 |
| 2.4.4 Chapter 4: Parties acting in a secondary role | 25 |
| 2.4.5 Chapter 5: The nature and role of special-purpose institutions in synthetic securitisation schemes | 26 |
| 2.4.6 Chapter 6: Risk and risk management in synthetic securitisation schemes | 26 |
| 2.4.7 Chapter 7: The transfer of risk in synthetic securitisation schemes | 26 |
| 2.4.8 Chapter 8: Securities issued by the special-purpose institution in a synthetic collateralised debt obligation | 26 |
| 2.4.9 Chapter 9: Conclusion: Synthesis and recommendations | 27 |
| 2.4.10 Bibliography                            | 27 |
| 2.4.11 Abbreviations                           | 27 |
| 2.5 Interpretation                             | 27 |
| 2.6 Stylistic aspects                          | 28 |
Chapter 2: Synthetic securitisation schemes in definition and context
1 General 31
2 Defining the synthetic securitisation scheme 32
   2.1 Etymological considerations in theory and practice 32
   2.2 Statutory definition of synthetic securitisation schemes 35
3 The origins of synthetic securitisation schemes 39
   3.1 Common perceptions 39
   3.2 Securitisation and false analogies 40
      3.2.1 High Middle Age Genoa 40
      3.2.2 Renaissance France 40
      3.2.3 Early modern Netherlands 41
      3.2.4 Nineteenth century Prussia 42
   3.3 Synthetic securitisation per se 43
4 Rationales for synthetic securitisation 46
   4.1 Regulatory rational: Basel 46
   4.2 Micro-economic rationale 49
5 An overview of the Financial Crisis 50
   5.1 Brief chronology 50
   5.2 An incident in the history of greed 53
6 Synthetic securitisation schemes in the South African context 58
7 Synthetic securitisation schemes in the Canadian context 60
8 Synthetic securitisation schemes in the German context 62
9 Final remarks 65

Chapter 3: Parties acting in a primary role
1 Introduction 73
2 Parties acting in a primary role 74
   2.1 General 74
   2.2 Originator 78
      2.2.1 General aspects 78
      2.2.2 ABCP programmes specifically 80
      2.2.3 Originators in Canadian law 82
   2.3 Remote originator 85
   2.4 Sponsor 88
   2.5 Repackager 91
| 2.5.1 | South Africa | 91 |
| 2.5.2 | Canada | 97 |

3 Final remarks 98

**Chapter 4: Parties acting in a secondary role** 101

1 Point *in limine* 101

2 Introduction 102

3 Credit enhancement 104

3.1 General 104

3.2 Internal credit enhancement 108

3.3 External credit enhancement 113

4 Liquidity facilities 116

5 Underwriting 119

6 Purchaser of senior commercial paper 121

7 Servicing agent 122

8 Counterparty to a transaction in a bank’s trading book 124

9 Final remarks 125

**Chapter 5: The nature and role of special-purpose institutions in synthetic securitisation schemes** 129

1 General 129

2 SPIs in context 131

3 Defining the SPI 135

3.1 General 135

3.2 Relevant form of business enterprise 137

3.3 The bullet-proof factor 139

3.4 The SPI’s rationale 143

3.5 Final thoughts 144

4 Control of the SPI 145

5 Management of the SPI 147

6 The applicability of the Collective Investment Schemes Control Act 152

6.1 General 152

6.2 Public offer 153

6.3 Investors contributing for a participatory interest in a CIS portfolio 156
Unfunded credit derivatives incorporating ISDA terminology 231

Settlement 235

Credit events 238

5 Credit derivatives compared with insurance contracts 244

6 Final remarks 247

Chapter 8: Securities issued by the special-purpose institution in a synthetic collateralised debt obligation 253

1 Introduction 253

2 Corporate finance versus structured finance? 255

3 Banks and the business of a bank 259

3.1 The concept of bank in brief 259

3.2 The business of a bank 259

3.2.1 Banks Act 94 of 1990 259

3.2.2 The business of a bank as a punitive measure 263

3.2.3 Canada 265

3.2.4 Germany 267

4 Commercial paper in synthetic securitisation schemes 269

4.1 Commercial paper as defined in paragraph 1 of the Schedule 269

4.2 Commercial paper in terms of the Commercial Paper Notice 272

4.3 Commercial paper in terms of paragraph 14 of the Schedule 274

5 Disclosure 276

6 Stratification of risk 279

7 Final remarks 283

Chapter 9: Conclusion: Synthesis and recommendations 287

1 Hypotheses relating to the research problem and problem question 4 287

1.1 Challenges 287

1.2 Antagonism regarding synthetic securitisation and legal reaction thereto 290

1.3 Relevance of this study 291

1.4 The future of synthetic securitisation 292

1.4.1 Regulatory development and unregulated counterparties 293

1.4.2 Regulatory valuation 295

2 Hypotheses relating to the other problem questions 297
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Summary of Thesis

The objective of this thesis is to critically analyse synthetic securitisation schemes in South African law as synthetic collateralised debt obligations using primarily credit default swaps (CDSs). This transpires from the perspective of primarily company law, and secondarily securities law and the law of contract. It includes a contextualised study of these schemes with regards to their origins, their significance regarding the recent financial crisis, and their rationales – micro-economic influence and Basel capital requirements. Not only are the participants, such as parties acting in a primary role and secondary role and special-purpose institutions, studied, but also the obligations between these parties, such as the CDS contract, and the meaning of commercial paper, the legal nature of credit-linked notes, the business of a bank, and the influence of recent case law. It also includes a consideration of synthetic securitisation schemes in terms of the Collective Investment Schemes Control Act 45 of 2002. Furthermore, the role of systemic risk and moral hazard is explained, as well as the interaction between synthetic securitisation schemes, credit rating agencies and the function of risk management. The CDS is compared with insurance contracts, and a discussion of the 2014 International Swaps and Derivatives Association Credit Derivative Definitions is incorporated. For legal comparison, the South African model is compared with Canadian law and its unfunded credit derivatives in the light of recent regulation, and compared to German law and its prevalence of funded credit derivatives. Finally, suggestions are made as to the future of synthetic securitisation schemes.
Key terms

Commercial paper; credit risk; credit derivatives; credit default swaps; credit-linked notes; parties acting in a primary role; parties acting in a secondary role; special-purpose institutions; synthetic securitisation; the business of a bank.
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Chapter 1
General introduction

1 Introduction and purpose
2 Methodology
   2.1 Problem questions
   2.2 Ambit of the study
   2.3 Comparative aspects
   2.4 Structure of this thesis
      2.4.1 Chapter 1: General introduction
      2.4.2 Chapter 2: Synthetic securitisation schemes in definition and context
      2.4.3 Chapter 3: Parties acting in a primary role
      2.4.4 Chapter 4: Parties acting in a secondary role
      2.4.5 Chapter 5: The nature and role of special-purpose institutions in synthetic securitisation schemes
      2.4.6 Chapter 6: Risk and risk management in synthetic securitisation schemes
      2.4.7 Chapter 7: The transfer of risk in synthetic securitisation schemes
      2.4.8 Chapter 8: Securities issued by the special-purpose institution in a synthetic collateralised debt obligation
      2.4.9 Chapter 9: Conclusion: Synthesis and recommendations
      2.4.10 Bibliography
      2.4.11 Abbreviations
   2.5 Interpretation
   2.6 Stylistic aspects

1 Introduction and purpose
The purpose of this study is to critically analyse synthetic securitisation schemes in South African law. The legal subjects utilised for this study are primarily company law, and secondarily securities law and the law of contract; therefore, it is a work of corporate law – at the University of Pretoria, the hypernym ‘corporate law’ signifies company law, securities law
(also securities regulation) and international takeovers and reorganisations. The law of contract is relevant since corporate law constitutes a specialisation thereof.\(^1\) Securitisations are complex schemes,\(^2\) which is aggravated by the multidimensional nature of said corporate law.\(^3\) In corporate finance, primary and secondary roles regarding equity are often pragmatically conservatively assumed by a single institution;\(^4\) the dispersed model in structured finance is a risk management manifestation,\(^5\) being intrinsically multifaceted owing to the inter-corporate\(^6\) and/or corporate-quasi-corporate\(^7\) relationships between different parties: Tasks are performed hypothetically by numerous parties but practically by a few parties performing more than one task.\(^8\) Therefore, an analysis is demanded of both participants’ roles in a synthetic securitisation scheme and the respective legal obligations \textit{inter se}. A study of statutory law, \textit{capita selecta} of quasi-international law, and common law will be undertaken for this purpose. However, the consequent difficulty for comprehension derives from single themes, such as senior commercial paper, being relevant to numerous participants. Thus, the challenge established is to express these matters in a coherent academic format, since a primary presentation of a theme implies the loss of comprehension of participants and their roles, whilst the primary presentation of the latter implies unwanted duplication of the theme.

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\(^1\) E.g. HS Cilliers \textit{et al} Cilliers & Benade \textit{Corporate Law} (2000) 179.


\(^5\) As above.


\(^7\) As above; JT Pretorius & PA Delport (eds) ‘Companies in general’ in JT Pretorius (ed) \textit{Hahlo’s South African company law through the cases: A source book} (1999) 11. Being \textit{inter alia} a work of company law, this work does not extend to the law of trusts, which consequently excludes discussions of trusts and their role in synthetic securitisation schemes.

\(^8\) Karoly (n 2 above) 25.
Historic and contextual insight are *sine qua non* for a comprehension of synthetic securitisations in law; therefore, the foremost introduction to a study of synthetic securitisation schemes is the historic divide that existed between commercial and investment banks.\(^9\) The former have become progressively involved in sovereign or corporate plain vanilla product issues,\(^10\) thereby consuming a segment of the latter’s business ambit.\(^11\) This is borne in mind with the fact that derivatives are not bear market inventions. Capital limitations and scarce financial intermediation established the classic banker; bull markets created the banking salespersons of exclusive products.\(^12\) Therefore, synthetic securitisation is perceived as an eventuality of investment banking innovation. Whilst derivative utilisation in securitisation was not novel – for example, interest rate swaps are applied to traditional securitisation schemes\(^13\) – the use of credit derivatives was,\(^14\) and structures had developed thereto.\(^15\) This was a part of the genesis of the parallel banking system.\(^16\) Then, less than a decade ago, the greatest financial meltdown since the Wall Street Crash of 1929 was globally experienced.\(^17\) These events, referred to herein as the ‘Financial Crisis’\(^18\) – also the ‘Great Financial Crisis’\(^19\) in socialist circles\(^20\) – signaled the expiration of the greatest period of wealth creation in human history, being the decade from 1997 until 2007.\(^21\) During the latter period, the number of dollar millionaires increased by 4 million and the assets controlled by high net worth individuals increased by twenty trillion dollars.\(^22\) This significant increase in wealth has been attributed to structured finance.\(^23\)

\(^9\) M Fleuriet *Investment banking explained: An insider’s guide to the industry* (2008) 1 et seq.
\(^10\) Fleuriet (n 9 above) 191-192.
\(^11\) Fleuriet (n 9 above) 192.
\(^12\) DN Chorafas *Credit derivatives & the management of risk including models for credit risk* (2000) 58.
\(^14\) Bell & Dawson (n 2 above) 549.
\(^15\) Bell & Dawson (n 2 above) 550 et seq.
\(^16\) A Batchvarov ‘Quantitative aspects of the collapse of the parallel banking system’ in A Lipton & A Rennie (eds) *The Oxford handbook of credit derivatives* (2011) 574.
\(^18\) See Simkovic (n 2 above) in general.
\(^19\) Foster & Magdoff (n 17 above) 8.
\(^20\) As above.
\(^22\) Associates of Merrill Lynch and Capgemini (n 21 above) xx et seq.
\(^23\) Associates of Merrill Lynch and Capgemini (n 21 above) xxi.
However, credit has a well-recorded cyclical nature. Despondency in bear markets either signifies the swiftness of economic forgetfulness, or the impetus to justify the uniqueness of any particular financial crisis. The frequency of financial crises presumes a symbiosis between it and economic aspirations. That it constitutes an accustomed development in capitalist history yet remains historically unique is a blanket statement applicable to virtually every financial crisis of the twentieth century. However, the relevant financially engineered products had been regarded as the imperative financial market innovation since the 1930s. Contemporaneously, this subject retains importance, given its curious role in corporate finance and financial intermediation deviation, its interesting capitalisation, its contribution to the Financial Crisis and its little bespoken inversion of the latter. These circumstances justify a legal analysis of George Soros’ ‘weapons of mass destruction’, as well as their history.

This critical analysis is novel to South African legal academic discourse. Without it, a meaningful dialogue on credit derivatives goes lame, just as this work must be consequent to Locke’s thesis on traditional securitisation schemes. Its specialisation encapsulates diverse aspects of corporate law – as a doctoral thesis demands a sufficiently wide research ambit – for a perception – as a doctoral thesis demands sufficient depth – of the doctrine of synthetic securitisation specifically. Furthermore, in the absence of formal indications of doctoral theses limitations, this work has been completed to resemble theses locally and abroad. Numerous

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25 As above.
26 As above.
27 As above.
28 Foster & Magdoff (n 17 above) 8.
30 See ch 8 below.
31 See ch 5, 8 below.
aspects addressed in this work can be used for dissertations and theses in their own right, and without unnecessary digression, those instances are indicated.

2 Methodology

2.1 Problem questions

Certain problem questions manifest, expressly or implicitly, from the aforesaid. Therefore, this study is limited to revolve around specific enquiries intended to be alluded to in this work:

1. What does the term ‘synthetic securitisation scheme’ mean to the jurist, and specifically to the civil jurist?
2. Which parties are involved in a synthetic securitisation scheme and, more specifically, what are their actual roles?
3. What are the legal obligations existing between said participants in a synthetic securitisation scheme, i.e., what are the legal mechanics of a synthetic securitisation scheme?
4. With the Financial Crisis in mind, what is the role of risk in synthetic securitisation, including systemic risk and moral hazard as it pertains to the law?
5. As an extension of the third question above: What is the legal nature of credit derivatives and commercial paper with regards to synthetic securitisation schemes?
6. More generally: Which aspects of synthetic securitisation schemes, in the statutory law(s) that regulate(s) it, need to be addressed?

2.2 Ambit of the study

Exclusivity and innovation, as will be discussed, constituted the impetus for commercial variations of synthetic securitisation technology that the jurist, through the reactive science of law, must qualify. To mitigate an encyclopaedic attempt to discuss synthetic securitisation in general, a priori legal certainty is required to contextualise this notion for purposes of doctoral study; however, the particular manifestation thereof selected must be relevant. Whereas the reference to synthetic securitisation in the title of this work may seem prima facie misleading, it is qualified through a contextualised reference to the South African jurisdiction. Therefore, a synthetic securitisation scheme in this thesis is regarded as a type of collateralised debt obligation (CDO).
A CDO is a broad and commercial term for credit portfolio securitisation,\textsuperscript{36} encompassing the issue or sale\textsuperscript{37} to investors of repackaged portfolios of credit risk,\textsuperscript{38} which become stratified into different tranches of securities\textsuperscript{39} in order to diminish or remove the party acting in a primary role’s on-hand’s credit risk.\textsuperscript{40} More specifically, a synthetic securitisation scheme in this work is regarded as a synthetic CDO given the use of synthetic sale\textsuperscript{41} with singular references to hybrid CDOs. Although synthetic CDOs also hold collateral assets,\textsuperscript{42} the difference between synthetic CDOs and hybrid CDOs is the nature of such assets.\textsuperscript{43} Synthetic CDOs hold only ‘high grade assets, mostly non-defaultable securities’,\textsuperscript{44} whereas hybrid CDOs acquire defaultable assets.\textsuperscript{45} The implication is that a SPI in a synthetic securitisation scheme acquiring debt instruments\textsuperscript{46} or by implication engaging in true sale or acquiring asset-backed securities\textsuperscript{47} (ABSs) means that additional credit risk is introduced into the scheme,\textsuperscript{48} which creates a hybrid CDO.

Variations on credit derivatives utilised often accompany variations on synthetic securitisations. Taylor identifies the main typology of credit derivatives as credit default swaps (CDSs)\textsuperscript{49} – which comprise the majority of transactions\textsuperscript{50} – and total rate of return swaps (TRSs).\textsuperscript{51} Chaplin follows a broader approach, and categorises credit derivatives as either ‘single name’ credit derivatives (comprising CDSs, spread options and TRSs), credit-linked notes (CLNs) and portfolio credit derivatives (comprising CDOs and portfolio spread options).\textsuperscript{52} Both approaches are impure, since the former excludes significant credit derivative variations, and the latter ignores \textit{inter alia} the prevalence of CDSs in CDOs. Furthermore, such a distinction is theoretical, since CLNs and CDSs can be concurrently used in a synthetic

\textsuperscript{37} Cilliers et al (n 1 above) 257-258.
\textsuperscript{38} Das (n 36 above) 307.
\textsuperscript{39} As above.
\textsuperscript{40} As above.
\textsuperscript{41} See Karoly (n 2 above) 13. Synthetic sale is this work is limited to credit derivatives and does not extend to guarantees as part of the primary objective.
\textsuperscript{42} Fabozzi & Kothari (n 13 above) 215.
\textsuperscript{43} As above.
\textsuperscript{44} As above.
\textsuperscript{45} As above.
\textsuperscript{46} As above.
\textsuperscript{47} As above.
\textsuperscript{48} As above.
\textsuperscript{49} F Taylor \textit{Mastering derivative markets} (2011) 229.
\textsuperscript{50} G Chaplin \textit{Credit derivatives: Trading, investing, and risk management} (2010) 49.
\textsuperscript{51} Taylor (n 49 above) 229.
\textsuperscript{52} Chaplin (n 50 above) 49-51.
securitisation scheme. The schedule to the Banks Act\textsuperscript{53} that regulates securitisation schemes in South Africa\textsuperscript{54} (the Schedule) differentiates between funded and unfunded credit derivatives.\textsuperscript{55} In terms of the latter, a premium is paid for risk protection and is known as ‘CDS style’,\textsuperscript{56} whereas the former relates to such protection being embedded in a CLN with a fixed or floating coupon as counter-performance for notional exposure to the transaction.\textsuperscript{57} This differentiation of credit derivatives is often not relevant only for classification of credit derivatives, but rather for classification of synthetic securitisation schemes. This thesis primarily focuses on synthetic securitisation as a synthetic CDO and will focus on the employment of CDSs, subject to legal comparison.

This primary focus on unfunded credit derivatives usually invokes the mechanics of indirect synthetic securitisation and consequently the utilisation of special-purpose institutions (SPIs). Codified company law in South Africa is subject to the Banks Act 94 of 1990,\textsuperscript{58} but the principle in \textit{In re Dominion Trust Co. and U.S. Fidelity Claim}\textsuperscript{59} has been included in South African law to categorise or exclude activities within or from the business of a bank.\textsuperscript{60} However, financial and monetary statistics categorise SPIs as ‘other financial intermediaries’,\textsuperscript{61} with (traditional) securitisations involving disintermediation.\textsuperscript{62} SPI’s securities issues are excluded from the business of a bank in the Schedule.\textsuperscript{63} Irrespectively, this study of synthetic securitisation schemes is not concerned with banking law as a manifestation of credit law, but rather with the legal personality and securities relevant to banking; therefore, it resorts within the classical ambit of corporate law.

Furthermore, the general provisions of synthetic securitisation schemes designate the transferor as the wide ‘institution’\textsuperscript{64} (with apt bank references)\textsuperscript{65} – later contextualised as acting in a

\begin{thebibliography}{99}
\item \textsuperscript{53} 94 of 1990.
\item \textsuperscript{54} n 6 above.
\item \textsuperscript{55} n 6 above, para 1 definition of ‘synthetic securitisation scheme’.
\item \textsuperscript{56} Chaplin (n 50 above) 205-206.
\item \textsuperscript{57} As above.
\item \textsuperscript{58} Companies Act 71 of 2008 sec 5(4)(b)(i)(gg).
\item \textsuperscript{59} (1918) 3 WWR 1023 26 BCR 339.
\item \textsuperscript{60} Banks Act 94 of 1990 sec 1.
\item \textsuperscript{61} N Gumata & J Mokoena ‘Note on the impact of securitization transactions on credit extension by banks’ (2005) December \textit{South African Reserve Bank Quarterly Bulletin} 60 61.
\item \textsuperscript{62} Jobst (n 2 above) 733.
\item \textsuperscript{63} n 6 above, 3.
\item \textsuperscript{64} Schedule (n 6 above) para 5(1)(a)(i).
\item \textsuperscript{65} Schedule (n 6 above) para 1 definition of ‘institution’.
\end{thebibliography}
‘primary role’\(^{66}\) – with the phrase ‘…an institution acting in a primary role or any of its associated companies or, when [sic.] such an institution is a bank…’,\(^{67}\) implying that synthetic securitisation is not in principle a blanket ‘banking law’ activity. This is an oversimplification: South African securitisation laws were not drafted in terms of corporate law terminology, thereby constraining legal certainty. Contrary to the exchange of commercial designations in financial circles, jurists are cumbersomely left to make jurisprudential sense of structured finance. This work is intended to vernacularise synthetic securitisation in a corporate law context.

2.3 Comparative aspects

This is not a thesis in terms of the subject of legal comparison. From an economic perspective, synthetic securitisations are somewhat consistent and as such comparative across jurisdictions (which is a *contradictio in terminis*, since singular designation presupposes economic regularity); from a legal perspective, synthetic securitisations present complex nuances as a slave to pragmatism with regards to the typology of credit derivatives, SPI prevalence, the practice surrounding credit-enhancement a liquidity facilities, etc. This has been expertly portrayed by Das in his publication, *Credit derivatives: CDOs & structured credit products*. Another dimension is then the divergent laws of various jurisdictions relating to these specialised schemes.

Doctoral study demands an element of diagnostic legal comparison. For this purpose, the jurisdictions of Canada, especially the state of Ontario, and Germany are used. The former is a common law jurisdiction, bearing in mind that corporate law in South Africa is influenced by common law,\(^{68}\) of which it is widely known that its corporate legislation has been used to draft the South African counterpart.\(^{69}\) Research shows that Canadian synthetic securitisations are usually indirect, employing CDSs for synthetic sale. The latter is a civil law jurisdiction (even taking into regard the role of the *Code civil des Français*), bearing in mind that South Africa is primarily a civil law jurisdiction, and evidently primarily securitising from an original position, e.g. direct synthetic securitisation, with CLNs and CDSs, which is the applicable

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\(^{66}\) Schedule (n 6 above) para 5(2)(b).

\(^{67}\) As above.

\(^{68}\) Cilliers *et al* (n 1 above) 19 et seq.

hypothetical emergent approach thereto in this work. The law relating to German securitisation is inaccessible to a reader not conversant in the German language, and this comparative presentation of its aspects, personally translated, provides a scarce anglophone opportunity to gain insight therein. The ideal practice of isolating comparative aspects from South African law would prove impractical herein – attention is often drawn to specific legal variations requiring either abrupt attention or simplicity through direct visual comparison – and as such the comparative aspects are integrated in the main text.

2.4 Structure of this thesis
2.4.1 Chapter 1: General introduction
This chapter serves as an introduction to the thesis and sets out the purpose of the work. The methodology used is described, and it entails the problem questions, the ambit of the study, the structure of the thesis, the nature of the comparative study, and how the work must be interpreted.

2.4.2 Chapter 2: Synthetic securitisation schemes in definition and context
A decompositional approach to definition of synthetic securitisation schemes is used, commencing with a wider definition and narrowing the perspective to strict definition for purposes of this work. The origins of synthetic securitisation are considered together with its rationales – relating to micro-economics and capital adequacy – and the nature of the Financial Crisis. The purpose of this chapter is not only to define synthetic securitisation ex lege, but also to comprehend it against an historical and regulatory background.

2.4.3 Chapter 3: Parties acting in a primary role
This chapter constitutes a study of the primary participants to synthetic securitisation schemes. The parties acting in a primary role are the originator, remote originator, sponsor(s) and repackager. The purpose of this chapter is to study the participants to a synthetic securitisation scheme and the legal obligations inter se. This chapter also alludes to the fourth problem question.

2.4.4 Chapter 4: Parties acting in a secondary role
This chapter constitutes a study of the secondary participants to synthetic securitisation schemes. The secondary aspects studied are credit enhancement, both internal and external, liquidity facilities, underwriting, the purchaser of senior commercial paper, the servicing agent
and the counterparty to a transaction in a bank’s trading book. This chapter extends from the discussion in the third chapter in alluding to the fourth problem question.

2.4.5 Chapter 5: The nature and role of special-purpose institutions in synthetic securitisation schemes
The SPI constitutes the focus of the relevant model of a synthetic CDO. This chapter defines and contextualises the SPI. The relevant form of business enterprise is discussed – which in this thesis will be limited to the company as separate legal entity – the bullet-proof factor significant to securitisation schemes, the SPI’s rationale, control of the SPI and management of the SPI. This includes a study of the applicability of the Collective Investment Schemes Control Act\textsuperscript{70} to synthetic securitisation schemes. The purpose of this chapter is to allude to the second, third and fourth problem questions raised above.

2.4.6 Chapter 6: Risk and risk management in synthetic securitisation schemes
In this chapter risk is defined for purposes of a legal study of synthetic securitisation schemes, as well as the role of risk and return in synthetic securitisation schemes. Thereafter, the relationship between risk and the Basel capital requirements is discussed, credit risks in synthetic securitisation schemes, as well as moral hazard, systemic risk and risk management. Credit rating agencies (CRAs) have suffered criticism regarding the Financial Crisis. This chapter also defines CRAs, and views the role and regulation of CRAs \textit{a priori} and \textit{a posteriori} to the Financial Crisis, in order to further address the fourth problem question above.

2.4.7 Chapter 7: The transfer of risk in synthetic securitisation schemes
This chapter encompasses the rationale for the transfer of credit risk and defines the credit derivative contract \textit{per se} through a decompositional approach from credit derivatives in the wide sense to CDSs specifically and CLNs for purposes of comparison. The features of these contracts are closely studied, and the CDS is compared with the insurance contract. The purpose of this chapter is to address the third and fifth problem questions.

2.4.8 Chapter 8: Securities issued by an SPI in a synthetic CDO
Corporate finance and structured finance are compared, with regard for the definition and contextualisation of commercial paper as debt instruments, as preference shares and in terms

\textsuperscript{70} 45 of 2002.
of the schedules to the Banks Act,\textsuperscript{71} with regard for aspects of capital and the stratification of risk. Most importantly, the notion of banks \textit{contra} the business of a bank is studied using statutory law and case law.

\textbf{2.4.9 Chapter 9: Conclusion: Synthesis and recommendations}

This chapter constitutes a synthesis subsequent to the analysis of the main body of this work. Attention is given to the identified problem questions for the main purposes of comprehending synthetic securitisations in South African law. In the light of the discussion on the role of synthetic securitisations subsequent to the Financial Crisis, recommendations are made regarding the law relating to synthetic securitisations.

\textbf{2.4.10 Bibliography}

This section contains the sources consulted during the research stage of this doctoral programme. It is divided into books, case law (domestic and international), government and official publications (domestic and international), the internet (a wide category, which contains sources such as commentary by legal practitioners, website of relevant organisations, programme memoranda of synthetic securitisation schemes in practice, academic papers, etc.), journal articles, reports and papers, and theses and dissertations.

\textbf{2.4.11 Abbreviations}

This chapter contains, for ease of access, the abbreviations used in this work.

\textbf{2.5 Interpretation}

It is \textit{sine qua non} to entertain Professor Michael Katz’ reference to the irrationality of the investor community at the oral defence of the research proposal of this work, based on Descartes’ first rule for the direction of the mind: ‘The end of study should be to direct the mind towards the enunciation of sound and correct judgments on all matters that come before it.’\textsuperscript{72} Investors’ decision to invest in a synthetic securitisation scheme, especially in the shareholders’ equity of a SPI, would \textit{res ipsa loquitur} conform to the random walk hypothesis. However, textbook economic models intermittently prove unrealistic,\textsuperscript{73} investors irrational\textsuperscript{74}

\textsuperscript{71} 94 of 1990.
\textsuperscript{72} R Descartes \textit{Key philosophical writings} (1997) 3.
\textsuperscript{73} Beinhocker (n 21 above) 21-35.
\textsuperscript{74} As above.
and infallible institutions collapsible.\textsuperscript{75} Quantitative analytic demonstration is proving that market psychology rather resembles complex bionetworks subject to evolutionary laws – differentiation, selection and amplification\textsuperscript{76} – with inductively, afore deductively, rational investors.\textsuperscript{77}

The fragmentation of doctrines implies that economic literati are predisposed for resolving such conundrums, whilst the law is a reactive science. The question posed in law refers to whether increased regulation produces efficient regulation (considering the metaphysical discrepancy between means and ends), and the protagonism of legal interpretation. The former requires an exposition in own right. The latter is influenced by the common law stimulus on local corporate law generating verbatim interpretation\textsuperscript{78} – positivism constituting a subjective objective approach. Legal dynamism is then encapsulated in the principle that ‘the law is always speaking’, established in South Africa by the Supreme Court of Appeals in \textit{Golden China TV Game Centre v Nintendo Co Ltd}.\textsuperscript{79} This interpretation in terms of legislative scheme\textsuperscript{80} – teleology constituting an objective subjective approach – is perhaps a realistic legal riposte in the doctrinal parallel deconstruction that interpretation ends in transitory irresolution, due to its subjective nature, only to lead to subsequent reinterpretation.\textsuperscript{81} Company law seems to be neither ignorant of evolution in business nor in statutory interpretation: The new framing of corporate goals has already manifested in South Africa through the enlightened shareholder approach.\textsuperscript{82} However, the enigmatic rules of interpretation incorporated in law has resulted in an eclectic philosophic system; therefore, reliance is placed on principles of critical reasoning where legal interpretation fails to provide meaningful results.

\textbf{2.6 Stylistic aspects}

This thesis is rendered according to the publication style guidelines of the Pretoria University Law Press (PULP), as at 11 January 2015. Digression has only been undertaken in singular instances, such as the indentation of paragraphs and footnotes, the utilisation of abbreviated reference to previous notes pertaining to discussions in footnotes. Digression has also

\textsuperscript{75} Ch 2 below, paras 4, 5.
\textsuperscript{76} Beinhocker (n 21 above) 11.
\textsuperscript{77} Beinhocker (n 21 above) 116-117.
\textsuperscript{78} C Botha \textit{Wetsuitleg: ’n Inleiding vir studente} (2005) 70-71.
\textsuperscript{79} 1997 1 SA 405 (A), as quoted in Botha (n 78 above) 71-72.
\textsuperscript{80} Botha (n 78 above) 51-53.
\textsuperscript{81} Botha (n 78 above) 64-66.
transpired in mitigation of possible confusion, for example, the PULP guidelines provide an exception to cross-referencing with regards to *inter alia* documents, although it is uncertain whether this includes legislation; however, the risk exists that the reader may consider a specific part of legislation applicable in a cross referencing. Therefore, in order to mitigate this potential confusion, the full citation of government or official publications are provided, with the exception of, firstly, express indications to the contrary, secondly publications by the Office of the Superintendent of Financial Institutions in Canada, and thirdly BASEL publications. Since the PULP guidelines seem to limit unnecessary punctuation and stylistic irregularity, foreign proper nouns relating to enterprises have not been italicised in the text, although all other foreign terms, irrespective of the context, have been italicised. In the absence of direction in the PULP guidelines, direction is taken from the SKY400 referencing guidelines or the guidelines of the *De Jure* journal are used, albeit in a complementary fashion to the PULP guidelines for purposes of consistency. Since neither of the aforesaid style guidelines cater for all aspects of a doctoral thesis *en toto*, stylistic guidance from the theses of Delport\(^3\) and Locke\(^4\) has been taken.

The law herein is stated as at 26 August 2015.


\(^4\) Locke (n 35 above) in general.
# Chapter 2

## Synthetic securitisation schemes in definition and context

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>General</td>
</tr>
<tr>
<td>2</td>
<td>Defining the synthetic securitisation scheme</td>
</tr>
<tr>
<td>2.1</td>
<td>Etymological considerations in theory and practice</td>
</tr>
<tr>
<td>2.2</td>
<td>Statutory definition of synthetic securitisation schemes</td>
</tr>
<tr>
<td>3</td>
<td>The origins of synthetic securitisation schemes</td>
</tr>
<tr>
<td>3.1</td>
<td>Common perceptions</td>
</tr>
<tr>
<td>3.2</td>
<td>Securitisation and false analogies</td>
</tr>
<tr>
<td>3.2.1</td>
<td>High Middle Age Genoa</td>
</tr>
<tr>
<td>3.2.2</td>
<td>Renaissance France</td>
</tr>
<tr>
<td>3.2.3</td>
<td>Early modern Netherlands</td>
</tr>
<tr>
<td>3.2.4</td>
<td>Nineteenth century Prussia</td>
</tr>
<tr>
<td>3.3</td>
<td>Synthetic securitisation <em>per se</em></td>
</tr>
<tr>
<td>4</td>
<td>Rationales for synthetic securitisation</td>
</tr>
<tr>
<td>4.1</td>
<td>Regulatory rational: Basel</td>
</tr>
<tr>
<td>4.2</td>
<td>Micro-economic rationale</td>
</tr>
<tr>
<td>5</td>
<td>An overview of the Financial Crisis</td>
</tr>
<tr>
<td>5.1</td>
<td>Brief chronology</td>
</tr>
<tr>
<td>5.2</td>
<td>An incident in the history of greed</td>
</tr>
<tr>
<td>6</td>
<td>Synthetic securitisation schemes in the South African context</td>
</tr>
<tr>
<td>7</td>
<td>Synthetic securitisation schemes in the Canadian context</td>
</tr>
<tr>
<td>8</td>
<td>Synthetic securitisation schemes in the German context</td>
</tr>
<tr>
<td>9</td>
<td>Final remarks</td>
</tr>
</tbody>
</table>

## 1 General

Although language is the medium of philosophical discourse, it precariously suggests the illusion of concreteness.\(^1\) Synthetic securitisation schemes are the import of practical, rather

\(^1\) B Russell *Human knowledge* (2009) 59.
than academic, genius, and proper comprehension for academic purposes is moreover obtained through ostensive rather than verbal definition. This chapter fulfills the primary role of definition and contextualisation. From such definitions, a clear indication crystallises that synthetic securitisation schemes are intrinsically tied to risk. The typology of risk defines the implementation of a particular derivative, just as the wider concept of risk identifies the hackneyed – almost a decade subsequent to the Financial Crisis – notions of systemic risk and moral hazard. Upon commencement of entertaining the first problem question, the fourth problem question is also raised for both its own purposes as well as the former. The origins of synthetic securitisation schemes, credit derivatives and CDS’ are studied, whereafter the foundation of the Financial Crisis with specific reference to synthetic securitisation schemes is discussed.

2 Defining the synthetic securitisation scheme

2.1 Etymological considerations in theory and practice

The frequent suspiciousness of complex notions aggregated from simple ideas becomes relevant in comprehending securitisations etymologically. That is, to take supposedly clear concepts and ‘see whether we are not in some confusion about them and too easily reaching conclusions on the assumption that we understand them well enough.’ The troublesome definition of its basis, ‘security’, refers to either ownership or ‘creditorship’ [sic] in Anglo American law, which is not completely incompatible with security as a real or personal accessory obligation in Roman law. However, in modern parlance, a disconnected dialogue with regards to the notion of security exists between jurists in the law of things and the law of contract, and jurists in securities law. The former – the classic meaning of security – encapsulated in the former, seemingly loses any relevance in its usage in the latter due to the

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2 Ch 1 para 2.1.
3 As above.
4 As above.
5 J Locke Of the abuse of words (2009) 82.
7 As above.
9 PB Gove et al (eds) Webster’s third new international dictionary and seven language dictionary (1966) 2054. Reliance on an American dictionary is justified given the purported origin of securitisations in the United States of America (USA).
fact that it relates to the assets of the issuer similar to that of a general notarial bond,\textsuperscript{11} which in the case of debt instruments provides for preference.\textsuperscript{12}

The statutory definitions of the latter, as they appear internationally, are and have been fairly wide, as a juxtaposition between the South African Financial Markets Act,\textsuperscript{13} the American Banking Act of 1933\textsuperscript{14} (the so-called Glass-Steagall Act)\textsuperscript{15} and the Ontarian Securities Act\textsuperscript{16} will show. In civil subjective law, shares, share warrants and derivatives are respectively collections of personal rights\textsuperscript{17} incapable of \textit{dominium}.\textsuperscript{18} As much as puritanical denotation

\begin{itemize}
\item \textsuperscript{11} M Vermaas (ed) ‘Capital structure: Shares and debentures’ in Pretorius, JT (ed) \textit{Hahlo’s South African company law through the cases: A source book} (1999) 171.
\item \textsuperscript{12} As above. However, the wide classification by Ward J in \textit{Coetzee v Rand Sporting Club} 1918 WLD 74 [As above.], in quoting Bowen LJ in \textit{English and Scottish Mercantile Investment Co v Button} 1892 2 QB 700 712 [As above.], relieves debt instruments from preference in order to constitute securities, with the possible induction then that this applies to all securities in the securities law sense.
\item \textsuperscript{13} Financial Markets Act 19 of 2012 sec 1: “securities” means—
\begin{enumerate}
\item listed and unlisted—
\begin{enumerate}
\item shares, depository receipts and other equivalent equities in public companies, other than shares in a share block company as defined in the Share Blocks Control Act, 1980 (Act No. 59 of 1980); 
\item debentures, and bonds issued by public companies, public state-owned enterprises, the South African Reserve Bank and the Government of the Republic of South Africa; 
\item derivative instruments; 
\item notes; 
\item participatory interests in a collective investment scheme as defined in the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002), and units or any other form of participation in a foreign collective investment scheme approved by the Registrar of Collective Investment Schemes in terms of section 65 of that Act; and instruments based on an index; 
\item units or any other form of participation in a collective investment scheme licensed or registered in a country other than the Republic; 
\item the securities contemplated in paragraphs (a)(i) to (vi) and (b) that are listed on an external exchange; 
\item an instrument similar to one or more of the securities contemplated in paragraphs (a) to (c) prescribed by the registrar to be a security for the purposes of this Act; 
\item rights in the securities referred to in paragraphs (a) to (d), but excludes—
\begin{enumerate}
\item money market securities, except for the purposes of Chapter IV; or if prescribed by the registrar as contemplated in paragraph (d); 
\item the share capital of the South African Reserve Bank referred to in section 21 of the South African Reserve Bank Act, 1989 (Act No. 90 of 1989); and 
\item any security contemplated in paragraph (a) prescribed by the registrar’. 
\end{enumerate}
\end{enumerate}
\end{enumerate}
\item \textsuperscript{14} 12 USC 227.
\item \textsuperscript{16} RSO 1990 c S5 sec 1(1).
\item \textsuperscript{17} ‘A share in a company is a \textit{jus in personam}, or rather a bundle of \textit{jura in personam}, the content of which depends partly upon the provisions of the memorandum and articles of association and partly upon the provisions of the Companies Act.’ – \textit{Oakland Nominees (Pty) Ltd v Gelria Mining & Investment Co (Pty) Ltd} 1976 1 SA 441 (A) 444 C-D.
\end{itemize}
disregards the statutory classification as movable incorporeal property,\(^{19}\) the predicament of this liberal perspective results in the predisposition of securities for spoliation orders,\(^{20}\) which circumvents the greater \textit{onus} for specific performance\(^{21}\) – this stemmed from confusion between civil law of things and common property law in South Africa has introduced the consideration of general acceptance and effectiveness into local corporate law,\(^{22}\) although this is dialectically fallacious as an \textit{argumentum ad populum}.\(^{23}\) This \textit{inter alia} applies to shares in an SPI, the commercial paper issued by it, as well as the credit derivative prevalent in a synthetic securitisation scheme.

Should this influence of English law be interpreted further, the effect manifests as it does in the vocabulary of the Registar in the Schedule,\(^{24}\) \textit{inter alia} with regards to the use of the term ‘obligation’. This term does not necessarily carry the same meaning in English law as it does in civil law: In the latter case, performance transpires in terms of an obligation; in terms of the former, an obligation is the duty to perform. According to Fox, performance in English law does not necessarily constitute a bilateral act, as was argued in the case of \textit{Nissan South Africa (Pty) Ltd v Marnitz NO},\(^{25}\) but rather a unilateral act.\(^{26}\) Rather, performance is subject to the subjective intention of the performer.\(^{27}\) The Registrar’s utilisation of this term seems to be based on the English approach, which begs the question as to what extent the Registrar intended to include principles of the English law of contract in securitisation schemes, such as the bilateral nature of performance.

At a constitutional level, the Bill of Rights, which objectively protects\(^{28}\) the derogable rights\(^{29}\) in section 25, likely includes securities\(^{30}\) since ‘property’ has been interpreted as ‘those resources that are generally taken to constitute a person’s wealth, and that are recognized [sic.]

\(^{19}\) Companies Act 71 of 2008 sec 35(1).
\(^{20}\) Wessels (n 18 above) 16-17.
\(^{21}\) As above.
\(^{22}\) \textit{Oakland} (n 18 above) 444C-D; see HS Cilliers \textit{et al Cilliers & Benade Corporate Law} (2000) 243 n 23, n 27.
\(^{25}\) 2005 1 SA 441 (SCA).
\(^{27}\) As above.
\(^{28}\) Constitution of the Republic of South Africa 1996 sec 7(2).
\(^{29}\) Constitution of the Republic of South Africa 1996 secs 7(3), 37(5)(c).
\(^{30}\) Currie & De Waal (n 18 above) 536-537.
and protected by law’; however, as a consequence of presupposing securities’ ‘ownership’, constitutional recourse for the nominative securities holder becomes moot. Taken somewhat out of context, we may quote Lord Devlin (read by Lord Pearce) in that ‘[t]he common law is tolerant of much illogicality, especially on the surface; but no system of the law can be workable if it has no logic at the root of it.’ Therefore, the etymological basis of securitisation with regards to the term ‘security’ is subject to a disputed legal nature from jurisdictional incongruity, which holds a risk in litigation for activist securities holders in a synthetic securitisation scheme. Furthermore, we can deduce that this term holds little resemblance to what it was initially intended to denote.

2.2 Statutory definition of synthetic securitisation schemes

Inadequate definitions of ‘securitisation’ pervade for the South African civil jurist in sources, which includes those supplied by Chammah of First Boston, Giddy of NYU Stern, Gumata and Mokoena of the South African Reserve Bank (SARB) and Fleuriet of the Cour d’Appel de Paris and Université Paris Dauphine. Perhaps this is justified by it being neither their

31 Currie & De Waal (n 18 above) 539.
32 Currie & De Waal (n 18 above) 537-538.
33 Hedley Byrne & Co Ltd v Heller & Partners Ltd (1964) AC 465.
34 As above.
35 As above.
primary nor secondary goals. If modern writers can not reach consensus on the elements or factors of securitisation, and the caution is heeded that there is ‘no firm conceptual architecture for…[the] relatively new market [of synthetic securitisation]’, then attaching an exhaustive definition to synthetic securitisation in general is precarious. The deduction can be made that any such definition may circumstantially lack the conditions for an ostensive definition.

Two instances in the Schedule pervade in which meaning is ascribed to synthetic securitisation schemes – the one mandatory, the other herewith oversimplified as discretionary. The former defines a synthetic securitisation scheme as a scheme in terms of which an SPI issues commercial paper to investors to primarily utilise such performance received for obtaining credit risk exposure relating to an underlying asset, a reference asset or a reference entity through funded or unfunded credit derivative instruments or guarantees, and assets for purposes of collateral. The SPI primarily performs in terms of its issued commercial paper, or to an institution acting in a secondary role. Such performance is rendered conjunctively from cash flow on the collateral assets and premiums or fees performed to the SPI by an institution acting in a primary role. Since credit risk is also intrinsically transferred through true sale, a synthetic securitisation schemes is an amalgamation of traditional securitisation and credit derivatives, entailing the on-balance sheet transfer of credit risk exposure with the effect of affording only partial economic substance without genuine asset transfer.

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42 See Giddy (n 39 above) in general; see Teasdale (n 36 above) in general.
44 Russell (n 1 above) 62.
45 As above.
46 As above.
47 n 24 above, para 1 definition of ‘synthetic securitisation scheme’.
48 Schedule (n 24 above) para 1 definition of ‘synthetic securitisation scheme’.
49 As above.
50 As above.
52 MI Greenberg & E Uwaifo ‘Key issues in structuring a synthetic securitization transaction’ in A Preston (ed) Europe securitisation and structured finance guide 2001 (2001) 139-140.
53 MI Greenberg & E Uwaifo ‘Key issues in structuring a synthetic securitization transaction’ in Preston (n 52 above) 139; Jobst (n 51 above) 49; Schedule (n 24 above) para 5(1)(a)(i).
The second instance is paragraph 5(1)(a) of the Schedule, which, as mentioned above, is *prima facie* pre-emptory given both paragraph 3 of the Schedule and certain diction. The Schedule provides interpretively that structural aspects, specified as ‘[g]eneral’ provisions, constitute ‘general commentary and descriptions’ and this is provided in conjunction with the provision that provisions subjected thereto are to be ignored if in conflict with the remainder of the Schedule or imposing supplementary obligations on any participant. As already mentioned, it is uncertain whether the term ‘obligation’ herewith refers to supplementary contractual relationships or to supplementary duties in terms of existing contractual relationships. Whilst it is also uncertain what paragraph 3 of the Schedule actually means, such uncertainty is aggravated by the use of terms such as ‘normally’ and verbs such as ‘can’, ‘will tend’ and ‘may’ in the provisions relating to structural aspects of synthetic securitisation schemes. It seems to indicate that such general provisions are subject to semantics and discretionary application. The specific adjectival use of the term ‘general’ indicates that these provisions do not reflect the features of a general synthetic securitisation scheme, but rather constitute general ‘commentary and descriptions’ on synthetic securitisation schemes. This means that, although a statutory definition of ‘synthetic securitisation scheme’ exists, the features of such general scheme, in the statutory sense, remain unknown. Since a schedule classifies as legislation, we can deduce that such ‘general commentary and descriptions’ serve no purpose other than in-text *contemporanea expositio*, which does not digress from the fact that it is an express rebuttal of the presumption of effectual and purposeful

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54 n 24 above.
55 As above.
56 As above.
57 n 24 above, para 3(1).
58 As above.
59 As above.
60 n 24 above, para 3(1)(a).
61 n 24 above, para 3(1)(b).
62 Para 2.1 above.
63 Schedule (n 24 above) para 3(1)(b).
64 n 24 above.
65 n 24 above, para 5(1)(a).
66 n 24 above, para 5(1)(a)(ii).
67 n 24 above, para 5(1)(a)(v).
68 n 24 above, para 5(1)(b), 5(1)(c).
69 n 24 above, para 5(1).
71 Schedule (n 24 above) para 3(1).
72 The features of synthetic securitisation from a Platonic perspective also remain relative unknown, given the fact that it is largely a metaphysical concept.
74 Schedule (n 24 above) para 3(1).
75 Botha (n 73 above) 87.
Furthermore, the interpretation of the Schedule’s interpretation clause is further convoluted by the absence of any indication of conjunction or disjunction between paragraph 3(1)(a) and paragraph 3(1)(b) therein.

These uncertain provisions state that normally a synthetic securitisation scheme is a transaction in terms of which the risk of a specified pool of reference assets, reference entities or underlying is transferred to a SPI, presumably from a party acting in a primary role, through credit derivatives, with the effect of affording only partial economic substance without genuine asset transfer. No indication is supplied as to whether the provisions from an including paragraph 5(1)(a)(i) of the Schedule to and including paragraph 5(1)(a)(v) of the Schedule function conjunctively or disjunctively; therefore, it becomes prevalent that an isolated analysis of paragraph 5(1)(a)(i) of the Schedule presents the following predicament: The metaphor presented in paragraph 5(1)(a)(i) of the Schedule is too restrictive, since it fails to encompass all the nuances and mechanics involved in a synthetic securitisation scheme; furthermore, whereas certain schemes in other areas of corporate law may pertain to a single or a single specie of transactions, a synthetic securitisation scheme contains numerous transactions which are in no way a single specie apart from the transfer of risk. No express reference is made in the Schedule as to whether the relevant assets need not be in the dominium or possessio of the party acting in a primary role that transfers such risk as set out in the aforesaid, especially since it is provided that a scheme ‘may’ alter the transferor’s risk profile. The risk is stratified into a minimum of two risk positions associated with diverse amounts of credit risk, and the junior or subordinated risk positions potentially absorb losses without interrupting performance on more senior tranches. Investors’ risk associated with SPI-issued commercial paper is

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76 Botha (n 73 above) 74.
77 n 24 above.
79 MI Greenberg & E Uwaifo ‘Key issues in structuring a synthetic securitization transaction’ in Preston (n 52 above) 139; Jobst (n 51 above) 49; Schedule (n 24 above) para 5(1)(a)(i).
80 n 24 above.
81 As above.
82 As above.
83 As above.
84 As above.
85 n 24 above, para 5(1)(a)(i).
86 n 24 above, para 5(1)(b).
87 Schedule (n 24 above) para 5(1)(a)(i).
88 Schedule (n 24 above) para 5(1)(a)(ii).
primarily subject to performance on said underlying risk exposures.\textsuperscript{89} Paraphrased, performance on the SPI’s issued commercial paper depends on the performance of the underlying risk exposures, and the tranches issued are intended to be economically shock-absorbent to the point of only addressing senior paper upon exhausting the subordinate.

\section{The origins of synthetic securitisation schemes}

\subsection{Common perceptions}

Listed among the major financial advancements in recent decades\textsuperscript{90} and asserted as American in origin,\textsuperscript{91} mortgage loan securitisation guaranteed by the Government National Mortgage Association (Ginnie Mae) began by 1970 according to \textit{inter alia} the Securities Industry and Financial Markets Association (SIFMA),\textsuperscript{92} with the United States’ (US’s) securitisation beyond mortgages\textsuperscript{93} starting in March 1985 with the $192 million offer of lease-backed notes by Sperry Lease Finance Corporation\textsuperscript{94} and underwritten by First Boston.\textsuperscript{95} According to Saayman and Styger, ‘[t]he word “securitization” first appeared in the Wall Street Journal in 1977, although the Journal did not recognise it as a real word’.\textsuperscript{96} In truth, certain aspects of securitisation has older roots, although a reckoning of securitisation with such instances en toto would be a false analogy.\textsuperscript{97}

\footnotesize
\begin{enumerate}
\item Schedule (n 24 above) para 5(1)(a)(iii).
\item Jobst (n 51 above) 48.
\item SL Schwarcz ‘Structuring and legal issued of asset securitization in the United States’ in Norton & Spellman (n 36 above) 19; SIFMA ‘Mortgage-backed securities (MBS) and collateralized mortgage obligations (CMOS)’ http://www.rbcw-usa/file-588373.pdf (accessed 8 January 2013) 3; Cumnins (n 36 above) 1; Fleuriet (n 41 above) 22; Jobst (n 51 above) 48.
\item WA Chammah ‘An overview of securitization’ in Norton & Spellman (n 37 above) 4-5.
\item As above.
\item Saayman & Styger (n 91 above) 746.
\end{enumerate}
3.2  Securitisation and false analogies

3.2.1  High Middle Age Genoa
Origins have been contended from the 1164 Genoese *compera*, where a syndicate’s performance of supplying funding was met with the counter-performance of a *luoghe*, with such interest-free *prestiti* evolving to encompass a return, a *ligatio pecuniae* (although suspended during the Chioggia War) and followed by the *monte nuovo*, *monte novissimo* and *monte de sussidio*. This is an incorrect genesis of securitisation, since it was a syndicated loan, an example of collateralised lending, performed to the State. Said counter-performance was nationally regulated as a tax to constitute a guarantee of repayment, with the *naturalia* stipulating that the State had the duty to perform these collected taxes to the syndicate until complete repayment.

3.2.2  Renaissance France
Fleuriet regards a probable origin as the controversial *Rentes sur l’Hotel de Ville* (referred to by Karl Marx in *Das Kapital*), issued in 1522 by Paris’ *bureau de ville* at an *arréage* of 8.33% and backed by municipal revenues. Disappointingly, King Francis I, its initiator upon the suggestion of Chancellor Antoine de Prat, whether to finance Italian

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100 Tracy (n 99 above) 10-11.


102 As above.

103 As above.

104 AN Hamscher *The parlement of Paris after the Fronde, 1654-1673* (1976) 71.

105 Fleuriet (n 41 above) 23.

106 As above.

107 Hamscher (n 104 above) 71.

108 Tracy (n 99 above) 21; D Stasavage *States of credit: Size, power, and the development of European polities* (2011) 133.

109 As above.


111 Stasavage (n 108 above) 133.

112 As above.
campaigns\textsuperscript{113} or for personal finance recovery\textsuperscript{114} – raised less than a million \textit{livres tournois} through such \textit{rentes} during his reign.\textsuperscript{115} Save for considering \textit{rentes} as credit created from property,\textsuperscript{116} which developed from the 12\textsuperscript{th} century aristocracy’s pledge of peasants’ usage fees for credit from the clergy\textsuperscript{117} (frankly, French princes mortgaged any valuable source of income),\textsuperscript{118} the latter is a mere link in the chain of public debt developments.\textsuperscript{119} The \textit{Rentes sur l’Hôtel de Ville} was also merely an example of collateralised lending with taxes as security.\textsuperscript{120}

3.2.3 Early modern Netherlands

Dutch economic accomplishment since 1590\textsuperscript{121} and the asset-backed securities issued by Johan Deutz to the House of Austria,\textsuperscript{122} financed by a 4\% loan\textsuperscript{123} and collateralised by a monopoly granted to Deutz over the produce of Austrian quicksilver mines\textsuperscript{124} was a continuation of this collateralised lending. Following the falter of the Verenigde Nederlandse Oost-Indische Compagnie (VOC), loans were issued on public markets from 1753 to 1795,\textsuperscript{125} backed by mortgages on plantations and based on the Deutz model.\textsuperscript{126} Numerous negotiaties backed by US funds were issued by the firms of Stadnitski, Van Staphorst, Van Eeghen, Ten Cate & Van Vollenhoven\textsuperscript{127} on Dutch capital markets from 1782 to 1794,\textsuperscript{128} and in 1794 the Amsterdam-based firm of Daniel Crommelin & Sons issued negotiaties backed by American notes.\textsuperscript{129} Apart from American debt, the Dutch also floated negotiaties based on American immovable property

\textsuperscript{113} As above.
\textsuperscript{114} Ertman (n 110 above) 99.
\textsuperscript{115} Tracy (n 99 above) 22, Ertman (n 110 above) 99.
\textsuperscript{116} Tracy (n 99 above) 7-8; ‘[A] financial instrument providing the holder with an annuity, and offered by private individuals and corporate bodies; those drawn on the Paris Hôtel de ville were used as a form of long-term, lower interest debt by the monarch…’ – G Rowlands \textit{The financial decline of a great power: War, influence, and money in Louis XIV’s France} (2012) xvii.
\textsuperscript{117} Tracy (n 99 above) 8.
\textsuperscript{118} Tracy (n 99 above) 18.
\textsuperscript{119} Ertman (n 110 above) 99.
\textsuperscript{120} EN White ‘France and the failure to modernize macroeconomic institutions’ in MD Bordo & R Cortés-Conde \textit{Transferring wealth and power from the old to the new world: Monetary and fiscal institutions in the 17\textsuperscript{th} through the 19\textsuperscript{th} centuries} (2001) 85.
\textsuperscript{121} Thomas, Van der Merwe & Stoop (n 10 above) 74.
\textsuperscript{123} As above.
\textsuperscript{124} As above.
\textsuperscript{125} Frehen, Goetzmann & Rouwenhorst (n 122 above) 290.
\textsuperscript{126} As above.
\textsuperscript{127} Frehen, Goetzmann & Rouwenhorst (n 122 above) 295.
\textsuperscript{128} Frehen, Goetzmann & Rouwenhorst (n 122 above) 294.
\textsuperscript{129} Frehen, Goetzmann & Rouwenhorst (n 122 above) 295.
such as the Holland Land Company’s 1793 issue\textsuperscript{130} and the 1805 issue backed by land in New York State.\textsuperscript{131}

3.2.4 Nineteenth century Prussia

The 18\textsuperscript{th} century is also noteworthy for the issue of public bearer bonds backed by mortgages held by \textit{Landschaften}.\textsuperscript{132} A noteworthy text on the topic is that by Wandschneider, an associate professor of economics at Occidental College in Los Angeles,\textsuperscript{133} entitled ‘\textit{Landschaften} as credit purveyors – The example of East Prussia’.\textsuperscript{134} With Prussia emerging from the Seven Years War,\textsuperscript{135} Frederick the Great tended to the disrupted credit lines\textsuperscript{136} (especially to restore liquidity)\textsuperscript{137} by establishing \textit{Landschaften} – organisations with start-up capital,\textsuperscript{138} which were in reality public corporations under government supervision\textsuperscript{139} Historical data confirms that \textit{Landschaften} were successful in monitoring its constitutive estates.\textsuperscript{140} Estates were mortgaged to the \textit{Landschaften} by its members who wished to obtain credit.\textsuperscript{141} The \textit{Landschaften} then issued \textit{Pfandbriefe}\textsuperscript{142} (mortgage-based debt instruments) and all \textit{Landschaften} held joint liability related to liquid and illiquid assets.\textsuperscript{143} This form of finance has successfully persisted to this day, since \textit{Pfandbriefe} are reputedly (post-Financial Crisis) secure mortgage assets.\textsuperscript{144} The \textit{Landschaften} model is likely the true precursor of modern traditional securitisation, given shared obligations: Firstly, in both the \textit{Landschaften} model as in the traditional securitisation model, a credit agreement exists between two parties, with the creditor \textit{res ipsa loquitur} obtaining rights against the debtor; secondly, these rights are pooled to exploit their value for the creation of securities. In the \textit{Landschaft} model, the recourse of modern

\begin{thebibliography}{99}
\bibitem{130} As above.
\bibitem{131} Frehen, Goetzmann & Rouwenhorst (n 122 above) 298.
\bibitem{132} As above.
\bibitem{133} https://www.oxy.edu/faculty/kirsten-wandschneider (accessed 20 January 2015).
\bibitem{135} Wandschneider (n 134 above) 2.
\bibitem{136} Wandschneider (n 134 above) 4, 6.
\bibitem{137} SL. Schwarcz ‘The conundrum of covered bonds’ (2011) 66 \textit{The Business Lawyer} 561 563-564.
\bibitem{138} As above; see Wandschneider (n 134 above) 5-6.
\bibitem{139} Wandschneider (n 134 above) 6.
\bibitem{140} M Toherkinsky \textit{The Landschaften and their mortgage credit operations in Germany (1770-1920) (1922) 25.}
\bibitem{141} Toherkinsky (n 140 above) 16.
\bibitem{142} Toherkinsky (n 140 above) 28.
\bibitem{143} Wandschneider (n 134 above) 7 et seq.
\bibitem{144} As above.
\bibitem{145} As above.
\end{thebibliography}
Pfandbriefe against both the issuer and the pool of assets\textsuperscript{146} would mitigate efforts at credit risk transfer \textit{per se}. This benefit is not prevalent in the traditional securitisation scheme, since the securities provide recourse against the SPI as \textit{iura in persona} and not, as discussed above, as \textit{iura in rem}. If those securities contained \textit{iura in rem}, then traditional securitisation would likely be akin to the \textit{Landschaft} model.

3.3 \textbf{Synthetic securitisation \textit{per se}}

Whilst the aforementioned may be historical bases for traditional securitisation schemes, the perspective must be narrowed to synthetic securitisation schemes. The incomparability of the \textit{Landschaften} model, for example, for present purposes is due to the recourse of modern Pfandbriefe against both the issuer and the pool of assets,\textsuperscript{147} which logically mitigates credit risk transfer. According to the now defunct Lehman Brothers, the credit derivatives market has only been developing since the late 1990’s\textsuperscript{148} ‘from almost nothing in 1995’.\textsuperscript{149} Ostensibly first manifesting at New York’s Bankers Trust bank in 1991 as an application of interest rate and currency swap logic to credit risk\textsuperscript{150} by \textit{inter alia} John Crystal and Peter Freund,\textsuperscript{151} movers and shakers such as Peter Hancock and Bill Demchak of J.P. Morgan pursued this notion\textsuperscript{152} due to capital regulation\textsuperscript{153} and the inhibition of systemic risk,\textsuperscript{154} until its endemic use caused the packaging of multiple diverse credit risks\textsuperscript{155} with the advantage of increasing investors’ risk diversification.\textsuperscript{156} The commencement of synthetic securitisation can perhaps be found in J.P. Morgan’s ‘Broad Secured Trust Offering’\textsuperscript{157} [\textit{sic}.] (Bistro)\textsuperscript{158} – colloquially ‘B.I.S. total rip off’\textsuperscript{159} due to it epitomising the cat and mouse game that bankers and regulators constantly

\begin{itemize}
  \item \textsuperscript{146} Wandschneider (n 134 above) 8, 10.
  \item \textsuperscript{147} As above.
  \item \textsuperscript{149} D O’Kane “Credit derivatives explained: Market, products and regulations” March 2001 http://www.investinginbonds.com/assets/files/LehmanCredDerivs.pdf (accessed 20 January 2013) 3.
  \item \textsuperscript{150} G Tett ‘Non-technical introduction’ in A Lipton & A Rennie (eds) \textit{The Oxford handbook of credit derivatives} (2011) 4.
  \item \textsuperscript{151} As above.
  \item \textsuperscript{152} G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 5.
  \item \textsuperscript{153} As above.
  \item \textsuperscript{154} As above.
  \item \textsuperscript{155} As above.
  \item \textsuperscript{156} As above.
  \item \textsuperscript{157} As above.
  \item \textsuperscript{158} As above.
  \item \textsuperscript{159} As above.
\end{itemize}
engage in. Although the SPI’s secondary capital sources were minute in relation to the originator’s credit portfolio, a low risk event probability factor sustained grand credit ratings. The latter scheme is the *locus classicus* for the topic of this thesis. A secondary example is C*Strategic Asset Redeployment Program 1999-1 Ltd (C*Star) scheme, which is discussed elsewhere.

As if curiosity was not sufficiently satisfied subsequent to the 1998 Asian financial crisis and the internet crash, banks introduced ‘so-called tradeable credit derivative indices’, constituting (in commercial parlance) contracts that could be traded *per se*, based on a basket of CDSs. This can perhaps be viewed as the zenith of applying synthetic technology to CDOs. For example, credit derivatives were written on an ABS index. From the 1990’s to the first decade of the new millennium, mortgage risk appetite grew to a point where the demand for commercial paper based on sub-prime mortgage loans exceeded the supply of sub-prime mortgage loans, causing increased use of synthetic methods for amending elasticity. The *impetus* for this financial engineering seems to have been a shortage of sub-prime residential mortgage backed securities (RMBS) spurring the use of credit derivatives for such a market and which was boosted through Markit’s (mortgage) credit derivate index, Associates Business Exchange (ABX), whilst similar indices for other underlying transactions already existed, such as Credit Default Swap Index (CDX), iTraxx and LCDX. These events need to be borne in mind together with the economic aggravation of

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161 See Cilliers et al (n 22 above) 199.
162 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 5-6.
164 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 6.
165 As above.
166 As above.
167 As above.
169 Fabozzi & Kothari (n 168 above) 226.
170 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 6, 7.
171 As above.
172 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 6.
173 As above.
174 As above.
175 As above.
176 As above.
177 As above.
178 As above.
179 As above.
Greenspan’s 2001 reduction of short-term interest rates and the Asian saving surplus that decreased yield on sovereign bonds. From the 1990’s to the first decade of the new millennium, the use of credit derivatives swayed from hedging to speculation with the global value of transacted credit derivatives increasing sixty-fold. On the one hand, the Bank for International Settlements’ (BIS) concern for systemic risk was disregarded in the absence of statistical evidence, given the predominant over-the-counter (OTC) nature of credit derivatives; on the other hand, preservation against political and economic blows was attributed to credit derivatives. However, despite the bull market, many tailor-made instruments proved illiquid and therewith their valuations intricate, paving the way for further arbitrage opportunities. Copious parties were involved, and whilst rating agencies viewed synthetic securitisation as a new business opportunity and provided AAA ratings to senior tranches, banks were becoming apathetic to counterparties’ performance ability, resulting in the exploitation of credit derivatives for speculation and arbitrage rather than hedging. Frankly, the aforementioned factors contributed to such a state of decadence that traders entered low prices for credit derivatives early in the year and then later revalue them at a higher price, with the difference constituting profit. Soon the Financial Crisis ensued.

180 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 6.
181 As above.
182 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 7.
183 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 3.
184 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 8.
185 As above.
186 As above.
187 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 6-8.
188 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 8.
189 As above.
190 As above.
191 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 6.
192 As above.
193 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 7.
194 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 6-7.
195 G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 150 above) 8-9.
196 As above.
4 Rationales for synthetic securitisation schemes

4.1 Regulatory rationale: Basel

Banks’ commercial profiles have recently changed.\textsuperscript{197} As capital market financial intermediaries,\textsuperscript{198} mitigating insolvency from borrowers’ defaults with cash reserves,\textsuperscript{199} US banks extended significant loans to Argentina, Brazil and Mexico\textsuperscript{200} with soaring economic costs of capital.\textsuperscript{201} Fearing a second Great Depression,\textsuperscript{202} capital requirements were consented to\textsuperscript{203} under the auspices of the BIS at Basel,\textsuperscript{204} causing immense management of the capital base\textsuperscript{205} and the need to devolve surplus assets,\textsuperscript{206} thereby giving way to traditional securitisation.\textsuperscript{207} The Basel Committee on Banking Supervision (the Committee), a forum for banking supervision collaboration to augment comprehension of and globally advance banking supervision through exchanging information to endorse common understanding,\textsuperscript{208} has its Secretariat located in Basel,\textsuperscript{209} with membership including Canada, Germany and South Africa.\textsuperscript{210} Guidelines and supervisory standards, e.g. standards on capital adequacy,\textsuperscript{211} may be developed through said consent, which commenced with the BIS’ International Convergence of Capital Measurement and Capital Standards of July 1988,\textsuperscript{212} colloquially the Basel I Accord, and was superseded by the International Convergence of Capital Measurement and Capital Standards: A Revised Framework of June 2004,\textsuperscript{213} colloquially the Basel II Accord, which was comprehensively published in June 2006.\textsuperscript{214} Following the crisis of 2007 and 2008, Basel 2.5

\begin{flushleft}
\textsuperscript{197} I Bell & P Dawson ‘Synthetic securitization: Use of derivative technology for credit transfer’ (2002) 12 Duke Journal of Comparative & International Law 541 542 et seq.
\textsuperscript{198} Bell & Dawson (n 197 above) 542.
\textsuperscript{199} Bell & Dawson (n 197 above) 543.
\textsuperscript{200} As above.
\textsuperscript{201} Bell & Dawson (n 197 above) 543-544.
\textsuperscript{202} Bell & Dawson (n 197 above) 544.
\textsuperscript{203} As above.
\textsuperscript{204} As above.
\textsuperscript{205} As above.
\textsuperscript{206} Bell & Dawson (n 197 above) 544-545.
\textsuperscript{207} Bell & Dawson (n 197 above) 545.
\textsuperscript{208} ‘About the Basel Committee’ http://www.bis.org/bcbs/about.htm (accessed 12 December 2012).
\textsuperscript{209} As above.
\textsuperscript{210} As above.
\textsuperscript{211} As above.
\end{flushleft}
was implemented for improved risk-measurement related to securitisation and trading book exposures.\footnote{215}

Basel III, published in December 2010 for implementation on 1 January 2013 with transitional arrangements valid until 1 January 2019,\footnote{216} currently addresses systemic risk by raising capital quality and quantity (with shareholder’s equity as the focal point) for banks’ loss-absorption,\footnote{217} enhancing risk coverage in specifically capital markets,\footnote{218} launching supplementary capital buffers,\footnote{219} launching a globally harmonised leverage ratio as a backstop to the risk-based capital gauge\footnote{220} and to enclose the accumulation of extreme leverage,\footnote{221} resilient supervisory standards,\footnote{222} including public disclosure,\footnote{223} and risk management,\footnote{224} launching minimum global liquidity standards to advance banks’ pliability to severe short term strain\footnote{225} and improve longer term financial support,\footnote{226} and initiating capital buffers to be developed in periods of prosperity that can be raised during periods of strain.\footnote{227} The Group of Central Bank Governors and Heads of Supervision (GHOS) authorised the Committee’s anticipated process to supervise implementation of Basel III,\footnote{228} consisting of opportune espousal thereof (Level 1)\footnote{229} (only India, Japan and Saudi Arabia by 1 January 2013),\footnote{230} regulatory uniformity therewith (Level 2),\footnote{231} and constancy of outcomes, originally attending to risk-weighted assets (Level 3).\footnote{232}

Whereas true sale for indirect risk reduction, i.e. traditional securitisation schemes,\footnote{233} became one method of circumventing the Basel requirements, the direct approach was risk transfer without true sale, i.e. synthetic securitisation schemes.\footnote{234} As will be set out elsewhere, other

\footnote{216} As above.
\footnote{217} As above.
\footnote{218} As above.
\footnote{219} As above.
\footnote{220} As above.
\footnote{221} As above.
\footnote{222} As above.
\footnote{223} As above.
\footnote{224} As above.
\footnote{225} As above.
\footnote{226} As above.
\footnote{227} As above.
\footnote{228} Basel Committee on Banking Supervision (n 215 above) 6.
\footnote{229} As above.
\footnote{230} As above.
\footnote{231} As above.
\footnote{232} As above.
\footnote{233} Schedule (n 24 above) para 4(1)(c).
\footnote{234} Schedule (n 24 above) para 5(1)(b).
jurisdictions emphasise the quasi-possessio of super senior commercial paper for this end. Locally, effective and verifiable risk transfer\(^{235}\) and attention against duplication\(^{236}\) is primarily required, which is confusing since no reference is made to guarantees.\(^{237}\) Verifiability seemingly pertains to the opinion of independent legal counsel in paragraph 5(2)(n) of the Schedule;\(^{238}\) however, no further indication is given as to the nature of such legal counsel. It would not be unreasonable to speculate that ‘effective’\(^{239}\) transfer broadly hints at non-fictional risk transfer presumably based on the adage of *plus valeat quod agitur quam quod simulate concipitur*, as well as economically efficient use of such transferred risk. The latter would legally imply correct classification of premiums for tax purposes, and commercially imply the SPI’s ability to transact based on such risk, i.e. the issue of commercial paper. Specifically, effective transfer is absent if the risk transfer breaches a stipulation of the relevant underlying transaction.\(^{240}\) This provision is odd in that its ambit extends to associated companies,\(^{241}\) which defies the logic of separate legal personality. Furthermore, effective transfer statutorily eliminates the SPI’s right of recourse against an institution acting in a primary role or its associated companies or, if said institution is a bank, against an institution within its banking group pertaining to costs, expenses or losses incurred in connection with risk transfer.\(^{242}\) It is necessary to note that this constitutes an elimination of the right *per se* and not a prohibition on recourse.

However, the Schedule\(^{243}\) fails to entertain the notion of piercing the corporate veil, which would address the liability of the mentioned institution’s or institutions’ director(s). Furthermore, it is important to note that the aforementioned provision only applies to the mentioned institution’s or institutions’ primary role performance; should performance transpire in terms of a secondary role, this provision would not exist if such performance transpires in terms of a separate transaction.\(^{244}\) This not only implies that conduct cannot transpire *ex lege*

\(^{235}\) Schedule (n 24 above) para 5(1)(e)(i). Neither ‘effective’ nor ‘verifiable’ are defined in the Schedule [n 24 above.] and as such they retain their respective ordinary meanings.

\(^{236}\) Schedule (n 24 above) para 5(1)(e)(ii).

\(^{237}\) Schedule (n 24 above) para 5(1)(e).

\(^{238}\) n 24 above.

\(^{239}\) n 24 above, para 5(1)(e)(i).

\(^{240}\) Schedule (n 24 above) para 5(2)(d).

\(^{241}\) Schedule (n 24 above) para 1: “‘associated company’, in relation to an institution other than a bank or an institution within a banking group that transfers assets in terms of a traditional securitisation scheme or risk in terms of a synthetic securitisation scheme to a special-purpose institution, means a subsidiary or fellow subsidiary of that institution and includes an associate of that institution…”.

\(^{242}\) Schedule (n 24 above) para 5(2)(b).

\(^{243}\) n 24 above.

\(^{244}\) Schedule (n 24 above) para 5(2)(b).
but must transpire *ex contractu*, but then again raises the legal uncertainty as to whether a ‘separate transaction’ can merely be a separate obligation or whether this constitutes an additional contractual formality that necessitates a separate contract *en toto*.

The provision relating to the right of recourse also falls away if losses based on the transferred risks incur whilst being subject to warranties supplied by an institution acting in a primary role or its associated companies or, if said institution is a bank, against an institution within its banking group, except if the warranties bear a relation to the future creditworthiness of the obligor in terms of transferred risk and the warranties relate to matters not falling within the control of the warrantor. Interestingly, the ambit of this provision does not include costs or expenses incurred in connection with the risk transfer. Whilst the justifications of these exceptions would seem *res ipsa loquitur*, the conjunctive contrarily and nonsensically indicates that the prevalence of either one of these facts *per se* would not render the situation an exception.

### 4.2 Micro-economic rationale

Traditionally, corporate finance is acknowledged as statically completing the market in creating capital, as expressed through the entity concept. However, primary and secondary capital sources may not address all preferences and therefore not complete market allocations for all commodities and contingencies, creating an inefficient equilibrium. By express transfer or sequential replication of risks and contingent outcomes through derivatives, dynamic market completion is created, i.e. synthetic securitisation assists issuers in exploiting price discrepancies between the ‘acquired (and often illiquid) assets and the price investors are willing to pay for them (if diversified in a greater pool of assets).’

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245 Schedule (n 24 above) para 5(2)(b).
246 Schedule (n 24 above) para 5(2)(c).
247 Schedule (n 24 above) para 5(2)(c)(i).
248 Schedule (n 24 above) para 5(2)(c)(ii).
250 As above.
251 *Cilliers et al* (n 22 above) 200.
252 *Cilliers et al* (n 22 above) 199.
253 *Culp* (n 249 above) 9, 10.
254 *Culp* (n 249 above) 9.
255 As above.
256 *Culp* (n 249 above) 10.
257 As above.
258 *Jobst* (n 51 above) 49.
On the contrary, transaction cost and asymmetrical knowledge influences may spur derivative use, despite initial preference satisfaction, at a lower cost.\textsuperscript{259} On the one hand, financial institutions employ credit derivatives – an efficient technique for diverse institutions to administer the various constituents of lending\textsuperscript{260} – to, according to Lehman Brothers, ‘hedge credit risk, reduce risk concentrations on their balance sheets, and free up regulatory capital’;\textsuperscript{261} on the other hand, non-financial corporate issuers view the benefit of overcoming ‘agency costs of asymmetric information in external finance… due to more information intensive origination of claims and greater operational efficiency’\textsuperscript{262} and ‘improve asset-liability management, as the issuance [sic.] of securitised debt [fund] assets whose future cash flows are matched to the repayment schedule of debt investors.’\textsuperscript{263}

It is \textit{res ispa loquitur} that synthetic sale may amend the risk profile of the assets remaining on a bank’s balance sheet in terms of both the quality and spread of risk;\textsuperscript{264} therefore, the provisions relating to credit risk mitigation instruments\textsuperscript{265} in terms of the Banks Act’s\textsuperscript{266} regulations are applied in calculating the bank’s required capital and reserve funds.\textsuperscript{267} Apart from the Schedule’s\textsuperscript{268} interpretive supremacy to the aforesaid legislation, eligible capital and eligible guarantors are limited to specific categories in terms of the Banks Act.\textsuperscript{269}

\section{5 An overview of the Financial Crisis}

\subsection{5.1 Brief chronology}

It would serve little purpose to reiterate all the events between the share suspension of leading US sub-prime lender, New Century Financial, on 12 March 2007 due to fears of imminent insolvency\textsuperscript{270} (declaring insolvency less than a month later),\textsuperscript{271} and the Securities and Exchange

\begin{thebibliography}{99}
\bibitem{259} Culp (n 249 above), 10, 11.
\bibitem{261} O’Kane (n 149 above) 3.
\bibitem{262} Jobst (n 36 above) 733.
\bibitem{263} As above.
\bibitem{264} Schedule (n 24 above) para 5(1)(b).
\bibitem{265} Schedule (n 24 above) para 5(2)(a).
\bibitem{266} 94 of 1990.
\bibitem{268} n 24 above.
\bibitem{269} 94 of 1990; n 24 above, para 5(2)(a).
\bibitem{271} As above.
\end{thebibliography}
Commission’s (SEC) ban on short selling of financial shares in 19 September 2008\textsuperscript{272} (one day after a similar ban in the United Kingdom (UK)).\textsuperscript{273} According to Dickenson of Fordham Law School, the unemployment rate in the USA hit a sixteen year record low on 20 November 2008,\textsuperscript{274} and US consumer prices showed the greatest monthly decline since before the Second World War,\textsuperscript{275} causing fear of deflation.\textsuperscript{276} As Partnoy of the University of San Diego School of Law and Skeel of the University of Pennsylvania Law School prompts, structured finance had caused scares prior to the Financial Crisis, for example in the case of Enron\textsuperscript{277} or General Motors.\textsuperscript{278} However, only noteworthy events related to the Financial Crisis are set out herein.

According to Foster and Magdoff, the Financial Crisis commenced ‘…somewhat inconspicuously…’ in the summer of 2007 with the default of two Bear Sterns hedge funds.\textsuperscript{279} A more truthful rendition would be that government sponsored enterprises ‘…were unaware of the threat of moral hazard…’.\textsuperscript{280} Already on 16 March 2007 sub-prime lender Accredited Home Lenders Holding liquidated $2.5 billion of its sub-prime loan book.\textsuperscript{281} One month later, the Union Bank of Switzerland (UBS) closed Dillon Read Capital Management, its US sub-prime division,\textsuperscript{282} and three months later General Electric sold its sub-prime lender Waterfield Mortgage Company (WMC).\textsuperscript{283} On 6 August 2007 American Home Mortgage declared insolvency,\textsuperscript{284} and three days later Banque de Paris et des Pays-Bas (BNP Paribas) suspended three investment funds.\textsuperscript{285} The largest mortgage lender, Countrywide, acquired a $2 billion cash addition from Bank of America on 23 August 2007,\textsuperscript{286} (only to be acquired by Bank of America by middle January 2008).\textsuperscript{287} On 15 October 2007, the Japanese Nomura closed its

\textsuperscript{273} As above.
\textsuperscript{275} As above.
\textsuperscript{276} As above.
\textsuperscript{277} F Partnoy & DA Skeel ‘The promise and perils of credit derivatives’ (2007) 75 University of Cincinnati Law Review 1019 1032–1034.
\textsuperscript{278} As above.
\textsuperscript{279} JB Foster & F Magdoff The great financial crisis: Causes and consequences (2009) 11.
\textsuperscript{281} ‘Timeline: Sub-prime losses’ (n 270 above).
\textsuperscript{282} As above.
\textsuperscript{283} As above.
\textsuperscript{284} As above.
\textsuperscript{285} As above.
\textsuperscript{286} As above.
\textsuperscript{287} As above.
related business subsequent to severe losses, and on 22 November 2007 the UKs Kensington Mortgages withdrew all its sub-prime mortgages. On 14 December 2007, Citigroup closed seven of its SPIs, and within a week Morgan Stanley sold 9.9% of its shareholding to the Chinese state owned company China Investment Corporation (CIC). By 6 March 2008 the £1 billion hedge fund controlled by Peloton Partners was rendered insolvent. Carlyle Capital followed one week later.

Even though apprehension related to sub-primes became apparent on Wall Street on 13 March 2007, the Dow Jones Industrial Average only fell on 27 July 2007 with the Financial Times Stock Exchange (FTSE) 100 index reaching its lowest mark in more than four years less than a week afterwards. The International Monetary Fund (IMF) only issued a warning relating to the global impact of the Financial Crisis on 17 October 2007. The largest drop in indices since the 9/11 attack would only transpire on 21 January 2008. By 6 September 2007, the European Central Bank (ECB) had already pumped billions of Euro’s into the Eurozone banking sector on four occasions, totaling €250 billion. By middle-December, the ECB lent $500 billion to European commercial banks. On 12 November 2007, Citigroup, Bank of America and JP Morgan Chase proposed a $75 billion fund to restore confidence to credit markets. On 13 December 2007, global central banks reached consensus on adding at least $100 billion into short-term inter-bank credit markets, and adding loans of $200 billion on 11 March 2007.

On 17 January 2008, Lehman Brothers Holdings Inc retrenched 1,300 of its workforce and on 15 September 2008, merely a week after the Federal National Mortgage Association (Fannie

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288 As above.
289 As above.
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302 As above.
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304 As above.
Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) were taken into administration,\(^{305}\) it initiated insolvency procedures\(^{306}\) – the first of its sort after Drexel Burnham Lambert in 1990.\(^{307}\) By May 2008, Citigroup had suffered $40.7 billion worth of losses, with UBS suffering $38 billion, Merrill Lynch $31.7 billion, the Hong Kong and Shanghai Banking Corporation (HSBC) $15.6 billion, Bank of America $14.9 billion, Morgan Stanley $12.6 billion, Royal Bank of Scotland $12 billion, JP Morgan Chase $9.7 billion, Washington Mutual $8.3 billion, Deutsche Bank $7.5 billion, Wachovia $7.3 billion, Credit Agricole $6.6 billion, Credit Suisse $6.3 billion, Mizuho Financial $5.5 billion, Bear Stearns $3.2 billion and Barclays $3.2 billion worth of losses.\(^{308}\) September 2008 saw the default of Reserve Primary Fund,\(^{309}\) the merger of HBOS with Lloyds TSB,\(^{310}\) the takeover of Wachovia,\(^{311}\) the nationalisation of Bradford & Bingley,\(^{312}\) and capital injections into Fortis, Hypo Real Estate and Dexia.\(^{313}\)

### 5.2 An incident in the history of greed

It was a period of mirth for the press during the Financial Crisis,\(^{314}\) but it is not the role of the jurist to be sensationally overwhelmed by tabloids and, if note is taken thereof, it must be soberly approached. In retaining perspective, it is notable that the Financial Crisis was neither the first of its sort\(^{315}\) nor unique in its cause.\(^{316}\) Commercial law is an intrigue of four centuries’ efforts by debtors and their secured creditors to produce diverse security interests on debtors’ property without buyers or other creditors noticing, and the demands of unsecured creditors for notice when debtors’ assets are subjected to security interests\(^{317}\) – a pragmatic test of the *concursum creditorum* principle.\(^{318}\) According to Simkovic, courts have addressed this problem with the doctrine of secret liens: Lien-holders have priority according to the establishment of the claim in time relative to others (not the *prior in tempore potior in iure* principle in civil

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\(^{305}\) Borio *et al* (n 272 above) 3.

\(^{306}\) As above.

\(^{307}\) Borio *et al* (n 272 above) 6.

\(^{308}\) ‘Timeline: Sub-prime losses’ (n 270 above).

\(^{309}\) Borio *et al* (n 272 above) 3.

\(^{310}\) As above.

\(^{311}\) As above.

\(^{312}\) As above.

\(^{313}\) As above.

\(^{314}\) See Dickenson (n 274 above) 3.


\(^{317}\) Simkovic (n 316 above) 255.

law), and secret liens – liens not properly disclosed – become punitively subordinated.\textsuperscript{319} The question then arises what we are to understand under ‘secret liens’ in a civil law context, given the fact that Simkovic is an Anglo American jurist.

A lien in South African law is better known as a right of retention,\textsuperscript{320} and is ‘…the right to retain physical control of another’s movable or immovable property as security for payment of a claim for money or labour expended on that property…’.\textsuperscript{321} Simkovic attributes the common law origins of secret liens to the statute 13 Eliz c 5, and to the case of Clow v Woods 5 Serg & Rawle 275 1819 WL 1895 Pa 1819,\textsuperscript{322} although the civil lawyer would judge the facts therein as presenting a hypothec. In returning to the etymology of security,\textsuperscript{323} the latter has either a personal or a real nature,\textsuperscript{324} the former being surety and the latter encompassing the now obsolete \textit{fiducia}, and \textit{pignus} and \textit{hypotheca}.\textsuperscript{325} The right of retention has different origins from the aforementioned, and comes from the factual situation\textsuperscript{326} of \textit{possessio}.\textsuperscript{327} Naturally, there did exist \textit{possessio} in the juristic sense,\textsuperscript{328} but for our purposes the manifestation of \textit{detentio} is significant.\textsuperscript{329} For Simkovic, irrespective of legalese, the cause of the Financial Crisis is based on clandestine transactions, whether it is designated as hidden leverage or secret liens.\textsuperscript{330} This is an interesting position, given the lack of resources alluding to this cause.

The doctrine prohibiting secret liens is colloquially known as ‘strong-arm power’\textsuperscript{331} and appears in the USA (Bankruptcy Code 11 U.S.C sec 544(a)(1))\textsuperscript{332} as the power of trustees to nullify clandestine transfers made before insolvency.\textsuperscript{333} South African law has created various duties in order to realise the strong-arm power. The trustee must investigate the affairs and transactions of the insolvent prior to sequestration and report thereon.\textsuperscript{334} The insolvent has the

\begin{thebibliography}{9}
\bibitem{319} Simkovic (n 316 above) 256.
\bibitem{320} CG van der Merwe with A Pope ‘Real security’ in F du Bois (ed) \textit{Wille’s principles of South African law} (2007) 661.
\bibitem{321} As above.
\bibitem{322} n 240 above, 256.
\bibitem{323} See para 2.1 above.
\bibitem{324} Thomas, Van der Merwe & Stoop (n 10 above) 217.
\bibitem{325} As above.
\bibitem{326} Thomas, Van der Merwe & Stoop (n 10 above) 161.
\bibitem{327} Thomas, Van der Merwe & Stoop (n 10 above) 166 \textit{et seq}.
\bibitem{328} Thomas, Van der Merwe & Stoop (n 10 above) 168.
\bibitem{329} Thomas, Van der Merwe & Stoop (n 10 above) 168.
\bibitem{330} Simkovic (n 316 above) in general.
\bibitem{331} Simkovic (n 316 above) 258.
\bibitem{332} As above.
\bibitem{333} As above.
\bibitem{334} Insolvency Act 24 of 1936 sec 81.
\end{thebibliography}
duty not to conceal or destroy financial records or assets, not to have an unlawful preference of creditor(s) and not to conceal liabilities in addition to its duty to keep proper records. Do corporate liquidations differ from sequestrations in these respects? Although the legislation providing for liquidation mentions the keeping of proper records only indirectly, it is a statutory requirement that companies must keep proper records. The Companies Act does not contain a section similar to section 132 of the Insolvency Act, but incorporates it and extends it to a solvency test. Without digressing, mention is made in obiter that the said inclusion made in the 1973 Companies Act confuses more than it assists the jurist, since one is not certain which of the numerous provisions are included as such.

Asset securitisation as a secret lien falls beyond the scope of this work, and has been discussed by Locke to a certain extent. More important is the use of credit derivatives, specifically CDSs, for secret liens. Although these instruments are OTC and unregulated, a second matter arises: What does Simkovic mean when he argues that credit derivatives are secret liens? Consider the following example: Numerous banks turned to American Internation Group Ltd (AIG) as a counterparty to CDSs prior to the Financial Crisis, so that it had sold $440 billion protection. ‘AIG appears to have used credit default swaps as a kind of secret lien, hiding the extent of its leverage and appearing more creditworthy than it actually was…’. Leverage entails that the return on ordinary shareholder’s equity, expressed as a percentage, is larger than the return on total capital employed, expressed as a percentage, due to an increase in external equity relative to total capital employed subject to such external equity bearing relatively low interest. This, and numerous other, are confusing statements since Simkovic is not referring to ‘leverage’ in the classical sense at all. The concept of ‘hidden leverage’ would

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335 Insolvency Act 24 of 1936 sec 132.
336 Insolvency Act 24 of 1936 sec 135.
337 Insolvency Act 24 of 1936 sec 133.
338 Insolvency Act 24 of 1936 sec 134.
342 24 of 1936.
344 As above.
345 Locke (n 97 above) 205 et seq.
346 Simkovic (n 316 above) 271.
347 As above.
348 Simkovic (n 316 above) 272.
349 Cilliers et al (n 22 above) 215.
350 As above.
351 As above.
denote a concern issuing debt instruments not appearing on its balance sheet, which is not the case here. In truth, the realisation of credit events in a systemic fashion would not adversely affect the leverage effect.\textsuperscript{352} A consideration of so-called ‘financial leverage’, which is the ratio of total debt to total shareholders’ equity,\textsuperscript{353} requires a comprehension of (and not necessarily know, since this remains a law thesis) the accounting treatment of CDSs. According to PricewaterhouseCoopers (PwC), whereas initially derivative effects were reserved for the income statement only, public concern forced the Financial Accounting Services Board (FASB) to indicate these instruments on the balance sheet.\textsuperscript{354} Although these instruments consist of rights and duties equivalent to assets and liabilities respectively,\textsuperscript{355} they are not bifurcated in the balance sheet and will be indicated as either asset or liability\textsuperscript{356} based on fair value.\textsuperscript{357} However, a derivative’s position may switch from asset to liability within a brief period of time,\textsuperscript{358} although it will be current if it matures within one year,\textsuperscript{359} although the latter, in the case of credit derivatives, will surely be affected by hedging activity and the issue of debt.\textsuperscript{360} In addition, synthetic CDOs may require bifurcation.\textsuperscript{361} Without further delay, the deduction can be made that CDSs will indeed affect the financial leverage of a firm, which begs the question as to whether this is a secret lien. It appears as if the leverage is not hidden absolutely since it is accounted for in the relevant firm’s balance sheet, but it there may be hidden leverage due to the nature of the value of the CDS, which is based on three variables.\textsuperscript{362}

\textsuperscript{352} As above:
Assume: \[\text{Return on ordinary shareholders’ equity (\%) } \cdots (1); \text{ and } \text{Return on total capital employed (\%) } \cdots (2).\]
\[\text{Return on ordinary shareholders’ equity (\%)} > \text{Return on total capital employed (\%) }\]
\[\Rightarrow \text{ net profit (post taxation & pref dividend) } > \text{ net profit (post taxation) } \]
\[\text{ordinary shareholders’ equity} \]
\[\text{total capital employed}\]

To simplify, assume: pref dividend = 0
Assume: net profit post taxation = \(y\)
Assume: ordinary shareholders’ equity = \(z\)
Assume: total capital employed = \(x\)
In a firm using leverage, we know that: \(x > z\)
Therefore: \((1) > (2)\)
Now, assume, due to systemic risk realization: \(y \rightarrow 0\)
The result remains: \((1) > (2)\)


\textsuperscript{355} As above.
\textsuperscript{356} As above.
\textsuperscript{357} As above.
\textsuperscript{358} PricewaterhouseCoopers LLP (n 354 above) 10 – 4.
\textsuperscript{359} As above.
\textsuperscript{360} PricewaterhouseCoopers LLP (n 354 above) 10 – 5.
\textsuperscript{361} PricewaterhouseCoopers LLP (n 354 above) 3 – 52.
\textsuperscript{362} Simkovic (n 316 above) 272.
The underlying’s value,\textsuperscript{363} the incidental formula for establishing duties,\textsuperscript{364} and creditworthiness.\textsuperscript{365} The complexity\textsuperscript{366} is respectively attributed to: ‘…the [difficulty in determining] the value of the underlying assets…because of the mathematically complex structuring that governs loss allocation among tranches and because of limited information about the credit quality of the underlying loans…’;\textsuperscript{367} ‘…[the difficulty in determining] the extent of counterparties’ [duties]…to each other because of the subjective nature of determining when a “credit event” has occurred and the risk that disagreement will result in litigation…’\textsuperscript{368} and ‘…[the difficulty in determining] the creditworthiness of counterparties…because they too have extensive and hard-to-measure exposures to derivatives…’\textsuperscript{369}

As for creditworthiness, it requires mention that, prior to the Financial Crisis, credit ratings on securitised claims were higher than those of secured claims due to the SPI’s insolvency remoteness;\textsuperscript{370} furthermore, the underestimated risk price was due to US originators holding the most junior tranche of issued commercial paper – economically defeating the purpose of true sale\textsuperscript{371} – causing over-optimistic ratings.\textsuperscript{372} Frankly, creditors’ underestimated risk prices and interest rates create value for the SPI, which transpires from over-optimistic investors or an under-estimation of the SPI’s leverage.\textsuperscript{373} Two aspects require attention: Investor sophistication and disclosure. Not only did investor sophistication in assessing creditworthiness not always encompass a combination of the SPI’s risk retention and its balance sheet,\textsuperscript{374} but there was also an over-reliance on guarantees without cognisance of the SPI’s leverage.\textsuperscript{375} Both traditional and synthetic securitisation schemes are somewhat opaque.\textsuperscript{376} Limited disclosure in tradition schemes not only caused professionals to underestimate SPI’s loss exposure,\textsuperscript{377} but CDS’s complexity, limited disclosure and superior

\textsuperscript{363} As above.
\textsuperscript{364} As above.
\textsuperscript{365} As above.
\textsuperscript{366} Simkovic (n 316 above) 272-273.
\textsuperscript{367} Simkovic (n 316 above) 273.
\textsuperscript{368} Simkovic (n 316 above) 273-274.
\textsuperscript{369} Simkovic (n 316 above) 274.
\textsuperscript{370} Simkovic (n 316 above) 265.
\textsuperscript{371} Simkovic (n 316 above) 266-267.
\textsuperscript{372} Simkovic (n 316 above) 269.
\textsuperscript{373} Simkovic (n 316 above) 265-266.
\textsuperscript{374} Simkovic (n 316 above) 269.
\textsuperscript{375} As above.
\textsuperscript{376} Simkovic (n 240 above 269, 272.
\textsuperscript{377} Simkovic (n 316 above) 269.
treatment in insolvency rendered them ideal for hidden leverage. It is difficult to obtain information regarding actual synthetic securitisation schemes, but whether it is due to a lack of disclosure or due to a lack of publication remains moot. Simkovic identifies the ignorance of market participants by virtue of lack of managerial oversight and employment of quant jocks without sufficient financial or economic knowledge.

6 Synthetic securitisation schemes in the South African context

SARB, the South African Revenue Service (SARS) and Delloite have exulted the growth of the domestic securitisation market. According to Gumata and Mokoena, ‘...the issuance [sic.] by private banks has increased from R250 million in 1989 (United Building Society Ltd’s securitisation of its mortgage book; by 1989, $800 billion in mortgage-backed securities had already been issued in the US) to a cumulative total of R26,0 billion by the end of October 2005…’, mostly transpiring through the Bond Exchange of South Africa (BESA) according to Van den Berg. The quoted clause is vague in that the term ‘private bank’ has no legal basis in South African law, or it is ambiguous in that the latter’s role could be that of an originator/repackager or sponsor, exaggerated by the sub-heading’s phrase ‘...involving domestic banks…’ and the indicated table’s reference to ‘issuer’.

Although Fitch Ratings emphasises progress in the South African securitisation market during the previous decade, South Africa’s ‘securitization’ [sic.] developments dawdled towards the end of the millennium according to Van der Berg. Although securitisation was used for corporate equipment rentals and leases in 1992, it mostly stagnated until a mortgage boom...
in 1999, which roughly coincided with a period of development in applying securitisation to collateralised loan obligations (CLO), future cross-border flows, future rebate flows, properties and trade receivables. Not that relative inactivity constrained regulation – the Schedule had been preceded by more than four previous editions. It has been contended that this stagnation was ascribed to regulatory restrictions, which were alleviated by the 2001 Notice, which constituted alignment with international capital adequacy guidelines.

By 2005 the only two synthetic securitisation schemes in South Africa were the R12.5 billion Lexpub 15 Investments Ltd scheme, colloquially Fresco 1 Ltd, and Procul Ltd. In Fresco I, the underlying was credit risk inherent in credit originated by Rand Merchant Bank (RMB), specifically 107 loans, of which 94% was corporate credit and rated 'AA(zaf)/F1+(zaf)'. The SPI issued six tranches of funded notes worth R1.082 billion, of which the top five tranches were sold for R914 million to fifteen investors as follows: R188 million Class A secured fixed-rate notes rated ‘AAA(zaf)’, R183 million Class B secured fixed-rate notes rated ‘AA(zaf)’, R191 million Class C secured fixed-rate notes rated ‘A (zaf)’, R228 million Class D secured fixed-rate notes rated ‘BBB(zaf)’ and R124 million Class E secured fixed-rate notes rated ‘BB(zaf)’. A CDS was used that accounted for 90% of the SPI’s capital structure, with the collateral being government bonds.

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393 As above.
394 As above.
395 n 24 above.
397 Jacobs & Van den Berg (n 396 above) in general.
399 Fitch Ratings (n 383 above) 4.
400 As above.
401 As above.
402 Structured finance international (n 398 above) 1.
403 As above.
404 Structured finance international (n 398 above) 2.
405 Fitch Ratings (n 383 above) 4.
406 Structured finance international (n 398 above) 1.
407 As above.
408 Structured finance international (n 398 above) 2.
409 As above.
410 As above.
411 As above.
412 As above.
413 Structured finance international (n 398 above) 1.
414 As above.
Procul Ltd was a scheme by FirstRand Bank Ltd, initiated in 2002 and matured in 2010, of credit risk underlying retail instalment automotive loans originated by Wesbank. Eight tranches were issued worth R2 billion rated by Fitch. Furthermore, on 17 July 2007, SPI Fresco 2 entered into a CDS with FirstRand Bank for domestic and international credit exposures on the latter’s balance sheet, maturing 2013. The ratings were as follows: Class A1 rated ‘AAA(zaf)’, Class A2 rated ‘AAA(zaf)’, Class B1 rated ‘AA(zaf)’, Class B2 rated ‘AA(zaf)’, Class C rated ‘A+(zaf)’, Class D rated ‘A-(zaf)’, Class E rated ‘BBB(zaf)’, Class F rated ‘BBB-(zaf)’ and Class G rated ‘BB(zaf)’.

7 Synthetic securitisation schemes in the Canadian context

By 2000, when the market for credit derivatives was diminutive yet emergent, relative to established derivative products, the largest percentage of synthetic schemes were undertaken in New York and London. Canada was slow to embrace credit derivatives, presumably due to ‘…Canadian banks’ access to cost-effective funding through their retail deposit base, as well as their ability to achieve a broad diversification of credit risk internally through their

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415 Fitch Ratings (n 383 above) 4.
417 As above.
418 Fitch Ratings (n 383 above) 4.
419 As above.
420 As above.
421 As above.
422 FirstRand (n 416 above).
424 As above.
425 As above.
428 As above.
429 As above.
430 As above.
431 As above.
432 As above.
433 As above.
434 As above.
436 As above.
437 As above.
438 Kiff & Morrow (n 435 above) 6.
439 As above.
national branch networks…”440 Whether Canada eventually reacted to global competition, as proposed by Kiff and Morrow of the Bank of Canada’s Financial Markets Department,441 or not, is irrelevant: Between 2004 and mid-2007 the use of CDSs became common in Canada.442 In the case of Attorney General of Quebec, Applicant v. Attorney General of Canada, Respondent and Attorney General of Alberta, Barreau du Québec and Canadian Bankers Association, Interveners443 the Quebec Court of Appeal took into regard the content of the Wise Persons’ Committee (2003), the Crawford Panel Report (2006) and the Hockin Panel Report to acknowledge that 80% of Canadian derivative transactions are transnational and that that market is very international.

Canadian CDSs were primarily funded through asset-backed commercial paper (ABCP) programmes.444 The use of ABCP programmes in Canada caused an incongruity between assets and liabilities445 since SPIs were involved in long term sales of the often volatile underlying relative to stable short term commercial paper446 in addition to leverage;447 therefore, the SPIs were vulnerable to runs on the bank.448 In aggravation, many ABCP programmes were hybrid structures449 with credit derivatives leveraged to 60%,450 leaving the SPIs vulnerable to alterations in the credit market.451

Given the Montreal Accord, as discussed elsewhere,452 it comes as no surprise that these schemes have become less attractive.453 According to Chant, Professor Emeritus of Economics at Simon Fraser University, in a research study prepared for the Expert Panel on Securities Regulation,454 the affected SPIs in terms of the Montreal Accord were Apollo Trust, Apsley

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440 As above.
441 As above.
444 Feldman (n 442 above) 8.
446 As above.
447 As above.
448 Chant (n 445 above) 20.
449 As above.
450 As above.
451 Ch 3 below.
452 As above.
453 Feldman (n 442 above) 8.
454 Chant (n 445 above) 1.
Trust, Aria Trust, Aurora Trust, Comet Trust, Encore Trust, Gemini Trust, Ironstone Trust, MMAI-I Trust, Newshore Canadian Trust, Opus Trust, Planet Trust, Rocket Trust, SAT, Selkirk Funding Trust, Silverstone Trust, SIT III, Slate Trust, Symphony Trust and Whitehall Trust. Similar to South Africa, the disclosed investors in the SPI were mostly corporate and often international, whether external or not. According to Goodman of McMillan Binch LLP in an article prepared for the Canadian Business Law Review, banking regulations will be relevant when Canadian financial institutions are involved in CDSs. The persisting schemes are primarily private CDS transaction. This is ironic, as the concept of structured finance, rather than corporate finance, contributed to the number of ABCP programmes in Canada. With a larger scope of assets to choose from, non-bank sponsored ABCP programmes increased by 23% between 2004 and 2006, accounting for 48% of $117 billion ABCP at the latter time.

8 Synthetic securitisation schemes in the German context

Synthetic securitisation schemes comprised at least forty percent of South African schemes by the end of 2005, regardless of the continued prominence of traditional securitisation schemes. According to the British Banker Association (BBA), credit derivatives had globally shown swift growth since 1996; in the third world, it emerged contemporaneously with the Asian Crisis, with some contending it was elicited by the 1998 Russian sovereign bond default. However, its third world growth had been affected by the Argentine turmoil.

455 Chant (n 445 above) 7.
456 Para 6 above.
457 Chant (n 445 above) 47-48.
458 As above.
459 Companies Act 71 of 2008 sec 1: "external company" means a foreign company that is carrying on business, or non-profit activities, as the case may be, within the Republic, subject to section 23(2)...
461 Feldman (n 442 above) 8.
462 Although this distinction is discussed at a later stage, suffice to state here that corporate finance works on the principle of ‘originate-to-distribute’ – meaning that an institution originates assets and subsequently issues – and structured finance works on the principle of ‘acquire-to-distribute’ – meaning that an institution purchases assets and subsequently issues - see Chant (n 445 above) in general.
463 Chant (n 445 above) 20.
464 As above.
465 As above.
466 As above.
467 Gumata & Mokoena (n 40 above) 61.
469 As above.
470 As above.
471 Ranciere (n 468 above) 5.
Contrary to the position of both South Africa and Canada, the rate of synthetic securitisation in Germany had surpassed that of its traditional counterpart\textsuperscript{472} due to historic\textsuperscript{473} tax obstacles on true sale.\textsuperscript{474} Perhaps the greatest difference from the aforesaid systems is the consortium of German commercial banks establishing the True Sale Initiative platform (TSI GmbH) to not only afford issuers of paper based on German collateral with a cheaper consistent issuance platform that complies with domestic competition law and regulatory requirements,\textsuperscript{475} but also to permit participating financial institutions to securitise reference loan portfolios via a special limited liability SPI ‘owned’ by three charitable foundations.\textsuperscript{476} Due to true sale restrictions, many mortgage-backed securities were initially, and specifically since 2001, synthetic and executed issues via the Kreditanstalt für Wiederaufbau (KfW) PROVIDE platform\textsuperscript{477} with CLNs.\textsuperscript{478}

Research on the subject shows that, on whole, the South African regulatory approach to securitisations seem to have been more liberal than Germany. After the sale of receivables in November 1990 to an off-shore SPI despite the Bundesaufsichtsamt für das Kreditwesen’s\textsuperscript{479} (BAKred),\textsuperscript{480} and later Bundesanstalt für Finanzdienstleistungsaufsicht’s\textsuperscript{481} (BAFin)\textsuperscript{482}, reservations\textsuperscript{483} on disintermediation and interference with bank-customer confidential relationship\textsuperscript{484} (argumentatively the first German securitisation),\textsuperscript{485} the second scheme only transpired in April 1995 with the sale of DM523 million receivables to an off-shore SPI. Non-

\textsuperscript{473} As above.
\textsuperscript{474} As above.
\textsuperscript{476} As above.
\textsuperscript{477} International Monetary Fund (n 475 above) 8, 12.
\textsuperscript{478} International Monetary Fund (n 475 above) 12.
\textsuperscript{480} As above.
\textsuperscript{481} ‘Federal Financial Supervisory Authority’; Wang (n 479 above) 29.
\textsuperscript{482} Wang (n 479 above) 6.
\textsuperscript{485} International Monetary Fund (n 475 above) 8.
offshore German securitisation was only permitted by the banking regulator in 1997,\textsuperscript{486} with the \textit{Gewerbesteuergesetz},\textsuperscript{487} specifically income tax on bank-originated assets purchased by SPIs, being amended in 2003 by the \textit{Gesetz zur Förderung von Kleinunternehmen und zur Verbesserung der Unternehmensfinanzierung}.\textsuperscript{488} Two other contributing factors were the 2004 removal of value-added tax (VAT) on receivables servicing,\textsuperscript{489} and the 2005 introduction of Refinancing Register which omitted the recording of mortgage transfers in land registers.\textsuperscript{490} The effect of the latter was that the number of traditional securitisation schemes to synthetic securitisation schemes in Germany increased by 59\% between 2000 and 2007.\textsuperscript{491}

Germany was indeed affected by the Financial Crisis. After peaking in 2006,\textsuperscript{492} the securitisation market decreased by €25 billion and 16 schemes.\textsuperscript{493} The securitisation market based on underlying mortgages virtually stagnated,\textsuperscript{494} although few conclusions can be drawn from this, given that Germany has a trusted \textit{Pfandbrief} system in place.\textsuperscript{495} The German bailouts of Depfa, Düsseldorfer Hypothekenbank, EuroHypo AG and Hypo Real Estate Group (Deutsche Pfandbriefbank) signaled the Bundesrepublik’s willingness to support the latter market.\textsuperscript{496} What can be said, is that once the Germans liberalised with regards to securitisation, they invested in bad assets such as Greek bonds and US subprime debt.\textsuperscript{497} The cumulative losses on commercial paper issued between 2005 and 2007 were only 0.16 percent by 2010.\textsuperscript{498} According to Wittinghofer of Baker & McKenzie in 2008, only two SPI’s were severely affected by the Financial Crisis at that time.\textsuperscript{499} In the first instance, Rhineland Funding, sponsored by Industriekreditbank (IKB Bank),\textsuperscript{500} was unable to roll over commercial paper,\textsuperscript{501}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{486} International Monetary Fund (n 475 above) 8-9.
\item \textsuperscript{487} “[T]rade tax law” – International Monetary Fund (n 475 above) 9.
\item \textsuperscript{488} “Act to the Support of Small Businesses” – International Monetary Fund (n 475 above) 9; International Monetary Fund (n 475 above) 8-9.
\item \textsuperscript{489} International Monetary Fund (n 475 above) 9.
\item \textsuperscript{490} As above.
\item \textsuperscript{491} K Birke ‘German market for mortgage backed securities (MBS)’ (2008) 23 \textit{Journal of International Banking Law and Regulation} 618 618.
\item \textsuperscript{492} As above.
\item \textsuperscript{493} As above.
\item \textsuperscript{494} As above.
\item \textsuperscript{495} International Monetary Fund (n 475 above) 32.
\item \textsuperscript{496} International Monetary Fund (n 475 above) 29.
\item \textsuperscript{497} J Ewing ‘In Germany, little appetite to change troubled banks’ (2013) 10 August \textit{The New York Times} B3 B3.
\item \textsuperscript{498} International Monetary Fund (n 475 above) 12-13.
\item \textsuperscript{499} S Wittinghofer ‘Overview of the German securitisation market and recent legal developments’ in Deutsche Bank (sponsor) \textit{Global securitisation and structured finance} 2008 (2008) 194.
\item \textsuperscript{500} As above.
\item \textsuperscript{501} As above.
\end{itemize}
\end{footnotesize}
necessitating a liquidity facility of €8.1 billion,\textsuperscript{502} with KfW – IKB Banks’ majority shareholder\textsuperscript{503} – assembling a €4.8 billion umbrella facility for IKB Bank.\textsuperscript{504} Eventually, doubt regarding Rhineland Funding and IKB Bank’s risk profiles forced KfW to perform on IKB Banks’s duties towards Rhineland Funding.\textsuperscript{505} The second instance occurred less than a week after Countrywide acquired a cash injection from Bank of America,\textsuperscript{506} when the German Sachsen Landesbank was sold to Landesbank Baden-Wuertemberg.\textsuperscript{507} However, the bailout of German banks between 2008 and 2012 eventually cost €646 billion,\textsuperscript{508} being second only to Britain\textsuperscript{509} and some $160 billion more than the USA set aside for its Troubled Asset Relief Program.\textsuperscript{510}

Was Deutsche Bundesbank’s 1997 statement that ‘frequently-voiced objections run counter to the finding that there is virtually no known instance so far in the United States or in other countries of an ABS transaction having failed’\textsuperscript{511} a spell on German markets? There seem to be differing opinions on the matter. According to Jörg Rocholl, president of the European School of Management and Technology, ‘…Germany was actually hit very hard by the financial crisis…’. According to the International Monetary Fund (IMF), German securitisations ‘performed very well during the credit crisis’,\textsuperscript{512} with no counterpart to the Canadian re-evaluation.\textsuperscript{513}

\section*{9 Final remarks}

Without digression, though knowing that its exclusion would be an \textit{argumentum ad lapidem}, it is noteworthy that an etymological comprehension of securitisation from its base noun is puritanically a masked man fallacy. Although the Schedule\textsuperscript{514} signifies the SPI’s

\textsuperscript{502} As above.
\textsuperscript{503} As above.
\textsuperscript{504} As above.
\textsuperscript{505} S Wittinghofer ‘Overview of the German securitisation market and recent legal developments’ in Deutsche Bank (n 499 above) 194-195.
\textsuperscript{506} ‘Timeline: Sub-prime losses’ (n 270 above).
\textsuperscript{507} S Wittinghofer ‘Overview of the German securitisation market and recent legal developments’ in Deutsche Bank (n 499 above) 195.
\textsuperscript{508} Ewing (n 497 above) B3.
\textsuperscript{509} As above.
\textsuperscript{510} As above.
\textsuperscript{512} International Monetary Fund (n 475 above) 12.
\textsuperscript{513} See para 7 above.
\textsuperscript{514} n 24 above.
commercial paper (i.e. ‘creditorship’), 515 the role of shareholding (i.e. ‘ownership’) 516 is neglected. A liberal interpretation of these notions, i.e. in terms of common law, provides for legal uncertainty in South African securities law; 517 a conservative approach is dubious since the Registrar failed to allude thereto in the Schedule. 518 The current interpretation of the latter raises the question as to the nature of shareholders’ *iura in rem* in a synthetic securitisation and the collection of rights in the SPI. Should this sophism prove dubious, the reality remains that the SPI’s *a priori* issue of commercial paper, as indicated in the statutory definition of a synthetic securitisation scheme, 519 renders the concept of securitisation, within the context of synthetic securitisation for our purposes, a denial of the antecedent. The deduction is that this term holds little resemblance to what it sets out to denote.

Securitisation also holds little resemblance to what it initially *en toto* denoted. Etymologic scrutiny of the term ‘securitisation’ further reveals an initial pragmatic denotation of disintermediation, 520 encompassing the infamous 521 junk bond market. 522 It is contemporaneously more strictly – perhaps too strictly – defined 523 as an epitome of structured finance, 524 being the production of bespoke instruments due to high-street products’ inability to satisfy corporate needs. 525 Synthetic securitisation specifically is the on-balance sheet 526 transfer of assets’ credit risk and/or market risk to a SPI usually 527 through derivatives 528 (not to be confused with synthetic short sale). This common definition is inadequate for various reasons. Firstly, it is ignorant of the taxonomy of synthetic securitisation, as it only refers to indirect synthetic securitisation and excludes reference to direct synthetic securitisation which is often accompanied by the utilisation of CLNs. As will be noted at a later stage, 529 this proves to be a realistic predicament in the Schedule. 530 Secondly, the definition constitutes a slippery

515 Gove *et al* (n 9 above) 2054.
516 As above.
517 Para 2.1 above.
518 n 24 above.
519 Para 2.2 above.
520 Fabozzi & Kothari (n 168 above) 3.
522 As above.
523 Fabozzi & Kothari (n 168 above) 4.
524 As above.
525 As above.
526 Karoly (n 36 above) 13.
527 Ch 7 below.
528 n 24 above.
slope in that, if said definition is the crux of (synthetic) securitisation, i.e. the creation of a derivative as the security based on a specified underlying, then the process of transacting on any and all derivatives constitutes synthetic securitisation. If the latter proves not to be the case, then an etymological circular reasoning is rendered, since the definition disregards the securities created by the SPI in an indirect synthetic securitisation. This is fortunately rectified by said statutory definition of ‘synthetic securitisation scheme’.

Thirdly, the definition under discussion refers to both credit and market risk, with the term ‘credit risk’ not consistently used in the Schedule. Credit risk is explained elsewhere. Irrespective of varying definitions, the CFA Institute defines market risk as ‘the risk associated with interest rates, exchange rates, [sic.] and equity prices’. Interest rate risk, being a contributory risk, is based on interest rate changes whether as borrowers’ greater funding cost or investors lower yields and is often explained in terms of the Heath-Jarrow-Morton (HJM) structure. The implication is that banks either have asset or liability sensitivity, with risk on the former based on asset reinvestment prior to liability repayment, and risk on the latter based on liability roll-overs prior to the availability of assets; therefore, it has been suggested that interest rate risk can be mitigated through proper matching of liabilities and assets. This is reminiscent of Aiken’s ‘[t]he proper matching of costs and revenues carries the relation of capital and income further than does the relation of principal and income’, i.e. the preference of the solvency and liquidity test above the capital maintenance rule. Whereas the transferor of risk in a synthetic securitisation scheme has asset

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531 n 24 above.
532 Ch 6 below.
535 Williamson (n 533 above) 17.
536 Taylor (n 533 above) 32.
537 Taylor (n 533 above) 74.
539 Williamson (n 533 above) 14-16.
540 As above.
541 As above.
542 As above.
543 As above.
sensitivity, the SPI has liability sensitivity, the latter being the contextual application of the solvency and liquidity test\textsuperscript{544} by the SPI. This would be based on balance sheet bifurcation, as already discussed.\textsuperscript{545}

However, the Schedule\textsuperscript{546} is silent on the application of interest rate derivatives by transferors or SPIs. SPIs may, in practice, may employ ‘tailor-made’\textsuperscript{547} interest rate swaps ‘to alter cash flow characteristics of the assets (liabilities) to match the characteristics of liabilities (assets)’,\textsuperscript{548} in terms of which two counterparties – the fixed rate payer and the fixed rate receiver (of which a SPI can be the one or the other) – agree to ‘exchange periodic interest payments’,\textsuperscript{549} the cash amount of such interest payments being based on a predetermined principal, called the notional amount.\textsuperscript{550} \textit{Res ipsa loquitur} the utility of interest rate swaps would be less in synthetic securitisation schemes than in traditional securitisation schemes. Nonetheless, the application of interest rate swaps do not constitute a \textit{conditio sine qua non} for synthetic securitisation, and as such the transfer of market risk, as described by Karoly above, is erroneous except in such circumstances as when the respective said parties enter into additional derivative agreements in order to amend their exposure to the rates applicable to a credit derivative \textit{inter se}.

Furthermore, currency risk, or exchange rate risk,\textsuperscript{551} obviously relevant in cross-border cash flow in terms of a securitisation, is the risk of asset values changing due to exchange rate variations.\textsuperscript{552} The same balance sheet management argument exists with regards to currency risk: Transactions with altering repayment provisions and receivables with manifold unhedged currency denominations compel the SPI to reconcile asset cash flows with distributions to investors.\textsuperscript{553} Failure to execute such reconciliation would trouble the scheduled amortisation and the contractual terms of repayment due to market flux.\textsuperscript{554} Once again, this is not \textit{sine qua

\textsuperscript{544} Companies Act 71 of 2008 sec 4.
\textsuperscript{545} Para 5.2 above.
\textsuperscript{546} n 24 above.
\textsuperscript{547} Fabozzi & Kothari (n 168 above) 108.
\textsuperscript{548} As above.
\textsuperscript{549} Fabozzi & Kothari (n 168 above) 101.
\textsuperscript{550} As above.
\textsuperscript{551} Williamson (n 533 above) 13.
\textsuperscript{552} As above.
\textsuperscript{553} Jobst (n 36 above) 740-741.
\textsuperscript{554} Jobst (n 44 above) 741.
non to the hypothetical synthetic securitisation, and should not unnecessarily invoke the relevance of market risk.

The consequent conclusion is that commercial denotations of synthetic securitisation, not for purposes of commerce but rather given the de facto utilisation of them de iure, as well as the statutory definition prove jurisprudentially unsatisfactory. Definition of synthetic securitisation surfaces through excessive research of theoretical and practical examples in order to ascertain the golden thread for purposes of comprehending its Platonic form. The latter noun is non-metaphysically presented here as ‘the possibility of structure’.555 The designation becomes meaningless,556 in juxtaposition to its constituents, subject to the following proviso: The substance557 of the financial world within a specific jurisdiction has a form and content,558 in which synthetic securitisations, as states of affairs559 resort, exist, and since it is res ipsa loquitur that a discussion of synthetic securitisations within the financial world of a specific jurisdiction would be virtually infinite, only the most significant aspects necessary for proper comprehension are discussed.

Synthetic securitisations can be understood with regards to the greater purposes that they serve:560 Lawful omission of Basel capital requirements561 and a micro-economic impetus.562 Certain impetuses are intrinsic to the latter, such as institution(s) acting in a primary role transfer(s) risk to an unregulated SPI with individual corporate capital for funding purposes.563 Certain other contended impetuses are superfluous since the same principle applies in normal cases of corporate finance, such as the justification that the stratification of risk presents elasticity in the market for different tranches of commercial paper.564 However, bearing the causes of the Financial Crisis in mind,565 regulation in the former circumstances only pertains to bank regulators;566 therefore, an arbitrage opportunity exists between the party acting in a

556 ‘Only facts can express a sense, a set of names cannot…’ – Wittgenstein (n 555 above) 14.
557 Wittgenstein (n 555 above) 8.
558 As above.
559 Wittgenstein (n 555 above) 9.
560 Para 4 above.
561 Para 4.1 above.
562 Para 4.2 above.
563 Das (n 163 above) 343.
564 Das (n 163 above) 343-344.
565 Para 3 above.
566 Das (n 163 above) 343.
primary role’s capital requirements and its economic asset risk.\textsuperscript{567} An important proviso not mentioned by Das is that this will transpire if the return on the SPI’s pool of risk surpasses the acquisition cost of such pool of risk.\textsuperscript{568} This form of risk arbitrage\textsuperscript{569} had surpassed the main \textit{impetus} of avoiding Basel requirements,\textsuperscript{570} and had caused the systemic exploitation of synthetic securitisation schemes. It was an eventuality: It is an example of recent arbitrage development not only in the deviation from positions on traditional securities to positions on derivatives,\textsuperscript{571} but also the arbitrageur’s changing role from a rogue shareholder to an activist.\textsuperscript{572}

The aforesaid arbitrage did not exist in isolation. Its environment was one of regulatory vicissitudes: Greater regulation of banks’ risk management and less focus on individual obligations,\textsuperscript{573} liberalisation – whether through interest rate deregulation or restrictions investment instrument selection\textsuperscript{574} – and finally increased regulation of the capital base.\textsuperscript{575} This environment has been conducive for increasing financial crises,\textsuperscript{576} with moral hazard as a significant factor.\textsuperscript{577} Although the first vicissitude is discussed throughout this thesis, and specifically in chapter 6 below, the third has been alluded to above.\textsuperscript{578} The second vicissitude relates to banks, but in truth also parties acting in primary roles and SPI’s, may have gambled on resurrection, i.e. identifying a high risk portfolio with excellent centripetal risk-return if the scheme works out but great centrifugal losses if it does not.\textsuperscript{579} Therefore, it becomes a matter of interest as to the prevalence of credit derivative utilisation regarding such gambling on resurrection.\textsuperscript{580} Combine this with the fact that neither capital requirements\textsuperscript{581} nor the capabilities of regulatory agencies were realistically updated,\textsuperscript{582} and the consequence is a

\begin{thebibliography}{582}
\bibitem{567}
As above.
\bibitem{568}
Fabozzi & Kothari (n 168 above) 211-212.
\bibitem{569}
As above.
\bibitem{570}
As above.
\bibitem{571}
\bibitem{572}
Wyser-Pratte (n 570 above) 17.
\bibitem{573}
\bibitem{574}
As above.
\bibitem{575}
As above.
\bibitem{576}
As above.
\bibitem{577}
As above.
\bibitem{578}
Para 4 above.
\bibitem{579}
As above.
\bibitem{580}
Hellman, Murdock & Stiglitz (n 573 above) 149.
\bibitem{581}
As above.
\bibitem{582}
As above.
\end{thebibliography}
possible recipe for disaster in the marketplace. These aspects will also be alluded to in this work.

However, it would be unfair not to note that the South African synthetic securitisation market has proven to be relatively resilient. The South African securitisation market got off to a late start, although local movers and shakers took the initiative to involve this emerging market in the complexities of synthetic securitisation. Although only a few schemes were transacted, the South African synthetic securitisation market has remained steady despite significant credit downgrades. The stratification has been loss absorbent despite credit events\textsuperscript{583} and rating agencies have considered the outlook on commercial paper’s performance stable.\textsuperscript{584} Notes are usually not written down due to the efficiency of excess spread.\textsuperscript{585} Schemes such as Procul have survived the Financial Crisis and matured without suffering any losses.\textsuperscript{586} Both Canada and Germany also commenced with conservative sentiments towards securitisation, but Canada’s employment of ABCP programmes caused a serious solvency mismatch rendering synthetic securitisation somewhat unfashionable at present. It appears as if the public has mixed sentiments regarding Germany’s financial market in the light of the Financial Crisis.

\textsuperscript{583} Reuters (n 422 above).
\textsuperscript{584} As above.
\textsuperscript{585} As above.
\textsuperscript{586} FirstRand (n 416 above).
Chapter 3
Parties acting in a primary role

1 Introduction
The structural challenge relating to an academic discussion of synthetic securitisation schemes has been alluded to elsewhere.¹ Whereas chapter 2 above constitutes a presentation of the theme, chapter 3 furthers this by studying the primary participants. The Schedule² ostensibly divides participants in a synthetic securitisation scheme into four groups: the genus of a party acting in a primary role, the genus of a party acting in a secondary role, the SPI, and the investors in the SPI. This chapter deals with parties acting in a primary role – their manifestations in a corporate setting as well as the activities undertaken by them. No express indication is provided in the Schedule³ as to the reason for their classification, which requires an implicit study. In answering the second and third problem questions, it is also noteworthy

¹ Ch 1 para 1 above.
³ As above.
that various frictions are prevalent between said participants (figure 3.1 below).⁴ Some of these aspects are included in these discussions. Friction seems to predominantly stem from asymmetric information, which is based on uncertainty and quality.⁵

![Diagram of the securitisation process]

**Figure 3.1**

### 2 Parties acting in a primary role

#### 2.1 General

There exists a party *a priori* – and possibly later – within a securitisation scheme that seeks to deal with risk,⁶ to obtain relief from capital requirements,⁷ or to achieve off-balance sheet financing.⁸ Whether such initial party’s traditional securitisation scheme counterpart has been designated an originator,⁹ seller¹⁰ or transferor,¹¹ the Schedule¹² explicitly refers to such party as an ‘institution’ in relation to synthetic securitisations schemes,¹³ contrary to traditional

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⁷ As above.

⁸ As above.


¹⁰ Fabozzi & Kothari (n 6 above) 12.


¹² n 2 above.

¹³ n 2 above, para 5(1)(a)(i).
securitisation schemes’ ‘transferring institution’. The latter is not defined in the Schedule, although the defined term ‘transfer’ is a common denominator to both traditional and synthetic securitisation schemes. The answer to this puzzle is provided in paragraphs 4(1)(a)(i)(A) and 4(1)(a)(i)(B) of the Schedule, which refers to the transfer of assets to the SPI or the assets acquired by the SPI, and, although subject to paragraph 3, this is confirmed in paragraph 4(2)(a) of the Schedule. The provision made for assets acquired by the SPI likely refers to the possible prevalence of borrower SPIs. This argument is supported by the singular reference to transfer – and not acquisition – of assets at paragraph (a) of the definition of ‘originator’ and in the definition of ‘repackager’.

14 n 2 above, para 4(2).
15 n 2 above.
16 n 2 above, para 1: “transfer” in relation to—
(a) a traditional securitisation scheme means the sale and transfer of assets; or
(b) a synthetic securitisation scheme means the transfer of risk by means of a credit-derivative instrument or guarantee, or such other method of transfer as may be directed or specified in writing by the Registrar.
17 n 2 above.
18 As above.
19 Karoly (n 9 above) 17.
20 Schedule (n 2 above) para 1: “originator” in relation to—
(a) a traditional securitisation scheme means an institution that, whether at the commencement or during the life of the traditional securitisation scheme, transfers assets from its own balance sheet, which assets are assets other than national Government securities or qualifying items, in terms of a traditional securitisation scheme;
(b) a synthetic securitisation scheme means an institution that, whether at the commencement or during the life of the synthetic securitisation scheme, uses a credit-derivative instrument to transfer the risk associated with a specified pool of assets, other than national Government securities or qualifying items, to investors without actually selling the assets;
(c) an asset-backed commercial paper programme means an institution that serves as a sponsor in respect of the programme that acquires exposures other than from the sponsor's own balance sheet.
Provided that when—
(i) the assets, other than national Government securities or qualifying items, referred to in paragraph (a) above; or
(ii) the risk associated with a specified pool of assets, other than national Government securities or qualifying items, referred to in paragraph (b) above, constitute 10 per cent or less of the total assets or risks transferred, such an institution shall for purposes of this Schedule be regarded as—
(A) a repackager; or
(B) when such an institution also acts as a sponsor in respect of the same securitisation scheme, as a sponsor’.
21 Schedule (n 2 above) para 1: “repackager” means an institution that, whether at the commencement or during the life of a traditional or synthetic securitisation scheme, acquires and subsequently—
(a) transfers the assets; or
(b) transfers the risk relating to assets, consisting of national Government securities or qualifying items of third parties via its balance sheet in terms of a traditional or synthetic securitisation scheme: Provided that an institution that, whether at the commencement or during the life of the traditional or synthetic securitisation scheme, acquires and subsequently transfers the assets or risk(s) relating to assets, consisting of assets other than national Government securities or qualifying items of third parties via its balance sheet in terms of the said...
The said ‘institution’ in synthetic securitisation schemes is inclusively defined as ‘a bank or any other institution within a banking group’ with both the former and the latter of the disjunctive being defined in the Banks Act and presumably excluding the possibility of the institution being a trust with regards to the former. Whilst the former relates to a public company registered as a bank, the latter not only illogically uses an associative reference at paragraph (a) but also departs from the concept of relation and inter-relation and includes a manner of interconnectedness that has a likely adverse influence subject to another institution’s financial difficulty. Whilst the singular ‘institution within a banking group’ is not defined in the Schedule, the plural ‘institutions within a banking group’ is indeed and extends to joint ventures although the plural is never used in the Schedule except disjunctively with the singular, the plural which could be construed as discrepant in substantia from the singular if it was not for the singular references at paragraphs (c) and (e) of the definition of the plural.

A further problem with the definition of ‘institution’ is the fact that the definition of ‘banking group’ renders the *eiusdem generis* rule inapplicable, though the most vexing point is the term ‘institution’ not specifically pertaining to its *dasein* in paragraph 5(1)(a)(i), but is also employed with regards to servicing agents and sponsors. Fortunately, some certainty is
afforded in the definition of ‘primary role’. Whereas this definition expressly stipulates a participatory role, ‘primacy’ *per se* relates to the nature of the expressly identified parties in the said respective schemes. The common meaning of ‘primary’ typifies such a nature as either preeminent or essential, with the former’s fallibility based on its subjection to opine, and the latter’s presumptuousness based on its circumstance. Furthermore, such a designation must be differentiated from the unrelated concept of the primary market.

An institution acting in a primary role has an economically organisational nature – being legally some form of business enterprise as already discussed above – which subjects the concern to three constricting factors: technology, information and the market. Information and organisation *per se* entails the principal-agent problem, which relates to the *a priori* choice of ‘business organisation’ or ‘business enterprise’. This leads us to consider the disjunctive employed in the definition of ‘institution’, since ‘any other institution within a banking group’ can be ‘natural or juristic persons’. The phrase ‘one or more of which is a bank’, given the aforementioned interpretation, does not exclude a natural person as being an ‘institution’ in a synthetic securitisation scheme, since the definition of ‘institutions within a banking group’ employs the term ‘may’ which has its particular semantics in legal

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38 Schedule (n 2 above) para 1: ‘“primary role” means the participation by an institution in a traditional or synthetic securitisation scheme as an originator, remote originator, sponsor or a repackager’.
41 HS Cilliers *et al* *Cilliers & Benade Corporate Law* (2000) 4-5.
42 M Parkin ‘Organizing production’ in CFA Institute (n 40 above) 103 *et seq*.
43 M Parkin ‘Organizing production’ in CFA Institute (n 40 above) 108-109.
44 M Parkin ‘Organizing production’ in CFA Institute (n 40 above) 109 *et seq*.
45 Cilliers *et al* (n 41 above) 4-5.
46 See n 22 above.
47 As above.
48 See n 29 above.
49 Banks Act 94 of 1990 sec 1(1).
interpretation. The reader should herewith also consider the definition of ‘branch’ and the provisions of section 18A of the Banks Act. The same logic can be applied to the use of the term ‘institution’ in other manners in the Schedule. It has already been noted above that the definition of ‘institutions within a banking group’ can even include unrelated institutions, since the list, which is already not a *numerus clausus*, *en toto* constitutes a wider ambit than merely related and inter-related persons.

2.2 **Originator**

2.2.1 **General aspects**

The term ‘originator’ had been previously used to refer to *inter alia* inventors of intellectual property, and, according to Martín-Olivier and Saurina of *Banco de España*, banks’ creation of loans; thus inductively being the creator of, in the economic sense, objects and, in the legal sense, the rights implicit therewith. The Uniform Commercial Code (UCC) as enacted in Michigan expressly defines ‘originator’ in its article on funds transfers as ‘the sender of the first payment order in a funds transfer’. According to Karoly, this designation relates to an institution’s instigation of a securitisation scheme. ‘[O]rigination’, being a permutation of the original statutory noun, is defined by Simkovic as ‘the initial step of making loans to

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51 Banks Act 94 of 1990 sec 1: “branch” means an institution that is not a public company as contemplated in section 11(1), but by means of which a foreign institution conducts the business of a bank in the Republic under an authorization referred to in section 18A”.
52 94 of 1990.
53 n 2 above.
54 Schedule (n 2 above) para 1: “institutions within a banking group” means the following institutions that may form part of a banking group:
   (a) All banks in such a group.
   (b) All subsidiaries, joint ventures, or associates of such banks.
   (c) The controlling company of such banks.
   (d) All other subsidiaries, joint ventures and associates of such bank controlling company.
   (e) Any other entity designated by the Registrar”.
55 Companies Act 71 of 2008 sec 2.
56 As above.
57 As above.
60 See Uniform Commercial Code Act 174 of 1962 art 4A.
61 Uniform Commercial Code Act 174 of 1962 sec4 A 104(c) of the sender of the first payment order in a funds transfer.
62 Karoly (n 9 above) 17.
individual borrowers’, rendering the creation of ‘assets’ the denominative justification, and by Katz as ‘generation’. Davis defines the originator traditionally as ‘[t]he seller of assets...[that] transfers ownership of...assets to the SPV and usually continues to service the assets in exchange for a management fee’. Jurists have also referred to originators financially as the ‘operating company’, even though such terminology is too vague – ‘operating activities’, being the chief daily determinant transactions of income, are not exclusive to originators.

It is necessary to briefly mention an oddity in the Schedule with regards to possible financial instruments employed. Contrary to the disjunctive between ‘credit-derivative instruments’ and ‘guarantees’ employed at paragraph (b)(i) in the definition of “synthetic securitisation scheme”, the Schedule does not contain the same reference to guarantees in paragraph (b) of the definition of ‘originator’. In terms of a strict legislative interpretation it would appear as if the Schedule effectively, yet nonsensically, excludes an originator’s use of guarantees in synthetic securitisations. The exclusion of explicit reference to letters of credit in the Schedule may relate to the fact that letters of credit can serve as guarantees.

64 Simkovic (n 63 above) 215.
65 Schedule (n 2 above) para 1: “asset” means an asset as defined in the Framework for the Preparation and Presentation of Financial Statements in terms of Financial Reporting Standards, as amended from time to time.
70 Friction exists between obligors and originators. [Ashcraft & Schuermann (n 4 above) 5.] This is not a work of credit law; rather, reference shall not be made to a priori offer exchanges, but the sophistication of obligors. [Ashcraft & Schuermann (n 4 above) 5.] Contrary to companies’ inclination to profit optimisation, natural persons have no such imperative save individual prudence; therefore, obligors may be ignorant of the exhaustive options of financial opportunities, [Ashcraft & Schuermann (n 4 above) 5.] or incapable of making the superlative decision, [Ashcraft & Schuermann (n 4 above) 5.] or irrationally make inferior decisions. [Ashcraft & Schuermann (n 4 above) 5.] The resultant disproportionate bargaining positions exhibit the risk of predatory lending. [Ashcraft & Schuermann (n 4 above) 5.]
71 n 2 above.
72 n 2 above, par 1.
73 n 2 above.
74 Greenshields v Willenburg (1908) 25 SC 568, as quoted in Botha (n 50 above) 72.
75 n 2 above.
76 S Das Credit derivatives: CDOs & structured credit products (2005) 29.
77 n 2 above.
2.2.2 ABCP programmes specifically

A paragraph relating to either ABCP programmes or assets *per se* may *prima facie* appear out of place in a work of this subject matter, since the reference to assets immediately connotes the use of true sale which is largely beyond the ambit of this work. The legal rationale will be discussed below. The commercial rationale is based on the impact of ABCP programmes: It is noteworthy that, according to Beaudin *et al* of McMillian LLP, ABCP programmes recently drove the well-developed and significant Canadian securitisation market into re-evaluation. According to Kelly, Kroft and McElheran of Stikeman Elliot LLP, rating agency DBRS changed its R-1 (high) rating standards in 2007 from a steadfast liquidity facility accessible in market disturbance due to the failure of a SPI to perform on maturing ABCP, to a steadfast liquidity facility accessible to perform upon maturing for the duration that the reference asset maintains an investment-grade rating and does not default. Not only did this inhibit the market, but SPIs found refinancing and liquidity facilities increasingly inaccessible. The latter relates to the tacit concurrence of market participants that non-bank sponsored ABCP programmes have concluded – this active market desiccated, with non-bank sponsors incapable of refinancing maturing ABCP’s and accessing on hand liquidity facilities, whilst

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80 As above. The affected SPIs were named in chapter 2 para 7 above. The respective sponsors of the affected SPIs were Coventree Capital Inc (Apollo Trust, Aurora Trust, Comet Trust, Gemini Trust, Planet Trust, Rocket Trust and Slate Trust), Quanto Financial Corporation (Apsley Trust and Whitehall Trust), National Bank Financial (Ironstone Trust, MMAI-I Trust and Silverstone Trust), Nereus Financial Inc (SAT and SIT III), Newshore Financial Services Inc (Aria Trust, Encore Trust, Newshore Canadian Trust, Opus Trust and Symphony Trust) and Securitus Financial Corporation (Selkirk Financing Trust) – J Chant ‘The ABCP crisis in Canada: The implications for the regulation of financial markets’ http://0-www.expertpanel.ca.innopac.up.ac.za/documents/research-studies/The%20ABCP%20Crisis%20in%20Canada%20-%20Chant.English.pdf (accessed 6 February 2015) 6.


82 As above.
83 As above.
84 As above.
85 As above.
86 Beaudin *et al* (n 79 above) 1.
87 As above; K Kelly, PJ Kroft & M McElheran ‘Asset securitization in Canada: Recent important developments’ in Deutsche Bank (n 81 above) 37.
88 K Kelly, PJ Kroft & M McElheran ‘Asset securitization in Canada: Recent important developments’ in Deutsche Bank (n 81 above) 38.
89 As above.
90 As above.
investors’ funds were frozen,\textsuperscript{91} causing the leading court-administered debt restructuring (the Montreal Accord)\textsuperscript{92} in Canadian history.\textsuperscript{93}

An ABCP programme is expressly defined in the Schedule\textsuperscript{94} and has been oversimplified\textsuperscript{95} as a short-term securitisation scheme.\textsuperscript{96} Although the designation of this activity is reminiscent of a traditional securitisation scheme, these programmes are not only subject to the Registrar’s discretion,\textsuperscript{97} but also disjunctively relate to ‘other exposures’.\textsuperscript{98} Although the latter is not defined, it may also relate to a risk exposures – the Schedule\textsuperscript{99} is compatible with a synthetic securitisation scheme constituting an ABCP programme. As already noted, this was prevalent in Canada. Since an ‘originator’ also means ‘an institution that serves as a sponsor in respect of the programme that acquires exposures other than from the sponsor’s own balance sheet’,\textsuperscript{100} the sponsor will be regarded as an originator in an ABCP programme – a principal that is echoed at paragraph (c) of the definition of a ‘sponsor’.\textsuperscript{101} The term ‘sponsor’ has a wide definition which is further dealt with below.\textsuperscript{102} Suffice to say for present purposes that it is defined in the Schedule\textsuperscript{103} as an institution that, either in fact or in substance, performs certain activities:\textsuperscript{104} management of the ABCP programme,\textsuperscript{105} advising the ABCP programme,\textsuperscript{106} placement of securities on the market,\textsuperscript{107} provision of a liquidity facility to the ABCP programme,\textsuperscript{108} or provision of a credit-enhancement facility to the ABCP programme.\textsuperscript{109}

\textsuperscript{91}Beaudin \textit{et al} (n 79 above) 1.
\textsuperscript{92}K K Kelly, PJ Kroft & M McElheran ‘Asset securitization in Canada: Recent important developments’ in Deutsche Bank (n 81 above) 38.
\textsuperscript{93}Beaudin \textit{et al} (n 79 above) 1.
\textsuperscript{94}n 2 above, para 1: “‘asset-backed commercial paper (‘ABCP’ ) programme’ means a programme in terms of which predominately commercial paper with an original maturity of one year or less is issued to investors, which commercial paper is backed by assets or other exposures held in an insolvency remote special-purpose institution, or such other programme as may be specified in writing by the Registrar’.
\textsuperscript{95}The consideration of this to be an oversimplification does not relate to the common commercial tenets of ABCP programmes, but rather to the legal implications of the applicable legislation. However, such a discussion would constitute a digression at this stage.
\textsuperscript{96}Fabozzi & Kothari (n 6 above) 169.
\textsuperscript{97}Schedule (n 2 above) para 5 \textit{et seq}.
\textsuperscript{98}As above.
\textsuperscript{99}n 2 above.
\textsuperscript{100}See n 20 above.
\textsuperscript{101}See n 37 above. Here the reader comes to comprehend the reference to ‘non-bank sponsored ABCP programmes’ in ch 2 para 7 above. South African law and Canadian law is very similar on this point, as will be seen in para 2.2.3 below.
\textsuperscript{102}See para 2.4 below.
\textsuperscript{103}n 2 above.
\textsuperscript{104}n 2 above, para (c) of the para 1 definition of ‘sponsor’.
\textsuperscript{105}n 2 above, para (c)(i) of the para 1 definition of ‘sponsor’.
\textsuperscript{106}As above.
\textsuperscript{107}n 2 above, para (c)(ii) of the para 1 definition of ‘sponsor’.
\textsuperscript{108}n 2 above, para (c)(iii) of the para 1 definition of ‘sponsor’.
\textsuperscript{109}n 2 above, para (c)(iv) of the para 1 definition of ‘sponsor’.

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No hint of meaning as to ‘in fact’ or ‘in substance’ is cast; therefore, such phrases retain their common meanings. ‘[I]n fact’ would strictly refer the institution actually performing the said activities; loosely, it would refer to the institution only alleging to be performing, or maybe performing, the said activities. ‘[I]n substance’ would refer to the institution in essence or inherently performing the said activities. Suspended between the principal that every word is important and interpretation ex abundante cautela the interpretive inclination tends towards the common law presumption of effectual and purposeful legislation, and it is proposed that the phrase ‘in fact or in substance’ must denote that the institution may in essence or in name only perform the said activities and retain its designation. Furthermore, it is imperative that cognisance is taken of the conjunctives and disjunctives employed. The activities to be performed are the managing or advising on the ABCP programme, and placing securities into the market, and/or providing a liquidity facility to the ABCP programme or providing a credit-enhancement facility to the ABCP programme.

2.2.3 Originators in Canadian law

The Office of the Superintendent of Financial Institutions (OSFI) in Canada has issued a guideline, in separate chapters, with regards to capital adequacy requirements, and which has been effective since December 2014. OSFI ‘regulates and supervises all banks in Canada, and all federally incorporated or registered trust and loan companies, insurance companies, cooperative credit associations, fraternal benefit societies and private pension plans’, to the exclusion of consumer-related issues and the securities industry. The included institutions

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110 See n 37 above.
111 See Onions (n 39 above) 667.
112 As above.
113 Onions (n 39 above) 2063.
114 Keyter v Minister of Agriculture 1908 NLR 522, as quoted in Botha (n 50 above) 70, and as quoted in Makone & Another v Chairperson of the Zimbabwe Electoral Commission and Another (2008) ZAHLR 38: ‘It is the duty of the court to give effect to every word which is used in a statute unless necessity or absolute intractability of the language employed compels the Court to treat the words as not written…Another cardinal rule in ascertaining the meaning of a statute is that in construing the words used we are to ascertain the meaning from the words themselves, and not from what we imagine to have been the intention of the legislature.’
115 Secretary for Inland Revenue v Somers Vine 1968 2 SA 138 (A), as quoted in Botha (n 50 above) 71.
116 Botha (n 50 above) 74.
117 n 27 above.
118 Own italics.
121 As above.
are known as Federally Regulated Financial Institutions.\textsuperscript{122} The Guideline\textsuperscript{123} applies to banks,\textsuperscript{124} bank holding companies,\textsuperscript{125} cooperative retail associations,\textsuperscript{126} federally regulated trust companies\textsuperscript{127} and federally regulated loan companies.\textsuperscript{128}

Although the Guideline\textsuperscript{129} contains no definition of ‘originator’, it indeed defines ‘originating bank’.\textsuperscript{130} It appears as if OSFI here,\textsuperscript{131} and throughout chapter seven,\textsuperscript{132} only refers to banks with regards to the securitisation framework,\textsuperscript{133} and not to the other ‘institutions’\textsuperscript{134} that the Guideline applies to.\textsuperscript{135} The Canadian definition of ‘originating bank’\textsuperscript{136} is very similar to the South African definition of ‘originator’.\textsuperscript{137} The first paragraph of the former appears to be intended to encapsulate the first two paragraphs of the latter, but falls short of doing this due

\textsuperscript{123} n 119 above, 1.
\textsuperscript{124} Bank Act SC 1991 c 46 sec 2: “‘bank’ means a bank listed in Schedule I or II”. The latter schedules literally contain lists of all the banks in Canada.
\textsuperscript{125} Bank Act SC 1991 c 46 sec 2: “‘bank holding company’ means a body corporate that is incorporated or formed under Part XV”.
\textsuperscript{126} Cooperative Credit Associations Act SC 1991 c 48 sec 2: “‘association’ means a body corporate referred to in section 14”; Cooperative Credit Associations Act SC 1991 c 48 sec 14: ‘This Act applies to the former-Act association, and to every body corporate incorporated or formed by or under this Act, so long as it is not discontinued under this Act”; Cooperative Credit Associations Act SC 1991 c 48 sec 2: “‘body corporate’ means an incorporated body wherever or however incorporated”; ‘retail association’ is implicitly included as such an ‘association’.
\textsuperscript{127} Trust and Loan Companies Act SC 1991 c 45 sec 2: “‘company’ means a body corporate to which this Act applies”; Trust and Loan Companies Act SC 1991 c 45 sec 12: ‘This Act applies to every body corporate—
\textsuperscript{(a)} that is incorporated or continued under this Act,
\textsuperscript{(b)} to which the Trust Companies Act applied immediately before the coming into force of this section, or
\textsuperscript{(c)} to which the Loan Companies Act applied immediately before the coming into force of this section, and that is not discontinued under this Act’.
\textsuperscript{129} n 119 above.
\textsuperscript{130} n 119 above, 6 sec 7.2.1 para 18: ‘For risk-based capital purposes, a bank is considered to be an originator with regard to a certain securitisation if it meets either of the following conditions:
\textsuperscript{(a)} The bank originates directly or indirectly underlying exposures included in the securitisation; or
\textsuperscript{(b)} The bank serves as a sponsor of an asset-backed commercial paper (ABCP) conduit or similar programme that acquires exposures from third-party entities. In the context of such programmes, a bank would generally be considered a sponsor and, in turn, an originator if it, in fact or in substance, manages or advises the programme, places securities into the market, or provides liquidity and/or credit enhancements’.
\textsuperscript{131} As above.
\textsuperscript{132} n 119 above.
\textsuperscript{133} n 119 above, 3 sec 7.1 para 4.
\textsuperscript{134} n 128 above, 5 para 1.
\textsuperscript{135} As above.
\textsuperscript{136} See n 130 above.
\textsuperscript{137} See n 20 above.
to unscrupulous drafting. This resolves around the question of what OSFI considers ‘exposures’ to be. Whilst OSFI indicates what this means, it is confusing, since the reader does not know if OSFI intended different meanings to ‘securitisation exposure’ and to ‘exposure’. Two separate notions can be grasped: Firstly, as to OSFI’s meaning of the former to be the inverse of the South African understanding of the latter, the legal basis of the former is elusive since it goes beyond the South African legal understanding of a ‘right’ or ‘interest’. If another interpretation is followed, taking into regard the definition of underlying instruments, it appears as if the Guideline is presenting an extremely limited genus of securitisable assets. OSFI notes that an institution will be considered the supplier of the assets if ‘the assets are held on the balance sheet of the institution at any time prior to being transferred to an [sic.] SPI’. It is uncertain what ‘supplier of assets’ means. From OSFI notes it appears that it can refer to remote originators and sponsors; therefore, the possibility exists that the aforesaid quotation refers to the originating bank.

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138 See n 130 above.
139 n 119 above, 4-5 sec 7.1 para 11-12: ‘11. Banks’ exposures to a securitisation are hereafter referred to as “securitisation exposures”. Securitisation exposures can include but are not restricted to the following: asset-backed securities, mortgage-backed securities, credit enhancements, liquidity facilities, interest rate or currency swaps, credit derivatives and tranched cover as described in Chapter 5 – Credit Risk Mitigation, paragraph 87. Reserve accounts, such as cash collateral accounts, recorded as an asset by the originating bank must also be treated as securitisation exposures… 12. A resecuritisation exposure is a securitisation exposure in which the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation exposure. In addition, an exposure to one or more resecuritisation exposures is a resecuritisation exposure…’.
140 Presumably for purposes of the securitisation framework only.
141 As above.
142 n 119 above, 5 sec 7.1 para 17: ‘Underlying instruments in the pool being securitised may include but are not restricted to the following: loans, commitments, asset-backed and mortgage-backed securities, corporate bonds, equity securities, and private equity investments. The underlying pool may include one or more exposures’.
143 See n 128 above.
144 As above.
145 It is uncertain how ‘assets…held on the balance sheet of the institution’ differs from assets the institution holds on its balance sheet.
146 n 119 above, 6 para 19.
147 As above.
148 As above.
149 As above.
2.3 Remote originator

The remote originator,\(^\text{150}\) *alias* the bridge loan\(^\text{151}\) or warehouse lender,\(^\text{152}\) supplies interim funds during the construction of a scheme\(^\text{153}\) to fast-track the marketing and issue of securities.\(^\text{154}\) However, a remote originator is not *sine qua non* to a securitisation scheme: In practice, the sponsor acts as initial financier to the scheme.\(^\text{155}\) These are realistic circumstances if the sponsor is a bank and able to mobilise internal funds,\(^\text{156}\) which is presumably the more probable situation with synthetic securitisation schemes; otherwise, a remote originator would be the initial financier.\(^\text{157}\) In traditional securitisation schemes, the underlying assets are said to be kept ‘in warehouse’ until sale.\(^\text{158}\) Although this is a figure of speech, closer scrutiny in the case of synthetic securitisation is necessary. A direct\(^\text{159}\) method in a traditional securitisation scheme, as inferred from the Mortgage Bankers Association, would be a short-term revolving line of credit to the SPI\(^\text{160}\) involving secured lending.\(^\text{161}\) The Schedule\(^\text{162}\) contradicts itself on this point, since it provides for the counter-performance on the commercial paper issued on the primary market to be used to enter into the credit derivative,\(^\text{163}\) but also for a remote originator to supply these funds.\(^\text{164}\) Read together, it proposes that the SPI does not have enough funds via the primary market to perform in terms of the credit default swap, meaning that the solvency test\(^\text{165}\) is not satisfied and that repercussions upon a credit event may be systemic. The Schedule\(^\text{166}\) makes no mention of the interim nature of assistance by a remote originator,\(^\text{167}\) but

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\(^{150}\) Schedule (n 2 above) para 1: “remote originator” means an institution that directly or indirectly lends money to a special-purpose institution in order for the special-purpose institution to take transfer of assets in terms of a traditional securitisation scheme or risk in terms of a synthetic securitisation scheme”. Remote origination has a wider meaning in Canada. Office of the Superintendent of Financial Institutions in Canada (n 119 above) 6 para 19: ‘An institution is considered the supplier of the assets…[i]f the institution [i.e. remote originator] lends to an SPE in order for that SPE to grant a loan to a borrower as though it were the institution [i.e. originating bank].’ It is uncertain how this will happen, due to limitations on the relationship between the originating bank in the SPI. [Office of the Superintendent of Financial Institutions in Canada (n 119 above) 8-9 para 33.] Two possibilities are agency and the sale, specifically, of external equity.

\(^{151}\) Karoly (n 9 above) 21.

\(^{152}\) As above.

\(^{153}\) As above.

\(^{154}\) As above.

\(^{155}\) As above.

\(^{156}\) As above.

\(^{157}\) As above.

\(^{158}\) As above.

\(^{159}\) As above.

\(^{159}\) Ashcraft & Schuermann (n 4 above) 6; n 37 above.

\(^{160}\) See n 150 above.


\(^{162}\) As above.

\(^{163}\) n 2 above.

\(^{164}\) n 2 above, para 1 definition of ‘synthetic securitisation scheme’.

\(^{165}\) See n 150 above.

\(^{166}\) Companies Act 71 of 2008 sec 4.

\(^{167}\) n 2 above.

\(^{168}\) See n 150 above.
the previous example has illustrated that the only safe time to use a remote originator in a synthetic securitisation scheme is as an initial measure, for example if the funding raised from the primary market is less than the amount required to take transfer of the risk at the very beginning of the scheme, and the SPI repays the remote originator once its cash flow enables it to rid itself of the remote originator.

The presence of a remote originator can be destructive to synthetic securitisation schemes: Although the remote originator is defined in relation the SPI, it remains a party acting in a primary role yet differentiated from originators/repackagers. Unless it holds equity in the SPI, its interest is not in the success of the scheme, but in return of the notional amount and the interest thereon. As markets change, so does its perception of the underlying assets/risks in the scheme so that it demands more security for the credit it provides to the SPI, the risk being that, although the remote originator’s credit is available for use if the credit event transpires, the SPI’s assets are tied up in the remote originator so that the SPI cannot perform in terms of the credit derivative.

As an institution acting in a primary role, the remote originator may not directly or indirectly acquire or hold any equity share capital of or exceeding twenty percent of all the nominal value of the SPI. A few matters become relevant with regard to this provision. Firstly, the superfluous term ‘equity share capital’ either epitomises legislative drafting or it constitutes a desultory attempt at an Americanism; in any event, the phraseology identifies the prevalence of par value (PV) shares in terms of the Companies Act 68 of 1973. Fortunately, it remains possible to superimpose a percentage-based logic on the mechanics of no par value (NPV) shares that currently pervade our corporate law regime. Secondly, although it is my conclusion that the disjunctive between ‘acquire’ and ‘hold’ was an attempt to include beneficial shareholding, this aim becomes redundant through the wording of section 56(1) of the Companies Act. However, the remote originator is disenfranchised of the right

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168 As above.
169 Schedule (n 2 above) para 1 definition of ‘primary role’.
170 E.g. Ashcraft & Schuermann (n 4 above) 6.
171 Schedule (n 2 above) para 1 definition of ‘primary role’.
172 Schedule (n 2 above) para 5(2)(o)(i)(A).
173 See n 115 above.
174 See Cilliers et al (n 41 above) 222-224.
175 Companies Act 71 of 2008 sec 35(2).
176 71 of 2008.
to determine the outcome of the voting at a SPI’s general meeting.\(^\text{177}\) This is somewhat of an inversion of the law interpreted in *Smuts v Booyensmarkplaas (Edms) Bpk en ’n Ander v Booyens*,\(^\text{178}\) where the Court decided that restrictions on transferability of shares in a private company constitutes a *pactum de non cedendo*.\(^\text{179}\) According to Delport – on 4 August 2010 in a lecture of the LRR801 module at the University of Pretoria – the latter approach is erroneous, in that such shares actually constitute collections of rights and duties in which the right beyond said restrictions is not prevalent. It is possible that the remote originator will hold voting rights in terms of its shares in the SPI; however, the statutory condition pragmatically provides that the remote originator’s exercised majority vote through *de facto* control at a general meeting must be disregarded.\(^\text{180}\) As such, a reference to these rights as control rights\(^\text{181}\) becomes a misnomer.

It is uncertain what a ‘general meeting’\(^\text{182}\) denotes. It is presumed that this will relate, under these circumstances, to the remote originator’s annual general meeting (AGM).\(^\text{183}\) However, the obscure reference to ‘general meeting’ at regulation 113(1)(b) of the 2011 Companies Regulations\(^\text{184}\) hints at a meeting akin to a shareholders meeting\(^\text{185}\) in terms of section 61(1) and section 61(2) of the Companies Act,\(^\text{186}\) whereas a shareholders meeting in terms of section 61(3) seems too dislocated from the context of ‘general meeting’ in the Company Regulations.\(^\text{187}\) Section 45 of the Companies Act\(^\text{188}\) would be inapplicable if the remote originator, being a company with the primary business of lending money, exercises its function in the ordinary course of its business;\(^\text{189}\) therefore, a meeting in terms of section 61(3) is unlikely to occur to such remote originators. However, in the absence of said exception, and in

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\(^{177}\) Schedule (n 2 above) para 5(2)(o)(i)(B).

\(^{178}\) 2001 4 SA 15 (SCA).

\(^{179}\) Smuts (n 178 above) 18.

\(^{180}\) This statement is attributed Prof PA Delport, as per the lecture presented on 1 September 2010 for the same course at the same university.

\(^{181}\) As above.

\(^{182}\) Schedule (n 2 above) para 5(2)(o)(i)(B).

\(^{183}\) Companies Act 71 of 2008 ‘annual general meeting’ at secs 1, 61(7) *et seq*.


\(^{185}\) Companies Act 71 of 2008 sec 1: “shareholders meeting”, with respect to any particular matter concerning a company, means a meeting of those holders of that company’s issued securities who are entitled to exercise voting rights in relation to that matter’.

\(^{186}\) 71 of 2008.

\(^{187}\) See n 184 above.

\(^{188}\) 71 of 2008.

\(^{189}\) Companies Act 71 of 2008 sec 45(1)(b)(ii).
the presence of a section 61(3) meeting, the remote originator would be extending a ‘[l]oan or other financial assistance’ to the SPI in terms of section 45 of the Companies Act.\textsuperscript{190}

Given the function of remote originators, it would not be surprising to have encountered them holding shares akin to the historical deferred shares in the SPI, subject to the said limitation,\textsuperscript{191} prior to the implementation of the Companies Act 71 of 2008. Since shareholding in the SPI technically constitutes the first buffer\textsuperscript{192} in the securitisation scheme’s stratified model,\textsuperscript{193} the economic spei of the shares\textsuperscript{194} would simply be an added gain for a remote originator receiving such shares as counter-performance. However, the remote originator’s role as per definition varies from the scenarios presupposed, e.g. the fees and/or premium paid to the SPI by the remote originator,\textsuperscript{195} which is primarily utilised for the issued commercial paper\textsuperscript{196} or channeled to institutions acting in a secondary role.\textsuperscript{197} These provisions are nonsensical since the remote originator is in practice not likely to be a party to the applicable credit derivative, just as all references to ‘fees’ in the Schedule\textsuperscript{198} relate to parties acting in a secondary role.

\subsection*{2.4 Sponsor}

Sponsors in relation to ABCP programmes have been discussed elsewhere.\textsuperscript{199} In addition, a sponsor is defined, in relation to synthetic securitisation schemes, as an institution that facilitates indirect risk transfer (i.e. not from the sponsor’s own balance sheet) \textit{ex officio} as an arranger and/or structuror to the SPI, either at commencement or during the synthetic securitisation scheme’s existence.\textsuperscript{200} Therefore, whereas it was apparent from secondary sources that the remote originator plays only an initial role,\textsuperscript{201} the sponsor is, according to the Schedule,\textsuperscript{202} not limited to a specific time-frame of the scheme. The sponsor is a ‘structured

\begin{footnotesize}
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\item[190] 71 of 2008.
\item[191] See Cilliers \textit{et al} (n 41 above) 232-233; PA Delport \textit{The new Companies Act manual} (2011) 33 n 40.
\item[192] See Das (n 76 above) 329.
\item[193] Schedule (n 2 above) para 5(1)(a)(i).
\item[194] Another concept attribute to Prof PA Delport.
\item[195] Schedule (n 2 above) para (c)(B) of the para 1 definition of ‘synthetic securitisation scheme’.
\item[196] Schedule (n 2 above) para (c)(i) of the para 1 definition of ‘synthetic securitisation scheme’.
\item[197] Schedule (n 2 above) para (c)(ii) of the para 1 definition of ‘synthetic securitisation scheme’.
\item[198] n 2 above.
\item[199] Para 2.2.2 above.
\item[200] n 37 above. In Germany, the concept of a sponsor ambiguous, since it can refer to both sponsor as we have come to understand it to mean, and to KfW that sponsors the securitisation platform. [K Birke ‘German market for mortgage backed securities (MBS)’ (2008) 23 \textit{Journal of International Banking Law and Regulation} 618 618; see ch 2 para 8 above.] There are two platforms for synthetic securitisation in Germany, viz. PROMISE and PROVIDE. [Birke (n 200) 618.] This is discussed elsewhere.
\item[201] Para 2.3 above.
\item[202] n 2 above.
\end{footnotes}
\end{footnotesize}
financier’, an ‘arranger’ that manages the securitisation process for the originator/repackager,\textsuperscript{203} undertaking the preliminary feasibility study,\textsuperscript{204} due diligence\textsuperscript{205} (which, according to Teasdale of Yieldcurve.com\textsuperscript{206} and Ashman and Bestwick of Walkers,\textsuperscript{207} involves examining the assets’ past and projected future performance) and financial analysis\textsuperscript{208} (\textit{inter alia} strategising for beneficial accounting treatment and lulling capital regulation compliance),\textsuperscript{209} appointing the required service providers,\textsuperscript{210} determining the scheme and securities’ structure(s),\textsuperscript{211} ensuring the presence of non-petition language in the agreements between the SPI and relevant parties,\textsuperscript{212} ensuring the SPI’s insolvency-remoteness,\textsuperscript{213} consulting with the rating agency,\textsuperscript{214} marketing the commercial paper,\textsuperscript{215} and ensuring that the SPI’s winding-up by voting security holders or trustees with similar rights does not violate a

\textsuperscript{203} Karoly (n 9 above) 19. It will be clear to the reader from the sponsor’s functions set out above that certain obligations would exist between the sponsor and the originator on the one hand, and the sponsor and the SPI on the other. This also validates the statement that ‘securitisation is a time-consuming and complex endeavour’ [N Locke ‘Aspects of traditional securitisation in South African law’ unpublished LLD thesis, University of South Africa, 2008 34] which causes ‘many advisors who have successfully completed one securitisation utilising the expertise they have acquired in follow-up transactions. It has also led originators to engage in repeat securitisations’. [Locke (n 203) 34.] It would be superfluous to set out the obligations between the sponsor, the SPI and the originator/repackager here, since the only deduction that can be made from the lack of information thereto in the Schedule [n 2 above.] is that this is a matter left to the discretion of said parties. At the minimum the following deserves mention: With reference to ‘asset management and other financial market dealings’, [D Frase ‘The management contract’ in D Frase (ed) \textit{Law and regulation of investment management} (2011) 62.] Frase states that a service ‘by way of business’ [D Frase ‘The management contract’ in Frase (n 203) 62.] for remuneration ‘normally’ [D Frase ‘The management contract’ in (n 203) 62.] constitutes a contract. [D Frase ‘The management contract’ in Frase (n 203) 62.] Whereas the employment of the term ‘normally’ may \textit{prima facie} seems superfluous, the ongoing nature of financial market dealings presupposes disputes relating to or based on performance rendered in the absence of a written contract. [D Frase ‘The management contract’ in (n 203) 62.] South African law distinguishes between, primarily, actual consensus and, secondarily, ostensible consensus. [A Van Aswegen \textit{et al} \textit{Kontraktereg} (2004) 12.] The establishment of actual consensus ignores the subjectivity of contract parties in favour of the externalisation of said parties’ will or intentions. [Van Aswegen \textit{et al} (n 203) 12.] Whereas one may be bluffed to regard the latter as an objective approach, it is actually a subjective approach in the light of courts’ application of the \textit{plus valet quod agitur quam quod simulate concipitur} principle. [Van Aswegen \textit{et al} (n 203) 65.] Ostensible consensus exists where one party has the reasonable belief of consensus, [Van Aswegen \textit{et al} (n 203) 12, 51.] for which the basis of contractual liability would be considerations such as \textit{bona fides}, legal certainty, creation of unacceptable risks and protection of reasonable expectations. [Van Aswegen \textit{et al} (n 203) 12.].

\textsuperscript{204} Karoly (n 9 above) 19.

\textsuperscript{205} As above.


\textsuperscript{207} I Ashman & H Bestwick ‘Securitisation in the Cayman Islands’ \url{https://www.securitization.net/pdf/walkers_sec_070202.pdf} (accessed 29 January 2013) 3.

\textsuperscript{208} Karoly (n 9 above) 19.

\textsuperscript{209} Ashman & Bestwick (n 207 above) 1.

\textsuperscript{210} Karoly (n 9 above) 19.

\textsuperscript{211} Karoly (n 9 above) 19-20.

\textsuperscript{212} Ashman & Bestwick (n 207 above) 3.

\textsuperscript{213} As above.

\textsuperscript{214} Karoly (n 9 above) 20.

\textsuperscript{215} As above.
condition or contravene any stipulation. However, ‘structurors’ are apparently investment bankers, also known as the lead manager or programme administrator, gathering the underlying and issuing the securities on the primary market. The discrepancy between the ‘arranger’ and ‘structuror’ has been based on the former’s pro-activity and the latter’s role once the scheme is operative, although some regard them as synonymous. The sponsor has also been referred to as the ‘dealer’. Although these may sound like various roles, they are usually undertaking by a single person, for example in the asset backed domestic medium term note programme of On the Cards Investments II (Pty) Ltd guaranteed by Storecard Guarantee Corporation II (Pty) Ltd both of these roles were assumed by ABSA Capital, and in the asset backed note programme of Blue Granite Investments the arranger was the Standard Bank of South Africa Ltd (SBSA), the dealer was SBSA ‘and any other [d]ealer appointed under the Issuer Programme from time to time in terms of the Programme Agreement, which appointment may be for a specific issue or on an ongoing basis’, the administrator was SBSA ‘acting through its Group Finance division’.

The sponsor operates in a precarious position with regards to numerous participants of the synthetic securitisation scheme. Primarily, there exists a possibility of asymmetric information

216 Ashman & Bestwick (n 207 above) 3.
220 As above. The role of sponsors seems to be similar in Canada, where they are known to ‘[e]stablish conduits, select and administer the assets held by the conduit, and arrange for the sale of its issues of commercial paper’ – Chant (n 80 above) 6.
221 Karoly (n 9 above) 20.
223 Das (n 76 above) 416.
between an originator and a sponsor\textsuperscript{231} since the former can either make misrepresentations to the sponsor, or can transact with obligors subject to a mistake,\textsuperscript{232} causing predatory lending/borrowing.\textsuperscript{233} This may be curbed through the issue of warranties by the originator to the sponsor.\textsuperscript{234} A breach of such warranties is a contended rationale for the repurchase of risk;\textsuperscript{235} however, this justification is dubious in South African law given the doctrine of separate legal personality. However, the inverse is also true: There exists possible asymmetric information between sponsors and remote originators,\textsuperscript{236} asset managers\textsuperscript{237} and CRAs\textsuperscript{238} with regards to the quality of the underlying transactions,\textsuperscript{239} which is known as an ‘adverse selection problem’.\textsuperscript{240} This does not necessarily boil down to null and void or voidable contracts based of \textit{dolus} or \textit{error}, but may simply relate to sponsors securitising risk on lemons and dispense with better quality credit elsewhere.\textsuperscript{241} In hybrid CDOs the remote originator’s doubt concerning the value of underlying assets triggers proactive defence against their overvaluation as collateral assets,\textsuperscript{242} which can force sponsors to take a funded position in the event of haircuts.\textsuperscript{243} Secondly, investors’ asset managers also suffers from asymmetric information with sponsors,\textsuperscript{244} which can be mitigated by proper due diligence by the asset manager, the sponsors’ repute and its possible credit enhancement. Thirdly, CRAs may also be victims of sponsors’ lemons.\textsuperscript{245}

\section*{2.5 Repackager}

\subsection*{2.5.1 South Africa}

According to the Schedule,\textsuperscript{246} a ‘repackager’ is succinctly an institution that acquires and thereafter transfers the risk relating to third parties’ national Government securities\textsuperscript{247} or

\begin{thebibliography}{99}
\bibitem{231} Ashcraft & Schuermann (n 4 above) 5.
\bibitem{232} Ashcraft & Schuermann (n 4 above) 5-6.
\bibitem{233} As above.
\bibitem{234} Ashcraft & Schuermann (n 4 above) 6; Akerlof (n 5 above) 500.
\bibitem{235} Ashcraft & Schuermann (n 4 above) 6.
\bibitem{236} As above.
\bibitem{237} As above.
\bibitem{238} Ashcraft & Schuermann (n 4 above) 6-7.
\bibitem{239} Ashcraft & Schuermann (n 4 above) 7.
\bibitem{240} As above.
\bibitem{241} As above.
\bibitem{242} Ashcraft & Schuermann (n 4 above) 6-7.
\bibitem{243} Ashcraft & Schuermann (n 4 above) 6-7.
\bibitem{244} Ashcraft & Schuermann (n 4 above) 7.
\bibitem{245} n 2 above.
\bibitem{246} As above.
\bibitem{247} As above.
\bibitem{248} Ashcraft & Schuermann (n 4 above) 7.
\bibitem{249} n 2 above.
\end{thebibliography}

\textsuperscript{241} Securitisation of national Government securities must be distinguished from national Governments securitising their receivables. Indeed, ‘financial institutions, large corporates [sic.], quasi-government agencies and even local governments and municipalities’ [AA Jobst ‘Asset securitization as a risk management and funding tool: What
qualifying items via its balance sheet in terms of and either at commencement or during a synthetic securitisation scheme. According to Kothari, repackaging refers to the repackaging of credit or other structured products into original products, i.e. repackaging by component (structured finance resecuritisations), or repackaging existing credit into credit with a different term, i.e. repackaging by tenure (revolving or refinancing type structures). Rephased in terms of the synthetic variant, repackaging or re-bundling may denote institutions transferring securities’ credit risk to other institutions in whichever fashion in order for the latter institution to issue securities based on the credit risk of the former securities, therefore creating viable investments based on the credit risk of possibly inaccessible or unattractive securities.

It is clear from the definition that an originator will not deal with the specified assets, or, if it does, it will become a repackager. ‘[N]ational Government securities’ is defined in the Schedule as ‘all loan stock issued by the national Government or instruments guaranteed by national Government securities’ [N]ational Government securities’ is defined in the Schedule as ‘all loan stock issued by the national Government or instruments guaranteed by small firms need to know’ (2006) 32 Managerial Finance 731 731.] are involved in securitisation schemes. In the first world, the Italian Dipartimento del Tesoro undertook the 1999 securitisation of delinquent social security contributions in order to decrease its fiscal deficit. [V Kothari ‘Securitisation of government revenues’ http://www.vinodkothari.com/govtrevenues.htm (accessed 19 December 2012.)] By 2004, the Italian Government had already extended its basis of receivables to state-owned real estate (Società Cartolarizzazione Immobili Pubblici Srl), [Eurostat ‘Three decisions on Italy: SCIP, ISPA and Concessionari d’imposta’ 2005 http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-230 52005-AP/EN/2-23052005-AP-EN.PDF (accessed 4 January 2013).] concession for a high-speed rail link (Infrastrutture S.p.A. with Rete Ferroviaria Italiana S.p.A. and Treno Alta Velocità S.p.A.) [Eurostat (n 247.)] and lottery revenues, [P Munter ‘The Italian experience: Flair keeps deficit in check’ 2004 http://www.ft.com/intl/cms/s/1/e5d3994-3ef2-11d9-8e70-00000e2511c8.htm l#axzz2GzE1lYet (accessed 4 January 2012).] Another famous example is the so-called ‘tobacco bonds’ issued by various US states based on the securitisation of receivables owing in terms of the master settlement agreement between forty-six states and the four largest tobacco producers (Brown & Williamson Tobacco Corp., Lorillard Tobacco Co. Philip Morris Inc. and RJ Reynolds Tobacco Co.), [‘Master settlement agreement’ http://ag.ca.gov/tobacco/pdf/1msa.pdf (accessed 1 February 2015.)] Third world governments, e.g. Argentina, Brazil, Mexico and Venezuela, [S Ketkar & D Ratha ‘Securitization of future flow receivables: A useful tool for developing countries’ 2001 http://www.imf.org/external/pubs/ft/fandd/2001/03/ketkar.htm (accessed 19 December 2012.)] have also employed the securitisation process. Even though experts from the Royal Bank of Scotland and the World Bank have suggested participation from developing countries subsequent to the devaluation of the Mexican peso, the Asian liquidity crisis and the Russian and Equadoran debt defaults, [Ketkar & Ratha (n 247.)] involvement actually dates back to Telmex in 1987. [S Das Perspectives on financial services (2009) 235.]

See n 21 above.


As above.

As above.

As above.

As above.

As above.

As above.


Giesecke (n 255 above) 1 – 1.

n 2 above.

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the national Government’. The capitalisation of ‘government’ signifies that the ambit of the phrase is limited to the South African government. ‘[Q]ualifying items’ are defined in the Schedule as ‘all loan stock listed on the Bond Exchange of South Africa, or any other loan stock listed on a financial exchange licensed by the Financial Services Board’. Both the originator and the repackager are creditors relative to the obligor with regards to assets or possibly risks actually held; therefore, the difference resorts in the concepts of asset and equity. An understanding of this is necessary, since the term ‘assets’ is defined in the Schedule and is a singular term that has relevance in the process of true sale in traditional securitisations and hybrid CDO’s, but is also evident in the definition of a synthetic securitisation scheme as to the SPI’s performance of commercial paper to investors, with investors’ counterperformance – so-called ‘proceeds’ – utilised for credit-risk exposure and assets serving as collateral. However, ‘[t]raditional securitisation must be distinguished from synthetic securitisation. In a synthetic securitisation the assets are not transferred to the SPV.’ Given the aforementioned, these assets are not intrinsic in the synthetic securitisation process, but are statutorily necessitated, through the use of the conjunctive ‘and’, in order to aid in payments on issued

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\text{\textsuperscript{258} n 2 above, para 1.}
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\text{\textsuperscript{259} n 2 above.}
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\text{\textsuperscript{260} n 2 above, para 1.}
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\text{\textsuperscript{261} n 2 above. I specifically excluded legal comparison on this matter, since, firstly, most jurisdictions have not codified securitisations and, secondly, given the aforementioned, such a comparison resorts within the field of accounting rather than law.}
\]
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\text{\textsuperscript{262} n 2 above, para (a) of the para 1 definition of ‘synthetic securitisation scheme’. The question arises as to whether the collateral assets in the latter could coincide with the underlying assets in the former, e.g. in a hybrid scheme. Such a postulation is rejected by the express provision that the ‘commercial paper [issued]…are claims against the said assets transferred or required’ [n 2 above, para 4(1)(a)(i)] – inclusio unius est exclusio alterius. [Botha (n 50 above) 109]. It is mentioned in obiter that the latter quotation is in any event exemplary of bad legislative drafting, since it takes no cognisance of the principle of separate legal personality. [see Salomon v Salomon and Co Ltd 1897 AC 22 HL.] A counterargument may be that inter alia cash flows arising from such assets [n 2 above, para (c)(ii)(A) of the para 1 definition of ‘synthetic securitisation scheme’] are used to make payments inter alia with respect to the issued commercial paper [n 2 above, para (c)(i) of the para 1 definition of ‘synthetic securitisation scheme’] may not denigrate such a postulation. Perhaps one can argue that the assets’ ‘collateral’ nature must indicate liquidity as a counter-argument, [M Fleuriet Investment banking explained: An insider’s guide to the industry (2008) 202; see IH Giddy ‘Asset securitization in Asia’ 2000 http://mx.nthu.edu.tw/~chclin/Class/absasia.pdf (accessed 9 January 2013).] but then again, illiquidity is not always the rationale for securitisation. In any event, ‘collateral’ is neither defined in the Schedule [n 2 above.] nor in the Banks Act 94 of 1990, nor does the Schedule [n 2 above.] indicate what the nature and extent of such collateral should be. This casts some doubt on the following clauses by Locke: ‘Traditional securitisation must be distinguished from synthetic securitisation. In a synthetic securitisation the assets are not transferred to the SPV.’ [Locke (n 203 above) 15.]
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\text{\textsuperscript{263} n 2 above, para (b) of the para 1 definition of ‘synthetic securitisation scheme’.}
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\text{\textsuperscript{264} n 2 above, para (b)(i) of the para 1 definition of ‘synthetic securitisation scheme’.}
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\text{\textsuperscript{265} n 2 above, para b(ii) of the para 1 definition of ‘synthetic securitisation scheme’.}
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\text{\textsuperscript{266} Locke (n 203 above) 15. Whereas the Schedule [n 2 above] makes a clear distinction between traditional and synthetic securitisation schemes, it makes no mention of hybrid structures. Therefore, it relies at its core on the difference between true and synthetic sale.}
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\text{\textsuperscript{267} Schedule (n 2 above) para (b)(ii) of the para 1 definition of ‘synthetic securitisation scheme’.}
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commercial paper\textsuperscript{268} or to institutions acting in a primary or secondary role.\textsuperscript{269} Although we employ the term ‘aid’ here in understanding that such payments are also made from the fees and/or premiums that the SPI receives,\textsuperscript{270} the conjunctive ‘and’\textsuperscript{271} indicates that such collateral assets’ employment is necessitated.

Not only can the express reference to ‘assets’ not be a pure affirmation of the entity principle\textsuperscript{272} since it is \textit{res ipsa loquitur} from the conjunctive ‘and’\textsuperscript{273} that the entity principle encompasses more than just such assets, but neither can such reference, with the conjunctive borne in mind, be re-affirmative of the entity principle since that would constitute legislative drafting grossly \textit{ex abundante cautela}. Paragraph (b) of the definition of ‘liquidity facility’\textsuperscript{274} supports this logic. Therefore, this begs the question as to the Registrar’s intended definition and ambit of the term ‘assets’.\textsuperscript{275} For example, whilst a reserve account, effectively constituting an ‘asset’, has

\begin{itemize}
  \item[(a)] time differences between the payment of interest and principal on the assets transferred, or other payments due in terms of a traditional securitisation scheme, and payment in respect of the senior commercial paper;
  \item[(b)] time differences between the payment of interest and principal on assets that serve as collateral, purchased in terms of a synthetic securitisation scheme, and payment in respect of the senior commercial paper;
  \item[(c)] market disruptions; or
  \item[(d)] a combination of any of the matters specified above, and which facility does not constitute a credit-enhancement facility’.
\end{itemize}

\textsuperscript{268} Schedule (n 2 above) para (c)(i) of the para 1 definition of ‘synthetic securitisation scheme’.
\textsuperscript{269} Schedule (n 2 above) para (c)(ii) of the para 1 definition of ‘synthetic securitisation scheme’.
\textsuperscript{270} Schedule (n 2 above) para (c)(B) of the para 1 definition of ‘synthetic securitisation scheme’.
\textsuperscript{271} Schedule (n 2 above) para (c)(A) of the para 1 definition of ‘synthetic securitisation scheme’.
\textsuperscript{272} The capital employed by primary and secondary investors, [Cilliers \textit{et al} (n 41 above) 199, 221.] collectively constituting equity, [Cilliers \textit{et al} (n 41 above) 199-200.] is quantitatively equal to, [Cilliers \textit{et al} (n 41 above) 221.] according to the entity concept, [Cilliers \textit{et al} (n 41 above) 200] the employment of capital, [Cilliers \textit{et al} (n 41 above) 221.] i.e. assets, [Cilliers \textit{et al} (n 41 above) 221.] by the institute (assets are indicated as the debit to the credit of capital in the double entry system). [Cilliers \textit{et al} (n 41 above) 206].
\textsuperscript{273} Schedule (n 2 above) para (b) of the para 1 definition of ‘synthetic securitisation scheme’.
\textsuperscript{274} Schedule (n 2 above) para 1: ‘“liquidity facility” means a facility provided in respect of a traditional or synthetic securitisation scheme in order to cover deficiencies in cash flows within the said securitisation scheme(s), resulting from, amongst other things,
\begin{itemize}
  \item[(a)] time differences between the payment of interest and principal on the assets transferred, or other payments due in terms of a traditional securitisation scheme, and payment in respect of the senior commercial paper;
  \item[(b)] time differences between the payment of interest and principal on assets that serve as collateral, purchased in terms of a synthetic securitisation scheme, and payment in respect of the senior commercial paper;
  \item[(c)] market disruptions; or
  \item[(d)] a combination of any of the matters specified above, and which facility does not constitute a credit-enhancement facility’.
\end{itemize}
\textsuperscript{275} The experienced jurist knows that the common law, and much positive law, is not the correct venue to look for the answer. An asset is conceptually, and often for our purposes, distinguishable from a ‘thing’, [\textit{Bürgerliches Gesetzbuch} sec 90; PhJ Thomas, \textit{CG van der Merwe & BC Stoop Historiese grondslae van die Suid-Afrikaanse privaatreg} (2000) 153-154; LN van Schalkwyk & P de W van der Spuy \textit{Algemene Beginsels van die sakereg} (2008) 4.] which is not only a legal term but also traditionally had a virtually unlimited ambit. [M Radin ‘Fundamental concepts of Roman law’ (1925) 13 \textit{California Law Review} 207 207-209.] In addition, the widespread use of ‘property’, [\textit{Constitution of the Republic of South Africa} 1996 sec 25; \textit{Oblowitz v Oblowitz} 1953 4 SA 426 (C); \textit{De Charmoy v Day Star Hatcheries (Pty) Ltd} 1967 4 SA 188 (D); \textit{Lorentz v Melie and Others} 1978 3 SA 1044 (T); \textit{Cape Explosive Works Ltd and Another v Denel (Pty) Ltd and Others} 2001 3 SA 569 (SCA), Insolvency Act 24 of 1936; Deeds Registries Act 47 of 1937; Prescription Act 18 of 1943; Wills Act 7 of 1953; Prescription Act 68 of 1959; Security by means of Movable Property Act 57 of 1993] despite various efforts, [Thomas, \textit{Van der Merwe & Stoop} (n 276) 116; \textit{Regal v African Superslate (Pty) Ltd} 1963 1 SA 102 (A); \textit{Trust Bank van Afrika Beperk v Eksteen} 1964 3 SA 402 (A).] demonstrates that South African law has not been divested of English influences and its consequent perplexities. [see J Ball ‘The boundaries of property rights in English law’ (2006) 10.3 \textit{Electronic Journal of Comparative Law} 1 3 et seq; see DM Fox ‘Defective payments of
been utilised as the SPI’s first buffer against incurred losses, such a reserve account has been equated with the SPI’s joint stock capital in the BISTRO scheme. However, in the C*Star scheme, the reserve account constituted the SPI’s first loss commercial paper tranche.

The Schedule specifically defines ‘assets’, bearing in mind that securitisation often deals with intangible assets, ‘as defined in the Framework for the Preparation and Presentation of Financial Statements (“the Framework”) in terms of Financial Reporting Standards, as amended from time to time’. It is approved for issue by the Accounting Standards Board, which is established by the Minister of Finance and has a statutorily uncategorised separate legal personality. In other words, this is a commercial definition of ‘assets’. The incorporeal money in South African and English law’ (2009) 4 Tydskrif vir die Suid-Afrikaanse Reg 638] Apart from certain contextualisations of ‘property’ [Trust Property Control Act 57 of 1988 sec 1.] or ‘assets’, [see Insolvency Act 24 of 1936 sec 2 (read with Viljoen v Venter NO 1981 2 SA 152 (W)), sec 20(2), sec 23(5), sec 24(2) and sec 82(6) (read with Ex parte Anthony 2000 4 SA 116 (K)); Trust Property Control Act 57 of 1988 sec 12; Financial Institutions Act (Protection of Funds) 28 of 2001 sec 4(5); Land and Agricultural Development Bank 15 of 2002 sec 33 and sec 34; Long Term Insurance Act 52 of 1998 sec 63-sec 65; Badenhorst v Bekker NO 1994 2 SA 155 (N); Du Plessis v Pienaar NO 2003 1 SA 671 (SCA)] the latter has been equated to so-called ‘positiewe vermoënsbestandeel’ in private law. [J Neethling, JM Potgieter & PJ Visser Deliktereg (2006) 210; ‘Positiewe vermoënsbestandeel…is al die vermoënsregte van ‘n persoon, soos die verschillende soorte saaklike regte, immaterieelgoedereregte [sic.] en vorderingsregte. Die geldwaarde van die regte word bepaal deur die markwaarde van die objek daarvan en enige beperkinge op die regte. Vermoënsverwagtinge is ook deel van die vermoë en is die regtens erkende verwagting van ‘n persoon om in die toekoms vermoënsregte te verwerf. Dit gaan oor ‘n kans of moontlikheid wat van so aard is dat die reg dit beskerm’ – Neethling, Portgieter & Visser (n 275) 211.] However, the reference to an expectation in the commercial definition of ‘assets’ above has no correlation to the inclusion of expectation as a so-called vermoënsbestandeel; therefore, the comparison above is incorrect (similarly, a liability, as the opposite of an asset, can not have the so-called negatiewe vermoënsbestandeel as its legal equivalent, since the same argument applies to spei on debt). [Neethling, Portgieter & Visser (n 275) 211.] A counterargument to such a conclusion could be that it is rhetorical since a false analogy is drawn – not in substance but in context – in that legal interpretation must not be superimposed upon non-legal matters.

276 Das (n 76 above) 333.
277 As above.
278 Das (n 76 above) 335.
279 n 2 above.
281 n 2 above, para 1.
282 Framework for the preparation and presentation of financial statements (June 2004), Preamble.
283 Public Finance Management Act 1 of 1999 sec 87(1).
284 Public Finance Management Act sec 87(2).
285 Commercially, assets are resources controlled by a person consequent to past events and from which future economic benefits to the person are expected to flow, [CFA Institute (n 69 above) G-2.] consisting of assets preserved with no conversion to facilitate the generation of revenue (non-current assets), [Cilliers et al (n 41 above) 205-206.] assets which in the ordinary course of business are produced or procured with the eventual purpose of profitable conversion into cash (circulating or floating assets as current assets) [Cilliers et al (n 41 above) 205-206.] and readily available cash, cash in the bank and investments of excess funds that are payable on demand (liquid assets as current assets). [Cilliers et al (n 41 above) 205-206.] ‘Asset’, although not a legal term, has such a wide common definition that its Latin origin, ad satis, could linguistically presuppose the solvency and liquidity test [Onions (n 39 above) 110; PB Gove et al (eds) Webster’s third new international dictionary and seven language dictionary (1966) 131].
blasé reference to ‘members’\textsuperscript{286} ambiguously presupposes either a close corporation\textsuperscript{287} or a company,\textsuperscript{288} though no compulsory state ‘ownership’\textsuperscript{289} is specified. However, the Framework’s definition\textsuperscript{290} of and extensive elaboration\textsuperscript{291} on assets relates only to the public sector,\textsuperscript{292} which may render its employment inapplicable to the private sector based on the interpretive rule of \textit{cessante ratione legis, cessat et ipsa lex}.\textsuperscript{293}

Although the Framework\textsuperscript{294} provides an extensive descriptive definition,\textsuperscript{295} it presents numerous challenges, for example it specifies that assets ‘provide’\textsuperscript{296} a means for entities to achieve their objectives.\textsuperscript{297} This notion is economically odd in that assets inherently constitute the means for entities to achieve their objectives. Rather, and despite possible confusion,\textsuperscript{298} shareholders’ equity and long-term external equity equates to former, being capital employed, providing the means to obtain assets, being the employment of capital.\textsuperscript{299} For purposes of brevity, the critique of said definition will not be included in the main text of this thesis.\textsuperscript{300}

\footnotesize{\textsuperscript{286} Public Finance Management Act 1 of 1999 sec 88.\textsuperscript{287} Close Corporation Act 69 of 1984 sec 28 and \textit{et seq.} read with definition of ‘member’ at sec 1.\textsuperscript{288} Companies Act 61 of 1973 ch 5.\textsuperscript{289} Companies Act 71 of 2008 sec 8(2)(a) read with definition of ‘state-owned company’ in sec 1.\textsuperscript{290} Framework for the preparation and presentation of financial statements (June 2004) para 66(a).\textsuperscript{291} Framework for the preparation and presentation of financial statements (June 2004) para 69-79.\textsuperscript{292} Framework for the preparation and presentation of financial statements (June 2004) para 3.\textsuperscript{293} Botha (n 50 above) 106.\textsuperscript{294} Framework for the preparation and presentation of financial statements (June 2004).\textsuperscript{295} Framework for the preparation and presentation of financial statements (June 2004) para 69-79.\textsuperscript{296} Framework for the preparation and presentation of financial statements (June 2004) para 69.\textsuperscript{297} As above.\textsuperscript{298} Cilliers \textit{et al} (n 41 above) 206.\textsuperscript{299} Cilliers \textit{et al} (n 41 above) 221.\textsuperscript{300} The definition makes redundant references to the non-legal term ‘potential’ (e.g. ‘embodying “service potential”’ and ‘embodying “future economic benefits”’), \textsuperscript{284}Framework for the preparation and presentation of financial statements (June 2004) para 69.] and ‘[the future economic benefit or service potential embodied in an asset is the potential to…]’ \textsuperscript{284}Framework for the preparation and presentation of financial statements (June 2004) paras 70, 71.] which dilutes the envisioned essence of an economic asset. It is only when we comprehend these collateral assets’ \textsuperscript{285}[Schedule (n 2 above) para (b)(ii) of the para 1 definition of ‘synthetic securitisation scheme’.] role in payments from their cash flows. \textsuperscript{285}[Schedule (n 2 above) para (c)(A) of the para 1 definition of ‘synthetic securitisation scheme’.] Further challenges with regards to the definition of ‘assets’ are as follows: (i) The phrase ‘[i]t may also take the form of convertibility into cash or cash equivalents’ \textsuperscript{284}Framework for the preparation and presentation of financial statements (June 2004) para 70.] subsequent to a reference to operating activities \textsuperscript{284}Framework for the preparation and presentation of financial statements (June 2004) para 70.] is superfluous; (ii) The competencies of \textit{dominium}, specifically the \textit{ius disponendi}, do not affect a \textit{res} \textsuperscript{284}Framework for the preparation and presentation of financial statements (June 2004) para 70.]; (iii) Provision is not made for ‘[a]ssets that are [not] used to deliver goods and services…’ \textsuperscript{284}Framework for the preparation and presentation of financial statements (June 2004) para 71.]; (iv) The use of external equity (liabilities) \textsuperscript{284}Cilliers \textit{et al} (n 41 above) 200.] to achieve an entity’s objectives is ignored \textsuperscript{284}Cilliers \textit{et al} (n 41 above) 200.] and \textsuperscript{284}Cilliers \textit{et al} (n 41 above) 200 et seq.]; (v) Ignorant of a concern’s total cost (Total cost = Total fixed cost + Total variable cost), \textsuperscript{284}[M Parkin ‘Output and costs’ in CFA Institute (ed) \textit{Economics Vol 2 Level 1} (2011) 139.] convertibility is mentioned without indicating an envisioned time frame (in the short-run, the quality of the asset envisioned will most likely be technologically-based) \textsuperscript{284}[M Parkin ‘Output and costs’ in CFA Institute (n 300) 144-145.]; (vi) Not only are limited competencies, \textit{viz. the ius utendi} \textsuperscript{284}Framework for the preparation and presentation of financial statements (June 2004) paras 72(a), 72(c).] and \textit{ius disponendi}, \textsuperscript{284}Framework for the preparation and presentation of financial statements (June 2004) paras 72(b), 72(d).]
Upon specifically considering repackaging from the perspective of synthetic securitisation schemes, we stumble upon a concept both complex and possibly, from a practical viewpoint, alien to South African practice thus far. A repackager in traditional schemes will be normal originator subjecting specific assets to true sale;\(^{301}\) in a synthetic scheme the repackager will be an institution transferring risk relating to specific assets.\(^{302}\) An important aspect of the repackager is that it will only transfer such assets or risks subsequent to acquisition thereof.\(^{303}\) Further reference to assets is left for the jurist undertaking a study of traditional securitisation schemes. There are two possible interpretations as to the role of the repackager for present purposes: The first is that the repackager acquires the assets and subsequently transfer the risk relating to such assets to the SPI,\(^{304}\) and secondly that it acquires only the risk relating to such assets and subsequently transfers such risk to the SPI.\(^{305}\) Both possibilities may be correct given the mechanics of synthetic securitisation schemes.

\(^{301}\) See n 21 above.

\(^{302}\) As above.

\(^{303}\) As above.

\(^{304}\) See n 21 above.

\(^{305}\) See n 21 above.
2.5.2 Canada

Canadian securitisation vocabulary does not formally seem to contain the notion of ‘repackaging’, but refers to ‘resecuritisation’. The astute reader will intuitively realise that there is some conceptual common ground between these notions. This definition does not prima facie assist us much given the uncertainty already ascribed to the Canadian notion of ‘securitisation exposure’. The crux appears to be that one of the underlying assets must be a ‘securitisation exposure’. The only inference that can be drawn is that a resecuritisation hints at the case where commercial paper in terms of one securitisation scheme is utilised as underlying for a second securitisation scheme. This is confirmed in the OSFI notes to the Guideline, especially its crucial element of stratification of the resecuritised-to-be underlying. Clearly, the existence of underlying assets in more than one SPI does not eventually per se qualify as a resecuritisation, but this statement is vague, since it can refer to different SPIs in the original securitisation scheme or to different SPIs in the resecuritisation scheme. The conclusion is that overlapping of South African repackaging and Canadian resecuritisation can only conceptually transpire if the ‘resecuritisation exposure’ is a ‘qualifying [item]’.

3 Final remarks

The Schedule, upon closer inspection, contains vague concepts and provisions with regards to parties acting in a primary role, which upsets legal certainty. Firstly, it seem to exclude the use of guarantees for the transfer of risk, whereas the role of the latter appears indisputable in case law. Secondly, given the paragraph (b) of the definition of ‘synthetic securitisation scheme’, it is uncertain what the role of remote originators are in practice. Thirdly, the use

306 Office of the Superintendent of Financial Institutions in Canada (n 119 above) 5 sec 7.1 para 12: ‘A resecuritisation exposure is a securitisation exposure in which the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation exposure. In addition, an exposure to one or more resecuritisation exposures is a resecuritisation exposure.’
307 Para 2.2.3 above.
308 See n 409 above.
309 n 119 above.
310 n 119 above, 5 para 13.
311 As above.
312 Schedule (n 2 above) para 1: “qualifying items” means all loan stock listed on the Bond Exchange of South Africa, or any other loan stock listed on a financial exchange licensed by the Financial Services Board”.
313 Schedule (n 2 above), para 1.
314 As above.
316 Para 2.2.1 above.
317 Para 2.3 above.
of the term ‘assets’ at paragraph (b)(ii) of the definition of ‘synthetic securitisation scheme’, read with paragraph 4(1)(a)(i)(A) of the Schedule, invokes positivistic uncertainty, since the interpretation can be made that the SPI, through the conjunctive employed at the end of paragraph (b) of the definition of ‘synthetic securitisation scheme’, can only participate in synthetic securitisation for purposes of a hybrid structure. Whether or not that is the case, the meaning and the application of the term ‘assets’ remains dubious.

It is also uncertain what the ambit of the term ‘institution’ is. No doubt its inclusive definition intended a wide ambit, just as the Schedule’s departure from relation and inter-relation does, but irrespective of how one chooses to apply the principles of statutory interpretation to it, the conclusions have certain legal ramifications. It is uncertain whether the term ‘institution’ is limited by the definition in the Banks Act, since it would appear contrary to the exclusion of synthetic securitisation from the business of a bank to limit such institution to banks. It is doubtful that this was the intention of the Registrar. With regard to the alternative, i.e. such institution otherwise being a member of a banking group, it would constitutes a predicament if the issuer of CLNs, being a SPI, is to be regulated as an originator and consequently regarded as such an ‘institution’, since in such circumstances the trust model would be inconsistent with the statutory nature of a bank.

It is furthermore uncertain if the Registrar intended to include synthetic securitisations as ABCP programmes in South African law, although this possibility now exists. A vexatious predicament with regards to ABCP programmes surfaces upon considering its statutory definition in juxtaposition to paragraph 5(2)(a)(vi) of the Schedule. According to the latter, a significant amount of credit risk associated with the underlying exposure must be transferred

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318 n 2 above, para 1.
319 n 2 above.
320 n 2 above, para 1.
321 Para 2.5.1 above.
322 Para 2.2.1 above.
323 n 2 above.
324 Para 2.1 above.
325 As above.
326 94 of 1990.
327 See ch 8 below.
328 Para 2.1 above.
329 See ch 7 below.
330 Para 2.2.2 above.
331 n 2 above.
to investors.\textsuperscript{332} It is uncertain what a significant amount of credit risk is, and whether it constitutes more than fifty percent of such risk. However, said provision is discreet on the method or security utilised to transfer such risk. The former definition expressly provides that predominantly commercial paper of a certain nature must be issued to investors,\textsuperscript{333} and it is uncertain if the adjective ‘significant’ is to be regarded as synonymous to the adverb ‘predominantly’.

In an ABCP programme, the originator expressly constitutes a sponsor in that it does not transfer exposures from its own balance sheet.\textsuperscript{334} This seems to exclude the possibility that an originator in a ABCP synthetic programme can transfer exposures from its own balance sheet assets, which would have been permitted if paragraph (b) of the definition of ‘originator’ applied.\textsuperscript{335} This slippery slope argument presents predicaments with paragraph (c) of the definition of ‘sponsor’,\textsuperscript{336} in that paragraph (ii) of the latter not only hints at such a sponsor being an underwriter or SPI, but also the uncertainty prevailing due to the mixed use of conjunctives and disjunctives.

\textsuperscript{332} See n 323 above.
\textsuperscript{333} See n 37 above.
\textsuperscript{334} Schedule (n 2 above) para (c) of the para 1 definition of ‘originator’.
\textsuperscript{335} Schedule (n 2 above) para 1.
\textsuperscript{336} See n 37 above.
Chapter 4
Parties acting in a secondary role

1 Point in limine
2 Introduction
3 Credit enhancement
   3.1 General
   3.2 Internal credit enhancement
   3.3 External credit enhancement
4 Liquidity facilities
5 Underwriting
6 Purchaser of senior commercial paper
7 Servicing agent
8 Counterparty to a transaction in a bank’s trading book
9 Final remarks

1 Point in limine
This chapter is included as a matter of necessity, given the application of the second and third problem questions. Whilst it is res ipsa loquitur that aspects of credit law may apply to some of the substance of this chapter, it is rendered only according to the subjects identified for the study.¹ This constraint is not an isolated incident, as was assumed from the frictions inherent in securitisation as identified by Ashcraft and Schuermann:² There exists a risk of predatory lending between the originator/repackager and the obligors³ which can be equated with reckless credit as defined in section 1 and section 80 of the National Credit Act,⁴ and of which the system risk inherent thereto can be mitigated by the originator/repackager’s reliance on section

¹ Ch 1 para 1 above.
³ Ch 3 para 1 above.
⁴ 34 of 2005.
81 of the National Credit Act.\textsuperscript{5} However, some of the cases in this chapter will be excluded from the application of the National Credit Act\textsuperscript{6} through the provisions of its section 4(1)(a)(i). In practice, the same department in a law firm that would handle securitisation would also handle financing, the latter entailing significant knowledge of credit law. In academia, these aspects are structurally divided between corporate and credit law, of which said instances in this chapter likely relates to aspects of credit prevalent in corporate law. A greater concern seemed to be the ability to conduct a structured discussion of the sub-topic of parties acting in a secondary role. As will be seen, the aspects relating to parties acting in a secondary role overlap to such an extent that a sufficient discussion of one party acting in a secondary role may leave little or nothing to be said of another party. This discussion does not stray from the categories specified in the Schedule.\textsuperscript{7}

2 Introduction

It is uncertain what the term ‘secondary role’ means with regards to synthetic securitisation schemes. Although there is an express definition of it in the Schedule,\textsuperscript{8} said definition\textsuperscript{9} contains no denotation but rather a \textit{numerus clausus}, an enumerative definition of the parties acting in a secondary role.\textsuperscript{10} Unfortunately, none of the sources approached defined ‘secondary role’ in any manner. The foremost enquiry is then whether this term could be defined with regards to participation in a primary role. Although express reference to certain legal effects clinging to participation in a primary role\textsuperscript{11} was made above, circumspection is required in using the \textit{inclusio unius est exclusio alterius} argument in such a case – the terms ‘primary role’ and ‘secondary role’ may have been used by the Registrar for purposes of convenience only.\textsuperscript{12} The second enquiry is whether it could be argued that a SPI has a right of recourse against a participant in a secondary role based on the argument that an SPI has no such recourse against a party acting in a primary role.\textsuperscript{13} It would seem not, since such a right of recourse, being a

\textsuperscript{5} As above.
\textsuperscript{6} As above.
\textsuperscript{8} n 7 above.
\textsuperscript{9} n 7 above, para 1: ‘“secondary role” means the participation by an institution in a traditional or synthetic securitisation scheme, as a provider of a credit enhancement facility, a provider of a liquidity facility, an underwriter, a purchaser of senior commercial paper, a servicing agent or a counterparty to a transaction included in the trading book of a bank’.
\textsuperscript{10} As above.
\textsuperscript{11} See ch 3 above.
\textsuperscript{12} Dissatisfaction with making or interpreting laws based on convenience has already been expressed [Ch 2 para 2.1 above.].
\textsuperscript{13} Schedule (n 7 above) para 5(2)(b).
remedy in terms of the law of contract, is dependent on the existence of a credit derivative.\textsuperscript{14} If instituted against a party acting in a secondary role, it will be met with a special plea – a plea in abatement\textsuperscript{15} – by the party acting in a secondary role due to a lack of \textit{locus standi}.\textsuperscript{16} Nothing prohibits a SPI from instituting legal action, based on a right of recourse \textit{ex contractu} or \textit{ex delictu}, against a party acting in a secondary role in the event of, respectively, breach of contract\textsuperscript{17} or breach of a duty of care.\textsuperscript{18} The third enquiry is whether it could be argued that a party acting in a secondary role’s corporate veil can be pierced.\textsuperscript{19} Similarly, the predicament just \textit{a priori} described applies, subject to the party acting in a secondary role’s common law right or right in terms of the Companies Act\textsuperscript{20} to institute proceedings. It is important to note that, although parties can be sued in the alternative, it remains the discretion of the applicable forum, especially if the forum has inherent jurisdiction (being also the case with a forum that has an equivalent jurisdiction to that of a provincial High Court or a local division with concurrent jurisdiction) to pierce the corporate veil, subject to specific recourse to that effect in the Companies Act.\textsuperscript{21} The participants acting in a secondary role do not perform a primary function, meaning that their role is not essential or preeminent.\textsuperscript{22} Not all synthetic securitisations, in principle, require parties or any particular party acting in a secondary role, be that due to the type of credit derivative used,\textsuperscript{23} the resources of the participants already existent, etc. Similarly, not all synthetic securitisations, in practice, may have all or any particular party acting in a secondary role.

The Schedule\textsuperscript{24} refers to ‘participation’ with regards to a scheme. Primary sources, apart from the possibility of case law, have yet to be viewed in which the parties relevant to a scheme of arrangement\textsuperscript{25} are referred to as ‘participants’ or their conduct being described as ‘participation’. Neither ‘scheme’ nor ‘participation’ are legal terms, but rather constitute the

\begin{flushleft}
\textsuperscript{14} This is based on the medieval principle of \textit{pacta sunt servanda}. \\
\textsuperscript{15} A da Silva \textit{Magistrate’s Court Practice 2013} (2013) 68. \\
\textsuperscript{16} C du Plessis \textit{High Court Practice 2013} (2013) 32-33. \\
\textsuperscript{17} See L Hawthorne \& J Lotz \textit{Contract law casebook} (1999) 195 \textit{et seq}. \\
\textsuperscript{18} Legal practitioners often view a duty of care as the basis for taking legal action in terms of a delict. In truth, the duty of care only becomes relevant with regards to the element of unlawfulness in a delict. [Neethling, J, Potgieter, JM \& Visser, PJ \textit{Delikereg} (2006) 52 \textit{et seq}.] For this reason, the Afrikaans term for a delict, ‘\textit{onregmatige daad}’ is more explanatory since it emphasises the breach in terms of the relevant element in its designation. \\
\textsuperscript{19} E.g. ch 3 para 2.1 above. This raises the question as to recourse against a participant acting in a primary role also acting in a secondary role. \\
\textsuperscript{20} 71 of 2008. \\
\textsuperscript{21} 71 of 2008. \\
\textsuperscript{22} Ch 3 para 2.1 above. \\
\textsuperscript{23} See ch 5 below. \\
\textsuperscript{24} n 7 above. \\
\textsuperscript{25} Companies Act 71 of 2008 sec 114.
\end{flushleft}
Registrar’s utilisation of commercial terminology to circumvent tedious descriptions of the contractual relationships, i.e. obligations, between the different parties. The *genus* of a scheme for present purposes is a fact, and not a state of affairs, if one correctly understand the former to merely imply the existence of a state of affairs if one follows the modern reasoning behind the law of things rather than that of the Romans. Any scheme in particular is a proposition. Since a scheme as a fact exists in a *demesne* of law, the proposition of any particular scheme must be subject to the rules of law. A participant participates, in the ordinary sense of the word, in the practical manifestation of such a proposition. Applying what has already been noted with regards to parties acting in a secondary role, some concept of what ‘secondary role’ means surfaces. For the rest of this chapter, an extensive definition will be utilised by examining the parties acting in a secondary role to determine their significance.

3 **Credit enhancement**

3.1 **General**

The Schedule does not define credit enhancement *per se*, although it indeed provides a definition for ‘credit-enhancement facility’. The former is, in its widest sense, the internal or

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26 Ch 2 para 2.1 above.
28 As above.
29 As above.
32 Wittgenstein (n 27 above) 26 et seq.
33 Wittgenstein (n 27 above) 42: ‘A tautology’s truth is certain, a proposition’s possible, [*sic.*] a contradiction’s impossible’.
34 n 7 above.
35 Here Canadian law is perused for an answer: ‘A credit enhancement is a contractual arrangement in which the bank retains or assumes a securitisation exposure [See ch 3 para 2.2.3 above.] and, in substance, [See ch 3 para 2.2.2 above.] provides some degree of added protection to other parties to the transaction.’ [Office of the Superintendent of Financial Institutions in Canada ‘Guideline: Capital Adequacy Requirements: Chapter 7 – Structured credit products’ December 2014 http://www.osfi-bsif.gc.ca/Eng/Docs/CAR_chpt7.pdf (accessed 10 February 2015) 7 sec 7.2.4 para 23.] Canadian law goes further to explain the term ‘enhancement’ in OSFI’s notes to said Guidelines with regards to traditional securitisation schemes. [Office of the Superintendent of Financial Institutions in Canada (n 35) 7 para 24.] Contextualised to synthetic securitisation, it is an arrangement to an SPI covering losses associated with the underlying to protect investors if premiums on the credit derivative are insufficient to provide timeous performance on the SPI’s commercial paper. [Office of the Superintendent of Financial Institutions in Canada (n 35) 7 para 24.] It ‘improve[s] or support[s] the credit rating on more senior tranches, and therefore the pricing and marketability of the ABS’. [Office of the Superintendent of Financial Institutions in Canada (n 35) 7 para 24.]
36 Schedule (n 7 above) para 1: ‘“credit-enhancement facility” means any facility or arrangement in terms of which the provider of such a facility or obligor under the arrangement is obliged to absorb losses associated with—

(a) the assets transferred in terms of a traditional securitisation scheme; or

(b) the risk transferred in terms of a synthetic securitisation scheme,

including both a first-loss credit-enhancement facility and a second-loss credit-enhancement facility’.
external enhancement,\textsuperscript{37} whether transaction-specific\textsuperscript{38} or programme-wide,\textsuperscript{39} of the issued commercial paper’s credit ratings\textsuperscript{40} to keep investors’ security at an adequate risk level\textsuperscript{41} and supply insolvency-remoteness to the SPI.\textsuperscript{42} Credit enhancement can take the form of either a facility or an arrangement. As a facility, this would imaginably be a credit facility in terms of the National Credit Act\textsuperscript{43} if \textit{inter alia} the relevant threshold in its section 7(1) is satisfied – otherwise it would refer to a facility with similar characteristics to that of a credit facility in said statute – although this remains uncertain since the Schedule\textsuperscript{44} never refers to a ‘credit facility’. ‘[C]redit facility’ is indeed defined in said Act,\textsuperscript{45} and is classified as a credit agreement.\textsuperscript{46} A credit facility is thus a credit agreement\textsuperscript{47} in terms of which the credit provider\textsuperscript{48} has the duty\textsuperscript{49} to perform by paying (an) amount(s) or supplying goods or services,\textsuperscript{50} subject to the consumer’s election,\textsuperscript{51} to the consumer\textsuperscript{52} or ‘or on behalf of, or at the direction of’\textsuperscript{53} the consumer.\textsuperscript{54} The credit provider further also has the duty\textsuperscript{55} to either defer the duty of the consumer to pay fully or in part for the goods or services\textsuperscript{56} or to repay the relevant amount(s),\textsuperscript{57} or to bill the consumer intermittently for any part of the goods or services or amount.\textsuperscript{58} It is clear from the National Credit Act\textsuperscript{59} that the credit provider must be reimbursed for the said expenses on its part,\textsuperscript{60} but said Act provides no indication that the consumer is responsible for


\textsuperscript{38} Schedule (n 7 above) para 6(1)(b)(i).

\textsuperscript{39} Schedule (n 7 above) para 6(1)(b)(ii); Karoly (n 37 above) 55.


\textsuperscript{41} Karoly (n 37 above) 55.

\textsuperscript{42} As above.

\textsuperscript{43} 34 of 2005.

\textsuperscript{44} n 1 above.

\textsuperscript{45} National Credit Act 34 of 2005 sec 1: “‘credit facility’ means an agreement that meets all the criteria set out in section 8(3)’.

\textsuperscript{46} National Credit Act 34 of 2005 sec 1: “‘credit agreement’ means an agreement that meets all the criteria set out in section 8’.

\textsuperscript{47} National Credit Act 34 of 2005 sec 8(3).

\textsuperscript{48} National Credit Act 34 of 2005 sec 1: “‘credit provider’, in respect of a credit agreement to which this Act applies, means…the party who extends credit under a credit facility’.

\textsuperscript{49} National Credit Act 34 of 2005 sec 8(3)(a).

\textsuperscript{50} National Credit Act 34 of 2005 sec 8(3)(a)(i).

\textsuperscript{51} As above.

\textsuperscript{52} As above.

\textsuperscript{53} As above.

\textsuperscript{54} As above.

\textsuperscript{55} National Credit Act 34 of 2005 sec 8(3)(a).

\textsuperscript{56} National Credit Act 34 of 2005 sec 8(3)(a)(ii).

\textsuperscript{57} As above.

\textsuperscript{58} As above.

\textsuperscript{59} 34 of 2005.

\textsuperscript{60} National Credit Act 34 of 2005 sec 8(3)(b).
such reimbursement, rendering the term ‘counter-performance’ dubious. The term ‘consumer’ is defined in said Act and will be, subject to *inter alia* said threshold, the SPI. Thus, it is uncertain whether the SPI *per se* will have to render counter-performance to the provider of a credit enhancement facility. The provider of the credit enhancement facility, i.e. the credit provider, will be a bank or another institution in that same banking group. This is an interesting position, since not all credit providers are necessarily banks, just as not all banks are necessarily deposit-taking institutions.

It is even more uncertain what the Registrar meant with its reference to the possibility of an arrangement. For the experienced jurist, this can only imply the scheme that related to shares, being a scheme of arrangement, as a compromise related to debentures. The current Companies Act distinguishes between a scheme of arrangement and a compromise, although it is uncertain what the difference between them is apart from the additional provisions relating to compromises, given the wide term ‘securities’ used with regards to

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61 National Credit Act 34 of 2005 sec 1: ‘“consumer”, in respect of a credit agreement to which this Act applies, means … the party to whom credit is granted under a credit facility’.


63 Ex parte Federale Nywerhede Bpk 1975 1 SA 826 (W); Ex parte Satbel (Edms Bpk): In re Meyer v Satbel (Edms Bpk) 1984 4 SA 347 (W); Ex parte Natal Coal Exploration Co Ltd 1985 4 SA 279 (W); Ex parte NBSA Centre Ltd 1987 2 SA 783 (T); Ex parte Mielie-Kip Ltd 1991 3 SA 449 (W); Ex parte Garlick Ltd 1990 4 SA 324 (C).

64 E.g. Ex parte Millman: In re Multi-Bou (Pty) Ltd 1987 4 SA 405 (C). It has always been difficult to differentiate between a scheme of arrangement relating to shareholders and a compromise relating to debenture-holders [Ex parte Kaplan: In re Robin Consolidated Industries Ltd 1987 3 SA 413 (W); Ex parte Strydom: In re Central Plumbing Works (Natal) (Pty) Ltd 1988 1 SA 616 (D); Ex parte Lebowa Development Corporation Ltd 1989 3 SA 71 (T).]

65 71 of 2008.

66 Companies Act 71 of 2008 sec 114.

67 Companies Act 71 of 2008 sec 155.

68 As above.
schemes of arrangement.\textsuperscript{69} The question remains how credit enhancement can, for present purposes, be structured through an arrangement. The definition of ‘credit-enhancement facility’ contains a reference to obligors,\textsuperscript{70} the latter not being defined in the Schedule\textsuperscript{71} and therefore retains its ordinary meaning. However, the ordinary meaning of an ‘obligor’ is: ‘One who binds himself to another to another by contract; the person who gives a bond or obligation’.\textsuperscript{72} The term ‘obligor’ is commonly found in literature on securitisation and can usually be interpreted to denote a creditor. For present purposes – using its ordinary meaning – it can denote either a particular class of shareholder or a specific type of creditor whose external equity may or may not conform to the provisions relating to commercial paper.\textsuperscript{73} \textsuperscript{74} The SPI must be able to utilise this capital for reinvestment in order to not only meet the rights and \textit{spei} in terms of the aforesaid, but also to increase the robustness of its balance sheet. However, the returns on the shareholders equity and external equity will be huge to be commensurate the risk inherent in such securities. This still does not explain why this form of credit enhancement must take the form of an arrangement, given that the Companies Act\textsuperscript{75} uses verbs in the present tense to describe a process of change in the capital structure of the relevant company,\textsuperscript{76} which in this case will be the SPI. According to the Schedule,\textsuperscript{77} the valuations relating to credit enhancements shall transpire at the commencement of the scheme.\textsuperscript{78} The only ‘arrangement’ in the sense of a ‘scheme of arrangement’ can transpire once the Registrar exercises its discretion sometime after the commencement of the scheme.\textsuperscript{79}

According to the Schedule,\textsuperscript{80} the purpose of credit enhancement is ‘to protect investors…from losses’.\textsuperscript{81} With regards to indirect\textsuperscript{82} traditional securitisation schemes, credit enhancement depends on the credit quality of the assets and not the originator or the repackager;\textsuperscript{83} thus it centers around the SPI, and rightly so according to the principle of separate legal personality.

\begin{footnotesize}
\begin{enumerate}
\item Companies Act 71 of 2008 sec 114.
\item n 36 above.
\item n 7 above.
\item CT Onions \textit{The shorter Oxford English dictionary} (1955) 1351.
\item Schedule (n 7 above) sec 6 in general.
\item See para 3.2 below.
\item 71 of 2008.
\item Companies Act 71 of 2008 sec 114.
\item n 7 above.
\item Schedule (n 7 above) para 6(2)(c).
\item As above.
\item n 7 above.
\item n 7 above, para 6(1)(a).
\item See ch 5 below.
\item FJ Fabozzi & V Kothari \textit{Introduction to securitization} (2008) 85.
\end{enumerate}
\end{footnotesize}
By substitution it is then argued that credit enhancement in synthetic securitisation schemes depends on the quality of credit risk. Speaking of dependency, the credit enhancement facility granted is subject to the provider’s ‘normal credit approval and review processes’. This applies in addition to the *incidentalia* that will exist. Similarly, the SPI will have no recourse against the provider of the credit enhancement facility save for the ‘fixed contractual obligation specified in the facility’. Even though the level of credit enhancement is a variable, defined by the nature of the scheme, quality of the underlying, and the goal rating, the method of credit enhancement depends on acceptance by rating agencies and investors, supply and pricing, with external credit enhancement as the *forte* of banks or insurers (credit-enhancers) at a significant fee. Internal credit enhancement is effected through collateralisation variations, lock-up mechanisms, triggered amortisations and stratification; external credit enhancement is effected through credit wraps, guarantees, letters of credit, liquidity facilities, subordinated loans and surety bonds.

### 3.2 Internal credit enhancement

Was the reference to credit enhancement as an arrangement above a reference to an external or internal credit enhancement ‘facility’? It is presumed that the use of the arrangement structure is more common with regards to internal credit enhancement; however, not all examples of internal credit enhancement constitute arrangements. Collateralisation variations *in essence* refer to diversification – be that diversification of the collateral *ex nudo*, or the example used above, which will be a hybrid between external and internal credit enhancement. Another example of collateralisation variations would be diversification so that the SPI’s portfolio of

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84 Schedule (n 7 above) para 6(2)(a)(vi).
85 Schedule (n 7 above) para 6(2)(a)(i).
86 Karoly (n 37 above) 55; Fabozzi & Kothari (n 84 above) 85.
87 Karoly (n 37 above) 55.
88 As above.
89 As above.
90 Karoly (n 37 above) 56-57.
91 Karoly (n 37 above).
92 As above.
93 BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in Carey & Stulz (n 62 above) 559-560.
94 As above; Karoly (n 37 above) 58.
assets contains significant cash reserves, such as unconditional deposits with a bank, constituting a highly liquid first line of defence. The line between collateralisation variation and cash-collateralisation becomes fictitious. There are examples which fall clearer into the latter category, such as excess spread. This is only defined in the Schedule, but is never referred to in it again. In the US this is known as a credit enhancement interest-only strip and is equal to a percentage of the difference between a securitisation’s monthly revenue and distributions, servicing fees and charge offs, paid into a SPI’s account. This is defined in the Schedule, but is also never referred to again. Mandel, Morgen & Wei seem to have erred on this point, since it appears from said schedule as if the Registrar had future value in mind with regards to credit enhancement interest-only strips, and presumably present value for excess spread. This difference is discussed in chapter 5 below.

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95 Karoly (n 32 above) 57. In Germany, the reserve fund is regarded as additional credit enhancement. [Bayern LB ‘ABS Handbuch: Einführung in Asset-Backed Securities’ 2006 http://www.true-sale-international.de/fileadmin/tsi_downloads/ABS_Research/Informationsmaterial_und_Literatur/Einfuehrende_Handbuecher_und_Leitfaeden/ABS_Handbuch_baylb_GERMAN.pdf (accessed 11 March 2015) 14-15.] The reserve fund is upon commencement of the scheme usually only partially funded and is topped-up during until the conclusion of the excess spread. [Bayern LB (n 95) 14-15.]

96 See Banks Act 94 of 1990, sec 1 definition of ‘deposit’.

97 Mandel, Morgan & Wei (n 62 above) 37; contra Schedule (n 7 above) para 6(1)(b)(i). However, the habit of comprehending collateral as serving only the purpose of internal credit enhancement must be circumscribed. [Bayern LB (n 96 above) 16.] The rating of the commercial paper issued by the transferor is sometimes worse than the rating of the SPI’s senior commercial paper. [Bayern LB (n 95 above) 16.] The collateral serves to boost the ratings of the commercial paper; therefore valuable collateral must underlie the commercial paper, such as government bonds. [Bayern LB (n 95 above) 16.]

98 n 7 above, para 1: “excess spread” in relation to a securitisation scheme means income received by a special-purpose institution, net of any relevant costs and expenses’. In Canadian law it is ‘generally’ [Office of the Superintendent of Financial Institutions in Canada (n 35 above) 8 sec 7.2.7 para 30.] defined as ‘gross finance charge collections and other income received by the trust or special purpose entity minus certificate interest, servicing fees, charge-offs, and other senior trust or SPE expenses’. [Office of the Superintendent of Financial Institutions in Canada (n 35 above) 8 sec 7.2.7 para 30.] In Germany, it is defined as internally created when the average margin of the securitised portfolio, after costs, exceeds the commercial paper’s average interest rate. [Bayern LB (n 95 above) 14.]

99 Mandel, Morgen & Wei (n 62 above) 37.

100 Karoly (n 37 above) 57.

101 Mandel, Morgen & Wei (n 62 above) 37.

102 Karoly (n 37 above) 57.

103 n 7 above, para 1: “credit-enhancing interest-only strip” means an asset that—

(a) represents a valuation of cash flows related to future margin income; and

(b) is subordinated’.

The term has virtually the same meaning in Canadian law. [Office of the Superintendent of Financial Institutions in Canada (n 30 above) 7 sec 7.2.5 para 26: ‘A credit-enhancing interest-only strip (I/O) is an on-balance sheet asset that (i) represents a valuation of cash flows related to future margin income, and (ii) is subordinated.’.]

104 From what could be established, German law concurs with this position. [Bayern LB (n 95 above) 14.]
A clearer example is over-collateralisation. In a traditional securitisation, over-collateralisation would entail the assets’ value exceeding that of the issued commercial paper,\textsuperscript{105} based on a debt coverage ratio.\textsuperscript{106} The SPI relies on greater retention of the income from the underlying assets.\textsuperscript{107} In a synthetic securitisation scheme, over-collateralisation must then necessarily manifest if the value of the risk in terms of the synthetic sale initially exceeding the value of the issued commercial paper so that the premiums are not largely paid over to the holders of the commercial paper. The debt coverage ratio mentioned may be ‘the amount of income relative to the interest payment’\textsuperscript{108} in a traditional securitisation scheme; therefore, the amount of ‘fees and/or premiums’\textsuperscript{109} performed by the party acting in a primary role to the SPI\textsuperscript{110} will be regarded as relative to the interest on the commercial paper. This is provided for in the Schedule.\textsuperscript{111}

A cross-collateralisation agreement in traditional securitisation schemes becomes relevant where the underlying assets are composed of numerous loans or if a loan is secured over more than one thing,\textsuperscript{112} which will stipulate that all things constituting security for the respective loans will collateralise the commercial paper liability \textit{en toto},\textsuperscript{113} causing accelerated prepayment of the underlying assets \textit{en toto} to avoid the commercial paper’s default if a single underlying asset defaults.\textsuperscript{114} This has also been referred to as a blanket mortgage.\textsuperscript{115} Cross-collateralisation is based on secured loans. Although synthetic securitisation schemes only relate to risk-transfer and not asset-transfer, the credit derivative has bearing on the transacted premiums and little else. However, nothing inhibits the existence of a cross-collateralisation agreement in the case of synthetic securitisation, since the transferor can ‘accelerate prepayment’\textsuperscript{116} on the assets of which the risk has been transferred to the SPI.

\textsuperscript{106}Karoly (n 37 above) 56.
\textsuperscript{107}As above.
\textsuperscript{108}As above.
\textsuperscript{109}Schedule (n 7 above) para (c)(B) of the para 1 definition of ‘synthetic securitisation scheme’.
\textsuperscript{110}As above.
\textsuperscript{111}n 7 above, para (c) of the para 1 definition of ‘synthetic securitisation scheme’.
\textsuperscript{112}Karoly (n 37 above) 56.
\textsuperscript{113}As above.
\textsuperscript{114}Karoly (n 37 above) 56-57.
\textsuperscript{115}As above.
\textsuperscript{116}As above. It is uncertain what ‘accelerated prepayment’ means, since prepayment intrinsically entails repayment prior to maturity. [Bayern LB (n 95 above) 7.] In Germany, this is accompanied by disclosure to investors. [Bayern LB (n 96 above) 7.] Although there is no express reference to disclosure in the Schedule [n 7 above.] with regards to early amortization, such information may qualify for disclosure in terms of para 16(2)(a)(xii) of the Schedule. [n 7 above.] Great prepayments reduces the weighted average maturity of the

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Other methods of internal credit enhancement are tranching, also known as credit tranching, subordination, lock-up mechanism and triggered amortisation. However, the SPI’s capital structure is discussed elsewhere. As a method of credit enhancement, the deduction of discrepant default risks on discrepant payment priorities is imperative. This implies a minimum of two securities classes, although South African SPIs generally have three to four. Since all accounts must be exhausted prior to even subordinate debt incurring losses, tranching constitutes the ‘second-line of defense’. Karoly’s argument that tranching only enhances investment grade securitities is erroneous; hypothetically, all tranches not affected by a lower tranches’ losses can be regarded as beneficiaries of credit enhancement by tranching. Tranching has a wide effect, and credit-enhancing interest-only strips are subject to subordination.

With the securitisation of revolving or substitutable assets, contractual events may transpire for the ex lege winding up of the SPI, known as triggered amortisation or, in the Schedule, as ‘early amortisation’. Although ‘revolving assets’ are defined, the Schedule goes further to describe them as credit exposures of which the obligor’s drawn amount against a credit facility varies within agreed parameters. What is interesting is that the Registrar seemingly

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117 Jobst (n 62 above) 732.
118 Karoly (n 37 above) 56.
119 As above.
120 Karoly (n 37 above) 57.
121 As above.
122 Ch 8 below.
123 Karoly (n 37 above) 56.
124 Huntley & Pottas (n 105 above) 4.
125 As above.
126 See cash-collateralisation above.
127 Mandel, Morgen & Wei (n 62 above) 37.
128 As above.
129 Karoly (n 37 above) 56.
130 Huntley & Pottas (n 105 above) 4; Mandel, Morgen & Wei (n 62 above) 37.
131 n 104 above.
132 Karoly (n 32 above) 57.
133 n 7 above.
134 n 7 above, para 13.
135 n 7 above, para 1: “revolving assets” mean loan facilities or other underlying transactions in terms of which debtors under such loan facilities or other underlying transactions are permitted to vary, within an agreed limit, the amount utilised in terms of the underlying transaction, or to repay amounts in terms of the underlying transactions at their own discretion, subject, in certain circumstances, to a minimum amount per payment period or in accordance with a fixed repayment schedule’.
136 n 7 above.
137 n 7 above, para 12 (1)(a).
limits the securitisation of revolving assets to originators to the exclusion of repackagers.\textsuperscript{138} The reason why early amortisation is relevant with securitisation of revolving assets\textsuperscript{139} is due to its increased counterparty risk, credit risk, liquidity risk and moral risk\textsuperscript{140} that stem from ‘the complexity of the arrangements,’\textsuperscript{141} the fluctuating nature and indefinite maturity of the underlying exposures, and the shared interest of the originator and investors’.\textsuperscript{142} Therefore, securitisation of revolving assets necessitate a robust risk management framework,\textsuperscript{143} additional capital adequacy\textsuperscript{144} and consensus that there will be no favouritism to interest on commercial paper over the originator’s interest,\textsuperscript{145} and that the risk transferred to the SPI will be subjected to random selection ‘when only a portion of a particular class of revolving assets is securitised’.\textsuperscript{146}

The Schedule\textsuperscript{147} provides for both early amortisation that complies (controlled)\textsuperscript{148} and does not comply (uncontrolled)\textsuperscript{149} or non-controlled\textsuperscript{150} with the conditions set out in the Schedule.\textsuperscript{151} Early or triggered controlled amortisation means that counter-performance is restored\textsuperscript{152} at the pace of a straight-line amortisation\textsuperscript{153} to investors in commercial paper before the maturity of said paper\textsuperscript{154} by sharing amounts outstanding on a pro rata basis with the originator\textsuperscript{155} for a
period of repayment or default of 90 percent of the debt.\textsuperscript{156} Any subsequent exposures become the liability of the originator,\textsuperscript{157} which necessitates a robust capital and liquidity plan.\textsuperscript{158} It is a method of investor protection, since the trigger is usually the deterioration of the underlying’s credit quality.\textsuperscript{159} An alternative to early amortisation, being less extreme, is a lock-up mechanism, which entails the \textit{ex lege} alteration of distribution due to sub-standard performance of the underlying.\textsuperscript{160}

### 3.3 External credit enhancement

The Schedule\textsuperscript{161} makes no express reference to ‘internal credit-enhancement’. An initial interpretation is that this is due to the limits of the Registrar’s language,\textsuperscript{162} since the Schedule\textsuperscript{163} in truth only expressly regulates credit enhancement ‘facilities’, which are intrinsically external.\textsuperscript{164} External or off-balance sheet\textsuperscript{165} credit enhancement is less effective than a quantitatively equal internal variant,\textsuperscript{166} since enhancers themselves may default.\textsuperscript{167} It is imaginable that the systemic risk realisation if the credit enhancement provider is also a participant to the scheme in a primary role. Similar to what was perceived with regards to internal credit enhancement above, an external credit enhancement facility can be categorised as either a first-loss credit enhancement facility\textsuperscript{168} (first-loss)\textsuperscript{169} or a second-loss credit

\textsuperscript{156} Schedule (n 7 above) para 13(2)(a)(iii); Office of the Superintendent of Financial Institutions in Canada (n 35 above) 7 sec 7.2.6 para 27(c).
\textsuperscript{157} Schedule (n 7 above) para 13(1)(a).
\textsuperscript{158} Schedule (n 7 above) para 13(2)(a)(i); Office of the Superintendent of Financial Institutions in Canada (n 35 above) 7 sec 7.2.6 para 27(a).
\textsuperscript{159} Schedule (n 7 above) para 13(1)(a).
\textsuperscript{160} Karoly (n 37 above) 57.
\textsuperscript{161} n 7 above.
\textsuperscript{162} Wittgenstein (n 27 above) 68.
\textsuperscript{163} n 7 above.
\textsuperscript{164} Even though this seems to be the logic answer, it is not necessarily the Legislature’s intention. Canadian law provides for numerous examples of ‘facilities’ [Office of the Superintendent of Financial Institutions in Canada (n 35 above) 7 para 25.] which do not necessarily classify as credit facilities, such as ‘recourse provisions…subordinated security structures; subordinated standby lines of credit; subordinated loans; third party equity; swaps that are structured to provide an element of enhancement… In addition, these facilities include any temporary financing facility…provided by an institution to an enhancer or to an SPE to bridge the gap between the date a claim is made against a third party enhancer and when payment is received’. [Office of the Superintendent of Financial Institutions in Canada (n 35 above) 7 para 25.] The only conclusion that I draw from this is that the Canadian Legislature has afforded a different and wider meaning to the term ‘facility’.
\textsuperscript{165} Huntley & Pottas (n 105 above) 4.
\textsuperscript{166} As above.
\textsuperscript{167} As above.
\textsuperscript{168} Schedule (n 7 above) para 1: “‘first-loss credit-enhancement facility” means a credit-enhancement facility that represents the first level of credit enhancement in a traditional or synthetic securitisation scheme’.
\textsuperscript{169} A Jacobs & EG van den Berg ‘South African securitisation regulatory developments’ 2001 http://www.securitization.net/pdf/decil_secede01.pdf (accessed 15 April 2013) 2. This must not be confused with what is known in Germany as \textit{das First Loss Piece}, which is the riskiest tranche of commercial paper issued. [Bayern LB (n 95 above) 7.]
enhancement facility\textsuperscript{170} (second-loss).\textsuperscript{171} The first-loss extends substantial protection;\textsuperscript{172} the second-loss ‘consist[s] of subordinated securities or some form of [tradable] marketable credit enhancement’\textsuperscript{173} subject to the Registrar’s discretion.\textsuperscript{174} According to the Schedule,\textsuperscript{175} a second-loss ‘benefits’ from the existence of a first-loss\textsuperscript{176}—being simply unscrupulous diction, since it seems dubious that a provider of the second-loss would transact based on such a motive. What rather appears to be the case is that the provider of the first-loss must record its historic losses\textsuperscript{177} or estimate its future losses\textsuperscript{178} by way of ‘simulation or other technique’\textsuperscript{179} The second-loss may only be drawn once the first-loss has been exhausted,\textsuperscript{180} and if the statutory provisions relating to a second-loss are not honoured, the facility shall be regarded as a first-loss for calculating the provider’s capital adequacy.\textsuperscript{181} It appears as if the main discrepancy between first-loss and second-loss is the treatment for capital adequacy:\textsuperscript{182} Since the former absorbs the highest risk, it is regarded as a capital impairment if the facility is provided by the originator or repackager;\textsuperscript{183} the latter is subject to the degree of protection provided by first-loss,\textsuperscript{184} and is treated as first-loss if the conditions relating to the degree of protection are not met.\textsuperscript{185}

\textsuperscript{170} Schedule (n 7 above) para 1: ‘“second-loss credit-enhancement facility” means a credit-enhancement facility that represents the second and further levels of credit enhancement in a traditional or synthetic securitisation scheme: Provided that—

(a) such facility benefits from a substantial first-loss credit-enhancement facility, that is, when the first-loss credit-enhancement facility covers some multiple, as opposed to a fraction, of historical losses or expected losses estimated by way of simulation or other technique; and

(b) such facility may be drawn only after the first-loss credit-enhancement facility has been exhausted,

and when there has not been compliance the above conditions, the facility concerned shall for purposes of calculating a bank’s prescribed capital requirement be regarded as a first-loss credit-enhancement facility in terms of this Schedule’.

\textsuperscript{171} Jacobs & Van den Berg (n 169 above) 2.

\textsuperscript{172} Schedule (n 7 above) para 6(2)(b)(ii). It is uncertain what substantial protection means and encompasses.

\textsuperscript{173} Schedule (n 7 above) para 6(2)(b)(iii).

\textsuperscript{174} As above.

\textsuperscript{175} n 7 above.

\textsuperscript{176} See n 170 above.

\textsuperscript{177} Schedule (n 7 above) para 6(2)(b)(ii).

\textsuperscript{178} As above.

\textsuperscript{179} As above.

\textsuperscript{180} See n 170 above.

\textsuperscript{181} Schedule (n 7 above) para 6(2)(b)(iii).

\textsuperscript{182} Jacobs & Van den Berg (n 169 above) 2.

\textsuperscript{183} As above.

\textsuperscript{184} As above.

\textsuperscript{185} As above.
The first-loss is normally transaction-specific, whereas the second-loss is normally programme-wide. According to the Schedule, the former provides for the distinct features and credit risk of the underlying whereas the latter provides for the composition and size of the SPI’s portfolio. Irrespective, the credit enhancement facilities have a logical duration, with the second-loss’ duration being dependent on the duration of the first-loss. This term concludes at a specified maturity date that will be the sooner date of either the assets or the commercial paper being the redeemed, or a contractually agreed date. It is uncertain what this provision means, since, in the event of a traditional securitisation scheme, the assets are transferred in true sale and are not redeemed, whereas in a synthetic securitisation scheme we do not work with assets per se. In terms of the presumption of effectual and purposeful legislation the reference to assets as included in the Registrar’s intention then must be regarded as including this with regard to both traditional and synthetic securitisation schemes. The only conclusion drawn from this is that such sooner date may be the date on which the obligors settle their debts in term of the underlying. Therefore, this constitutes a resolutive term or a resolutive condition, depending on the terms of the agreement. There is also a strange provision included that prima facie seems like alternative performance, but falls short of such a stipulation. The Schedule drafts this paragraph in terms so wide that it appears as if any party to the scheme may make the said appointment; in truth, the only party capable of making such an appointment is a party that has a causa, who will have the right to make such an appointment subject to reasonably conditions qualifying such a step.

It is important to distinguish between the different credit enhancement facilities in a scheme based on their priority, and especially so if the same bank or institution in such banking

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186 Schedule (n 7 above) para 6(1)(b).
187 Schedule (n 7 above) para 6(1)(b)(i).
188 Schedule (n 7 above) para 6(1)(b)(ii).
189 Schedule (n 7 above) para 6(2)(a)(ii).
190 n 7 above.
191 n 7 above, para 6(1)(b)(ii).
192 Schedule (n 7 above) para 6(2)(a)(i).
194 Schedule (n 7 above) para 6(2)(a)(iii): ‘Subject to reasonable qualifying conditions, parties involved in a…synthetic securitisation scheme or a person acting on behalf of these parties shall have the unequivocal right to select an alternative party to provide a credit-enhancement facility’.
195 n 7 above.
196 It is uncertain what is meant by ‘unequivocable right’ - n 7 above, para 6(2)(a)(iii).
197 n 7 above, para 6(2)(a)(ii).
198 Schedule (n 7 above) para 6(2)(b)(i).
group provides different credit enhancement facilities. All the credit enhancement facilities must, according to the Schedule, be contracted on a market related basis. This is echoed in the provision that a second-loss must either constitute subordinated securities or marketable ‘credit-enhancement’, subject to the Registrar’s discretion. Although it is difficult to imagine banks transacting on non-market-related bases, the Financial Crisis has once again proven how fickle the markets truly are and how economic valuations are not consistently realistic. In addition, it is often difficult with the involvement of credit derivatives to determine the true market related basis. It is important to remember that these facilities’ positions cannot be subordinated in a scheme, also because the details of the facility are disclosed to the investors. The Registrar fortunately provides for one circumstance of ex lege credit enhancement, being the case where the transferor transfers assets to the SPI below book value, in which case the transferor shall bear this ‘first-loss’ unless it indicates it as a loss on its balance sheet. There seems to be no similar provision for synthetic securitisation schemes. However, it appears that this may be interpreted as a punitive measure, just as when the transferor and/or its associated companies or institutions in its banking group conclude a ‘swap agreement’ to the intentional detriment of the former party or parties.

4 Liquidity facilities

Whilst some regard liquidity facilities as categorical to external credit enhancement, others regard them as distinct. No doubt, being identified as ‘facilities’, they remain credit facilities
and therefore credit subject to the National Credit Act\textsuperscript{213} if \textit{inter alia} said threshold is satisfied, although the conjunctive used in the definition of ‘liquidity facility’\textsuperscript{214} indicates that such a liquidity facility may not constitute a credit enhancement facility. The distinction is usually, in practice, based on the difference between ‘slow pay’ and ‘no pay’.\textsuperscript{215} SPIs face the risk of liquidity deficits\textsuperscript{216} below distribution owing to constricted business and consequential limited capacity to acquire debt.\textsuperscript{217} This risk realises due to \textit{inter alia}\textsuperscript{218} time differences between coupon and principal payments on transferred assets\textsuperscript{219} – in the event of a traditional securitisation scheme\textsuperscript{220} – or collateral assets\textsuperscript{221} – in the event of a synthetic securitisation scheme\textsuperscript{222} – and performance in terms of senior commercial paper,\textsuperscript{223} and/or market interruptions.\textsuperscript{224} Liquidity facilities, particularly short-term loan facilities,\textsuperscript{225} are provided by banks\textsuperscript{226} – known as ‘liquidity providers’\textsuperscript{227} – upon discrepancies existing between incoming cash flows and

\textsuperscript{213} 34 of 2005.
\textsuperscript{214} Schedule (n 7 above) para 1: “‘liquidity facility’ means a facility provided in respect of a traditional or synthetic securitisation scheme in order to cover deficiencies in cash flows within the said securitisation scheme(s), resulting from, amongst other things,

(a) time differences between the payment of interest and principal on the assets transferred, or other payments due in terms of a traditional securitisation scheme, and payment in respect of the senior commercial paper; or

(b) time differences between the payment of interest and principal on assets that serve as collateral, purchased in terms of a synthetic securitisation scheme, and payment in respect of the senior commercial paper; or

(c) market disruptions; or

(d) a combination of any of the matters specified above,

and which facility does not constitute a credit-enhancement facility”. It is known as \textit{Liquiditätsfazilitäten} in Germany. [Bayern LB (n 95 above) 14.].
\textsuperscript{215} Huntley & Pottas (n 105 above) 5. This distinction does not seem to be hard and fast in Germany. According to Bayern LB, ‘[s]o kann die Fazilität zur Zahlung von Zinsen und Kapital an die Investoren herangezogen werden, falls die Zahlungen aus dem verbrieften Pool hierfür nicht ausreichen.’ [‘Thus, the facility may be used to pay interest or capital to investors where the payment from the securitized pool fails to do so.’] [Bayern LB (n 95 above) 14.]; contra: ‘Liquiditätsfazilitäten stellen durch die Abdeckung von Zahlungseingängen innerhalb der Struktur eine Verbesserung der Liquidität, jedoch nicht der Bonität der verbrieften Assets dar.’ [‘Liquidity facilities provide, through the cover of payment bottlenecks within the structure, an improvement in liquidity, but not the credit quality of the securitised assets.’] [Bayern LB (n 95 above) 14.].
\textsuperscript{216} See n 214 above.
\textsuperscript{217} BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in Carey & Stulz (n 62 above) 560-561.
\textsuperscript{218} See n 214 above.
\textsuperscript{219} As above.
\textsuperscript{220} As above.
\textsuperscript{221} As above.
\textsuperscript{222} As above.
\textsuperscript{223} As above. In Germany, the provision of a liquidity facility seems to accommodate only senior commercial paper. [Bayern LB (n 95 above) 14.].
\textsuperscript{224} As above.
\textsuperscript{225} Karoly (n 37 above) 23; Schedule (n 7 above) para 1: “‘short-term liquidity facility’ means a liquidity facility provided in respect of a traditional or synthetic securitisation scheme, for a period of less than one year’.
\textsuperscript{226} Huntley & Pottas (n 105 above) 5.
\textsuperscript{227} Karoly (n 37 above) 23.
distributions. This is candid, since the Schedule makes no provision for liquidity facilities taking the form of an arrangement. The conclusion is that liquidity facilities must be distinguished from what is classified above as external credit enhancement facilities. Similarly, liquidity facilities and internal credit enhancement facilities cannot correspond since the former is purely based on a facility, whereas the latter may fall within some ordinary meaning of ‘arrangement’.

It may be initial curiosity why the definition makes no reference to the time difference between premium payments in terms of credit derivatives and the senior commercial paper, especially since payments on commercial paper is expressly justified from premiums and it is also a matter that must be disclosed. The Schedule is direct on excluding this from the ambit of liquidity facilities. This is a thought-provoking matter, since it is excluded from the ambit of external credit enhancement, it is excluded from underwriting, as it is excluded from servicing. Similarly, repudiation of the credit derivative is statutorily prohibited if the credit quality deteriorates. It is conceivable that the SPI may then rely on internal credit enhancement, such as early amortisation, cross-collateralisation or a lock-up mechanism; however, all of these options are based on a change in circumstance relating to the underlying. A remedy is sought that the SPI may utilise against the protection buyer should it default on its premium payments. The practitioner may regard such a question as superfluous,

228 Huntley & Pottas (n 105 above) 5.
229 n 7 above.
230 See para 3.3 above.
231 See paras 3.1, 3.3 above. ‘Im Gegensatz zur Liquiditätsfacilität steht der Reserve Fund zur Verrechnung mit Verlusten zur Verfügung.’ [Translated according to the authors’ intention rather than diction: ‘Contrary to the liquidity facility, the reserve fund exists to offset prevalent losses.’] [Bayern LB (n 95 above) 15.] This statement does not capture the motive of the SPI in using an internal credit enhancement measure, which is actually for purposes of credit ratings. Nonetheless, liquidity facilities do not facilitate losses, and this is an important pragmatic differentiation from credit enhancement.
232 Schedule (n 7 above) para 1 definition of ‘synthetic securitisation scheme’.
233 Schedule (n 7 above) para 16(2)(a)(vi).
234 n 7 above.
235 n 7 above, para 7(2)(a)(i).
236 Schedule (n 7 above) para 6(1)(a) – the credit enhancement facility in the Schedule [n 7 above.] protects the investors and not the SPI.
237 Para 5 below.
238 Schedule (n 7 above) para 9(1)(a)(ii).
239 Schedule (n 7 above) para 5(2)(l)(ii). This seems to be the international inclination. In Germany, if true sale decreases the quality of the transferor’s resultant portfolio, BaFin may impose certain requirements in terms of the Principles Concerning the Capital and Liquidity of Credit Institutions. [‘Asset-backed securities in Germany: The sale and securitisation of loans by German credit institutions’ (1997) Deutsche Bundesbank Monthly Report July 1997 60 http://people.stern.nyu.edu/igiddy/ABS/Germansecuritization.pdf (accessed 20 January 2015)].
240 Para 3.2 above.
241 As above.
242 As above.
since in reality SPIs are indeed treated as empty shell companies\textsuperscript{243} that would never institute proceedings against parties acting in a primary role, and secondly the provisions relating to circumstance, as set out above, rather than a particular remedy. Not that a corporate Oedipus complex is to be instilled in parties acting in a primary roll, but the law operates in practice subject to the rule of law, and practitioners are cautioned from early on not to practice on policy. As will be set out elsewhere,\textsuperscript{244} legal issue is taken with the matter-of-fact leaderless structure of a SPI.\textsuperscript{245} There is no statutory restriction on the SPI’s right to institute action against the transferor for non-performance of the premium\textsuperscript{246} and since non-performance of the premiums fall within the control of the transferor, it can issue a warranty in this regard to the SPI.\textsuperscript{247}

Some of the salient features of liquidity facilities are similar to those of credit enhancement facilities, such as maturity,\textsuperscript{248} documentation,\textsuperscript{249} distinction \textit{inter se},\textsuperscript{250} market related transaction,\textsuperscript{251} recourse restriction,\textsuperscript{252} alternative providers,\textsuperscript{253} and approval.\textsuperscript{254} However, as of yet, only liquidity facilities provided to SPIs in indirect synthetic securitisation schemes have been considered. The role of liquidity facilities in direct synthetic securitisation schemes may not be substantially different, given the fact that reference to an SPI with regards to the specific paragraph on liquidity facilities in the Schedule\textsuperscript{255} only mentions SPIs in the subparagraph entitled ‘[g]eneral’.\textsuperscript{256}

5 Underwriting

The jurist comprehends two ordinary meanings for ‘underwriter’: Either it underwrites insurance policies or it underwrites corporate securities. According to Hossain, Islam and Siddiquee, the underwriter of the scheme advises the seller on the securities’ structure, as well

\textsuperscript{243} BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in Carey & Stulz (n 62 above) 550.
\textsuperscript{244} See ch 5 and ch 6 below.
\textsuperscript{245} BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in Carey & Stulz (n 62 above) 550.
\textsuperscript{246} Schedule (n 7 above) para 5(2)(b).
\textsuperscript{247} Schedule (n 7 above) para 5(2)(c)(ii).
\textsuperscript{248} Schedule (n 7 above) para 7(2)(a)(ii).
\textsuperscript{249} Schedule (n 7 above) paras 7(2)(d), 7(2)(h).
\textsuperscript{250} Schedule (n 7 above) para 7(2)(a)(iii).
\textsuperscript{251} Schedule (n 7 above) para 7(2)(a)(iv).
\textsuperscript{252} Schedule (n 7 above) para 7(2)(b).
\textsuperscript{253} Schedule (n 7 above) para 7(2)(c).
\textsuperscript{254} Schedule (n 7 above) para 7(2)(a)(v). In Germany, liquidity facilities are strictly regulated. [True Sale International ‘The potential development of a high quality securitisation market in the EU: The answers of the True Sale International GmbH (TSI), Germany’ http://www.true-sale-international.de/fileadmin/tsi_downloads/TSI_kompakt/Fragebogen_Part_Two___ABCP_Market_.pdf (accessed 11 March 2015) 5.].
\textsuperscript{255} n 7 above.
\textsuperscript{256} n 7 above, para 7(1)(a).
as the pricing and marketing thereof. Teasdale contends that the underwriter, also known as a placement agent, structures the ‘deal’ and ‘places’ the securities. The selection of an underwriter is based on its fees, marketing skills and reputation. The underwriter may not be defined in the Schedule, but underwriting indeed is. The basic role of the underwriter is actually much simpler than the definition sets it out to be: In the event that the SPI does not wish to invite investors to subscribe to its commercial paper, it can use the underwriter to invite investors to purchase its commercial paper. The underwriter assumes the risk of undersubscription and manages oversubscription. Therefore, the reference to ‘exposure’ is apt. As for the rest of said definition, it is uncertain whether the inclusive definition attempts to define ‘underwriting’ or ‘underwriting commitments’. However, the definition refers to facilities with regards to the risk of undersubscription, whereas the Companies Act compels the SPI to receive consideration for any shares prior to such issue and, if otherwise, compliance with section 40(5) of the Companies Act transpires.

The underwriter must be a bank, although it is uncertain which parties already party to the scheme may assume such a role – the Schedule makes express reference to originators and remote originators on the one hand, and sponsors and repackagers on the other, but does not prohibit other parties from assuming this role as long as the originator and remote originator, and the sponsor and repackager, comply with the conditions set out in the Schedule.

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258 Karoly (n 37 above) 20.
260 Teasdale (n 40 above) 5.
261 Karoly (n 37 above) 20.
262 Teasdale (n 40 above) 5.
263 h 7 above.
264 n 7 above, para 1: “‘underwriting” means exposure that includes all underwriting commitments, whether in writing or verbally, including all note-issue facilities and revolving underwriting facilities in respect of which the contingent risk arises from the bank’s role as underwriter of such issues, guaranteeing to provide funds when other parties have refused to do so’.
266 As above.
267 See n 266 above.
268 71 of 2008.
269 Companies Act 71 of 2008 sec 40(4).
270 71 of 2008.
271 See n 266 above.
272 n 7 above.
273 n 7 above, para 8(1)(a).
274 n 7 above, para 8(1)(a).
275 n 7 above, para 8(1)(b).
276 n 7 above.
originator or remote originator is the underwriter, then, subject to the Registrar’s discretion, additional capital adequacy rules are imposed. Such an underwriter must ensure that ninety percent of the SPI’s ‘total debt raised’, to the exclusion of its acknowledged credit-enhancement facilities, is issued, otherwise such securitised risk will not be derecognised. This ostensibly means that ninety percent of the commercial paper must be issued, i.e. offered and accepted, through the underwriter for sale. The implication is that if the SPI elects to utilise the subscription method instead of the sale method, this ninety percent condition will not apply, but simply a ‘significant amount’ of the securitised risk must be transferred to the investors. Any senior commercial paper held by the originator or remote originator in excess of the ninety percent sold to investors statutorily constitutes a second loss. If the sponsor or repackager is the underwriter, then, upon conclusion of the underwriting period, any senior commercial paper retained rated inferior to a BBB-equivalent status will be statutorily regarded as a first-loss for capital adequacy purposes. If the rating is BBB- or superior, then the senior commercial paper will be risk-weighted. If not rated, the senior commercial paper will be treated according to the Bank Regulations.

6 Purchaser of senior commercial paper

An elaborate discussion of purchasers of senior commercial paper, as a matter of stratification, is reserved for chapter 8 below. Suffice to state here that stratification bears on what is known in Germany as Verlustverrechnung, and is based on the practice of umgedrehten Seniorität, which resembles the South African principle of tranching. As already stated, liquidity facilities exist inter alia to ensure that performance is rendered on senior commercial paper. This is the only tranche of commercial paper that originators may invest in, although institutions acting in a primary role may not be the only investors in senior

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277 Schedule (n 7 above) para 8(1)(a)(i).
278 As above.
279 Schedule (n 7 above) para 8(1)(a)(i).
280 Schedule (n 7 above) para 5(2)(a)(vi).
281 Schedule (n 7 above) para 8(1)(a)(ii).
282 Schedule (n 7 above) para 8(1)(b)(i).
283 Schedule (n 7 above) para 8(1)(b)(ii).
284 Schedule (n 7 above) para 8(1)(b)(iii).
285 Schedule (n 7 above) para 1: “senior commercial paper” means commercial paper issued in terms of a traditional or synthetic securitisation scheme, the purchase of which commercial paper does not constitute providing a first-loss or second-loss credit-enhancement facility.
286 Schedule (n 7 above) para 5(1)(a)(i).
287 ‘Loss offset’ [Bayern LB (n 95 above) 7.].
288 ‘Inverted seniority’ [Bayern LB (n 95 above) 7.].
289 Schedule (n 7 above) para 5(2)(h)(i).
commercial paper, subject to the Registrar’s discretion. According to the Schedule, this is the only tranche that can be subjected to early amortisation.

7 Servicing agent

The Schedule defines the term ‘servicing agent’. It carries the same meaning in Germany, where it is said to recover demanded outstanding balances and is known as either the servicer or der Verwalter, whereas in Canada, the reference is not so much to the servicer or the servicing agent as it is to servicer advances. It seems as if the Registrar intended the servicer to be appointed in terms of a contract of agency. This role is, according to the Schedule, only undertaken by a bank or an institution within a banking group, although such requirement does not seem to apply in the two latter jurisdictions. This role may also be assumed by a participant in a primary role and, in the event of a hybrid CDO, the transferor will not be regarded as holding indirect control of the assets subject to true sale by virtue of such transferor holding servicing rights. This is a necessary provision, given the consideration of greater control over employees than over agents. The Schedule provides that, in the event of a participant in a primary role acting as a servicing agent, the servicing agent will not deliver the relevant performance to the SPI unless the performance has been received from the obligor, although a short term advance may be provided to the SPI at the servicing agent’s discretion.

290 Schedule (n 7 above) para 5(2)(k)(i).
291 As above.
292 n 7 above.
293 n 7 above, para 13(1)(a).
294 n 7 above.
295 n 7 above, para 1: ‘“servicing agent” means an institution that acts as servicing agent in relation to the collection of the amounts due in terms of a traditional or synthetic securitisation scheme’.
296 Bayern LB (n 95 above) 24.
297 As above.
298 See Office of the Superintendent of Financial Institutions in Canada (n 35 above) in general.
299 See the reference to ‘agency’ at Schedule (n 7 above) para 9(1)(b).
300 n 7 above.
301 As above. In Germany, this state of affairs is the rule rather than the exception. [Bayern LB (n 95 above) 24.]
302 In the event of an exception, the servicer is known as the ‘Special Servicer’. [Bayern LB (n 95 above) 24.]
303 n 1 above, para 4(2)(b)(iii). The position is expressly the same in Canada. [Office of the Superintendent of Financial Institutions in Canada (n 35 above) sec 7.3.1 para 36(b).]
304 See Ongevallekommissaris v Onderlinge Versekeringsgenootskap AVBOB 1976 4 SA 446 (A) in general.
305 n 7 above.
306 n 7 above, para 9(1)(b). The position is similar in Canada. [Office of the Superintendent of Financial Institutions in Canada (n 35 above) para 72.]
307 n 7 above, para 9(1)(c). In Canada, ‘[s]ubject to national discretion, if contractually provided for, servicers may advance cash to ensure an uninterrupted flow of payments to investors so long as the servicer is entitled to full reimbursement and this right is senior to other claims on cash flows from the underlying pool of exposures.’ [Office of the Superintendent of Financial Institutions in Canada (n 35 above) para 71.]. However, it must be
The Schedule demands the prevalence of a ‘formal servicing agreement’, which has an uncertain denotation, although it presumably refers to the compulsory formality of a written contract, setting out the services that the servicing agent must provide as well as the standard thereof, although the Schedule does not specify what such a standard should be or entails. It is doubtful that the Registrar here refers to the common law standard of the duty of care and skill or bona fides, since such standards would apply ex lege. The purpose of this formality may be to circumvent the doctrine of an undisclosed principal. The remuneration that the SPI must perform to the servicing agent must be, statutorily, market-related and may not be deferred, subordinates or waived. Positive law dictates that it must be commensurate with similar practices or at least reasonable. The servicing agent, unlike the underwriter, does not assume risk of any sort. Whilst it assists in the delivery of performance per se to the SPI within specified or reasonable time, neither the SPI nor the investors have recourse for performance against the servicing agent, which appears in the disclosure document, although this seems to merely be a codification of the common law indemnification of an agent. It is uncertain why the Registrar provides a statutory discretion to the servicing agent to withdraw from its role upon reasonable notice; paraphrased, it constitutes an unconditional cancellation.

repaid within thirty-one days. [Office of the Superintendent of Financial Institutions in Canada (n 35 above) para 73.]

308 n 7 above.
309 n 7 above, para 9(1)(a)(i).
310 As above.
311 As above.
312 n 7 above.
314 SR van Jaarsveld ‘Die verteenwoordiger’ in Nagel (n 313 above) 170-171.
315 See Cullinan v Noordkaaplandse Aartappel-kernmoerkwekers Koöperasie Bpk 1972 1 SA 767 (A) in general. It is uncertain whether the remedy of estoppel will be excluded in these cases.
316 Schedule (n 7 above) para 9(1(a)(iv).
317 Schedule (n 7 above) para 9(1(d).
318 See the locus classicus, Barnabas Plein & Co v Sol Jacobson & Son 1928 AD 25, in general for the factors relating to remuneration.
319 Para 5 above.
320 SR van Jaarsveld ‘Die verteenwoordiger’ in Nagel (n 313 above) 171.
321 SR van Jaarsveld ‘Die verteenwoordiger’ in Nagel (n 313 above) 169.
322 n 7 above, para 9(1)(a)(ii).
323 As above. It deserves note that, in Germany, the servicer has the duty to exercise regular reporting with regards to the course of the transaction, [Bayern LB (n 9 above) 24.].
324 E.g. Blumenthal v Bond 1916 AD 29.
325 Schedule (n 7 above) para 9(1)(a)(iii).
326 Office of the Superintendent of Financial Institutions in Canada (n 35 above) para 73.
8 Counterparty to a transaction in a bank’s trading book

According to Financial Times, banks’ activities are classified as either banking or trading, irrespective of the securities held.\(^{327}\) Prior to the Financial Crisis, banks transferred great value to their trading books given the lower capital adequacy requirements relating thereto.\(^{328}\) In South Africa, transactions falling in the trading book of a bank do not qualify as ‘the business of a bank’,\(^{329}\) although the Schedule\(^{330}\) specifically regulates such activity.\(^{331}\) This is discussed in detail elsewhere.\(^{332}\) The Schedule\(^{333}\) does not provide the specific transactions relating to the synthetic securitisation scheme that will be relevant; instead, the relevant paragraph is drafted in the widest sense to encompass any contractual relationship between a bank, irrespective of it acting in a primary role, and an SPI which reflects in the bank’s trading book.\(^{334}\) The Schedule\(^{335}\) provides the reader with some concept of an intended ambit, relating to the trading of the SPI’s commercial paper\(^{336}\) or the acquisition of the SPI’s assets, beneficial interest therein, or risk,\(^{337}\) although the subparagraph in which the aforesaid appears constitutes a compulsory provision that may set out the ambit only in an inclusive fashion.

The Registrar undoubtedly tries to limit the association between a bank’s trading book and possible transactions with an SPI, be that with regards to recourse or with regards to long-term commitment. As for the former, the applicable provision in the Schedule\(^{338}\) is unscrupulously drafted so that its exact meaning is uncertain.\(^{339}\) Does said provision imply that the bank has no such recourse, or that the SPI has no such recourse? Either way, recourse will be limited to the existence of a *causa* and the provisions set out in the Schedule\(^{340}\) or the Bank Regulations. As for the latter, the Schedule\(^{341}\) provides that there may be no duty on the bank to enter into

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\(^{328}\) As above.

\(^{329}\) Banks Act 94 of 1990 sec 1 definition of ‘the business of a bank’.

\(^{330}\) n 7 above.

\(^{331}\) n 7 above, para 10.

\(^{332}\) See ch 8 below.

\(^{333}\) n 7 above.

\(^{334}\) n 7 above, para 10(1)(a).

\(^{335}\) n 7 above.

\(^{336}\) n 7 above, para 10(1)(a)(iv)(A).

\(^{337}\) n 7 above, para 10(1)(a)(iv)(B).

\(^{338}\) n 7 above.

\(^{339}\) n 7 above, para 10(1)(a)(i): ‘[T]here shall be no recourse to the bank beyond the fixed contractual obligations provided for in the transaction that is included in the trading book of the bank’.

\(^{340}\) n 7 above.

\(^{341}\) As above.
any further transaction with the SPI apart from the transactions existing at any applicable point in time\textsuperscript{342} and even then it must be transacted on market-related terms.\textsuperscript{343}

9 Final remarks

The categorical difference between parties classified as acting in a primary or secondary role is nonsensical. As already stated,\textsuperscript{344} the Registrar likely used the categorisation of ‘primary role’ and ‘secondary role’ for purposes of convenience only. Similar categorisation is not traced in German or Canadian law. As already mentioned, the activities in securitisations can be executed by numerous parties or by few parties executing more than one role.\textsuperscript{345} It is understandable that the literati in commerce and/or economics may prefer such a classification for purposes of mitigating uncertainty, but the jurist comprehends the applicability of different contracts between similar parties; therefore, no confusion can exist. Apart from the same parties in different legal contexts, the effects \textit{per se} of legal activities render the activities categorised as ‘secondary roles’ complex, for example, subordination must appear in discussions on internal credit enhancement, the second-loss in external credit enhancement, liquidity facilities, purchasers of senior commercial paper, and then, implicitly, transactions in a bank’s trading books. But none of this demands a fragmentation of participants in a synthetic securitisation scheme.

The existence of a cornucopia of credit enhancement measures supply the SPI with the option of electing the measure(s) that would supply the best ratings and the best protection against default, whilst bearing the SPI’s optimisation of profit in mind. The SPI is at liberty to choose from both internal and/or external credit enhancement. Although the latter is never described as a necessity, there are some measures of the former that are intrinsic to the basic structure of a synthetic securitisation scheme, such as stratification. Whether the SPI elects to use a facility or an arrangement of some sort, it is bound to cost the SPI, be that through counter-performance to the credit facility provider or the loss based on the time value of money\textsuperscript{346} or lower return on investment of the collateral due to the requirement of liquidity.\textsuperscript{347} The bottom line is that synthetic securitisation schemes are not created for the purposes of satisfying legal

\begin{itemize}
\item \textsuperscript{342} n 7 above, para 10(1)(a)(ii).
\item \textsuperscript{343} n 7 above, para 10(1)(a)(iii).
\item \textsuperscript{344} Para 2 above.
\item \textsuperscript{345} Ch 1 para 1 above.
\item \textsuperscript{346} This is discussed in ch 5 below.
\item \textsuperscript{347} Para 3 above.
\end{itemize}
requirements; synthetic securitisation schemes are simply be subject to legal requirements. Therefore, the SPI will impose such credit enhancement measures as are necessary to safeguard the interest of the investors bearing in mind the SPI’s optimisation of profit. The astute jurist will now enquire as to the motive behind credit enhancement for purposes of credit ratings, and this is to be answered in the same breath as the following statement: There is no standard in the Schedule with regard to the extent of overall credit enhancement to be supplied. The provision of credit enhancement for purposes of ratings may serve numerous roles, such as marketing for different investor classes, but once the commercial paper has been issued, the economic activities of the SPI must be based on the best-interests of inter alia its shareholders and its debt-instrument holders.

Underwriters may fulfill an important function in the aftermath of the Financial Crisis. By this time, the reader may come to understand that there are numerous frictions in a synthetic securitisation structure, but, on the advice of Donald Trump, “[p]rotect the downside and the upside will take care of itself”. Therefore, although the underwriter is not at all a necessary figure in a synthetic securitisation scheme, the bad reputation that securitisations have received after the Financial Crisis may cause the public to be wary of a specific synthetic securitisation scheme’s commercial paper. Therefore, it may be wise to use the services of an underwriter to take care of the risk of undersubscription. However, the role of the servicer may be juxtaposed to this. It is doubtful whether a synthetic securitisation scheme necessitates a servicing agent. Little information can be procured regarding servicing in synthetic securitisation schemes. In a traditional securitisation scheme, the servicer is responsible for transferring, for example, the payments on the credit extended to the obligors by the transferor in the light of the fact that the claims have been sold to the SPI and the performance is now owing to the SPI. In a synthetic securitisation scheme, the claims are not sold and remain on the balance sheet of the transferor; only the risk is transferred, which in practice means that the transferor must make payments to the SPI. It is uncertain why the transferor would require a servicing agent to ensure performance of the premiums that it has contracted to itself.

See e.g. Schedule (n 7 above) para 17.
n 7 above.
The reader may here refer to indirect instances, such as n 7 above, para 5(2)(i)(ii), but the use of the word ‘may’ is emphasised at n 7 above, para 6(2)(a).
See ch 2 above.
Para 5 above.
The role of the trading book of a bank deserves a master’s dissertation or doctoral thesis in own right. Banks have been accused of holding millions in toxic debt in their trading books prior to the Financial Crisis, which contributed to that debacle.\footnote{See n 327 above.} Firstly, it must be borne in mind that antagonism against central banking and banking \textit{per se} has, after centuries, become a cliché. The sensible jurist ignores hidden hand theories. ‘Success…has many fathers, but failure is an orphan.’\footnote{M Fleuriet \textit{Investment banking explained: An insider’s guide to the industry} (2008) 3.} There is no simple answer to the Financial Crisis. Virtually since inception a thousand years ago, banks have been classified as either commercial banks or investment banks,\footnote{Fleuriet (n 356 above) 3-15 in general.} the former primarily involved in the taking of deposits\footnote{As above.} and therefore that which constitutes ‘the business of a bank’,\footnote{See n 329 above.} the latter’s activities resembling the activities in the trading book of the bank much more than the other.\footnote{Fleuriet (n 356 above) 3-15 in general.} This latter activity is more commonly known as ‘proprietary trading’ or, colloquially, ‘prop trading’.\footnote{Fleuriet (n 356 above) 124.} It is interesting that regulators take issue with prop trading, whilst bearing the downside in mind, since the basic principle still applies that profit optimisation serves the interests of \textit{inter alia} the bank’s securities holders.\footnote{See n 351 above.} The downside is that lower capital requirements on the trading book of a bank means possible systemic risk realisation,\footnote{See n 327 above.} and imposing additional regulations on the trading book of a bank may just motivate a bank to shed its unwanted risk via securitisation.
Chapter 5
The nature and role of special-purpose institutions in synthetic securitisation schemes

1 General
2 SPIs in context
3 Defining the SPI
   3.1 General
   3.2 Relevant form of business enterprise
   3.3 The bullet-proof factor
   3.4 The SPI’s rationale
   3.5 Final thoughts
4 Control of the SPI
5 Management of the SPI
6 The applicability of the Collective Investment Schemes Control Act
   6.1 General
   6.2 Public offer
   6.3 Investors contributing for a participatory interest in a CIS portfolio
   6.4 Sharing risk and benefit
7 Final remarks

1 General
Securitisation can usually be found defined in relation to structured finance, but not vice versa. In conducting research for this thesis, it was found that synthetic securitisation is virtually never referred to against the backdrop of structured finance. The shrewd jurist – the epistemologist – understands this to have little, if any, significance. When the BIS attempted to define structured finance,\(^1\) it rather presented common denominators and inadequately included the necessary

\(^1\) FJ Fabozzi & V Kothari *Introduction to securitization* (2008) 4-5: ‘Structured finance instruments can be defined through three key characteristics: (1) pooling of assets (either cash-based or synthetically created); [sic.] (2) tranching of liabilities that are backed by the assets pool (this property differentiates structured finance from
prevalence of ABSs. Therefore, this excerpt from Fabozzi, Davis and Choudry’s definition with regards to the subject matter is preferred: ‘…techniques employed...be they concerned with funding, liquidity, risk transfer, or other need…’. 2 Synthetic securitisation does not demand the pooling of assets; it in general entails asset (for purposes of risk) identification and selection, 3 although the jurist must be wary in considering when the latter distinction constitutes a commercial, rather than legal, consideration. 4 There is no confusion with secured lending, since the BIS’s three characteristics 5 would apply conjunctively in synthetic securitisation schemes and the tranched liabilities would bear on liabilities in terms of the secured loan rather than assets in terms of a securitisation. Although the third characteristic refers to the transfer of assets, 6 it conclusively binds the characteristics for differentiating corporate finance from structured finance, given the imperative of an SPI, 7 for what it is worth. 8 The word ‘usually’ 9 hints at the South Africa structured finance possibility where SPIs would be superfluous, such as the direct transfer of credit risk to a protection seller 10 through a CDS or CLN, 11 removing the SPI’s operational costs. 12

Figure 5.1

traditional ‘pass-through’ securitizations); [sic.] (3) de-linking of the credit risk of the collateral asset pool from the credit risk of the originator, usually through use of a finite-lived, standalone special purpose vehicle’.

2 Fabozzi & Kothari (n 1 above) 4.
3 Fabozzi & Kothari (n 1 above) 68-70.
4 As above.
5 Fabozzi & Kothari (n 1 above) 4-5.
6 As above.
7 Another distinction is that drawn between banking and securitisation. Figure 5.1 below sets out the archetypal structure of commercial banking, whilst figure 5.2 presents the structure of securitisation as it extends business activity to capital markets. [DN Chorafas Credit derivatives & the management of risk including models for credit risk (2000) 7-8.].
8 Ch 2 paras 4.1, 7 above.
9 Fabozzi & Kothari (n 1 above) 4-5.
11 MI Greenberg & E Uwaifo ‘Key issues in structuring a synthetic securitization transaction’ in Preston (n 10 above) 142.
12 As above.
An implied *consensus* exists in most local sources that securitisation not only involves SPIs, but that SPIs form the centre of such schemes. Herewith also exists a primary basis for discussing synthetic securitisation schemes herein in terms of corporate law.\(^{13}\) Complete works exist on the topic of SPIs.\(^{14}\) The possibility of prospective theses on SPIs *per se* is not discounted from the academic community; therefore, this chapter is limited to the context of synthetic securitisation schemes. However, the question arises whether SPIs indeed form the centre of synthetic securitisation schemes. This will be the first topic of discussion in this chapter. Upon understanding what the SPI is, the legal interaction between the SPI and the other participants involved in a synthetic securitisation scheme is also comprehended.\(^{15}\)

### 2 SPIs in context

It is contended that in Germany the employment of a SPI is the exception rather than the rule in synthetic securitisation schemes.\(^{16}\) Whether this is a jurisdictionally valid argument will be explored at a later stage. Schemes not employing a SPI have been referred to as ‘direct synthetic securitisation’.\(^{17}\) An example of this is Deutsche Bank AG’s CAST 1999-1 scheme (figure 5.5

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\(^{13}\) Ch 1 para 1 above.

\(^{14}\) E.g. BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in M Carey & RM Stulz (eds) *The risks of financial institutions* (2007) 549 *et seq*.

\(^{15}\) Ch 3 para 1 above.


\(^{17}\) Böhringer *et al* (n 16 above) 53.
In direct synthetic securitisation, according to Böhringer et al from Deloitte & Touche Germany, the issuing function of the SPI and the originating function of the originator are amalgamated in the originator. This is achieved by issuing CLNs, which are ‘funded balance sheet assets that offer synthetic credit exposure to a reference entity in a structure designed to resemble a synthetic [debt instrument]]. A detailed discussion of CLNs at this stage would be a digression, both because it is included elsewhere and because it would lend undue complexity to present purposes given that the term CLN is merely an umbrella term for a range of products that cannot be discussed en toto due to length limitations on this work.

A reference to CLNs requires specification, on a case to case basis, whether reference is made to credit linked structured notes—which include total return swap linked notes, credit spread linked notes and credit default linked notes—repackaged credit linked notes or synthetic bonds. The use of CLNs does not necessarily imply direct synthetic securitisation: A protection buyer can sell CLNs to investors via an intermediate bond-issuing entity to transfer the credit risk, as set out in figure 5.3 below. This is usually the case with repackaged credit linked notes and synthetic bonds. However, the CLNs are not likely to cover all the exposures of the reference portfolio; therefore, CDSs are employed for the remaining exposures, which are underwritten by an Organisation for Economic Cooperation and Development (OECD) bank.

In Germany, where direct synthetic securitisation, as already noted, ostensibly transpires, the role of pooling assets is undertaken by the originator/repackager internally, so that it issues

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18 MI Greenberg & E Uwaifo ‘Key issues in structuring a synthetic securitization transaction’ in Preston (n 10 above) 142.
19 n 16 above, 28.
20 Böhringer et al (n 16 above) 25.
21 Ch 7 below.
22 S Das Credit derivatives: CDOs & structured credit products (2005) 249 et seq.
23 Chaplin (n 30 above) 147.
24 Das (n 22 above) 249, 251-274.
25 Das (n 22 above) 251-259.
26 Das (n 22 above) 259-263.
27 Das (n 22 above) 263-274.
28 Das (n 22 above) 275-298.
29 Das (n 22 above) 298-303.
31 As above.
32 As above.
33 Böhringer et al (n 16 above) 28.
34 As above.
35 Böhringer et al (n 16 above) 28.
36 As above.
CLNs rather than ABSs causing losses to be absorbed by the CLNs. These direct synthetic securitisation schemes without disintermediation is also known as limited recourse note programmes, as set out in figure 5.4 below. Upon considering the advantages of direct synthetic securitisation we must consider the advantages of synthetic securitisation *per se* in Germany:

Fewer risks occur in a synthetic transaction in comparison to a conventional transaction. Only credit and currency/exchange rate risks apply in a synthetic transaction. Liquidity, prepayment and reinvestment risks do not have to be taken into consideration as most synthetic structures have replenishment and no SPV.

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38 As above.
39 Chaplin (n 30 above) 145.
40 As above.
41 Böhringer et al (n 16 above) 29.
Figure 5.4

- Protection buyer (CLN issuer)
- Investor
- Synthetic exposure
- Reference credit

Figure 5.5

- Reference claims
- Cashflow
- Exposure

- Class A and B Treuhänder
  - Transfer of Pfandbriefe as collateral
  - Credit protection amounts
  - Swap counterparty
  - Fixed payments

- Class A (AAA/Aaa)
- Class B (AA/Aaa)
- Class C (A/Aa3)
  - Issue proceeds
  - P & I
  - P & I if Deutsche Bank AG defaults
3 Defining the SPI

3.1 General

The respective definitions of ‘originator’ and ‘repackager’ present no indication of the party taking transfer of credit risk. This *prima facie* provides for both direct and indirect synthetic securitisation. This is an example of unscrupulous legislative drafting, since an absence of any indication suggests transfer *in vacuo*. This is perhaps, given the discussion in chapter 2 paragraph 2.2 above, corrected by paragraph 5(1)(a)(i) of the Schedule with reference to (a) ‘special-purpose institution[s]’. Since both the latter as well as the term ‘institution’ are used in the Schedule, it is presupposed that the common denominator their wording is ‘institution’. It is doubted whether the prevalent consequences were intended, hence interpretation is improved by considering these concepts as *inclusio unius et exclusio alterius*. However, ‘special-purpose institution’ is not an exclusive designation in South Africa; for example, SARS has referred to SPIs as special purpose vehicles (SPVs). In the absence of a definition of ‘vehicle’ in banking and tax legislation, the ordinary meaning would relate to manifestation and transmission. The former entails the pooling of assets or securities, and/or their identification or selection, as mentioned above, and the latter entails the diffusion of value with the issue of commercial paper. Since both these aspects are discussed elsewhere, one is inclined to believe that this unsatisfactory approach circumvents the crux of a SPI. Despite the relative importance of SPIs to securitisation schemes, not all SPIs are established for purposes of securitisation.

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42 See ch 3 n 20 above.
43 See ch 3 n 21 above.
45 See ch 3 n 22 above.
46 n 44 above.
49 See ch 5 para 1 above.
The Schedule\textsuperscript{53} expressly defines ‘special-purpose institution’.\textsuperscript{54} This definition implies that a SPI has a\textit{ numerus clausus} of common characteristics: It takes the form of specific business enterprise,\textsuperscript{55} it is insolvency remote\textsuperscript{56} and it is ‘incorporated, created or used solely for the purpose of the implementation and operation of a…synthetic securitisation scheme’.\textsuperscript{57} Each of these characteristics shall be subsequently discussed with regards to synthetic securitisation schemes.

3.2 Relevant form of business enterprise

Some literature refers to SPIs as ‘special-purpose entities’ (SPEs),\textsuperscript{58} which is surprising if one takes into account that such literature classifies the SPI as ‘a limited partnership, a limited liability company, a trust, or a corporation’.\textsuperscript{59} This opinion will only be valid if the entity theory applies to the partnership.\textsuperscript{60} A limited partnership,\textsuperscript{61} or a partnership \textit{en commandite} for South African purposes\textsuperscript{62} – given the aggregate theory\textsuperscript{63} – may be the closest equivalent of an unincorporated enterprise to an incorporated one\textsuperscript{64} save for a trust, but it remains unincorporated and therefore not an entity;\textsuperscript{65} similarly, a trust is not incorporated but \textit{quasi-}...
incorporated,\textsuperscript{66} and thus falls short of being an entity.\textsuperscript{67} The Canadians, for example, seem to prefer to the term ‘SPE’.\textsuperscript{68} It is defined, for present purposes, as an entity\textsuperscript{69} organised for the specific purpose of synthetic securitisation,\textsuperscript{70} with its activities limited to accomplish this purpose subject to appropriateness,\textsuperscript{71} and structured for the purpose of isolation from the parties acting in a primary role.\textsuperscript{72}

The Schedule\textsuperscript{73} limits SPIs to companies or trusts.\textsuperscript{74} Any justification for this limitation in South African legislation remains speculative. The so-called ‘limited partnerships’,\textsuperscript{75} as already noted, actually partnerships \textit{en commandite},\textsuperscript{76} historically served as a catalyst for the revival of the Roman \textit{universitas}.\textsuperscript{77} It is difficult to contemplate the exclusion of partnerships \textit{en commandite} from securitisation in South Africa based solely on the lack of perpetual existence\textsuperscript{78} since securitisation schemes in practice have a limited existence. It is also uncertain why closed corporations were\textsuperscript{79} excluded as possible SPI’s. Whereas the initial rationale for the establishment of such vehicles in South African law\textsuperscript{80} may not necessarily be parallel to the

\textsuperscript{67} Reference to SPIs as SPEs in South Africa requires circumspection, since the latter is domestically a misnomer. This thesis is not primarily concerned with the use of trusts as SPIs in synthetic securitisation schemes. This does not subtract from the general role of trusts in securitisations globally – frankly, the first Australian securitisations, according to law firm Clayton UTZ, were based on First Australian National Mortgage Acceptance Corporation (FANMAC) Trusts [Clayton UTZ ‘A guide to the law of securitisation in Australia’ 2005 http://www.claytonutz.com/downloads/Securitisation_4thEd_Mar05.pdf (accessed 21 February 2015) 8.]. Canadian securitisations, for example, firmly operate around a SPI trust structure due to its flexibility in that jurisdiction [P Beaudin \textit{et al} ‘Structured lending and securitisation in Canada: Overview’ 2010 http://www.practicallaw.com/7-502-7802?source=relatedcontent# (accessed 20 March 2013) 2.] and tax benefits, [Beaudin \textit{et al} (n 67) 2.] although ‘preferential tax treatment has become less important as capital taxes have largely been eliminated’. [Beaudin \textit{et al} (n 67) 2.].
\textsuperscript{69} Canada recognises three forms of partnerships: A general partnership, [EJ Johnson & GC Lille ‘The taxation of partnerships in Canada’ (2009) August/September \textit{Bulletin for International Taxation} 381 381.] a limited partnership in terms of the State of Ontario’s Limited Partnerships Act R.S.O. 1990, Chap. L.16, [Johnson & Lille (n 69) 381-382.] and a limited liability partnership (‘LLP’). [Johnson & Lille (n 68) 381-382.] However, a partnership in Canada is not subject to the entity theory. [Johnson & Lille (n 69) 381 383.].
\textsuperscript{70} Office of the Superintendent of Financial Institutions in Canada (n 68 above) 8 sec 7.2.9 para 32.
\textsuperscript{71} As above.
\textsuperscript{72} As above.
\textsuperscript{73} n 44 above.
\textsuperscript{74} See n 54 above.
\textsuperscript{75} Delport (n 60 above) 198-199.
\textsuperscript{76} As above.
\textsuperscript{77} See Delport & Pretorius (n 66 above) 8-11; M Fleuriet \textit{Investment banking explained: An insider’s guide to the industry} (2008) 27-29.
\textsuperscript{78} HS Cilliers \textit{et al} \textit{Cilliers & Benade Corporate Law} (2000) 4.
\textsuperscript{79} Delport (n 60 above) 218.
\textsuperscript{80} Cilliers \textit{et al} (n 78 above) 574-575.
use of synthetic securitisations, nothing in material law would prohibit such an employment. But one comes to enquire as to the corporate type that a SPI will assume given its company structure. An institution acting in a primary role is limited to the appointment of one director of the SPI on a Board of a minimum of three members.\textsuperscript{81} It is a slippery slope argument that the SPI must necessarily be a public company just because the current company legislation specifies a minimum of three directors in such a company.\textsuperscript{82} Not only was this not the case when the Schedule\textsuperscript{83} was drafted,\textsuperscript{84} but a SPI’s memorandum of incorporation (MOI) may provide for a higher number of directors.\textsuperscript{85} The Schedule\textsuperscript{86} makes no reference to the public issue of commercial paper,\textsuperscript{87} and the possibility exists that the disclosure document and a prospectus may be interpreted as two separate documents.\textsuperscript{88} An SPI cannot be a non-profit company\textsuperscript{89} (NPC), based on its non-conformity with \textit{inter alia} item 1(1)(a) of Schedule 1 to the Companies Act,\textsuperscript{90} but if the Schedule\textsuperscript{91} is interpreted as not necessitating a public issue of commercial paper, then there is no restriction on SPIs being private companies.\textsuperscript{92}

### 3.3 The bullet-proof factor

The gist of the SPI is the so-called ‘bullet-proof factor’,\textsuperscript{93} i.e. the characteristic of insolvency remoteness in securitisations.\textsuperscript{94} The bullet-proof factor is effortlessly conceivable with regards to traditional securitisation schemes in the sense of the risk of recharacterisation and derecognition. Derecognition commercially denotes the separation of underlying assets or risk, depending on the nature of the scheme, from the originator or repackager to the SPI.\textsuperscript{95}

\textsuperscript{81} Schedule (n 44 above) para 5(2)(p)(i).
\textsuperscript{82} Companies Act sec 66(2)(b).
\textsuperscript{83} n 44 above.
\textsuperscript{84} Companies Act 1 of 1973 sec 208(1).
\textsuperscript{85} Delport (n 60 above) 80.
\textsuperscript{86} n 44 above.
\textsuperscript{87} See e.g. n 44 above, para 14.
\textsuperscript{88} For more details and a further discussion of this matter, see ch 8 below.
\textsuperscript{89} Companies Act 71 of 2008 sec 1: ““non-profit company” means a company-
(a) incorporated for a public benefit or other object as required by item 1(1) of Schedule 1; and
(b) the income and property of which are not distributable to its incorporators, members, directors, officers or persons related to any of them except to the extent permitted by item 1(3) of Schedule 1’.
\textsuperscript{90} 71 of 2008.
\textsuperscript{91} n 44 above.
\textsuperscript{92} Although the Schedule [n 44 above.] at para 3(1)(b) provides that the provisions under the heading ‘[g]eneral’ ‘shall not be regarded as imposing additional obligations on any of the parties involved in a…synthetic securitisation scheme’, this is not reciprocated with other laws, i.e. other laws can impose unlimited additional obligations.
\textsuperscript{93} This is term is discerned from the references of BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in Carey & Stulz (n 14 above) 597.
\textsuperscript{94} See n 54 above.
\textsuperscript{95} Schedule (n 44 above) paras 5(1)(a)(i), 5(1)(b).
referred to as legal isolation\textsuperscript{96} or insulation.\textsuperscript{97} Whereas it may be a misnomer in jurisdictions where assets are required to remain on-balance sheet, it is legally sound through the exercise of the initial institution’s (transferring institution or institution)\textsuperscript{98} competencies. The risk of recharacterisation is not discussed in this work due to the hazard it poses to true sale.\textsuperscript{99}

The risk of recharacterisation is not truly existent with regards to synthetic securitisation schemes in the same manner as it is known in traditional securitisation schemes. With regards to recharacterisation, it must be borne in mind that, in synthetic securitisation schemes, true sale is substituted with so-called synthetic sale\textsuperscript{100} being the underlying transaction;\textsuperscript{101} however, the term ‘synthetic sale’ is a misnomer since the consensual agreement, i.e. the credit


\textsuperscript{97} E.g. Locke (n 96 above) 60, 357.

\textsuperscript{98} Ch 3 para 2.1 above.

\textsuperscript{99} See Karoly (n 52 above) 13; MI Greenberg & E Uwaifo ‘Key issues in structuring a synthetic securitization transaction’ in Preston (n 10 above) 139; N Gumata & J Mokoena ‘Note on the impact of securitization transactions on credit extension by banks’ (2005) December South African Reserve Bank Quarterly Bulletin 60 60; KC Kettering ‘True sale of receivables: A purposive analysis’ (2008) 16 ABI Law Review 511 511; V Kothari ‘The true sale question’ http://www.vinodkothari.com/truesale.htm (accessed 7 January 2013); A Shtatnov ‘The elusive true sale in securitization’ 2012 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=21150 54 (accessed 7 January 2013) in general. This means ‘totally divest[ing] the transferring institution…of all rights and obligations originating from the underlying assets’. [Schedule (n 44 above) para 4(2)(a)] This has been substantially translated as the objective theory of contract [LF van Huyssteen, SWJ van der Merwe & CJ Maxwell Contract Law in South Africa (2010) 140-141; see Home Bond Co v McGeesney 239 US 568 (1916); see WR Barnes ‘The French subjective theory of contract: Separating rhetoric from reality’ (2008) 83 Tulane Law Review 359 et seq. and/or the rule of plus valeat quod agitur quam quod simulacre concipitur. [See BC Plant Hire CC t/a BC Carriers v Grenco (SA) (Pty) Ltd (1090/2002) 2003 ZAWCHC 70; 2004 1 All SA 612 (C) (12 December 2003) 33; Hallmark Cards Incorporated v Yun Choy Limited and the Standard Chartered Bank (Hong Kong) Limited 2012 1 HKLRD 396, as quoted in S Bagaria ‘Substance v/s form conflict in true sale | Hong Kong Court goes by the language used by the parties’ http://www.vinodkothari.com/true%20sale%20%20substance%20v.%20form%20conflict.pdf (accessed 7 January 2012) and JSM Mayer Brown ‘True sale or not – the nature of the factoring agreement’ 2012 http://www.mayerbrown.com/files/Publication/9e0ac87f-fb26-460-92od-98935b9f0491/Presentation/PublicationAttachment/c897ce0e-1e4-4df-acce-a190be994c5/12251.PDF (accessed 7 January 2012); Locke (n 96 above) 357 et seq.] The abject efforts [Kettering (n 100) 515.] of American courts with regards to the prominent [John A Newman v Irwin Schiff 778 F.2d 460, 54 USLW 2306 19.] former, though there have existed disparaged [Barnes (n 99) 359 n 22.] versions (some being somewhat earlier, such as Hotchkiss v National City Bank 200 F 287 293 (SDNY 1911)), are reduced to the prevalence of an agreement, the unilateral ability to change terms, and recourse. [Major’s Furniture Mart Inc 602 F2d 538 (3d Cir 1979) aff’g 449 F Supp 538 (ED Pa 1978), as quoted in Shtatnov (n 99) 2 et seq.] This obscurity is reverberated in US legislation [Employee Abuse Prevention (Durbin-Delahunt) Act of 2002 sec 102.] and further muddled by the application of bankruptcy law. [S Schwartz ‘The impact of bankruptcy reform on ‘true sale’ determination in securitization transactions’ (2002) 7 Fordham Journal of Corporate & Financial Law 353 355.] In juxtaposition, South African efforts are based on terminology, possible objective, pre- and post-contractual circumstances, determination of purchase price, limited competencies, repurchase clauses, [E.g. Shtatnov (n 99) 5 et seq.] and guarantees on reciprocal performance. [Locke (n 96 above) 360-362.] Irrespective, a true sale classification remains a ‘weighing…[of] factors’. [Kettering (n 99) 526; Shtatnov (n 99) 5 et seq.] Locke (n 96 above) 360-362.]

\textsuperscript{100} Ch 1 para 2.2 n 41 above.

\textsuperscript{101} Schedule (n 44 above) para 1: ‘‘underlying transaction’’ means the transaction in terms of which-
(a) an asset that is transferred by an institution in terms of a traditional securitisation scheme; or
(b) the risk that is transferred by an institution in terms of a synthetic securitisation scheme, had its origin’.

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derivative, is not a contract of sale or the so-called real agreement, statutorily designated as the ‘transfer’\textsuperscript{102} of risk\textsuperscript{103} being more akin to perfection\textsuperscript{104} than transfer. The absence of true sale is a beneficial feature in synthetic securitisation, since it mitigates the costs of hiring independent legal counsel to determine whether true sale has transpired.\textsuperscript{105}

Just as true sale has the effect of changing the balance sheet of the transferor,\textsuperscript{106} so does this legal fiction have the effect of amending the transferor’s risk profile.\textsuperscript{107} But many things can go awry with derecognition in synthetic securitisation, in which derecognition has little bearing on the transferor’s balance sheet but much bearing on its capital adequacy.\textsuperscript{108} For example, mention has been made of the factor of repurchase clauses with regards to true sale,\textsuperscript{109} but in synthetic securitisation schemes, ‘retention or repurchase of significant securitisation exposures by the institution that transferred the risk may undermine the intent of a synthetic securitisation scheme to transfer risk to a third party’.\textsuperscript{110} This statement falls short of \textit{prima facie} encapsulating its true complexity. The reference here to ‘retention’, stated in a commercial sense, means that the protection buyer will retain some of its risk (exposures) whilst the credit derivative is in place, which may or may not influence the protection buyers’ premiums to the protection seller. This can transpire in many ways in the legal sense, for example the credit derivative is concluded subject to a suspensive condition on certain risk (exposures), or it can transpire as a method of security, but not as a method of set-off. The latter is neither categorised under the ‘repurchase’ of risk, in which the protection buyer and protection seller amend the credit derivative agreement in order to provide for a smaller pool of risk (exposures) with a presumable equivalent deduction in protection. The important adjective used is ‘significant’.\textsuperscript{111} However, this word is not defined in the Schedule\textsuperscript{112} and must retain its ordinary meaning, but similar to the description of the section 112 activity in the Companies Act,\textsuperscript{113} even its ordinary meaning does not provide enough reason to conclude that it poses a simple majority of risk (exposures). Frankly, the ordinary meaning of ‘significant’

\begin{footnotesize}
\begin{enumerate}
\item See ch 7 below.
\item Schedule (n 44 above) para 5(1)(a)(i).
\item Schedule (n 44 above) para 5(2)(g).
\item Böhringer \textit{et al} (n 16 above) 31; see Schedule (n 44 above) para 4(2)(b)(i).
\item Schedule (n 44 above) para 4(1)(c).
\item Schedule (n 44 above) para 5(1)(b).
\item Ch 2 para 4.1 above.
\item See n 99 above.
\item Schedule (n 44 above) para 5(1)(c).
\item See n 101 above.
\item n 44 above.
\item 71 of 2008.
\end{enumerate}
\end{footnotesize}
does not appear to have any direct relation to majority, but will rather have bearing on the most important risk (exposures),\textsuperscript{114} which will have to be discerned on a case to case basis.

Another example is set out in paragraph 5(1)(e) of the Schedule.\textsuperscript{115} The reduction in credit-risk exposure for the transferor shall only be permitted if ‘the bank achieves an effective and verifiable transfer of risk’,\textsuperscript{116} ‘such risk mitigation was not already taken into account in the calculation of the required capital and reserve funds of the reporting bank’.\textsuperscript{117} It is uncertain whether these provisions apply conjunctively or disjunctively. Even the reference to risk mitigation\textsuperscript{118} can follow from the introductory clause and not necessary the former provision. The matter of effective and verifiable risk transfer has been discussed elsewhere.\textsuperscript{119} The latter provision is self-explanatory as a provision against duplication.

As a final note, it is brought to the reader’s attention that in jurisdictions where trust structures are preferred, such as Canada,\textsuperscript{120} the bullet-proof factor requires additional attention – since separate legal personality does not exist for a trust, the lawyers from McMillan LLP submit that ‘the SPV, its assets and its identity’ must be isolated.\textsuperscript{121} Their submissions translate as restrictions in the trust deed relating to the powers and activities of\textsuperscript{122} and organisational changes\textsuperscript{123} to the SPI rendering the SPI assets at risk,\textsuperscript{124} insulating the SPI assets from claims resulting from trustee activities,\textsuperscript{125} ensuring that no third party has claim to the assets,\textsuperscript{126} shielding the SPI from fatal tax incursion,\textsuperscript{127} appointing a NPC as trust beneficiary,\textsuperscript{128} or obtaining the beneficiary’s termination rights waiver.\textsuperscript{129}

\textsuperscript{114} Onions (n 48 above) 1892.
\textsuperscript{115} n 44 above.
\textsuperscript{116} Schedule (n 44 above) para 5(1)(e)(i).
\textsuperscript{117} Schedule (n 44 above) para 5(1)(e)(ii).
\textsuperscript{118} As above.
\textsuperscript{119} Ch 2 para 4.1 above.
\textsuperscript{121} Beaudin \textit{et al} (n 67 above) 3.
\textsuperscript{122} This would naturally also pertain to the objectives of the SPI; see Feldman \textit{et al} (n 119 above) 2.
\textsuperscript{123} It is uncertain what the authors mean by this. Organisational changes may denote either structural changes or managerial amendments. Pragmatically, the former would make more sense.
\textsuperscript{124} Beaudin \textit{et al} (n 67 above) 3.
\textsuperscript{125} As above.
\textsuperscript{126} As above.
\textsuperscript{127} As above.
\textsuperscript{128} As above.
\textsuperscript{129} As above.
3.4 The SPI’s rationale

The disjunctive between ‘created’,130 ‘incorporated’131 and ‘solely used’132 leaves much to the imagination.133 Incorporation presumably refers to incorporation as a company in terms of the Companies Act,134 i.e. acquisition of legal personality through a general enabling Act.135 In terms of the previous Companies Act,136 the SPI’s rationale would be set out in the SPI’s memorandum of association under main business and/or main object.137 In terms of the current Companies Act138 both the Act139 and the Companies Regulations140 per se are quiet on this matter. Only a company’s objectives surface, and then only in the examples of MOIs in the Companies Regulations.141 Apart from the possibility of an SPI obtaining legal personality through a separate statute,142 the applicability of ‘creation’143 has become superfluous since the loophole for acquisition of separate legal personality through conduct144 has been closed through the very definition of a NPC145 in the Companies Act.146 147 But the SPI need not be a company that is ab initio incorporated for the purpose it embodies in a synthetic securitisation scheme;148 the Schedule,149 provides for a situation that a company, and presumably a company that previously had a different objective, can be used for purposes of a synthetic securitisation scheme.150 However, in all instances, the sole purpose of the SPI must be the implementation and operation of a synthetic securitisation scheme.151 If we study this purpose closer, we find that the conjunction between ‘implementation’ and ‘operation’152 implies that the same SPI

130 See n 54 above.
131 As above.
132 As above.
133 These terms shall only be discussed here with regard to a company structure.
135 Cilliers et al (n 79 above) 6-7.
137 Cilliers et al (n 79 above) 69.
138 71 of 2008.
139 Companies Act 71 of 2008.
142 Cilliers et al (n 79 above) 6-7.
143 See n 54 above.
144 Cilliers et al (n 79 above) 7-8.
145 See n 90 above.
146 71 of 2008.
147 See para 3.2 above.
148 The difference between the purpose of a SPI [See n 54 above.] and the intent of a synthetic securitisation scheme [See n 110 above.] is stressed, although it is uncertain what the extent of these differences are.
149 n 44 above.
150 See n 54 above.
151 As above.
152 As above.
must both implement and operate throughout the lifespan of the synthetic securitisation scheme. In principle, implementation and operation are distinguishable, just as winding-up and liquidation are and, in context, since the latter is not included, SPIs can consequently not be subjected to it. It is difficult to imagine that a SPI will never be liquidated, but it must remain insolvency remote, at least for the duration of the synthetic securitisation scheme.

3.5 Final thoughts
The SPI has been erroneously defined as a business enterprise established to undertake the narrowly-defined, and thus impermanent, purposes, which is not entirely true. Such are the characteristics of term structures commonly associated with single-borrower transactions contrary to conduit structures, erroneously generalised by Jobst, commonly associated with multi-borrower transactions with origination and warehousing and subject to extended terms and periodical ‘replenishment’. Unfortunately, the respective sources made these statements with regards to traditional securitisation schemes, which is supported by the Schedule. However, this is still applicable to synthetic securitisation schemes. The synthetic variation of a single-borrower transaction will entail the transaction of a single, or initially specified, credit derivative, whereas the synthetic variant of a conduit structure entails the further transfer of risk through additional credit derivatives or amending the existing credit derivatives. In South Africa, a specific scheme may only exercise the latter for purposes of ‘maintaining the capital value of the portfolio of risk included in the scheme’, subject to the Registrar’s discretion. It is uncertain what the quoted phrase means. On the one hand, this may mean that the transferor may transfer additional risk to the SPI to maintain the capital adequacy assurance that it obtained through the initial or planned synthetic sale, which is dependent on the alteration of risk inherent on the exposures that it planned to securitise. On the other hand, this may mean that the transferor may transfer additional risk in order to maintain the benefit that the SPI was acquiring via the premium payments. The Schedule goes further to prohibit such a conduit

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153 As above.
154 Feldman et al (n 120 above) 2.
155 See n 54 above.
156 See n 54 above.
157 Karoly (n 52 above) 12.
159 Karoly (n 52 above) 12.
160 n 44 above, para 4(2)(k).
161 Schedule (n 44 above) para 5(2)(g).
162 Schedule (n 44 above) para 5(2)(g)(ii).
163 n 44 above.
structure if it constitutes the provision of a credit enhancement facility,\textsuperscript{164} which effectively excludes the first option provided above.\textsuperscript{165}

4 Control of the SPI

An SPI have been referred to as an ‘orphan’ company.\textsuperscript{166} An institution acting in a primary role \textit{per se} or with its associated companies, and, if such an institution is a bank, such a bank \textit{per se} or with any institution(s) within its banking group\textsuperscript{167} will not ‘directly or indirectly acquire or hold any equity share capital in such a [SPI] of which the nominal value represents 20 per cent or more of the nominal value of all the issued equity share capital in the [SPI].’\textsuperscript{168} Even if said institution(s) could exercise its/their \textit{de facto} control, the provision at paragraph 5(2)(o)(i)(B) of the Schedule\textsuperscript{169} would prohibit such majority vote of being taken into regard at the SPI’s general meeting. This provision does not prohibit voting even if it is apparent, given the quorum, that such institution(s) would exercise a majority vote; it merely renders such a majority vote of no legal effect.\textsuperscript{170} Although paragraph 5(2)(o) was drafted in terms of the predominant\textsuperscript{171} PV system prevalent in terms of the previous Companies Act,\textsuperscript{172} it is \textit{prima facie} easily translatable to the NPV system in terms of the current Companies Act.\textsuperscript{173} However, it must be established what the Registrar meant in its reference to ‘directly or indirectly acquire or hold’.\textsuperscript{174} It appears as if the ‘indirect’ position has bearing on a subsidiary\textsuperscript{175} relationship, and the ‘direct’ position would transpire in the absence of a subsidiary relationship. This would be the case if one of the four circumstances as set out in the Companies Act\textsuperscript{176} at section 3 would be prevalent.\textsuperscript{177} References to ‘acquire and hold’, and variations thereon, are commonly found in the legal practitioner occupation, specifically in contracts, and the broad impression is that said phrase is inserted to tend to the widest possible ambit. To ‘hold’ equity is the simplest to explain, and indicates subscription or sale in the primary market, or sale, including

\begin{footnotes}
\item[164] n 44 above, para 5(2)(g)(i).
\item[165] n 44 above, para 1 definition of ‘credit-enhancement facility’.
\item[166] I Ashman & H Bestwick ‘Securitisation in the Cayman Islands’ https://www.securitization.net/pdf/walkers_sec_070202.pdf (accessed 29 January 2013) 2.
\item[167] Schedule (n 44 above) para 5(2)(o)(i).
\item[168] Schedule (n 44 above) para 5(2)(o)(i)(A).
\item[169] n 44 above.
\item[170] This logic is compatible with the Companies Act 71 of 2008, e.g. sec 3(2)(a).
\item[171] Cilliers \textit{et al} (n 78 above) 223.
\item[172] 61 of 1973 sec 74.
\item[173] 71 of 2008 sec 35(2).
\item[174] Schedule para 5(2)(o)(i).
\item[175] Companies Act 71 of 2008, sec 1: “‘subsidiary has the meaning determined in accordance with section 3’.
\item[176] 71 of 2008.
\item[177] Companies Act 71 of 2008 secs 3(1)(a)(i), 3(1)(a)(ii). A better exposition is found in Delport (n 60 above) 105 \textit{et seq}.
\end{footnotes}
a long position, in the secondary market. Without further ado, the said acquisition is regarded as including those cases where the acquirer acts in an intermediary position in obtaining said shareholders’ equity. But more burdensome is the phrasing that the Registrar chose – it is doubtful whether the said provision provides for cases where said party obtains rights and duties in terms of the shareholders’ equity. For purposes of brevity, the legal implications – alluded to in chapter 2 paragraph 2.3 above – of Botha v Fick en ‘n Ander178 is not repeated, although it is tempting to argue, in the absence of legal restriction (except for those already discussed), that the said party may obtain such rights and duties without prohibition in terms of paragraph 5(2)(o)(i)(A) of the Schedule.179 The inclusion of a reference to beneficial interest with regard to trusts180 and the absence thereof with regards to the comparative provision with regards to companies,181 supports this logic.

Not only does paragraph 5(2)(o)(i) of the Schedule182 fail to indicate whether subparagraphs (A) and (B) are conjunctive or disjunctive, but neither does paragraph 5(2)(o)(ii) of the Schedule183 provide any direction on the matter. With the emphasis placed on creditor protection in terms of the new regime,184 a disjunctive interpretation presents predicaments pertaining to the SPI’s control. Since debt instruments can now be created with control rights,185 the institution(s) acting in a primary role can obtain any form of majority control through the issued commercial paper with the aforesaid paragraphs apply disjunctively. Since the common share categorisations have been done away with in the new regime,186 institution(s) acting in a primary role can convert hybrid instruments187 into debt instruments with voting rights to circumvent paragraph 5(2)(o)(i)(A) of the Schedule.188 Furthermore, and if the disjunctive does apply, sections 64(2) and 64(8) of the Companies Act,189 read with section 64(1), can also be used to circumvent paragraph 5(2)(o)(i)(A) of the Schedule.190 If this

178 (713/92) 1994 ZASCA 184; 1995 2 SA 750 (AD); 1995 2 All SA 78 (A) (30 November 1994).
179 n 44 above.
180 Schedule (n 44 above) para 5(2)(o)(ii)(A).
181 Schedule (n 44 above) para 5(2)(o)(i)(A).
182 n 44 above.
183 As above.
185 Companies Act 71 of 2008 sec 43(3)(a).
186 Delport (n 60 above) 33 n 40.
187 n 44 above, para 1 definition of ‘commercial paper’.
188 n 44 above.
189 71 of 2008.
190 n 44 above.
is a conjunctive, the limitation in paragraph 5(2)(o)(i)(A) of the Schedule\textsuperscript{191} may be superfluous since the control rights are in any event to be statutorily disregarded in terms of paragraph 5(2)(o)(i)(B) of the Schedule.\textsuperscript{192}

\section{Management of the SPI}

SPIs are often portrayed – whether per commissio or per ommissio (given the little available literature on the internal structure of SPIs) – as empty shells available for exploitation by parties acting in primary roles. Antagonists may find\textsuperscript{193} this circumvention of banking law\textsuperscript{194} with regard to synthetic securitisation schemes vexing; however, the moral abhorrence experienced is not commensurate with the common law definition of fraud,\textsuperscript{195} irrespective of the number of people regarding it as such (legal practitioners seem to raise this point of criticism first). The notion of an empty shell in operation involved in transactions worth multi-million units of currency is doubtlessly distressing from a company law perspective. The purpose of SPIs has been described, with regards to synthetic securitisation schemes, as ‘have[ing] no activities and no liabilities other than what is incidental to owning and distributing the proceeds of collections of the receivables.’\textsuperscript{196} If this were to be true, one may enquire as to how many of the SPI’s corporate objectives would be \textit{incidentalia} of the MOI between statutorily prescribed parties.\textsuperscript{197}

Furthermore, according to Gorton and Souleles, SPIs ‘have no independent management or employees’\textsuperscript{198} and are ‘essentially robot firms that have no employees, make no substantive economic decisions, [and] have no physical location’.\textsuperscript{199} From an economic perspective, this is sensible since the party acting in a primary role is using the principle of separate legal personality to exercise economic activities otherwise unavailable to it. From a legal perspective, this is fallacious: Every company is statutorily obliged to have both proper management\textsuperscript{200} and an address.\textsuperscript{201} However, since the economic community views SPIs from this perspective, this may constitute a paramount anomaly in the synthetic securitisation scheme.

\begin{thebibliography}{99}
\bibitem{191} As above.
\bibitem{192} As above.
\bibitem{193} See ch 8 below.
\bibitem{194} As above.
\bibitem{197} Companies Act 71 of 2008, sec 15(6).
\bibitem{198} BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in Carey & Stulz (n 14 above) 550.
\bibitem{199} As above.
\bibitem{200} Companies Act 71 of 2008, sec 66 \textit{et seq}.
\bibitem{201} It is yet to be witnessed that company is successfully registered with the CIPC without an address.
\end{thebibliography}
Not only does the Schedule provide for the SPI having proper management, but the SPI’s Board must be independent of the institution acting in a primary role and, if said institution is a bank, of any other institution within its banking group. The significant difference between the provisions of paragraphs 5(2)(o) and 5(2)(p) is the fact that the latter does not make provision for the institution acting in a primary role’s associated companies, except to the extent that such institution is a bank in which event it automatically applies. This provision has great relevance in terms of the Companies Act, since section 66(1) of said Act extends the management of the Board to the company’s affairs rendering the best interest of the company not equal to the best interests of the shareholders, but rather to the best interests of the Board. These aspects have been described elsewhere. The power endowed in the Boards of the associated companies of the institution acting in a primary role (not being banks or within a banking group) would enable said institution’s group of companies to appoint an effective majority of the Board and therewith control the SPI, thereby limiting the practical effect of the control restrictions set out in paragraph 5(2)(o) of the Schedule. The use of the mandatory ‘must’ can be interpreted and applied to an SPI in two ways: Either the Board of the SPI is endowed with a positive duty to management the company, or the SPI’s Board per se is responsible for management. Fortunately, section 66(1) makes provision for both cases.

The notion of a company without pragmatic management invokes predicaments with regard to too many dimensions of corporate law that are subordinate to explanation at doctorate level. As such, and bearing the concept of separate legal personality in mind, the idea of a company without ‘independent management’ is absurd.

Bearing the aforesaid in mind, the hackneyed allegation that SPIs do not undertake economic decisions is to be considered. According to Cilliers et al, incorporation addresses a collective inclination for involvement in an endeavour, as well as reaping the advantages of legal

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202 n 44 above.
203 n 44 above, para 5(2)(p).
204 As above.
205 As above.
206 See ch 3 n 22 above.
207 71 of 2008.
208 Wessels (n 184 above) 26-28.
209 See n 206 above.
210 Companies Act 71 of 2008 sec 3(1)(a)(ii).
211 n 44 above.
212 Companies Act 71 of 2008, sec 66(1).
213 As above.
214 Cilliers et al (n 78 above) 4.
personality.\textsuperscript{215} This is \textit{res ipsa loquitur} to synthetic securitisation schemes. More specifically, the directors of the SPI are in a fiduciary position towards the SPI,\textsuperscript{216} which was traditionally interpreted as acting in the best interests of the long term shareholders.\textsuperscript{217} Whilst the corporate regime in terms of the current Companies Act\textsuperscript{218} advocates the enlightened shareholder approach,\textsuperscript{219} this does not necessarily deviate from a rudimentary focus on profit optimisation.\textsuperscript{220} The implication is that the Board of the SPI has a duty towards the SPI, and therewith the long-term shareholders of the SPI, for optimisation of profit. Central to the

\footnotesize{
\textsuperscript{215} As above.
\textsuperscript{216} Delport (n 60 above) 89-91.
\textsuperscript{217} Wessels (n 184 above) 25-27, 53-54.
\textsuperscript{218} 71 of 2008.
\textsuperscript{220} See n 224 below.
}
comprehension of this argument is the concept of interest,\textsuperscript{221} be that interest as a rate of return for the SPI,\textsuperscript{222} interest as a discounting rate\textsuperscript{223} or interest as an opportunity cost.\textsuperscript{224}

\textsuperscript{221} Consider an interest rate $r$ as the sum of a real risk-free interest rate, [RA DeFusco et al ‘The time value of money’ in CFA Institute (ed) Ethical and professional standards and quantitative methods Vol 1 Level 1 (2011) 256-257.] an inflation premium, a default risk premium, [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221) 257.] a liquidity premium and a maturity premium. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221) 257.] A real risk-free interest rate is also calculable as being equal to the difference between, on the hand, the sum of one and the nominal risk-free interest rate, [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221) 257.] divided by the sum of one and the inflation rate, and on the other hand, one. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221) 257.].

\textsuperscript{222} The first justification of interest, and therewith also the SPI’s Board’s decision of economic activity, is investment-related. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 255-256.] The classic definition of an investment operation is: ‘An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative.’ [DL Dodd & B Graham Security Analysis (2009) 106.] The soundness of this disjunctive can be questioned as a complex question fallacy. [MES van den Berg Critical reasoning and the art of argumentation (2010) 20-21.] Any investment is classifiable as a business investment, financial investment, sheltered investment or analyst’s investment. [Dodd & Benjamin (n 222) 109.] Although hypothetical investment opportunities increase as the complexity of enterprise structures and transactions, such as synthetic securitisation schemes, augment, a full discussion on the topic of business investments is unnecessary for purposes of this work. Variations will exist on the nature of agreements, stipulations and counterparts. Business investments remain a matter of capital budgeting. [Dodd & Benjamin (n 222) 109; RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (ed) Ethical and professional standards and quantitative methods Vol 1 Level 1 (2011) 312.] i.e. the allocation of funds to comparatively long-term projects or investments. [RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (n 222) 312.] From this viewpoint, a company, such as the SPI in a synthetic securitisation scheme, is a portfolio of investments or projects. [RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (n 222) 312.] In circumstances of mutually exclusive projects, the application of the net present value rule (NPV rule) would be ideal. [RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (n 222) 313.] The net present value $NPV$ of an investment is equal to the present value $PV_i$ of its cash inflows minus the $PV_i$ of its cash outflows, [RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (n 222) 312.] otherwise calculated as the sum of the expected net cash flow $CF_t$ at time $t$ divided by the sum of one plus the discount rate or opportunity cost of capital $r$, over the investment’s projected life $N$. [RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (n 222) 313.] A positive $NPV$ indicates an increase in shareholder value in the SPI, [RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (n 222) 313.] a negative $NPV$ indicates a decrease in shareholder value, [RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (n 222) 313.] and a $NPV$ equal to zero indicates that the company becomes larger but shareholder value remains unaffected. [RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (n 222) 313.] This is indicated in formula 5.1 below. [RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (n 222) 313.] A less reliable method is the application of the internal rate of return rule (IRR rule) that supplies a single number for an investment’s rate of return. [RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (n 222) 314.] The reason for preferring the NPV rule to the IRR rule is the discrepancies that arise in ranking ventures according to profitability using the two methods. [RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (n 222) 317-319.] This would be the result of different timings of project cash flows or differences in size or scale of projects. [RA DeFusco et al ‘Discounted cash flow applications’ in CFA Institute (n 222) 317-319.].

$$NPV = \sum_{t=0}^{N} \frac{CF_t}{(1 + r)^t}$$

Formula 5.1

Not only is ‘financial investment’ [Dodd & Benjamin (n 222) 109.] a commercial term, but the notion of ‘investment’, as with ‘speculation’, are legitimate commercial realities with no black letter private law bases. Financial investments can best be translated into legalese as mercantile facts that resort within the law of things or the law of obligations as per the law of things relating to corporeal things, incorporeal things and the law of obligations. Its distinction from business investments remains a matter of perspective. Differentiation based on the former being linked to an industry (‘a particular branch of productive labour’) [Onions (n 48 above) 995.] and
the latter being linked to a market (‘[t]he meeting together of people for the purchase and sale of provisions or live stock, publicly exposed, at a fixed time and place’) [Onions (n 48 above) 1208.] must be employed with caution, since the concepts of ‘industry’ and ‘market’ may overlap in the economic sense.

223 The second justification of interest is the time value of money, [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 255-256.] i.e. investors would want to rest assured that their capital in the SPI is being invested in order to obtain the best value for the period of investment. At its basic level, a single cash flow with discrete compounding has a future value \( FV \) for an investment \( N \) periods from the present where the present value of that investment is \( PV \) and the interest rate is \( r \) per period. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 258.] See formula 5.2 below in this regard. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221) 259.] In circumstances with a frequency of compounding in excess of once per annum, the interest rate quoted is rather the stated annual interest rate or quoted interest rate, [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 263-264.] where an investment with a present value of \( PV \) will have a future value of \( FV \) at \( N \) periods from the present and the stated annual interest rate is \( r \) and the frequency is \( m \). [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 263-264.] This is expressed in formula 5.3 below. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 263-264.].

\[
FV_N = PV(1 + r)^N
\]

\[
FV_N = PV[1 + (r_s + m)]^{mN}
\]

Irrespective of the stated annual interest rate, future values increase according to the frequency of compounding. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 265-267.] The stated annual interest rate can be annualised to ascertain a single rate that excludes the problem of frequency of compounding, as long as the future values correspond. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 265-267.] This single rate is known as the effective annual rate (EAR). [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 265-267.] If the frequency of compounding becomes infinite (i.e. \( m \to \infty \)), we will have to use the transcendental number \( e = 2.7182818 \) so that the formula for calculating EAR can be accordingly adapted. [DeFusco et al (n 221 above) 265-267.] See for this reason formulas 5.4, 5.5 and 5.6 below. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 265-267.].

\[
EAR = [1 + (r_s + m)]^m - 1; \text{ Periodic interest rate } = r_s + m.
\]

\[
\log FV_N = \log PV \times r_s N \log e
\]

\[
(-r_s)
\]

\[
\therefore \text{ EAR } = \sqrt[m]e - 1
\]

An annuity is a limited set of equal chronological cash flows, [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 267.] whether as an annuity due (first cash flows at \( t = 0 \)) [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 267.] or an ordinary annuity (first cash flow at \( t = 1 \)). [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 267.] In juxtaposition, a perpetuity is an unlimited set of equal chronological cash flows. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 267.] An ordinary annuity has a future value \( FV \) over \( N \) periods if the annuity amount is \( A \) and the interest rate per period is \( r \) (formula 5.7), [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 267-268.] and it has a present value \( PV \) over \( N \) periods if the annuity amount is \( A \) and the interest rate per period is \( r \) (formula 5.8). [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 270-272.] A perpetuity has a present value \( PV \) over \( N \) periods if the annuity amount is \( A \) and the interest rate per period is \( r \), where the first cash flow is at \( t = 1 \). [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 278-281.] However, as \( N \to \infty \), the formula for calculating the present value for a perpetuity must be adapted accordingly. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 278-281.] For purposes of the latter, see formulae 5.9 and 5.10 below. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 278-281.].
6 The applicability of the Collective Investment Schemes Control Act

6.1 General

The Collective Investment Schemes Control Act (CISCA) contains an express definition of ‘collective investment scheme’ (CIS). Although a ‘scheme’, in the absence of an express definition of ‘scheme’ it retains its ordinary meaning. The corporate jurist associates ‘scheme’ commonly with ‘scheme of arrangement’ and particularly with securitisation.

\[
FV_N = A\left\{\left[1 + r\right]^N - 1\right\} + r
\]

Formula 5.7

\[
PV = A\left\{\left[1 - (1 + r)^-N\right] + r\right\}
\]

Formula 5.8

\[
\sum_{t=1}^{\infty} [1 + r]^t
\]

Formula 5.9

\[
PV = A + r
\]

Formula 5.10

224 The third justification is micro-economic viability. [RA DeFusco et al ‘The time value of money’ in CFA Institute (n 221 above) 256-257.] The Afrikaans translation of the term ‘profit company’ in the Companies Act 71 of 2008 – maatskappy met winsbejag – indicates that the Legislature fundamentally misunderstands ‘profit’ in that sense for profit in accounting terms, instead of economic profit. Contrary to accounting practice that entails measuring assets and liabilities, income and expenditure, the economic approach is pro-active. Opportunity cost is the highest-valued substitute forgone, [M Parkin ‘Organizing production’ in CFA Institute (ed) Economics Vol 2 Level 1 (2011) 101.] comprising explicit [M Parkin ‘Organizing production’ in CFA Institute (n 224) 101-102.] and implicit costs. [M Parkin ‘Organizing production’ in CFA Institute (n 224) 101-102.] The former relates to monetary payments – whether as expenditure on resources or lease capital; [Parkin (n 224) 101.] the latter relates to forgone alternatives not entailing disbursement – whether in the utilisation of own capital (constituted of economic depreciation and interest forgone) [M Parkin ‘Organizing production’ in CFA Institute (n 224) 101-102.] or the owner’s own time or financial resources (normal profit). [M Parkin ‘Organizing production’ in CFA Institute (n 224) 101-102.] According to Huntley and Pottas, ‘[t]he assets usually also have a funding cost attached to them, even if it is the cost of internal cash resources of the company that may be more profitably employed elsewhere’. [A Huntley & A Pottas (2006) ‘Simply Securitisations: Connecting the process’ (2006) http://www.deloitte.com/assets/Dcom-SouthAfrica/Local%20Assets/Documents/ZA_FinancialInstitutionservices_SimplySecuritisation_090107(1).pdf (accessed 19 November 2012) 2].

225 45 of 2002.

226 Collective Investment Schemes Control Act 45 of 2002 sec 1: ‘“collective investment scheme” means a scheme, in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio, and in terms of which—

(a) two or more investors contribute money or other assets to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest; and

(b) the investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis, determined in the deed,

but not a collective investment scheme authorised by any other Act’.

227 Collective Investment Schemes Control Act 45 of 2002 sec 1 definition of ‘collective investment scheme’.

228 3467 references to the term ‘scheme’ existed on the Juta Online Law Publication engine between 1947 and 20 February 2015.

229 E.g. Companies Act 71 of 2008 sec 114.

230 See Schedule (n 44 above).
Uncertainty is inherent in recourse to ordinary meanings, and the phrase ‘in whatever form’ dilutes the definition so as to indicate a legislative intention that whatever a scheme may be this Act, irrespective of how esoteric, the jurist may ascribe whichever form it wishes to it, which is absurd, and not so in the philosophical sense (the author has witnessed this dialectic once before, when Seife mathematically proved, in all-seriousness, that Winston Churchill was a carrot). The definition contains a singular inclusive reference to open-ended investment companies, which renders the noscitur a sociis principle inadequate. A CIS ostensibly has three main elements that are discussed hereafter. In each discussion, the law relating CISs as commensurate with that relating to synthetic securitisation schemes is explored. According to the CIS definition, it will fall short of being a CIS in terms of CISCA if it is authorised by another statute, from which it is deduced that CISCA will not apply if a CIS is established through another statute. This is a slippery slope fallacy, since, contextually, it would imply that if a synthetic securitisation scheme were to meet the requirements of a CIS in terms of CISCA, CISCA would not apply.

6.2 Public offer

The CIS definition contains this clause: ‘[I]n pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio’. ‘[M]embers of the public’ is expressly defined but has an uncertain ambit given its inclusive definition. However, public offers in South African securities law are primarily regulated by the

231 Collective Investment Scheme Control Act 45 of 2002 sec 1 definition of ‘collective investment scheme’.
232 Collective Investment Scheme Control Act 45 of 2002 sec 1: “‘this Act’ includes a regulation, notice, rule and any other measure having the force of law made under this Act’. [T]his Act’, as used in the definition of ‘this Act’ presumably refers to CISCA.
233 See A Camus *The myth of Sisyphus* (1975) in general.
235 Collective Investment Scheme Control Act 45 of 2002 sec 1 definition of ‘collective investment scheme’; Collective Investment Scheme Control Act 45 of 2002 sec 1: “‘open-ended investment company’ means a company with an authorised share capital, which is structured in such a manner that it provides for the issuing of different classes of shares to investors, each class of share representing a separate portfolio with a distinct investment policy’.
237 See n 226 above.
238 Collective Investment Scheme Control Act 45 of 2002 sec 1 definition of ‘collective investment scheme’.
239 Collective Investment Scheme Control Act 45 of 2002 sec 1: “members of the public” includes—
(a) members of any section of the public, whether selected as clients, members, shareholders, employees or ex-employees of the person issuing an invitation to acquire a participatory interest in a portfolio; and
(b) a financial institution regulated by any law, but excludes persons confined to a restricted circle of individuals with a common interest who receive the invitation in circumstances which can properly be regarded as a domestic or private business venture between those persons and the person issuing the invitation’.

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Companies Act\textsuperscript{241} and not by CISCA. The Companies Act\textsuperscript{242} defines ‘offer’\textsuperscript{243} and ‘offer to the public’\textsuperscript{244}. The latter also has an uncertain ambit since it is inclusively defined; therefore, it is surmised that a public offer may be any invitation excluding a secondary offer\textsuperscript{245} through an exchange,\textsuperscript{246} or an instance provided for in section 96 of the Companies Act.\textsuperscript{247} According to Delport, in a lecture presented on 15 August 2010 in die LRR801 module at the University of Pretoria’s LLM Corporate Law programme, the term ‘public’ is indeed somewhat defined in section 95 of the Companies Act.\textsuperscript{248} According to section 95(2) of the Companies Act,\textsuperscript{249} ‘a person is to be regarded…as being a member of the public, despite that person being a shareholder of the company or a purchaser of goods from the company’. Although \textit{prima facie} a definition of ‘member of the public’ and not ‘public’, the definition of ‘offer to the public’ commences with the clause: ‘[A]n offer of securities to be issued by a company to any section of the public’\textsuperscript{250}. The conclusion is that the public, in terms of Chapter 4 of the Companies Act 71 of 2008, may be at least a single person. Given the lack of further information in CISCA, it is a presumption that similarities exist between an offer to the public in terms of the Companies Act\textsuperscript{251} and the compulsory offer element in CISCA, if it is borne in mind that membership in terms of the current company law regime has been discarded.

The CIS definition refers to both invitation and permission\textsuperscript{252}. The former is explicable in terms of the hackneyed securities law principle that an offer includes an invitation;\textsuperscript{253} the latter is

\begin{itemize}
  \item \textsuperscript{241} 71 of 2008.
  \item \textsuperscript{242} As above.
  \item \textsuperscript{243} Companies Act 71 of 2008 sec 95(1)(g): “offer”, in relation to securities, means an offer made in any way by any person with respect to the acquisition, for consideration, of any securities in a company’.
  \item \textsuperscript{244} Companies Act 71 of 2008 sec 95(1)(h): “offer to the public”—
    \begin{enumerate}
      \item includes an offer of securities to be issued by a company to any section of the public, whether selected:
        \begin{enumerate}
          \item (aa) as holders of that company’s securities;
          \item (bb) as clients of the person issuing the prospectus;
          \item (cc) as the holders of any particular class of property; or
          \item (dd) in any other manner; but
        \end{enumerate}
      \item (ii) does not include—
        \begin{enumerate}
          \item (aa) an offer made in any of the circumstances contemplated in section 96; or
          \item (bb) a secondary offer effected through an exchange’.
        \end{enumerate}
    \end{enumerate}
  \item \textsuperscript{245} Companies Act 71 of 2008 sec 95(1)(m): “secondary offering” means an offer for sale to the public of any securities of a company or its subsidiary, made by or on behalf of a person other than that company or its subsidiary’.
  \item \textsuperscript{246} See n 244 above.
  \item \textsuperscript{247} 71 of 2008.
  \item \textsuperscript{248} As above.
  \item \textsuperscript{249} As above.
  \item \textsuperscript{250} See n 244 above.
  \item \textsuperscript{251} 71 of 2008.
  \item \textsuperscript{252} See n 226 above.
  \item \textsuperscript{253} Cilliers \textit{et al} (n 78 above) 257; see \textit{Peek v Gurney} 1873 LR 6 HL 377.
\end{itemize}
obscure since both the Companies Act\textsuperscript{254} and CISCA are silent thereon, although it also surfaces in the definition of ‘portfolio’\textsuperscript{255} and in the definition of ‘foreign collective investment scheme’.\textsuperscript{256} A \textit{posteriori}, the Financial Markets Act\textsuperscript{257} provides that an exchange may permit authorised users to trade in securities to fulfill their obligations if trading thereof has been suspended;\textsuperscript{258} \textit{a priori}, exchanges are compelled to make listing requirements that are compulsory for securities’ listing.\textsuperscript{259} The conclusion with regards to permission relates to the general powers of a particular exchange, such as the JSE.\textsuperscript{260} If it appears \textit{prima facie} as if the matter of permission is superfluous in that it is implied, it is to be borne in mind that the Legislature used the wording, ‘in pursuance of which’,\textsuperscript{261} which lends a wider ambit than the probable legislative intention.

The definition of ‘synthetic securitisation scheme’\textsuperscript{262} refers to the issue of commercial paper to investors, but not to the public or non-public nature of such issues. Furthermore, the Schedule\textsuperscript{263} provides that ‘a material portion of the commercial paper shall be represented by

\begin{itemize}
    \item \textsuperscript{254} 71 of 2008.
    \item \textsuperscript{255} Collective Investment Scheme Control Act 45 of 2002 sec 1: "‘portfolio’ means a group of assets including any amount of cash in which members of the public are invited or permitted by a manager to acquire, pursuant to a collective investment scheme, participatory interest in a specific class which as a result of its specific characteristics differs from another class of participatory interests'.
    \item \textsuperscript{256} Financial Markets Act 19 of 2012 sec 1: "foreign collective investment scheme” means a scheme, in whatever form, carried on in a country other than the Republic, in pursuance of which members of the public—
        \begin{itemize}
            \item (a) are invited or permitted to invest money or other assets in one or more groups of assets (whether called a portfolio or by any other name) of such scheme;
            \item (b) acquire an interest or undivided share (whether called a unit or by any other name) in such a group of assets upon such investment; and
            \item (c) participate proportionately in the income or profits and the risk derived from such investment'.
        \end{itemize}
    \item \textsuperscript{257} 19 of 2012.
    \item \textsuperscript{258} Financial Markets Act 19 of 2012 sec 12(4).
    \item \textsuperscript{259} Financial Markets Act 19 of 2012 sec 11.
    \item \textsuperscript{260} JSE Limited Listing Requirements sec 1.1.
    \item \textsuperscript{261} See n 256 above.
    \item \textsuperscript{262} Schedule (n 44 above) para 1: “synthetic securitisation scheme” means a scheme whereby a special-purpose institution—
        \begin{itemize}
            \item (a) issues commercial paper to investors; and
            \item (b) uses the proceeds of such issuance primarily to obtain—
                \begin{itemize}
                    \item (i) credit-risk exposure relating to—
                        \begin{itemize}
                            \item (A) an underlying asset;
                            \item (B) a reference entity; or
                            \item (C) a reference asset,
                        \end{itemize}
                    \end{itemize}
            \end{itemize}
            through the use of funded or unfunded credit-derivative instruments or guarantees, and
            \begin{itemize}
                \item (ii) assets that serve as collateral; and
            \end{itemize}
        \end{itemize}
    \item \textsuperscript{263} n 44 above.
mezzanine positions that are transferred to third parties’. This is unscrupulous, since legal drafting should lead to the utilisation of the same terminology throughout a legal document. Neither the discrepancy between ‘investors’ and ‘third parties’, nor the references to ‘third party investors’ support legal certainty. The Schedule deals specifically with the issue of commercial paper. Unfortunately, paragraph 14 of the Schedule makes no reference to public or non-public issues. However, a compulsory disclosure element accompanies the issue of commercial paper. Although the disclosure element is discussed elsewhere, it is possible, at this stage and for present purposes, to regard the disclosure document and a prospectus to be analogous. Since any initial public offering and primary offering of unlisted securities requires a prospectus, and taking into regard that a primary offer is an offer to the public, it is deduced that an issue of commercial paper in terms of a synthetic securitisation scheme is an offer to the public.

6.3 Investors contributing for a participatory interest in a CIS portfolio

In conjunction to the aforesaid, CISCA requires a minimum of two investors in a CIS. CISCA expressly provides: ‘[A]nd in terms of which two or more investors contribute…’ This is not a reference to the issue of securities but to subscription to or purchase of the securities; i.e. it does not mean that the offer to the public can only be made to at least two

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264 n 44 above, para 5(2)(h)(ii).
265 E.g. Schedule (n 44 above) para 5(2)(k)(i).
266 E.g. Schedule (n 44 above) para 5(2)(h)(ii).
267 E.g. Schedule (n 44 above) para 5(1)(c).
268 n 44 above.
269 n 44 above, para 14.
270 n 44 above.
271 Schedule (n 44 above) para 14(1)(c).
272 See ch 8 below.
273 Although the Companies Act 71 of 2008 does not define ‘prospectus’ it indeed defines ‘registered prospectus’ at sec 95(1)k) as ‘a prospectus that complies with this Act and—

(i) in the case of listed securities, has been approved by the relevant exchange; or
(ii) otherwise, has been filed’.

274 Companies Act 71 of 2008 sec 99(2), sec 95(1)(e): “initial public offering” means an offer to the public of any securities of a company, if—

(i) no securities of that company have previously been the subject of an offer to the public; or
(ii) all the securities of that company that had previously been the subject of an offer to the public have subsequently been re-acquired by the company’.

275 Companies Act 71 of 2008 sec 95(1)(i): “primary offering” means an offer to the public, made by or on behalf of a company, of securities to be issued by that company, or by another company—

(i) within a group of companies of which the first company is a member; or
(ii) with which the first company proposes to be amalgamated or to merge’.

277 See n 226 above.
278 Cilliers et al (n 78 above) 257.
279 Cilliers et al (n 78 above) 258.
investors, but the inverse: That the CIS must have at least two investors. The Schedule\textsuperscript{280} contains a similar provision: For purposes of promoting market discipline\textsuperscript{281} and subject to the Registrar’s discretion,\textsuperscript{282} commercial paper ‘shall be transferred’ to more than one investor.\textsuperscript{283} This could have been simplified if, in each case, provision were made for a public issue and such issue were subjected to a statutory condition of minimum invitation, or if the concept of ‘public’ was redefined so as to limit its current ambit. As of yet, the scheme makes an issue to at least one person, but if allotment to only one person is made, then the entire issue fails – among the securities’ personal rights must exist a condition of this sort. Furthermore, an enquiry surfaces as to securities of different of different maturity: If at any specific time only one investor’s securities held are still in issue, does the scheme fall through? It would appear not: CISCA focuses on investors’ contribution and therefore an eventuality described above does not impede on this; the Schedule focuses on transfer, which similarly remains unaffected.

These CIS investors perform with money or other assets,\textsuperscript{284} which is commensurate with the Companies Act\textsuperscript{285} since barter is included for offers to the public.\textsuperscript{286} The only indication in the Schedule\textsuperscript{287} as to the nature of such counter-performance, for present purposes, is found in the definition of synthetic securitisation scheme, which provides for the receipt of ‘proceeds’ as counter-performance for the issue of commercial paper.\textsuperscript{288} Since ‘proceeds’ is neither defined in the Schedule\textsuperscript{289} nor in the Banks Act,\textsuperscript{290} reliance is placed on its ordinary meaning. According to the Oxford Dictionary, it means ‘[t]hat which proceeds from something; procedure, outcome, profit’.\textsuperscript{291} Therefore, this term is in itself wide enough to include the relevant considerations in both CISCA and the Companies Act.\textsuperscript{292}
The performance by the CIS is to hold a participatory interest in a portfolio of the CIS. ‘[P]articipatory interest’ is defined in CISCA. If this definition is filtered, it is prevalent that a participatory interest is any interest – being a term denoting something other than either beneficial or nominal interest, but indeed any other type of interest (in the ordinary sense of the term) that corporate jurists ascribe to such interest (in the sense just described) for cases where corporate jurists either have no specific designation or try to describe something in the widest possible terms – undivided share or share. It is prevalent from the definition of ‘share’ that a ‘participatory interest’ has a wider ambit than ‘proprietary interest’. The commercial paper issued by s SPI in terms of a synthetic securitisation scheme can doubtlessly resort within the definition of ‘participatory interest’.

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293 See n 256 above.
294 See n 226 above.
295 Collective Investment Scheme Control Act 45 of 2002 sec 1: “participatory interest” means any interest, undivided share or share whether called a participatory interest, unit or by any other name, and whether the value of such interest, unit, undivided share or share remains constant or varies from time to time, which may be acquired by an investor in a portfolio.
296 Reference to stable or volatile prices with regards to participatory interest are excluded here, since this denotes the possible price reaction in most securities.
297 As above.
298 Companies Act 71 of 2008 sec 1: “beneficial interest”, when used in relation to a company’s securities, means the right or entitlement of a person, through ownership, agreement, relationship or otherwise, alone or together with another person to—
   (a) receive or participate in any distribution in respect of the company’
   (b) exercise or cause to be exercised, in the ordinary course, any or all of the rights attaching to the company’s securities; or
   (c) dispose or direct the disposition of the company’s securities, or any part of a distribution in respect of the securities,
   but does not include any interest held by a person in a unit trust or collective investment scheme in terms of the Collective Investment Schemes Act, 2002 (Act 45 of 2002).
299 There is no reason why beneficial or nominal interest may not still be applicable to CISs in the common law sense.
300 Here, ‘share’ is used in the common law sense.
301 Companies Act 71 of 2008 sec 1: “share” means one of the units in which the proprietary interest in a profit company is divided’.
302 As above.
303 Schedule (n 44 above) para 1: “commercial paper” means—
   (a) any written acknowledgement of debt, irrespective whether the maturity thereof is fixed or based on a notice period, and irrespective whether the rate at which interest is payable in respect of the debt in question is a fixed or floating rate; or
   (b) debentures or any interest-bearing written acknowledgement of debt issued for a fixed term in accordance with the provisions of the Companies Act; or
   (c) preference shares, but does not include bankers’ acceptances’.
304 See n 295 above.
6.4 Sharing risk and benefit

The investors described must share both the risk and the benefit of the investment on a *pro rata* basis or on any other basis set out in the deed.\(^{305}\) This is peculiarly phrased by the Legislature. *In strictu sensu*, one can share in risk in a predetermined fashion and then share in losses in another. Sharing in risk, as will be set out elsewhere, means that an investor can compute the probability of loss and the consequence of loss and bear the resultant value in units of money in mind; however, there may be provisions in the deed for facilities to cover losses in the event that the risk realises, which renders the sharing of loss discrepant from sharing in risk.\(^{306}\) However, it is difficult to contemplate that the Legislature here intended risk-sharing through the board without taking into consideration different classes of issued participatory interest, and this is indeed confirmed in the definition of ‘portfolio’.\(^{307}\)

The definition of ‘portfolio’\(^{308}\) in CISCA is wide enough to encapsulate the capital structure of the SPI to which investors look. Is risk-sharing and benefit-sharing in a synthetic securitisation scheme more complex than risk-sharing and benefit-sharing in a CIS due to the stratification of risk?\(^{309}\) Although pragmatically true, in theory the CIS definition provides for a wider ambit with the possibility of greater complexity: ‘[T]he investors share the risk and the benefit of investment in proportion to their participatory interest in a portfolio of a scheme or on any other basis, determined in the deed’.\(^{310}\) The sharing of risk and the sharing of benefit in a SPI by holders of commercial paper can resort within this wide ambit supplied by CISCA.

7 Final remarks

SPIs are applied for a variety of purposes, with securitisation in general and synthetic securitisation specifically constituting but one utilisation, for example, the SPI is known as a *Fonds Communs de Créances* in French\(^{311}\) and a *fondo de titulización* in Spanish.\(^{312}\) The former, though tedious to properly translate, means ‘common fund of debts’, which is too

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\(^{305}\) As above.

\(^{306}\) See ch 6 below.

\(^{307}\) See Ch 8 below on stratification of risk based of securities’ classes.

\(^{308}\) See n 255 above.

\(^{309}\) See n 226 above.

\(^{310}\) See e.g. X de Kergommeaux, GS Marc & GL Nouel ‘Securitizing corporate receivables: An attractive way to finance your business’ 2001 http://www.securitization.net/international/Europe/France/Gide/Marc_Kergommeaux051510.asp (accessed 13 April 2013).

limited for present purposes. The latter translates as ‘fund of securitisation’, being too specific. The BIS sets out considerations for using an SPI, but they are too extensive to be included here, given length limitations, and they resort beyond the primary ambit of this work.

The economic perspective that SPIs are orphan companies is legally unprovoked – the internal and external structures are significant. The economic perspective originates from SPIs being considered bank extensions. The law provides measures affording independence to securitisation SPIs such as limitation on the right of recourse, divergent company names, limitations on investments in the SPI and the management of SPIs. Some sources attribute this to the so-called ‘trustee’. In Germany, the common law trust is not expressly described in codifications; given the German opinion that trusts are tax avoidance instruments, they are heavily taxed. A manifestation thereof, the Truehand, is based on the obligation between the Treugeber and Treuhand. The Truehand is prevalent in German synthetic securitisations, responsible for observing the servicer, holding collateral and administration of performance to noteholders. In the Deutsche Bank AG’s CAST 1999-1 synthetic securitisation scheme, the Truehand held the most senior commercial paper similar to transferors in South African law. The interaction with the Truehand is substantially exposited in chapter 2 of the Bürgerliches Gesetzbuch. It is, however, imperative that the trustee must be independent of the transferor. The bottom line is that the term ‘trustee’ is often attributed as above, but constitutes a commercial and legal term for such position in jurisdictions where trusts are moreover used for the structure of a SPI, such as the USA or the UK. For present purposes, the

313 Basel Committee on Banking Supervision (n 51 above) 11-19.
314 E.g. ch 4 para 2 above.
315 Schedule (n 44 above) para 5(2)(q). In Canada, OSFI goes further to prohibit ‘any connection implied with the institution by, for example, using a symbol closely associated with the institution’. [Office of the Superintendent of Financial Institutions in Canada (n 68 above) para 33.]
316 Schedule (n 44 above) paras 5(2)(h)(i), 5(2)(o)(i)(A). In Canada, the institution may not own any shares in the SPI, [Office of the Superintendent of Financial Institutions in Canada (n 68 above) para 33.] nor may it own pref shares. [Office of the Superintendent of Financial Institutions in Canada (n 68 above) para 33.] See in this regard n 44 above, para 1 definition of ‘commercial paper’.
320 Bähringer (n 16 above) 10.
321 Para 2 above. A similarity is found in Canadian law at Office of the Superintendent of Financial Institutions in Canada (n 68 above) para 8.
322 Schedule (n 44 above) para 5(2)(h)(i).
323 Office of the Superintendent of Financial Institutions in Canada (n 68 above) para 33.
SPI has a Board in terms of company law. Canadian regulation provides that none of the members of the Board of the ‘institution’ may serve such a role in a SPI if the SPI has less than three Board members. In South African law, the Schedule stresses independence from the institution acting in a primary role, although the exact meaning of such independence is uncertain. It is a legal certainty that an institution acting in a primary role may only appoint one director to the board of the SPI. Whilst the Board has fiduciary duties towards the shareholders of the SPI, the trustee, in terms of company law, of the SPI will have fiduciary duties towards the holders of commercial paper. Therefore, the SPI’s independence shields it from abuse by institutions acting in a primary role.

The corporate jurist is contemporaneously comfortable discussing securitisation within virtually any jurisdiction. However, previously SPIs were incorporated off-shore due to either the absence of securitisation regulation or the presence of legal constraints—the implication being that securitisation did not organically evolve in every jurisdiction, and some institutions in certain jurisdictions were anxious to adopt the securitisation mechanics domestically. An example thereof was Germany in November 1990, when BaFin stressed its reservations with regard to an off-shore traditional securitisation scheme. The securitisation continued despite BaFin’s demand to desist from the scheme, presumably because it was outside the German jurisdiction, although the scheme was cut short in compliance with BaFin’s request. It appears as if domestic securitisation in Germany was the result of demand for local schemes. Off-shore SPIs, for whatever purpose, are contemporaneously still prevalent, especially in tax-

324 As above.
325 n 44 above.
326 n 44 above, para 5(2)(p).
327 Schedule (n 44 above) para 5(2)(p)(i).
328 n 216 above.
329 Cilliers et al (n 78 above) 236.
330 See De Kergommeaux, Marc & Nouel (n 31 above).
332 As above.
333 As above.
havens such as Switzerland and Guernsey. An example of a consideration for off-shore SPIs is on-balance sheet financing. For purposes of hybrid CDOs, it remains important that the principles of separate legal personality are consequential to the general practice of on-balance sheet financing. Off-balance sheet financing is the exception, being the avoidance of equity or asset entries on that same company’s balance sheet. The rules relating to off-balance sheet financing differ amongst jurisdictions; South African exclusions from off-balance sheet financing will be justified by various factors such as definition, materiality (as a threshold rather than a qualitative characteristic), and possible causality to any effect on financial statement elements. Albeit Jacobs and Van den Berg emphasise the originator’s divestiture of rights, duties, risks and rewards in South African securitisations, the ABS’s ‘asset’ description regards ownership and constituent competencies as categorically inessential considerations; however, weight is lent to possessio, ascribable only to SPIs. Therefore, balance sheet structures are improved by the South African off-balance sheet approach to securitisations. These aspects must be addressed by jurists authoring on traditional securitisation schemes. However, the conclusion is that proper domestic regulation inhibits the need for off-shore SPIs

A synthetic securitisation scheme possibly qualifies as a CIS in terms of CISCA, but some uncertainty remains with regard to this. No relevant obiter dicta was provided in the case of Pieter Hendrik Strydom NO and Others v Johan Hendrik Bakkes and Others to this effect. To conclude that synthetic securitisation schemes classify as CISs demand a study of the requirements thereof as well as regard for possible exclusions. Although reference was made

338 As above.
339 Framework for the Preparation and Presentation of Financial Statements (June 2004) para 69 et seq.
340 Framework (n 339 above) para 47.
341 Framework (n 339 above) para 76.
342 Karoly (n 72 above) para 99.
343 Framework (n 339 above) para 76.
344 Framework (n 339 above) para 111.
345 Framework (n 339 above) para 112.
346 Karoly (n 52 above) 78.
347 Karoly (n 52 above) 77.
to a slippery slope fallacy above,\(^{350}\) it us doubtful that the meaning derived from exclusion in CISCA reflects the legislative intention; rather, it is inferred that the legislative intention was more in line with foreign CISs defined in the Financial Markets Act.\(^{351}\) The matter of a public offer in CISs is frustrating, since the inclusion of a public offer in the definition of a CIS\(^{352}\) prohibits trading in the secondary market of such participatory interest, although it is doubtful that that was the legislative intention. There is no provision in the Schedule\(^{353}\) that requires an issue of commercial paper to constitute an offer to the public. Frankly, the conclusion reached above in this regard is based on inductive reasoning which has in itself been subjected to criticism as a method of philosophical analysis. As for the number of investors\(^{354}\) and the nature of commercial paper relating to participatory interest,\(^{355}\) synthetic securitisation schemes and CISs seem to correlate. The same would possibly in practice be the case with sharing of risk and benefit.\(^{356}\) Should it be determined that the disclosure document and a prospectus constitute two different documents, the conclusion may be that synthetic securitisation schemes and CISs are not analogous.

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\(^{350}\) Para 6.1 above.

\(^{351}\) 19 of 2012.

\(^{352}\) See n 226 above.

\(^{353}\) n 44 above.

\(^{354}\) Para 6.3 above.

\(^{355}\) As above.

\(^{356}\) Para 6.4 above.
Chapter 6

Risk and risk management in synthetic securitisation schemes

1 Introduction
2 Defining risk for present purposes
3 The basic relationship between risk and return
4 Risk and the Basel capital requirements
5 Credit risks in synthetic securitisation schemes
6 Credit ratings
   6.1 South Africa
   6.2 Canada
   6.3 Germany
7 Moral hazard and systemic risk
8 Risk management
9 Risk maintenance
10 Risk repurchase
11 Final remarks

1 Introduction

The definition of a ‘synthetic securitisation scheme’ in the Schedule provides for the SPI’s acquisition of credit risk exposure relating to an underlying asset, a reference asset or a reference entity. A clear concept of such assets and entities is necessitated for the drafting of the synthetic sale contract, specifically regarding performance and valuation. Irrespective of the personal rights relating to performance, the realised financial benefit may deviate from it. This constitutes the notion of risk that will be studied in this chapter. The more exclusive focus on risk, rather than derecognition, is arguably the greatest differentiating factor between

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2 n 1 above, para 1.
3 DN Chorafas Credit derivatives & the management of risk including models for credit risk (2000) 34.
4 As above.
5 As above.
traditional securitisation schemes and synthetic securitisation schemes. Therefore, this chapter forms the basis for the remainder of this thesis. It anticipates the discussion of credit derivatives⁶ (and sets out the basic tenets of credit risk necessary to understand the latter) as well as commercial paper.⁷ This chapter also discusses the issue of moral hazard⁸ that has surfaced as a catch phrase during and after the Financial Crisis.⁹ Therefore, this chapter commences by defining the concept of ‘risk’ in its most basic form,¹⁰ in portfolios,¹¹ as well as its statistical nature,¹² with due regard for the various risk classes in existence.¹³

There will be a specific focus on credit risk¹⁴ and the discussion is extended to risk-return,¹⁵ since risk points to both ‘[a]n upside element of potential gain’¹⁶ and ‘[a] downside possibility such as exposure to loss’.¹⁷ These aspects are sine qua non for the ensuing discussion on risk management.¹⁸ Before discussing the matters of risk maintenance¹⁹ and risk repurchase,²⁰ as set out in the Schedule,²¹ focus is required for the controversial point of rating agencies and their role and pitfalls with regards to synthetic securitisation schemes.²² Too much can be said on the topic of CRAs in general and CRAs in specific with regards to the Financial Crisis to satisfy all the reader’s needs on that topic in this work. Subsequent to this research, the conclusion became apparent that the topic of CRAs per se, as well as securitisation and CRAs, deserve postgraduate research in their own right. This is a thesis on synthetic securitisation schemes, not CRAs, and paragraph 5 below is included for purposes of discussing the relationship between the former and credit ratings. Subsequent to a fundamental understanding

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⁶ Ch 7 below.
⁷ Ch 8 below.
⁸ Para 7 below.
⁹ See Ch 2 para 5 above.
¹⁰ Para 2 below.
¹¹ As above.
¹² As above.
¹³ Para 5 below.
¹⁴ As above.
¹⁵ Para 3 below.
¹⁶ Chorafas (n 3 above) 35.
¹⁷ As above.
¹⁸ Para 8 below.
¹⁹ Para 9 below.
²⁰ Para 10 below.
²¹ n 1 above.
²² Para 6 below.
of risk, moral hazard and systemic risk, concepts of risk management are introduced.

2 Defining risk for present purposes

There is no intention of digressing from the legal objective of this work into an elaborate mathematical discussion of risk, or a commercial or engineering discussion of risk management. When we come to terms with the concept of risk in this paragraph and in this chapter it is only for purposes of gaining a better understanding of synthetic securitisation schemes and the law regulating them. And in order to better understand credit derivatives one must first come to terms with the fact that risk has been gradually re-defined in the marketplace. Since the Schedule does not define ‘risk’, it retains its common meaning. It has been defined as the possibility of an uncertain event transpiring, producing an unwanted consequence. However, risk features probability contra possibility, irrespective of qualitative or quantitative expression. Risk is the growth of consequence by probability (see formula 6.1 below). This explains why the amount of commercial paper in a synthetic securitisation scheme would be less than that in a comparable traditional securitisation scheme, since the equivalent of the assets in true sale’s commercial paper face value does not need to be issued, but rather the equivalent of the face value of the hedged assets multiplied by the probability of a credit event occurring.

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23 Paras 2, 3, 4 and 5 below.  
24 Para 6 below.  
25 Para 7 below.  
26 Para 8 below.  
28 n 1 above.  
29 L Brown (ed) The new shorter Oxford English dictionary on historical principles (1993) 2609: ‘[d]anger; (exposure to) the possibility of loss, injury, or other adverse circumstance’, ‘[(e)xposure to] the possibility of commercial loss, spec (a) in the case of insured property or goods, (b) as part of economic enterprise and the source of entrepreneurial profit’, ‘[(e)xposure to] the possibility of commercial loss, spec (a) in the case of insured property or goods, (b) as part of economic enterprise and the source of entrepreneurial profit’ or ‘[a] chance or possibility of danger, commercial loss, or other risk’; BA Garner et al (ed) Black’s law dictionary (2004) 1353: ‘[t]he uncertainty of a result, happening, or loss; the chance of injury, damage, or loss; esp., the existence and extent of the possibility of harm’.  
31 K Visser Principles of risk management (2008) 1.3 et seq.  
32 Visser (n 31 above) 5.11 et seq.  
33 Visser (n 31 above) 1.3.  
34 Das (n 27 above) 345.  
35 As above.  
36 As above.
risk = consequence \times probability 

Formula 6.1

Whereas formula 6.1 is applicable for any particular risky venture, it must be borne in mind that synthetic securitisation stems from a portfolio of assets, which requires risk weighting: 37

risk weighted assets = (asset class_1 \times probability_1) + (asset class_2 \times probability_2) + \ldots + (asset class_n \times probability_n) 

Formula 6.2.1

\[ \therefore \text{risk weighted assets} = \sum_{i=1}^{n} (\text{asset class}_i \times \text{probability}_i) \]

Formula 6.2.2

Another method of approaching risk through quantitative analysis would be through statistics, although this is not the primary approach suggested for the jurist to keep in mind for purposes of defining risk throughout the rest of this work. An event is a particular set of outcomes 38 resorting within statistical inference, 39 and in considering probability \( P \) as a quantity between 0 and 1 40 if event \( E \) transpires, and the sum of probabilities of a set of mutually exclusive and exhaustive 42 events as 1,43 the discrepancy between a certain \( (P = 1) \) and an uncertain event \( (P \leq 1) \) becomes apparent.44 Therefore, the fallacy suggests that certain events declassify risk. Bearing in mind that the derivatives market is zero sum, presupposing lawful hedging possibilities, it is concluded at this early stage of this chapter, for purposes of this chapter, that

40 RA DeFusco et al ‘Probability concepts’ in CFA Institute (n 38 above) 437. This employment of integers is the variation of expressing percentages as fractions.
41 I.e. only one event can transpire at a specific point in time – RA DeFusco et al ‘Probability concepts’ in CFA Institute (n 38 above) 437.
42 I.e. it envelops all possible outcomes – RA DeFusco et al ‘Probability concepts’ in CFA Institute (n 38 above) 437.
43 RA DeFusco et al ‘Probability concepts’ in CFA Institute (n 38 above) 437.
44 As above.
not all risks are ‘unwanted’ as mentioned previously. This concept is carried further in both paragraphs 3 and 8 below.

3 The basic relationship between risk and return
The statement by hedge fund manager Gordon Gekko in the film Wall Street, that ‘what’s worth doing is worth doing for money’ is true at virtually every corner of micro-economics for protagonists of the one polarity of the Big Tradeoff, and constitutes the SPI’s motivation for assuming the transferor’s credit risk and the investor’s motivation for assuming it consequently from the SPI. Sources are full of references to either speculation and/or hedging with regards to securitisation schemes. Many of these notions are excluded herein since they are better fitting for research in the field of investment management. However, it deserves note that these concepts, being disparate economic activities, are respectively the increase and decrease of risk according to diverse risk appetites. Circumstantially, as with speculators simultaneously hedging, such a discrepancy may prove fictional. Nonetheless, profiting from the risk-return principal is an undercurrent of speculation, further proving that not all risk is unwanted. The reader must also have a basic grasp of this in order to appreciate the motives and interests of parties to a credit derivative in the synthetic securitisation market, and investors’ inclination to transact on the SPI’s commercial paper. Therefore, these mechanics will be briefly discussed in this paragraph in order to equip the reader to grasp discussions on the latter aspects later in this thesis.

Descriptive statistics dictates the use of dispersion (variation or standard deviation) for risk identification. Any data group, population or sample, can be subjected to tabular intervallic display (a ‘frequency distribution’) and graphically represented as a frequency polygon.

47 As above.
48 Williamson (n 46 above) 36.
49 Williamson (n 46 above) 35-36.
50 Ch 7 below.
51 Ch 8 below.
52 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 343.
53 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 381 et seq.
54 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 381.
55 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 343-344.
56 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 345 et seq.
57 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 354-357.
plotting, for example, probability on the y-axis and rate of return on the x-axis. Upon establishing central tendency with an arithmetic mean dispersions around such mean indicate risk. Stated more simply, if one can determine the relationship between probabilities and rates of return for data sets, one can come to the conclusion that instances falling outside the mean represent risk. For \( N \) observations with \( X_i \) as the \( i \)th observation, the population mean is \( \mu \) (see formula 6.3 below). For \( N \) observations with \( X_i \) as the \( i \)th observation, the sample mean is \( \bar{X} \) (see formula 6.4 below).

\[
\mu = \left( \sum_{i=1}^{N} X_i \right) \div N
\]

Formula 6.3

\[
\bar{X} = \left( \sum_{i=1}^{N} X_i \right) \div N
\]

Formula 6.4

For any population the variation will be \( \sigma^2 \) (formula 6.5 below) and the standard deviation \( \sigma \) (formula 6.6 below); for any sample the variance will be \( s^2 \) (formula 6.7 below) and the standard deviation \( s \) (formula 6.8 below).

\[
\sigma^2 = \left[ \sum_{i=1}^{N} (X_i - \mu)^2 \right] \div N
\]

Formula 6.5

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58 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 353 et seq.
59 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 357 et seq.
60 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 381.
61 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 358.
62 As above.
63 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 358-360.
64 As above.
65 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 384.
66 As above.
67 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 384-386.
68 As above.
69 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 386-387.
70 As above.
71 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 387-390.
72 As above.
\[ \sigma = \sqrt{\left\{ \sum_{i=1}^{N} (X_i - \mu)^2 \right\} \div N} \]

Formula 6.6

\[ s^2 = \left\{ \sum_{i=1}^{N} (X_i - \bar{X})^2 \right\} \div N \]

Formula 6.7

\[ s = \sqrt{\left\{ \sum_{i=1}^{N} (X_i - \bar{X})^2 \right\} \div N} \]

Formula 6.8

Upon determination of risk through dispersion, return-risk is calculable with the inverse of coefficient of variation.\(^73\) Coefficient of variation indicates the relative dispersion,\(^74\) i.e. the standard deviation per unit of mean return.\(^75\) For any set of observations with standard deviation \(s\) and mean \(X\), the coefficient of variation is \(CV\)\(^76\) (see formula 6.9 below).\(^77\)

\[ CV = s \div X \]

Formula 6.9

Therefore, for any mean return of \(X\) with standard deviation of \(s\), the return-risk (inverse coefficient of variation)\(^78\) is \(CV^{-1}\)\(^79\) (see formula 6.10 below).\(^80\)

\[ CV^{-1} = X \div s \]

Formula 6.10

\(^73\) RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 395-399.
\(^74\) RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 393-395.
\(^75\) As above.
\(^76\) As above.
\(^77\) As above.
\(^78\) RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 395-396.
\(^79\) As above.
\(^80\) As above.
The employment of risk-free return will supply a more precise return-risk ratio than the inverse coefficient of variation. Therefore, for any portfolio $p$ with mean return $R_p$ and a return $R_F$ on a risk-free asset and standard deviation $s_p$ on the entire portfolio, the Sharpe ratio will be $S_h$ (see formula 6.11 below).

$$S_h = \frac{(R_p - R_F)}{s_p}$$

Formula 6.11

In addition, beta can be incorporated into return-risk through the capital asset pricing model (CAPM), which dictates, for example, that the required return on a commercial paper investment by an investor in a synthetic securitisation scheme will be $R_e$ and equal to the sum of a risk-free rate $R_F$, and the difference between the average or expected market return rate $R_m$ and the risk-free rate $R_F$, times beta $\beta$ (see formula 6.12 below). The model is expressed here in its simplest form for ready accessibility by jurists. Inquisitive readers may consult the teaching notes by Professor Alex Shapiro of NYU Stern or Karl Sigman of Columbia University.

$$R_e = R_F + (R_m + R_F)\beta$$

Formula 6.12

4 Risk and the Basel capital requirements

Now that the reader has some grasp of the notion of risk, as would be expected of the author to supply in a work on this topic, it is important to reveal a startling fact on the subject of this chapter. Much has already been said in this work on synthetic securitisation and management,

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81 RA DeFusco et al ‘Statistical concepts and market returns’ in CFA Institute (n 39 above) 396-399.
82 As above.
83 As above.
84 See para 7 below.
86 As above.
89 Paras 2, 3 above.
whether that draws from sources,\textsuperscript{90} references to Basel,\textsuperscript{91} or otherwise. However, as much as capital adequacy is based on risk management,\textsuperscript{92} securitisation, be that traditional or synthetic, is not based on risk but on rather on capital and profit. Then again, the negative connotation that the New Economic Rights Alliance (NEWERA) has used in similar regards,\textsuperscript{93} nor any views expressed by conspiracy theorists against the free market, is hereby attached to this.

If an institution, in isolation, primarily wanted to transfer its risk, it would most likely have transacted on either an insurance contract with a third party of a credit derivative without the securitisation scheme. There is much literature for the jurist to indulge in on the former, and very little legal literature on the latter. In a securitisation scheme, the institution primarily seeks capital relief, since the liquidity necessitated in terms of capital requirements restricts higher return on investment of the required capital. This creates a dilemma. The institution is regulated by the same government to execute inter alia two opposing activities: Maximise its profit for its securities holders\textsuperscript{94} and retain capital that makes the former objectively impossible. In order to do both, it must lawfully decrease its risk to lawfully decrease its capital adequacy. Thus the motivation for securitisation, a scheme created by members of the public when the State sets the rules against each other: The institution devolves its risk, either truly or synthetically, to investors in direct securitisation\textsuperscript{95} or a SPI in indirect securitisation,\textsuperscript{96} in order to decrease the mandatory capital and increase its legally required profit optimisation.

Basel represents a more objective approach at determining capital adequacy than the subjective risk determination set out above.\textsuperscript{97} However, if an objective approach is indeed followed, then the ‘legislative’ authority – bearing in mind the principle of pacta tertii nec nocent nec prosunt\textsuperscript{98} – must ensure that its objective risk determination is realistic, which has not always been the case, otherwise new Basel Accords would not periodically have been issued. Therewith, blame is not necessarily passed to the BIS, since evolution in the financial markets necessitates evolution in objective regulation. It rather becomes a matter of timeous evolution in objective regulation, and not ex post facto amendments as were seen with the Financial

\textsuperscript{90} E.g. Ch 2 n 36 above.
\textsuperscript{91} E.g. Ch 2 para 4.1 above.
\textsuperscript{92} Ch 2 para 4.1 above.
\textsuperscript{94} The reader may obtain a better comprehension of this notion from ch 5 above.
\textsuperscript{95} See ch 5.
\textsuperscript{96} As above.
\textsuperscript{97} Para 2 above.
Crisis. It is not the intention to enter into an elaborate discussion on capital adequacy beyond what has already been said, since on a timeline in any instance, as the reader can deduce from the aforementioned, capital adequacy predates the synthetic securitisation process, which is the focus of this work. South Africa,\textsuperscript{99} Canada\textsuperscript{100} and Germany\textsuperscript{101} have acceded to the Basel III Accord, and whether or not Basel III, or objective regulation in any event, constitutes the best practice must be reserved for a study of capital adequacy \textit{per se}. The reason for this is that the risk transferred in terms of a synthetic securitisation scheme by an institution is not risk subjectively calculated, but risk which is incidentally objectively calculated inherent in the capital that the institution is desirous to devolve.

Cynics criticise synthetic securitisation as a process in which banks rid themselves of toxic risk, and it has now been ascertained that that is not the primary motive of institutions involved in synthetic securitisation schemes since risk as a driving factor falls away. Indeed, it has been seen that investors in commercial paper in terms of synthetic securitisation schemes in South Africa have never lost par.\textsuperscript{102} A view held by cynics which is more readily agreed with is that many banks should not have assumed toxic risk in the first place. This is a matter better addressed by credit law, and during the research for this work the opportunity has arisen to discuss securitisations with credit law specialists who criticise securitisation due to making the aforementioned blunder. Once one moves on from the primary motivation, one again sees that synthetic securitisation is in theory a risk management and profit optimisation process (which squarely accounts for this chapter) in its own right. In the event of indirect synthetic securitisation, the SPI, which must not be an empty shell company,\textsuperscript{103} assumes the risk at a market related price\textsuperscript{104} (i.e. the premiums), of which it can invest the premiums for profit optimisation and supply the risk to investors through debt instruments, being the natural role that investors in debt instruments assume. In isolation, no value is lost in this scheme, and it functions on the micro-economic premises of supply and demand, market completion and

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{99} Directive 5/2013 issued in terms of section 6(6) of the Banks Act, 1990.
\item \textsuperscript{102} S Thomas ‘Securitisation’ 2012 http://www.financialmail.co.za/fm/2012/07/12/securitisation (accessed 26 April 2015).
\item \textsuperscript{103} See ch 5 above.
\item \textsuperscript{104} Is this risk really worth its market related price? That is a rhetoric question is left to other jurists for academic research.
\end{itemize}
\end{footnotesize}
opportunity cost. The corporate law in such a process is pure, although more is said on this in chapter 8 below. In addition, this lucid view must provide the reader with a comprehension of why securitisation schemes naturally fall outside the scope of the business of a bank, as is also discussed in chapter 8 below. It is not to say, however, that no value will be lost in practice when such a scheme is exposed to the economic elements, and as such proper risk management measures are required, which will be discussed elsewhere in this chapter.

5 Credit risks in synthetic securitisation schemes

Discrepancies exist in risk categorisation: The Banks Act105 per se neither defines nor directly categorises risks, albeit indirectly by including an apparent *numerus clausus* of risks in the definition of ‘employee in charge of a risk management function’106 (however, Williamson’s encompassing term ‘bank risks’107 has no legal basis). Partridge-Hicks and Hartland-Swann simplify investment considerations to *inter alia* credit risk, liquidity risk and interest rate risk.108 The Schedule109 is ridden with uncategorised risk references, which are *inter alia* deductively distinguishable as the transfer of credit risk from the employment of credit-derivatives or the stratification of credit risk to the SPI.110 Credit risk consists of risks associated with credit lines, concentration risk and settlement risk,111 although the latter, often referred to as Herstatt risk consequent to the 26 June 1974 settlement failure of Herstatt bank,112 has been greatly eliminated since 2002 with the introduction of the Continuous Linked Settlement (CLS) Payments versus Payments (PvP) system.113

The credit line of a client is the risk exposure, based on an assessment of the said client’s public financials, which a bank is prepared to assume.114 If multiple instruments use the same credit line115 and exceed the latter’s total, the credit line is ‘broken’.116 In order to mitigate systemic risk,117 regulators ensure banks’ capital adequacy with Basel III. Capital adequacy for credit

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105 94 of 1990.
107 E.g Williamson (n 46 above) 10.
109 n 1 above.
110 n 1 above, para 5(1)(a)(i).
111 F Taylor *Mastering derivative markets* (2011) 35 et seq.
112 Taylor (n 111 above) 37.
113 As above.
114 n 113 above, 35.
115 Taylor (n 111 above) 35.
116 As above.
lines consists of ‘going concern’ assets,\(^{118}\) alias Common Equity Tier 1 (CET 1) instruments\(^{119}\) or Tier 1 capital,\(^{120}\) consisting of capital instruments subject to Article 26 of the proposed EU regulations,\(^{121}\) share premium accounts related to the aforesaid,\(^{122}\) retained earnings,\(^{123}\) accumulated income,\(^{124}\) reserves\(^{125}\) and funds for general banking risk,\(^{126}\) and Additional Tier 1 capital\(^{127}\) consisting of instruments subject to Article 49 of the proposed EU regulations and their share premium accounts.\(^{128}\) On the other hand, concentration risk is synonym with counterparty risk in that the former denotes risk exposure to any counterparty\(^{129}\) based on uneven counterparty distribution in any banking relationship (e.g. credit extension).\(^{130}\) It derives its designation from the concentration of business executed with any counterparty.\(^{131}\) Although assets are dispersed, credit derivatives are focused on causing concentrated counterparty risk\(^{132}\) and making this risk category the most prevalent in securitisation.\(^{133}\)

6 Credit ratings

6.1 South Africa

‘[C]redit rating’\(^{134}\) is contextually defined in the Schedule\(^{135}\) and is defined in general in the Credit Rating Services Act.\(^{136}\) The Schedule\(^{137}\) also defines ‘domestic rating’,\(^{138}\) although the


\(^{119}\) Accenture (n 118 above) 16.

\(^{120}\) As above.

\(^{121}\) As above.

\(^{122}\) As above.

\(^{123}\) As above.

\(^{124}\) As above.

\(^{125}\) As above.

\(^{126}\) As above.

\(^{127}\) Accenture (n 118 above) 18.

\(^{128}\) As above.

\(^{129}\) Taylor (n 111 above) 36.

\(^{130}\) As above.

\(^{131}\) As above.

\(^{132}\) Chorafas (n 3 above) 4-5.

\(^{133}\) Chorafas (n 3 above) 13.

\(^{134}\) n 1 above, para 1: “credit rating” means a rating assigned by an eligible institution to commercial paper issued in respect of a traditional or synthetic securitisation scheme’.

\(^{135}\) n 1 above.

\(^{136}\) 24 of 2012, para 1: “credit rating” means an opinion regarding the creditworthiness of—

(a) an entity;
(b) a security or a financial instrument; or
(c) an issuer of a security or a financial instrument,
using an established and defined ranking system of rating categories, excluding any recommendation to purchase, sell or hold any security or financial instrument’.

\(^{137}\) n 1 above.

\(^{138}\) n 1 above, para 1: “domestic rating” means a rating that—

(a) is tiered against an assumed best possible rating, which is usually that of the national Government;
latter is nonsensically never referred to again in it. Although credit ratings in terms of the Credit Rating Services Act\textsuperscript{139} are domestic,\textsuperscript{140} this must be distinguished from the contextualised ‘domestic rating’ in the Schedule.\textsuperscript{141} As such, ‘external credit rating’\textsuperscript{142} is not the inverse of ‘domestic rating’ because domestic rating is not subject to an external credit rating agency.\textsuperscript{143} In South African law, a significant amount of issued commercial paper, which is termed ‘structured finance instrument[s]’\textsuperscript{144} in the Credit Rating Services Act,\textsuperscript{145} must be subject to a CRA’s ratings,\textsuperscript{146} subject to the Registrar’s discretion.\textsuperscript{147} Whether this is a good or a bad thing, in a manner of speaking, is subject to the perspective on it, since, although we have referred to the greed of CRAs prior to the Financial Crisis elsewhere in this work,\textsuperscript{148} the Credit Rating Services Act\textsuperscript{149} was undoubtedly created for better objective regulation\textsuperscript{150} of CRAs subsequent to the debacle of the Financial Crisis. The Credit Rating Services Act\textsuperscript{151} differentiates between ratings of structured finance instruments and other securities, in that ‘[a] registered credit rating agency’\textsuperscript{152} must ensure that rating categories\textsuperscript{153} ascribed to structured finance instruments are clearly differentiated, which entails employing an additional symbol to distinguish structured finance instruments from rating categories for other entities, financial instruments, issuers or

\begin{itemize}
  \item[(b)] does not incorporate the sovereign risks of South Africa;
  \item[(c)] gives an indication of the relative risks only within the Republic of South Africa, and
  \item[(d)] may not necessarily be comparable across different countries’.
\end{itemize}

\textsuperscript{139} 24 of 2012.
\textsuperscript{140} Credit Rating Services Act 24 of 2012 sec 3.
\textsuperscript{141} n 1 above.
\textsuperscript{142} Credit Rating Services Act 24 of 2012 sec 1: “‘external credit rating’ means a credit rating issued by an external credit rating agency’.
\textsuperscript{143} Credit Rating Services Act 24 of 2012 sec 1: “‘external credit rating agency’ means a person who provides credit rating services and who is authorised or registered by a regulatory authority to perform credit rating services similar to those regulated under this Act and who is subject to the laws of a country other than the Republic, which laws—
  \begin{itemize}
    \item[(a)] establish a regulatory framework which is approved by the registrar as being equivalent to that established by this Act; and
    \item[(b)] are supervised and monitored by a regulatory authority’.
\end{itemize}
\textsuperscript{144} Credit Rating Services Act 24 of 2012 sec 1: “‘structured finance instrument’ means a financial instrument or other asset resulting from a securitisation transaction or other structured financial transaction or scheme’.
\textsuperscript{145} 24 of 2012 sec 1.
\textsuperscript{146} Schedule (n 1 above) para 5(2)(k)(ii).
\textsuperscript{147} As above.
\textsuperscript{148} Ch 2 para 5 above.
\textsuperscript{149} 24 of 2012.
\textsuperscript{150} Credit Rating Services Act preamble
\textsuperscript{151} 24 of 2012.
\textsuperscript{152} Credit Rating Services Act 24 of 2012 sec 10(2), sec 1: “‘registered credit rating agency’ means a credit rating agency or an external credit rating agency registered in terms of section 5”.
\textsuperscript{153} Credit Rating Services Act 24 of 2012 sec 1: “‘rating category’ means a rating symbol, such as a letter symbol or a numerical symbol which might be accompanied by appending identifying characters, used in a credit rating to provide a relative measure of risk to distinguish the different risk characteristics of the type of rated entity, issuer or financial instrument or other asset’.
In a market where sophistication between investors may differ drastically, it is important that potential investors need to know what they are getting themselves into upon investing in commercial paper issued in terms of a synthetic securitisation scheme. Therefore, this provision seems laudable.

Only one instance is provided for in the Schedule for unrated commercial paper. In terms of South African law, an originator that is a bank may invest in the SPI’s commercial paper, as long as such investment only comprises the most senior tranche. The implication of this provision is that originators and repackagers that are not banks and repackagers that are banks may invest in any tranches of the SPI’s commercial paper. However, it is uncertain what the term “[r]etained senior unrated tranches” means, although the presumption may be made that it only refers to the most senior tranches that originating banks may hold. Readers may have encountered this tranche in other literature as the ‘super senior tranche’. South African law takes the conservative stance of only acknowledging such a super senior tranche for purposes of risk mitigation if the SPI has an external credit-enhancement facility or collateral or if the provided conditions are met in full: Firstly, the most senior tranche, rated at least AAA or equivalently, must be either ‘demonstrably legally subordinated to’ or ‘rank pari passu with’ the ‘[r]etained senior unrated [tranche]’; secondly, the maturities of the commercial paper in the aforesaid first condition must be equal to or longer than the maturities of the ‘[r]etained senior unrated [tranche]’; thirdly, the first-losses and second-losses must correspond with paragraph 6 of the Schedule. The benefit of this conservative approach is that it prima facie ensures that the originator that is a bank cannot circumvent CRAs by structurally creating a tranche of commercial paper that subordinates the highest rated

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154 Credit Rating Services Act 24 of 2012 sec 10(2).
155 As above.
156 Schedule (n 1 above) para 5(2)(h)(i).
157 Schedule (n 1 above) para 5(2)(i).
158 As above.
159 Schedule (n 1 above) para 5(2)(i)(i).
160 As above; n 1 above, para 5(2)(i)(ii)(A).
161 n 1 above, para 5(2)(i)(ii)(A). It is difficult to imagine a ‘demonstrable’ legal subordination – a tranche either is legally subordinated or it is not.
162 n 1 above, para 5(2)(i)(ii)(A). If the minimum objective test is ranking pari passu, then a phrasing that includes demonstrable legal subordination is superfluous.
163 As above; n 1 above, para 5(2)(i)(ii)(A).
164 n 1 above, para 5(2)(i)(ii)(B).
165 n 1 above, para 5(2)(i)(ii)(C).
commercial paper. The disadvantage of this provision is that it is not clear what it means: Is the existence of the said senior rated tranche a prerequisite for the existence of the said senior unrated tranche? In addition to the aforesaid, the Schedule\textsuperscript{166} specifies that ‘a significant amount’ of the commercial paper must be rated,\textsuperscript{167} except if the Registrar exercises its discretion\textsuperscript{168} and subject to conditions set out by it to allow for an unrated synthetic securitisation structure.\textsuperscript{169} The purpose of market discipline\textsuperscript{170} may translate as legal certainty for us, although it remains uncertain what ‘a significant amount’\textsuperscript{171} of the commercial paper would mean.

In the light of the censure CRA’s have been subjected to, there is no doubt that readers need to be reminded that credit ratings do not constitute a \textit{panacea} that ensures financial freedom for investors. The Financial Crisis Inquiry Commission (FCIC) referred to CRAs as ‘key enablers’ of the Financial Crisis,\textsuperscript{172} whose ‘flawed computer models [and]…pressure from financial firms that paid for the ratings [and]…relentless drive for market share [and]…lack of resources to do the job despite record profits, and…absence of meaningful public oversight’ were catalysts.\textsuperscript{173} The Credit Rating Services Act\textsuperscript{174} undoubtedly attempts to address some of these critiques,\textsuperscript{175} although it should be apparent to the reader that is would be impossible for any government to address all these problems. As for public oversight, the Act inhibits the utilisation of credit ratings not endorsed or issued by a registered CRA in terms of the Act\textsuperscript{176} or approved by the Registrar.\textsuperscript{177} As much as the Act provides for a detailed registration process for CRAs,\textsuperscript{178} it also empowers the Registrar to suspend or deregister CRAs under certain circumstances.\textsuperscript{179}

\begin{itemize}
\item \textsuperscript{166} n 1 above.
\item \textsuperscript{167} n 1 above, para 5(2)(k)(ii)
\item \textsuperscript{168} As above.
\item \textsuperscript{169} As above.
\item \textsuperscript{166} Schedule (n 1 above) para 5(2)(k).
\item \textsuperscript{169} As above.
\item \textsuperscript{170} ‘Conclusions of the Financial Crisis Inquiry Commission’ fcic-static.law.stanford.edu/edn_media/fcic-reports/fcic_final_report_conclusions.pdf (accessed 28 May 2014) xxv.
\item \textsuperscript{172} As above.
\item \textsuperscript{173} 24 of 2012.
\item \textsuperscript{174} Credit Rating Services Act 24 of 2012 Preamble: ‘To provide for the registration of credit rating agencies; to provide for the regulation of certain activities of credit rating agencies; to provide conditions for the issuing of credit ratings and rules on the organisation and conduct of credit rating agencies; and to provide for matters connected therewith’.
\item \textsuperscript{175} Credit Rating Services Act 24 of 2012 sec 4 (1)(a).
\item \textsuperscript{176} Credit Rating Services Act 24 of 2012 sec 4(1)(b).
\item \textsuperscript{177} Credit Rating Services Act 24 of 2012 sec 5.
\item \textsuperscript{178} Credit Rating Services Act 24 of 2012 sec 6.
\end{itemize}
What is to be done concerning flawed computer models?\textsuperscript{180} Certainly, this becomes a difficult area for the Legislature to speculate in, also because many of these \textit{avant-garde} financial structures were the brainchildren of quantitative analysts, making it difficult for jurists to judge the mathematical models that were employed. This has both a theoretical, being in this case statutory, basis, as well as a practical, being in this case case law, basis. The Legislature expressly requires comprehensive organisational and bookkeeping procedures, internal rheostats, effective risk calculation procedures, and effective control and preservation arrangements for data crunching systems,\textsuperscript{181} as well as for CRAs to use suitable systems, means and processes to safeguard endurance and consistency of its services.\textsuperscript{182} As for what this expressly entails, the relevant forum will have to rely on the testimony of expert witnesses to determine the compliance to this provision on a case to case basis. Another concern is the ‘pressure from financial firms that [pay] for the ratings’.\textsuperscript{183} For this, as well as for CRA’s ‘relentless drive for market share’\textsuperscript{184} the Legislature responded by requiring CRA’s organisation to guarantee that its interests neither prejudices its credit ratings’ independence and integrity, nor the accuracy of its services.\textsuperscript{185} Lastly, CRA’s ‘lack of resources to do the job despite record profits’ has also come under scrutiny. The Legislature’s reaction to this was the provision for consistent observation and assessment of the suitability and efficacy of its systems, internal rheostats and arrangements and take fitting actions to address insufficiencies.\textsuperscript{186} In addition, CRAs are required to always have the needed knowledge and experience to execute its services.\textsuperscript{187}

6.2 Canada
South Africa was not the only country addressing the regulation of CRAs through objective law during 2012. On 27 January 2012, the Ontario Securities Commission (OSC) issued a press release announcing the adoption of an instrument\textsuperscript{188} to this effect.\textsuperscript{189} However, this was the

\textsuperscript{180} ‘Conclusions of the Financial Crisis Inquiry Commission’ (n 172 above) xxv.
\textsuperscript{181} Credit Rating Services Act 24 of 2012 sec 7(e).
\textsuperscript{182} Credit Rating Services Act 24 of 2012 sec 7(g).
\textsuperscript{183} ‘Conclusions of the Financial Crisis Inquiry Commission’ (n 172 above) xxv.
\textsuperscript{184} As above.
\textsuperscript{185} Credit Rating Services Act 24 of 2012 sec 7(d).
\textsuperscript{186} Credit Rating Services Act 24 of 2012 sec 7(h).
\textsuperscript{187} Credit Rating Services Act 24 of 2012 sec 7(i).
eventuality by the Group of Twenty (G20), as is evident from a message in April 2009, `w`e have agreed on more effective oversight of the activities of Credit Rating Agencies, as they are essential market participants, to address the problems set out above, paraphrased as a lack of transparency (which translates to asymmetry), the eminence of the rating procedure and conflicts of interest. We come to realise that all these efforts at regulations were a holistic development. The Instrument defines ‘designated rating organization’ (DRO) with reference to applicable statutory law. The securities legislation applicable in Ontario, the Securities Act, other than the Financial Markers Act which is quiet on CRAs, defines ‘credit rating organization’ and ‘credit rating’. The said instrument provides for its version of the definition of ‘external credit rating agency’, which is ‘DRO affiliate’. The Instrument goes further to define not only ‘rated entity’ and ‘rated securities’, but also ‘securitized product’.

191 As above.
192 ‘Conclusions of the Financial Crisis Inquiry Commission’ (n 172 above) xxv.
193 Rousseau (n 190 above) 21, 22.
194 Rousseau (n 190 above) 21.
195 Rousseau (n 190 above) 22-24.
196 Rousseau (n 190 above) 25-27.
197 Rousseau (n 190 above) sec 2.
198 n 188 above.
199 n 188 above, Annex B sec 1: “designated rating organization” means a credit rating organization that has been designated under securities legislation’.
200 RSO 1990 c S5.
201 19 of 2012.
202 Securities Act RSO 1990 c S5 sec 1(1): “credit rating organization” means a person or company that issues credit ratings; (“organisme de notation”).
203 Securities Act RSO 1990 c S5 sec 1(1): “credit rating” means an assessment that is publicly disclosed or distributed by subscription concerning the creditworthiness of an issuer, (a) as an entity, or (b) with respect to specific securities or a specific pool of securities or assets; (“notation”).
204 Instrument (n 188 above) Annex B sec 1: “DRO affiliate” means an affiliate of a designated rating organization that issues credit ratings in a foreign jurisdiction and that has been designated as a DRO affiliate under the terms of the designated rating organizations’ designation’.
205 n 188 above.
206 n 188 above, Annex B sec 1: “rated entity” means a person or company that is issuing, or that has issued, securities that are the subject of a credit rating issued by a designated rating organization and includes a person or company that made a submission to a designated rating organization for the designated rating organization’s initial review or for a preliminary rating but did not request a final rating’.
207 n 188 above, Annex B sec 1: “rated securities” means the securities issued by a rated entity that are the subject of a credit rating issued by a designated rating organization’.
208 n 188 above, Annex B sec 1: “securitized product” means any of the following:

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The OSC has gone further than its South African counterpart in ensuring the independence of CRAs, in that at minimum a half, but not less than two, of the members DRO Board must be independent of the DRO and its DRO affiliates, which independence precludes a member accepting advisory, consulting, advisory or any compensatory fee from the relevant DRO or its DRO affiliate, an employee of either the relevant DRO or its DRO affiliate, having any relationship that may objectively interfere with its independence, or having been a member of the DRO for more than five years. In addition the aforementioned independence, the DRO must also appoint an operationally independent ‘compliance officer’ acting as a subjective rheostat for the DRO’s activities and regularly reporting to the OSC, also as a pro-active measure. The Instrument contains a rigorous regulation of rating procedure, ensuring the adoption, implementation and enforcement of the code of conduct, using practises that are arduous, methodical, incessant and experience-based. The DRO must determine whether the practices relating to a securitisation scheme are suitable upon its risk profile changing significantly, and amend the credit rating if reasonable concern is caused. If DRO’s methods

(a) a security that entitles the security holder to receive payments that primarily depend on the cash flow from self-liquidating financial assets collateralizing the security, such as loans, leases, mortgages, and secured or unsecured receivables, including:
   (i) an asset-backed security;
   (ii) a collateralized mortgage obligation;
   (iii) a collateralized debt obligation;
   (iv) a collateralized bond obligation;
   (v) a collateralized debt obligation of asset-backed securities;
   (vi) a collateralized debt obligation of collateralized debt obligations;

(b) a security that entitles the security holder to receive payments that substantially reference or replicate the payments made on one or more securities of the type described in paragraph (a) but that do not primarily depend on the cash flow from self-liquidating financial assets that collateralize the security, including:
   (i) a synthetic asset-backed security;
   (ii) a synthetic collateralized mortgage obligation;
   (iii) a synthetic collateralized debt obligation;
   (iv) a synthetic collateralized bond obligation;
   (v) a synthetic collateralized debt obligation of asset-backed securities;
   (vi) a synthetic collateralized debt obligation of collateralized debt obligations’.

209 Instrument (n 188 above) Annex B sec 8(2).
211 Instrument (n 188 above) Annex B sec 8(3)(b).
212 Instrument (n 188 above) Annex B sec 8(3)(c).
214 Instrument (n 188 above) Annex B secs 12(4), 12(5).
215 Instrument (n 188 above) Annex B sec 1: ‘‘compliance officer’’ means the compliance officer referred to in section 12’.
216 Instrument (n 188 above) Annex B sec 12(2).
217 Instrument (n 188 above) Annex B sec 12(1).
218 Instrument (n 188 above) Annex B sec 12(3).
219 n 188 above.
220 n 188 above, Appendix A sec 2.1.
221 n 188 above, Appendix A sec 2.2.
222 Instrument (n 188 above) Appendix A sec 2.9.
evolve, it must identify the affected ratings, monitor and review them and apply new ratings, as well as communicate such changes.

The Instrument also contains numerous provisions regulating the integrity of the rating procedure, such as enforcement of the Instrument on not only DROs but also its agents and employees, a provision stipulating that such parties ‘must deal fairly, honestly and in good faith’ with interested parties and a provision that such parties will not supply any guarantee to a rating. Corporate governance demands proper oversight of the DRO, and in the event of a securitisation scheme, at least one independent member of the Board must have objective expertise in the product. It also covers conflicts of interest and precludes cases where a financial interest is held in the rating. Transparency is advanced inter alia through opportune disclosure of ratings, as well as its methodologies.

**6.3 Germany**

Canadian regulation was implemented only subsequent to the European Union’s Regulation (EC) No 1060/2009. The Regulation identifies some problem areas with regards to CRAs, such as independence and integrity, stability of capital markets, early detection of credit

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223 Instrument (n 188 above) Appendix A sec 2.12.
224 Instrument (n 188 above) Appendix A sec 2.12(a).
225 Instrument (n 188 above) Appendix A sec 2.12(b).
226 Instrument (n 188 above) Appendix A sec 2.12(c).
227 Instrument (n 188 above) Appendix A sec 2.12(d).
228 Instrument (n 188 above) Appendix A sec 2.15.
229 n 188 above.
230 n 188 above, Appendix A sec 2 Part C.
231 n 188 above.
232 n 188 above, Appendix A sec 2.16.
233 n 188 above, Appendix A sec 2.17.
234 As above.
235 n 188 above, Appendix A sec 2.19.
236 Instrument (n 188 above) Appendix A sec 2 Part D.
237 Instrument (n 188 above) Appendix A sec 2.22.
238 As above.
239 Instrument (n 188 above) Appendix A sec 3.
240 Instrument (n 188 above) Appendix A sec 3.4.
241 Instrument (n 188 above) Appendix A sec 4 Part A.
242 Instrument (n 188 above) Appendix A sec 4.1.
243 Instrument (n 188 above) Appendix A sec 4.2.
244 Instrument (n 188 above) Appendix A sec 4.4(b).
245 Instrument (n 188 above) sec 2.
247 n 246 above, art 6.
248 n 246 above, art 7.
deterioration, conflicts of interest, rating quality, transparency and surveillance. It negatively defines credit ratings and provides for the main business of credit rating and prohibits a CRA of performing consulting work or making recommendations concerning securitisation schemes. It provides for methodologies that are arduous, methodical, incessant, based on experience, as it must be justifiable and firmly validated. CRAs must also disclose their methodologies to interested parties and the regulation extends to employees or other persons involved. The Regulation also provides the motivation for the Ontarian provision relating to independence. The Regulation was amended by Regulation (EU) No. 513/2011, shortly referred to as CRA II, which supplies exclusive competence to the European Securities and Markets Authority (ESMA) for registration and supervision of CRAs in the EU. This was again amended by Regulation (EU) No. 462/2013, shortly referred to as CRA III, precluding exclusive reliance on credit ratings by CRAs, containing further provisions relating to conflicts of interest and maximum duration of a CRA’s contract.

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249 n 246 above, art 10.
250 As above.
251 As above.
252 As above.
253 As above.
254 Regulation (n 246 above) arts 19, 20 and 21: ‘This Regulation should not apply to credit ratings that a credit rating agency produces pursuant to an individual order and provides exclusively to the person who ordered it and which are not intended for public disclosure or distribution by subscription’, ‘Investment research, investment recommendations and other opinions about a value or a price for a financial instrument or a financial obligation should not be considered to be credit ratings’ and ‘An unsolicited credit rating, namely a credit rating not initiated at the request of the issuer or rated entity, should be clearly identified as such and should be distinguished from solicited credit ratings by appropriate means’.
255 Regulation (n 246 above) art 22.
256 As above.
257 As above.
258 Regulation (n 246 above) art 23.
259 Regulation (n 246 above) art 24.
260 Regulation (n 246 above) art 25.
261 Regulation (n 246 above) art 26.
262 n 246 above.
263 n 246 above, article 29.
265 Bundesgerichtshof (n 264 above).
267 Bundesgerichtshof (n 264 above).
268 Bundesgerichtshof (n 264 above).
269 n 266 above, art 12; Bundesgerichtshof (n 264 above).
demanding less reliance on CRAs, encouraging more and smaller CRAs and presenting a rotation of CRAs for re-securitisation.

These regulations have been implemented in Germany on a national level subsequent to a first draft of the bill thereto by the federal government on 14 March 2014, a second draft of the bill thereto by the federal government on 30 March 2014 and parliamentary debates. As the title of the legislation suggests, the German government enacted this legislation to reduce the dependence of CRAs, which is prima facie the opposite intention of the Canadian and South African government. This is perhaps at best understood from the phrasing of the Bundesgerichtshof, which contended that the ratings were uncritical and schematic and often led to the inadequate assessment of default risk, being a major catalysts to the Financial Crisis. To be truthful, the Gesetz zur Verringerung der Abhängigkeit von Ratings is not so much a new statute as it is an amendment act, amending the Wertpapierhandelsgesetz, the Kreditwesengesetz, the Kapitalanlagegesetzbuch, the Versicherungsaufsichtsgesetz and the Genossenschaftsgesetz, inter alia creating numerous administrative offences.

7 Moral hazard and systemic risk

By this time, the reader must be able to tacitly identify the reasons why synthetic securitisation schemes were involved in an event of systemic risk with such great repercussions as the Financial Crisis. Being too elaborate to include in one chapter, let alone one paragraph, moral hazard has been emphasised since the first chapter, albeit not designating it as such in order not

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270 n 266 above, art 9.
271 n 266 above, art 11.
272 n 266 above, art 14.
275 ‘Entwurf eines Gesetzes zur Verringerung der Abhängigkeit von Ratings’ (n 274 above).
277 As above.
278 As above.
279 As above.
283 Gesetz zur Verringerung der Abhängigkeit von Ratings vom 10 Dezember 2014 sec 5.
285 Ch 2 para 5 above.
to confuse the reader. The logic is fairly simple, and a few examples will be briefly reiterated. Firstly, the prime originators in synthetic securitisation schemes are banks, and extension of credit without realistic adequate capital based on the computation of risk inherent in credit extension, is moral hazard and may cause systemic risk. The answer to this was Basel. Secondly, SPIs are corporate orphans and consequently little focus is placed on its internal management in academic circles. This has been mentioned in chapter 5. Thirdly, CRA’s greed led to unrealistic ratings of commercial paper which constituted moral hazard per se. This has already been discussed as far as possible without digressing into a doctoral level study of CRAs.

The term ‘moral hazard’ has become a buzz word surrounding the Financial Crisis. According to Dickenson of Fordham Law School, moral hazard is the propensity of own utility optimisation at other’s cost without one enduring all consequences or benefits thereof. In deconstruction, Black’s Law Dictionary defines ‘hazard’ as ‘[d]anger or peril; esp., a contributing factor to a peril’; we understand the concept of ‘hazard’ to be distinguishable from ‘risk’, the former being the source of the realisation of a risk event in terms of risk management nomenclature. To connote moral hazard with the Financial Crisis would be an oversimplification given its prevalence, e.g. its inherency in all insurance contracts or reckless credit in credit law. Ironically, securitisation initially provided devices to insurers to address moral hazard. Today, this concept is met with little erudition although the term has been in circulation for two centuries. Black’s Law Dictionary defines moral hazard specifically as ‘[a] hazard that has its inception in mental attitudes. Examples include dishonesty, carelessness, and insanity. The risk that an insured will destroy property or allow

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287 See ch 3 above.
288 Ch 2 para 4.1 above.
289 See ch 5 above.
291 Garner (n 29 above) 735.
292 Visser (n 31 above) 9.4.
295 National Credit Act 34 of 2005 sec 80.
297 Doherty & Richter (n 294 above) 11.
it to be destroyed (usu. by burning) in order to collect the insurance proceeds is a moral hazard. Also, an insured’s potential interest, if any, in the burning of the property is sometimes called a moral hazard.’

Mathematically, we may define moral hazard as ‘[arising] when individuals engage in risk sharing under conditions such that their privately taken actions affect the probability distribution of the outcome’.

Dow argues that moral hazard exists without an explicit ethical judgment, albeit with an implicit value judgment with regards to socially-optimal markets; i.e. in terms of the Big Tradeoff one only pays regard to market efficiency. In viewing moral hazard so broadly, we are reminded that ethics and law are distinguishable normative systems, and this work has little bearing on an ethics study in terms of humanities. However, it is conceded that the aforesaid has precipitated into law in that the Minister may prescribe a category of companies that must now each have a social and ethics committee. Viewing moral hazard more strictly, the regulation of managerial judgment in transferring institutions has both common and statutory law bases. The rights and duties of individual members of said management may exist from different legal bases. The one is sui generis, with elements of Roman agency (epitomising moral hazard economically as the principal-agency problem) and English trust. The other, as an implication of section 15(6)(c) of the Companies Act, bearing in mind that such Act is silent on the nature of the contractual relationship, may be an employment contract – a modern locatio conductio operis. Such statutory effect diverges from the common law position that directors do not have a right to counter-performance.

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300 Garner (n 29 above) 736.
301 B Hölmstrom ‘Moral hazard and observability’ (1979) 10 The Bell Journal of Economics 74 74.
302 Dow (n 299 above) 3.
303 As above.
304 M Parkin ‘Efficiency and equity’ in CFA Institute (n 45 above) 53 et seq.
305 D Kleyn & F Viljoen Beginnersgids vir regstudente (2002) 3 et seq.
306 Companies Act 71 of 2008 sec 1 definition of ‘Minister’.
307 Companies Act 71 of 2008 sec 72(4).
309 M Havenga (ed) ‘Company officers’ in JT Pretorius (n 311 above) 272.
explained elsewhere, the basis of securitisation is the Board acting in the best interest of the shareholders.316

The problem with moral hazard that has been experienced in this research is that it is easy to identify in synthetic securitisation but difficult to quantify; a clearer concept is that of systemic risk, perhaps because hazard is risk in utero and therefore somewhat metaphysical.317 Systemic risk is measured with beta ($\beta$)318 which is mathematically defined as the covariance of return with the return of the market en toto.319 Stated in simple terms, it compares the performance of assets with the performance of its market. Some evidence shows that CDO announcements increase applicable banks’ beta risk;320 some suggest that such securitisation participants have lower solvency risk and higher profits.321 Giddy suggests that securitisation can lower risk,322 presumably by dividing risk among investors323 in terms of securities issues324 – this is not inconsistent with Anson’s suggestion that securitisation repositions risk.325 Frankly, the exact behaviour of risk with regards to securitisation seems unclear. However, it is clear from experience that the prevalence of moral hazard in synthetic securitisation schemes may cause systemic risk.

What exactly is systemic risk? Market instability attributable to irregularities in the symbiosis between market liquidity and funding liquidity326 links the 2007 crisis and the 1907 panic as substantive parallels.327 Furthermore, with sixteen global investment banks bailing out ninety percent of Long Term Capital Management (LTCM) for $3.6 billion on 23 September 1998,328 the Financial Crisis had seconded the notion in less than a decade that alternative investment

316 Ch 2 para 5.2 above; para 4 above.
317 “Hazard & risk” (n 293 above).
319 As above.
321 As above.
323 As above.
327 As above.
328 Fleuriet (n 326 above) 115.
funds lack the expertise to manage liquidity risk. Such ‘liquidity crises’ complement systemic (or systematic) risk. The latter consequentially ‘disrupt[s] financial markets, and thereby the efficient channeling of resources, to such a great degree that it causes a significant loss to, or collapse of, the real economy as a whole, being sudden and often unexpected – essentially a ‘Black Swan’. It is impossible to be ‘diversified away’. Since the fear of systemic risk was academically associated with credit derivatives on the eve of the Financial Crisis and the World Economic Forum identified a global asset meltdown risk in 2007, the crisis was not a Black Swan. According to Partnoy and Skeel, credit derivatives magnify rather than constrain systemic risk, presumably due to hedge funds’ bulk investments.

Alternative investment funds relate to unregistered investment companies, e.g. hedge funds, private equity funds and venture capital funds. Hedge funds hold pools of assets, with interest in such assets not sold in a registered public offer; private equity funds provide capital to unlisted companies; venture capital funds provide capital to ventures that may not be able to acquire capital elsewhere. These distinctions are superficial. According to the SEC, hedge funds can operate three broad trading strategies: market trend, event-driven, and arbitrage.

Although solvency and liquidity in contemporary company law are often collaborating considerations, their related risks have modest commonality: solvency is a balance sheet consideration, whereas solvency risk is a quantitative analytical permutation of the capital therein; liquidity is a cash flow consideration, whereas liquidity risk is a balance sheet impasse. Lest déjà vu surrounding liquidity risk as the inability to meet obligations of client-demanded funds, note that it stems from diverse maturities. Liquidity risk is not without sub-categorisation: cash flow risk, funding risk and market liquidity risk. Therefore, Williamson’s definition of liquidity risk above is too limited in encompassing only cash flow risk. Funding risk is based on a lack of market liquidity, inhibiting the procurement of external equity. Market liquidity risk per se is a micro-economic supply-related predicament. Widely denoted, it is inertia to purchase and sale: Since elasticity of demand is equal to the percentage change in quantity demanded divided by the percentage change in price, , the collapse of the real economy as a whole, hypothetically and in exaggeration being , renders the risk .

An imperative characteristic of inertia was confirmed in the Financial Crisis: an asset that you want to sell and cannot is more dangerous than an asset that you want to buy and cannot.

<table>
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<tr>
<th>Formula 6.13</th>
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<td>( E_d = \frac{\Delta Q}{\Delta P} )</td>
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An imperative characteristic of inertia was confirmed in the Financial Crisis: an asset that you want to sell and cannot is more dangerous than an asset that you want to buy and cannot. In terms of formula 6.1, a consequence , the collapse of the real economy as a whole, hypothetically and in exaggeration being , renders the risk .

See NN Taleb *The Black Swan* (2008) in general. Dickenson (n 333 above) 4. In terms of formula 6.1, a consequence , the collapse of the real economy as a whole, hypothetically and in exaggeration being , renders the risk .


As above.

Visser (n 31 above) 1.14.

Partnoy & Skeel (n 338 above) 1032.

therein being leveraged to the hilt. Cecchetti, Gyntelberg and Hollanders exposed the following bases of systemic risk: Firstly, an opaque OTC derivative markets with regards to gross exposures and unregulated counterparties, which relates to both pragmatic shortcomings of formula 6.1 (since the realisation of risk events cause pecuniary loss closer to the circumstance factor than the risk exposure) and leveraged investments of hedge funds.

A classic example of systemic risk – one that is mention herein specifically due to its prevalence in the Financial Crisis – is a ‘run on the bank’. Hedge funds, through interest rate arbitrage, exploit the direct proportionality between interest rates and maturities by using the counter-performance of sales in the short-term bond market for purchases in the long-term bond market, known as a ‘carry trade’. This strategy is the traditional basis of banking. Given depositors’ contractual right to draw funds at any time, the coincidental exercise of such right by all depositors can render the corresponding duty on the banks practically impossible, given the illiquidity of its investments – a risk event known as a “run on the bank”. For example, on 14 September 2007, Northern Rock shares plummeted after publication of its rescue by Bank of England. On the next day, the public tried to withdraw their deposits from Northern Rock, and on the following day the British Government announced that it guaranteed the public’s Northern Rock savings. One month later, Northern Rock had to defend itself before the Treasury Select Committee and by 19 November 2007, bids had been made to purchase the bank at below market value. Another example is as follows: By 22 June 2007 Bear Sterns revealed that it had undertaken the largest bailout since LTCM with regards to two of its hedge funds; a month later, it seized assets from another in an effort to curtail losses. On 15 June

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342 Partnoy & Skeel (n 338 above) 1040.
343 SG Cecchetti, J Gyntelberg & M Hollanders ‘Central counterparties for over-the-counter derivatives’ (2009) September BIS Quarterly Review 45 50 et seq.
344 n 343 above, 50-51.
345 n 343 above, 50.
346 n 343 above, 50-51.
347 n 343 above, 50.
348 n 343 above, 50, 51.
350 Okamoto (n 349 above) 192-193.
351 Okamoto (n 349 above) 193-194.
353 As above.
354 As above.
355 As above.
356 As above.
357 As above.
358 As above.
2007 Merrill Lynch seized $800 million worth of assets from two hedge funds managed by Bear Sterns and subsequently sold enough thereof on 20 June 2007 to cover its exposure to the two funds.\(^{359}\) On 31 July 2007, Bear Sterns was required to stop client’s withdrawals and redemptions on a third fund.\(^{360}\) By middle January 2008, Scottish Equitable followed suit.\(^{361}\) On 14 March 2008 Bear Sterns received emergency funding\(^{362}\) and on 17 March 2008 JP Morgan Chase acquired Bear Stearns at a mere $240 million in a transaction supported by $30 billion in Federal loans.\(^{363}\)

Systemic risk is at best understood using correlation. Such a discussion is included on correlation, due to the fact that its importance is also stressed in the Credit Rating Services Act.\(^{364}\) Chaplin has also mentioned the role of correlation in the Financial Crisis.\(^{365}\) Suffice to state that statistical inference is based on probability theory,\(^{366}\) with reward measured by expected return\(^{367}\) and risk measured by variance of return\(^{368}\) in any portfolio. Variance and standard deviation have been explained elsewhere\(^{369}\) and the reader is advised to grasp such concepts prior to any attempts at comprehending this part of the discussion. Covariance captures the influence of co-movements (linear associations) of returns on portfolio variance.\(^{370}\) Given the random variables of reward on two assets \(R_a\) and \(R_b\) in a portfolio, the covariance ‘is the probability-weighted average of the cross products of each random variable’s deviation from its own expected value’:\(^{371}\)

\[
\text{Cov}(R_a, R_b) = E\{[R_a - E(R_a)][R_b - E(R_b)]\}
\]

Formula 6.14

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\(^{360}\) ‘Timeline: Sub-prime losses’ (n 352 above).

\(^{361}\) As above.

\(^{362}\) As above.

\(^{363}\) As above.

\(^{364}\) 24 of 212 sec 9(c).


\(^{366}\) Para 2 above.

\(^{367}\) RA DeFusco et al ‘Probability concepts’ in CFA Institute (n 38 above) 450, 458 et seq.

\(^{368}\) RA DeFusco et al ‘Probability concepts’ in CFA Institute (n 38 above) 451, 458 et seq.

\(^{369}\) Para 3 above.

\(^{370}\) CFA Institute (ed) (n 320 above) G-7; RA DeFusco et al ‘Probability concepts’ in CFA Institute (n 38 above) 460-463.

\(^{371}\) RA DeFusco et al ‘Probability concepts’ in CFA Institute (n 38 above) 460.
A decrease in covariance renders variance, and therewith standard deviation, smaller, implying less risk at a constant expected return and inherently constituting the benefit of diversification.\textsuperscript{372} Correlation constitutes an even more perceptive method for ascertaining the prevalence of diversification benefit,\textsuperscript{373} in that it is calculated as a number (\(\rho\)) between –1 and +1,\textsuperscript{374} with 0 indicating no linear relationship,\textsuperscript{375} a positive correlation indicating a positive linear relationship,\textsuperscript{376} and a negative correlation the opposite.\textsuperscript{377} Given the random variables of reward, \(R_a\) and \(R_b\), correlation is defined in any one of the following ways:

\[
\rho(R_a, R_b) = \frac{\text{Cov}(R_a, R_b)}{\sigma(R_a) \sigma(R_b)}
\]

Formula 6.15.1

\[
\text{Corr}(R_a, R_b)
\]

Formula 6.15.2

\[
\rho_{ab}
\]

Formula 6.15.3

The predicament of correlation is that ‘there is no single correlation that correctly captures the relationship and risk’,\textsuperscript{378} since correlation, firstly, remains a variable,\textsuperscript{379} and secondly, increases sharply during financial crises,\textsuperscript{380} contrary to its small changes during economic stability.\textsuperscript{381} Correlation is a significant driver in the valuation of CDO structures’ risk tranches,\textsuperscript{382} and said sharp increase is destructive on the value of quality investments.\textsuperscript{383} In a run on the bank, as we saw in the Financial Crisis, the correlation increased tremendously,\textsuperscript{384} which has a tremendous effect on pricing in CDO structures.\textsuperscript{385}

\textsuperscript{372} RA DeFusco et al ‘Probability concepts’ in CFA Institute (n 38 above) 461.
\textsuperscript{373} RA DeFusco et al ‘Probability concepts’ in CFA Institute (n 38 above) 463.
\textsuperscript{374} RA DeFusco et al ‘Probability concepts’ in CFA Institute (n 38 above) 464.
\textsuperscript{375} As above.
\textsuperscript{376} As above.
\textsuperscript{377} As above.
\textsuperscript{378} Chaplin (n 365 above) 12.
\textsuperscript{379} As above.
\textsuperscript{380} As above.
\textsuperscript{381} As above.
\textsuperscript{382} Chaplin (n 365 above) 12-13.
\textsuperscript{383} Chaplin (n 365 above) 13.
\textsuperscript{384} As above.
\textsuperscript{385} As above.
8 Risk management

Traditionally, an originator of credit would hold the implied personal rights until their extinguishment in terms of the debtor’s counter-performance, implying that a debtor’s default implies pecuniary loss to the originator; in terms of securitisation, a transferor transfers its risk, whether through true or synthetic sale, rendering it irrelevant to the originator whether the debtor defaults. This seems to be the source of antagonists’ problem with securitisations. In terms of the principle of separate legal personality, the transferor’s Board has no duties to the SPI and the SPI’s security holders; however, the Board of the SPI will have duties to the shareholders of the SPI, which may include the transferor.

Initially, synthetic securitisation schemes were static, lending themselves to simplicity where investors would merely analyse the underlying credit risk and exploit the margins for arbitrage purposes. However, the bear market subsequent to the internet bubble deteriorated credit quality and default correlation, which introduced managed synthetic securitisation schemes in order to identify poor performance and react thereto. Despite this, synthetic securitisation schemes are still only lightly managed due to a pre-arranged management structure. Views on the management of SPIs have been expressed elsewhere, and this paragraph serves as a continuation of that theme from the dissimilar perspective of risk. According to Jobst of the IMF, risk management is ‘a transmission and control mechanism, which encapsulates different approaches of how firms choose between the risk-return profiles of alternative (investment) strategies to maximise shareholder value.’ In this sub-paragraph, it is to be established how the management of these firms go about the quoted activity.

The Schedule provides that ‘[a] bank that wishes to engage in a synthetic securitisation scheme shall have in place a robust risk-management framework, the fundamental elements of

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386 Dowd (n 296 above) 143.
387 As above.
388 Das (n 27 above) 417.
389 As above.
390 As above.
391 As above.
392 As above.
393 As above.
394 As above.
395 As above.
396 Ch 5 para 5 above.
398 n 1 above.
which framework are specified in regulation 23(9)(d) of the Regulations relating to Banks. It is uncertain which ‘Regulations relating to Banks’ the Registrar refers to, since at the time that the Schedule was published, the applicable regulations were virtually superceded by new regulations, although the latter has been updated once again. The applicable regulation deals with directives for monthly returns on credit risk, which constitutes a ‘soft law’ aspect for banking practice, rather than the ‘hard law’ that is discussed in this thesis. On the latter topic, the reader must first know that the risk committee, also known as the asset and liability committee (ALCO), is the primary organ of a bank involved in risk management. In South Africa, it is statutorily instituted and consists of at least three members of the Board of which at least two are non-executive directors. Neither the Banks Act nor the Companies Act provides a definition for ‘member of the board of directors’. It is presumably the same as ‘a member of the board of a company’ and consequently included in the ambit of ‘director’. Although its designation is irrelevant, the disjunctive excludes alternate directors by whatever designation. In addition, the Banks Act, in superceding the Companies Act, restricts section 72(2)(a)(i) with regards to risk committees.

399 n 1 above, para 5(1)(d).
400 As above.
401 n 1 above.
405 Williamson (n 46 above) 22 et seq.
406 Canadian law does not necessitate a similar committee for banks, although the bank’s directors can appoint other committees deemed necessary and delegate to such committees directorial powers and provide such committees with appropriate duties. [Bank Act SC 1991 c 46 sec 193.] In practice, numerous banks in Canada have an ALCO, such as the Royal Bank of Canada [Royal Bank of Canada 2015 http://www.rbc.com/governance/_assets-custom/pdf/risk-committee-mandate.pdf (accessed 29 April 2015).] In Germany, the Gesetz über das Kreditwesen is quiet on the matter of risk committees, German legislation indeed indirectly refers to delegation of powers [e.g. Aktiengesetz secs 97(2), 394.] Numerous German banks indeed have ALCOs, such as Deutsche Bank [Deutsche Bank ‘Committees’ 2015 https://www.deutsche-bank.de/en/content/committees.htm (accessed 29 April 2015).].
407 Banks Act 94 of 1990 sec 64A.
408 n 407 above, sec 64A(1).
409 94 of 1990.
410 71 of 2008.
411 Banks Act 94 of 1990 sec 64A(1).
412 See Companies Act 71 of 2008 sec 1: “‘director’ means a member of the board of a company, as contemplated in section 66, or an alternative director of a company and includes any person occupying the position of a director or alternate director, by whatever name designated”.
413 As above.
414 As above.
415 As above.
416 94 of 1990.
Although there is no certainty on the matter, the explicit reference to non-executive directors presumably indicates a person not falling within the paragraph (b) definition of “executive officer” if we apply to principle of *inclusio unius est exclusio alterius*. Since the latter only refers to directors as employees, some directors may be excluded from the ambit: Similar to common law, section 15(6)(c) of the Companies Act provides for an unspecified contractual relationship. Traditionally, such non-executive directors need not have executed unremitting attention to company affairs, since their duties were sporadic. Apart from not requiring the duties or qualifications of auditors or accountants, they neither required distinct shrewdness, proficiency, aptitude, astuteness or familiarity with the business of the company. Their duty of care was tested at a objective subjective level. Similar to the Companies Act 61 of 1973, the Companies Act 71 of 2008 uses the general term ‘director’ and does not entail a statutory distinction between executive and non-executive directors. However, whereas the content of the duty to care and skill in terms of the 1973 Companies Act regime was based on the common law, the Companies Act 71 of 2008 retains the common law and includes the business judgment rule. In effect the delictual basis of the duty of care and skill remains, although the test formulated in the *Jorgenson* case is amended: The

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418 Banks Act 94 of 1990 sec 64A(1).
419 Banks Act 94 of 1990 sec 1: “[E]xecutive officer”, in relation to any institution—
(a) that is not a bank, includes any manager, the compliance officer, the secretary of the company and any director who is also an employee of such an institution;
(b) that is a bank, includes any employee who is a director or who is in charge of a risk management function of the bank, the compliance officer, secretary of the company or any manager of the bank who is responsible, or reports, directly to the chief executive officer of the bank”.
420 Banks Act 94 of 1990 sec 1.
421 See *Göhle and Schneider v Westies Minerale (Edms) Bpk* 1970 2 SA 685 (A).
422 71 of 2008.
423 Delport (n 313 above) 21 n 58.
424 *Fisheries Development Corporation of SA Ltd v Jorgenson* 1980 4 SA 156 (W) 165.
425 As above.
426 n 425 above, 166.
427 As above.
428 As above.
429 Companies Act 61 of 1973 sec 1: “director” includes any person occupying the position of director or alternate director of a company, by whatever name he may be designated’.
430 n 414 above.
431 Cilliers (n 308 above) 147-148.
432 Delport (n 313 above) 91-92.
433 Companies Act 71 of 2008 sec 76(3)(c).
434 Directors’ duties are codified in the Canada Business Corporation Act RSC 1985 c C-44 sec 122: '(1) Every director and officer of a corporation in exercising their powers and discharging their duties shall—
(a) act honestly and in good faith with a view to the best interests of the corporation; and
(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.
(2) Every director and officer of a corporation shall comply with this Act, the regulations, articles, by-laws and any unanimous shareholder agreement.
reasonability (the objective element) of the non-executive director is no longer only intimately based on his individual knowledge and experience (the subjective element); the objective element is now, in addition to an amended subjective element,\textsuperscript{435} not only fully introduced,\textsuperscript{436} but also extended to all directors.\textsuperscript{437}

The functions of the risk committee\textsuperscript{438} resonate with the information supplied, yet a more relevant matter in the aftermath of the Financial Crisis is the liability of such committee members. Since committees and Boards have equivalent authority on the matter referred to it,\textsuperscript{439} subject to the MOI,\textsuperscript{440} and section 66(1) expands the role of the Board,\textsuperscript{441} the risk committee is endowed with significant authority. In the past, ‘director[s] [were] not liable for mere errors of judgment’,\textsuperscript{442} ‘[i]n respect of all duties that may [have been] properly…left to some other official, a director [was], in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly’\textsuperscript{443} and ‘[h]e [was] entitled to accept and rely on the judgment, information and advice of the management, unless there [were] proper reasons for querying such.’\textsuperscript{444} Whilst it is uncertain what the Court intended the initial

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\textsuperscript{(3)} Subject to subsection 146(5), no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with this Act or the regulations or relieves them from liability for a breach thereof.

Directors’ duty of care and skill are also codified in the Aktiengesetz, which is quoted herein using the English translation of Norton Rose: ‘93. (1) In conducting business, the members of the management board shall employ the care of a diligent and conscientious manager. They shall not be deemed to have violated the aforementioned duty if, at the time of taking the entrepreneurial decision, they had good reason to assume that they were acting on the basis of adequate information for the benefit of the company. They shall not disclose confidential information and secrets of the company, in particular trade and business secrets, which have become known to the members of the management board as a result of their service on the management board. The duty referred to in sentence 3 shall not apply with regard to a recognized auditing agency pursuant to § 342b of the Commercial Code within the scope of the audit.’ Fiduciary duties in German law is a different matter altogether, since the Aktiengesetz in quiet thereon. This silence is based on the principle of Gemeinwohlsklausel, which is closely tied with the NSDAP Führerprinzip, and supplies some autonomy to management for purposes of the company and the welfare of people and empire. [G Teubner ‘Corporate fiduciary duties and their beneficiaries; A functional approach to the legal institutionalization of corporate responsibility’ http://www.jura.uni-frankfurt.de/43829689/Coporate_fiduciary.pdf (accessed 29 April 2015) 154-155.] Fortunately, this position has been rectified by the Deutscher Corporate Governance Kodex sec 4.

\textsuperscript{435} Companies Act 71 of 2008 sec 76(3)(c)(ii).

\textsuperscript{436} Companies Act 71 of 2008 s76(3)(c)(i).

\textsuperscript{437} ‘[A] director of a company’ in the Companies Act 71 of 2008 sec 76(3), read with the definition of ‘director’ in the Companies Act 71 of 2008 sec 1.

\textsuperscript{438} Banks Act 94 of 1990 sec 64A(2).

\textsuperscript{439} Companies Act 71 of 2008 sec 72(2)(c).

\textsuperscript{440} Companies Act 71 of 2008 sec 72(2).

\textsuperscript{441} Companies Act 71 of 2008 sec 66(1); Delport (n 315 above) 66-67.

\textsuperscript{442} Fisheries (n 424 above) 166.

\textsuperscript{443} As above.

\textsuperscript{444} As above.
proviso\textsuperscript{445} to mean, it is doubtful that statutory delegation from Board to risk committee\textsuperscript{446} would be improper. In terms of the Companies Act,\textsuperscript{447} neither the creation of a risk committee, nor the delegation by the Board of powers to the risk committee, nor actions taken by the risk committee alone satisfy or constitute compliance with the statutory director’s duties.\textsuperscript{448} According to Delport, this implies that power/authority is delegable, but not responsibility.\textsuperscript{449} \textit{A contraria}, the word ‘alone’\textsuperscript{450} implies that the aforesaid requires supplementation for delegable responsibility; however, in the absence of such statutory provisions, the conclusion is commensurable with Delport’s deduction. Therefore, the \textit{ratio} in \textit{Fisheries Development Corporation of SA Ltd v Jorgenson}\textsuperscript{451} (Fisheries case) at 166 is excluded.\textsuperscript{452} Therefore, the deduction is that the risk committee will not bear any responsibility; the Board will bear responsibility for the risk committee.\textsuperscript{453} Fortunately, the prescribed constituents of the risk committee provide for assimilation.\textsuperscript{454}

Risk management can also be regarded as a tool. Even though risk management has become integral to banking operations, the bullet-proof factor\textsuperscript{455} was doubtlessly introduced to \textit{inter alia} remove default risks relating to securitisation schemes from the responsibilities of \textit{inter alia} banks. However, it must be borne in mind that synthetic securitisation constitutes, at least secondarily,\textsuperscript{456} a method of risk management, by commoditising risk to ‘sell’ it. As such, risk transfer in synthetic sale may alter the risk-profile of remaining on-balance sheet assets in quality and spread.\textsuperscript{457} Although it is uncertain what is meant by these two terms, the former likely refers to qualitative assessment at the risk analysis stage of the risk management process,\textsuperscript{458} whether based on simple risk matrixes\textsuperscript{459} or complex risk matrixes with probability and consequence measures.\textsuperscript{460} The latter term traditionally refers to an option strategy with

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{445} As above: ‘In respect of all duties that may properly be left to some…’
\item\textsuperscript{446} Banks Act 94 of 1990 sec 64A(1).
\item\textsuperscript{447} 71 of 2008.
\item\textsuperscript{448} Companies Act 71 of 2008 sec 72(3).
\item\textsuperscript{449} Delport (n 313 above) 88.
\item\textsuperscript{450} Companies Act 71 of 2008 sec 72(3).
\item\textsuperscript{451} 1980 4 SA 156 (W).
\item\textsuperscript{452} See Delport (n 313 above) 88 n 58.
\item\textsuperscript{453} Banks Act 94 of 1990 sec 64A(1).
\item\textsuperscript{454} As above.
\item\textsuperscript{455} See ch 5 above.
\item\textsuperscript{456} Para 4 above.
\item\textsuperscript{457} Schedule (n 1 above) para 5(1)(b).
\item\textsuperscript{458} Visser (n 31 above) 5.11.
\item\textsuperscript{459} As above.
\item\textsuperscript{460} Visser (n 31 above) 5.12.
\end{enumerate}
\end{footnotesize}
identical options with different expiration or exercise price being respectively purchased and sold.\textsuperscript{461}

The Financial Crisis begs the question of risk managing synthetic securitisation as a risk management tool. Although securitisation schemes resort beyond the ambit of ‘the business of a bank’,\textsuperscript{462} that does not render the risk committee’s role in securitisation schemes superfluous. Whereas the risk committee is an appraiser of risk-related policy-making,\textsuperscript{463} a securitisation scheme remains a ‘practice’\textsuperscript{464} in managing risk. Where ‘toxic’ debt is characteristic of a risk concentration\textsuperscript{465} or becomes a key risk\textsuperscript{466} or where such a risk concentration appears relatively unprofitable in their risk assessments,\textsuperscript{467} securitisation schemes provide a method of disposal in mitigation.\textsuperscript{468} On the other side of the spectrum, the prevalence of systemic risk requires a bank to have a ‘robust risk-management framework’ in place.\textsuperscript{469} This likely refers to risk management processes, which will be expansions of the generic model set out in diagram 6.1 below.\textsuperscript{470} It is currently know, in accounting regulation, e.g., FASB 133, IAS 39 and IFRS 7, that credit derivatives are rendered on-balance-sheet instruments\textsuperscript{471} and legal regulation has overcome the lack of contractual standardisation\textsuperscript{472} with the 1987 implementation of International Swaps and Derivatives Association’s master agreements.\textsuperscript{473}

Chorafas justifies the slow European acceptance of credit derivatives based on strict relationship management.\textsuperscript{474} It is uncertain how he ties this notion with the commentary by Deutsche Bank’s Hans Voit on credit derivatives,\textsuperscript{475} \textit{viz.} that Deutsche Bank is still undergoing a learning curve with regards to credit derivatives.\textsuperscript{476} Commerzbank’s credit derivative

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\textsuperscript{461} CFA Institute (ed) (n 318 above) G-30.  
\textsuperscript{462} See ch 8 below.  
\textsuperscript{463} Banks Act 94 of 1990 sec 64A(2)(a).  
\textsuperscript{464} As above.  
\textsuperscript{465} Banks Act 94 of 1990 sec 64A(2)(b).  
\textsuperscript{466} Banks Act 94 of 1990 sec 64A(2)(e).  
\textsuperscript{467} Banks Act 94 of 1990 sec 64A(2)(d).  
\textsuperscript{468} Banks Act 94 of 1990 sec 64A(2)(e).  
\textsuperscript{469} n 1 above, para 5(1)(d).  
\textsuperscript{470} Taylor (n 111 above) 3.  
\textsuperscript{471} I Bell & P Dawson ‘Synthetic securitization: Use of derivative technology for credit transfer’ (2002) 12 Duke Journal of Comparative & International Law 541 548.  
\textsuperscript{472} As above.  
\textsuperscript{473} Chorafas (n 3 above) 58; see Fleuriet (n 326 above) \textit{et seq} for more information on relationship management.  
\textsuperscript{474} Chorafas (n 3 above) 58.  
\textsuperscript{475} As above.
instruments are weekly set through a procedure of internal control. Cultural perspective becomes less relevant if the perspective pertains to effective risk management.

Diagram 6.1

9 Risk maintenance

A bank or another institution within its banking group acting in a primary role can discretionally replace the risk transferred with risk relating to a different asset of equivalent credit quality. Virtually the same provision applies with regards to assets in traditional securitisation schemes. In the spirit of transparency, OSFI can determine the originator in a securitisation scheme by implementing a look-through approach that can also be utilised to confirm that apposite capital maintenance transpires, although digression into that aspect will not transpire herein. Capital maintenance here does not primarily have the ontological dimension connected to it in the study of share repurchases, but rather bears on servicing. Another instance where maintenance becomes prevalent in Canadian models is in the event of early amortisation, since the levels of excess spread levels may vary for distinct reasons, and parties to a securitisation scheme may maintain prevailing levels of excess spread through the addition of new accounts to the scheme, disguising portfolio decline – thus the imperative of proper supervision. As of yet, none of these instances seem to address the matter of risk maintenance that is explored herein. The closest that OSFI comes to this matter is that of reputational risk: A bank aware of this must measure the amount of potential support

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477 As above.
478 Schedule (n 1 above) para 5(2)(e).
479 Schedule (n 1 above) para 4(2)(k).
481 As above.
482 Office of the Superintendent of Financial Institutions in Canada (n 480 above) para 72.
483 Office of the Superintendent of Financial Institutions in Canada (n 480 above) para 24.
484 As above.
485 As above.
486 As above.
487 n 480 above, Appendix 7-3 para 25.
necessary to cover its potential losses in this regard.\textsuperscript{488} The bottom line is that it is difficult to imagine that Canadian securitisations schemes would not in practice execute risk maintenance, which must also apply in Germany.

Although the reader’s first reaction to this statutorily permitted facultative performance would be that it stands in direct opposition with the multitude of conditions that regulate synthetic and true sale respectively, this replacement is a necessary provision for the working of conduit structures as well as the underlying assets’ differing maturity dates. The imperative of equivalency included in this provision relates to a sense of fairness towards the SPI in terms of the credit derivatives. This logic is implicitly confirmed by the Schedule\textsuperscript{489} in that further risk will only be permitted to maintain the capital value of the portfolio of risk included in the scheme.\textsuperscript{490} However, such transfer of further risk must not be construed as constituting a credit-enhancement facility.\textsuperscript{491} Such further transfer of risk is also permissible subject to the Registrar’s discretion and any conditions determined by it.\textsuperscript{492}

10 Risk repurchase

A bank or another institution within its banking group acting in a primary role can ‘repurchase’ risk from the SPI;\textsuperscript{493} however, such ‘repurchase’ must be implicitly consensual and expressly not in terms of a prior obligation to that effect\textsuperscript{494} which would logically render the synthetic sale a fiction \textit{ab initio}. The term ‘repurchase’ here is merely another misnomer in the collection of misnomers relating to synthetic sale and discussed elsewhere. It is commercially better conceptualised as a party acting in a primary role buying itself partially out of a transaction with the SPI. Legally, this is easier said than done – since there was no consensual agreement of sale, the institution acting in a primary role’s re-acquisition of risk is actually a deduction of the risk exposure in terms of the credit derivative. Whilst the Schedule\textsuperscript{495} provides that ‘[t]he repurchase of risk relating to an asset shall be conducted on market related terms and conditions’;\textsuperscript{496} it must be borne in mind that the SPI has already divided and sold this risk to

\textsuperscript{488} n 480 above, Appendix 7-3 para 28.
\textsuperscript{489} n 1 above.
\textsuperscript{490} n 1 above, para 5(2)(g).
\textsuperscript{491} Schedule (n 1 above) para 5(2)(g)(i).
\textsuperscript{492} Schedule (n 1 above) para 5(2)(g)(ii).
\textsuperscript{493} Schedule (n 1 above) para 5(2)(f(i).
\textsuperscript{494} Schedule (n 1 above) para 5(2)(f)(ii).
\textsuperscript{495} n 1 above.
\textsuperscript{496} n 1 above, para 5(2)(f)(i).
investors, and the Schedule\textsuperscript{497} is quiet on the matter as to whether the value of the commercial paper, at a specific moment in time, compares realistically to the value of the risk with regards to the underlying asset. The Schedule\textsuperscript{498} only specifies that external auditors must certify the fair market value of the risk.\textsuperscript{499}

What we do know is that such risk repurchase will be subject to a bank's normal credit approval and review processes,\textsuperscript{500} and the repurchase of risk may not exceed ten percent of maximum value of the SPI's portfolio,\textsuperscript{501} excluding normal trading in Government securities and qualifying items.\textsuperscript{502} This percentage is subject to the Registrar’s discretion.\textsuperscript{503} However, the repurchasing instituting must be wary of the fact that retention or repurchase of significant risk can be used to determine that the intent of the scheme, i.e. transfer of risk to investors, is a fiction.\textsuperscript{504} Furthermore, if the repurchasing institution is also the provider of a liquidity facility, the provisions in the Schedule relating to liquidity facilities will continue to apply.\textsuperscript{505}

11 Final remarks

As already noted,\textsuperscript{506} this challenging chapter constitutes the basis for the forthcoming chapters on the transfer of risk from the transferor to SPI through credit derivatives\textsuperscript{507} and the subsequent transfer of risk from the SPI to investors through commercial paper and shares.\textsuperscript{508} One undertone that is prevalent in this chapter, is that synthetic securitisation schemes have the advantage over their traditional variants in that the absence of ABSs excludes prepayment or extension risk due to fixed maturity CDSs.\textsuperscript{509}

Despite credit events, actual synthetic securitisation structure \textit{per se} is also a basis of risk,\textsuperscript{510} which is why entire chapters have been dedicated herein for structure and commercial paper

\textsuperscript{497} n 1 above.
\textsuperscript{498} As above.
\textsuperscript{499} n 1 above, para 5(2)(f)(v).
\textsuperscript{500} Schedule (n 1 above) para 5(2)(f)(iii).
\textsuperscript{501} Schedule (n 1 above) para 5(2)(f)(iv).
\textsuperscript{502} As above.
\textsuperscript{503} As above.
\textsuperscript{504} Schedule (n 1 above) para 5(1)(c).
\textsuperscript{505} Schedule (n 1 above) para 5(2)(f)(vi).
\textsuperscript{506} Para 1 above.
\textsuperscript{507} Ch 7 below.
\textsuperscript{508} Ch 8 below.
\textsuperscript{509} Das (n 27 above) 341.
\textsuperscript{510} Das (n 27 above) 418.
respectively. This means that in addition to credit risk,\textsuperscript{511} cash flow priorities on the risk-stratified commercial paper classes present a sliding scale for risk,\textsuperscript{512} i.e. there can also a risk of marked-to-market losses\textsuperscript{513} that entail credit quality or spreads, or default correlation amendments which may not affect the long-term income investor at maturity,\textsuperscript{514} but which would affect sellers on the secondary market\textsuperscript{515} except the holder of senior commercial paper.\textsuperscript{516}

Risk calculation in synthetic securitisation schemes is a complex matter. The actual employed risk models are the forte of rocket scientists, but the jurist requires a fundamental understanding of risk in order to comprehend synthetic securitisation schemes. John Walsh, a director of Group of 30, has mentioned that credit derivatives will spur revision of capital requirements and cause the reinterpretation of risk.\textsuperscript{517} It is \textit{res ipsa loquitur} that has proven to be true. This is due to the fact that credit derivatives evolved from plain vanilla ways of dealing with default risk,\textsuperscript{518} and the logical effect is that our perceptions of credit risk had to change as well, irrespective of whether credit derivatives are in reality regenerated timeworn products\textsuperscript{519} or not. In reality, credit derivative are a reinvented way of trading in liability.\textsuperscript{520} But the mathematical models initially required to comprehend these instruments resorted within the expertise of quantitative analysts. The dilemma is that the jurist requires an understanding of the commercial realities inherent in these products in order to make an educated analysis of such schemes, and ensure legitimate creation thereof. The latter will be discussed at greater length in chapter 8 below. In this chapter, the basic principles of risk have been set out – the commodity traded in in synthetic securitisation schemes – and the reader will have to comprehend these features in order to truly appreciate the work that follows.

Irrespective of the complexity of risk models, parties involved in these schemes need to understand the risks and risk models involved. Though these models may have been created by quantitative analysts, all parties involved in a synthetic securitisation scheme need to know

\begin{flushleft}
\textsuperscript{511} As above.
\textsuperscript{512} Das (n 27 above) 418-419.
\textsuperscript{513} Das (n 27 above) 419.
\textsuperscript{514} As above.
\textsuperscript{515} As above.
\textsuperscript{516} As above.
\textsuperscript{517} Chorafas (n 3 above) 5.
\textsuperscript{518} Chorafas (n 3 above) 3.
\textsuperscript{519} As above.
\textsuperscript{520} Chorafas (n 3 above) 40.
\end{flushleft}
what they are getting involved. I have discussed director’s duties in this chapter, and it has been stressed that it is not across all jurisdictions a prerequisite that a company, be that a bank, must have a risk committee. The crux is that the directors’ duties for parties involved in these schemes will have bearing on risk models, and it is the profession responsibility of the Board to be versed in these mechanics. Parties involved must ensure that a solid reporting structure is in place so that the Board is completely aware of the risks involved, conveyed in a way that all members of the Board will understand.

South African credit ratings have not materially affected performance on commercial paper as of yet given the Financial Crisis. For this, the following example is used: On 14 May 2009 Fitch Ratings placed tranches Class A1 to Class G of Fresco 2 Ltd on Rating Watch Negative (RWN) after commencing an updating of ‘its mapping analysis of FirstRand Bank’s…internal credit scores’, which is based on criteria changes by Fitch Ratings and credit deterioration of both the domestic corporates represented in the underlying, as well as the international banks. On 12 November 2010, Fitch Ratings downgraded all these tranches, suddenly stating that such downgrades were the result of criteria changes and not credit deterioration. The downgrades were as follows: Class A1 was downgraded from AAA(zaf) to AA-(zaf) and remained on RWN, Class A2 was downgraded from AAA(zaf) to AA-(zaf) and remained on RWN, Class B1 was downgraded from AA(zaf) to BB(zaf), Class B2 was downgraded from AA(zaf) to BB(zaf), Class C was downgraded from A+(zaf) to B+(zaf), Class D was downgraded from A-(zaf) to B(zaf), Class E was downgraded

521 Para 8 above.
522 As above.
523 Chorafas (n 3 above) 307.
524 Chorafas (n 3 above) 308.
526 As above.
527 As above.
528 As above.
529 As above.
530 As above.
531 As above.
532 As above.
533 As above.
534 As above.
535 As above.
536 As above.
from BBB(zaf) to B(zaf),\textsuperscript{537} Class F was downgraded from BBB-(zaf) to B(zaf),\textsuperscript{538} and Class G was downgraded from BB(zaf) to B-(zaf).\textsuperscript{539} Although Fitch Ratings regarded the commercial paper’s outlook as stable,\textsuperscript{540} it assigned a loss severity rating of 4 to classes B1, B2 and C,\textsuperscript{541} and a loss severity rating of 5 to classes D and lower.\textsuperscript{542} On 12 July 2012,\textsuperscript{543} Fitch Ratings affirmed Fresco 2’s ratings as follows: Class A1 at BBB(zaf),\textsuperscript{544} Class A2 at BBB(zaf),\textsuperscript{545} Class B1 at BB(zaf),\textsuperscript{546} Class B2 at BB(zaf),\textsuperscript{547} Class C at B+(zaf),\textsuperscript{548} Class D at B(zaf),\textsuperscript{549} Class E at B(zaf),\textsuperscript{550} Class F at B(zaf)\textsuperscript{551} and Class G at B-(zaf),\textsuperscript{552} with all the commercial paper’s outlook being stable.\textsuperscript{553}

Credit ratings may not be a panacea, but proper and progressive regulation may serve for risk mitigation. It is not only a matter of actual performance on commercial paper at the end of the day, but also a matter of proper credit rating and, given evolution in our quantitative knowledge, a matter of progression in ratings. The current econometric uncertainties have left us without sure-fire methods for predicting market behavior. Inherent in this is the fact that ‘ratings are investment recommendations and do not provide a guarantee against loss’.\textsuperscript{554} But jurists require some sense of certainty, some qualitative way of working with ratings in their execution of structuring synthetic securitisation schemes. If we bear in mind that ‘[i]nvestors relied on…[credit ratings], often blindly. In some cases, they were obligated to use them, or regulatory capital standards were hinged on them’\textsuperscript{555} we find that the jurist has very little substance to rely on in this regard. The South African jurist must rely on various secondary sources to procure information in order to understand ratings. CDO tranches specifically are

\begin{footnotesize}
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\item As above.
\item As above.
\item As above.
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\item As above.
\item As above.
\item As above.
\item As above.
\item As above.
\item Das (n 27 above) 346.
\item ‘Conclusions of the Financial Crisis Inquiry Commission’ (n 172 above) xxiv.
\end{enumerate}
\end{footnotesize}
usually rated by international rating agencies, such as Fitch Rating (Fitch), Moody’s Investor Service (Moody’s) or S&P, using factors the asset quality, the asset manager, credit enhancement, expected credit losses, stress testing, transaction structure and transaction monitoring. With regards to synthetic CDO’s, the CRA will be concerned with whether or not the CDS conforms to ISDA documentation, the credit events and settlement methods. Finally, the CRA can determine the portfolio loss distribution for different tranches. The Credit Rating Services Act is not expressly concerned with these factors or with these methods. Once again, the practicability of any specific approach will be subject to judgement of expert witness testimony. Said Act does, however, require from CRAs to assume and enforce proper measures to dignify its issued ratings (this is an objective subjective test, requiring all objectively relevant and available data to be administered through the CRA’s subjective process), measure its methods from past results but also frequently review its methods and ‘establish internal arrangements to monitor the impact of changes in macro-economic or financial market conditions on credit ratings’. Canadian regulations, especially those by OSFI, contain much detail. It is obvious that the latter will serve best in the short term, but the former will stand the test of time as markets and knowledge evolve.

556 Das (n 27 above) 346.
557 Das (n 27 above) 346-347.
558 Das (n 27 above) 347.
559 Das (n 27 above) 348-349.
560 Das (n 27 above) 348.
561 As above.
562 Das (n 27 above) 347.
563 Das (n 27 above) 347-348.
564 Das (n 27 above) 352.
565 As above.
566 As above.
567 Das (n 27 above) 353.
568 24 of 2012.
569 Credit Rating Services Act 24 of 2012 sec 9(a).
570 Credit Rating Services Act 24 of 2012 sec 9(b).
571 Credit Rating Services Act 24 of 2012 sec 9(c).
572 Credit Rating Services Act 24 of 2012 sec 9(d).
Chapter 7

The transfer of risk in synthetic securitisation schemes

1 Introduction
2 Further notes on the rationale for credit risk transfer
3 The International Swaps and Derivatives Association
4 Aspects of credit derivatives
   4.1 The credit derivative defined in general
   4.2 Funded and unfunded credit derivatives
      4.2.1 General
      4.2.2 Funded credit derivatives: CLNs
         Definition
         Synchronisation between the practice of CLNs and the Schedule
         Consideration whether CLNs are regulated as commercial paper
         CLNs in Germany
      4.2.3 Unfunded credit derivatives: CDSs
         Continuing with Germany with respect to CDSs
         Unfunded credit derivatives incorporating ISDA terminology
         Settlement
         Credit events
4 Credit derivatives compared with insurance contracts
5 Final remarks
1 Introduction

In chapter 2 above, mention was made\(^1\) that normally,\(^2\) in a synthetic securitisation scheme,\(^3\) an institution transfers,\(^4\) in synthetic sale,\(^5\) risk,\(^6\) specifically credit risk,\(^7\) associated with a specified pool of underlying assets, reference entities or reference assets\(^8\) to a SPI\(^9\) or investors\(^10\) through funded or unfunded credit-derivative instruments or guarantees.\(^11\) It is noteworthy \textit{a priori} that the plural assets and entities\(^12\) contradicts the singular in the ‘synthetic securitisation scheme’ definition,\(^13\) which renders plural constructions – for example portfolio, basket and index-based credit derivative trades\(^14\) – and paragraph 5(1)(a)(iv) of the Schedule,\(^15\) nonsensically impossible through interpretation \textit{ex contrariis}.\(^16\) Two possibilities exist given effectual and purposeful legislation:\(^17\) Firstly, an interpretation that credit exposure must relate to a single asset or entity, given the content of paragraph 3(1)(a) of the Schedule.\(^18\) The possibility of a more liberal argument then is that credit exposure may relate to a class of similar assets or entities, although there is no statutory basis for such an interpretation. However, teleology would dictate that the legislative scheme\(^19\) is accomplished by regarding this as a \textit{casus ommissus} in said definition, which can be rectified by analogical interpretation.\(^20\) Credit derivative utilisation in any event more frequently relates to reference entities than to underlying or reference assets.\(^21\) The latter is a two dimensional

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\(^1\) Ch 2 para 2.2 above.
\(^3\) Schedule (n 2 above) para 1 definition of synthetic securitisation scheme.
\(^4\) Schedule (n 2 above) para 5(1)(a).
\(^5\) E.g. ch 2 para 2.2 above.
\(^6\) See ch 6 in general above.
\(^7\) See ch 6 para 5 above.
\(^8\) This is commercially known as a ‘universe of obligors’ – S Das \textit{Credit derivatives: CDOs & structured credit products} (2005) 417.
\(^9\) Schedule (n 2 above) para 5(1)(a)(i); e.g. ch 6 para 4 above.
\(^10\) As above.
\(^11\) Schedule (n 2 above) para 1 definition of synthetic securitisation scheme.
\(^12\) n 2 above, para 5(1)(a).
\(^13\) n 2 above, para 1.
\(^15\) n 2 above.
\(^16\) n 2 above, para 3(1)(a); see C Botha \textit{Wetsuitleg: ‘n Inleiding vir studente} (2005) 109.
\(^17\) Botha (n 16 above) 74 \textit{et seq}.
\(^18\) n 2 above.
\(^19\) Botha (n 16 above) 51, 108-109.
\(^20\) Botha (n 16 above) 110.
\(^21\) Fabozzi & Kothari (n 14 above) 306-307.
definition containing the imperative risk isolation factor,\textsuperscript{22} whereas as the definition set out above is three dimensional.

Given acquaintance with the risk concept,\textsuperscript{23} this chapter pertains to credit risk transfer. The complexity of the credit derivative \textit{genus}, or a \textit{specie} thereof, merits doctoral study thereof \textit{per se}, which would be premature at this stage of South African legal study for the reason set out elsewhere.\textsuperscript{24} This chapter analyses credit derivatives for purposes of synthetic securitisation schemes within the parameters of this work, being primarily the CDS contract and secondarily the CLN contract, with reference to South African, Canadian and German law. For purposes of simplicity, this chapter commences with an argument from the \textit{prima facie} simpler model of direct synthetic securitisation\textsuperscript{25} to ensure a contextual understanding of this sub-topic. Definition is a decompositional approach; contextualisation is a de-emphasising approach. With regards to the latter, historic contextualisation dictates that a credit derivative does not equate to the \textit{genus} of specific contracts in the closed system of Roman obligations\textsuperscript{26} or in the puritanical modern sense,\textsuperscript{27} although conceptually constituting a specific contract through the principle that the law is always speaking\textsuperscript{28} or \textit{per usum com}.\textsuperscript{29} The local population of academic securities law specialists is small; therefore, these explanations in the classical mode are scarce, the express \textit{essentialia} of CDSs are absent – all being the indicia of prominent inter-disciplinary study in the US and the company law contra law of contract historical critical origins of securities law. Irrespectively, a complex financial instrument is intended to be rendered palatable herein for South African jurist.\textsuperscript{30}

2 Further notes on the rationale for credit risk transfer

Derivatives do not date from the 1980’s, despite that decade being the epoch wherein such financial instruments gained prominence. Despite this market resulting from the late twentieth century

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\textsuperscript{22} Das (n 8 above) 28.
\textsuperscript{23} See ch 5 above.
\textsuperscript{24} See ch 1 para 1 above.
\textsuperscript{25} Para 4.2.2 below.
\textsuperscript{26} PhJ Thomas, CG van der Merwe & BC Stoop \textit{Historiese grondslae van die Suid-Afrikaanse privaatreg} (2000) 233-234.
\textsuperscript{28} Botha (n 16 above) 71-72.
\textsuperscript{29} JM Otto & B Prozesky-Kuschke ‘Inleiding tot die kontraktereg’ in Nagel (n 27 above) 39.
\textsuperscript{30} See ch 1 para 1.
\end{flushleft}
international financial crises\textsuperscript{31} – being the solution to handling credit, currency and basis risk\textsuperscript{32} – options, i.e. equity derivatives, date back to \textit{inter alia} second century BCE Egypt\textsuperscript{33} and forward contracts, i.e. agricultural derivatives, date back to second century Babylon where the Temple of Šamaš, the shrine to the sun god, was the market maker.\textsuperscript{34} This security surfaced once more in 13th century Europe.\textsuperscript{35} Literati in civil jurisdictions rather research commercial practices compatible with their legal vernacularisation: The Romans acknowledged the principle of risk in the law of obligations, as in the \textit{emptio spei} and \textit{emptio rei speratae},\textsuperscript{36} possibly being the origin of futures for the \textit{quirites}. However, that empire did not have a secondary market for these derivatives,\textsuperscript{37} justifying why those markets only developed after the fall of the Western Roman Empire.\textsuperscript{38} In that context, a derivative is historically critically defined is a promise with variable market value, subject to the promissor’s ability to perform and the value of the underlying.\textsuperscript{39} That ‘promise’ – the so-called \textit{stipulatio},\textsuperscript{40} the prominent Roman \textit{quasi contract}\textsuperscript{41} which formed the common denominator of the \textit{solemnitas}\textsuperscript{42} – relaxed subsequent to the classical period.\textsuperscript{43}

An enquiry \textit{ab initio} is the hypothesis regarding credit derivative transaction in the Roman Empire given its laws, despite the lack of modern financial infrastructure.\textsuperscript{44} The unassuming riposte entails using the \textit{stipulatio}: One party promises performance to the other, with a separate \textit{stipulatio} that the latter party promises to perform an amount of \textit{sestertii} to the former party subject to a positive suspensive condition. However, the concept of risk transfer \textit{per se} is \textit{prima facie} a foreign notion to the civil jurist, since risk can be qualified as a thing in the wide sense,\textsuperscript{45} but is not classically

\begin{footnotesize}
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\item I Bell & P Dawson ‘Synthetic securitization: Use of derivative technology for credit transfer’ (2002) 12 \textit{Duke Journal of Comparative & International Law} 541 547.
\item Bell & Dawson (n 31 above) 547.
\item As above.
\item DN Chorafas \textit{Credit derivatives & the management of risk including models for credit risk} (2000) 89-90.
\item Thomas, Van der Merwe & Stoop (n 26 above) 336.
\item Weber (n 37 above) 10.
\item Weber (n 37 above) 4.
\item A Berger \textit{Encyclopedic dictionary of Roman Law, Volume 43} (1953) 716.
\item Thomas, Van der Merwe & Stoop (n 26 above) 241.
\item Thomas, Van der Merwe & Stoop (n 26 above) 267.
\item Thomas, Van der Merwe & Stoop (n 26 above) 234.
\item Since this is not a work of Roman law, it is trusted that the reader will not be offended by the apparent disregard herein for legal development during the millennium-long existence of the Western Roman Empire.
\item Thomas, Van der Merwe & Stoop (n 26 above) 153.
\end{enumerate}
\end{footnotesize}
subject to Gaius’ concept of an incorporeal thing *ex iure*\(^{46}\) and as such not *res in commercio*.\(^{47}\) Not only is risk not commoditised *ex lege* in civil law, but the notion of insurable interest is foreign to the civil jurist.\(^{48}\) The latter, as an implicit or inherent feature of an obligation, was certainly not a foreign concept to the Roman jurist,\(^{49}\) but it may have constituted an unenforceable natural obligation. Irrespective of its maritime prevalence in the Digesta, the common acceptance of risk transfer as commodity transfer, i.e. as delivery or performance, did not signify risk as a thing *ex iure*. Therefore, from a civil law perspective, the notion that derivatives were created to address non-performance is justified.\(^{50}\)

Economists will argue that securitisation is more dependent on the concept of liabilities than that of assets.\(^{51}\) The historic emphasis placed on assets in banking was met by a liability-based preoccupation in the 1980s,\(^{52}\) be that through money markets\(^{53}\) or derivatives.\(^{54}\) In the decade that followed, liabilities surpassed financial events,\(^{55}\) with debt financing surpassing profits or capital raised through the primary market.\(^{56}\) It would not be incorrect to state that this is a confirmation of the opinion that synthetic securitisation schemes are driven by capital and profits rather than risk.\(^{57}\) Credit derivatives became a logical expansion of risk management,\(^{58}\) a singular solution to various parties’ demands: Banks yearned for risk transfer and dispersion, investors were keen on trading credit risk for higher yields, and traders aspired to hedge against interest rate and price volatility.\(^{59}\) This was one of the amendments to the financial environment, as already mentioned.\(^{60}\)

\(^{46}\) Thomas, Van der Merwe & Stoop (n 26 above) 154.
\(^{47}\) Thomas, Van der Merwe & Stoop (n 26 above) 157 et seq.
\(^{50}\) Weber (n 37 above) 4.
\(^{51}\) The puritanical jurist may argue that assets and liabilities do not form part of law in its strict sense, but this is rebutted by the existence of rules regulated these matters in South African objective law.
\(^{52}\) Chorafas (n 34 above) 32.
\(^{53}\) Chorafas (n 34 above) 32-33.
\(^{54}\) Chorafas (n 34 above) 33.
\(^{55}\) As above.
\(^{56}\) As above.
\(^{57}\) Ch 5 in general above.
\(^{58}\) Bell & Dawson (n 31 above) 549.
\(^{59}\) Fleuriet (n 35 above) 127.
\(^{60}\) Ch 2 para 9 above.
Then again, credit derivatives also presented advantages to traditional securitisations and secondary loan sales.\(^{61}\) In practice, sentimentalism surrounds the objectives of vulture funds\(^{62}\) at times of financial difficulty;\(^{63}\) true sale may suffer recharacterisation in some jurisdictions or may otherwise, as with servicing agreements, be expensive,\(^{64}\) just as a bank’s sale of partial credit exposure is often impossible or burdensome.\(^{65}\) Credit derivatives constructively remove the administrative exasperations of asset heterogeneity,\(^{66}\) if at all statutorily possible in South Africa,\(^{67}\) just as synthetic securitisation schemes, due to the absence of ABSs and the employment of a fixed maturity CDSs, excludes prepayment and extension risk.\(^{68}\) Regulators are slowly embracing securitisation again given the need for credit in economies,\(^{69}\) but reputational risk mitigation is necessary with regards to bank’s relationship management if corporate clients suddenly encounter re-negotiations with unknown parties.\(^{70}\)

The bottom line is that liability prominence in the 1990s was held to be potentially addressed by innovation effecting exponential economic growth,\(^{71}\) and as such a particular innovation to this trend was the advent of the credit derivative.\(^{72}\) In 2007, credit derivatives were described as ‘perhaps the most significant and successful financial innovation of the last decade.’\(^{73}\) Some of these credit derivatives, such as CDSs (which constitute the foundation for more complex structured credit instruments),\(^{74}\) may have been considered and proven at the time to be liquid, which could have addressed the need to short credit risk in illiquid secondary bond markets.\(^{75}\)

\(^{61}\) Bell & Dawson (n 31 above) 549.
\(^{63}\) Bell & Dawson (n 31 above) 549.
\(^{64}\) Bell & Dawson (n 31 above) 549-550.
\(^{65}\) Bell & Dawson (n 31 above) 550.
\(^{66}\) Bell & Dawson (n 31 above) 550.
\(^{67}\) Para 1 above.
\(^{68}\) Das (n 8 above) 341.
\(^{70}\) Bell & Dawson (n 31 above) 549.
\(^{71}\) Chorafas (n 34 above) 33-34.
\(^{72}\) Chorafas (n 34 above) 32.
\(^{74}\) As above.
However, as already noted, the illiquidity of some of these instruments became prevalent in the Financial Crisis. ISDA recognised that credit derivatives could drastically stimulate financial markets, which was a rationale for its standardisation in this field.

3 The International Swaps and Derivatives Association

It is *res ipsa loquitur* that efforts at legal standardisation across jurisdictions have been transpiring for decades. Relevant to the aforesaid, a notable work regarding this process, as well as its difficulties, was presented by Pistor to the United Nations Conference on Trade and Development. In 1985, the International Swaps and Derivatives Association (ISDA) was established to render OTC derivative markets benign and competent. Not only is this echoed in the introduction to the 2014 ISDA Credit Derivative Definitions (referred to in the body of this text as the 2014 Definitions), but emphasis is also placed on legal certainty in providing parties to a credit derivative agreement with common terminology. However, no information prevalent in the introduction to the 2014 Definitions may be construed as interpretative guidelines to the 2014 Definitions, and said introduction expressly provides for the directory, and not peremptory, role of the 2014 Definitions. Numerous parties in South Africa, Germany and Canada are either primary members or subscribers to ISDA. Although ISDA has already standardised the confirmation, i.e. the contract, of CDSs in terms of the ISDA Master Agreement in 1991, the first effort at issuing definitions regarding credit derivatives transpired in 1999, which was followed...
by the 2003 definitions. On 8 September 2014, Alvarez of Latham & Watkins LLP referred to the revision of the latter definitions as ‘likely the biggest overhaul of the definitions in more than a decade’. These definitions became effective on 22 September 2014.

The 2014 Definitions is a quasi-international law instrument based on the reference to it providing a ‘basic framework’ to credit derivative transactions and its ‘free-standing’ nature. As such, its application is not compulsory, neither do all of the definitions and provisions set out in the 2014 Definitions need to be included in a document. Despite the caveats provided in introduction to the 2014 Definitions, said introduction expressly provides that it ‘…is not part of the [2014] Definitions and is not offered an interpretation of the [2014] Definitions…’. Besides losing interpretative function as either a preamble or *contemporanea expositio*, the introduction, through denying the consequent, comes to serve a prosaic rather than legal function, the justifies its own disregard by a court. Even if this were not the case, a court may still employ the 2014 Definitions for interpretative purposes, subject to the parol evidence rule, irrespective of ISDA’s caveat’s and based on its inherent jurisdiction.

It is uncertain if the document in which such definitions and provisions are incorporated must indicate – expressly, tacitly or implicitly – whether the document is subject to the 2014 Definitions, or whether the incorporation of definitions and provisions, as incorporated in the document, must indicate the extent to which the document is subject to the 2014 Definitions – bearing in mind that the latter will be an example of tacit and/or implicit indication. If it is established that definitions and provisions are incorporated in the document, then they will bear the meaning as they have in the 2014 Definitions, unless the contrary is indicated. In the absence of such indications, there

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86 JI deV Robbé *Securitization law and practice: In the face of the credit crunch* (2008) 136.
88 As above.
89 2014 ISDA Credit Derivative Definitions Introduction.
90 As above.
91 As above.
92 As above.
93 Botha (n 16 above) 80-81.
94 Botha (n 16 above) 87.
96 2014 ISDA Credit Derivative Definitions Introduction.
97 As above.
are dragons for reliance on application based on the definition of a ‘credit derivative transaction’ in the 2014 Definitions. According to ISDA, a ‘credit derivative transaction’ is ‘any transaction that is identified in the related Confirmation as a Credit Derivative Transaction or any transaction that incorporates the Definitions…’. This definition remained unchanged from the 2003 ISDA Credit derivative Definitions (referred to in the body of this text as 2003 Definitions). However, if it is established that reliance must be placed on the incorporation of the 2014 Definitions, then transactions may be included as credit derivatives that do not in substance constitute the confirmations of such securities at all.

4 Aspects of credit derivatives

4.1 The credit derivative defined in general

A security – its historical critical analysis which has been briefly alluded to elsewhere – is a bundle of personal rights and/or duties and/or spei, from which the spes of economic income or growth is derived, irrespective of the motive for which it is used. Although the role of motive is arguable in South African law, it serves a purpose in this definition to note that securities are not always employed – lawfully or unlawfully – for the purpose apparent in most similar securities’ creation. It is difficult to define the security genus in securities law, given the pervading diversity in the typology. In law, it is likely a product of the human compulsion to designate. Irrespective, it is res ipsa loquitur that any security, whether defined as such in the Financial Markets Act or not, the latter taking into regard the noscitur a sociis principle for substance

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98 2014 ISDA Credit Derivatives Definitions art 1 sec 1.8: “ISDA” means the International Swaps and Derivatives Associations, Inc’.
99 ISDA Credit Derivatives Definitions art 1 sec 1.2: “Confirmation” means, with respect to a Credit Derivative Transaction, one or more document and other confirming evidence exchanged between the parties or otherwise effective which, take together, confirm or evidence all of the terms of that Credit Derivative Transaction’.
100 2014 ISDA Credit Derivatives Definitions art 1 sec 1.1. ‘Definitions’ is defined is defined at 2014 Credit Derivatives Definitions Introduction, and refers to the 2014 ISDA Credit Derivatives Definitions.
101 2003 ISDA Credit Derivative Definitions art 1 sec 1.1.
102 Ch 2 para 2.1 above.
104 M Vermaas (ed) ‘Capital Structures: Shares and Debentures’ in Pretorius (n 103 above) 149.
105 E.g. in the case of shares the spei for economic performance from the counterparty in the form of dividends.
106 19 of 2012.
107 Botha (n 16 above) 107.
and not listing, is of a contractual nature – of which so-called ‘trading’ thereof or therein constitutes cession, delegation or assignment – and this includes references to derivatives.

Derivatives are comprehended \textit{a priori} since ‘[c]redit derivatives are traditional derivatives re-engineered to a credit orientation.’\textsuperscript{108} A derivative specifically is a financial instrument utilised for managing or obtaining risk;\textsuperscript{109} in broader terms, it is an instrument with performance based on or derived from the behavior of an underlying asset’s price\textsuperscript{110} – which asset need not be the object of purchase or sale – with the possibility of a payable premium.\textsuperscript{111} The JSE defines ‘derivative instruments’ with reference to section 1 of ‘the Act’,\textsuperscript{112} being the Financial Markets Act.\textsuperscript{113} However, the classical jurist may wish to paraphrase this definition in terms of civil legal terms: A derivative instrument, or derivative in short, is a contract – the Financial Markets Act\textsuperscript{114} employs the disjunctive in order to provide the widest possible bases for derivatives; however, it is uncertain as to what type of derivative in civil law would not be regarded as a contract – which consists of rights and duties – and possibly \textit{spei} depending on the circumstances – and the value of the latter rights and duties are dependent on the value of another set of rights and/or duties. Neither the terms ‘contract’ nor ‘financial instruments’ are defined and they thus retain their ordinary meanings, subject to the commentary already provided above. With regard to credit derivatives, the Schedule\textsuperscript{115} fails to define these securities. A credit derivative can be defined as a method through which the holder thereof detaches and divides credit risk from market risk,\textsuperscript{116} consequently allowing the credit risk to be transferred, be that for hedging or trading – or indirectly for arbitrage\textsuperscript{117} – by the investor exposed to such risk\textsuperscript{118} through a possible payable premium,\textsuperscript{119} by

\begin{footnotesize}
\begin{enumerate}
\item Das (n 8 above) 1.
\item F Taylor \textit{Mastering derivative markets} (2011) 2.
\item Fleuriet (n 35 above) 102.
\item Taylor (n 109 above) 3.
\item JSE Derivatives Rules 20 February 2015 sec 2.10.
\item 19 of 2012 sec 1: ‘“derivative instrument” means any—
\begin{enumerate}
\item financial instrument; or
\item contract,
\end{enumerate}
that creates rights and obligations and whose value depends on or is derived from the value of one or more underlying asset, rate or index, on a measure of economic value or on a default event’.
\item 19 of 2012.
\item Schedule (n 2 above).
\item Taylor (n 109 above) 229; see ch 2 para 9 above.
\item See ch 2 para 9 above.
\item Blanco, Brennan & Marsh (n 77 above) 9.
\item Taylor (n 109 above) 229.
\end{enumerate}
\end{footnotesize}
subjecting an investor’s – who is keen on assuming such risk\textsuperscript{120} – payment to the occurrence of a credit event on another contract,\textsuperscript{121} thereby being a repackaging and redistributing of credit risk.\textsuperscript{122}

\section*{4.2 Funded and unfunded credit derivatives}

\subsection*{4.2.1 General}

The Schedule\textsuperscript{123} expressly refers to the use of funded or unfunded credit derivatives\textsuperscript{124} – synonymously funded or unfunded synthetic securitisations.\textsuperscript{125} In a funded scheme, the protection seller renders performance at commencement of the credit derivative contract term,\textsuperscript{126} and receives periodic payments during the term of the transaction similar to interest but at a higher value due to its nature as a premium.\textsuperscript{127} Subject to non-occurrence of a credit event, the protection seller is reimbursed for such initial performance at maturity.\textsuperscript{128} The benefit of funded synthetic securitisation schemes, specifically the initial performance, enables the protection buyer to mobilise such funds subject to discounting at a higher rate in order to enable it to afford the premiums; however, it is \textit{res ipsa loquitur} that this increases systemic risk. It has been contended that funded synthetic securitisation schemes resemble traditional securitisation schemes.\textsuperscript{129} Rather, a funded synthetic securitisation scheme strikes the untrained eye as \textit{prima facie} akin to a standard issue of debt instruments.

Unfunded synthetic securitisation schemes may be regarded as a fusion of traditional securitisation and credit derivative technologies.\textsuperscript{130} In such schemes, such initial performance does not necessarily transpire, and is only necessary when the credit event occurs:\textsuperscript{131} The protection seller may either receive the premiums periodically during the term of the transaction, or it may receive these payments in full at commencement.\textsuperscript{132} Despite said express reference to funded credit

\begin{thebibliography}{99}
\bibitem{120} Blanco, Brennan & Marsh (n 77 above) 9.
\bibitem{121} Bell & Dawson (n 31 above) 549.
\bibitem{122} Fleuriet (n 35 above) 205.
\bibitem{123} n 115 above.
\bibitem{124} n 115 above, para 1 definition of ‘synthetic securitisation scheme’.
\bibitem{125} E.g. Bell & Dawson (n 31 above) 555 \textit{et seq}.
\bibitem{126} Bell & Dawson (n 31 above) 555.
\bibitem{127} As above.
\bibitem{128} Bell & Dawson (n 31 above) 555-556.
\bibitem{129} Bell & Dawson (n 31 above) 555.
\bibitem{130} As above.
\bibitem{131} Bell & Dawson (n 31 above) 556.
\bibitem{132} As above.
\end{thebibliography}
derivatives in the Schedule,\textsuperscript{133} it is apparent from its provisions that unfunded credit derivatives were the primary consideration for the Registrar – perhaps due to the fact that unfunded schemes are most eminent in South African finance. For example, the definition of ‘synthetic securitisation scheme’ in the Schedule,\textsuperscript{134} despite utilising a conjunctive,\textsuperscript{135} necessarily distinguishes between commercial paper and credit derivatives, as well as presupposes a time frame in which the issue of the former proceeds the latter. This creates a contradiction in that the interpretation paragraph makes no limiting or restrictive provisions relating to the definitions,\textsuperscript{136} whilst the Schedule\textsuperscript{137} provides for the use of unfunded credit derivatives. From a positivistic perspective, the use of funded credit derivatives in South African law is thus prohibited; from a teleological perspective, the denominative blunder must be ignored, although this does not satisfy the presumption of effectual and purposeful legislation.\textsuperscript{138} Furthermore, the definition of ‘synthetic securitisation scheme’ expressly refers to the SPI.\textsuperscript{139}

4.2.2 Funded credit derivatives: CLNs

Definition

Funded credit derivatives hypothetically manifest as direct synthetic securitisation,\textsuperscript{140} equated with funded synthetic securitisation.\textsuperscript{141} In the absence of an SPI, a CLN\textsuperscript{142} may be used, as is prevalent in the German jurisdiction.\textsuperscript{143} The CLN relates more directly to the prominence of liabilities, as has been set out elsewhere.\textsuperscript{144} In a traditional securitisation scheme the transferor is the creditor and the obligors are the debtors with regards to the applicable credit agreement(s); the transferor is the debtor and the SPI the creditor in terms of true sale of the personal rights and duties forming the object of such true sale; the SPI is the debtor and the investors in commercial paper therein the creditors. The logic presented in the aforementioned statement is not chronological, as is prevalent

\textsuperscript{133} n 115 above.
\textsuperscript{134} n 115 above, para 1.
\textsuperscript{135} n 115 above, para (a) of the para 1 definition of ‘synthetic securitisation scheme’.
\textsuperscript{136} n 115 above, para 3.
\textsuperscript{137} n 115 above.
\textsuperscript{138} Botha (n 16 above) 74 et seq.
\textsuperscript{139} Schedule (n 115 above) para 1.
\textsuperscript{140} See ch 5 above.
\textsuperscript{141} Bell & Dawson (n 31 above) 555 et seq.
\textsuperscript{142} The CLN may adhere to the definition of a credit derivative transaction, as set out in para 3 above.
\textsuperscript{144} See ch 2 above in general.
in the definition of ‘traditional securitisation scheme’. However, it is clear from the aforementioned that, as the transfer of personal rights and duties are followed from the obligors to the eventual investor, creditors are metamorphosed into debtors, which displays the prominence of liabilities. Parallel to the aforementioned – in the economic sense – in an indirect synthetic securitisation scheme, the transferor is the creditor and the obligors are the debtors, the transferor is synthetically the debtor and the SPI is synthetically the creditor, and the SPI is the synthetic debtor and the investors the synthetic creditors. The role of liabilities remains prevalent, although here limited by probability to the risk of non-performance already alluded to.

However – once again in the economic sense – in a direct synthetic securitisation scheme, the transferor is metamorphosed directly into a synthetic debtor with regards to the investors without the risk of non-performance being first transferred to the SPI intermediary. In the true economic sense, the transferor and the SPI are unified within incorporation. This is a strategy of accounting rather than law. As the originator of credit and the issuer of products comprising the risk of non-performance coincide in a single subject, it is an originator with regards to the asset-side and an issuer with regards to the liabilities-side of its balance sheet. A CLN is an amalgamation of credit derivative and fixed income technologies, which as a CDO is further amalgamated with securitisation technology. The term or abbreviation, ‘CLN’, is actually a hypernym for various credit derivatives. Since the 2014 Definitions widely define the credit derivative transaction, it is presumed that ISDA intended to draft general definitions applicable to all types of credit derivatives, irrespective of indirect or direct synthetic securitisation. The Austrian Erste Bank defines a CLN as an interest-bearing debt instrument of which par and the coupon are subject to the financial health of the underlying debtor.

145 Schedule (n 115 above) para 1; see para 4.2.1 above.
146 Böhringer et al (n 143 above) 28.
147 As above.
148 As above.
149 Das (n 8 above) 239.
150 As above.
151 Das (n 8 above) 249-251.
152 See para 3 above.
Synchronisation between the practice of CLNs and the Schedule

A CLN in a direct synthetic securitisation is issued by a party acting in a primary role fulfilling the role of both a party acting in a primary role and the SPI. It is uncertain whether the issuer of the CLNs will be regulated as a party acting in a primary role, as a SPI, or as both a party acting in a primary role and a SPI in terms of the Schedule. If the former is the situation, then such schemes are unlawful in South Africa given that they are inconsistent with the definition of ‘synthetic securitisation scheme’, which invokes the application of paragraph 17 of the Schedule. If the issuer is the situation, then the statutory restrictions on further risk transfer becomes void, meaning that the issuer can transfer unlimited credit risk through CLN issues by virtue of paragraph 5(2)(a)(vi) despite such transfer not constituting risk maintenance, which includes such transfer constituting a credit enhancement facility and nullifies the Registrar’s discretion in such cases. In terms of the principle of effective and purposeful legislation, paragraph (a) read with paragraph (b) of the definition of ‘synthetic securitisation scheme’ may indeed be construed as to indicate that the issuer of a CLN will be regulated as a SPI.

If the issuer is regulated as both a party acting in a primary role and a SPI, then the concept of treasury shares is effectively introduced in South African law, the Schedule introduces a new limitation on the issuer’s acquisition of own shares and the limitation on subsidiaries to hold shares in their holding company is extended.

The Schedule provides that a primary role participant, either per se or with its associated companies, and if such participant is a bank, that bank per se or with any institution(s) in that banking group of which the participant is a member, is prohibited from directly or indirectly

\[ ^{154} \text{n 115 above.} \]
\[ ^{155} \text{As above.} \]
\[ ^{156} \text{Schedule (n 115 above) para 5(2)(g).} \]
\[ ^{157} \text{Schedule (n 115 above) para 5(2)(g)(i).} \]
\[ ^{158} \text{Schedule (n 115 above) para 5(2)(g)(ii).} \]
\[ ^{159} \text{Botha (n 16 above) 74 et seq.} \]
\[ ^{160} \text{Schedule (n 115 above) para 1.} \]
\[ ^{161} \text{See Companies Act 71 of 2008 secs 35(3), 35(5)(a).} \]
\[ ^{162} \text{n 115 above.} \]
\[ ^{163} \text{Companies Act 71 of 2008 sec 48(2)(b)(i).} \]
\[ ^{164} \text{n 115 above.} \]
acquiring or holding twenty percent or more of the all the ‘equity share capital’ in a SPI,\textsuperscript{165} or having the right to determine the voting outcome at the SPI’s general meeting.\textsuperscript{166} Although the Companies Act\textsuperscript{167} expressly provides that a company may not issue shares to itself,\textsuperscript{168} and re-acquired shares will have the status of authorised unissued shares,\textsuperscript{169} the Banks Act\textsuperscript{170} prevails with regards to this inconsistency.\textsuperscript{171} Since authorised unissued shares are merely rights conceptually \textit{in utero}, based on the Roman principle that a subject cannot have a remedy against itself and deductively not a right against itself, a company cannot ‘hold’ authorised unissued shares, as would be the inconsistency between the Schedule\textsuperscript{172} and the Companies Act,\textsuperscript{173} which seems to introduce treasury shares into South African law.

With regards to this verb ‘hold’, the conclusion is that the issuer is restricted to not holding twenty percent or more of its own total share capital. With regards to the verb ‘acquire’, read with the collection of parties acting in a primary role associated in the Schedule,\textsuperscript{174} the conclusion is that the issuer is restricted to not acquiring twenty percent or more of its own total share capital; however, a subsidiary is now entitled to acquire no more than \((20\% - 1)\) of the total share capital of its holding company, contrary to section 48(2)(b)(i) of the Companies Act.\textsuperscript{175} Due to the phrasing in paragraph 5(2)(o)(i)(B) of the Schedule,\textsuperscript{176} it is uncertain whether section 48(2)(b)(ii) of the Companies Act\textsuperscript{177} is replaced so that voting rights may be exercised on such shares acquired by a subsidiary company.

\textsuperscript{165} n 115 above, para 5(2)(o)(i)(A).
\textsuperscript{166} n 115 above, para 5(2)(o)(i)(B).
\textsuperscript{167} 71 of 2008.
\textsuperscript{168} Companies Act 71 of 2008 sec 35(3).
\textsuperscript{169} Companies Act 71 of 2008 sec 35(5).
\textsuperscript{170} 94 of 1990.
\textsuperscript{171} Companies Act 71 of 2008 sec 5(4)(b)(i)(gg).
\textsuperscript{172} n 115 above.
\textsuperscript{173} 71 of 2008.
\textsuperscript{174} n 115 above, para 5(2)(o).
\textsuperscript{175} 71 of 2008.
\textsuperscript{176} n 115 above.
\textsuperscript{177} 71 of 2008.
Consideration whether CLNs are regulated as commercial paper

Commercial paper is discussed in detail elsewhere. The purpose of this paragraph is to consider whether CLNs constitute commercial paper and inductively debt instruments. Mention has been made of the hybrid nature of CLNs. CLNs originated from the lack of market completion in debt markets, *inter alia* the prevalence of credit risk outweighing the size of debt markets, sovereign debt overshadowing corporate debt, the limited diversity of available credit risk, debt instrument structures’ subjection to issuers’ financing requirements rather than investors’ needs, government deficits-spurred demand for alternative exposure to credit risk and increased volatility. Although derivatives may address these needs, investors required a funded security in a simple administrative format that could be rated.

A debt instrument is inclusively defined in the Companies Act as ‘securities other than shares of a company, irrespective of whether or not issued in terms of a security document, such as a trust deed’, subject to the proviso that a debt instrument is not a ‘promissory note and loan, whether constituting an encumbrance on the assets of the company or not’. There are two problems with this definition. Firstly, the former quote is wide enough to include all securities listed in the Financial Markets Act, given the definition of ‘securities’ in the Companies Act, and this is not restricted *in extremis* by the content of the latter quote. Secondly, although a debt instrument is intrinsically credit and therefore constitutes a loan, the definition thus comprises all securities excluding those constituting credit. Once again the presumption of effectual and purposeful

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178 See ch 7 below.
179 See para 4.2.2 above.
180 Das (n 8 above) 241.
181 Das (n 8 above) 242.
182 As above.
183 As above.
184 As above.
185 Das (n 8 above) 243.
186 Das (n 8 above) 244.
187 As above.
188 Das (n 8 above) 247 et seq.
189 71 of 2008.
190 Companies Act 71 of 2008 sec 43(1)(a)(i).
191 Companies Act 71 of 2008 sec 43(1)(a)(ii).
192 Companies Act 71 of 2008 sec 43(1)(a)(i).
193 19 of 2012.
194 71 of 2008 sec 1.
legislation, and a teleological interpretation is necessitated. The Legislature likely intended the term ‘debt instrument’ as synonymous to the old ‘debenture’, which may be justified by focusing on the conjunctive in the second quote that a debt instrument is not credit intrinsic in a negotiable instrument. However, case law does not seem to support this interpretation. In the case of Pieter Hendrik Strydom NO and Others v Johan Hendrik Bakkes and Others, Murphy J consistently referred to the commercial paper issued in terms of an apparent securitisation scheme as promissory notes and also included such reference thereto in his court orders in casu, which, in terms of the principle of stare decisis, has the effect that commercial paper in a securitisation scheme, as debt instruments, effectively constitute promissory notes and thus negotiable instruments. Should it be established that CLNs are to be regulated as commercial paper in terms of the Schedule, then CLNs may consequently constitute value paper.

A debenture has never been precisely defined. It is fundamentally an acknowledgement of debt, irrespective of whether the debenture constitutes an encumbrance on the corporate issuer’s assets, which consequently introduces the possibility that some debt instruments may be akin to the English law concept of a security. The salient features include performance by the investor to the company, with the company performing intermittently in a process of discounting, with par being performed at maturity. Having the features of a fixed income instrument, a CLN is an obligation consisting of inter alia the personal right of performance of a fixed or floating coupon by the issuer. According to Erste Bank, yield on this interest-bearing debt instrument usually exceeds sovereign and corporate debt, which logically constitutes its allure, although the implication being that the default risk is larger. CLNs are issued to investors subject to a
stratification of risk,\textsuperscript{207} which would equate such securities with commercial paper and consequently render such securities in terms of subparagraph (a) of the paragraph 1 definition of ‘synthetic securitisation scheme’ in the Schedule.\textsuperscript{208} Therefore, such securities seem to constitute external equity\textsuperscript{209} of the issuer which is regulated as a party acting in a primary role and/or a SPI. A rebuttable presumption to this effect is created by the fact that the JSE regards CLNs as interest rate securities,\textsuperscript{210} and that it was subject to The Mark-to-Market Valuation Rules of the Bond Exchange of South Africa of 21 November 2005 at paragraph 3.2. The latter was confirmed in the programme memorandum of the SBSA ZAR 10 billion CLN programme\textsuperscript{211} and the programme memorandum of the Nedbank Ltd ZAR 15 billion CLN programme.\textsuperscript{212} As a presumed debt instrument, it is a contract and consists of a bundle of personal rights\textsuperscript{213} and the parties can be considered to be a creditor (the company) and a debtor (the debt instrument holder).

However, CLNs are intrinsically credit derivatives, and as derivatives – though not subject to the JSE Derivatives Rules\textsuperscript{214} – the respective parties can be considered to be a protection seller and a protection buyer. Although most credit derivatives are OTC, CLNs are mobilised on the stock exchange and are therefore to be regulated by the applicable stock exchange as an applicable exchange-based security: Since the JSE has no rules pertaining to credit derivatives, CLNs are regulated as interest rate securities (IRS). However, the credit derivative nature of CLNs is evidenced in the ISDA terminology utilised in the respective programme memoranda of the said SBSA\textsuperscript{215} and Nedbank\textsuperscript{216} issues. The interest on these CLNs is akin to premium payments, and it is based on the credit risk of the institution’s debtor. The latter is the underlying, and means that the institution provides credit to a third party debtor at the same time or prior to the institution

\begin{footnotes}
\item[207] See Böhringer \textit{et al} (n 143 above) 28.
\item[208] p 115 above.
\item[213] See para 4.1 above.
\item[214] 20 February 2015.
\item[215] The Standard Bank of South Africa Ltd (n 211 above).
\item[216] Nedbank Ltd (n 212 above).
\end{footnotes}
issuing the CLNs. The value of the credit in the underlying and the value of the CLNs issued are equal. The CLN is transacted subject to the resolutive condition that it can mature upon transpiration of credit event relating to the credit supplied to said third party debtor. The CLN is also subject to the suspensive condition that, upon said credit event, the investor has a right to performance from the institution that is equal to the realisable claim that the third party investor is able to perform to the institution, known as the recovery rate: Upon transpiration of a credit event, prepayment is triggered and investors inherit the underlying debt.\textsuperscript{217} This is permissible in that the performance to investors is \textit{certum} – either determined or determinable.\textsuperscript{218} The inquisitive jurist versed in the law of contracts rather than securities law may wonder why the three parties do not use a more conventional contractual arrangement, such as either delegation of the third party debtor’s duties or session of the institution acting in a primary role’s right to claim against the third party debtor, both disjunctive models subjecting the investor’s performance to the institution acting in primary role. The answer thereto is that the CLN model as it exists follows Ockham’s razor in securities law: In the example of delegation, the third party debtor would require the consensus of all investors in issued CLNs for such purposes.

\textbf{CLNs in Germany}

An example of CLNs is the cost discounting method of Germany’s standardised securitisation platforms – the PROMISE platform and the PROVIDE platform.\textsuperscript{219} However, there are limitations to the utilisation of these platforms: The PROMISE platform (\textit{Platform Promise})\textsuperscript{220} can only be used for securitisation of credit risk inherent in credit provided to German small and medium size enterprises (SMEs), known as \textit{das Mittelstandt},\textsuperscript{221} and the PROVIDE platform (\textit{Platform Provide})\textsuperscript{222} can only be used for securitisation of credit risk inherent in residential mortgage loans,\textsuperscript{223} so-called \textit{Hypothekenkredite}.\textsuperscript{224} The originator of the aforesaid assets, pooled together, transfers its credit risk relating thereto through a CDS to KfW, which stratifies the credit risk into

\begin{footnotesize}
\textsuperscript{217} As above.
\textsuperscript{218} Thomas, Van der Merwe & Stoop (n 26 above) 249.
\textsuperscript{219} J Breitenecher et al Asset Securitisation in Deutschland (2005) 85.
\textsuperscript{221} Breitenecher et al (n 219 above) 85.
\textsuperscript{222} ‘Provide-Residential Mortgage Securitisation’ – Ricken (n 220 above) 49.
\textsuperscript{223} As above.
\textsuperscript{224} Ricken (n 220 above) 49.
\end{footnotesize}
different tranches through a SPI situated in Ireland. This is an oversimplification: In truth, KfW enters into a CDS with an OECD bank with regards to the highest quality underlying credit risk.

The mezzanine risks are transferred to a PROMISE or PROVIDE SPI through KfW certificates credit-linked to the underlying asset pool’s performance. Little information is publicly available regarding these credit-linked certificates, or Schuldscheine. According to Kraue and Litten of Norton Rose Fulbright in Frankfurt, Schuldscheine are ‘traditional German floating or fixed [OTC] debt instrument[s] with a typical maturity of 2 to 10 years and a typical volume of EUR 10 to 500m’, usually held by sophisticated institutional investors. In German law, a Schuldseine is not legally regarded as a ‘debt security’ since the intrinsic rights are subject to assignment, enforcement requires no presentation, the issuer has the right to defences based on the underlying or against previous assignees, they do not classify as deposits and prospectuses are not required for issue. These certificates are enigmatic in that they are, according to Wittek and Kreppel of Jones Day, quasi securities, and a detailed discussion thereof will digress from the ambit and purpose of this work. Only two aspects deserve note for present purposes: Firstly, Schuldseine are regarded as loans between the PROMISE or PROVIDE SPI and KfW; secondly, Schuldseine constitute collateral eligible as such for the Eurosystem. The Schuldseine may be substituted with CDSs. The highest risks are transferred to a junior CDS.

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225 Breitenecher et al (n 219 above) 85.
226 Breitenecher et al (n 219 above) 86.
227 Breitenecher et al (n 219 above) 86-87.
228 ‘Certificates of indebtedness’ – Robbé (n 86 above) 230.
230 As above.
231 As above.
232 As above.
233 As above.
234 As above.
235 As above.
236 As above.
237 As above.
238 As above.
241 Krause & Litten (n 229 above).
242 Tavakoli (n 240 above) 225.
counterparty through a CDS. The PROMISE or PROVIDE SPI then issues stratified CLNs to investors. The basic structure of this is given in figure 7.1 below.

The question as to the nature of CLNs unfortunately suffers the same categorical predicaments in Germany as in South Africa. CLNs are traded on the Börse Frankfurt as structured bonds. The question arises, with due regard for paragraph 4.2.3 below, whether commercial paper, without an amalgamation with credit derivative technology, has any relevance in German law. The section 4(36) definition of securitisation in Richtlinie 2006/48/EG des Europäischen parlaments und des rates vom 14. Juni 2006 über die Aufnahme und Ausübung der Tätigkeit der Kreditinstitute (Neufassung) contains no indication as to the nature of the issued tranches; however, ‘tranche’ is defined at section 4(39) of said Richtlinie:

“Tranche”: vertraglich festgelegtes Segment des mit ein oder mehreren Forderungen verbundenen Kreditrisikos, wobei eine Position in diesem Segment — lässt man Sicherheiten, die von Dritten direkt für die Inhaber von Positionen in diesem oder anderen Segmenten gestellt werden, außer Acht — mit einem größerem oder geringeren Verlustrisiko behaftet ist als eine Position gleicher Höhe in jedem anderen dieser Segmente.

243 Breitenecher et al (n 219 above) 86.
244 As above.
245 Breitenecher et al (n 219 above) 86.
247 ‘‘Verbriefung”: Transaktion oder Struktur mit nachstehend genannten Charakteristika, bei dem das mit einer Forderung oder einem Pool von Forderungen verbundene Kreditrisiko in Tranchen unterteilt wird:

a) die im Rahmen dieser Transaktion oder dieser Struktur getätigten Zahlungen hängen von der Erfüllung der Forderung oder der im Pool enthaltenen Forderungen ab, und
b) die Rangfolge der Tranchen entscheidet über die Verteilung der Verluste während der Laufzeit der Transaktion oder der Struktur'.

(‘‘Securitisation”: A transaction or scheme with the following characteristics, in which the credit risk associated with a claim or pool of claims is tranched:

a) so that payments in terms of the transaction or scheme are dependent on the fulfillment of the claim or claims contained in the pool, and
b) the subordination of tranches determines the distribution of losses during the term of the transaction or the structure’.)
248 ‘‘Tranche”: A contractually established segment of or with several claims associated with credit risk, in terms of which a position in this segment — permitting a person to exclude herewith regard for collateral that is provided by third parties directly to the holders of positions in this or other segments — is vitiated with a greater or lesser risk of loss as a position of the same amount in each other these segments'.
It appears as if the employment of commercial paper in German synthetic securitisations are not prohibited, but practice dictates the use of CLNs. Furthermore, the Legislature indeed regarded CLNs as a specie of credit derivatives, classifying it, subject to the *eiusdem generis* rule already noted, among CDSs and TRSs.  

Figure 7.1

Originator

KfW

OECD Bank

Investors (with tranched securities)

CLNs

CRA

Premium

Performance upon credit event

Credit-linked certificates

Proceeds

Interest & Principal

Junior CDS Counterparty

Junior CDS

Protection of 3rd party interests (noteholders, swap counterparties, KfW)

Trustee

SPI: PROMISE/PROVIDE

Performance upon credit event

Premium

CDS

Pre-

CDS

Premium

Performance upon credit event

Proceeds

Interest & Principal

Investors (with tranched securities)
4.2.3 Unfunded credit derivatives: CDSs

Continuing with Germany with respect to CDSs

According to Ricken: ‘In der Praxis wird eine Vielzahl verschiedener Kreditderivate eingesetzt. Die folgenden Ausführungen beschränken sich jedoch auf die Erläuterung von Credit Default Swaps (CDS), die die am häufigsten verwendete Variante darstellen.’

The use of CDSs in synthetic securitisation utilising the PROVIDE or PROMISE platforms has been above. In addition, it is noted that when Böhringer et al of Deloitte & Touche Germany used the term ‘direct synthetic securitisation’ with regards to German securitisations, it was an oversimplification. German synthetic securitisation entails a complex structure that is a hybrid scheme between direct and indirect synthetic securitisation: Although the focus as of yet has been unfunded fragments, the accurate depiction is the classification that Ricker used when categorising the Syntetische (Kredit-)Verbriefungen as respectively mit Zweckgesellschaft or ohne Zweckgesellschaft, with both possibilities being vollfinanziert or teilfinanziert.

The PROVIDE or PROMISE platforms model is not the only model prevalent in Germany, but as a challenging structure it displays the more complex trends rendering other schemes palatable. The statutory definition of synthetic securitisation contains no express reference to the choice of credit derivative, thereby not excluding the utilisation of CDSs. For example, the Nymphenburg 2002-1 Ltd scheme entailed the transfer of credit risk by Bayerische Landesbank (as originator) to a SPI through guarantees, and the subsequent investment by the investors in the SPI through CLNs. A better example for present purposes is London Wall 2002-2 PLC, in which Deutsche

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250 In practice, a wide variety of credit derivatives are used. However, the following remarks are limited to the explanation of credit default swaps (CDS), which are the most commonly used variant.’ – Ricken (n 220 above) 27.
251 Böhringer et al (n 143 above) 53 et seq.
252 ‘Synthetic securitisations’ - Ricken (n 220 above) 27.
253 ‘With SPI’ – as above.
254 ‘Without SPI’ – as above.
255 ‘Fully funded’ – as above.
256 ‘Partially funded’ – as above.
Bank AG (originator) used one CDS to transfer senior credit risk to an OECD bank, another CDS to transfer junior credit risk to an OECD bank, and a third CDS to transfer the mezzanine risk to a SPI, the latter issuing CLNs to investors.\footnote{Emse (n 258 above) 95.} However, ‘naked’ CDSs in Germany have suffered negative connotations subsequent to, according to Cluley and Benton of Allan & Overy, BaFin’s temporary prohibition, from 19 May 2010 onward, of certain CDSs.\footnote{P Cluley & D Benton ‘Germany bans naked credit default swaps referencing eurozone sovereigns’ 18 May 2010 http://www.allenovery.com/publications/en-gb/Pages/Germany-bans-naked-credit-default-swaps-referencing-eurozone-sovereigns.aspx (accessed 26 July 2015).}

Unfunded credit derivatives incorporating ISDA terminology

It appears from the law of contract that the essentialia would be consensus on entering into a contract (which in commercial terms can be described as consensus on creating a CDS), and consensus on what the two parties thereto must perform. A common theme in all specific contracts is the requirement of consensus,\footnote{Own italicisation.} and although there might have been a time not so long ago when a CDS was a contractus re innominati, the prevalence of CDSs, irrespective of ISDA standardisation but doubtlessly influenced thereby, has amended this situation. Both parties to a CDS must have the intention to transact on a contract constituting a CDS.

A CDS is a method through which a protection buyer transfers risk to a protection seller.\footnote{See AON Financial Products Inc & AON Corporations v Société Générale US Court of Appeals August term 2006 Docket no 06-1080-cv (http://www.isda.org/press/pdf/cv_opn.pdf) (AON).} More specifically, it is a bilateral financial contract in terms of which a protection buyer renders periodic performance to a protection seller in return for a contingent performance if a predefined credit event transpires in reference credit.\footnote{As above.} Although the purpose of the credit derivative is to transfer risk, the motive behind their employment may be diverse, such as management of specific risk exposures and management of return on investment by the protection buyer\footnote{See Eternity Global Master Fund Ltd v Morgan Guaranty Trust Company of New York 375 F 3D 168, 172 (2d Cir 2004) (Eternity).} and earning income and diversification of portfolios by the protection seller.\footnote{As above.} According to the ISDA, a CDS is ‘a bilateral agreement designed explicitly to shift credit risk between two parties.’\footnote{International Swaps and Derivatives Association ‘About CDS’ 2015 http://www.isdacdsmarketplace.com/about-Cds_market (accessed 10 August 2015).} The party acting
in a primary role that transacts on the CDS is the buyer, which is the fixed rate payer. The latter definition has been amended from the 2003 Definitions. Although the rationale for said amendment is elusive, it is clear that the version in the 2003 Definitions provided for the possibility of delegation of the duty to render such fixed rate performance – which is usually a periodic payment effected in a series as set out in figure 7.2 below – whereas such delegation in terms of the 2014 Definitions would only be possible, in this instance, if the confirmation defines the fixed rate payer wide enough to include those delegates. In an indirect synthetic securitisation using an unfunded structure, the SPI would be the seller, which is the floating rate payer. This definition remained unchanged from the 2003 Definitions, and has the interpretation of restricting such party to the four corners of the confirmation so as to mitigate cession of the right to premiums or delegation of the duty to perform upon realisation of a credit event. It is *res ipsa loquitur* that all such restrictions are *inter alia* used to limit the possible complexities for synthetic securitisation schemes and consequently the number of contracting parties to such a scheme, in order to mitigate systemic risk.

267 2014 ISDA Credit Derivative Definitions art I sec 1.3.
270 Das (n 8 above) 29.
271 As above.
273 2014 ISDA Credit Derivative Definitions art I sec 1.4.
275 2003 ISDA Credit Derivative Definitions art II sec 2.12.
The rationale for these descriptions is that the buyer performs a fixed amount,\textsuperscript{276} payable on a fixed rate payer payment date either specified in the confirmation or determined by means of section 12.12 of the 2014 Definitions.\textsuperscript{277} With regards provision of the former dates as such in the confirmation, two exceptions exist: Firstly, if an event determination date\textsuperscript{278} transpires, the earlier termination date\textsuperscript{279} and the first settlement date\textsuperscript{280} regarding the credit event relating to said event determination date, will constitute the final fixed rate payer payment date;\textsuperscript{281} secondly, if the CDS constitutes a reference obligation trade only trade\textsuperscript{282} and termination does not transpire subsequent to the occurrence of an event determination date, the termination date is also fixed rate payer date.\textsuperscript{283} However, according to both the 2003 Definitions\textsuperscript{284} and the 2014 Definitions as already set out, such performance transpires \textit{in vacuo}.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure7.2.png}
\caption{Figure 7.2}
\end{figure}

\begin{itemize}
\item \textsuperscript{276} 2014 ISDA Credit Derivative Definitions art XII sec 12.5.
\item \textsuperscript{277} 2014 ISDA Credit Derivative Definitions art XII sec 12.5.
\item \textsuperscript{278} 2014 ISDA Credit Derivative Definitions art I sec 1.16.
\item \textsuperscript{279} 2014 ISDA Credit Derivative Definitions art I sec 1.15.
\item \textsuperscript{280} 2014 ISDA Credit Derivative Definitions art V sec 5.3.
\item \textsuperscript{281} 2014 ISDA Credit Derivative Definitions art XII sec 12.11.
\item \textsuperscript{282} 2014 ISDA Credit Derivative Definitions art II sec 2.12.
\item \textsuperscript{283} 2014 ISDA Credit Derivative Definitions art XII sec 12.11.
\item \textsuperscript{284} 2003 ISDA Credit Derivative Definitions art II sec 2.5.
\end{itemize}
The floating rate payer performs an amount to the fixed rate payer, known as the floating rate payer calculation amount,\textsuperscript{285} and is defined relevant to a trade date as the amount specified in the relevant confirmation.\textsuperscript{286} The trade date is the date on which the CDS contract is entered into.\textsuperscript{287} This amount may be reduced subsequent to the trade date if, firstly, there are different event determination dates with regards to the floating rate payer calculation amount, or an event determination date has only be established with regards to a portion of the floating rate payer calculation amount, in which event the other portion shall be interpreted as subject to a further credit derivative;\textsuperscript{288} secondly, if, for example, the exercise amount is less than the floating rate payer calculation amount, in which event a further credit derivative will be construed;\textsuperscript{289} thirdly, if more than one successor is identified, in which event the CDS will be divided.\textsuperscript{290}

The aforementioned reference to a successor requires clarification. The definition of ‘synthetic securitisation scheme’ in the Schedule\textsuperscript{291} refers to an underlying assets, a reference entity or a reference asset against which credit exposure is sought through the CDS. This is provided for in the 2014 Definitions as the reference obligation or the reference entity. Although the term ‘[o]bligation’ has always had a wide definition,\textsuperscript{292} the 2014 Definitions automatically include standard reference obligations as reference obligations,\textsuperscript{293} which are specified on the SRO list\textsuperscript{294} on the ISDA website.\textsuperscript{295} According to Linklaters, these efforts at standardisation relate to commonly traded reference entities,\textsuperscript{296} meaning that express specification of the relevant reference obligation is no longer required since it will be regarded as the reference obligation relating to a specified reference entity on the SRO list.\textsuperscript{297} The reference entity \textit{per se} is defined as the entity

\textsuperscript{285} 2014 ISDA Credit Derivative Definitions art XII sec 12.17.
\textsuperscript{286} As above.
\textsuperscript{287} 2014 ISDA Credit Derivative Definitions art I sec 1.13.
\textsuperscript{288} 2014 ISDA Credit Derivative Definitions art XII sec 12.17, art I sec 1.18.
\textsuperscript{289} 2014 ISDA Credit Derivative Definitions art XII sec 12.17, art I sec 1.33(b).
\textsuperscript{290} 2014 ISDA Credit Derivative Definitions art XII sec 12.17, art II sec 2.2(n).
\textsuperscript{291} \textsuperscript{n 115 above, para 1.}
\textsuperscript{292} 2003 ISDA Credit Derivative Definitions art II sec 2.14; 2014 ISDA Credit Derivative Definitions art III sec 3.1.
\textsuperscript{293} 2014 ISDA Credit Derivative Definitions art II sec 2.5.
\textsuperscript{294} 2014 ISDA Credit Derivative Definitions art II sec 2.6.
\textsuperscript{295} 2014 ISDA Credit Derivative Definitions art II sec 2.18.
\textsuperscript{297} As above.
specified as such in the confirmation,\textsuperscript{298} or its successor.\textsuperscript{299} In terms of the Schedule,\textsuperscript{300} this will likely be the originator or repackager\textsuperscript{301} in the event of an underlying asset, but will not necessarily include parties by association due to said wording\textsuperscript{302} of the Schedule\textsuperscript{303} – though such parties’ role are prevalent in other statutory scenarios – although in terms of the 2014 Definitions not in its capacity as the fixed rate payer \textit{ex officio}. The 2014 Definitions provide that the successor to the reference entity with regards to the entire CDS can \textit{inter alia} acquire such capacity through being the provider of a guarantee relating to at least seventy-five percent of the reference obligations.\textsuperscript{304} On the one hand, it is uncertain whether this provision would be enforceable in South Africa, since the \textit{causa} for the guarantor to assume duties with regards to the remainder of exposures seem dubious in civil law. More specifically, the \textit{causa} for the guarantor to assume the duty of premium performance to the SPI for the pro rata remainder of the premium relating to unguaranteed reference obligations in the capacity of a principal debtor,\textsuperscript{305} seems dubious. With due regard for paragraph 5(2)(a)(iv) of the Schedule,\textsuperscript{306} it is known that guarantees can substitute credit derivatives in synthetic securitisation schemes.\textsuperscript{307} This may then create the \textit{circulus in demonstrando} that the SPI becomes the successor, being both the guarantor and the protection seller, suddenly holding rights against itself. Although Basel III may prohibit an outright situation of this sort, the circumstances envisioned in article II section 2.2(a)(iii)\textsuperscript{308} still remains a possibility.

\textbf{Settlement}

Performance by the protection seller to the protection buyer, so-called ‘settlement’, can assume various traditional forms. In the case of cash settlement, the protection seller performs to the protection buyer a value equal to the price change of the underlying, being the difference between

\begin{footnotesize}
\textsuperscript{298} 2014 ISDA Credit Derivative Definitions art II sec 2.1.
\textsuperscript{299} 2003 ISDA Credit Derivative Definitions art II sec 2.1; 2014 ISDA Credit Derivative Definitions art II secs 2.1, 2.2.
\textsuperscript{300} n 115 above.
\textsuperscript{301} n 115 above, paras 5(1)(a)(i), 5(2)(b).
\textsuperscript{302} As above.
\textsuperscript{303} n 115 above, para 1 definition of ‘associated company’.
\textsuperscript{304} 2014 ISDA Credit Derivative Definitions art II sec 2.2.
\textsuperscript{305} \textit{List v Jungers} 1979 3 SA 106 (A) 119B-120F.
\textsuperscript{306} n 115 above.
\textsuperscript{307} n 115 above, para 1 definition of ‘synthetic securitisation scheme’.
\textsuperscript{308} 2014 ISDA Credit Derivative Definitions.
\end{footnotesize}
the value upon contracting on the CDS and the value immediately subsequent to the credit event.\textsuperscript{309}

In the case of physical settlement the protection buyer delivers or performs\textsuperscript{310} a specified asset subsequent to the credit event to the protection seller, thereby constituting true sale \textit{ex post facto}.\textsuperscript{311}

Fixed payment entails the protection seller performing to the protection buyer an \textit{a priori} specified fixed value, an estimate of loss,\textsuperscript{312} upon realisation of a credit event.\textsuperscript{313} In the case of actual workout/recovery value the protection seller performs to the protection buyer the CDS’s full face value, whilst the protection buyer performs to the protection seller all amounts recovered from obligors subsequent to the credit event.\textsuperscript{314}

ISDA vernacularised these settlement methods in a different fashion. Apart from the risk of re-classifying the protection seller as the ‘buyer’\textsuperscript{315} in cases of fixed payment, given performance at a fixed rate,\textsuperscript{316} the manner of performance by the seller, ‘settlement’,\textsuperscript{317} is more technically described. The definition of settlement\textsuperscript{318} \textit{prima facie} only takes into regard only physical settlement and auction settlement, the former being the settlement method and the latter being the fallback settlement method. The use of quotation marks seem to indicate that physical settlement requires \textit{verbatim} and express specification in the confirmation.\textsuperscript{319} The aforementioned \textit{prima facie} observation is slightly widened in the definition of settlement method\textsuperscript{320} with the inclusion of cash settlement. Paragraph (a) of the definition of ‘settlement method’ seems to indicate that – \textit{inter alia} through the use of quotation marks – that unless ‘auction settlement’ is specified verbatim in the confirmation, auction settlement will not transpire; however, the 2014 Definitions rectify this position by providing that auction settlement will transpire if no settlement method is specified ‘as applicable’ in the confirmation.\textsuperscript{321} Mere reference to auction settlement seems to be insufficient. Although a similar argument can be made out regarding cash settlement, ISDA rectified that

\begin{footnotesize}
\begin{enumerate}
\item Das (n 8 above) 29.
\item See ch 2 para 2.1 above.
\item Das (n 8 above) 29.
\item Das (n 8 above) 29-30
\item As above.
\item Das (n 8 above) 30.
\item 2014 ISDA Credit Derivative Definitions art I sec 1.3.
\item 2014 ISDA Credit Derivative Definitions art XII sec 12.6.
\item 2014 Definitions art v sec 5.1.
\item 2014 ISDACredit Derivative Definitions art V sec 5.1
\item As above.
\item 2014 ISDA Credit Derivative Definitions art V sec 5.2
\item 2014 ISDA Credit Derivative Definitions art V sec 5.2.
\end{enumerate}
\end{footnotesize}
situation through a provisions that cash settlement may apply; however, it is uncertain whether such provision constitutes an objective or subjective test. The fallback settlement method seems to apply only to express and verbatim cases of auction settlement, in which it would be cash settlement is expressly and verbatim provided for as such, otherwise physical settlement.

If physical settlement is applicable, the buyer must, on or before the physical settlement date, deliver to the seller deliverable obligations in terms of the notice of physical settlement (NOPS). Deliverable obligations are not unrelated to the applicable obligations of the reference entity or the reference obligations, but is defined wider. The notice of physical settlement is a notice with a *numerus clausus* of applicable contents. Firstly, the notice must state that the buyer intends to settle the credit derivative and requires performance as physical settlement – it is uncertain how the buyer would intend to settle the credit derivative, since that implies a duty intrinsic to the seller; secondly, it must contain an inventory of deliverable obligations to be delivered or performed to the seller; thirdly, the notice must specifically state the outstanding principal balance or the due and payable amount, or the cash amount in settlement currency except if it contradicts the former, in which case the face amount must be stipulated. The elements of a NOPS are also applicable when the buyer replaces deliverable obligations. Since true sale would contain the transfer of the same credit risk as in synthetic sale, the provisions of paragraph 5(2)(e) of the Schedule would inductively apply; however, the effect would be that this discretion would prohibit replacement of deliverable obligations with non-performing assets.

In the case of auction settlement, the seller will perform the auction settlement amount to the buyer on the auction settlement date, if the event determination date transpires on or prior to the auction

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322 As above.
323 2014 ISDA Credit Derivative Definitions art V sec 5.5.
324 2014 ISDA Credit Derivative Definitions art VIII sec 8.1.
325 2014 ISDA Credit Derivative Definitions art III sec 3.2.
326 2014 ISDA Credit Derivative Definitions art VIII sec 8.2.
327 As above.
328 See ch 2 para 2.1 above.
329 2014 ISDA Credit Derivative Definitions art VIII sec 8.2.
330 As above.
331 2014 ISDA Credit Derivative Definitions art VIII sec 8.2
332 n 115 above.
The auction settlement amount is the greater of zero or the floating rate payer calculation amount multiplied by an amount, expressed as a percentage, equal to the difference between the reference price and the auction final price. On the other hand, cash settlement entails performance by the seller to the buyer of the cash settlement amount – which, unless the parties have contracted to the contrary, is the greater of zero or the floating rate payer calculation amount multiplied by the difference between the reference price and the final price (the latter seemingly not expressed as a percentage) – on the cash settlement date, the latter being *inter alia* either the specified number of business days, alternatively three business days, subsequent to the final price calculation if the cash settlement amount is not specified in the confirmation, or the same business day provisions as mentioned subsequent to the event determination date.

**Credit events**

The paragraph on settlement above has displayed that the common description of the protection seller’s performance as transpiring upon the occurrence of a credit event is an oversimplification. It is interesting to note that the Schedule is virtually quiet on the topic of credit events. Blanco, Brennan and Marsh have referred to possible credit events as failure to pay, insolvency, obligation default, acceleration, repudiation, moratorium or restructuring. Objective certainty is clouded by the fact that credit events are usually subject to consensus *inter se*.

In the case of *Nomura International Plc v Credit Suisse First Boston International* (Nomura), Nomura International Plc (Nomura) entered into a credit derivative with Credit Suisse First Boston International (CSFB) for a variation of physical settlement – Nomura performs debt instruments to CSFB and CSFB counter-performs the value of such bonds – upon occurrence of a credit event. The reference entity, Railtrack Plc (Railtrack), ostensibly encapsulated non-contingent bonds with

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333 2014 ISDA Credit Derivative Definitions art VI sec 6.1.  
334 2014 ISDA Credit Derivative Definitions art VI sec 6.3.  
335 2014 ISDA Credit Derivative Definitions art VII sec 7.3.  
336 2014 ISDA Credit Derivative Definitions art VII sec 7.1.  
337 2014 ISDA Credit Derivative Definitions art VII sec 7.2  
338 n 115 above.  
339 Blanco, Brennan & Marsh (n 79 above) 11-12.  
deliverable obligation characteristics whilst the reference obligations encapsulated non-exchangeable bonds. The former had to be considered in terms of the sections 2.15 (Deliverable Obligations) and 2.19 (Method for Determining Deliverable Obligations) of the 1999 ISDA Credit Derivative Definitions (1999 Definitions), which it was found to satisfy, leaving consideration in terms of section 2.18(b)(vii) (Not Contingent) of the 1999 Definitions. It appears as if the debt instruments in terms of the reference entity were exchangeable bonds constituting vanilla convertibles, meaning that Railtrack did not have the right of conversion but the debt instrument holder and trustee did in certain circumstances – no conversion rights were inherent to the non-exchangeable bonds, rendering them pure vanilla. Conversion by the debt instrument holder entailed conversion of a £10 exchangeable bond into a Railtrack share usually valued at £18.40, with profit in excess of the latter quantum and the value of the conversion right being inherent in the exchangeable bond, although the non-exchangeable bonds at that time held a higher market price – the court fails to justify the profit in conversion, although this is likely justified through the NPV rule. The trustee’s conversion right related to the so-called ‘widows and orphans clause’.

It is surprising that Langley J avoided the fact that CSFB had contracted on contradicting terms and based its finding on obiter dicta: The credit derivative de facto inter alia pertained to exchangeable bonds, although the confirmation required no contingencies. It was correct to accept counsel for the claimant’s submission that ‘a line [had] to be drawn somewhere in determining what may properly be a “contingency”’, but it was incorrect to assume such discretion from the bench when the a priori intention of the parties to the credit derivative could be utilised: Since such terms were acceded to by CSFB a priori, it is res ipsa loquitur that CSFB did no regard exchangeable bonds as without contingency. With regard to Langley J’s ratio decidendi, being as

341 Nomura (n 340 above) para 11.
342 As above.
343 Nomura (n 340 above) para 12.
344 As above.
345 As above.
346 Nomura (n 340 above) para 17.
347 As above.
348 As above.
349 See ch 5 n 222 above.
350 Nomura (n 340 above) para 19.
351 Nomura (n 340 above) para 30.
stated above in truth *obiter dicta*, it is doubtful that exchangeable bonds in other circumstances could be regarded as without contingency. Both the hypothetical right to conversion by the issuer as well as the right to conversion by the debt instrument holder would be provided for in the applicable *grundnorm* of the exchangeable bonds. The former would relate to a conditional duty inherent in the debt instruments, whereas the latter would relate to a right inherent in the debt instruments. If the term ‘obligation’\(^{352}\) was used in the civil law sense,\(^{353}\) then the phrase ‘is not subject to any contingency’\(^{354}\) would have an absolute application over both the former and the latter; if the term ‘obligation’\(^{355}\) was used in the common law sense,\(^{356}\) then the latter would be irrelevant and there could have been no doubt as to the performance of the exchangeable bonds upon physical settlement.

In the case of *Eternity Global Master Fund Ltd v Morgan Guarantee Trust Company of New York and JPMorgan Chase Bank*,\(^{357}\) the appellant (Eternity) entered into three CDSs with the respondent (Morgan) based on Argentine sovereign debt with inter alia repudiation/moratorium and restricting as credit events, with the former being the protection buyer and the latter the protection seller. The Argentine government instituted a voluntary debt exchange on sovereign debt, which Morgan refused to accept as a restructuring credit event. Thereafter, the Argentine government announced a public debt moratorium. Morgan refused to perform in terms of the third CDS, submitting that it had expired.

On appeal, the particularity of section 4.7 of the 1999 Definitions, relating to restructuring, was contended. Whereas Eternity argued that the voluntary debt exchange qualified as a restructuring based on an obligation exchange in terms of section 4.9 of the 1999 Definitions, or alternatively as an extension, deferral and/or subordination in terms of section 4.9 of 1999 Definitions, Morgan argued that the voluntary debt exchange was not a credit event since it was not expressly included in said section 2.9 definition of restructuring based on the fact that it was not an obligation exchange. In considering the question on ambiguity in the law of contract, the court lends itself to

\(^{352}\) *Nomura* (n 340 above) para 10.

\(^{353}\) See ch 2 para 2.1 above.

\(^{354}\) *Nomura* (n 340 above) para 10.

\(^{355}\) As above.

\(^{356}\) See ch 2 para 2.1 above.

\(^{357}\) 375 F 3D 168, 172 (2d Cir 2004).
an ambiguous ratio with regards to the obligation exchange. It confirms that the Argentine voluntary debt exchange does not fall conform to the ‘mandatory’ requirement in section 4.9 of the 1999 Definitions. Eternity argued that the voluntary debt exchange was an example of economic coercion, but the court denied a ratio on this point in the absence of testimony on the commercial context of CDSs.\textsuperscript{358} Furthermore, Eternity relied on the 1999 ISDA User’s Guide which, nonsensically, included optional exchanges as mandatory exchanges in an attempt to liberalise the interpretation or application of said provision;\textsuperscript{359} however, said User’s Guide was not formally promulgated.\textsuperscript{360}

The court considered the enumerated possibilities in section 4.7 of the 1999 Definitions based on ISDA’s use of the verbs ‘occurs’, ‘is agreed’ and ‘is announced’.\textsuperscript{361} It further continues to state that ‘[t]o negative the possibility that there was a restructuring credit event, it must be clear that none of the “events” described in §§ 4.7(a)(i)-(v) occurred with respect either to the participating obligations or to the nonparticipating obligations’.\textsuperscript{362} This was an example of denying the antecedent, since the court rendered this leap without conclusively considering whether the voluntary exchanged debt was mandatory or not. Therefore, the court’s elucidation of participating obligations\textsuperscript{363} is superfluous. In juxtaposition, the court’s elucidation of nonparticipating obligations\textsuperscript{364} is disappointingly inconclusive. Eternity relied on an alleged announcement by the Argentine Minister of Economics that restructured loans will domestically have the highest priority, whereupon the court considered this in the light of possible subordination given the fact that the 1999 Definitions did not exclude such announcements at section 4.7(a)(iv).\textsuperscript{365} The unscrupulousness of this consideration is proven by the inverse which is equally likely. Whilst the court holds that the confirmation did not seem to include the ISDA Restructuring Supplement to the 1999 definitions\textsuperscript{366} – which would have excluded said announcement for possible subordination\textsuperscript{367} it neglects to consider that the ISDA Restructuring Supplement could indicate

\begin{footnotesize}
\textsuperscript{358} Eternity (n 264 above) part B(i).
\textsuperscript{359} As above.
\textsuperscript{360} As above.
\textsuperscript{361} Eternity (n 264 above) part B(ii).
\textsuperscript{362} As above.
\textsuperscript{363} Eternity (n 264 above) part B(ii)(a).
\textsuperscript{364} Eternity (n 264 above) part B(ii)(b).
\textsuperscript{365} As above.
\textsuperscript{366} As above.
\textsuperscript{367} As above.
\end{footnotesize}
ISDA’s intention with regards to this matter, which could be vernacularised in South African law as *subsecuta observatio*\(^{368}\) and thereby included a regard for said Supplement, whilst equally being disregarded through an inductive approach of the mischief rule.\(^{369}\)

In the case of *AON Financial Products & AON Corporation v Société Generale*,\(^{370}\) Bear Sterns International Ltd (BSIL) had extended a loan to Ecobel Land Inc (Ecobel), subject to the suspensive condition of Ecobel obtaining a ‘surety bond’ from the Government Service Insurance System (GSIS), an agency of the Government of Philippines. For purposes of risk mitigation if GSIS would default, BSIL entered into a CDS with AON Corporation and AON Financial Products (together AON) with said surety bond as the reference obligation. The credit event was stipulated as ‘the failure by [GSIS] to make, when due, any payments under the Obligations for whatever reason or cause’. For purposes of risk mitigation should it default itself, AON entered into a CDS with Société Generale (SG). The contractual *numerus clausus* of credit events were failure to pay, a sovereign event, a cross default, a repudiation or a restructuring. However, the reference entity in the AON/SG CDS was specified as the Republic of Philippines and any successors, intrinsically being treasury bonds of the Republic of Philippines.

A year later, Ecobel defaulted on the loan to Bankers Trustee Company, BSIL’s assignee, and the GSIS refused performance in terms of the surety bond due to insufficient authorisation. AON subsequently refused to perform in terms of the BSIL/AON CDS based on non-occurrence of the contractual credit event. BSIL’s assignees successfully obtained judgment against AON in the New York District Court for the Southern District of New York. When AON then sought performance in terms of the AON/SG CDS, SG refused payment since GSIS was not expressly included in the definition of the reference entity. AON was successful in the court *a quo* against SG. On appeal, the court used a positivistic approach – although the court denied this expressly,\(^{371}\) it is not only prevalent from the *ratio decidendi* in general but also from the court’s disregard for the ostensible intention of the contracting parties\(^{372}\) – with regards to the definition of a credit event

\(^{368}\) Botha (n 16 above) 87.
\(^{369}\) Botha (n 16 above) 86-87.
\(^{371}\) AON (n 262) 14 -15.
\(^{372}\) AON (n 262 above) 20.
in the AON/SG CDS, with sovereign event being, criticising the court *a quo*’s neglect to consider the word ‘condition’\(^373\) and considering the applicability of an ‘act or failure to act’\(^374\) \(^{375}\).

\[
\text{[A] condition which is created by or results from any act or failure to act by the government of the Reference Entity or any agency or regulatory authority thereof, including the central bank of the Reference Entity, that has the effect of declaring a moratorium (whether de facto or de jure) on, or causing a failure to honour any obligation relating to, or cancelling or generally causing material changes to the terms and conditions of, any obligation issued by the government of the Reference Entity.}
\]

According to the court, GSIS’s lack of authority rendered its surety bond a putative obligation\(^376\) and did not constitute a ‘condition’\(^377\). Furthermore, the court disagreed that GSIS could be interpreted as the reference entity\(^378\) (‘Republic of Philippines and any Successors’),\(^379\) since the ISDA term ‘[s]overeign’ was not expressly used in the confirmation.\(^380\) At the time, ‘[s]overeign’ was defined as ‘any state, political subdivision or government, or any agency, instrumentality, ministry, department or other authority (including, without limiting the foregoing, the central bank) thereof,’\(^381\) which would have included GSIS as the reference entity, although the court disregarded such basis since the term was not used. Although the court’s *ratio* confirms the contents of paragraph 3 above,\(^382\) its correct conclusion was based on an incorrect reasoning: The contracted credit events indeed included the term ‘[s]overeign’, but limited the meaning thereof in its definition of sovereign event. In *obiter*, the court opined that the letter received by SG from AON did not constitute a credit event notice since it contained ‘the circumstances under which it would rescind its contention that SG “owed” AON’,\(^383\) and was therefore not irrevocable.\(^384\) Although the case law fails to contain sufficient information regarding said letter to surmise objectively that such letter satisfied the features of a credit event notice in the confirmation and

\[^{373}\text{AON (n 262 above) 14.}\]
\[^{374}\text{As above.}\]
\[^{375}\text{AON (n 262 above) 12.}\]
\[^{376}\text{AON (n 262 above) 14.}\]
\[^{377}\text{AON (n 262 above) 14-15.}\]
\[^{378}\text{AON (n 262 above) 19.}\]
\[^{379}\text{AON (n 262 above) 18.}\]
\[^{380}\text{AON (n 262 above) 20-21.}\]
\[^{381}\text{2003 ISDA Credit Derivative Definitions art II sec 2.26. This definition has been retained verbatim in at 2014 ISDA Credit Derivative Definitions art II sec 2.4.}\]
\[^{382}\text{AON (n 262 above) 22-23.}\]
\[^{383}\text{AON (n 262 above) 26.}\]
\[^{384}\text{2003 ISDA Credit Derivative Definitions art III sec 3.3; AON (n 262 above) 25-26.}\]

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the 2003 Definitions, said *obiter dicta* appears erroneous based on the court’s misinterpretation of the term ‘irrevocable’. Nothing in the letter indicated that the notice *per se* was revocable;\(^{385}\) rather, it would be closer to the truth to state that the duty to perform in said letter was revocable. Although closer to the truth, said duty was still not revocable in said letter, but rather conditional, and as such the letter did not fail the test utilised by the court in this regard.

5 **Credit derivatives compared to insurance contracts**

It has been indirectly established why puritanical jurists are confused by derivatives in general and credit derivatives specifically – even legal sources define these instruments in commercial terms. The term ‘risk’ is indeed a feature of the Roman law of contract, albeit based on the Roman obligation of purchase and sale. A certain point in terms thereof is reached at which time risk, so-called *periculum*,\(^ {386}\) is transferred from the seller to the purchaser, i.e. the transaction is *perfecta* or, more specifically, *emptio perfecta*.\(^ {387}\) The question arises as to whether *periculum* is distinguishable from the notion of risk for present purposes. Roman ‘risk’ pertains to an event transpiring so as to effect the successful delivery of a thing, and the herein relevant usage pertains to a credit event, being default on performance, which would be analogous to default on payment of the purchase price. However, there is no absolute rule compelling monetary consideration, which invokes the possibility of barter. The puritanical jurist will argue that classical contracts are not the haven of risk, otherwise risk would have been specifically mentioned in its *essentialia*. No doubt specific circumstances could have existed in practice where the parties regarded risk to be a primary consideration; such circumstances indeed exist contemporaneously, and is found in traditional securitisation schemes with regards to true sale. The subsequent question pertains to the role of the Roman concept of *perfecta* in credit derivatives, which can be described in one of two ways: Either the concept of *perfecta* falls away since no actual sale or barter transpires, or the credit derivative forces *perfecta* in principle. Reference is made to *perfecta* in the Schedule,\(^ {388}\) in which a conditional provision stipulates that ‘[o]nce a synthetic securitisation scheme has been perfected, the transfer by a bank acting in a primary role of further risk in terms of that scheme

\(^{385}\) 2003 ISDA Credit Derivative Definitions art III sec 3.3; *AON* (n 262 above) 25.


\(^{387}\) As above.

\(^{388}\) n 2 above.
shall be permissible only for purposes of maintaining the capital value of the portfolio of risk included in the scheme’. The fact that an analogous provision relates to true sale – of which the effect has been noted above – supports the indication that the Legislators intended the notion of perfecta to apply to synthetic sale as well, i.e. credit derivatives. Although insurance also pertains to the transfer of risk, the notion of perfecta is not inherent in insurance law.

In the locus classicus of Lake v Reinsurance Corporation Ltd, Galgut J confirmed the definition of an insurance contract as a bilateral contract, i.e. the insurer and insured inter se, in terms of which the insured performs a premium to the insurer and the insurer performs a sum of money, or its equivalent, upon the occurrence of a specified uncertain event in which the insured has an interest. In the Potts opinion, a credit derivative was distinguished from insurance contracts on two bases: Firstly, the protection seller’s duty of performance is not conditional on the protection buyer incurring loss or having a risk of loss; secondly, a credit derivative does not serve to protect the protection buyer’s insurable interest, i.e. the protection buyer’s rights are not conditional on the existence of an insurable interest. The impact of such a perspective is doubtful in South Africa, where courts have been hesitant to include insurable interest in the essentialia of an insurance contract. For example, in cases of naked CDSs, it is not necessary for the protection buyer in a credit derivative to have dominium, possessio, quasi-possessio or other forms of insurable interest in the reference asset, and whereas a patrimonial of insurable interest is sine qua non for an insurance claim, naked CDSs irrespectively justify the right to performance upon occurrence of a credit event. An alternative perspective would be that regarding indemnity, although it likely better crystallises from the Afrikaans term, ‘skadeloosstelling’. According to Robbé, the ‘key difference’ between an insurance contract and a credit derivative is the absence of indemnity, although he articulates it differently from Cousy in that he emphasises the fact that, whereas insurance contracts inter alia relate to probable economic detriment, i.e. loss, the settlement

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389 n 2 above, para 5(2)(g).
390 Schedule (n 2 above) para 4(2)(m).
391 1967 3 SA 124 (W) 127.
392 H Cousy ‘The delicate relationship between law and finance: The classification of credit default swaps’ (2014) 2 Tydskrif vir die Suid-Afrikaanse Reg 227 236.
393 B Prozesky-Kuschke ‘Inleiding tot die versekeringsreg en versekeringskontrakte’ in CJ Nagel (n 48 above) 297.
394 Cousy (n 392 above) 234.
395 B Prozesky-Kuschke ‘Inleiding tot die versekeringsreg en versekeringskontrakte’ in CJ Nagel (n 48 above) 297.
396 Robbé (n 86 above) 132.
397 B Prozesky-Kuschke ‘Inleiding tot die versekeringsreg en versekeringskontrakte’ in CJ Nagel (n 48 above) 297.
amount consented to in terms of a credit derivative does not necessarily have bearing on loss. This is prevalent in the difference between fixed payment on the one hand, and physical settlement and actual workout/recovery value, as noted above.  

The further enquiry would then be whether a CDS would constitute insurance if the protection buyer indeed has an interest, akin to an insurable interest, in the reference asset(s), i.e. if the protection buyer would indeed suffer loss upon occurrence of a credit event. During the Financial Crisis, the New York State Insurance Department (NYSID) took the position that credit derivatives indeed constituted insurance contracts if they were not ‘naked’. However, Harstad has correctly stated that that in cases of non-naked CDSs, losses are not necessarily immediate, for example if the settlement amount payable by the protection seller is calculable with reference to market value reduction of the underlying, the protection buyer has no duty to alienate the underlying ‘at that market value at that time’, thereby postponing and possibly circumventing loss. However, in practice the Court may decide to utilise the maxim plus valet quod agitur quam quod simulate concipitur to judge a specific case on its individual merits such as cases analogous to the CAST 1999-1 synthetic securitisation, in which interest akin to insurable interest was present, and actual loss was suffered. Subsequent positive law would have to be wary of adhering too strictly to such a ratio decidendi in the light of stare decisis, since a unsubstantiated blanket application of such CDS-insurance contract classification would result in the non-enforceability of non-naked CDSs, given that the causality of loss given risk realisation is sine qua non to the actual insurance claim.

In cases such as that with said approach, it is possible that a court may assimilate the two specific contracts, especially since existent case law on said difference is unsatisfactory, for example in the matter of AON, the Court mentioned boldly in obiter that ‘CDS agreements are thus significantly

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398 Para 4.2.3 Settlement above.
399 Cousy (n 392 above) 236.
401 As above.
402 As above.
403 Harstad (n 400 above) 47.
404 Harstad (n 400 above) 46-47.
405 B Prozesky-Kuschke ‘Inleiding tot die versekeringsreg en versekeringskontrakte’ in CJ Nagel (n 48 above) 305.
406 n 371 above.
different from insurance contracts”, but based such vague statement on wide economic comments made by the Court in *Eternity Global Master Fund Ltd v Morgan Guarantee Trust Company of New York* 375 F 3d 168 172 (2d Cir 2004), instead of legal principles.

Furthermore, it uses an unrelated economic description of CDSs contra insurance contracts, provided by ISDA – acting as *amicus curiae* on behalf of SG – to support such bold statement *ex post facto*.

However, the latter approach by a South African Court would raise the question as to how the insurance would be regulated. Although there may be circumstances in which a Court may reason a credit derivative to classify as a common law insurance contract, CDSs may, with some effort, be consequently regarded by a Court as a ‘guarantee policy’ in terms of the Short-Term Insurance Act. It is difficult to fathom how the *a priori* regulatory and economic rationales that Henderson proposes would be applied by South African courts in any other way than the punitive.

### 6 Final remarks

There are numerous predicaments inherent in credit derivatives in synthetic securitisation schemes in South Africa. Firstly, it appears as if complex credit derivative transactions – such as portfolio, basket and index-based credit derivative trades – are prohibited, with legality only attainable through an intricate and dubious exercise of legal interpretation. Secondly, the credit derivative has ostensibly never been legally dissected in South African law, rendering its *essentialia* and *naturalia* uncertain and subject to much research *de novo*. The *essentialia* have been deduced herein as consensus on entering into a credit derivative contract and consensus on the respective performance of the applicable parties. The precise *naturalia* is difficult to fathom, since credit derivatives are ‘bespoke instruments due to high-street products’ inability to satisfy corporate needs and require analysis on a case to case basis.

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407 n 371 above, 11.
408 n 371 above, 10-11.
409 AON (n 262 above) 11.
410 As above.
411 53 of 1998: ‘‘[G]uarantee policy” means a contract in terms of which a person, other than a bank, in return for a premium, undertakes to provide policy benefits if an event, contemplated in the policy as a risk relating to the failure of a person to discharge an obligation, occurs; and includes a reinsurance policy in respect of such a policy’.
413 Para 1 above.
414 As above.
415 Para 4.2.3 *Unfunded credit derivatives incorporating ISDA terminology* above.
416 Ch 2 para 9 above.
Credit derivatives are OTC derivatives, which means that they are not usually traded on an exchange – with the exception of, for example, CLNs. This does not affect the use and analysis of the definition of ‘derivatives’ above for legal interpretation, since the statutory definition of ‘securities’ includes listed and unlisted securities. ISDA has stepped in to provide standardisation to numerous OTC derivatives, thereby promoting legal certainty. Credit derivatives’ off-exchange status provides for increased structural flexibility and ability to address liquidity. However, inter alia isolated bilateral consensus, which has intricately rendered these instruments tailor-made, have also rendered them eventually illiquid and thus pricing thereof tedious. Both of these factors were witnessed prior to the Financial Crisis. It is difficult to supply a valuation of the underlying or reference assets, given the mathematically intricate structure of different tranches’ loss allocation and the inadequate information pertaining to the assets underlying the risk’s credit quality. Furthermore, counterparties’ duties are obscured by the subjective nature of credit event occurrence determination and litigation risk given disagreement thereon, and counterparties’ extensive exposures to derivatives render determination of their creditworthiness difficult. The conclusion is then that investment in credit derivatives require sophistication, which occurrence is often implausible since ‘…even basic information about OTC derivatives transactions can be extremely hard to come by’, market participants themselves are often unaware of the extent of their net exposures or the identity of

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417 Fleuriet (n 37 above) 103; Taylor (n 109 above) 224.
418 Financial Markets Act 19 of 2012 sec 1: “exchange” means a person who constitutes, maintains and provides an infrastructure—
(a) for bringing together buyers and sellers of securities;
(b) for matching bids and offers for securities of multiple buyers and sellers; and
(c) whereby a matched bid and offer for securities constitutes a transaction.’
420 Para 3 above.
421 Taylor (n 109 above) 312.
422 Fleuriet (n 37 above) 102.
423 Para 2 above.
424 M Simkovic ‘Secret liens and the financial crisis of 2008’ (2009) American Bankruptcy Law Journal 253 272: ‘The value of the derivative depends on three things: (i) the value of the underlying asset; (ii) the contractually negotiated formula that determines the counterparties’ obligations to each other based on that value; and (iii) the creditworthiness of the counterparty to the derivative, which determines the likelihood that the obligation will actually be paid’.
425 Ch 2 para 5 above.
426 Simkovic (n 424 above) 272-274.
427 As above.
428 As above.
429 Simkovic (n 424 above) 274.
430 Simkovic (n 424 above) 274-275.
counterparties to their transactions" and "[m]andatory disclosures to third parties are even more limited, and the industry group, the International Swaps and Derivatives Association, has resisted voluntary disclosure".

Predicaments regarding the nature of inclusion of ISDA definitions have been noted, and together with an a priori lack of circumspection by the contracting parties, it appears as if the principle of caveat subscriptor becomes prevalent in the litigious aspect of credit events. However, it appears from case law as if the principle of caveat subscriptor is not the main predicament in the execution of credit derivatives (apart from CLNs), but rather the adage of pacta sunt servanda – the case law cited shows how major participants contract on credit derivatives only to later seek discharge through litigation. Therefore, it is apparent that a legal risk clings to the use of credit derivatives. In the Nomura case, a party to a CDS inconsistently contracted on physical settlement of convertible debt instruments whilst seeking no contingency in the performance. In the Eternity case, a party to CDSs resorted to dictionary definitions and non-promulgated resources, beyond the confirmation in order to obtain performance.

Settlement per se has also historically presented legal problems. Richa has presented some of these issues at the International Finance Seminar in May 2007. The greatest predicament for present purposes seems to be backlogs. In September 2005, fourteen New York banks had a backlog of credit derivative confirmations, meaning that credit derivatives had been created through oral consent and that the parties thereto had postponed the drawing of written confirmations. In addition, settlements were also overdue. Although Richa primarily attributes the latter predicament to uncertainty regarding deliverable obligations, it has been showed above that the source is the fundamental pacta sunt servanda, with uncertainty thereafter originating from the

431 As above.
432 As above.
433 Para 3 above.
434 Para 4.2.3 Credit events above.
435 Nomura (n 340 above).
436 Eternity (n 264 above).
438 Richa (n 437 above) 1-2, 10-14.
439 Richa (n 437 above) 2, 17 et seq.
bench due to intricacies in legal interpretation. Another problem is the fact that credit risk exposure relating to a reference entity may entail that the protection buyer does not hold the contractual objects of physical settlement upon occurrence of credit events.\textsuperscript{441} When it seeks to obtain them, the market may prove inelastic.\textsuperscript{442} Richa addresses this so-called ‘bond squeeze’ by calling for an acquisition of the deliverables in anticipation;\textsuperscript{443} however, this proposition must be subjected on a case to case basis to consideration of the fiduciary duties of the protection buyer’s directors to optimise profits, as explained elsewhere, whilst the timing therefore is a matter better suited to quantitative analysis that law.

A further matter of legal risk is the classification of credit derivatives as insurance. This potentially constitutes the synthetic securitisation scheme variation of the apprehension for recharacterisation evident in traditional securitisation schemes. As already shown,\textsuperscript{444} this legal risk does not likely pertain to all credit derivatives in all circumstances; however, it is interesting to note that no segment of the South African \textit{trias politica} has thus far proposed such regulation of naked CDSs. It would be imaginably difficult to provide a blanket rule regarding this from the bench, and such a \textit{ratio decideni} would likely apply only to a particular case. The consequent risk forseen would then be the matter of innovation, since participants would subsequently add to the complexity of their transactions, with the risk of rendering them more opaque, and/or with more systemic risk, and/or with greater efforts at pricing. This is the cat and mouse game between bankers and regulators that has already been alluded to.\textsuperscript{445}

A specific area of synthetic securitisation in South Africa that is devoid of regulatory clarity is that of CLNs. Whilst these position of these instruments appear uncertain in the Schedule,\textsuperscript{446} they are traded on the JSE and subject to billion-rand programmes.\textsuperscript{447} Whilst the JSE has fortunately regulated these instruments, albeit as interest-rate securities, such regulation seems to propose that CLNs must be regulated as commercial paper in synthetic securitisation schemes. As already

\begin{flushleft}
\textsuperscript{441} Richa (n 437 above) 24.
\textsuperscript{442} Richa (n 437 above) 25.
\textsuperscript{443} n 437 above, 25.
\textsuperscript{444} Para 5 above.
\textsuperscript{445} Ch 2 para 3.3 above.
\textsuperscript{446} n 2 above.
\textsuperscript{447} Para 4.2.2 \textit{Consideration whether CLNs are regulated as commercial paper} above.
\end{flushleft}
indicated, this is merely a rebuttable presumption. In truth, the specific treatment of CLNs in synthetic securitisations remain uncertain.
Chapter 8
Securities issued by the special-purpose institution in a synthetic collateralised debt obligation

1 Introduction
2 Corporate finance versus structured finance?
3 Banks and the business of a bank
   3.1 The concept of bank in brief
   3.2 The business of a bank
      3.2.1 Banks Act 94 of 1990
      3.2.2 The business of a bank as a punitive measure
      3.2.3 Canada
      3.2.4 Germany
4 Commercial paper in synthetic securitisation schemes
   4.1 Commercial paper as defined in paragraph 1 of the Schedule
   4.2 Commercial paper in terms of the Commercial Paper Notice
   4.3 Commercial paper in terms of paragraph 14 of the Schedule
5 Disclosure
6 Stratification of risk
7 Final remarks

1 Introduction
According to the Schedule,\(^1\) the credit risk transferred to the SPI\(^2\) is stratified into a minimum of two varying risk positions,\(^3\) with the junior or subordinate risk positions potentially absorbing

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\(^2\) See ch 7 above.
\(^3\) n 1 above, para 5(1)(a)(i).
losses\textsuperscript{4} without interposing on performance to senior positions.\textsuperscript{5} Whilst the latter reference to risk positions\textsuperscript{6} corresponds with the former,\textsuperscript{7} the latter contrarily refers to ‘tranches’.\textsuperscript{8} This can be interpreted as \textit{prima facie} poor legislative drafting, since the jurist not versed in the practice of synthetic securitisation may conclude that risk positions and tranches are synonymous in referring to different classes\textsuperscript{9} of commercial paper issued by the SPI given that such tranches are rated\textsuperscript{10} which is akin to the seniority adjectively assigned to commercial paper.\textsuperscript{11} In truth, the term ‘risk [position]’ has a wider ambit than ‘[tranche]’ since the former includes shareholders’ equity.\textsuperscript{12} The argument that the former includes debt instruments\textsuperscript{13} is premature for an introductory paragraph, since it may be contingent on the interchangeability of security document,\textsuperscript{14} as is applicable to debt instruments,\textsuperscript{15} and disclosure document,\textsuperscript{16} as is applicable to commercial paper,\textsuperscript{17} and whether these documents overlap in practice. Although this has been presumed as of yet for purposes of structured dialectic, a critical analysis thereof is necessitated.\textsuperscript{18}

Although it can be contended that risk positions and tranches have different meanings, as hinted by Fabozzi and Kothari, caution is required against the error that the stratification of commercial paper in structured finance is akin to credit priority in debt instrument markets\textsuperscript{19} because this argument constitutes a structural fallacy.\textsuperscript{20} The latter position is that in debt markets there are

\textsuperscript{4} n 1 above, para 5(1)(a)(ii).
\textsuperscript{5} As above.
\textsuperscript{6} As above.
\textsuperscript{7} As above.
\textsuperscript{8} As above.
\textsuperscript{9} E.g. Companies Act 71 of 2008 sec 43(3); Schedule (n 1 above) para 4(1)(a)(ii).
\textsuperscript{10} Schedule (n 1 above) para 5(1)(a)(v).
\textsuperscript{11} Schedule (n 1 above) para 5(1)(a)(iii) read with para 5(2)(h)(i).
\textsuperscript{12} HS Cilliers \textit{et al} \textit{Cilliers & Benade Corporate Law} (2000) 199-200.
\textsuperscript{13} Companies Act 71 of 2008 sec 43.
\textsuperscript{14} Companies Act 71 of 2008 sec 43(1)(b): ‘“security document” includes any document by which a debt instrument is offered or proposed to be offered, embodying the terms and conditions of the debt instrument including, but not limited to, a trust deed or certificate’.
\textsuperscript{15} See ch 7 para 4.2.2 \textit{Consideration whether CLNs are regulated as commercial paper} above; Companies Act 71 of 2008 sec 43(1)(a): ‘“debt instrument”—
(i) includes any securities other than the shares of a company, irrespective whether or not issued in terms of a security document, such as a trust deed, but
(ii) does not include promissory notes and loans, whether constituting an encumbrance on the assets of the company or not.’
\textsuperscript{16} Schedule (n 1 above) para 16(2)(a).
\textsuperscript{17} Schedule (n 1 above) para (a) of the para 1 definition of ‘synthetic securitisation scheme’.
\textsuperscript{18} Ch 5 para 6.2 above.
\textsuperscript{20} MES van den Berg \textit{Critical reasoning and the art of argumentation} (2010) 28 \textit{et seq}.
classes of debt instruments (statement \( P_1 \));\(^{21}\) different classes of debt instruments have different credit priorities, being ‘subordination’ (statement \( P_2 \)); therefore, different credit priorities are prevalent in debt markets (deduction \( P_3 \)). The former position in structured finance is that in synthetic securitisation schemes credit risk is stratified (statement \( Q_1 \));\(^{22}\) different stratifications have different capacities for loss absorption (statement \( Q_2 \));\(^{23}\) therefore, there is a structure for risk of loss in a synthetic securitisation scheme (deduction \( Q_3 \)). As such, the posited equation of \( Q_1 = P_3 \) made is unfounded.

The purpose of this chapter is to discuss this matter of the wider ‘securities’ issued by the SPI, bearing in mind that it is no simple task given the unscrupulous legislative drafting found in the Schedule.\(^ {24}\) Apart from the example used above, another incident is the reference to ‘mezzanine positions’ transferred to ‘third parties’.\(^ {25}\) Such ‘third parties’ are presumably ‘investors’, since the third parties referred to in the definition of ‘repackager’\(^ {26}\) would render this provision unintelligible. In order to circumvent the problems intrinsic in this random use of synonyms, the reader must employ the method of systematic/contextual interpretation\(^ {27}\) by taking into regard that the SPI issues commercial paper to investors\(^ {28}\) of which ‘potential risk of loss’\(^ {29}\) is based on the SPI’s underlying risk exposures’ performance,\(^ {30}\) investment in a significant amount of the underlying credit risk exposure,\(^ {31}\) and in particular paragraph 5(1)(v) of the Schedule.\(^ {32}\)

2 Corporate finance versus structured finance?

Corporate finance is a commercial term referring to not only the nature of, but also the transfer of securities and interest in such securities on the primary and secondary market.\(^ {33}\) Its legal

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21 E.g. Companies Act 71 of 2008 sec 43(3).
22 Schedule (n 1 above) para 5(1)(a)(i).
23 Schedule (n 1 above) para 5(1)(a)(ii).
24 n 1 above.
25 Schedule (n 1 above) para 5(2)(h)(ii).
26 Schedule (n 1 above) para 1.
28 n 1 above, para (a) of the para 1 definition of ‘synthetic securitisation scheme’.
29 n 1 above, para 5(1)(a)(iv).
30 n 1 above, para 5(1)(a)(iii).
31 n 1 above, para 5(2)(vi).
32 n 1 above.
33 PA Delport The new Companies Act manual (2011) 29 et seq.
counterpart is securities law. Such securities constitute shareholders’ or external equity\textsuperscript{34} issued by a company, primarily for the purpose of raising capital.\textsuperscript{35} This can be regarded, for purposes of this work, as the ‘direct approach’ for raising capital, since in general the capital is raised by the separate legal entity \textit{per se}, causing primary and secondary sources\textsuperscript{36} to be designated as such relative to the aforesaid entity (in order to qualify this approach, i.e. to intermittently ignore the practical role of financial institutions in these offers,\textsuperscript{37} the reader must comprehend this to be a coarse-grained approach). According to Merrill Lynch and Capgemini, portfolios can consist of the following asset classes: Equities, fixed income, cash/deposits, real estate and alternative investments.\textsuperscript{38} Not only are such categorisations legally vague, but Graham and Dodd have also indicated on a commercial level that such titles may prove inaccurate.\textsuperscript{39} Equity refers to shareholder’s equity, irrespective of its type. Whereas different classes of shares were prevalent in terms of the common law and the previous Companies Act,\textsuperscript{40} section 37(2), subject to section 37(3), of the Companies Act\textsuperscript{41} provides for the restriction of voting rights.\textsuperscript{42} This is not only

\begin{itemize}
\item[] \textsuperscript{34} Cilliers \textit{et al} (n 12 above) 199 \textit{et seq}.
\item[] \textsuperscript{35} Cilliers \textit{et al} (n 12 above) 198.
\item[] \textsuperscript{36} Cilliers \textit{et al} (n 12 above) 199.
\item[] \textsuperscript{37} Companies Act 71 of 2008 sec 95(1)(g): “offer”, in relation to securities, means an offer made in any way by any person with respect to the acquisition, or consideration, of any securities in a company’.
\item[] \textsuperscript{38} Associates of Merrill Lynch & Capgemini \textit{Wealth: How the world’s high-net-worth grow, sustain and manage their fortunes} (2008) 125. This categorisation contains the blunder that hybrid securities are excluded. These instruments are designated in the Income Tax Act 58 of 1962 as ‘hybrid equity instruments’ and are defined in section 8E as: ‘(a) any redeemable preference share which the relevant company is obliged to redeem in whole or in part within a period of three years from the date of issue thereof, or which may at the option of the holder be redeemed in whole or in part within the said period, or in respect of which the holder has a right of disposal which may be exercised within the said period; or (b) any other share, if-
\item[] (i) the holder has a right of disposal in respect of such share which may be exercised within a period of three years from the date of issue thereof or at the time of issue of that share, the existence of the company issuing that share is to be terminated within a period of three years or is likely to be terminated within such period upon a reasonable consideration of all the facts at the time that share is issued; and
\item[] (ii) such share does not rank \textit{pari passu} as regards its participation in dividends with all other ordinary shares in the capital of the relevant company or, where the ordinary shares in such company are divided into two or more classes, with the shares of at least one of such classes, or any dividend payable on such share is to be calculated directly or indirectly with reference to-
\begin{itemize}
\item[] (aa) any specified rate of interest;
\item[] (bb) the amount of capital subscribed for such share; or
\item[] (cc) the amount of any loan or advance made directly or indirectly by the shareholder or by any connected person in relation to the shareholder.’
\end{itemize}
\item[] \textsuperscript{39} DL Dodd & B Graham \textit{Security Analysis} (2009) 113-115.
\item[] \textsuperscript{40} Delport (n 33 above) 33 n 40.
\item[] \textsuperscript{41} 71 of 2008.
\item[] \textsuperscript{42} See Delport (n 33 above) 33 n 40.
\end{itemize}
repeated in section 37(5)(a) of the Companies Act, but the same principle of restriction is applied to other constituent personal rights. This also has the effect of rendering Graham and Dodd’s standard patterns relating to ‘bonds’ (i.e. debentures or debt instruments), ‘preferred shares’ (i.e. preference shares) and ‘common stock’ (i.e. ordinary shares) superfluous.

The question then pertains to the pre-empted existence and nature of an ‘indirect approach’, and this is hinted at in Merrill Lynch and Capgemini’s categorisation as alternative investments. This is a poor term relating to a range of eclectic investment or speculation products, inter alia structured finance. Structured finance products have been classified as ‘new financial products’, although, as outlined elsewhere, this may be a contentious point. Securitisations are res ipsa loquitur within the ambit of structured finance. In securitisations, although interest is expressed in the nature of eventually issued securities, the primary concern is not the capital raised by the issue of securities on the primary market or subsequent trading on the secondary market. On the contrary, securitisations pertain to the transfer of assets or securities from one institution to another institution – which may be based on various concepts from corporate finance – with the latter institution being entrusted with the issuing if securities based on the aforementioned assets or securities. It would not be legally pure to argue from basic principles that in an indirect or partially funded synthetic securitisation scheme the transferring institution holds an indirect

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43 71 of 2008.
44 See Delport (n 33 above) 33 n 40.
45 Dodd & Graham (n 39 above) 112 et seq.
46 Companies Act 61 of 1973 sec 116 et seq.
47 Companies Act 71 of 2008 sec 43.
48 Dodd & Graham (n 39 above) 112 et seq.
49 Cilliers et al (n 12 above) 227 et seq.
50 Dodd & Graham (n 39 above) 112 et seq.
51 Cilliers et al (n 12 above) 232.
52 Delport (n 33 above) 33 n 40.
53 Associates of Merrill Lynch & Capgemini (n 38 above) 125.
55 Associates of Merrill Lynch & Capgemini (n 38 above) 125.
56 As above.
57 Fleuriet (n 54 above) 200.
58 Ch 2 para 3 above.
60 Or, it may rather be said that that is simply one of the facets of securitisation, which justifies without prejudice the position of those parties primarily interested in raising capital on the primary market in a securitisation scheme.
61 This is mention from a technical and from a structural perspective on securitisations. As already stated elsewhere, profit optimisation is the classical key, but then again it is the common denominator in so many mercantile impetuses.
interest in the raising of capital by the SPI; however, given that transferring institution may hold twenty percent of share capital in the SPI, such an interest in the SPI’s capital may sprout from shareholding.

There is no doubt that the basic securities law employed in cases of textbook corporate finance and textbook structured finance is often the same; therefore, given the apparent divergence in commerce between corporate finance and structured finance, it is common cause that the translation of corporate finance in commerce to securities law in law was premature. It is the same basic company law and the same securities law that would apply in both cases. An example is the common denominator of the economic duty of the company to use its resources for the best alternatives forgone, which has been explained elsewhere. Legally, this partially translates as the fiduciary duties of the directors to act bona fide in the best interest of the shareholders at common law level. This fragmented rendition is ascribed to the principle that fiduciary duties can only be violated by commissio. Even though fiduciary duties have now been codified, section 66(1) of the Companies Act now irrationally renders the statutory variant as the best interests of the directors. At best a jurist may apply the rule in Johannesburg Municipality v Cohen’s Trustees that the statutes must be interpreted in accordance with the common law. These principles not only apply to the SPI in the case of an indirect synthetic securitisation, but also to a company in terms of corporate finance.

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62 n 1 above, para 5(2)(p)(i)(A).
63 Australian Securities and Investment Commission v Rich (2009) NSWSC 1229, as quoted in Delport (n 33 above) 94 n 91. It appears from the judgment of Austin J that the matter related to the duty to care and skill and consequently its interplay with the business judgment rule [Australian Securities and Investment Commission v Rich (2009) NSWSC 1229 23 et seq].
64 Companies Act 71 of 2008 sec 76(3).
65 71 of 2008.
67 1909 TS 811 823, as quoted in Botha (n 27 above) 45.
3 Banks and the business of a bank

3.1 The concept of a bank in brief

In South Africa, a ‘bank’ is defined as ‘a public company registered as a bank in terms of this Act’.68 ‘[T]his Act’ is defined as ‘includ[ing] the regulations’.69 The plural ‘regulations’ is unspecified; the singular means ‘a regulation made under section 90’.70 The section 90 heading again employs the plural, with the provision of section 90(1)(a) seemingly encapsulating the section 1 ‘regulation[s]’. The author assumes that the said plural and singular forms are analogous.

In Germany, the Gesetz über das Kreditwesen71 defines ‘bank’ or terminology wherein the word ‘bank’ appears, unless provided otherwise, as a company name or an addendum to a company name for either describing the main purpose or for advertising,72 and may only be used by authorised credit institutions73 or enterprises carrying such designation upon the implementation of the Gesetz.74 The vast Canadian Bank Act,75 on the other hand, provides no substantial definition of ‘bank’, although it is classified as a federal financial institution.76 Section 2 provides that “bank” means a bank listed in Schedule I or II’, whilst the provided schedules merely constitute lists of bank names, fortunately supplying legal certainty.

3.2 The business of a bank

3.2.1 Banks Act 94 of 1990

External equity constitutes various accountable categories.77 Some content as to debt instruments has already been supplied,78 such as the possible legislative blunder that excludes loans and promissory notes from the ambit of so-called ‘debt instruments’.79 The ‘American rule’80 has diluted the capital maintenance rule’s symbiosis between primary with secondary investors81.

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68 Banks Act 94 of 1990 sec 1.
69 As above.
70 As above.
71 ‘Banking Act’.
72 Gesetz über das Kreditwesen sec 39(1).
73 As above.
74 As above.
75 SC 1991 c 46.
77 Cilliers et al (n 12 above) 200 et seq.
78 See ch 7 para 4.2.2 Consideration whether CLNs are regulated as commercial paper above.
79 Companies Act 71 of 2008 sec 43(1)(a)(ii).
80 Companies Act 71 of 2008 sec 4.
81 Cilliers et al (n 12 above) 199.
(where joint stock capital satisfying creditor claims on liquidation).\textsuperscript{82} Although the common law defines shares, the accounting reckoning of its value is loosely based on annuity calculation,\textsuperscript{83} being imperfect due to the prevalence of economic spei.\textsuperscript{84} Whereas annuity calculation for debentures is realistic, they have no common law definition.\textsuperscript{85} ‘The new provisions [in the Companies Act 71 of 2008] are simplified, but there is still no definition of a debenture, perhaps wisely so’\textsuperscript{86} – this opinion conceivably conforms to the National Economic Development and Labour Council’s (NEDLAC) aims, explained by the Department of Trade and Industry (DTI) to the Parliament Portfolio Committee on Trade and Industry on 10 May 2007,\textsuperscript{87} or to the purposes of the Companies Act.\textsuperscript{88} South African courts\textsuperscript{89} have relied on foreign case law\textsuperscript{90} to identify possible descriptions and contemplate a common denominator: the acknowledgment of debt.\textsuperscript{91}

However, it is submitted that Ward J’s induction is questionable – the approach would have been appropriate if the court aspired to identify a common denominator in case law, rather than ascertain a definition.

Even though codified company law is subject to codified banking law,\textsuperscript{92} it is \textit{res ipsa loquitur} that not all companies with external equity constitute banks. Debt instruments are to be compared with the definition of ‘deposit’ and ‘commercial paper’ in order to ascertain the applicability of the Banks Act\textsuperscript{93}. If the commercial paper issued by a special-purpose institution falls within the latter

\begin{footnotes}
\item[82] Cilliers \textit{et al} (n 12 above) 322 \textit{et seq}.
\item[84] Wessels (n 66 above) 16.
\item[86] F Cassim, D Davis & W Geach (eds) \textit{Companies and other business structures in South Africa} (2009) 52.
\item[87] The interpretative value of this was expressed in \textit{S v Dzukuda; S v Tilly; S v Tshilo} 2000 3 SA 229 (W) 233 as quoted in Botha (n 27 above) 85 and \textit{De Reuck v Director of Public Prosecutions, Witwatersrand Local Division} 2003 3 SA 389 (W) as quoted in Botha (n 27 above) 85.
\item[88] Companies Act 71 of 2008 sec 7.
\item[89] \textit{Coetzee v Rand Sporting Club} 1918 WLD 74 712 as quoted in M Vermaas (ed) ‘Capital structure: Shares and debentures’ in Pretorius (n 85 above) 171.
\item[90] \textit{English and Scottish Mercantile Investment Co v Brunton} (1892) 2 QB 700 as quoted in M Vermaas (ed) ‘Capital structure: Shares and debentures’ in Pretorius (n 85 above) 171.
\item[91] As above.
\item[92] Companies Act 71 of 2008 sec 5(4)(b)(i)(gg).
\item[93] 94 of 1990.
\end{footnotes}
definitions, then such issue would be ‘the business of a bank’. However, ‘the business of a bank’ contains express exclusions, the most important being paragraph (cc) for purposes of this work:

‘any activity of a public sector, governmental or other institution, or of any person or category of persons, designated by the Registrar, with the approval of the Minister, by notice in the Gazette, provided such activity is performed in accordance with such conditions as the Registrar may with the approval of the Minister determine in the relevant notice…’

Section 2 of the Banks Act provides that, in so far as the Banks Act imposes requirements with which institutions must comply before it may carry on the business of a bank, or in the lawful carrying on of the business of a bank, such provisions shall not apply to certain institutions. This provision is confusing since the reference to compulsory statutory requirements is followed by exclusions from such compulsory statutory requirements, with a list of excluded institutions to follow, which does not obviate the reference to compulsory statutory requirements. Nonetheless, the dual qualification is defined both a priori and in the present perfect. A contemplation of paragraph (a) may render the rationale for the phraseology as ex visceribus actus a misgiving. It refers to Chapter III in which section 11(1) and section 12(1) provide an unmentioned significant qualification: The dependence of the execution of the business of a bank on the person undertaking such conduct as being both a public company and registered as a bank in terms of the Banks Act. In the light of the section 1 definition of a ‘bank’ the substance of section 11(1) is redundant. Its purpose in indicating that registration refers to registration as a bank is superfluous, since the section definition of a ‘bank’ already provides for such a deduction. Section 12(1) expressly provides that authorisation is required by the aspiring institution, wishing to conduct the business of a bank, to establish such a bank in the first instance.

Whereas certain institutions are expressly excluded from the said provisions of the Act, certain schemes also resort beyond the ambit of ‘the business of a bank’, such as ‘securitisation

94 Banks Act 94 of 1990 sec 1.
95 As above.
96 As above.
97 Banks Act 94 of 1990.
98 Banks Act 94 of 1990 sec 2.
schemes’, consequently involving disintermediation, which is the ‘substitute[ion] [of] capital market-based finance for credit finance by sponsoring financial relationships without the lending and deposit-taking [sic.] capabilities of banks’. Financial and monetary statistics categorise SPIs as ‘other financial intermediaries’, resorted in the private-sector. This discrepancy from the monetary sector requires elucidation. Money is officially measured as either M1 or M2, the former being pure means of payment such as currency, traveler’s cheques and chequeing deposits, and the latter being means of payment and liquid assets such as deposits, including time deposits and savings deposit, money market mutual funds and including M1. SARB is a monopolist in the issue of a monetary base, the latter being the sum of banks’ deposits at the SARB, and domestic notes and coins, otherwise known as ‘reserves’. Whereas the reserve ratio is then the fluctuating ratio of reserves to M1 or/and M2, the required reserve ratio is compulsory and the desired reserve ratio is in excess of the latter based on the bank’s business needs. The difference between actual reserves and desired reserves is known as excess reserves. Monetary base and excess reserve are directly proportional. Subsequent to an open market operation, bank deposits and consequent money quantities increase with an ensuing currency drain. Therefore, Gumata and Mokoena’s statement above is based on SPIs not classifying as depository institutions in the monetary sector.

99 Schedule (n 1 above) 3.
100 Jobst (n 59 above) 733.
101 Jobst (n 59 above) 733.
103 As above.
105 M Parkin ‘Money, the price level, and inflation’ in CFA Institute (n 104 above) 362-362.
106 M Parkin ‘Money, the price level, and inflation’ in CFA Institute (n 104 above) 363.
107 As above.
108 As above.
109 M Parkin ‘Money, the price level, and inflation’ in CFA Institute (n 104 above) 459.
110 M Parkin ‘Money, the price level, and inflation’ in CFA Institute (n 104 above) 374-375.
111 M Parkin ‘Money, the price level, and inflation’ in CFA Institute (n 104 above) 375.
112 As above.
113 As above.
114 As above.
115 As above.
116 As above.
118 M Parkin ‘Money, the price level, and inflation’ in CFA Institute (n 104 above) 376.
119 M Parkin ‘Money, the price level, and inflation’ in CFA Institute (n 104 above) 376.
120 M Parkin ‘Money, the price level, and inflation’ in CFA Institute (n 104 above) 375-376.
121 M Parkin ‘Money, the price level, and inflation’ in CFA Institute (n 104 above) 364 et seq.
3.2.2 The business of a bank as a punitive measure

Judiciary attention has been drawn to the exclusion of securitisation from the business of a bank through the institution of proceedings by The New Economic Rights Alliance (NEWERA), an organisation with the objective of providing non-financial support to victims of corporate profit optimisation.\textsuperscript{122} The basic focus seems to be natural human rights,\textsuperscript{123} although it is uncertain what this term denotes. Given that the term ‘fundamental human rights’ would constitute an oxymoron, the term utilised seems to denote something else. The Preamble to the NEWERA constitution indicates that it aims at undermining the principle of \textit{pacta sunt servanda} if a party to a contract should find the contract in violation of such ‘natural human rights’.\textsuperscript{124} Furthermore, in a manner reminiscent of Jean-Jacques Rousseau, the Preamble seems to denigrate the principle of separate legal existence in favour of natural persons\textsuperscript{125} – bearing in mind that NEWERA itself is a NPC – as well as the economic principle of discounting\textsuperscript{126} and the classical aim of profit optimisation\textsuperscript{127} in favour of altruism. No mention is made of the enlightened shareholder approach.

On 19 December 2012, NEWERA issued an urgent application in the South Gauteng Division\textsuperscript{128} against the major South African banks,\textsuperscript{129} seeking interim restraint of debt collections and possible consequent judgments,\textsuperscript{130} review of existing judgments,\textsuperscript{131} and surrender of judgments against members of NEWERA,\textsuperscript{132} all based on securitisation.\textsuperscript{133} Part A of the application was ostensibly struck from the role due to lack of urgency,\textsuperscript{134} with costs \textit{de bonis propriis} subject to a rule \textit{nisi}.\textsuperscript{135} Two interlocutory applications were issued,\textsuperscript{136} both opposed by NEWERA.\textsuperscript{137} Despite intermittent

\textsuperscript{123} As above.
\textsuperscript{124} The New Economic Rights Alliance (n 122 above) para 3(2).
\textsuperscript{125} The New Economic Rights Alliance (n 122 above) para 3(3).
\textsuperscript{126} The New Economic Rights Alliance (n 122 above) para 3(4).
\textsuperscript{127} The New Economic Rights Alliance (n 122 above) para 3(5).
\textsuperscript{129} ‘Applicants practice notes’ (n 128 above) para 5.
\textsuperscript{130} ‘Applicants practice notes’ (n 128 above) para 6.1.
\textsuperscript{131} ‘Applicants practice notes’ (n 128 above) para 6.2.
\textsuperscript{132} ‘Applicants practice notes’ (n 128 above) para 6.3.
\textsuperscript{133} ‘Applicants practice notes’ (n 128 above) para 7.
\textsuperscript{134} ‘Applicants practice notes’ (n 128 above) para 11.
\textsuperscript{135} ‘Applicants practice notes’ (n 128 above) para 26.
\textsuperscript{136} ‘Applicants practice notes’ (n 128 above) para 12.
\textsuperscript{137} ‘Applicants practice notes’ (n 128 above) para 13.
procedural events, the crux is that NEWERA eventually failed to appear in court to argue costs. On the return date of the rule nisi, the matter was heard by Baqwa J, who confirmed the cost order and confirmed the proceedings instituted as vexatious.

However, on 31 August 2011, Blakes Maphanga Attorneys, acting for SBSA, mentioned per email to a client of SBSA that Blue Granite, a SPI of SBSA in a securitisation transaction, constituted a subsidiary. In the applicants’ practice notes in the matter of Investec Bank Ltd & Others v The New Economic Rights Alliance (NPC), counsel for the applicants indicated that Investec Bank Ltd’s co-respondents, being SPI’s, constituted subsidiaries. Baqwa J noted this in his judgement of that case. This constitutes non-compliance with paragraph 5(2)(o)(i)(A) of the Schedule, which could have triggered the application of paragraph 17 of the Schedule. The reason for the latter choice of past participle is based on the discrepancy between the effect of non-compliance by a non-bank institution and a bank. Should non-compliance be established, where relevant, the application of chapter VIII of the Banks Act would be triggered, the direct result would be that the Registrar may lodge application proceedings in the High Court to, in short, prohibit the contravention. The indirect result would be that the securitisation scheme would be regarded as being in the business of a bank, which would nullify the subsequent benefits that the scheme was created to gain from circumvention of banking regulation.

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138 'Applicants practice notes’ (n 128 above) paras 20, 21.
139 'Applicants practice notes’ (n 128 above) para 22.
141 'Judgment’ (n 140 above) para 31.
143 South Gauteng High Court, Case nr 48102/2012.
144 'Applicants practice notes’ (n 128 above) para 5.
145 ‘Judgment’ (n 140 above) para 3.3.
146 n 1 above.
147 As above.
148 Schedule (n 1 above) para 17.
149 Schedule (n 1 above) para 17(2).
150 94 of 1990.
151 Schedule (n 1 above) para 17(2).
152 Banks Act 94 of 1990 sec 81(1).
153 Schedule (n 1 above) para 17(1).
3.2.3 Canada

Historically, ‘banks’ and ‘the business of a bank’, as legally distinct concepts, were a discrepancy already referred to in Canada in the 1930s. The discrepancy between being a bank and carrying on the business of a bank was evident in In re Dominion Trust Co. and U.S. Fidelity Claim, in which the court held that the mere corporate performance of services analogous to those of banks does not indicate its carrying on of banking business, nor is it ultra vires of a Provincial Legislation to authorise a company to carry on that division of banking which entails the performance of such services.

Presently, Canada’s Bank Act not only provides no definition of ‘deposit’, but also provides no definition of ‘banking business’ or ‘business of a bank’. Although references are made to the latter, its consideration is distinguishable from the statutory-specific South African context above. Canadian securitisations do not appear exempted from banking legislation, since the Bank Act is ‘the charter of and applies to each bank.’ Even more interesting is the role that the banking regulatory bodies assume with regards to securitisations. OSFI, a division or branch of federal public administration under the definition of ‘department’ may publish applicable guidelines. As such, the Guideline: Capital Adequacy Requirements: Chapter 7 – Structured Credit Products, apply to all banks, to determine the applicable capital adequacy.

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155 FC Auld & WR Riddell (eds) An abridgment of banking and bills of exchange cases (1936) 7 et seq.
156 (1918) 3 WWR 1023 26 BCR 339.
157 SC 1991 c 46.
159 Para 3.2.2 above.
162 Financial Administration Act RSC 1985 c. F-11 sec 1 para (a.1) of the definition of ‘appropriate Minister’, read with Schedule I.1.
163 Financial Administration Act RSC 1985 c. F-11 sec 2 para (a.1) of the definition of ‘department’.
164 E.g. Corporation Capital Tax Regulation BC Reg 199/2002 sec 1(1) definition of ‘asset securitization guidelines’; see Beaudin (n 160 above).
166 n 165 above, sec 7.1 para 4.
167 n 165 above, Preamble.
being aware of esoteric variations of securitisation schemes, the applicable regulatory ambit has been widened to subject the aforementioned to economic, rather than legal, consideration.\textsuperscript{168} Capital adequacy for a transferring bank is mitigated if the transferor has no shares in a SPI,\textsuperscript{169} if the transferor’s name or symbolic close association is excluded from the SPI,\textsuperscript{170} if the transferor has none of its directors, officers or employees on the SPI’s Board (except if the SPI has at least 3 Board members),\textsuperscript{171} the transferor does not extend credit to the SPE on a subordinated basis,\textsuperscript{172} and the transferor does not support, except as provided elsewhere in the Guideline: Capital Adequacy Requirements: Chapter 7 – Structured Credit Products,\textsuperscript{173} the SPI’s losses or recurring expenses, or investors in the SPI.\textsuperscript{174} Banks are now required to have capital adequacy against securitisation exposures,\textsuperscript{175} which includes exposures arising from credit risk mitigants,\textsuperscript{176} holding of ABSs,\textsuperscript{177} holding a subordinated tranche,\textsuperscript{178} and credit enhancement or liquidity facilities extended.\textsuperscript{179} Whilst the latter two are \textit{res ipsa loquitur} in South African law, the holding of a subordinated tranche would not be applicable.\textsuperscript{180} It is interesting to note that capital requirements are required even in the case of synthetic securitisations. A more important question is whether the SPI must abide by capital requirements.

OSFI ‘expects’\textsuperscript{181} a minimisation of exposure by a transferor to risk ‘arising from its relationship with an SPE.’\textsuperscript{182} Although it appears from the aforementioned as if there is no prohibition of any quantity of shareholding of a transferring bank in a SPI, it is doubtful whether a transferring bank in practice would act to its own financial detriment by incurring capital adequacy through shareholding in a SPI. However, should a SPI be a subsidiary of the transferring bank, it is

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{168} Office of the Superintendent of Financial Institutions in Canada (n 165 above) sec 7.4.1 para 44.
\item \textsuperscript{169} Office of the Superintendent of Financial Institutions in Canada (n 165 above) sec 7.2.9 para 33.
\item \textsuperscript{170} As above.
\item \textsuperscript{171} As above.
\item \textsuperscript{172} As above.
\item \textsuperscript{173} Office of the Superintendent of Financial Institutions in Canada (n 165 above).
\item \textsuperscript{174} Office of the Superintendent of Financial Institutions in Canada (n 165 above) sec 7.2.9 para 33.
\item \textsuperscript{175} Office of the Superintendent of Financial Institutions in Canada (n 165 above) sec 7.4.1 para 44.
\item \textsuperscript{176} As above. For the meaning of credit risk mitigants, see Office of the Superintendent of Financial Institutions in Canada (n 165 above) sec 7.4.3(v) para 75.
\item \textsuperscript{177} As above.
\item \textsuperscript{178} As above.
\item \textsuperscript{179} As above.
\item \textsuperscript{180} Schedule (n 1 above) para 5(2)(h)(i).
\item \textsuperscript{181} Office of the Superintendent of Financial Institutions in Canada (n 165 above) sec 7.2.9 para 33.
\item \textsuperscript{182} As above.
\end{itemize}
\end{footnotesize}
uncertain whether the SPI would incur capital adequacy: The argument against such capital adequacy is the fact that the definition of a bank, as already set out herein, contains no reference to subsidiaries; the argument for such capital adequacy is the fact that the statutory definition of a foreign bank\textsuperscript{183} excludes subsidiaries with the resulting presumption that non-foreign banks would include subsidiaries, and that management of risk concentration must extend to subsidiaries in securitisation.\textsuperscript{184}

\subsection*{3.2.4 Germany}

The \textit{Gesetz über das Kreditwesen}\textsuperscript{185} defines ‘bank’ or terminology wherein the word ‘bank’ appears, unless provided otherwise, as a company name or an addendum to a company name for either describing the main purpose or for advertising,\textsuperscript{186} and may only be used by authorised credit institutions\textsuperscript{187} or enterprises carrying such designation upon the implementation of the \textit{Gesetz}.\textsuperscript{188} ‘Credit institutions’ are ‘enterprises which conduct banking business commercially or on a scale which requires a commercially organised business undertaking’.\textsuperscript{189} Furthermore, the definition of ‘[c]redit institutions’ also includes the ambit of the term ‘[b]anking business’,\textsuperscript{190} which comprises \textit{inter alia} ‘the acceptance of funds from others as deposits or of other unconditionally repayable funds from the public, unless the claim to repayment is securitised in the form of bearer or order bonds, irrespective of whether or not interest is paid (deposit business)’.\textsuperscript{191}

According to Meier and Kern, it is trite that SPI’s do not require ‘licensing’ since securitisations do not involve the transfer of undrawn commitments.\textsuperscript{192} Although the term ‘licensing’ does not appear in the Deutsche Bundesbank’s unofficial translation of the \textit{Gesetz über das Kreditwesen}, its \textit{quasi}-synonym, ‘authorisation’, is likely applicable: Authorisation from BaFin is required to conduct banking business or provide financial services commercially or on a scale which requires

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{183} Bank Act SC 1991 c 46 sec 2.
\item \textsuperscript{184} Office of the Superintendent of Financial Institutions in Canada (n 165 above) Appendix 7-3 part A para 1.
\item \textsuperscript{185} ‘Banking Act’.
\item \textsuperscript{186} \textit{Gesetz über das Kreditwesen} sec 39(1).
\item \textsuperscript{187} \textit{Gesetz über das Kreditwesen} sec 39(1) sentence 1.
\item \textsuperscript{188} \textit{Gesetz über das Kreditwesen} sec 39(1) sentence 2.
\item \textsuperscript{189} \textit{Gesetz über das Kreditwesen} sec 1(1).
\item \textsuperscript{190} \textit{Gesetz über das Kreditwesen} sec 1(1).
\item \textsuperscript{191} \textit{Gesetz über das Kreditwesen} sec 1(1) sentence 1.
\item \textsuperscript{192} W Meier & M Kern ‘Germany’ in S Kidd et al (eds) \textit{The international comparative legal guide to: Securitisation} 2012 (2012) 160.
\end{itemize}
\end{footnotesize}
a commercially organised business undertaking.\textsuperscript{193} Since ‘banking business’ is the \textit{forte} of credit institutions,\textsuperscript{194} and section 39(1) sentence 1 hints at authorisation of credit institutions, authorisation in section 32(1) presumably includes credit institutions. From this it is \textit{res ipsa loquitur} that (revolving)\textsuperscript{195} securitisations in German law resort beyond ‘banking business’, except in the case of factoring services providers.\textsuperscript{196}

This situation has been supplemented by the \textit{Richtlinie 2006/48/EG des Europäischen parlaments und des rates vom 14. Juni 2006 über die Aufnahme und Ausübung der Tätigkeit der Kreditinstitute (Neufassung)}, which provides that provisions must be adopted to guarantee the risk-based and regulatory sound treatment of securitisations to ensure that the risks and risk mitigation effects thereof are reflected in their capital requirements.\textsuperscript{197} It is apparent from German law that a specific study of this matter would better resort within an economic study. Whilst the definition of \textit{synthetische Verbriefung}\textsuperscript{198} expressly refers to banks\textsuperscript{199} – and nothing in said \textit{Richtlinie} excluding capital adequacy from synthetic securitisation – the definition of \textit{Originator} widely refers to an \textit{Unternehmen}\textsuperscript{200} and contains no reference to banks.\textsuperscript{201} This may be an example of unscrupulous legislative drafting, since a \textit{Kreditinstitut}\textsuperscript{202} is defined as an \textit{Unternehmen}.\textsuperscript{203} The risk-weighted capital adequacy is alluded to in section 95 of the \textit{Richtline}, although exceptions, not materially different from the Canadian circumstances, are provided for.\textsuperscript{204} However, such provisions all relate to the originator, and not the SPI. The definition of \textit{Zweckgesellschaft}\textsuperscript{205} expressly excludes the

\begin{itemize}
\item \textsuperscript{193} \textit{Gesetz über das Kreditwesen} sec 32(1).
\item \textsuperscript{194} \textit{Gesetz über das Kreditwesen} sec 1(1).
\item \textsuperscript{195} W Meier & M Kern ‘Germany’ in Kidd \textit{et al} (n 192 above) 160.
\item \textsuperscript{196} As above; \textit{Gesetz über das Kreditwesen} sec 1(1b) sentence 9.
\item \textsuperscript{197} \textit{Richtlinie 2006/48/EG des Europäischen parlaments und des rates vom 14. Juni 2006 über die Aufnahme und Ausübung der Tätigkeit der Kreditinstitute (Neufassung)} Preamble para 44.
\item \textsuperscript{198} ‘Synthetic securitisation’
\item \textsuperscript{200} ‘Enterprise’.
\item \textsuperscript{202} ‘Bank’.
\item \textsuperscript{204} \textit{Richtlinie 2006/48/EG des Europäischen parlaments und des rates vom 14. Juni 2006 über die Aufnahme und Ausübung der Tätigkeit der Kreditinstitute (Neufassung)} Anhang IX Teil 2 para 2(2).
\item \textsuperscript{205} ‘Special purpose institution’.
\end{itemize}
SPI from being considered a bank.\textsuperscript{206} It appears from this that a SPI would not have to comply with capital requirements.

4 \hspace{1em} \textbf{Commercial paper in synthetic securitisation schemes}

4.1 Commercial paper as defined in paragraph 1 of the Schedule

The term ‘commercial paper’ is expressly defined in the Schedule.\textsuperscript{207} Despite this definition, the term does not appear in the Companies Act,\textsuperscript{208} the Companies Regulations,\textsuperscript{209} the Banks Act\textsuperscript{210} or the Regulations relating to banks.\textsuperscript{211} Whereas paragraph (b) of said definition specifically refers to debentures, the nature of debt instruments has been indirectly discussed elsewhere.\textsuperscript{212} Paragraph (a) and paragraph (b) of said definition refers to written acknowledgements of debt. Fortunately, it has already been held that debentures may constitute ‘an instrument acknowledging…debt’.\textsuperscript{213} The adjective, ‘written’, casts uncertainty on commercial paper falling within the ambit of said paragraph (a), since it may indicate that such commercial paper is a negotiable instrument, or that its written form may be purely evidential. The only interpretative tool for the jurist in this case is the principle of \textit{noscitur a sociis}.\textsuperscript{214} Is there a common denominator\textsuperscript{215} prevalent to provide insight into the applicable teleology?


\textsuperscript{207} Schedule (n 1 above) para 1: ‘“commercial paper” means—

(a) any written acknowledgement of debt, irrespective whether the maturity thereof is fixed or based on a notice period, and irrespective whether the rate at which interest is payable in respect of the debt in question is a fixed or floating rate; or

(b) debentures or any interest-bearing written acknowledgement of debt issued for a fixed term in accordance with the provisions of the Companies Act; or

(c) preference shares, but does not include bankers' acceptances.’

\textsuperscript{208} 71 of 2008.


\textsuperscript{210} 94 of 1990.


\textsuperscript{212} Ch 7 para para 4.2.2 \textit{Consideration whether CLNs are regulated as commercial paper} above.

\textsuperscript{213} M Vermaas (ed) ‘Capital structure: Shares and debentures’ in Pretorius (n 85 above) 171.

\textsuperscript{214} Botha (n 27 above) 107-108.

\textsuperscript{215} \textit{Colonial Treasurer v Rand Water Board} 1907 TS 479 as quoted in Botha (n 27 above) 107.
Paragraph (a) of said definition contains a reference to counter-performance based on a fixed or floating rate. Fixed income, although a widely employed term with regards to debt instruments, can in certain instances constitute a misnomer. Debt instruments have traditionally been juxtaposed to shares on the bases of *inter alia* investment *versus* speculation and safety *versus* risk. This flows from a proposed definition of ‘investment’ which points to safety of principal and satisfactory returns. However, investment banks have introduced ‘new financial products’ within this fixed-income business sphere that have features contrary to the plain-vanilla archetype, such as Merrill Lynch’s liquid yield option notes (LYONs) that constitute zero coupon convertible debt instruments. Fortunately, this is excluded through the imperative of interest in the definition of commercial paper. Although still fixed-income instruments, subordinated debt provide little safety due to their unsecured nature and junior priority in payment and are therefore speculative. Another economic right intrinsic in some debt instruments is the right to counter-performance based on a floating rate. The London Interbank Offered Rate (LIBOR) – the interest rate at which a bank borrows funds from another bank in terms not exceeding one year – is an example of a floating rate. Not only does this rate differ between banks, but it is also subject to supply and demand. The British Bankers Association (BBA) calculates the LIBOR fix (alias the BBA LIBOR rates) daily for varying terms by utilising the sixteen most active banks per currency, ignoring the four lowest and highest rates and calculating an average on the resultant eight rates. Two interesting aspects of LIBOR is the paradox that inter-bank lending is risky whilst its short term and quality of participants renders it low risk, and, albeit a short term rate, it does not necessarily presuppose utilisation only in ABCP’s. It is significant for our purposes to remember that the applicable loan transactions may

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216 Graham & Dodd (n 39 above) 102.
217 Fleuriet (n 54 above) 200 *et seq.*.
218 Fleuriet (n 54 above) 192.
219 Fleuriet (n 54 above) 200.
220 See n 207 above.
221 Fleuriet (n 54 above) 201.
224 As above.
225 Chaplin (n 222 above) 4.
226 Taylor (n 223 above) 18-19.
227 Taylor (n 223 above) 18.
228 As above; Chaplin (n 222 above) 4.
229 Chaplin (n 222 above) 4.
230 Taylor (n 223 above) 19.
involve a party that is not a bank; therefore, an additional margin,\textsuperscript{231} known as the credit spread,\textsuperscript{232} will be included in the rate, e.g. \(x\text{-month LIBOR} + y\%\).\textsuperscript{233} Therefore, safety in investment cannot be the common denominator.

The inclusion of preference shares, a hybrid security, obfuscates the present analysis further. Preference shares are not statutorily defined in South African law, although the Income Tax Act\textsuperscript{234} classifies preference shares as hybrid equity instruments.\textsuperscript{235} The reference to preference shares at paragraph (c)\textsuperscript{236} is understandable – these hybrid securities\textsuperscript{237} constitute fixed-value investments.\textsuperscript{238} Two considerations must constantly be borne in mind: Firstly, these instruments are considered shares in the Companies Act,\textsuperscript{239} and secondly, unlike debt instruments that may have a guaranteed annual income,\textsuperscript{240} inadequate profits may render the value of preference shareholder’s annual entitlement to as little as zero.\textsuperscript{241} However, the latter may be a rationale in the SPI’s issue of preference shares, since it retains the income feature contrary to zero coupon bonds, yet provides the SPI with suppleness with regards to dividend declaration in bear markets,\textsuperscript{242} even if the preference shares are cumulative.\textsuperscript{243} Readers must bear in mind that convertibility\textsuperscript{244} is limited by the denotative ambit of commercial paper.\textsuperscript{245}

However, ‘preference share’ has an express definition in terms of the Schedule.\textsuperscript{246} Firstly, the wording of the definition seems to indicate that more than one class of preference share may be issued by the SPI, and that preference shares forming part of the joint stock capital of the SPI will

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{231} As above.
\item \textsuperscript{232} As above.
\item \textsuperscript{233} As above.
\item \textsuperscript{234} 58 of 1962.
\item \textsuperscript{235} See n 38 above.
\item \textsuperscript{236} See n 207 above.
\item \textsuperscript{237} Cilliers \textit{et al} (n 12 above) 226 fn39.
\item \textsuperscript{238} Graham & Dodd (n 39 above) 190 \textit{et seq}.
\item \textsuperscript{239} Delport (n 33 above) 33-35.
\item \textsuperscript{240} Cilliers \textit{et al} (n 12 above) 237; G Arnold \textit{The Financial Times guide to investing} (2010) 198.
\item \textsuperscript{241} Arnold (n 240 above) 198.
\item \textsuperscript{242} Arnold (n 240 above) 198.
\item \textsuperscript{243} Cilliers \textit{et al} (n 12 above) 227; Arnold (n 240 above) 199.
\item \textsuperscript{244} Cilliers \textit{et al} (n 12 above) 230; Arnold (n 240 above) 199.
\item \textsuperscript{245} See n 207 above.
\item \textsuperscript{246} n 1 above, para 1: “‘preference share’, when issued by a special-purpose institution that is a company, means such preference shares not forming part of the equity share capital of the special-purpose institution.’
\end{itemize}
\end{footnotesize}
not be designated ‘preference share[s]’ in terms of the Schedule.\textsuperscript{247} Secondly, any share, of which a preference share is merely a common law class of share,\textsuperscript{248} consists of personal rights\textsuperscript{249} that can be grouped into economic \textit{spei} and control rights.\textsuperscript{250} Any exclusion of such rights does not detract from the fact that it constitutes a share. However, its exclusion from the joint stock capital is nonsensical.

In conclusion, it is uncertain whether the adjective ‘written’ refers to value paper or has an evidentiary basis. It does not \textit{de facto} necessarily refer to a consequential series of performances, as much as it does not \textit{de facto} necessarily refer to equal quantities of performance. Rather, it appears to refer \textit{de iure} to an economic right to performance that is \textit{a priori} contractually determinable, and if not rendered in a consequential series, it may be cumulative.

\textbf{4.2 Commercial paper in terms of the Commercial Paper Notice}

The express exclusion of bankers’ acceptances in said definition of commercial paper is reminiscent of another instrument issued in terms of another schedule\textsuperscript{251} to the Banks Act,\textsuperscript{252} the activity of which also falling outside the ambit of the business of a bank.\textsuperscript{253} The Schedule contains an express reference to this.\textsuperscript{254} Although the Schedule commences with the wording at paragraph 14(1)(a) that ‘Notwithstanding anything to the contrary contained in the Commercial Paper Notice…’, this does not seem to \textit{a priori} exclude commercial paper in terms of the Commercial Paper Notice\textsuperscript{255} \textit{en toto}. The Commercial Paper Notice\textsuperscript{256} defines commercial paper expressly.\textsuperscript{257}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{247} n 1 above.
\item \textsuperscript{248} Delport (n 33 above) 32 \textit{et seq}.
\item \textsuperscript{249} M Vermaas (ed) ‘Capital structure: Shares and debentures’ in Pretorius (n 85 above) 149.
\item \textsuperscript{250} As above.
\item \textsuperscript{251} South Africa (1994) Designation of an activity not falling within the meaning of ‘the business of a bank’ (commercial paper) (Government Notice No 2172, 1994) \textit{Government Gazette} 16167, December 14 (Commercial Paper Notice).
\item \textsuperscript{252} 94 of 1990.
\item \textsuperscript{253} Commercial Paper Notice (n 251 above) Preamble.
\item \textsuperscript{254} Schedule (n 1 above) para 1 definition of ‘Commercial Paper Notice’.
\item \textsuperscript{255} n 251 above.
\item \textsuperscript{256} As above.
\item \textsuperscript{257} Commercial Paper Notice (n 251 above) para 1: “commercial paper” means—
\begin{enumerate}
\item any written acknowledgement of debt irrespective of whether the maturity thereof is fixed or based on a notice period, and irrespective of whether the rate at which interest is payable in respect of the debt in question is a fixed or floating rate; and
\item debentures or any interest-bearing written acknowledgment of debt issued for a fixed term in accordance with the provisions of the Companies Act 1973 (Act No. 61 of 1973), but does not include banker’s acceptances”.
\end{enumerate}
\end{itemize}
\end{footnotesize}
Apart from its exclusion of a reference to preference shares, the latter definition contains the same predicaments as that discussed above.\textsuperscript{258} It appears to be limited to public issues\textsuperscript{259} and appear conducive to synthetic securitisation schemes since, the SPI, as the ‘ultimate borrower’,\textsuperscript{260} would not extend, directly or indirectly, money loans or credit as the protection seller in terms of the credit derivative.\textsuperscript{261}

Commercial paper issued in terms of the Commercial Paper Notice\textsuperscript{262} may only be issued of transferred at minimum in minimum denominations of R1 million,\textsuperscript{263} by a listed company,\textsuperscript{264} or by a company eat least eighteen months prior to issue thereof had a total audited net value of R100 million,\textsuperscript{265} excluding intangible non-marketable\textsuperscript{266} or off-balance sheet assets,\textsuperscript{267} or by a juristic person authorised thereto by the Registrar\textsuperscript{268} (unless the commercial paper is listed\textsuperscript{269} or bank-endorsed\textsuperscript{270} or issued for more than 5 years\textsuperscript{271} or issued by the central government\textsuperscript{272} or backed by

\begin{flushright}
\textsuperscript{258} Para 4.1 above. \\
\textsuperscript{259} Commercial Paper Notice (n 251 above) para 2. \\
\textsuperscript{260} Commercial Paper Notice (n 251 above) para 3(2): Only the following entities may be the ultimate borrower of money obtained from the general public against the issue of commercial paper, namely—
\begin{itemize}
  \item[(a)] the issuer; or
  \item[(b)] in the case where the issuer is a company—
    \begin{itemize}
      \item[(i)] a wholly owned subsidiary of the issuer; or
      \item[(ii)] a holding company of the issuer; or
    \end{itemize}
  \item[(c)] in the case where the issuer is a juristic person other than a company, any other juristic person that would have been a wholly owned subsidiary or holding company of the issuer—
    \begin{itemize}
      \item[(i)] had the issuer been a company; or
      \item[(ii)] in the case where such other juristic person, too, is not a company, had both the issuer and the other juristic person been a company; or
    \end{itemize}
  \item[(d)] a juristic person of which the board of directors, or in the case where such juristic person is not a company, of which the governing body, is controlled by and customarily acts in accordance with the directions or instructions of the issuer’.
\end{itemize}
\textsuperscript{261} Commercial Paper Notice (n 251 above) para 3(4). \\
\textsuperscript{262} n 251 above. \\
\textsuperscript{263} n 251 above, para 3(1)(a). \\
\textsuperscript{264} n 251 above, para 3(1)(b)(i). \\
\textsuperscript{265} n 251 above, para 3(1)(b)(ii). \\
\textsuperscript{266} n 251 above, para 3(1)(b)(ii)(aa). \\
\textsuperscript{267} n 251 above, para 3(1)(b)(ii)(bb). \\
\textsuperscript{268} n 251 above, para 3(1)(b)(iii). \\
\textsuperscript{269} n 251 above, para 3(1)(A). \\
\textsuperscript{270} n 251 above, para 3(1)(B). \\
\textsuperscript{271} n 251 above, para 3(1)(C). This seems to be an a priori requirement. Read with para 1(a) of the definition of ‘commercial paper’ above, the commercial paper seem to be permitted to be in issue for more than 5 years. \\
\textsuperscript{272} n 251 above, para 3(1)(D).
\end{flushright}
4.3 Commercial paper in terms of paragraph 14 of the Schedule

Both expositions in paragraphs 4.1 and 4.2 above seem to be limited by the Schedule. The commercial paper must be issued or transferred at minimum in minimum denominations R1 million. The same wording is found in the Commercial Paper Notice. It is uncertain what the teleological difference between the verbs ‘issued’ and ‘transferred’ is. One possibility is that, in order to widen the ambit of the applicable provision, ‘issued’ relates to an investor acquiring the commercial paper directly from the SPI, whereas ‘transferred’ relates to an investor acquiring the commercial paper indirectly from an agent of the SPI, such as an investment bank. The reason why this possibility is doubted is due to the fact that the normal meaning of the verb ‘issued’ is wide enough to include both possibilities; therefore, ‘transferred’ may refer to the secondary market. However, the latter is doubtful since the Legislature’s rationale for regulating the secondary market is uncertain. If the latter is to be the case, then the practical implications thereof remain obscure, for example, the wording of the applicable provision does not indicate that rights inherent in the commercial paper cannot be ceded at a value equal to less than the prescribed denomination.

Exceptions to said minimum denomination are when the commercial paper is listed, endorsed by a bank, issued for more than 5 years or backed by an ‘explicit’ national government guarantee. Two ostensible deductions can be made from these exceptions. Firstly, these provisions point towards a legislative effort in ensuring less litigious schemes, commercial paper

273 n 251 above, para 3(1)(E).
274 Commercial Paper Notice (n 251 above) para 3(7).
275 Schedule (n 1 above) para 14(1)(b).
276 Schedule (n 1 above) para 14(1)(b)(i).
277 n 251 above, para 3(1)(a).
278 Schedule (n 1 above) para 14(1)(b)(i)(A).
279 Schedule (n 1 above) para 14(1)(b)(i)(B). This provision also constitutes a rebuttable presumption against synthetic securitisation schemes resorting within the business of a bank, and would have to be expressly addressed, if the circumstances present themselves, by a court wishing to hold the opposite.
280 Schedule (n 1 above) para 14(1)(b)(i)(C). See also n 275 above in this regard.
281 It is uncertain what this term denotes, and how it differs from the similar provision in Commercial Paper Notice (n 251 above) para 3(1)(E).
282 It is uncertain what the difference between central government [Commercial Paper Notice (n 251 above) 3(1)(D).] and national government is.
283 Schedule (n 1 above) para 14(1)(b)(i)(D).
holder’s confidence, and market stability. This is not an effort to protect debt instrument holder’s rights: The Schedule refers to commercial paper in issue for longer than five years, instead of maturity transpiring after five years, providing for conversions. However, as a rule of thumb, synthetic securitisation schemes generally exist for approximately five years, just as liquid CDSs usually mature after five years. Secondly, it becomes apparent that the Legislature comprehends the prevalence of serious risks in these schemes, and though not discouraging their prevalence and understanding their economic role, indeed ensuring that the issues are not reckless.

Paragraph 14(1)(b)(iii) provides that commercial paper will only be issued by a juristic person authorised thereto in writing by the Registrar in the event of inter alia a synthetic securitisation in accordance with the Schedule and subject the Registrar’s conditions in such written authorisation. The context of this provision is dubious. Other than in the Commercial Paper Notice, the absence of a conjunctive or disjunctive between paragraphs 14(1)(b) and 14(b)(ii) implies that an issue of commercial paper must either be subject to the former or the latter, or that the Registrar’s authorisation is required in all cases. Furthermore, it is uncertain what the legislative intent with the reference to juristic person is, since a juristic person is not defined in the Schedule, nor was it defined in the Companies Act, nor is it defined in the Banks Act. The Schedule includes a possible trust structure for the scheme, but it is res ipsa loquitur that trusts are not by common law juristic persons. The Banks Act indeed provides for a juristic person other than a company, but refers to trusts separately. This would have been a point of uncertainty in terms of the Companies Act 61 of 1973, since SPI’s would have been unsure whether

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284 n 1 above.
286 As above.
287 n 1 above.
288 n 251 above, para 3(1)(b).
289 n 1 above.
291 94 of 1990.
292 n 1 above.
293 See n 1 above, para 1 definition of ‘special-purpose institution’.
294 94 of 1990.
296 Banks Act 94 of 1990 para 6(3)(e).
to abide by paragraph 14 of the Schedule\textsuperscript{297} is such an SPI were a trust; however, the current Companies Act\textsuperscript{298} explicitly includes trusts in the definition of ‘juristic person’\textsuperscript{299}.

5 Disclosure

In chapter 5 paragraph 6.2 above, it was presumed that an offer of commercial paper was a public offer in order to gauge the application of CISCA. The purpose of this paragraph on disclosure is to determine in detail what the nature of an offer in terms of the Schedule\textsuperscript{300} is. The activity of synthetic securitisation is statutorily designated as falling outside the ambit of the business of a bank if the SPI accepts money from the general public as performance for the counter-performance of commercial paper by the SPI.\textsuperscript{301} Apart from the requirement then that commercial paper can only be issued against a cash consideration, it seems as if the ambit of the Schedule\textsuperscript{302} is limited to the issue of commercial paper to the general public. It thus appears as if there is a non-statutory category of synthetic securitisation which surfaces when the offer of commercial paper is not extended to the general public. However, in such circumstances, a synthetic securitisation scheme would fall within the ambit of the business of a bank. It was surmised in chapter 5 paragraph 6.2 above that the public can be a single subject. The term ‘general public’ excludes this possibility, although it includes the possibility that the public is merely more than one subject.\textsuperscript{303} This can now be retroactively confirmed through reference to chapter 6.2 above. The conclusion is then that CISCA would indeed apply, since its offer requirements on this matter are similar to the Schedule.\textsuperscript{304}

In chapter 5 paragraph 6.2 above, the presumption was created that the issue of commercial paper in terms of the Schedule\textsuperscript{305} is a public offer based on the disclosure element.\textsuperscript{306} The SPI must issue a disclosure document in a synthetic securitisation scheme which ‘shall clearly state,\textsuperscript{307} amongst

\begin{itemize}
\item \textsuperscript{297} n 1 above.
\item \textsuperscript{298} 71 of 2008.
\item \textsuperscript{299} See Companies Act 71 of 2008 para (b) of the sec 1 definition of ‘juristic person’.
\item \textsuperscript{300} n 1 above.
\item \textsuperscript{301} Schedule (n 1 above) para 2(1).
\item \textsuperscript{302} As above.
\item \textsuperscript{303} Schedule (n 1 above) para 5(2)(k)(i).
\item \textsuperscript{304} n 1 above.
\item \textsuperscript{305} n 1 above.
\item \textsuperscript{306} n 1 above, para 14(1)(c).
\item \textsuperscript{307} It is uncertain whether this is a subjective or objective test.
\end{itemize}
other things the SPI’s name, the SPI’s auditor’s name, the ‘total amount of commercial paper to be issued’ by the SPI, whether that particular commercial paper issue is listed, a description of the credit derivative and the nature of risk transferred, the cash flows on collateral assets, or received premiums, to be employed for the SPI’s performance on the commercial paper, the SPI’s auditor’s confirmation that the commercial paper issue complies with said schedule, details of credit enhancement facilities and liquidity facilities, that the SPI is bullet-proof, a confirmation of the independence of the SPI’s Board, and any other information that may reasonably be necessitated to enable investors to ascertain the nature of risk in an investment in such commercial paper. This disclosure document must be signed and dated by two directors of the SPI. The disclosure requirement goes further to indicate that investors must be informed that the activity falls beyond the ambit of the business of a bank since the investment is not a deposit, and that the investment is subject to investment risk that includes possible repayment delays and loss performance, and that the institution acting in a primary role, together with its associative element, provides no guarantee on the commercial paper. The Registrar failed to indicate whether such information must be included in the disclosure document or must be separately disclosed; either way, this information is possibly irrelevant in the light of paragraph 3(1) of the Schedule.

308 Schedule (n 1 above) para 16(2)(a). It is uncertain to which other things the Registrar refers, since there already exists a separate provision that the Registrar may impose additional disclosure requirements [Schedule (n 1 above) para 16(2)(b)].
309 Schedule (n 1 above) para 16(2)(a)(i).
310 Schedule (n 1 above) para 16(2)(a)(ii).
311 The Registrar does not indicate whether this is the total monetary amount of the commercial paper to be issued, or the number of commercial paper to be issued.
312 Schedule (n 1 above) para 16(2)(a)(iii).
313 Schedule (n 1 above) para 16(2)(a)(iv).
314 Schedule (n 1 above) para 16(2)(a)(v).
315 This should have been a conjunctive, since the principle of inclusio unius est exclusio alterius now applies.
316 Schedule (n 1 above) para 16(2)(a)(vi).
317 Schedule (n 1 above) para 16(2)(a)(vii).
318 Schedule (n 1 above) para 16(2)(a)(viii).
319 Schedule (n 1 above) para 16(2)(a)(ix).
320 Schedule (n 1 above) para 16(2)(a)(x).
321 Schedule (n 1 above) para 16(2)(a)(xi).
322 Schedule (n 1 above) para 16(2)(a)(xii).
323 Schedule (n 1 above) paras 16(2)(c)(i), 16(2)(e).
324 Schedule (n 1 above) para 16(1).
325 n 1 above.
Whilst it at first appears in the Companies Act\textsuperscript{226} that there is a difference between a prospectus and a registered prospectus, section 99(8) provides that a person is prohibited from issuing a prospectus or a putative prospectus, whether such putative prospectus purports\textsuperscript{227} to be non-putative or objectively misunderstood to be non-putative, unless it is a registered prospectus. Unlisted securities and listed securities subject to a IPO, must comply with the prospectus requirements in section 100 of the Companies Act.\textsuperscript{228} It must contain all the information to an investor’s avail to reasonably assess the ‘assets and liabilities, financial position, profits and losses, cash flow and prospects of the company in which a right or interest is to be acquired’\textsuperscript{229} and ‘the securities being offered and rights attached to them’.\textsuperscript{230} The conclusion is then at this early stage that a prospectus is not a disclosure document, but that a disclosure document may be a prospectus given the provisions of paragraphs 16(2) and 16(2)(xii) of the Schedule.\textsuperscript{231} The applicable situation for listed securities is not completely divergent, since the JSE Limited Listing Requirements defines a prospectus as ‘a prospectus issued in accordance with the Act and in compliance with Section 6 if issued by an issuer or new applicant’.\textsuperscript{232} ‘[T]he Act’\textsuperscript{233} is defined as ‘the Companies Act, 2008 (Act No. 71 of 2008), as amended, or any law that may replace it wholly or in part, from time to time’.\textsuperscript{234} Section 6 of the JSE Limited Listing Requirements pertains to pre-listing statements, which expressly include prospectuses.\textsuperscript{235} The pre-listing statement is an extensive document of which the requirements will not, for purposes of brevity and in the light of length limitations, be duplicated here. However, a study of the requirements of pre-listing statements shows that pre-listing statements are not disclosure documents, but that disclosure documents may be pre-listing statements on the bases already set out above.

However, the conclusion is that a prospectus in terms of the Companies Act\textsuperscript{236} or a pre-listing statement in terms of the JSE Limited Listing Requirements is analogous to a disclosure document.

\textsuperscript{226} 71 of 2008.
\textsuperscript{227} Whether this is express, tacit or implicit is uncertain.
\textsuperscript{228} 71 of 2008.
\textsuperscript{229} Companies Act 71 of 2008 sec 100(2)(a).
\textsuperscript{230} Companies Act 71 of 2008 sec 100(2)(b).
\textsuperscript{231} n 1 above.
\textsuperscript{232} JSE Limited Listings Requirements Definitions.
\textsuperscript{233} As above.
\textsuperscript{234} As above.
\textsuperscript{235} JSE Limited Listing Requirements sec 6 Scope of section.
\textsuperscript{236} 71 of 2008.
in terms of the Schedule, since the statutory definition of a disclosure document is wide enough to include a prospectus or pre-listing statement, with the effect that a disclosure document cannot be bifurcated from either. The matter remains simple if the commercial paper issued by the SPI in terms of the Schedule constitutes commercial paper in terms of the Commercial Paper Notice, since commercial paper in terms of the latter requires either a prospectus or a placing document, with the disjunctive indicating that the two are divergent, but both being included in the definition of a disclosure document. In practice, the clear contradiction between the required content of disclosure in terms of the Commercial Paper Notice at paragraph 3(5)(b) and disclosure in terms of the Schedule at paragraph 16(1)(a), Will not provide difficulty. Perhaps the disclosure requirements that *prima facie* are the most conducive to disclosure in terms of the Schedule is that pertaining to CISCA at section 3, which will relatively always conform to a paragraph 16 disclosure document.

6 Stratification of risk

Any review of securitisation literature would reveal to the reader that the concept of stratification or tranching is prevalent in such schemes. It has already been noted that the jurist must be wary of concluding that risk positions and tranches are synonymous to different classes, and that the term ‘risk [position]’ has a wider ambit than ‘[tranche]’ since the former includes shareholders’ equity. This is confirmed in paragraph 4(1)(a)(ii) of the Schedule. However, the latter reference to shareholders’ equity is wider than the mere inclusion of preference shares in

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337 n 1 above, para 1; “disclosure document” means—
(a) a prospectus; or
(b) a placing document; or
(c) an offering circular; or
(d) any other document with similar import,

published in order to provide certain information relating to a traditional or synthetic securitisation scheme to prospective investors in the said securitisation scheme.

338 n 1 above.
339 n 251 above.
340 n 251 above, para 3(5).
341 Para 1 above.
342 Para 1 above.
343 n 1 above.
344 E.g. Companies Act 71 of 2008 sec 43(3); Schedule (n 1 above) para 4(1)(a)(ii).
345 Schedule (n 1 above) para 5(1)(a)(i).
346 Schedule (n 1 above) para 5(1)(a)(ii).
347 Cilliers *et al* (n 12 above) 199-200.
348 n 1 above.
the definition of commercial paper, and may refer to other classes of shares. An exclusive reference to commercial paper only has bearing on the term ‘[tranche]’,\(^{349}\) which means that only this is subject to the wider approach of offers to the public set out above.\(^{350}\) This constitutes a division of commercial paper into diverse classes with different payment priorities and, in accordance with the risk-return concept,\(^{351}\) varying default risks based on seniority.\(^{352}\) It resembles capital structure,\(^{353}\) although the Companies Act\(^{354}\) contains no explicit provisions with regard to debt instrument classes.\(^{355}\) Authorisation is regulated by section 36 of the Companies Act,\(^{356}\) although classification, which is separately indicated in said section,\(^{357}\) seems to be unregulated; therefore, the issue of such commercial paper is subject to the Board’s discretion\(^{358}\) and must resort within the four corners of the MOI\(^{359}\) and eventually the security document.\(^{360}\)

The inclusive definition of ‘security document’\(^{361}\) denotes that a security document is something wider than a trust deed or certificate.\(^{362}\) The reference to a certificate creates the presumption that such a security document is of evidentiary value and not value paper, which further supports the argument that commercial paper are not negotiable instruments. The problem with the definition of a security document is that its inclusive references do not appear to be *eiusdem generis*; interpreted differently, the second inclusion does not necessarily resort within the ambit of the first inclusion in all circumstances. The notion of a security document is reminiscent of a debenture covenant, since it contains the terms and conditions of the intended agreement.\(^{363}\) However, the fact that it includes an offer\(^{364}\) means that, in practice, it may be a document that is presented as an

\(^{349}\) Schedule (n 1 above) para 5(1)(a)(ii).
\(^{350}\) Para 5 above.
\(^{351}\) See ch 6 above.
\(^{353}\) BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in Carey & Stulz (n 361 above) 559 et seq.
\(^{354}\) Act 71 of 2008.
\(^{355}\) Companies Act 71 of 2008 sec 43.
\(^{356}\) Companies Act 71 of 2008 sec 43(3)(b).
\(^{357}\) Companies Act 71 of 2008 sec 43(2).
\(^{358}\) Companies Act 71 of 2008 sec 43(2).
\(^{359}\) Companies Act 71 of 2008 sec 43(2)(a).
\(^{360}\) Companies Act 71 of 2008 sec 43(1)(b).
\(^{361}\) As above.
\(^{362}\) As above.
\(^{363}\) Companies Act 71 of 2008 43(1)(b).
\(^{364}\) As above.
offer (invitation) and then, upon acceptance, constitutes the agreement *per se*, as is commonly found in the property market. However, in terms of the definition of a prospectus in the old Companies Act – despite the fact it only pertains to shares – a prospectus includes an invitation and is an offer, and since prospectus is not defined in this manner in the current Companies Act the prospectus and security document may converge. According to Cilliers *et al* the prospectus accompanies the offer, which in this case is the security document, meaning that the prospectus and security document may not converge. It is uncertain if the disclosure document would converge with the security document, although there are similar elements.

Whilst there seems to be no duty as to stratification, it is doubtful as to whether the Registrar would lend authorisation to a SPI’s continuously uniform issues. It seems more likely that the Registrar would lend authorisation if commercial paper becomes tranched into at least two discrepant risk positions. Although investor’s risk depends on the underlying exposures, junior or subordinated commercial paper is shock-absorbent in that they can absorb losses without affecting performance on more senior commercial paper. Frankly, there will be substantially higher loss severity for junior or subordinated commercial paper – ‘substantial’ in synthetic securitisations denoting that junior or subordinated commercial paper will suffer total loss before senior commercial paper is affected. This arrangement will at least be set out in the disclosure document and/or security document. The reciprocal effect of this arrangement is that senior commercial paper is not backed by a first-loss or second-loss credit-enhancement facility.

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365 See ch 5 para 6.2 above.
367 71 of 2008.
368 n 12 above, 269.
369 Schedule (n 1 above) paras 5(1)(a)(i), 3(1).
370 Schedule (n 1 above) para 14(1)(b)(ii).
371 Schedule (n 1 above) para 5(1)(a)(i).
372 Schedule (n 1 above) para 5(1)(a)(iii).
373 Schedule (n 1 above) para 5(1)(a)(ii).
374 Schedule (n 1 above) para 5(1)(a)(v).
375 Schedule (n 1 above) para 5(1)(a)(v).
376 Schedule (n 1 above) para 1 definition of ‘senior commercial paper’.
Senior tranches, usually rated as A grade, are typically issued on capital markets. SPIs can engage in personal efforts at relative credit enhancement through the issue of subordinated commercial paper usually rated as C grade and commonly known as the collateral invested amount (CIA). These subordinate tranches are rather privately placed and consequently little is known about them. It is prevalent that Gorton & Souleles’ use of the term tranching is similar to the Registrar’s concept of risk position. The most junior risk positions seem to be ‘equity-like claims’. Since commercial paper includes preference shares and preference shares are defined in the Schedule as not forming part of the SPI’s joint stock capital if issued by a company, such ‘equity-like claims’ are likely akin to the old categorisation of ‘ordinary shares’.

The rationale for stratification must now be noted. Whilst it is already known, apart from the obvious segmentation of credit risk, that traditional schemes can render illiquid assets available for investment, we must also bear in mind that stratification enables the SPI to issue high quality commercial paper and deductively lower the cost of purchasing the assets in true sale. Synthetic schemes employ stratification for a different reason: Such stratification creates higher risk mezzanine or subordinate tranches so that investors in such products are in a leveraged position through the SPI’s exercise of risk leverage, which entails the SPI utilising its total shareholder equity and non-senior tranches in order to establish the senior tranche’s credit quality. According to Das, the SPI’s corporate capital would usually be as set out in Table 8.1 below.

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377 BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in Carey & Stulz (n 361 above) 565.
378 BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in Carey & Stulz (n 361 above) 559-560.
379 BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in Carey & Stulz (n 361 above) 565.
380 As above.
381 BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in Carey & Stulz (n 361 above) 560.
382 As above.
383 n 1 above, para 1.
384 n 1 above.
385 n 1 above, para 1 definition of ‘preference share’.
386 BG Gorton & NS Souleles ‘Special purpose vehicles and securitization’ in Carey & Stulz (n 361 above) 560.
387 Delport (n 33 above) 32.
388 Das (n 285 above) 342.
389 As above.
390 As above.
391 As above.
392 As above.
393 As above.
394 As above.
395 n 288 above, 416.
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<th>Class of security</th>
<th>% of portfolio</th>
<th>Rating</th>
<th>Spread (bps to LIBOR)</th>
<th>Overcollateralisation (% of portfolio subordinated)</th>
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<td>90.0</td>
<td>Not rated</td>
<td>10</td>
<td>11.11</td>
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<tr>
<td>Senior</td>
<td>4.0</td>
<td>AAA</td>
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<td>6.38</td>
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<td>BBB/BB</td>
<td>250-500</td>
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<tr>
<td>Equity</td>
<td>2.0</td>
<td>Not rated</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 8.1

7 Final remarks

There exists a common law category of synthetic securitisation which is based on the issue of commercial paper other than to the general public, but such a scheme would resort within the ambit of the business of a bank.\(^{396}\) This is nonsensical in cases where a degree of sophistication is present, as in section 96 of the Companies Act.\(^{397}\) Statutory synthetic securitisations remain beyond the ambit of the business of a bank,\(^{398}\) and the brief exposition of the monetary system above\(^{399}\) elucidates the phrase ‘parallel banking system’\(^{400}\). Firstly, investors perform to the SPI, but such performance does not constitute deposits.\(^{401}\) Secondly, such investments are subject to discounting.\(^{402}\) Thirdly, although it has been deduced in this chapter that commercial paper is not value paper,\(^{403}\) the issue of value paper is not absolutely prohibited. However, a statutory synthetic securitisation scheme may be classified as resorting within the ambit of the business of a bank as a punitive measure in the event of non-compliance with the Schedule.\(^{404}\) Therefore, we see that the fact that the Schedule\(^{405}\) was drafted to encourage discipline in debt markets\(^{406}\) is not limited by

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\(^{396}\) Para 5 above.
\(^{397}\) 71 of 2008.
\(^{398}\) Para 3.2.1 above.
\(^{399}\) As above.
\(^{400}\) See ch 1 para 1 above.
\(^{401}\) Para 3.2.1 above.
\(^{402}\) Ch 5 para 5 n 225 above; para 4.1 above.
\(^{403}\) Paras 4.1, 4.2, 6 above.
\(^{404}\) n 1 above; para 3.2.2 above.
\(^{405}\) n 1 above.
\(^{406}\) n 1 above, para 5(2)(k).
Chorafas’ economic perspective that commercial paper can be subjected to public or private issue.\(^{407}\)

The underlying credit risk will be transferred by the SPI to more than one investor via senior commercial paper;\(^ {408}\) however, neither one of these minimum of two investor’s can be an institution acting in a primary role.\(^ {409}\) This provision expressly relates to senior commercial paper and does not account for mezzanine or inferior tranches.\(^ {410}\) The Registrar may discretionally permit ‘placement’\(^ {411}\) with a single investor\(^ {412}\) subject to such conditions as the Registrar may allocate;\(^ {413}\) however, said investor may not be an institute acting in a primary role.\(^ {414}\) This does not imply that parties acting in a primary role cannot invest in the SPI’s commercial paper.

A credit-rating agency must rate a significant amount of the commercial paper.\(^ {415}\) The Registrar discretionally permits an unrated scheme subject to its allocated conditions.\(^ {416}\) However, the general rule is that a significant amount of the externally rated credit risk must be issued to investors.\(^ {417}\) The retained senior unrated tranches will only be recognised for risk mitigation purposes if one of two scenarios is prevalent.\(^ {418}\) Firstly, external protection must be available that has been obtained from either a recognised protection provider or it must constitute eligible collateral.\(^ {419}\) Alternatively, the most senior rated commercial paper, rated at least AAA or equivalently, must be ‘demonstrably legally subordinated’ to or it must rank \textit{pari passu} with the unrated tranche,\(^ {420}\) the residual maturity of the subordinated rated tranches must be equal to or longer than the residual maturity of the unrated tranche.\(^ {421}\)

\(^{407}\) DN Chorafas \textit{Credit derivatives \& the management of risk including models for credit risk} (2000) 59.
\(^{408}\) Schedule (n 1 above) para 5(2)(k)(i).
\(^{409}\) As above.
\(^{410}\) As above.
\(^{411}\) As above.
\(^{412}\) As above.
\(^{413}\) As above.
\(^{414}\) As above.
\(^{415}\) Schedule (n 1 above) para 5(2)(k)(ii).
\(^{416}\) As above.
\(^{417}\) Schedule (n 1 above) para 5(2)(k)(iii).
\(^{418}\) Schedule (n 1 above) para 5(2)(i).
\(^{419}\) Schedule (n 1 above) para 5(2)(i)(i).
\(^{420}\) Schedule (n 1 above) para 5(2)(i)(ii)(A).
\(^{421}\) Schedule (n 1 above) para 5(2)(i)(ii)(B).
As intimidating as the complex schemes may appear to someone who has read corporate law and has a rudimentary comprehension the valuation of shares and debt instruments using fundamental analysis, one would be surprised as to hypothetic simplicity in valuing the commercial paper tranches in a synthetic securitisation scheme, since it corresponds with the method used to determine credit ratings. The loss distribution for a portfolio necessitates individual asset loss distributions and a measure of co-dependence. However, co-dependence does not exist for commercial paper due to the stratification, therefore constituting a third calculation. In practice, pricing remains the forte of quantitative analysts, given the intricacy in establishing parameters such as probability, which causes discrepancies between the risk neutral and actual models. Furthermore, dealings in commercial paper often require a regard for risk measures such as correlation sensitivity (Rho), credit spread convexity (Gamma), credit spread sensitivity (Delta), default sensitivity and time decay (Theta), although these variables are calculable under the unrealistic presumption that other parameters remain fixed.

According to the Schedule, a bank acting as an originator can invest in the SPI’s commercial paper, provided that such investment pertains only to the most senior commercial paper only and a ‘material portion’ of the commercial paper is mezzanine positions transferred to third parties. This provision of the Schedule is odd in that it only expressly refers to banks acting as originators, and not to institutions in general acting in a primary role or repackagers, which begs the question as to whether such parties not referred to may engage in such re-acquisition of risk.

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422 I.e. in risk neutral circumstances: \( \text{PV (received credit spread)} = \text{PV (expected counter-performance upon credit event)} \).  
423 Das (n 285 above) 419.  
424 Das (n 285 above) 419.  
425 As above.  
426 As above.  
427 Das (n 285 above) 420.  
428 As above.  
429 As above.  
430 As above.  
431 Das (n 285 above) 423.  
432 Das (n 285 above) 422-423.  
433 Das (n 285 above) 421-422.  
434 Das (n 285 above) 423.  
435 As above.  
436 Das (n 285 above) 423.  
437 n 1 above.  
438 n 1 above, para 5(2)(h).  
439 n 1 above, para 5(2)(h)(i).  
440 n 1 above, para 5(2)(h)(ii).
Whilst such extension would ostensibly *in pari materia* have no negative implications beyond the hackneyed consideration of the merits of each case, a more scientific approach would be to come to terms with the fact that no deductive argument can be rendered from it. We can initially state that the provisions in paragraph 5(2)(h) of the Schedule\textsuperscript{441} may also be interpreted as an express privilege of a bank acting as an originator to obtain commercial paper, the presumption exists that such provisions are obligatory.\textsuperscript{442} As for the rest, perhaps the induction may be made that such an extension would be sanctioned in the light of the semantics of legal interpretation, especially the use of positive, loose or vague language rendering this a directory provision.\textsuperscript{443} Unfortunately, irrespective of which way we argue this point, it will be subject to deconstructionist irresolution.\textsuperscript{444}

The commercial tenet indeed exists that the most senior commercial paper becomes re-tranched to create a ‘super senior tranche’\textsuperscript{445} which in the BISTRO and C*Star schemes constituted the largest tranche of commercial paper.\textsuperscript{446} Interestingly, this investment in the super senior tranche seems to be the greatest international legal divide in synthetic securitisations.\textsuperscript{447} The American BISTRO presented the use of a single CDS\textsuperscript{448} with the institution acting in a primary role holding the super senior tranche\textsuperscript{449} in order to obtain relief from capital requirements.\textsuperscript{450} This is not unlike the position is South African law.\textsuperscript{451} Contrarily, the latter relief can only be obtained in European schemes if a third party holds the super senior tranche,\textsuperscript{452} and different CDS’ are used for different eventual tranches,\textsuperscript{453} as in the case of Citibank/Salomon Smith Barney’s C*Strategic Asset Redeployment Program 1999-1 Ltd (“C*Star”) scheme.\textsuperscript{454} Irrespective of which of the aforesaid jurisdictions one studies, it has been shown that the market cost expressed as a percent per annum over LIBOR for super senior tranches are lower than AAA rated tranches.\textsuperscript{455}

\textsuperscript{441} n 1 above.
\textsuperscript{442} Botha (n 27 above) 115.
\textsuperscript{443} Botha (n 27 above) 114.
\textsuperscript{444} Botha (n 27 above) 65.
\textsuperscript{445} Das (n 285 above) 329, 341.
\textsuperscript{446} Das (n 285 above) 335, 339.
\textsuperscript{447} Das (n 285 above) 331.
\textsuperscript{448} Das (n 285 above) 328, 334.
\textsuperscript{449} Das (n 285 above) 331.
\textsuperscript{450} Das (n 285 above) 331.
\textsuperscript{451} Schedule (n 1 above) para 5(2)(h)(i).
\textsuperscript{452} Das (n 285 above) 331.
\textsuperscript{453} As above.
\textsuperscript{454} Das (n 285 above) 338-340.
\textsuperscript{455} Das (n 285 above) 337.
Chapter 9

Conclusion: Synthesis and recommendations

1 Hypotheses relating to the research problem and problem question 4
   1.1 Challenges
   1.2 Antagonism regarding synthetic securitisation and legal reaction thereto
   1.3 Relevance of this study
   1.4 The future of synthetic securitisation
      1.4.1 Regulatory development and unregulated counterparties
      1.4.2 Regulatory valuation

2 Hypotheses relating to the other problem questions
   2.1 Problem question 1
   2.2 Problem question 2 and problem question 3
   2.3 Problem question 5

3 Specific areas of further study

1 Hypotheses relating to the research problem and problem question 4

1.1 Challenges

Socrates relayed that: ‘[he] [has]…made him possess knowledge of how every aspect of the business is to be done so as to increase its utility.’ Credence in the casuistic application of this acumen in the synthetic securitisation sub-sector is an argumentum verbosium. The structural bases thereof – corporate law in general, and specifically company law, securities law and the law of contract – are inherently complex. Synthetic securitisation as a state of affairs raises the enquiry as to the identification of such affairs, for which the conceptual framework herein has been adopted

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1 Problem question 6 is addressed generally throughout this chapter.
2 Xenophanes Conversations of Socrates (1990) 338.
3 Ch 1 para 1 above.
4 As above.
5 As above.
6 Ch 2 para 9 above.
to simplify comprehension through a relatively accepted taxonomy. Holistically, connotation has oscillated from favour in respect of synthetic securitisation and credit derivatives prior to the Financial Crisis to disapproval thereafter. The Financial Crisis did not seem to be a Black Swan; \textit{a priori} failure to deal with moral hazard and systemic risk seemed to have a negligence dimension as well as a dimension that related to econometric comprehension that is tied to legal development. The former component requires a common law or statutory duty of care, but which a delictual matter beyond the present ambit and a recommended area of study subsequent to this work, save for the duty of care and skill which is significant for the directors of the SPI in distancing themselves from the notion that SPIs are empty shell companies. Although the limited \textit{dasein} of SPIs as set out in the Schedule\textsuperscript{11} sets a stronger tone than mandatory corporate objectives of the SPI, the SPI must remain independent, as is discussed elsewhere in this chapter as well. The latter component – legal development – appears overwhelmingly reactive,\textsuperscript{12} given the complexity of synthetic securitisation in terms of its creative genius of quantitative analysis.\textsuperscript{13} However, multiplicity in these recent economic technologies renders a wholly inclusive study for doctoral purposes objectively impossible; therefore, this work is limited to synthetic CDOs\textsuperscript{14} employing CDSs, although CLNs comprise a comparative element of this work.\textsuperscript{15}

A relative paucity of legal academic submissions on synthetic securitisation and credit derivatives exists, justifying the extended bibliography for this work comprising primary sources,\textsuperscript{16} the existing secondary academic sources, whether legal\textsuperscript{17} or not,\textsuperscript{18} and publications by law firms,\textsuperscript{19}

\textsuperscript{7} Ch 1 paras 1, 2.4 above; CA Hill ‘The furture of synthetic securitization: A comment on Bell & Dawson’ (2002) 12 Duke Journal of Comparative & International Law 563 564.

\textsuperscript{8} Ch 6 para 7 above.

\textsuperscript{9} Ch 1 para 2.5 above.

\textsuperscript{10} Ch 5 para 5 above.


\textsuperscript{12} See ch 1 para 2.2 above.

\textsuperscript{13} Ch 6 paras 1, 11 below.

\textsuperscript{14} Ch 1 para 2.2 above.

\textsuperscript{15} Ch 1 para 2.3 above.

\textsuperscript{16} E.g. Schedule (n 1 above).

\textsuperscript{17} E.g. Bell, I & Dawson, P ‘Synthetic securitization: Use of derivative technology for credit transfer’ (2002) 12 Duke Journal of Comparative & International Law 541.


accounting firms,$^{20}$ participants to synthetic securitisation schemes,$^{21}$ programme memoranda of actual securitisation schemes,$^{22}$ etc. The sway of quantitative analysts in fashioning these schemes have rendered them inaccessible. Furthermore, many existing academic works on the subject abroad appear encyclopedic and legally superficial – the latter apparently drawing from the superficial descriptions of securitisation in legislation – thereby not providing depth in critical analysis.

Synthetic securitisation is a dynamic field of study. During the rendition of this work, the law has continuously developed: The *a priori* Canadian common law synthetic securisation has been codified by OSFI,$^{23}$ and in the spirit of Basel III$^{24}$ the EU has promulgated instruments$^{25}$ and SARB has issued directives on counterparty credit risk (CCR).$^{26}$ It is recommended that academic study of synthetic securitisation must endure to continue for generation of an updated body of knowledge thereon for policy, corporate and professional utilisation, and improved public comprehension.

Despite not being an analysis of the Financial Crisis, synthetic securitisation was intrinsic therein so that its inclusion herein – to a certain extent – is *sine qua non*. There is no apparent consensus on the uniqueness of the Financial Crisis. However, these discrepancies are relative to the decompositional approach utilised for a perspective thereon. The approach *in extremis* dictates that economic cycles$^{27}$ will continue to exist. Doubtlessly, the financial instruments used in discrepant crises may be divergent, and banking innovation has led to intricate products$^{28}$ not understood *ex

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24 See ch 2 para 4.1 above.
27 Ch 1 para 1 above.
28 Ch 1 para 2.2 above.
visceribus. The common denominator in financial crises is arbitrage,²⁹ known as a ‘carry trade’,³⁰ ironically being the traditional basis of banking and hedge fund activity.³¹ The coincidental exercise of the right to freely withdraw deposits renders the corresponding duty on the banks objectively impossible given the illiquidity of its investments³² – a ‘run on the bank’ as systemic risk event.³³ This also transpired in the Financial Crisis – the beneficial creation of ‘synthetic liquidity’³⁴ boomeranged on bankers. Various factors also contributed to the Financial Crisis, such as leverage,³⁵ pitiable mortgage industry regulation³⁶ and accounting rules,³⁷ whilst institutions’ interrelation in synthetic securitisation schemes³⁸ spurred systemic risk and affected legislative perception of risk mitigation.³⁹

1.2 Antagonism regarding synthetic securitisation and legal reaction thereto

Synthetic securitisation has faced the challenge of public antagonism. In South Africa, the zenith thereof, sprouting from moral abhorrence, has manifested in the establishment of NEWERA and its litigious efforts to advance ‘natural human rights’.⁴⁰ Since morality is a divergent category from law as a normative system,⁴¹ ethical predicaments constitute a digression from the jurisprudential objective of this work. Sans policy documents for judicial notice, it could in extremis be entertained through consideration of the boni mores, although primary positive law has ostensibly omitted anathematisation of these schemes; rather, it has been indeed⁴² been subjected to legal development, which has domestically apparent in the Registrar’s continuous promulgation of new schedules to the Banks Act⁴³ relating to the regulation of securitisation schemes and the

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³⁰ Okamoto (n 29 above) 191-192.
³¹ Okamoto (n 29 above) 192-193.
³² Okamoto (n 29 above) 193-194.
³³ As above.
³⁶ As above.
³⁷ As above.
³⁸ G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 35 above) 3-4.
³⁹ G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 35 above) 3.
⁴⁰ Ch 8 para 3.2.2 above.
⁴¹ Ch 6 para 7 above.
⁴² Para 1.1 above.
⁴³ 94 of 1990.
promulgation of the Credit Rating Services Act,\textsuperscript{44} quasi-internationally apparent through the promulgation of Basel III\textsuperscript{45} and the 2014 ISDA Credit Derivative Definitions,\textsuperscript{46} and apparent abroad through the documents \textit{inter alia} referred to above.\textsuperscript{47}

Subsequent to the Montreal Accord, Canadian securitisation schemes have lost their attraction,\textsuperscript{48} although the rationale therefor is unsurprising: Reliance on ABCP programmes led to an asset-liability inconsistency based on volatility and exacerbated by leverage.\textsuperscript{49} German sentiments on synthetic securitisations surrounding the Financial Crisis are ambiguous, being torn between academic antagonism and the IMF and Deutsche Bundesbank’s optimism.\textsuperscript{50} In juxtaposition, the highly developed South African banking sector had the advantage of early codification. It has been noted throughout this work that the South African synthetic securitisation market has proven relatively resilient.

\subsection*{1.3 Relevance of this study}

Despite the bull market that has ensued, synthetic securitisation has not lost relevance. JPMorgan Chase and Morgan Stanley have attempted to reintroduce synthetic securitisation, although failing due to lack of investor interest.\textsuperscript{51} However, by December 2013, Citigroup marketed $100m of its senior commercial paper in a synthetic securitisation scheme to potential investors.\textsuperscript{52} This is unsurprising for Citigroup, given that it had sold $1 billion worth of commercial paper in synthetic CDO’s by 20 March 2013,\textsuperscript{53} and $2 billion worth of commercial paper in synthetic CDO’s in 2012.\textsuperscript{54} Both AllianceBernstein LP’s Ashish Shah and Legal & General Investment Management America’s David Knutson hinted that Citigroup is exploiting a credit cycle with weak interest rates.
on vanilla debt instruments.\textsuperscript{55} Bloomberg has now reported on Goldman Sachs’ new variation on the synthetic CDO theme in the \textit{a posteriori} pursuit of yield.\textsuperscript{56}

\subsection*{1.4 The future of synthetic securitisation}
Some contend that the future of synthetic securitisation schemes holds increasingly complex structures, such as in the telecommunication and utilities sector.\textsuperscript{57} Jobst has predicted the simplification of securitised products against regulatory development in capital adequacy and valuation and restoring investor confidence through increased marketability of all stratifications.\textsuperscript{58} Cecchetti, Gyntelberg and Hollanders have alluded to the contribution of an opaque OTC derivatives market, unregulated counterparties and leverage to systemic risk.\textsuperscript{59} Cohan, author of House of Cards, has attributed the Financial Crisis to a poor incentive system and bad risk management.\textsuperscript{60} Doubtlessly, an objective is to re-ensure credit derivative employment for systemic risk mitigation,\textsuperscript{61} which cannot be done by arguing that synthetic securitisation schemes are cheaper than traditional securitisation schemes\textsuperscript{62} given less required AAA rated commercial paper,\textsuperscript{63} which is in any event held by the transferor.\textsuperscript{64} The future of synthetic securitisation will depend on the robustness of the drives thereof, which also include credit risk management,\textsuperscript{65} increased portfolio value via synthetic sale,\textsuperscript{66} ‘institutional investors’ and asset managers’ inability to participate in credit markets given non-origination and loan administration infrastructure,\textsuperscript{67} and credit risk pricing arbitrage.\textsuperscript{68} As already mentioned, the causes of the Financial Crisis remains a

\footnotesize{\textsuperscript{55} As above. \\
\textsuperscript{58} A Jobst ‘What is securitization?’ (2008) September Finance & Development 48 49. \\
\textsuperscript{59} SG Cecchetti, J Gyntelberg, J & M Hollanders ‘Central counterparties for over-the-counter derivatives’ (2009) September BIS Quarterly Review 45 50-51. \\
\textsuperscript{61} G Tett ‘Non-technical introduction’ in Lipton & Rennie (n 35 above) 7. \\
\textsuperscript{62} S Das \textit{Credit derivatives: CDOs & structured credit products} (2005) 341. \\
\textsuperscript{63} As above. \\
\textsuperscript{64} As above; ch 4 para 6 above. \\
\textsuperscript{65} Das (n 62 above) 6. \\
\textsuperscript{66} As above. \\
\textsuperscript{67} As above. \\
\textsuperscript{68} As above.}
complex question,\textsuperscript{69} and any conclusive argument thereon is \textit{post hoc ergo propter hoc}. Therefore, the opposite, i.e. gauging the future of synthetic securitisations, is equally complex and due to length limitations not all of these aspects can be discussed. Furthermore, some of these aspects are more conducive to an economic study of synthetic securitisation schemes than a legal one.

1.4.1 Regulatory development and unregulated counterparties

The validity of Jobst’s first basis\textsuperscript{70} is uncertain. Despite Basel III’s promulgation, increased regulation regarding capital requirements was prevalent \textit{a priori} through Basel I and Basel II,\textsuperscript{71} causing credit derivative products’ increased complexity during bull markets.\textsuperscript{72} It is thus predicted that increased regulation will trigger more esoteric innovation. \textit{A priori} innovation\textsuperscript{73} – from the Argentina, Brazil and Mexico fiasco origins and consequentially the incessant cat and mouse game between bankers and regulators\textsuperscript{74} – led to the parallel banking system.\textsuperscript{75} The enquiry arises as to the regulatory categorisation of this parallel banking system. Securities law encompasses the legal vernacularisation of corporate finance:\textsuperscript{76} Companies utilise the direct approach, through the issue of shares and debt instruments, to raise capital.\textsuperscript{77} Companies utilise the indirect approach, based on liquid counter-performance received and subsequently invested in profit optimising ventures, to raise capital in securitisation schemes.\textsuperscript{78} This is the micro-economic rationale of synthetic securitisation.\textsuperscript{79} Banks are public companies and the corporate jurist’s exercise in measuring debt instrument issues against the ambit of deposits in the Banks Act\textsuperscript{80} creates the realisation that, despite additional regulation, the basis is unchanged. Banking law in South Africa is bifurcated between corporate and credit regulatory dimensions.\textsuperscript{81} This work is only a study of the former.\textsuperscript{82} Synthetic securitisation, although largely undertaken by banks specifically, is expressly and

\begin{itemize}
\item \textsuperscript{69} Cohan (57 above).
\item \textsuperscript{70} See n 58 above.
\item \textsuperscript{71} Ch 2 para 9 above.
\item \textsuperscript{72} Ch 1 para 1 above.
\item \textsuperscript{73} Ch 1 para 2.2 above.
\item \textsuperscript{74} Ch 2 para 3.3 above.
\item \textsuperscript{75} Ch 2 para 9 above.
\item \textsuperscript{76} Ch 8 para 2 above.
\item \textsuperscript{77} As above.
\item \textsuperscript{78} As above.
\item \textsuperscript{79} Ch 2 para 4.2 above.
\item \textsuperscript{80} 94 of 1990.
\item \textsuperscript{81} Ch 1 para 2.2 above.
\item \textsuperscript{82} As above.
\end{itemize}
implicitly excluded from the business of a bank: The express exclusion stems from the promulgation of the Schedule;\(^83\) the implicit exclusion stems from references to banks in the Schedule\(^84\) when mention is made of the transferor, designated as the ‘institution’.\(^85\)

Despite this exclusion, recent regulatory changes, specifically Basel III and SARB’s implementation thereof, have introduced capital requirements on synthetic securitisation through the back door. This is unsurprising, since it has already transpired in Canadian law\(^86\) and German law,\(^87\) where capital adequacy for banks constituting protection buyers in credit derivatives has been introduced. According to KPMG, this regulation seems to be based on value at risk (VaR),\(^88\) which has been alluded to with regards to coefficient of variation and standard deviation.\(^89\) This regulation does not seem to specifically relate to credit derivatives, but widely to OTC derivatives,\(^90\) and is not based on credit risk but rather on counterparty risk\(^91\) – since the BIS opined that default had been the minor cause of losses in the Financial Crisis, and credit value adjustment had been the major cause\(^92\) – thereby requiring a bank as party to a credit derivative to hold adequate capital.\(^93\) KPMG further argues that counterparty credit risk (CCR)\(^94\) differs from credit risk in that the uncertainty of exposure at default is based on impending market dynamics and bilateral risk.\(^95\) This has already been alluded to,\(^96\) and as the former is specifically prevalent in synthetic securitisation schemes where the credit derivative is based on assets held by a reference entity,\(^97\) it appears from the latter as if the fundamental predicament relating to \textit{pacta sunt servanda}\(^98\) is further based on counterparties’ inadequate means for settlement, which \textit{ex post facto}

\(^{83}\) n 11 above; ch 1 para 2.2 above.
\(^{84}\) n 11 above.
\(^{85}\) Ch 1 para 2.2 above.
\(^{86}\) Ch 8 para 3.2,3 above.
\(^{87}\) Ch 8 para 3.2,4 above.
\(^{89}\) Ch 6 para 3 above.
\(^{90}\) KPMG (n 85 above) 1.
\(^{91}\) As above.
\(^{92}\) KPMG (n 85 above) 1.
\(^{93}\) KPMG (n 85 above) in general.
\(^{95}\) n 85 above, 2.
\(^{96}\) Ch 7 para 6 above.
\(^{97}\) As above.
\(^{98}\) As above.
necessitates the requirement for retained capital for purposes of settlement. However, this may be a novel comprehension, but a positivistic interpretation of paragraph 5(1)(a)(iv) of the Schedule can squarely include the concept of CCR. In terms of Directive 5/2015 issued in terms of section 6(6) of the Banks Act 94 of 1990, both ZAR-OTC derivatives and local-OTC derivatives not cleared through a central counterparty (CCP) as well as CCPs that are unlicensed clearing houses are deemed subject to bilateral risk and required to hold adequate capital.

1.4.2 **Regulatory valuation**

Synthetic securitisation apparently assists in market completion. It is interesting that derivatives are progressively becoming trading features of assets since the constituent commercial features of assets become deductively judged by their respective capability for market completion, be that contingency (e.g. options), currency (e.g. FX futures), default (credit derivatives), liquidity (floating rate investments), interest rates (interest rate swaps). This then begs the question as to whether credit derivatives effectively completes its market – it appears as if the same matter of liquidity that securitisation initially hoped to address was a factor for its downfall.

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99 This is more than a mere conjunction, since the two concepts can overlap. A ZAR-OTC derivative is exclusively denominated and contracted in the Rand currency [Directive 10/2014 issued in terms of section 6(6) of the Banks Act, 1990 para 3.1.]; a local-OTC derivative is exclusively contracted between local counterparties [Directive 10/2014 issued in terms of section 6(6) of the Banks Act, 1990 para 3.1.].


101 Directive 5/2015 issued in terms of section 6(6) of the Banks Act 94 of 1990 para 2.2. See in this regard Financial Markets Act sec 1(1) definitions of ‘clearing house’ and ‘clearing member’.

102 Ch 2 para 4.2 above.

103 As above.

104 As above.

105 As above.

106 As above.

107 As above; F Taylor *Mastering derivative markets* (2011) 211 et seq.

108 Das (n 62 above) 2 et seq.

109 As above.

110 As above.

111 As above.

112 As above.

113 As above.

114 Para 2.2 above.

115 Ch 2 para 3 above.
Despite negligence in valuation prior to the Financial Crisis, CDSs remain intricate to valuate. This aspect is significant *inter alia* with relation to credit ratings. New regulation of CRAs will hopefully contribute to investor confidence in synthetic securitisation schemes. As already shown, the jurist requires careful examination of the new Credit Rating Services Act with the Schedule since domestic ratings in terms of the former are not synonymous to the contextualised ‘domestic rating’ in the Schedule, just as ‘external credit rating’ is not the inverse of ‘domestic rating’. Ratings of structured finance instruments must be differentiated from other categories as an implicit *caveat subscriptor* to investors. Transferors are also inhibited from investing in a super senior tranche without considering its rating. However, it is recommended that the Registrar provide some indication as to what the teleology is regarding the rating of a significant amount of commercial paper, in order to gauge the robustness of this approach. It is also necessary for the Registrar to provide strict provisions relating to the rating of commercial paper in the event that a CRA is deregistered.

In order to promote the robustness of ratings based on correct valuations, comprehensive organisational and bookkeeping procedures, internal rheostats, effective risk calculation procedures, and effective control and preservation arrangements for data crunching systems, are required of CRAs, as well as continuous monitoring of the objects of its ratings. However, the Legislature has failed to indicate what these measures entail, and it is recommended that either the Legislature must proactively issue regulations to said Act in order to extensively describe such measures, or forums must retroactively critically analyse the relevant methods casuistically. However, the latter may be inhibited by the excessive costs related to expert witnesses in such cases. In Canada, the OSC has, contrary to the South African Registrar as apparent in the Schedule,

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116 Ch 2 para 3.3 above.
117 As above.
118 24 of 2012.
119 n 11 above.
120 As above; Ch 6 para 6.1 above.
121 Ch 6 para 6.1 above.
122 As above.
123 As above.
124 As above.
125 As above.
126 As above.
127 As above.
expressly accepted CRAs as market participants. It may be wise for the Registrar to include CRAs in the Schedule as parties acting in a secondary role, since this will not affect the statutory definition of a synthetic securitisation scheme at subparagraph (c)(ii), although requiring other amendments such as paragraph 2(1). Nonetheless, valuation requires more econometric study, and it is recommended that up to date models, instead of wide descriptions of rheostats, must be incorporated into regulations to the Credit Rating Services Act in order to provide courts with a method of measuring negligence.

2 Hypotheses relating to the other problem questions
The 6 problem questions underlying this work have been extensively addressed throughout this work. It would serve no purpose to reiterate all the answers, propositions and conclusions relating to the problem question in this chapter; therefore, these questions are succinctly addressed in the following syntheses, unless otherwise specified in this chapter.

2.1 Problem question 1
Caveat lector regarding etymologic and historic-critical analysis of the concept of synthetic securitisation. The common law concept of security is more conducive to etymological comprehension of the securitisation notion than the civil law variation. Whilst this etymologic ambiguity is ex post facto diluted through English law influence in South Africa, it has obfuscated, contextually, the subjective law content of securities prevalent in synthetic securitisation schemes, which presents uncertainty in applicable remedies. Whilst securitisation has developed from secured lending in the High Middle Ages, it remains an advent of the late twentieth century, with synthetic securitisation its recent side-effect. The same

128 Ch 6 para 6.2 above.
129 n 11 above.
130 n 11 above, para 1.
131 n 11 above.
132 24 of 2012.
133 Ch 1 para 2.1 above.
134 Cg 2 para 2.1 above.
136 Ch 2 para 2.1 above.
137 As above.
138 Ch 2 para 3.2 above.
139 As above.
140 Ch 2 para 3.3 above.
applies to credit derivatives: Although such transactions could have been formulated in terms of
Roman law – providing the civil jurist with a vernacularised foundation – they are an innovation
of recent advent.\textsuperscript{141} The principles of South African common law – Roman Dutch law – provides
insight into the contextualised true legal nature of these instruments locally.

There is no fixed general definition of synthetic securitisation;\textsuperscript{142} however, statutory and common
law variations exist. The common law variation must always be tested against the Schedule\textsuperscript{143} to
avoid the application of punitive measures in terms of paragraph 17 thereof, although the ambit of
the latter is limited to banks acting as participants in a primary role,\textsuperscript{144} and to SPIs irrespective of
whether the aforementioned is a bank.\textsuperscript{145} The reference to a bank contains no associative reference.
It appears as if divergence from the statutory definition of synthetic securitisation\textsuperscript{146} and paragraph
2 of the Schedule\textsuperscript{147} constitutes a common law synthetic securitisation. A particular example of a
common law variation is when the commercial paper is not issued to the general public,\textsuperscript{148} in which
event the scheme will also not constitute a CIS.\textsuperscript{149} Irrespective of whether the party acting in a
primary role is a bank, common law synthetic securitisations are contrarily statutorily regulated by
other legislation, such as the Companies Act\textsuperscript{150} and the Banks Act,\textsuperscript{151} and constitute the business
of a bank.\textsuperscript{152} Therefore, the designation, common law synthetic securitisation, can only be
designated herein as such within quotation marks.

Whilst the ‘common law’ synthetic securitisation can have a virtually unlimited meaning given
virtually unlimited variations, the statutory definition of a synthetic securitisation scheme\textsuperscript{153} is
specific. An SPI issues commercial paper to investors\textsuperscript{154} through an offer to the general public.\textsuperscript{155}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{141} Ch 7 para 2 above.
\item \textsuperscript{142} Ch 2 para 2.2 above.
\item \textsuperscript{143} n 11 above.
\item \textsuperscript{144} n 11 above, para 17(1)(a).
\item \textsuperscript{145} n 11 above, para 17(2).
\item \textsuperscript{146} n 11 above, para 1.
\item \textsuperscript{147} n 11 above.
\item \textsuperscript{148} Ch 8 para 5 above.
\item \textsuperscript{149} Ch 5 para 6.2 above; as above.
\item \textsuperscript{150} 71 of 2008.
\item \textsuperscript{151} 94 of 1990.
\item \textsuperscript{152} Ch 8 para 7 above.
\item \textsuperscript{153} n 11 above.
\item \textsuperscript{154} Ch 2 para 2.2 above.
\item \textsuperscript{155} Schedule (n 11 above) para 2(1).
\end{itemize}
\end{footnotesize}
and uses the consideration received therefor primarily to enter into a funded or unfunded credit derivative or guarantee based on an underlying asset, reference asset or reference entity\textsuperscript{156} and to obtain collateral assets.\textsuperscript{157} The SPI renders primary performance on said commercial paper or to an institution acting in a secondary role\textsuperscript{158} from the collateral assets’ cash flow and premiums or fees received from institution acting in a primary role.\textsuperscript{159} This mandatory constitution may be supplemented by discretionary provisions in paragraph 5(1) of the Schedule,\textsuperscript{160} due to the working of paragraph 3.\textsuperscript{161} These discretionary provisions are \textit{inter alia} that the transferor of credit risk’s profile may be amended,\textsuperscript{162} that this credit risk is stratified into at least two risk positions with risk absorption ascending from ‘ordinary shares’ to the senior commercial paper,\textsuperscript{163} and that risk realisation is primarily subjected to performance on said underlying risk exposures.\textsuperscript{164} The fundamental common denominator between the ‘common law’ and statutory variants is the utilisation of traditional securitisation technology, whether within or without the application of the Schedule, as the case may be, and on-balance sheet risk transfer technology.\textsuperscript{165} Although synthetic securitisation schemes are hypothetically simpler than traditional securitisation,\textsuperscript{166} especially given the absence of true sale, the credit derivative dimension pragmatically provides the opposite.

Securitisation, in any form, is not a corporate finance or banking panacea. Sometimes it is simply not profitable or useful to securitise.\textsuperscript{167} Furthermore, it can be stated that synthetic securitisation schemes, and particularly unfunded synthetic securitisation schemes, have some \textit{res ipsa loquitur} drawbacks to traditional securitisation schemes, such as CDSs illiquidity.\textsuperscript{168} Fortunately, SARB has addressed the opacity regarding credit derivatives \textit{inter alia} through Directive 5/2015 issued in terms of section 6(6) of the Banks Act 94 of 1990. In juxtaposition, synthetic securitisation

\textsuperscript{156} Ch 2 para 2.2 above.
\textsuperscript{157} As above.
\textsuperscript{158} As above.
\textsuperscript{159} As above.
\textsuperscript{160} n 11 above.
\textsuperscript{161} Ch 2 para 2.2 above.
\textsuperscript{162} As above.
\textsuperscript{163} As above.
\textsuperscript{164} Schedule (n 11 above) para 5(1)(a)(iii).
\textsuperscript{165} Ch 2 para 2 above.
\textsuperscript{166} Ch 1 para 1 above.
\textsuperscript{168} E.g. ch 2 para 3.3 above.
schemes present certain benefits to traditional securitisation schemes. According to (the then) Deloitte & Touche Germany, the benefits of synthetic securitisation schemes pertain to management of the capital base,\(^{169}\) avoidance of derecognition,\(^{170}\) the low costs of synthetic sale\(^{171}\) and the ability to securitise heterogeneous pools of assets.\(^{172}\) They declare a comparative position as follows:\(^{173}\)

<table>
<thead>
<tr>
<th>Fully Funded</th>
<th>Example of funding costs (pa) assuming 5% LIBOR</th>
<th>Partially Funded</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior Notes (90) L+25</td>
<td>29 bps</td>
<td>18 bps</td>
</tr>
<tr>
<td>Mezzanine Notes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Junior Notes (3) L+150</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained Equity (3)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Fully Funded/ Conventional</th>
<th>Partially Funded</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-scheme regulatory capital</td>
<td>8.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>Post-scheme regulatory capital</td>
<td>3.00%</td>
<td>4.39%</td>
</tr>
<tr>
<td>Regulatory capital relief</td>
<td>5.00%</td>
<td>6.61%</td>
</tr>
<tr>
<td>Cost per unit of capital relief</td>
<td>0.17bps</td>
<td>0.20bps</td>
</tr>
</tbody>
</table>

Collectively Figure 9.1.

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\(^{169}\) Böhringer et al 31.  
\(^{170}\) As above.  
\(^{171}\) As above.  
\(^{172}\) Böhringer et al 31-32.  
\(^{173}\) Böhringer et al 30.
2.2 Problem question 2 and problem question 3

The etymological predicament above\(^{174}\) extends to ‘obligation’ in phraseology.\(^{175}\) An analysis of the Schedule\(^{176}\) shows that it is uncertain whether the Registrar casuistically refers continentally to an obligation as a contract, delict, *quasi*-contract or *quasi*-delict, or commonly to subjective duties.\(^{177}\) Furthermore, the relationships between participants in a synthetic securitisation scheme are subject to continuous friction. The party *a priori* desirous to deal with its credit risk is denoted the ‘institution’ where it pertains to the banking sector,\(^{178}\) although other provisions show the opposite.\(^{179}\) This creditor must proactively hedge itself against the legal risk of reckless credit against its obligors.\(^{180}\) The legal practitioners involved in such schemes must not only for the latter purposes, but for all purposes be wary of the flaws relating to the definition of an asset in a statutory synthetic securitisation scheme.\(^{181}\) An associative reference clings to this transferor which exceeds the corporate notion of relation or inter-relation,\(^{182}\) and which requires casuistic attention. This institution is either an originator,\(^{183}\) with the utilisation of guarantees excluded in this case,\(^{184}\) a sponsor in ABCP programmes,\(^{185}\) or a repackager. The institution constitutes the protection buyer of a credit derivative, and the SPI the protection seller. If this institution stands in a vertical contractual relationship with the SPI, its shareholding in relation to the latter is limited\(^ {186}\) and the *effect*\(^ {187}\) of its execution of its voting rights are stayed,\(^ {188}\) depending on the definition of ‘general meeting’.\(^ {189}\) This institution can also be the servicing agent or *der Verwalter*, although Canadian law is more concerned with the servicing performance.\(^ {190}\) It is ostensibly only in South African law that this relation is mandatory.\(^ {191}\) It is recommended that the Registrar provide more clarity

\(^{174}\) Para 2.1 above.
\(^{175}\) Ch 2 para 2.1.
\(^{176}\) n 11 above.
\(^{177}\) Ch 2 para 2.1 above.
\(^{178}\) Ch 3 para 2.1 above.
\(^{179}\) E.g. Schedule (n 11 above) para 5(2)(f)(iv).
\(^{180}\) Ch 3 para 1 above.
\(^{181}\) Ch 3 para 2.5.1 above.
\(^{182}\) Ch 3 para 2.1 above.
\(^{183}\) With regards to the banking sector, an ‘originating bank’ in Canada – Ch 3 para 2.2.3 above.
\(^{184}\) Ch 3 para 2.2.1 above.
\(^{185}\) Ch 3 para 2.2.2 above.
\(^{186}\) Schedule (n 11 above) para 5(2)(o)(i)(A).
\(^{187}\) Own italicisation. See ch 3 para 2.3 above.
\(^{188}\) Schedule (n 11 above) para 5(2)(o)(i)(B).
\(^{189}\) Ch 3 para 2.3 above.
\(^{190}\) Ch 4 para 7 above.
\(^{191}\) As above.
regarding the formal servicing agreement, since the standard of service by the servicing agent is uncertain.\textsuperscript{192} The Schedule\textsuperscript{193} is specific with regards to the performance by the SPI to the servicing agent for services rendered,\textsuperscript{194} presumably in order to assist the financial health of the institution.

The sponsor, beyond ABCP programs,\textsuperscript{195} often integrates with the dealer in practice\textsuperscript{196} and has non-time-based obligations \textit{ex contractu} to both the transferor and the SPI as a structured financier and arranger.\textsuperscript{197} The greatest risk that the sponsor’s presence conjures in any obligation is adverse selection,\textsuperscript{198} which is not covered by disclosure in the Schedule\textsuperscript{199} and which demands great contractual circumspection for any parting dealing with the sponsor, such as CRAs and investors\textsuperscript{200} through the use of, for example, warranties.\textsuperscript{201} The sponsor is ostensibly discrepant from the remote originator, which is, non-mandatorily,\textsuperscript{202} obliged \textit{ex contractu} to the SPI as an initial financier\textsuperscript{203} and which impedes on the SPI’s duty to use performance received from the commercial paper issue to obtain credit risk exposure through such financing\textsuperscript{204} in order to address the over-eager SPI’s lack of solvency.\textsuperscript{205} The SPI selling its soul to this creditor can \textit{in extremis} face illiquidity.\textsuperscript{206}

The repackager transfers credit risk in terms of, broadly defined yet oversimplified, debt instruments to a SPI.\textsuperscript{207} It can indulge in the synthetic securitisation of securities resorting within the field of corporate finance,\textsuperscript{208} or in the field of structured finance,\textsuperscript{209} the latter then being a

\textsuperscript{192} As above.
\textsuperscript{193} n 11 above.
\textsuperscript{194} Ch 4 para 7 above.
\textsuperscript{195} See n 185 above.
\textsuperscript{196} Ch 3 para 2.4 above.
\textsuperscript{197} As above.
\textsuperscript{198} Ch 3 para 1 above.
\textsuperscript{199} n 11 above.
\textsuperscript{200} Ch 3 para 2.4 above.
\textsuperscript{201} As above.
\textsuperscript{202} Ch 3 para 2.3 above.
\textsuperscript{203} As above.
\textsuperscript{204} As above.
\textsuperscript{205} As above.
\textsuperscript{206} As above.
\textsuperscript{207} Ch 3 para 2.5.1 above.
\textsuperscript{208} See ch 8 para 2 above.
\textsuperscript{209} As above.
synthetic securitisation of a securitisation,\textsuperscript{210} or a so-called resecuritisation in Canada,\textsuperscript{211} although the latter contributes unnecessary legal uncertainty for comparison.\textsuperscript{212}

There are also secondary participants to a synthetic securitisation scheme,\textsuperscript{213} although it is uncertain why they are rendered ‘secondary’.\textsuperscript{214} Credit enhancement either pertains to a specific transaction or an entire programme,\textsuperscript{215} and can be a facility, gauged against the National Credit Act,\textsuperscript{216} or an arrangement,\textsuperscript{217} subject to the Registrar’s discretion.\textsuperscript{218} If the reference to arrangement has another meaning, it may be commensurate with internal credit enhancement.\textsuperscript{219} In this work, examples of internal credit enhancement have been studied,\textsuperscript{220} although examples such as tranching are inherent in synthetic securitisation schemes.\textsuperscript{221} External credit enhancement has a systemic dimension in that such enhancers may also default,\textsuperscript{222} but consists of a first loss and a second loss\textsuperscript{223} with the former usually relating to a specific transaction,\textsuperscript{224} although distinguishable from the German \textit{First Loss Piece},\textsuperscript{225} and the latter to the entire programme.\textsuperscript{226} The second loss may relate to subordination,\textsuperscript{227} which presents the confusion between internal and external credit enhancement, and, irrespectively, institutions acting in a primary role must be wary of the effect that such an extension would have on their capital adequacy.\textsuperscript{228} There are cases of deemed credit enhancement, such as, in case of underwriting, senior commercial paper held by the originator or remote originator in excess of the ninety percent sold to investors constitutes a second loss,\textsuperscript{229} and if the underwriter is the sponsor or repackager upon conclusion of the underwriting period any

\textsuperscript{210} Ch 3 para 2.5.1 above.  
\textsuperscript{211} Ch 3 para 2.5.2 above.  
\textsuperscript{212} As above.  
\textsuperscript{213} See ch 4 above in general.  
\textsuperscript{214} Ch 4 para 2 above.  
\textsuperscript{215} Ch 4 para 3.1 above.  
\textsuperscript{216} 34 of 2005.  
\textsuperscript{217} Ch 4 para 3.1 above.  
\textsuperscript{218} As above.  
\textsuperscript{219} Ch 4 para 3.2 above.  
\textsuperscript{220} As above.  
\textsuperscript{221} As above.  
\textsuperscript{222} Ch 4 para 3.3 above.  
\textsuperscript{223} As above.  
\textsuperscript{224} As above.  
\textsuperscript{225} Ch 4 n 171 above.  
\textsuperscript{226} Ch 4 para 3.3 above.  
\textsuperscript{227} As above.  
\textsuperscript{228} As above.  
\textsuperscript{229} Ch 4 para 5 above.
senior commercial paper retained rated inferior to a BBB-equivalent status constitutes a first-loss. Credit enhancement is distinguished from liquidity facilities, being respectively assistance for ‘no pay’ and ‘slow pay’. Liquid deficits are attributable to paragraph 2(1)(c) of the Schedule and realise due to respective performance incongruities and market interruptions.

The protection seller is the SPI, which has a *numerus clausus* of characteristics. It is uncertain why the Registrar excluded partnerships *en commandite* and close corporations from being SPIs. It is recommended that such an inclusion will not detract from the nature of the bullet proof factor. In the absence of the legal risk of true sale recharacterisation, statutory synthetic securitisations face the legal risk of capital requirements if the bullet proof factor is not applied. In Canada, additional measures are required for this risk isolation. The SPI issues commercial paper to investors through the underwriter. The role of the underwriter is not mandatory; however, due to the risk averse approach usually subscribed to with regards to these schemes, it is not recommended that underwriting always transpire for these schemes merely to cater for under- and oversubscription. There is an inherent legal risk in underwriting: The securitised risk will not be derecognised until ninety percent of the SPI’s ‘total debt raised’ is issued. This legal risk is mitigated through a subscription approach, which only requires an, unspecified, significant amount of securitised risk.

It is recommended that, upon gauging the rationales for synthetic securitisation against capital adequacy statutorily required, synthetic securitisations should remain highly corporately dispersed models in practice. Provisions relating to institutions acting in a primary role assuming other
functions indicate an integrative approach regarding such schemes, despite statutory derecognition. It implicitly denies the independence of the SPI and the duty of the latter’s management to exclusively ensure profit optimisation of the SPI. Such assumptions increase the former’s capital requirements. Capital adequacy is risk-based, and not consequence-based, meaning that the transferor will never have sufficient capital for all worst-case scenarios. The dispersed approach, contra the integrative approach, provides for more participants to a specific scheme and less reliance upon the transferor’s capital.

2.3 Problem question 5

A statutory synthetic securitisation ostensibly excludes plural constructions, such as portfolio, basket and index-based credit derivative trades. Although this position can be rectified through legal interpretation, it is recommended that the Registrar reviews the Schedule in order to remove such schemes from the ‘common law’ category. Credit derivatives moreover relate to reference assets and reference entities than to underlying assets, with ensuing predicaments such as bond squeezes; therefore, it is recommended that the Registrar extends its legislative power in order to provide quantitatively informed provisions in mitigation. Credit derivatives have become relatively standardised through the attempts by ISDA, although the judicial perusal of ISDA Credit Derivative Definitions for purposes of contract interpretation remains indeterminate. Instead of approaching matters sub iudice through becoming an amicus curiae, it is recommended that ISDA provide express indications as to the application and inclusion of its definitions for legal certainty.

A credit derivative has been defined widely defined herein, since too many variations on the theme exist for a narrow definition.

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244 Ch 5 para 5 above.  
245 Ch 6 para 2 above.  
246 Ch 7 para 1 above.  
247 As above.  
248 n 11 above.  
249 Ch 7 para 1 above.  
250 Ch 7 para 6 above.  
251 Ch 7 para 5 above.  
252 Ch 7 para 3 above.  
253 Ch 7 para 4.2.1 above.
A credit derivative can be defined as a method through which the holder thereof detaches and divides credit risk from market risk, consequently allowing the credit risk to be transferred, be that for hedging or trading – or indirectly for arbitrage – by the investor exposed to such risk through a possible payable premium, by subjecting an investor’s – who is keen on assuming such risk – payment to the occurrence of a credit event on another contract, thereby being a repackaging and redistributing of credit risk.

As indicated by the Registrar, credit derivatives can be funded or unfunded, although the Schedule ostensibly excludes the utilisation of funded credit derivatives, specifically CLNs, in South African statutory synthetic securitisation. This is an obvious divergence from the German jurisdiction, where partially funded synthetic securitisations using a chromatic combination of CDSs and CLNs is the norm. Although CLNs are credit derivatives, they are also traded as IRSs on the JSE, and a rebuttable presumption exists that they are to be regarded as commercial paper. It is recommended that greater clarity with regards to these instruments must be provided by the Registrar.

The CDS instrument has been discussed in this work utilising the 2014 ISDA Credit Derivative Definitions (2014 Definitions) and the concept of a successor has been elucidated in terms of the Schedule. The 2014 Definitions only refer to reference obligations and reference entities, with the reference entity per se including its successor, so that the originator or repackager but not parties by association are included if underlying assets are prevalent. The Registrar must align the Schedule to include such parties by association. Article II section 2.2 of the 2014 Definitions is inconsistent with South African law, and inclusion thereof must transpire through the Registrar’s legislative powers, with circumspection regarding paragraph 5(2)(a)(iv) of the

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254 Para 2.1 above.
255 Ch 7 para 4.2.2 Synchronisation between the practice of CLNs and the Schedule above.
256 Ch 7 paras 4.2.2 CLNs in Germany above, 4.2.3 Continuing with Germany with respect to CDSs above.
257 Ch 7 para 4.2.2 Definition above.
258 As above.
259 Ch 7 para 6 above.
260 Ch 7 para 4.2.3 Unfunded credit derivatives incorporating ISDA terminology above.
261 As above.
262 As above.
263 As above.
264 As above.
265 As above.
Schedule.\textsuperscript{266} The Schedule\textsuperscript{267} furthermore extinguishes the protection buyer’s right against the protection seller with regards to costs, expenses or losses.\textsuperscript{268} Since the former is \textit{eiusdem generis}, it is wide enough to infer that the protection buyer also has no remedy for specific performance against the protection seller in the event of a credit event, which is nonsensical and must also be legislatively addressed.

The cases of \textit{Nomura International Plc v Credit Suisse First Boston International},\textsuperscript{269} \textit{Eternity Global Master Fund Ltd v Morgan Guarantee Trust Company of New York} and \textit{JPMorgan Chase Bank},\textsuperscript{270} and \textit{AON Financial Products & AON Corporation v Société Generale}\textsuperscript{271} showed the predicaments related to credit events based on \textit{pacta sunt servanda} and the inclusion of ISDA Definitions.\textsuperscript{272} The legal risk of recharacterisation of credit derivatives as insurance contracts has also been studied.\textsuperscript{273} It appears as if the Registrar’s reference to the perfecta principle excludes its intention of recharacterisation, whilst the risk continues with regards to naked CDSs.\textsuperscript{274}

A statutory synthetic securitisation scheme is likely a CIS, due to the width of CISCA,\textsuperscript{275} the synonymy between offers,\textsuperscript{276} the nature of the participatory interest of a CIS,\textsuperscript{277} and the sharing of risk and benefit.\textsuperscript{278} However, in relation to commercial paper, perspective must be widened to include the Companies Act\textsuperscript{279} and the Commercial Paper Notice.\textsuperscript{280} With regards to the former, the conclusive meaning of a debenture or debt instrument remains inconclusive,\textsuperscript{281} although a presumption against commercial paper being negotiable instruments is apparent.\textsuperscript{282}

\footnotesize{As above.  
\textsuperscript{266} n 11 above.  
\textsuperscript{267} n 11 above, para 5(2)(b).  
\textsuperscript{269} 375 F 3D 168, 172 (2d Cir 2004).  
\textsuperscript{271} Ch 7 paras 4.2.3 \textit{Credit events}.  
\textsuperscript{272} Ch 7 para 5 above.  
\textsuperscript{273} As above.  
\textsuperscript{274} Ch 5 para 6.1 above.  
\textsuperscript{275} Ch 5 para 6.2 above.  
\textsuperscript{276} Ch 5 para 6.3 above.  
\textsuperscript{277} Ch 5 para 6.4 above.  
\textsuperscript{278} 71 of 2008.  
\textsuperscript{279} South Africa (1994) Designation of an activity not falling within the meaning of ’the business of a bank’ (commercial paper) (Government Notice No 2172, 1994) \textit{Government Gazette} 16167, December 14.  
\textsuperscript{280} Ch 8 para 4.1 above.  
\textsuperscript{281} See ch 8 above in general.
paper in a synthetic securitisation scheme complies with the Commercial Paper Notice,\textsuperscript{283} but preference is always given to the Schedule\textsuperscript{284}. It is further recommended that the Registrar addresses the contextual predicament in paragraph 14(1)(b)(iii) of the Schedule as set out in chapter 8 paragraph 4.3 above. In the Schedule, stratification in its widest sense refers to risk positions, whilst it refers to commercial paper tranches in the strict sense.\textsuperscript{285} Therefore, the ambit of the former exceeds preference shares.\textsuperscript{286} Stratification is akin to capital structure,\textsuperscript{287} in that diverse classes of securities are issued by the SPI to investors with different payment priorities subject to entrenched economic rights or spes\textsuperscript{288}, matched with different default risks for investors therein due to seniority.\textsuperscript{289} Originators may only invest in the super senior tranche of commercial paper,\textsuperscript{290} although this provision is limited to banks.\textsuperscript{291} It is recommended that this provision be extended to include non-bank references and incorporate the associative reference in order to ensure the independence of the SPI.

3 Specific areas of further study

This work has \textit{inter alia} attempted to lay a local academic foundation for the study of synthetic securitisation. This presents opportunity for further academic study on the field credit derivatives \textit{per se} in law from the perspective of securities law and the law of contract. In order to contain the requisite depth and width, such a study would have to incorporate more than one type of credit derivative, such as a comparative study between CDSs and TRSs. In broader terms, a doctoral study of OTC derivatives and their regulation from the fields of company law, securities law and the law of contract may also be necessary in the future. Two particular matters that may have appeal for academia is the consideration of credit derivatives as games of chance, as proposed by

\textsuperscript{283} n 280 above.
\textsuperscript{284} Ch 8 para 4.2 above.
\textsuperscript{285} Ch 7 para 6 above.
\textsuperscript{286} As above.
\textsuperscript{287} As above.
\textsuperscript{288} As above.
\textsuperscript{289} As above.
\textsuperscript{290} As above.
\textsuperscript{291} Schedule (n 11 above) para 5(2)(h)(i).
Cousy,\textsuperscript{292} and the risk of insider trading in synthetic securitisation schemes. The former study will include present academic opinions,\textsuperscript{293} common law and legislation.\textsuperscript{294}

A study of insider trading in synthetic securitisation schemes must commence with the comprehension that insider trading is perhaps the epitome of the Big Tradeoff dilemma\textsuperscript{295} as it manifests in securities law. The rationale provided by Acharya and Johnson seem to be too limited;\textsuperscript{296} rather, three\textsuperscript{297} factors invoke the necessity of further study of insider trading in credit derivatives: Firstly, the general friction of asymmetric information also prevalent in synthetic securitisation schemes;\textsuperscript{298} secondly, the fact that the majority of parties to a synthetic securitisation scheme are insiders;\textsuperscript{299} thirdly, the fact that synthetic securitisation schemes are inherently opaque.\textsuperscript{300} A limiting factor of such a study in South African law is that credit derivatives are OTC and a regulated exchange for credit derivatives or related products does not exist. Although the statutory definition of ‘securities’ extends to unlisted securities,\textsuperscript{301} the direct statutory regulation of insider trading (‘…in the securities listed on a regulated market to which the inside information relates…’) of CDSs are perhaps excluded, since, although ‘regulated market’ is not statutorily defined, ‘regulated person’ indeed is\textsuperscript{303} and the Legislature may have intended a synonymous meaning to the terms.

Such as study could therefore possibly be based indirect statutory regulation of insider trading (‘…in the securities listed on a regulated market…which are likely to be affected by it’)\textsuperscript{304} of CDSs, since the imperative ‘inside information’\textsuperscript{305} extends conjunctively to

\begin{itemize}
\item \textsuperscript{292}I.H Cousy ‘The delicate relationship between law and finance: The classification of credit default swaps’ (2014) 2 Tydskrif vir die Suid-Afrikaanse Reg 227 236.
\item \textsuperscript{293}E.g. TL Hazen ‘Disparate regulatory schemes for parallel activities: Securities regulation, derivatives regulation, gambling, and insurance’ (2005) 24 Annual Review of Banking & Financial Law 375.
\item \textsuperscript{294}National Gambling Act 7 of 2004.
\item \textsuperscript{295}M Parkin ‘Efficiency and equity’ in CFA Institute (ed) Economics Vol 2 Level 1 (2011) 53 et seq.
\item \textsuperscript{297}Own italicisation.
\item \textsuperscript{298}See ch 3 para 1 above.
\item \textsuperscript{299}Acharya & Johnson (n 296 above) 111.
\item \textsuperscript{300}See ch 2 para 5.2 above.
\item \textsuperscript{301}Financial Markets Act 19 of 2012 sec 1(1).
\item \textsuperscript{302}Financial Markets Act 19 of 2012 sec 78(1)(a).
\item \textsuperscript{303}Financial Markets Act 19 of 2012 sec 1(1).
\item \textsuperscript{304}Financial Markets Act 19 of 2012 sec 78(1)(a).
\item \textsuperscript{305}As above.
\end{itemize}
‘information…which…if it were made public, would be likely to have a material effect on the price or value of any security listed on a regulated market’.

However, whether such indirect regulation exists is uncertain based on two reasons: Firstly, in a wide interpretation, it is uncertain what the reference to ‘specific and precise information’ denotes, since the specificity could either relate to the truthfulness of said information – in which event indirect regulation may be permitted – or to a semantic connection between the information and the affected securities – in which event indirect regulation is permitted; secondly, in strictu sensu, the definition of ‘insider’ contains no such secondary reference to affected securities and implies a semantic connection between the information and the insider.

The resulting recourse would then depend on the existence of common law variations on the insider trading theme, questioning Opoku’s confirmation of Hannigan’s coarse-grained statement that ‘insider trading is as old as the stock exchange itself’. However, the matter was obscured in the Securities Services Act (SSA) with regards to the legal nature of insider trading. At section 73, insider trading was classified as an offence, although the SSA is quiet on whether this invokes the application of criminal procedure or administrative law. Although section 73 ostensibly contained reverse onuses, which were declared unconstitutional in S v Mbatha: S v Prinsloo despite the difficulty it poses to such investigations, insider trading could have been prosecuted on criminal terms. In addition, a quasi-judicial process and civil litigation were also methods of addressing such transgressions. This reverse onus has been retained in the Financial Markets Act 19 of 2012 sec 77.

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307 As above.
308 As above.
312 R Tomasic, S Bottomley & R McQueen Corporations law in Australia (2002) 639; Goldswain (n 310 above) 64.
313 Pather and Another v Financial Services Board and Others (57617/10) 2014 ZAGPPHC 303; 2014 3 All SA 208 (GP); 2014 9 BCLR 1082 (GP) (20 March 2014) 76 (Pather case).
314 Pather (n 311 above) 29 et seq.
315 See Securities Services Act 36 of 2004 sec 77 in general; Pather (n 314 above) 37 et seq.
Act,\textsuperscript{317} and although the insider trading sanction is expressly indicated as an administrative penalty,\textsuperscript{318} references appear regarding civil and criminal procedure.\textsuperscript{319}

Although the postmodern administrative action can be \textit{res ipa loquitur} omitted from a study of common law origins of insider trading, the matter of common law bases is convoluted by the North Gauteng High Court’s confirmation that insider trading has never been prosecuted prior to the statutory introduction of its prohibition in South Africa.\textsuperscript{320} The civil aspects of insider trading possibly revolve around directors’ fiduciary duties, limited by considerations of materiality.\textsuperscript{321} However, it is uncertain whether insider trading as a rule is contradictory to directors’ acting in the best interest of a company, since there may be cases where insider trading has profited shareholders\textsuperscript{322} in which shareholders would have been indifferent to directors obtaining secret profits.\textsuperscript{323} However, the question inherent in directors’ fiduciary duties, viz. pertaining to who exactly the company ‘is’, seems to have been historically dynamic, which would convolute a puritanical historic study of common law origins of insider trading: Public welfare has become an increasingly prevalent consideration in corporate law,\textsuperscript{324} ostensibly \textit{a priori} based on moral notions\textsuperscript{325} given the difficulty of addressing Milton Friedman’s social responsibility conundrum\textsuperscript{326} head on, with numerous \textit{a posteriori} justifications.\textsuperscript{327}

In conclusion of this brief exposition of insider trading in synthetic securitisation schemes – for purposes of further study – the common law origins of insider trading in criminal law is also dubious. According to Burchill and Milton, fraud can be defined as the ‘[unlawful] making, with intent to defraud, a misrepresentation which causes actual prejudice or which is potentially
prejudicial to another.\textsuperscript{328} Although the notion of potential prejudice has been alluded to above, the matter of misrepresentation is encumbered by the provision that inside information must be specific and precise.\textsuperscript{329} The same applies to theft of the value of money.\textsuperscript{330} Therefore, a charge of fraud is more conducive in circumstances of alleged market manipulation.\textsuperscript{331}

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{329} Financial Markets Act 19 of 2012 sec 77.
\item\textsuperscript{330} Burchill & Milton (n 328 above) 688 \textit{et seq}.
\item\textsuperscript{331} Financial Markets Act 19 of 2012 sec 80(1)(a)(i).
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**Abbreviations**

‘They’ve got all these fancy names for trillions of dollars of credit: CMOs, CDOs, SIVs, ABSs. You know, I honestly think there’s maybe only seventy-five people in the world who know what they are.’ – Gordon Gekko in *Wall Street: Money Never Sleeps*

**-A-**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABCP</td>
<td>Asset-backed commercial paper</td>
</tr>
<tr>
<td>ABS</td>
<td>Asset-backed security</td>
</tr>
<tr>
<td>ABX</td>
<td>Associates Business Exchange</td>
</tr>
<tr>
<td>AGM</td>
<td>Annual general meeting</td>
</tr>
<tr>
<td>AIG</td>
<td>American International Group Ltd</td>
</tr>
<tr>
<td>ALCO</td>
<td>Asset and liability committee</td>
</tr>
<tr>
<td>AON</td>
<td>AON Corporation and AON Financial Products, collectively</td>
</tr>
</tbody>
</table>

**-B-**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>BAFin</td>
<td>Bundesanstalt für Finanzdienstleistungsaufsicht</td>
</tr>
<tr>
<td>BAKred</td>
<td>Bundesaufsichtsamt für das Kreditwesen</td>
</tr>
<tr>
<td>BBA</td>
<td>British Banker Association</td>
</tr>
<tr>
<td>BESA</td>
<td>Bond Exchange of South Africa</td>
</tr>
<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
</tr>
<tr>
<td>Bistro</td>
<td>Broad Secured Trust Offering</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>Banque de Paris et des Pays-Bas</td>
</tr>
<tr>
<td>BSIL</td>
<td>Bear Stearns International Ltd</td>
</tr>
</tbody>
</table>

**-C-**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>CAPM</td>
<td>Capital asset pricing model</td>
</tr>
<tr>
<td>CCP</td>
<td>Central counterparty</td>
</tr>
<tr>
<td>CCR</td>
<td>Counterparty credit risk</td>
</tr>
<tr>
<td>CDO</td>
<td>Collateralised debt obligation</td>
</tr>
<tr>
<td>CDS</td>
<td>Credit default swap</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
</tr>
<tr>
<td>--------------</td>
<td>-------------</td>
</tr>
<tr>
<td>CDX</td>
<td>Credit Default Swap Index</td>
</tr>
<tr>
<td>CET 1</td>
<td>Common Equity Tier 1</td>
</tr>
<tr>
<td>CIA</td>
<td>Collateral invested amount</td>
</tr>
<tr>
<td>CIC</td>
<td>China Investment Corporation</td>
</tr>
<tr>
<td>CIS</td>
<td>Collective investment scheme</td>
</tr>
<tr>
<td>CISCA</td>
<td>Collective Investment Scheme Control Act 45 of 2002</td>
</tr>
<tr>
<td>CLN</td>
<td>Credit-linked note</td>
</tr>
<tr>
<td>CLO</td>
<td>Collateralised loan obligation</td>
</tr>
<tr>
<td>CLS</td>
<td>Continuous Linked Settlement</td>
</tr>
<tr>
<td>CRA</td>
<td>Credit rating agency</td>
</tr>
<tr>
<td>CRO</td>
<td>Credit rating organization</td>
</tr>
<tr>
<td>CSFB</td>
<td>Credit Suisse First Boston International</td>
</tr>
<tr>
<td>C*Star</td>
<td>C*Strategic Asset Redeployment Program 1999-1 Ltd</td>
</tr>
<tr>
<td>DRO</td>
<td>Designated rating organization</td>
</tr>
<tr>
<td>DTI</td>
<td>Department of Trade and Industry</td>
</tr>
<tr>
<td>EAR</td>
<td>Effective annual rate</td>
</tr>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
</tr>
<tr>
<td>Ecobel</td>
<td>Ecobel Land Inc</td>
</tr>
<tr>
<td>ESMA</td>
<td>European Securities and Markets Authority</td>
</tr>
<tr>
<td>Eternity</td>
<td>Eternity Global Master Fund Ltd</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FANMAC</td>
<td>First Australian National Mortgage Acceptance Corporation</td>
</tr>
<tr>
<td>Fannie Mae</td>
<td>Federal National Mortgage Association</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Services Board</td>
</tr>
<tr>
<td>FASIT</td>
<td>Financial asset securitization investment trusts’</td>
</tr>
<tr>
<td>Acronym</td>
<td>Full Form</td>
</tr>
<tr>
<td>---------</td>
<td>-----------</td>
</tr>
<tr>
<td>FCIC</td>
<td>Financial Crisis Inquiry Commission</td>
</tr>
<tr>
<td>First-loss</td>
<td>First-loss credit-enhancement facility</td>
</tr>
<tr>
<td>Fitch</td>
<td>Fitch Rating</td>
</tr>
<tr>
<td>Freddie Mac</td>
<td>Federal Home Loan Mortgage Corporation</td>
</tr>
<tr>
<td>FTSE</td>
<td>Financial Times Stock Exchange</td>
</tr>
<tr>
<td>FV</td>
<td>Future value</td>
</tr>
<tr>
<td>G20</td>
<td>Group of Twenty</td>
</tr>
<tr>
<td>GHOS</td>
<td>Group of Central Bank Governors and Heads of Supervision</td>
</tr>
<tr>
<td>Ginnie Mae</td>
<td>Government National Mortgage Association</td>
</tr>
<tr>
<td>GSIS</td>
<td>Government Service Insurance System</td>
</tr>
<tr>
<td>HJM</td>
<td>Heath-Jarrow-Morton</td>
</tr>
<tr>
<td>HSBC</td>
<td>Hong Kong and Shanghai Banking Corporation</td>
</tr>
<tr>
<td>IKB Bank</td>
<td>Industriekreditbank</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IRR rule</td>
<td>Internal rate of return rule</td>
</tr>
<tr>
<td>IRS</td>
<td>Interest rate security</td>
</tr>
<tr>
<td>ISDA</td>
<td>International Swaps and Derivatives Association</td>
</tr>
<tr>
<td>JSE</td>
<td>Johannesburg Stock Exchange</td>
</tr>
<tr>
<td>KfW</td>
<td>Kreditanstalt für Wiederaufbau</td>
</tr>
</tbody>
</table>
LIBOR  London Interbank Offered Rate
LTCM  Long Term Capital Management
LYON  Liquid yield option notes

MBS  Mortgage-backed securities
MOI  Memorandum of incorporation
Moody’s  Moody’s Investor Service
Morgan  Morgan Guarantee Trust Company of New York and JPMorgan Chase Bank

NEDLAC  National Economic Development and Labour Council
NEWERA  The New Economic Rights Alliance
Nomura  Nomura International Plc
NOPS  Notice of physical settlement
NPC  Non-profit company
NPV  No par value
NPV  Net present value
NPV rule  Net present value rule
NYSID  New York State Insurance Department

OECD  Organisation for Economic Cooperation and Development
OSC  Ontario Securities Commission
OSFI  Office of the Superintendent of Financial Institutions
OTC  Over-the-counter

PLS  Property Loan Stock
| **PPSA** | Public Property Syndication Association |
| **PROMISE** | Promotional *Mittelstands* Loan Securitisation |
| **PROVIDE** | Provide Residential Mortgage Securitisation |
| **PULP** | Pretoria University Law Press |
| **PV** | Par value |
| **PV** | Present value |
| **PvP** | Payments versus Payments |
| **PwC** | PricewaterhouseCoopers |

- **-R-**

| **Railtrack** | Railtrack Plc |
| **REIT** | Real-estate investment trusts |
| **REMIC** | Real estate mortgage investment conduits |
| **re-REMIC** | Re-securitised real estate mortgage investment conduits |
| **RMB** | Rand Merchant Bank |
| **RMBS** | Residential mortgage backed security |
| **RWN** | Rating Watch Negative |

- **-S-**

<p>| <strong>S&amp;P</strong> | Standard &amp; Poor’s |
| <strong>SARB</strong> | South African Reserve Bank |
| <strong>SARS</strong> | South African Revenue Service |
| <strong>SBSA</strong> | Standard Bank of South Africa Ltd |
| <strong>SEC</strong> | Securities and Exchange Commission |
| <strong>Second-loss</strong> | Second-loss credit-enhancement facility |
| <strong>SG</strong> | Société Generale |
| <strong>SIFMA</strong> | Securities Industry and Financial Markets Association |
| <strong>SME</strong> | Small and medium size enterprises |
| <strong>SPE</strong> | Special purpose entity |
| <strong>SPI</strong> | Special purpose institution |
| <strong>SPV</strong> | Special purpose vehicle |</p>
<table>
<thead>
<tr>
<th>-T-</th>
<th>Total rate of return swap</th>
</tr>
</thead>
<tbody>
<tr>
<td>TRS</td>
<td>Total rate of return swap</td>
</tr>
<tr>
<td>TSI GmbH</td>
<td>True Sale Initiative platform</td>
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<table>
<thead>
<tr>
<th>-U-</th>
<th>Union Bank of Switzerland</th>
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</thead>
<tbody>
<tr>
<td>UBS</td>
<td>Union Bank of Switzerland</td>
</tr>
<tr>
<td>UCC</td>
<td>Uniform Commercial Code</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>US</td>
<td>United States</td>
</tr>
<tr>
<td>USA</td>
<td>United States of America</td>
</tr>
<tr>
<td>US FASB</td>
<td>US Financial Accounting Services Board</td>
</tr>
<tr>
<td>VAT</td>
<td>Value-added tax</td>
</tr>
<tr>
<td>VIE</td>
<td>Variable interest entities</td>
</tr>
<tr>
<td>VOC</td>
<td>Verenigde Nederlandse Oost-Indische Compagnie</td>
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<table>
<thead>
<tr>
<th>-W-</th>
<th>Waterfield Mortgage Company</th>
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<tr>
<td>WMC</td>
<td>Waterfield Mortgage Company</td>
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